ANALYTICAL ARTICLES
Economic Bulletin

4/2020

BANCO DE ESPAÑA
Eurosistema

BREXIT: SITUATION AND ECONOMIC CONSEQUENCES

Alejandro Buesa, Coral García, Iván Kataryniuk,
César Martín-Machuca, Susana Moreno and Moritz Roth

ABSTRACT

The effective departure of the United Kingdom (UK) from the European Union (EU) opens up a new period of relations between the two areas. The current health crisis limits economic policies' room for manoeuvre to accommodate the costs of transitioning to a new economic relationship, whatever final form it may take. This article describes the most recent developments in the negotiation process and outlines three possible scenarios for the future EU-UK trading relationship, providing simulations of the potential macroeconomic impact in each case. Moreover, the recent trend in trading and financial relations between the United Kingdom and Spain is set out in a box.

Keywords: Brexit, NiGEM, scenario analysis, tariffs, non-tariff barriers, migration, FDI.

JEL classification: F15, F47, F53.

The authors of this article are Alejandro Buesa, Coral García, Iván Kataryniuk, César Martín-Machuca, Susana Moreno and Moritz Roth, of the Directorate General Economics, Statistics and Research.

The end of the transition period envisaged in the Withdrawal Agreement (31 December 2020) represents the effective departure of the United Kingdom (UK) from the European Union (EU) following 48 years of integration. This situation opens up a new period in relations between the two areas. The current health crisis limits economic policies' room for manoeuvre to accommodate the costs of transitioning to a new economic relationship, whatever final form it may take. This article describes the most recent developments in the negotiation process and outlines three possible scenarios for the future EU-UK trading relationship, providing simulations of the potential macroeconomic impact in each case. The article also includes a box setting out the recent trend in trading and financial relations between the United Kingdom and Spain.

The negotiations between the United Kingdom and the EU

The process of the United Kingdom's withdrawal from the EU has been ongoing for over four and a half years since the referendum on the UK's membership of the EU in June 2016. During this period, the two parties first negotiated the terms of the withdrawal (Brexit), which formally took place on 1 February 2020, and have since gone on to broach the new framework for relations between them.[1]

The Withdrawal Agreement addressed the overarching questions posed by the United Kingdom's departure with regard to citizens' acquired rights in their country of residence, the economic obligations it assumed through its EU membership, and the border between the Republic of Ireland and Northern Ireland. Moreover, it established some measures to facilitate an orderly transition that will take effect at the end of a transition period, set for 31 December 2020. After this date, the EU's treaties and legal framework will cease to apply to the United Kingdom which, in turn, will no longer be a member of the Internal Market and the Customs Union.

Negotiations about the new framework for relations are being held according to a very tight schedule, given the objective of allowing for its ratification before 1 January 2021. The bases for this agreement were laid down in the October 2019 Political

1 See Vega (2019) and IRC Brexit Task Force (2020).

Declaration[2] setting out the future relationship between the European Union and the United Kingdom, in which the parties expressed their will to establish an ambitious partnership on economic and security and defence matters.

In the economic realm, the parties determined to reach a comprehensive trade agreement, forgoing the application of tariffs and quotas on the trade in goods. They also proposed facilitating customs processes and liberalising the provision of a broad range of services. This would be accompanied by a fisheries agreement and frameworks for close sectoral cooperation in areas such as transport and energy. Aware of the singularity of the agreement, and given the geographical proximity and economic interdependence, the Political Declaration underscored the need to ensure open and fair competition between the two blocs that included robust commitments to a level playing field. To this end, both undertook to maintain applicable social, employment, tax and environmental standards at their current levels. They also committed to maintaining a robust and comprehensive framework for State aid and free competition.

As regards financial services, in the Declaration the United Kingdom and the EU envisaged a relationship based on autonomous equivalence[3] frameworks that, in short, would preserve the two parties' respective regulatory and decision-making autonomy, within a framework of close regulatory and supervisory cooperation.

Negotiations aimed at setting out these political commitments in a binding agreement have highlighted the difficulty in striking a balance between, on the one hand, the shared aspiration of granting broad access to the respective markets and, on the other, the importance of safeguarding the integrity of the Internal Market (in the case of the EU) and of recovering full sovereignty (in the case of the United Kingdom).

In this context, aspects relating to the governance of the agreement, fair competition and fishing have proven to be the main stumbling blocks to reaching an agreement. The United Kingdom has been reluctant to accept regulatory alignment with the EU and to establish binding mechanisms for settling disputes between the parties and for enforcing the agreement at the domestic level; in this respect, it favours more flexible provisions, similar to those in other international agreements signed by the EU. The EU, however, has argued that the extremely ambitious nature of the

2 See European Commission (2019).

3 Equivalence is the process whereby the Commission assesses a specific foreign regulatory and supervisory framework and determines that it is equivalent to that of the EU. The equivalence decision allows EU competent authorities to recognise the third country's framework for the purposes of assessing compliance with certain EU regulatory or supervisory standards. Specifically, the equivalence arrangements enable overlaps in obligations to be reduced or eliminated, a less burdensome prudential regime to be applied, and, in some cases, allow access to the EU's markets. There is no single equivalence framework covering all financial services; instead each sectoral legal act determines the relevant scope, the criteria and conditions applicable, as well as the process envisaged for its granting. Many key banking or financial services, such as deposit-taking, lending and the provision of investment services to retail customers, are not covered by an equivalence-based access regime.

agreement with the United Kingdom requires robust guarantees in the area of fair competition and governance. In this respect, the parties have maintained divergent positions as regards including non-regression clauses to uphold current standards in the agreement and establishing a framework of clear and enforceable rules on State aid in the United Kingdom.

Despite the ambitious nature of the aspects covered, it is the first time in the EU's history that it has negotiated a trade treaty that does not have the objective of integration. Even under the full and comprehensive agreement scenario, on 1 January 2021 the EU-28's Internal Market will split into two separate markets, subject to different legislation. For this reason, the Withdrawal Agreement addressed the key matters so as to prevent disruption following the end of the transition period. Although the different actors have had time to adapt to the new scenario, preparations by public authorities and private economic agents have once again become more pressing with the approach of the deadline,[4] particularly taking into account the enormous uncertainty.

The economic effects of Brexit

Whether or not an agreement is reached and, if one is, the features of such an agreement will determine the economic effects of the United Kingdom's departure from the EU. Given the trade and financial integration of the two areas at present, these effects could be significant for the parties, including for the Spanish economy (see Box 1). To give an idea of the potential economic impact of this event in the absence of a benchmark agreement, assumptions need to be made about the new framework for integration and, specifically, its two key aspects: the tariffs applied and the so-called non-tariff barriers (NTBs). Non-tariff barriers refer to the frictions associated with differences in regulation, customs controls, logistics costs and other limitations on free trade.[5]

The trade agreements that the EU currently has with third countries provide a natural context in which to anchor the assumptions about these two aspects. Of its free

4 For example, regardless of the agreement on future relations, the end of the transition period will have implications for the financial sector in terms of licences, contract continuity, consumer protection and the prudential treatment of exposures. In order to safeguard financial stability, on 21 September the European Commission adopted a time-limited Decision to grant financial market participants an 18-month period to reduce their exposure to central counterparties (CCPs) in the United Kingdom. Specifically, on the basis of a joint analysis with the European Systemic Risk Board, the European Supervisory Authorities and the European Central Bank, the European Commission considers that financial stability risks could arise in the centralised clearing of derivatives through CCPs established in the United Kingdom in the event of a sudden interruption in the services they render to EU market participants.

5 NTBs do not have to be harmful per se; indeed, they can help reduce information asymmetry or ensure that certain standards (for example, health standards) are met, resulting in greater consumer confidence. However, the empirical evidence suggests that, in aggregate terms, they continue to represent an obstacle to trade and, in some cases, are more significant than traditional tariffs, as discussed by Hummels and Schaur (2013).

trade agreements (FTAs), the Comprehensive Economic and Trade Agreement with Canada (CETA) is currently the largest in scope and therefore provides a reference for a possible full and comprehensive agreement. The treaty envisages eliminating tariffs on 98% of goods, reducing NTBs and facilitating the trade in services and the mobility of some types of workers; it also contains explicit provisions on support for foreign investment.

Meanwhile, if an agreement were not reached before 1 January 2021, EU-UK trade relations would be governed by World Trade Organization (WTO) rules. This would entail the introduction of "Most Favoured Nation" tariffs, which are those imposed by WTO member countries on imports of goods from other members with which they have no preferential trade agreement. Moreover, the absence of provisions related to the trade in services would add a further source of uncertainty, given the importance of services exports in EU-UK relations and the imminent loss of financial services "passporting" rights at the end of the transition period.

The hypothetical scenario effects of Brexit on the EU and UK economies are simulated through the macroeconometric model NiGEM.[6] First, a baseline scenario is defined, based on the assumption that the United Kingdom retains its membership of the EU's Customs Union and access to the European Common Market. Second, various alternative scenarios are defined in line with the foregoing discussion: an FTA similar to CETA, an FTA with a more modest reduction in trade barriers, and a "no deal" scenario resulting in trade relations being governed by WTO rules. As mentioned above, the various scenarios differ primarily in terms of the tariffs imposed on the trade in goods and the impact of the NTBs. Further, the effects of Brexit on people's movement (migration) and on foreign direct investment (FDI) are considered, based on their relevance in EU-UK relations — especially under a broad FTA — and in line with other similar studies.[7] However, the possible adverse effects that Brexit could have on confidence and the uncertainty facing economic agents (financial markets, households and firms) are not considered as they would be extremely complex to calibrate against the current backdrop of a sharp downturn in these variables owing to the health crisis. Details of the calibration and assumptions of the three alternative scenarios are provided in Table 1.[8]

The results of the simulations are provided in Chart 1. The impact on the UK economy is considerable under all the scenarios, with cumulative GDP losses ranging between approximately 1.5% and 3% in the 2022 horizon. The EU loses around 0.4% of its GDP under the most adverse scenario in that period. Within the EU, the impacts had on the member countries are uneven, depending on the different trading exposure

6 This model has been developed by the National Institute of Economic and Social Research, an independent research institute in the United Kingdom.

7 See, for example, Hantzsche and Young (2019).

8 For the model's resolution, it is assumed that the economic agents base their expectations solely on historical trends and that there is no monetary or fiscal policy response to the disruptions introduced.

Table 1
CALIBRATION OF THE SCENARIOS

Transmission channel		Calibration	Scenario 1 CETA-type FTA	Scenario 2 Bare bones FTA	Scenario 3 Reversion to WTO rules
Trade	Tariffs	Cappariello (2017)	None	None	Most Favoured Nation tariffs on import prices: *4.2% (imports into EU from UK)* *5.3% (imports into UK from EU)*
	NTBs (a)	Berthou et al. (2019) Felbermayr et al. (2018)	Reversal of 50% of the NTBs reduced during European integration *(partial regulatory convergence and concessions:* ad valorem tariff of 6.1% for the EU and 9.4% for the UK	Reversal of 100% of the NTBs reduced during European integration: ad valorem tariff of 12.1% for the EU and 18.7% for the UK	
Net migration		Hantzsche et al. (2019) ONS (2019)	ONS forecasts: weighting of 75% medium variant + 25% low variant *(175,000 people per year)*		ONS forecasts: low variant *(100,000 people per year)*
FDI (b)		Hantzsche et al. (2019)	Average of "no deal" and "customs union" scenarios *Reduction of 21% (8% goods, 13% services)*		"No deal" scenario *Reduction of 24% (9% goods, 15% services)*

SOURCE: Banco de España.

a In the reference literature, NTBs are calculated in the form of a traditional (ad valorem) tariff on the basis of import prices.
b In some studies, the drops in FDI entail productivity losses, a channel which is not considered in these simulations.

to the United Kingdom in each case.[9] By channel, the contribution of the trade channel predominates in the EU economies, whereas the migration and FDI channels are particularly significant for the United Kingdom.[10] The simulations present GDP losses in an order of magnitude similar to those published by other bodies, although the simulation exercises contain assumptions of a different nature. For example, in its Autumn 2020 Forecast, the European Commission uses a static model (i.e. one that does not incorporate an economic policy response), based on input-output tables; this model estimates that the cumulative loss in GDP in 2022 under a "no-deal" scenario, compared with maintaining current trade relations, would be 3% for the United Kingdom and 0.75% for the EU.[11]

Final considerations

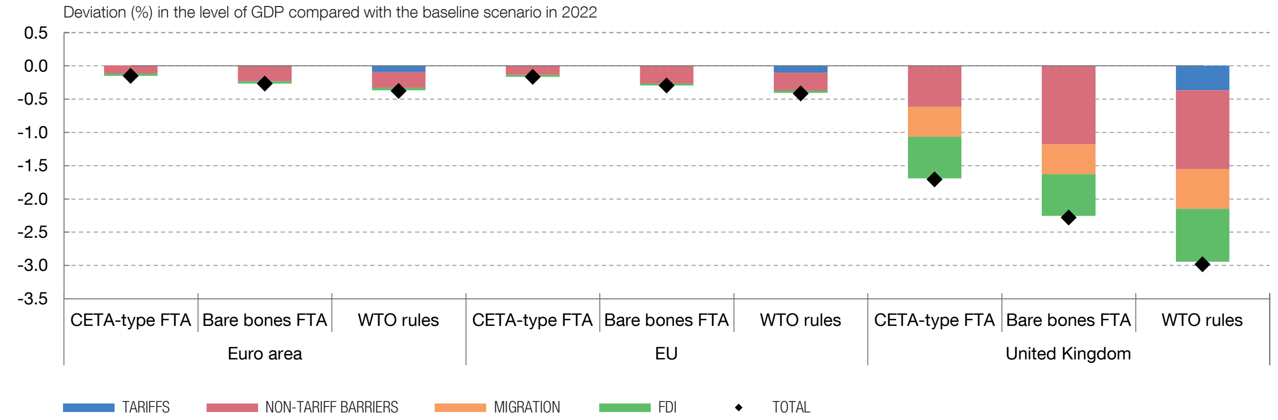
Whatever final form Brexit ultimately takes, its economic effects will be significant not only for the UK economy but also for the euro area and, in particular, the Spanish

9 For a detailed analysis of the effects on the Spanish economy, see Hurtado (2019).

10 Although the FDI channel has adverse effects on the EU in 2022, its contribution - and that of the migration channel - become positive in subsequent years, possibly owing to the diversion effects triggered by Brexit.

11 See European Commission (2020).

Chart 1
RESULTS OF THE SIMULATIONS OF THE THREE SCENARIOS



SOURCE: Banco de España.

economy, whose trade and financial exposure to the United Kingdom is notably greater than that of other large euro area economies.

The United Kingdom's departure from the EU is taking place in a context of considerable economic weakness brought about by the COVID-19 pandemic. Specifically, according to the Consensus Economics Forecasts for November, the UK economy is expected to decline by 11% in 2020. The European Commission estimates a contraction of 10.3% this year, 2.5 percentage points more than in the euro area. Against this backdrop, added to the uncertainty over the future course of the health crisis and its remission are the potential effects of the United Kingdom's exit from the EU. Moreover, the situation caused by the pandemic could potentially limit the economic policy response to the Brexit shock, in a setting in which a broad range of monetary and fiscal measures have been deployed.[12]

In short, the sharp decline in activity and the great uncertainty triggered by the health crisis heighten the need to promptly reach an agreement that will enable a new and far-reaching trade relationship to be built between the two areas.

4.12.2020.

12 See Cuadro-Sáez et al. (2020) for details of fiscal policy measures, and Aguilar et al. (2020) for the monetary policy response.

REFERENCES

Aguilar, P., Ó. Arce, S. Hurtado, J. Martínez-Martín, G. Nuño and C. Thomas. (2020). *The ECB monetary policy response to the COVID-19 crisis,* Occasional Paper No 2026, Banco de España.

Berthou, A., Á. Estrada, S. Haincourt, A. Kadow, M. Roth and M. E de la Serve (2019). *Assessing the macroeconomic impact of Brexit through trade and migration channels,* Occasional Paper No 1911, Banco de España.

Cappariello, R. (2017). "Brexit: estimating tariff costs for EU countries in a new trade regime with the UK", Questioni di Economia e Finanza, 469. Banca d'Italia.

European Commission (2019). "Revised text of the Political Declaration setting out the framework for the future relationship between the European Union and the United Kingdom", available at http://ec.europa.eu/commission/publications/revised-political-declaration_en.

— (2020). *European Economic Forecast: Autumn 2020,* Institutional Paper 136, available at https://ec.europa.eu/info/sites/info/files/economy-finance/ip136_en.pdf.

Cuadro-Sáez, L., F. S. López-Vicente, S. Párraga Rodríguez and F. Viani (2020). *Fiscal policy measures in response to the health crisis in the main euro area economies, the United States and the United Kingdom,* Occasional Paper No 2019, Banco de España.

Felbermayr, G., J. Gröschl and T. Steinwachs (2018). "The trade effects of border controls: evidence from the European Schengen agreement", *Journal of Common Market Studies,* 56(2), pp. 335-351.

Hantzsche, A., A. Kara, and G. Young (2019). "The economic effects of the UK government's proposed Brexit deal", *The World Economy,* (42), pp. 5-20.

Hantzsche, A., and G. Young (2019). "The economic impact of Prime Minister Johnson's new Brexit deal", *National Institute Economic Review,* 250, pp. F34-F37.

Hurtado, S. (2019). "Actualización de los efectos estimados para la economía española de la salida del Reino Unido de la UE", internal note, Banco de España.

Hummels, D., and G. Schaur (2013). "Time as a Trade Barrier", *American Economic Review,* 103(7), pp. 2935-2959.

IRC Brexit Task Force (2020). *A review of economic analysis on the potential impact of Brexit,* ECB Occasional Papers, No 249.

ONS (2019). "National population projections, migration assumptions: 2018-based", Office for National Statistics.

Vega, J. L. (coord.) (2019). *Brexit: current situation and outlook,* Occasional Paper No 1905, Banco de España.

Box 1

THE SPANISH ECONOMY'S EXPOSURE TO THE UNITED KINGDOM

This box describes the changes in recent years in the Spanish economy's exposure to the United Kingdom, through the trade and financial channels.[1]

Spain's trade exposure to the United Kingdom is significant. Spanish exports of goods and services to the United Kingdom accounted for 9.6% of the total in 2019, representing 3.4% of GDP that year. This trade exposure, lower than that of the euro area as a whole but higher than the German, French and Italian figures, notably includes Spanish tourism exports, which account for close to 1.2% of GDP (see Chart 1). Between 2015, the year before the Brexit referendum, and 2019, the weight of the United Kingdom in total Spanish goods and services exports

Chart 1
EXPORTS OF GOODS AND SERVICES. INTERNATIONAL COMPARISON
Spain: 2019. Other countries: 2018

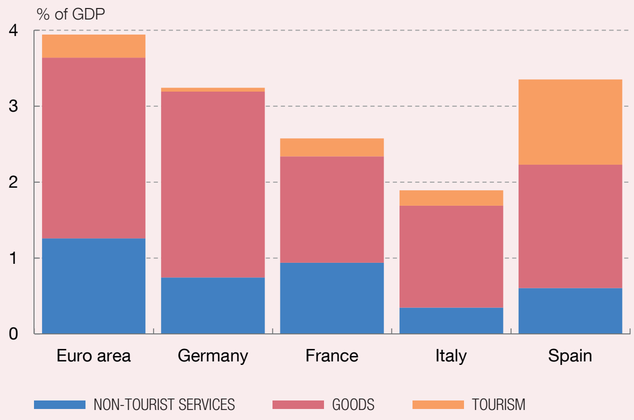


Chart 2
NON-RESIDENT TOURISM IN SPAIN, BY NATIONALITY
2019

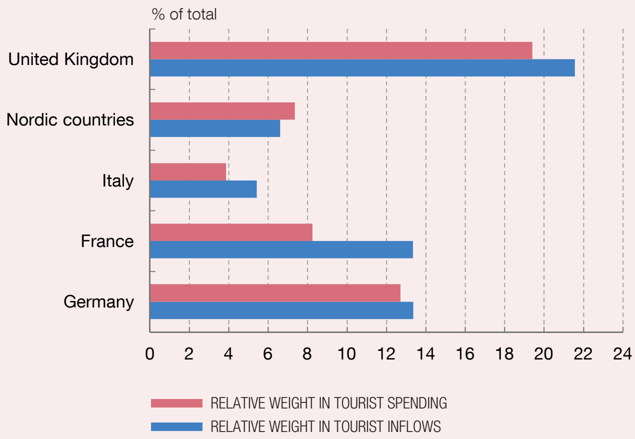


Chart 3
DIRECT AND PORTFOLIO INVESTMENT WITH THE UNITED KINGDOM
INTERNATIONAL COMPARISON
Data according to the end-investor criterion (IMF). 2018

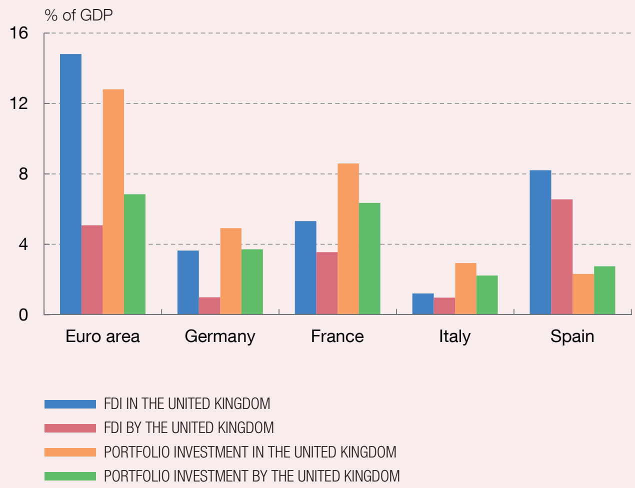
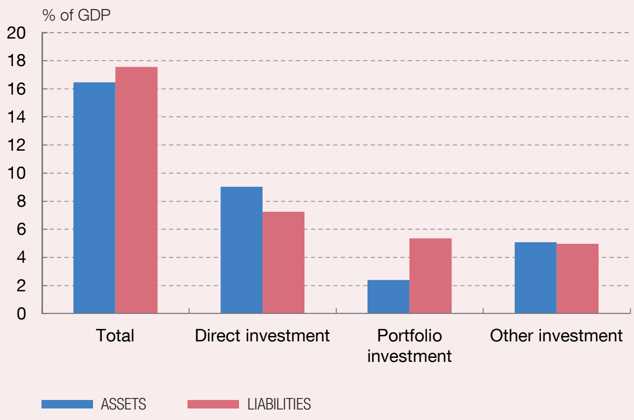


Chart 4
SPANISH EXTERNAL ASSETS AND LIABILITIES IN THE UNITED KINGDOM
2019 Q4 IIP data



SOURCES: Eurostat, IMF, INE and Banco de España.

1 For a detailed analysis of this exposure, see J.L. Vega (coord.) (2019), *Brexit: current situation and outlook*, Occasional Paper No 1905, Banco de España.

increased by almost 0.1 percentage points (pp). Tourism has been chiefly responsible for Spain's rising trade exposure to the British economy in recent years, with its weight relative to GDP growing by close to 0.2 pp. Notably, the bilateral trade flows between Spain and the British economy during the period analysed have been affected not only by Brexit, but also by other factors such as the behaviour of exchange rates and the cyclical position of the two economies.

In the tourism sector, the United Kingdom continued to be the Spanish economy's main issuing market in 2019, accounting for 21% of total tourist inflows and 19% of spending by non-resident tourists (see Chart 2). However, it should be noted that these figures were slightly lower than those recorded in 2015, mainly as a result of the gradual geographical diversification of non-resident tourism in Spain in recent years. This process was accompanied by the recovery, from 2018, of some of Spain's competitor destinations in the Mediterranean which had been affected by geopolitical tensions in prior years.

The weight in GDP of Spanish goods exports to the United Kingdom has decreased moderately in recent years, to 1.6%. According to Customs figures, goods exports to the United Kingdom accounted for 6.8% of total exports in this category in 2019 (0.5 pp lower than in 2015), making the British market the Spanish economy's fifth largest trading partner (in 2015, it ranked fourth), behind France, Germany, Italy and Portugal.

These developments have been largely influenced by two factors. First, by the drop in the percentage of Spanish firms exporting to the United Kingdom, vis-à-vis the total number of exporting firms. Specifically, from 2015 to 2019, this percentage fell by around 0.2 pp to 11% of the total, primarily due to the decline in the number of non-regular exporters.[2] Second, by the relatively subdued behaviour of sales in the automotive and certain food sectors in recent years. These goods, along with beverages, tobacco and intermediate industrial goods, represent the most significant portion of the bilateral exchanges with the United Kingdom.

Lastly, again referring to the trade channel, in 2019, Spanish exports of non-tourist services to the British market accounted for 11% of total exports included under this heading (0.8 pp more than in 2015) and 0.6% of GDP (almost 0.1 pp more than in 2015). Notable under exports of non-tourist services are telecommunications and financial services, reflecting the UK presence of Spanish multinationals from both these sectors.

Turning to the financial channel, the foreign direct investment (FDI) activity between Spain and the United Kingdom is clearly stronger, in terms of GDP, than that of Germany, France and Italy with the British economy (see Chart 3), and it has grown since 2015. In particular, Spanish FDI in the United Kingdom, with a notable weight in the financial and telecommunications sectors, accounted for 9% of GDP in 2019 (see Chart 4), making the British economy Spain's second most significant investment destination, in terms of size, after the United States. British FDI in Spain amounts to 6.5% of GDP, according to the International Monetary Fund (IMF),[3] and is mainly concentrated in the energy, telecommunications and tobacco sectors. In addition, British citizens continue to be the main foreign buyers of housing in Spain, mainly in the Mediterranean coastal areas and the islands. Thus, despite the relative stagnation observed in house purchases since the Brexit referendum, which broke the trend of sustained growth of previous years, UK citizens were responsible for 14% of the house purchases made by non-residents in 2019 (2% of total purchases, including those made by residents).

Portfolio investment activity between Spain and the United Kingdom is relatively limited, both in terms of GDP and when compared internationally (see Chart 3). Moreover, since 2015, British portfolio investment in Spain and in the euro area as a whole has declined significantly, by close to 40% and 30%, respectively, according to IMF data.

In short, compared with other large euro area economies, Spain has relatively strong links with the United Kingdom in trade (especially in the tourism, agrifood and automotive sectors) and finance (mainly in the form of FDI in the financial and telecommunications sectors). Naturally, the economic impact of Brexit on the Spanish economy will hinge on these direct exposures, and on the outcome of the ongoing negotiations, which remain marked by considerable uncertainty.

2 A firm is considered to be a regular exporter when it exports for at least four consecutive years.

3 The figures for investment in Spain are based on IMF information, which provides data according to the end-investor criterion, not that of the first-known counterpart.

In any event, this impact will probably be very uneven across regions and sectors. For example, regarding the trade exposure in terms of goods exports, a recent study by the Banco de España reveals that the regions of Murcia, Valencia, Galicia and Aragon would be the most exposed to a hypothetical adverse scenario where bilateral tariffs equivalent to the WTO average (close to 7% in aggregate terms) are imposed between the United Kingdom and the EU.[4] This would be due to both the relative high weight of the UK market in these regions' exports and to their specialisation in agrifood, textile and motor vehicle goods which, in this adverse scenario, would be subject to higher tariffs. However, this negative impact could to some extent be cushioned by the specific features of Spanish companies that export to the United Kingdom: on average, they are more labour productive and their sales are more geographically diversified compared to companies exporting to the main euro area economies.

Moreover, British tourism and investment in the second-home market are both highly concentrated in certain Spanish regions, which would be the most vulnerable to potentially adverse developments in the ongoing negotiations. Irrespective of Brexit, this high sensitivity of some Spanish regions to developments in the United Kingdom has already been recently observed in the context of the COVID-19 health crisis. In this regard, although the pandemic has had a very significant aggregate impact on tourism in Spain in recent months, it has particularly affected British tourism, highly conditioned by its reliance on air transport and the restrictions on international movement that were reinstated at the end of July, following the worsening of the epidemiological situation in Spain and the United Kingdom. Specifically, from January to September 2020, spending by British tourists in Spain fell by 81% year-on-year, more sharply than the spending by non-resident tourists overall (76%).[5] This decline is estimated to have had a greater negative impact on tourism in regions such as the Canary Islands and the Balearic Islands, the main destinations for British tourists in Spain.[6]

4 See Gutiérrez Chacón, E. and C. Martín Machuca (2020), "Spanish companies exporting goods to the United Kingdom: stylised features and recent developments by region", Analytical Articles, *Economic Bulletin* 3/2020, Banco de España.

5 According to Customs figures, in the same period Spanish goods exports to the United Kingdom also declined more sharply than total exports (19% compared with 14%), probably owing to the deeper contraction in economic activity in the United Kingdom in the first half of the year compared with that experienced by Spain's other main trading partners.

6 For further details of recent developments in tourism in Spain, see Box 8 "Recent developments in inbound tourism in Spain", *Economic Bulletin* 3/2020, Banco de España.