HSBC Global Research

18 January 2022

UK Brexit update

Taking stock, one year in

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Economics - United Kingdom

- A year into the (effective) post-EU era, UK exports are weak and the labour market is suffering acute shortages
- But the pandemic clouds the picture and it is too soon to draw firm conclusions on how much is due to Brexit
- As global trade and migration flows normalise, the impact may become more evident

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Happy birthday, dear Brexit

It is now just over a year since the end of the post-Brexit transition period, and in this note we take stock of the impact so far. Of course, the waters have been muddied by the impact of the pandemic. While we might have predicted weak exports, supply shortages and outward migration, all of these can, to some degree, be attributed to other factors. Indeed, in terms of goods exports, sales to non-European markets are down by considerably more than those to the EU.

The impact is more evident in imports, and in services, where the opposite is true: a divergence in financial, legal and professional service exports to EU and non-EU markets suggests there has been an impact. Indeed, no progress has been made on a financial services deal, and there is evidence of an impact in some areas, like equity trading. But the worst predictions have not come to pass, and London retains its number two spot in the global financial centre rankings (after New York) and its dominance of the European derivatives clearing market.

Labour market unclear too

We also think it is a little too soon to know how much of the UK's labour market shortages can be attributed to Brexit. ONS data suggest there may be around 300,000 fewer EU-born people in the UK compared with the peak in Q1 2020, but the pandemic may have been at least as decisive a factor as Brexit in these departures. As the situation normalises in 2022, we may see the UK stand out, due to its more stringent inward migration rules. This could mean the UK's inflation risks are particularly acute.

Article 16 still on the table

If post-EU life has been complicated with a trade deal, it would likely be considerably more so without one. With the UK still saying it could trigger Article 16, effectively annulling all or part of the Northern Ireland protocol, we could, in a worst case scenario, be back in the limbo land of 2016-19, where the fate of the whole Trade and Cooperation Agreement is in doubt. A 'no deal' Brexit may not yet be off the table.

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Happy birthday, dear Brexit

A year on from the end of the transition

New Year's Day 2022 marked the first anniversary of the end of the post-Brexit transition period, and hence the first year in which the UK was fully, effectively, out of the EU. In this note we take stock of the first year and the outlook from here.

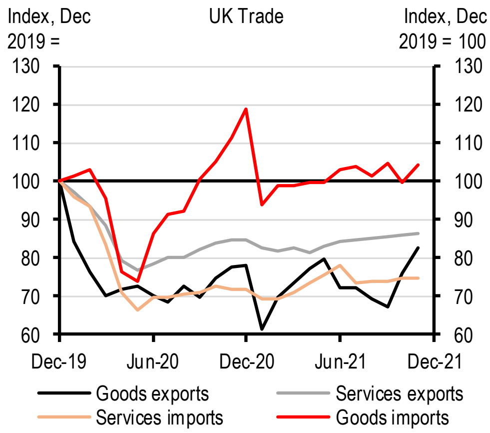
Exports: weak both in and out of the EU

UK goods exports are weak… but Brexit is not the obvious culprit

Let us begin by reviewing the data. UK goods exports have not recovered from the hit from the pandemic. While overall GDP was just 1.5% below pre-pandemic levels in Q3, exports of goods and services were over 20% below. Although the latest monthly data do point to the beginnings of a pick-up in October and November (chart 1), volumes remain very low indeed by historical standards, and the latest manufacturing PMIs show new export orders falling between September and December.

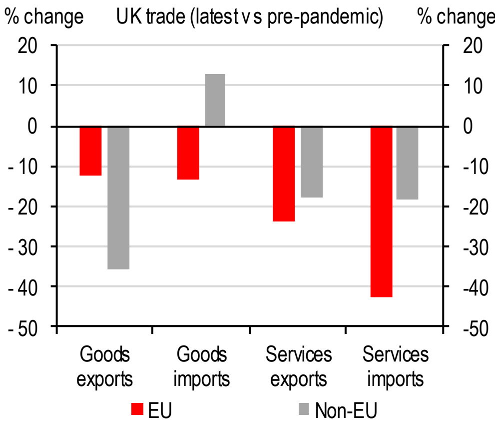
In terms of the breakdown, as far as goods are concerned, it is actually exports to *non-EU* destinations that have led the drag since the pandemic (being down 36% relative to pre-pandemic highs in Q3, compared with 13% for goods to the EU). The biggest falls by goods type were in UK mechanical machinery (particularly to the US, UAE and Singapore), while UK car exports to the US were also down quite a bit.

1.UK export volumes have not recovered from their pandemic lows



Source: ONS, HSBC

2. Trade flows have been hit hard by the pandemic



Source: ONS (NB goods data refer to change from Q321/Q419, services from Q221/Q419, services non-seasonally adjusted)

2019 is a slightly misleading comparison, due to a surge in non-monetary gold exports from the UK to non-EU destinations in the last quarter of the year. But the same is true if we compare with 2016, for example (chart 3). Non-EU exports are down by more than EU exports.

Considerable headwinds for those exporting into the EU

So, while Brexit has clearly not helped, we cannot say that it is the reason for the export underperformance. Instead, we would have to say that Brexit has added complications at a time when UK exports were already facing headwinds. After all, since the start of 2021, exporters have faced:

- New customs procedures, including UK export declarations and import requirements on entry to EU Member States
- Tariffs in cases where goods do not meet rules of origin requirements
- Health certification, new biosecurity requirements and border checks in the case of animal and plant exports
- The need for certification of both UK regulatory standards for goods produced in the UK and EU regulatory standards for those sold into the EU
- Separate checks, registration and VAT requirements for goods moving between Great Britain and Northern Ireland

Certainly, the surveys suggest the new trade barriers have been causing headaches for manufacturers:

> **“Exports remained the main area of weakness across the UK manufacturing sector, with new orders from abroad falling for the fourth month running. Brexit-related trade difficulties featured prominently in the comments**
>
> **IHS Markit PMI Press Release (UK flash, December 2021)**

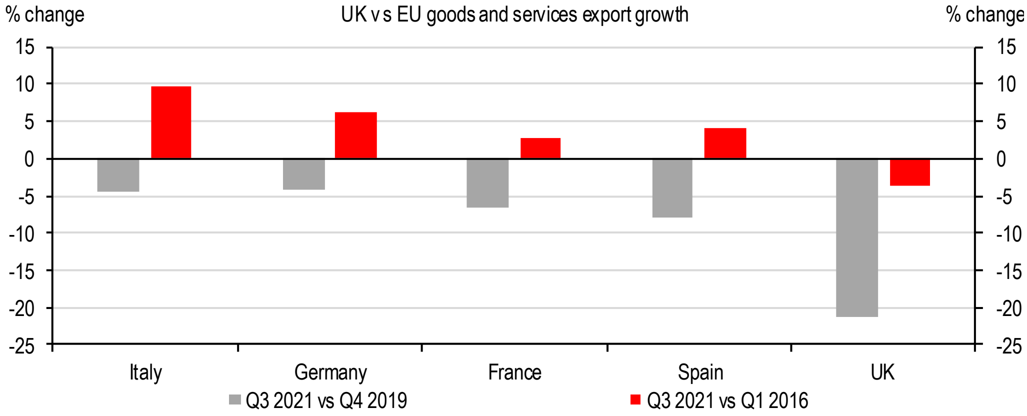
An additional survey conducted by the manufacturing association Make UK also found that the impact had been meaningful;

> **“One year on from leaving the EU, two thirds of companies said that leaving had moderately or significantly hampered their business, with over a half of companies (56%) fearing a further impact this year from customs delays due to import checks and changes in product labelling.**
>
> **Make UK Survey, 10 January 2022**

UK exports compare poorly to European equivalents

Of course, we might argue that some of the recent weakness has been supply driven. Car exports, for example, have plummeted globally due to the shortage of chips. But other countries face the same challenges, without the same overall result. For example, German exports of goods and services were just 4% off their Q4 2019 levels in Q3 2021, despite significant exposure to the auto sector, while the UK’s were 22% off (chart 3). Again, some of this might be explained by the surge in UK exports in Q4 2019 creating a high base. But the comparison with Q1 2016 does not show the UK in a much more favourable light.

3. UK underperformance suggests more than just global factors in play



Source: ONS, Eurostat, HSBC

One possibility is that there may be indirect impacts of Brexit, perhaps via lower investment in manufacturing ahead of the UK's departure, the relocation of manufacturers to other countries to avoid the complications, or difficulties in sourcing input goods. Whatever the explanation, we are not particularly optimistic about a reversal in fortunes: as Shanella Rajanayagam points out in her Trade Outlook, UK exports are forecast to be among the slowest to recover to pre-pandemic levels.

So what's the good news?

Deregulation and new trade deals may bring good news this year

On the plus side, the UK's manufacturers appear to be a little more optimistic as we have moved into the new year: the aforementioned Make UK survey found three quarters of companies expected conditions to improve this year. Moreover, as our trade economist, Shanella Rajanayagam points out, the UK has already signed a trade deal with Australia since leaving the EU, is in talks to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), is negotiating with New Zealand and India, and is set to start talks with-the Gulf Cooperation Council.

Moreover, the UK government said in September 2021 that it was launching plans to capitalise on regulatory independence by shelving laws that originated in the EU where they are not beneficial, and introducing reforms to improve digitisation and unleash innovation.

The opposite is true for services

The service sector divergence suggests a Brexit impact

Looking at the services trade data, the opposite is true: exports to and imports from the EU are down by more than elsewhere, though this is less timely, with the latest release with a breakdown by destination only showing data to Q2 2021. At that point, UK service exports were down 20% from their pre-pandemic levels, comprising a 24% fall in EU orders and an 18% fall in those from the rest of the world. Given the divergence is starkest in the regulated services that would be affected by Brexit – financial services (-18% versus -8%), legal services (-24% versus -5%) and professional/management consultancy services (-30% versus 11%), for example – the argument for Brexit as a driver here may carry more weight than it does for goods.

Indeed, there has been no progress on plans for a financial services trade deal, as laid out in the Memorandum of Understanding (MoU) as part of the Trade and Cooperation Agreement (not helped by the ongoing dispute over the Northern Ireland protocol, of which more below). While there has not been an exodus from the UK financial service sector, a lot of banks are now conducting more operations out of European subsidiaries – meaning more employment and investment in Europe and less in the UK (see for example, *Reuters, Bankers quit London as Brexit relocations to EU step up, 12 May 2021*). London has also lost its place as the Europe's top equity trading centre, with Amsterdam now seeing a (slightly) bigger share of that pie.

Still, the worst predictions for UK financial services have not come to pass: London retained its second place ranking in the Global Financial Centres Index in September 2021 (after New York), with European rivals seeing mixed performances:

> **Other leading Western European centres had mixed results, with Paris, Amsterdam, Madrid, Stockholm, Hamburg, and Munich moving up the rankings while Frankfurt, Zurich, Edinburgh, Luxembourg, Stuttgart, and Brussels fell back, as centres compete following Brexit.**
>
> **The Global Financial Centres Index 30, September 2021**

The worst predictions for financial services haven't come to pass… but it hasn't been great news either

Moreover, in November, the European Commission announced its intention to extend the waiver for European banks accessing UK based clearing houses, which still handle around 90% of euro-denominated derivatives transactions (*FT, Brussels to extend EU banks' access to UK clearing houses past June 2022, 10 November 2021*). Clearly, there is no financial centre in the bloc with the capacity to take on this EUR80trn market (FT), or at least not yet. But the EU still intends to reduce its reliance on London as a clearing centre.

So, a mixed picture so far, clouded by the collapse in services trade brought on by the pandemic. As global services trade recovers, we will continue to observe the trends in UK exports to the EU and outside it.

Imports look healthier… but geographical divergence significant

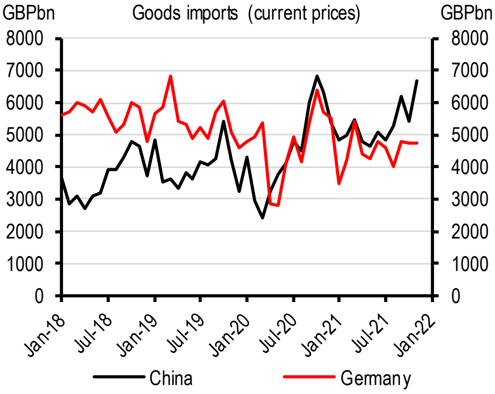
UK imports look decidedly healthier than exports. Relative to their pre-pandemic level, goods import volumes were down 1% in Q3 2021, while services imports were down 9%. However, the breakdown for both is striking: goods imports from the EU were down 13%, while those from outside the EU were up by the same amount. And this is before the UK implemented full customs checks for goods coming from the EU at the start of 2022.

Part of the strength of non-EU imports may reflect imports of personal protective equipment from mainland China (see, for example, *The Guardian, China replaces Germany as UK's biggest import market, 25 May 2021*, and chart 4). The need for the latter may fall away with time. But the contrast is nonetheless striking.

Could the UK become more reliant on imports?

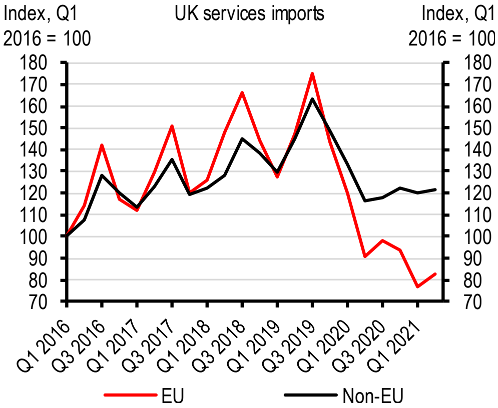
In general, though, it seems to be the case so far that UK exports have been hit harder than imports. Indeed, in some ways, Brexit may result in the UK being *more* reliant on imports, of food in particular. Trade deals with Australia and New Zealand could increase food imports from further afield (see for example, *the Grocer, NFU slams newly signed Australia trade deal as 'one-sided', 17 December 2021*), and farmers are worried about the impact of the phasing out of the EU Common Agricultural Payment subsidies. A report by the UK Parliament's public accounts committee found that plans to replace these with so called green payments were insufficient and unclear, and incentives to convert farmland to other uses, such as forestry, could result in an increase in food imports (FT, *UK's post-Brexit farm payment overhaul fuelled by 'blind optimism', 9 January 2022).*

4. Mainland China has overtaken Germany as the biggest source of UK imports



Source: ONS

5. The Brexit factor seems to be in play for services too



Source: ONS

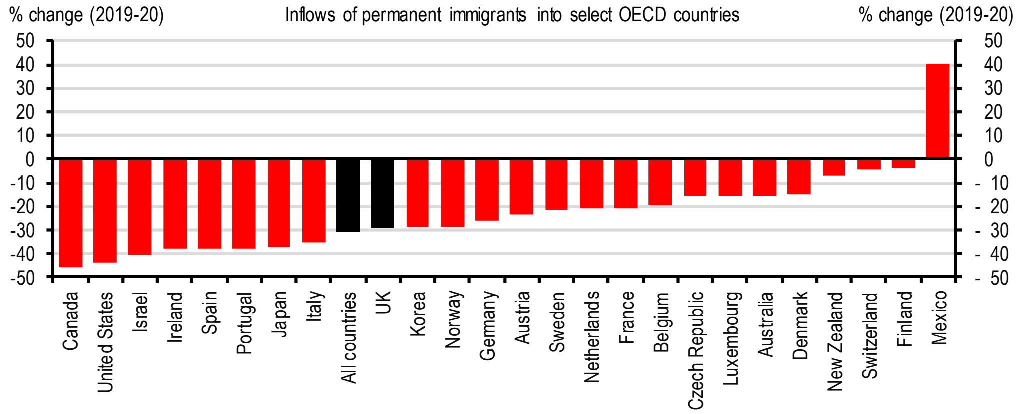
Impact on the labour market

Disentangling the labour market factors

The UK labour market has, in common with others worldwide, been struggling with a shortage of workers. Some of this has been attributed to Brexit (see, for example *Euronews, A year since Brexit: How bad are the UK's labour shortages now?, 3 January 2022*), though in reality there are multiple factors in play, not least a tightness in global labour supply which is pervading most developed market economies – and much reduced migration due to COVID-19 restrictions. For the UK, changes to the laws around self-employment (IR35) and long-standing recruitment issues (for example in HGV drivers) have also contributed.

So, is the UK in much worse a position than other DM economies due to Brexit? We would argue: not yet. Chart 6 shows what happened to inward migration across the developed world in 2020. The UK saw a fall of 30% in inward migration – far from the largest across the developed world. And that is not because it was coming from a low base. Indexing back to 2012 (chart 7), shows the UK inward migration in a similar position to the global average, and considerably lower than in the US.

6. The UK did not see bigger falls in immigration than other developed markets in 2020

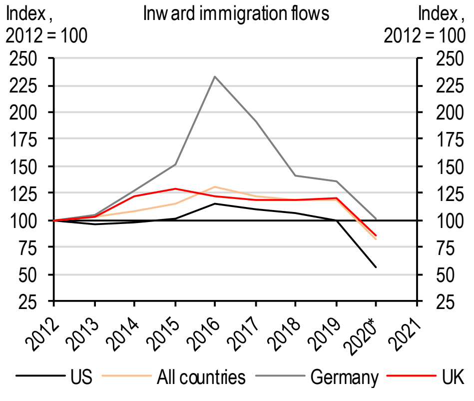


Source: OECD, HSBC

Around 300,000 EU-born people may have left the UK since Q1 2020…

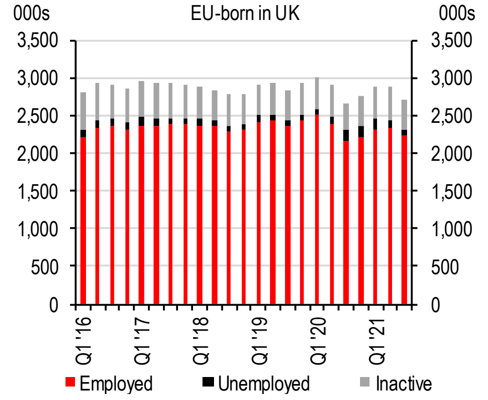
Additional and more timely data are hard to come by. The ONS does publish a breakdown of the labour force by country of birth (chart 8), though there are some doubts around the reliability of the labour force survey since the pandemic. For what they are worth, the data show that employment of EU-born workers was down by 11% in Q3 2021 from its peak in Q1 2020.

7. Even going back to 2012, the UK does not look too different



Source: OECD, HSBC Note: *2020 data are estimates

8. ONS figures suggest about 300,000 net departures since Q1 2020



Source: ONS, HSBC

Adding together the number of EU-born people who are employed, unemployed or inactive in the UK, according to the survey, shows a fall of 9.9% (or 300,000).

This suggests that the vast majority of the fall in employment reflects people no longer in the UK, not people becoming unemployed or inactive. It is certainly possible that this in turn reflects concerns over Brexit, but the survey doesn't tell us the reason. For most EU-born people in the UK, whether or not they had UK citizenship, the new Brexit regulations would have allowed them to apply for settled status and the right to remain in the UK. It is plausible that the pandemic prompted at least some of the departures.

What next?

We don't know why people left… but they might find it harder to return

Whatever the reason for leaving, EU-born workers may now find it harder to return to the UK, given considerably more stringent new rules. The UK government has made a number of concessions regarding inward migration, issuing temporary visas for truck drivers and in particular for fuel tanker drivers during the fuel crisis in October. Most recently, on 24 December, the government announced an extension of a scheme allowing fruit and vegetable growers to bring in seasonal workers for up to six months, and a provision that foreign social care workers will be eligible to enter the UK under a health and care visa "for at least a year".

Without timely migration data, it is hard to say how these initiatives will affect the labour market. We suspect that with their sector and time limitations, as well as the strong job opportunities and wages available elsewhere, the UK may still struggle to attract workers. Much will depend on how much wages rise, and how far the UK government sticks to – and is able to deliver on - its plan to foster a "high skill, high wage" domestic labour force.

The impact may become clearer as global migration flows normalise

So while the UK's labour market issues are clear, we cannot say conclusively that Brexit is the reason yet. That's not to say that Brexit won't have an impact if, as global migration flows normalise in 2022, the UK does not keep up. Indeed, the much more stringent rules and competitive global marketplace for labour make this scenario somewhat likely in our view. With the UK's already low unemployment rate by European standards, that points to supply constraints on growth and particularly acute inflation risks.

Article 16: Still on the table

It could yet get more complicated, if no solution is found regarding Northern Ireland, and the UK opts to trigger Article 16, annulling all or part of the Northern Ireland Protocol.

We highlighted this risk in October last year. Essentially, the UK is unhappy with what the protocol it signed up to means for GB-NI trade, and wants changes regarding customs and Sanitary and Phyto-sanitary (SPS) arrangements; regulatory burdens; subsidy control; VAT and excise procedures; and the oversight of the European Court of Justice[1]. While the government says its preference is to find a negotiated solution to these issues, it also says that talks so far have resulted in only very limited progress (namely on the topic of medicines). The UK says the conditions have already been met for triggering the 'safeguard' Article 16.

Liz Truss says the UK's position is unchanged and Article 16 is still on the table

Since we last wrote about it, Brexit Minister Lord Frost has resigned, to be replaced in the job by Foreign Secretary Liz Truss. However, despite commenting on a "reset" in the talks (BBC, 13 January 2022), the new chief negotiator is continuing to talk tough. In an editorial on 9 January, before the latest round of talks began, she said that the UK's position had not changed:

> **"I want a negotiated solution but if we have to use legitimate provisions including Article 16, I am willing to do that. I will not sign up to anything which […] still sees goods moving within our own country being subject to checks.**
>
> **Liz Truss, Sunday Telegraph, 9 January 2022**

Reports suggest that the New Year talks held in the UK between Ms Truss and European Brexit commissioner Maros Sefcovic went well, with a joint statement praising the "cordial atmosphere". Intensified talks are due to take place in late January, with Ireland's foreign minister Simon Coveney having said he hopes the situation will be resolved by the end of February.

The role of the ECJ is contentious

One major factor will be the UK's position on the ECJ. In mid-December, various media outlets reported that the UK had softened its position on the role of the court (see for example, *The Times, Britain accepts EU judges' role in Northern Ireland protocol, 17 December 2021*). Such a concession if confirmed would in our view be meaningful: the European side had never looked likely to concede the point, suggesting deadlock and, hence (potentially) Article 16. But Ms Truss' comments on 21 December suggest the UK concession is only a partial one: "we need goods to flow freely between Great Britain and Northern Ireland, end the role of the ECJ as the final arbiter of disputes between us, and resolve other issues"[2].

So what if the UK does trigger Article 16? The EU has said it would retaliate, but it is not clear what this would entail. It could refer the UK to an arbitration panel, or begin infringement proceedings (or both). If the UK does not comply with the rulings of the panel, the EU could terminate the whole Trade and Cooperation Agreement (with twelve months' notice) or just the trade part of the deal (with nine months' notice).

Could the EU terminate the whole Brexit deal?

The EU could take this action without a panel judgement, but only if one of the "essential elements" of the TCA is breached. According to a report by the UK's House of Commons, "it appears unlikely that triggering Article 16 would breach an essential element". But some on the EU side have suggested it is possible (see for example, *The Guardian, EU could shelve Brexit trade deal if UK triggers article 16, Irish minister warns, 7 November 2021*).

If the UK's trade situation is complicated with the trade deal, it could be considerably more so without it. This would essentially be a delayed 'no deal' Brexit. And even if it might be averted by talks in the notice period, it would put the UK back onto that uncertain path it was on between the referendum and the end of 2019. This weighed on business confidence and investment the first time round, and would likely do so again.

1 https://www.gov.uk/government/news/lord-frost-statement-on-the-protocol-on-irelandnorthern-ireland-17-december-2021--2
2 https://www.gov.uk/government/news/foreign-secretary-call-with-european-commission-vice-president-maros-sefcovic-21-december-2021

Conclusion: Impact may yet to be felt

Waiting for the muddy waters to clear

It was always going to be difficult to assess the impact of Brexit: there would always have been counterarguments and alternative explanations for apparently impacted exports, imports and labour market trends. The highly politicised nature of Brexit made that much predictable. But economists could never have predicted just how muddied the waters would become, against the backdrop of a global pandemic.

That is not to say we don’t believe Brexit is having and will continue to have an impact: our forecasts for UK GDP growth see more lost output than we see elsewhere. Our forecast export recovery is among the slowest in the world. We also think the impact on the labour market will become clearer as global migration flows normalise. That points to higher inflation pressures in the UK than elsewhere.

But those are forecasts. The impact should become clearer as the global clouds lift.

Disclosure appendix

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