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Week in Focus

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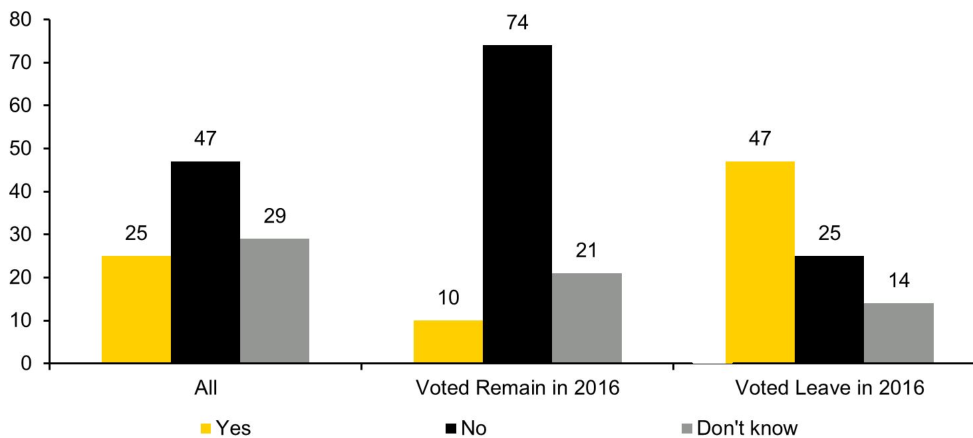
Brexit: Still not done

The UK government has introduced legislation to overturn the Brexit Withdrawal Agreement signed last year, which has infuriated the EU. If such legislation is enacted, it will threaten the prospect of reaching an agreement this year on future UK-EU relations. However, at this stage we continue to expect that a limited trade deal can be achieved. **Page 2**

Even the British are critical of their government's latest move
Answers to the question "Do you consider it acceptable that the government breaches international law?", percentages



Source: YouGov, Commerzbank Research

India's economy slumped in Q2, infections continue to rise: Anti-covid measures in India have subsequently been scaled back which is providing some support to the economy but is pushing infection numbers up again, which in turn is retarding the recovery. **Page 5**

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Brexit: Still not done

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Eleven months ago the UK and EU negotiated a post-Brexit Withdrawal Agreement. Having promised the electorate ahead of the December 2019 election that it would enact this legislation in accordance with the election slogan "Get Brexit done", the government has now introduced a new bill that by its own admission contravenes international law. If such legislation is enacted, it will threaten the prospect of a trade deal with the EU. It is too early to conclude that this will necessarily result in a no-deal Brexit and we continue to believe that a trade deal is still possible. But the outcome hangs in the balance and a no-deal outcome is a real possibility.

Trying to seal the Brexit deal

After the UK legally left the EU on 31 January 2020, the law mandated a period until end-2020 to allow the UK and EU to work out the specifics of a longer-term relationship. But it has proven to be a slow process characterised by frustration on both sides. The UK's position is that it seeks a Free Trade Agreement along the lines granted to Canada but is concerned that the EU is attaching conditions which impinge on UK sovereignty. The EU's position is that the UK is asking for greater access than has been granted to any other trade partner. Accordingly it is concerned to protect the single market by ensuring the UK will not seek to undermine existing regulations which give UK businesses an uncompetitive advantage. For this reason, the EU is asking the UK to publish, among other things, the rules that will govern state aid in future.

A new twist in the tale

The UK government last week presented the Internal Market Bill (IMB) which by its own admission will "*break international law in a very specific and limited way.*" This legislation was introduced because the government argues that the Withdrawal Agreement (WA) which it concluded with the EU in October 2019 and passed into British law in January 2020, threatens the economic integrity of the UK because it imposes a tariff border between Northern Ireland and Great Britain which runs through the Irish Sea. One of the specific provisions of the WA is that the limits on state aid which were in force when the UK was a member of the EU will also apply in the event that the WA comes into effect. The IMB addresses these problems by legislating that the same tariff regime applies in Northern Ireland as in the rest of the country and that the UK can make provisions *"disapplying, or modifying the effect of [state aid regulations] … notwithstanding any relevant international or domestic law with which they may be incompatible or inconsistent.*"

The IMB has now been presented to parliament and following its second reading earlier this week (a bill has to be passed three times before it is sent to the upper house for ratification), MPs passed it by a margin of 77 votes. This does not necessarily mean that it will pass a third reading but the margin is not far short of the government's overall majority of 80, suggesting that dissenters were few in number.

Why is this a problem?

At issue is the trustworthiness and credibility of the current government. Despite protestations to the contrary, it was well aware of what it was proposing when it signed the agreement with the EU. Moreover, it campaigned in last year's general election on a promise to enact the legislation, which it subsequently did in January 2020. It is worth recalling that the agreement which Theresa May's government reached with the EU envisaged a UK-wide 'single customs territory', avoiding the need for customs checks between Great Britain and Northern Ireland. But many MPs, including Boris Johnson, objected because it would have meant the UK remaining in a customs territory with the EU, removing the UK's ability to vary its tariffs.

The UK legal profession is united in its condemnation of the new bill which threatens to undermine the UK's international standing. This is particularly important since English law is often used as the basis for cross border legal contracts. Moreover, senior US politicians, including presidential candidate Joe Biden, have indicated that any action which threatens the Good Friday Agreement will prevent the UK and US reaching a post-Brexit trade deal.

An attempt to rationalise the UK government's action: It's about subsidies

It is important to understand that for many in government, Brexit is a means to an end and not an end in itself. In their view it represents a chance to reshape the economy for the digital age. The view from government circles is that the UK wishes to free itself of the state aid rules

in order that it can provide support to the industries of the future in an attempt to challenge US and Chinese tech titans. Ironically, the UK has traditionally been opposed to state aid to support particular industries. According to the EU's State Aid Scoreboard the UK share of state aid spending in 2018 was 0.34% of GDP versus an EU average of 0.76% (chart 1). It could thus double its support and not be out of line with the rest of the EU.

In any event, the UK's efforts to back industrial winners in the post-1945 era have generally been a failure. Previous efforts to back tech companies include ICL, formed in 1968 to create a British computer industry that could compete with major world manufacturers. The experience did not end well: ICL was bailed out in the early 1980s and sold to Fujitsu in 1990. Nor did the Conservative government raise any eyebrows when chipmaker ARM was sold to SoftBank, a Japanese firm, in 2016. If this is indeed one of the main motivations for the government's attempt to rip up previously negotiated international agreements, it is a very risky action.

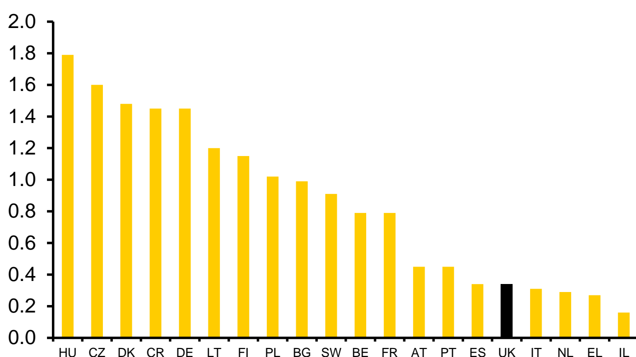
A trade deal is still possible if limited in scope

As important as it is to understand the UK's motivation, it is also important to recognise the EU's position. It does not want to be the bad guy – the one that walks away from the negotiating table – for fear of being branded as the party which inflicted significant economic damage on the UK in the event of no-deal. Accordingly, despite the provocation represented by the IMB the EU will keep the negotiating lines open for as long as possible.

Another round of bilateral negotiations is scheduled for 28 September to 2 October but before that, the EU has called on the UK to withdraw the IMB by end-September or potentially face a legal challenge at the European Court of Justice. However, it is crucial to note that it has not yet threatened to end trade negotiations. EU heads of government may take a different view. A crucial summit of EU leaders is scheduled for 15 October and in the view of Boris Johnson, there must be agreement by this point if it is to come into force by the end of the year. The EU has set a hard deadline of end-October, giving a maximum of two months for the EU council and the European parliament to scrutinise and ratify any deal. There will have to be a dramatic dialling down of the rhetoric in the next six weeks if this deadline is to be met.

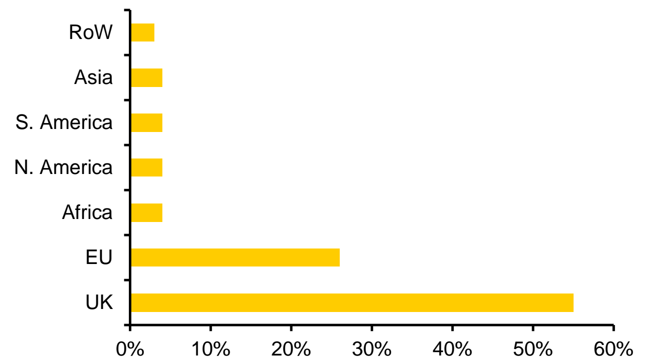
Our default position remains that neither side gains in the event of a no-deal Brexit and that both will seek to avoid it. This does not mean that a comprehensive trade agreement will be forthcoming. Indeed, our long-held position is that any deal achieved this year will be at best a "goods lite" arrangement which covers a limited range of sectors designated as being of critical economic importance (for example, autos and pharmaceuticals).

Chart 1 - UK provides limited state support
State support 2018, percent of GDP



Source: European Commission

Chart 2 - EU is a large supplier of food to the UK
Source by region, percent



Source: ONS

But the risks are high

However the risks to this view remain high. As a result, we view the prospect of an agreement at this stage as a 50-50 shot. There are two aspects to consider: (i) how the UK parliamentary process proceeds and (ii) how the EU responds.

There is still a possibility that the IMB will not survive a third reading in parliament, or at least come out significantly amended to remove the clauses which have so offended the EU. In a bid to get it through parliament, the prime minister has offered concessions allowing MPs a veto on implementing legislation which contravenes "*any relevant international or domestic law"* rather than it being decision only for government. It may also not emerge unscathed from the House of Lords, where opposition to the bill is very strong on the basis of the reputational damage that

it will cause. Moreover, convention dictates that manifesto commitments are not blocked by the Lords, but a policy which contravenes promises made to the electorate is likely to promote significant resistance. It is unlikely that the upper chamber can block the legislation indefinitely but it can act as a significant obstacle to government plans to get it quickly onto the statute book.

Assuming that the bill does pass into law, it is unlikely that the UK will back down in the face of the EU's request to withdraw the IMB by end-September. In the worst case, EU governments may decide at the summit in October to end their pursuit of a trade deal. Alternatively the EU could decide to issue legal proceedings whilst keeping the door open to further discussions. In this instance it is likely that discussions could proceed into November, or even December, as both sides seek a messy compromise.

Uncertainty and how to deal with it

Whilst the headlines focus on the high drama of the negotiations, it is the minutiae of trade details that is the biggest problem facing companies as they head towards end-2020. In the event of a no-deal Brexit EU companies exporting to the UK will no longer face a zero-tariff regime. According to analysis performed by the Trade Policy Observatory, the UK's new Global Tariff will subject 56% of imports from the EU to some form of duty at an average rate of around 1.5%. Obviously companies can quickly change their selling price to accommodate the tariff but as of now, they do not know whether they will have to do so.

But a much bigger problem is that companies do not know what sort of regulatory regime they will face. This brings into focus the issue of non-tariff barriers which impose much higher costs than import duties. Consider the case of the food industry. Around 26% of the food consumed in the UK originates in the EU (chart 2) and half of all food and beverages exports are destined for the EU. A harmonised labelling system for food products is a key element in ensuring the existence of a single market for this product. But in a no-deal Brexit, UK food product labelling will cease to be recognised within the EU (and presumably vice versa). As we get nearer the deadline this problem becomes more acute and it is increasingly likely that a series of temporary permissions will be required to prevent the worst case outcomes. Such an approach is already evident in areas such as financial services where both sides will allow the other access to clearing houses beyond 2020.

What it all means for the economy ...

It is possible that the UK will make good on its threat to resort to WTO regulations from 1 January 2021 but the economic damage to the UK as a result will likely be considerable. The simulation analysis we conducted in 2018[1] based on trade frictions resulting from a no-deal Brexit suggested this outcome could reduce output by between 3% and 8% relative to baseline on a five-year horizon (depending on the degree of policy accommodation). The economic situation has since become significantly worse following the Covid-induced recession. Accordingly a rational government which will be seeking re-election in 2024 is unlikely to want to take too many risks with the economy.

Consequently, and with just over three months until the end-2020 deadline, we are inclined to view 31 December as one more milestone on the road to Brexit rather than being the ultimate deadline by when the whole issue will be resolved. But the UK government will want to claim that some form of closure has been achieved, particularly since it won an election on the basis of delivering Brexit. It is primarily for this reason that we believe some form of "trade-lite" deal will be concluded although we currently view this as a 50-50 outcome.

... and for markets

Our forecast is predicated on the assumption that a hard Brexit can be avoided. That said, sterling volatility remains elevated and as numerous deadlines loom during the autumn, they will exert some downward pressure on sterling which is already trading below "fair" value. If a limited trade agreement can be reached, as we expect, this might provide some support for the currency and nudge it closer to fair value levels. But the upside is far smaller than the downside potential in the event that an agreement is not reached. In this sense, the currency risks are asymmetric. In the event of no deal, the BoE will be forced to take additional measures and we would reconsider our view that interest rates will not fall below zero. However, in the first instance it can be expected to sharply ramp up the bond buying programme.

[1] Economic Insight 'Brexit: When ideology meets reality' 23 November 2018

India's economy slumped in Q2, infections continue to rise

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Anti-covid policies in India are having an immense effect on the economy, inflicting a GDP contraction in Q2 of almost 24%. The measures have subsequently been scaled back which is providing some support to the economy but is pushing infection numbers up again, which in turn is retarding the recovery. The central bank (RBI) is allowing a stronger INR to curtail inflation but it may not risk too much INR strength in an effort not to jeopardise the economic revival.

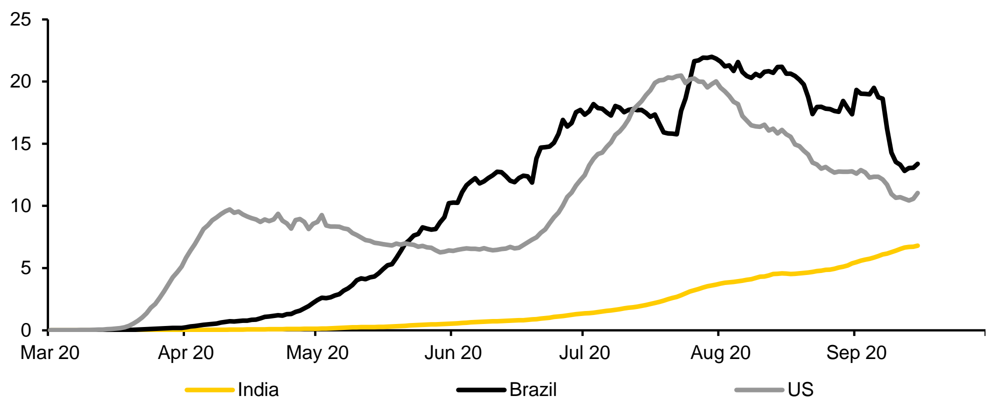
The Indian economy contracted by a whopping 23.9% year-on-year in Q2, a steeper decline than in almost any other country. The economy was already losing momentum last year and the stringent lockdown measures imposed in late March caused a steep drop in GDP.

The lockdown has been eased in the meantime – which carried a hefty price tag in terms of the health outcome. Total infections rose to 4.9 million as of 15 September. At this rate, India will overtake the US total of 6.6 million within a month. In relation to the population, India still has fewer new infections than the US and Brazil; unlike in these two countries, however, the trend remains clearly upwards (chart 1). The good news is that the mortality rate is still relatively low at 2%, partly due to the relatively young population where the average age is estimated at 28.4 in 2020.

Due to the high number of new infections, the domestically-driven Indian economy is likely to be held back for some time by restrictions, particularly in the services sector. For this year, we expect GDP to shrink by -4.4%, which is a significant slump, given the average growth of 6.8% over the last decade. For 2021, we expect real GDP to increase again by 7.1%, which would leave the economy well below its old growth trend.

The government's ability to pump prime the economy is limited. The drop in tax revenue exacerbates an already stretched and weak fiscal position. Given fiscal constraints, the Reserve Bank of India (RBI) is the only game in town. It slashed rates by 115bp to 4% this year. Its ability to cut further is hampered by stubbornly high inflation which was just under 7% year-on-year in August and averages 6.6% year-to-date. This is above the RBI's target range of 2-6%. RBI has thus allowed INR to strengthen with the aim of dampening imported inflation. USD-INR fell by over 2.5% in the past two months to below 74.00. If inflation moderates toward year-end, this provides leeway for the RBI to cut. However, we see a limit to INR appreciation. After all, the RBI certainly does not want to put the economic recovery at risk. Thus, we see USD-INR only slightly higher at around 74.50 by year-end.

Chart 1: India – Number of new infections still rising
New infections per 100k inhabitants, 7-day average



Source: ECDC, Commerzbank Research

No reason for OPEC to celebrate

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On the 60th anniversary of its foundation, OPEC is confronted with an oil price which it considers to be too low and discipline in production cuts appears to be crumbling. In addition, demand in the second half of the year is likely to recover more slowly than expected. We therefore see the price of Brent oil at the end of the year still only at USD 40 per barrel.

OPEC celebrated its 60th anniversary this week. However, the 13 members of the oil cartel are unlikely to feel like celebrating. The low oil price since the outbreak of the Corona pandemic has caused OPEC member states painful revenue losses. Admittedly, large production cuts mean that the price is significantly higher than in April, when it temporarily fell below USD 20 per barrel due to a massive slump in demand. However, the pre-crisis price level is still a long way off (chart 1). On the contrary, the oil price fell again at the beginning of September. At around USD 40 per barrel, Brent is quoted at a level well below needed by most OPEC countries for a balanced national budget.

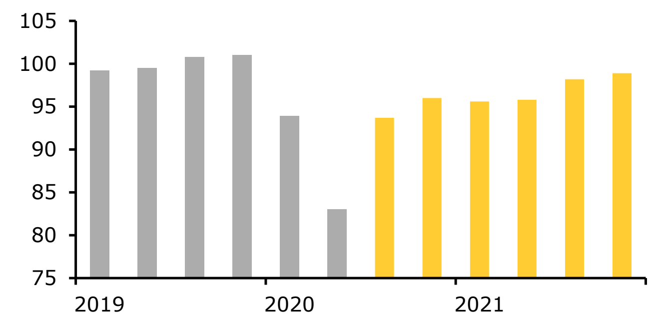
There is a risk that some countries will increase their production to compensate for the loss of revenue. In August, for example, the United Arab Emirates produced considerably more oil than would have been permitted under the agreement on production cuts. If this sets a precedent, oil supply could quickly significantly exceed demand. This is because the demand for oil has been recovering more slowly than expected since the summer in view of the high numbers of new corona infections. The International Energy Agency has revised its demand forecast for the fourth quarter downwards by around 600k barrels per day for example. Even at the end of 2021, according to this forecast, demand will still be lower than before the crisis (chart 2).

Against this backdrop, OPEC and allied oil-producing countries, such as Russia ("OPEC+"), must maintain a high level of production discipline if they are to gradually reduce the market oversupply that developed in the second quarter and thus achieve a higher oil price. However, we are sceptical that this will be achieved without a stronger recovery in demand and expect Brent to be at USD 40 per barrel by the end of the year. If the production cuts are implemented consistently and demand continues to recover, the oil market is likely to be undersupplied next year, which will open up scope for moderately higher oil prices in 2021.

Chart 1: Oil price well below pre-crisis level
Brent oil price in USD per barrel

Source: Bloomberg, Commerzbank Research

Chart 2: Oil demand recovers slowly
in million bpd, IEA forecast from Q3-20



Source: IEA, Commerzbank Research

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