

# Brexit update

**Nora Neuteboom**, Senior Economist

Tel.: 06 3968 7836 / [nora.neuteboom@nl.abnamro.com](mailto:nora.neuteboom@nl.abnamro.com)

**Jan-Paul van de Kerke**, Economist

Tel.: 06 4429 4475 / [jan-paul.van.de.kerke@nl.abnamro.com](mailto:jan-paul.van.de.kerke@nl.abnamro.com)

## Long-awaited Brexit with long-term consequences

- ▶ **Negotiations on a Brexit deal are still ongoing. The risks of no deal have increased but we expect that a deal will be struck eventually**
- ▶ **Even with a deal, Brexit will damage the Dutch economy**
- ▶ **Trade shocks triggered by border frictions cause a loss of 0,7% of Dutch GDP**
- ▶ **However, most substantial losses are longer-term in the form of reduced potential growth**
- ▶ **This reduction will be caused by, for example, structural trade adjustments and second round effects on innovation**
- ▶ **Relocation processes caused by Brexit may benefit low-wage countries more than the Netherlands**

### **Brexit is now a reality**

The United Kingdom will leave the EU on 31 December, when a transition period of informal membership ends, following its formal departure last January. At the time of publication, the EU and the UK remain deadlocked in talks over a post-Brexit free trade agreement. Our expectation is that a deal will be struck, but it is unclear whether this will be in 2020 or in 2021. Remaining points of contention in the negotiations are fish quotas, 'level playing field' provisions and the governance of the deal.

Meanwhile, non-tariff barriers (NTBs) will start to appear from 1 January for the trade of goods. In the short run, we expect NTBs in the form of customs frictions. While the extent of the checks at the UK border is not yet clear, it may include declarations at point of export, customs declarations and clearance forms. In the longer run we expect NTBs in the form of regulatory costs. One of the reasons why the UK wanted to leave the EU is the freedom not to adhere to certain EU regulations. Regulatory divergence from the EU, however, will make it increasingly difficult over time to trade goods, increasing the NTBs as time goes on.

Still, services are not covered yet and there is no stable 'equivalence' agreement covering the financial services sector. Such businesses would need to set up EU or UK subsidiaries, depending on the markets in which they are based, to trade in the other jurisdiction. Non-tariff barriers could cause major fractures in post-exit trade relations between the UK and the Netherlands. Nevertheless, it remains highly uncertain just how big non-tariff barriers will become – the more the UK diverges from EU norms over time, the bigger the barriers.

### **The potential negative effects on the Dutch economy**

The primary channel through which the Netherlands will be impacted by the Brexit is trade. The UK is a major trade partner for the Netherlands. For years, the UK has been the second biggest export destination for the Netherlands after Germany in

terms of the combined trade in goods and services. In 2019, exports of goods and services to the UK amounted to 60 billion euros to the Dutch economy. In value-added terms, this was almost 26 billion euros, or 3.3% of Dutch GDP. The export of services comprised slightly more than half of this – 13 billion euros compared to 12.5 billion euros in goods. While there is a deal on the table, the NTBs stemming from border frictions will lead to extra costs for Dutch exporters and, in the event that UK customs are overburdened, extra shipping time.

Border disruptions will most likely hurt the agricultural and food sector relatively hard, as they produce perishable food, plants and live animal stock. Long wait times at the border and extra costs for imported products because of these frictions will lead to demand reduction and may cause some UK business to substitute to domestically produced goods, or goods from outside the EU. After all, UK importers would be exempt from adherence to EU regulatory standards on goods imports from non-EU countries. This will harm the competitiveness of European exporters selling EU-compliant goods to the UK market.

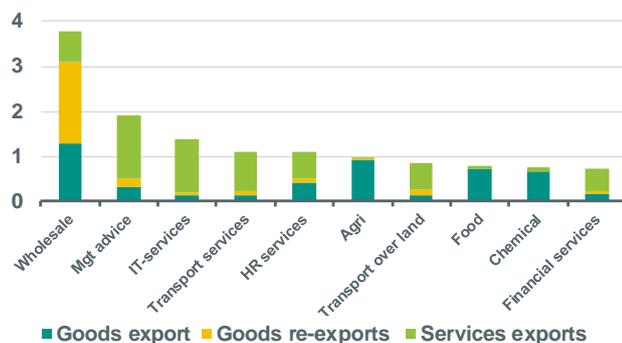
Not only will direct trade with the UK be impacted, but also indirect trade. For instance, Dutch companies may currently export intermediate goods to Germany, which Germany re-exports to the UK. When the UK steps out of the EU single market, these trade flows will also be hit. These [indirect network effects](#) of the trade shock are large and reinforce the overall impact of a trade shock. Lastly, the lower [UK growth perspective](#) will lead to less demand for Dutch export goods in general.<sup>1</sup>

For companies in the Netherlands that depend on products imported from the UK, the NTBs may cause higher costs of semi-finished products and thus lead to imported inflation. While over time companies may be able to refocus their supply chain towards different countries, temporal costs will be incurred. Companies that depend on just-in-time delivery have already started to increase their storage capacity within Europe, in anticipation of longer waiting times at the border.

While services are not restricted by tariff barriers and border checks, the export of services to the UK will also be negatively impacted by Brexit. Trade in goods and services are intertwined, as companies often offer packages by combining goods and services. In addition, services can be impacted by 'behind-the-border' requirements such as mutual recognition of qualifications or regulatory bodies. Moreover, services often depend on the freedom to establish businesses, freedom to move workers to the UK and free movement of data. There is still a lot of uncertainty regarding these issues. The OECD Services Trade Restrictiveness Index (STRI) quantifies cross-cutting barriers that affect services traded.<sup>2</sup> While the average STRI for EU 28 countries is 0.063, the average STRI for the top 10 export destinations for the Netherlands outside the EU 28 is around 0.27.

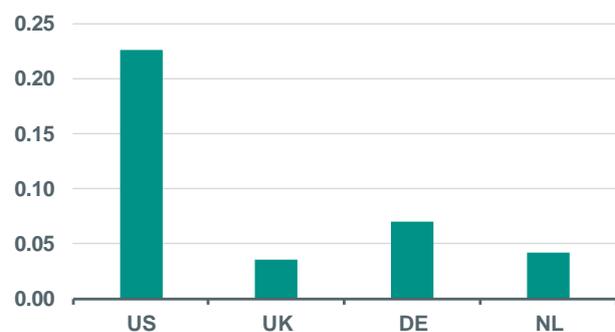
**Wholesale and trade are biggest export sectors**

Dutch exports to the UK (billion euros)



**STRI score for US is higher than EU countries**

The OECD Services Trade Restrictiveness Index (STRI)



<sup>1</sup> See [this](#) article for the Brexit effects on UK GDP expectations. And click [here](#) to see our forecasts regarding the GBP.

<sup>2</sup> The STRI indicators take values between zero and one, where one indicates the most restrictive trade environment.

Source: Statistics Netherlands (CBS)

Source: OECD

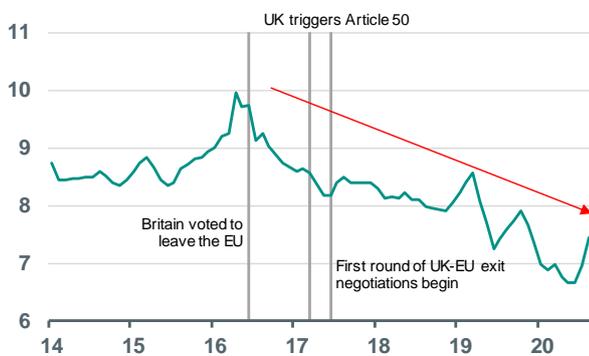
### The first effects on trade already visible

In 2019, the total value of Dutch exports to the UK was around 40 billion euros, which is approximately 0.5% less (in nominal terms) compared to 2018. The CBS reported that for three consecutive years, the growth of the export value in Dutch goods to the UK has been lagging growth in total Dutch goods trade. In 2020, this trends seems to have continued; recently the CBS [indicated](#) that for the first 10 months of 2020, Dutch domestically produced exports to the UK declined by 17% compared with 2019. Since overall exports declined by a smaller amount, the difference can probably be attributed to Brexit. The graph below shows exports since the Brexit vote. Dutch exports to the UK, as a percentage of total exports, have declined steadily over the last couple of years. It is hard to distinguish the Brexit effects from other macro-economic developments which are unrelated to Brexit, such as the increasing trade ties to emerging markets (i.e. China). However, the share of total trade to our biggest export partner, Germany, has not been declining but has remained constant in the last couple of years (at around 22%).

While some companies took precautionary measures to anticipate the end of the transition period on 31 December, others have not. The precise terms of the trade deal are still unclear, although there is certainty on the emergence of border checks. One reason for this suboptimal preparation might be that the Covid-19 pandemic has hampered companies' ability to take preventive measures, or such measures have become less of a priority.

#### Exports to UK on a declining path

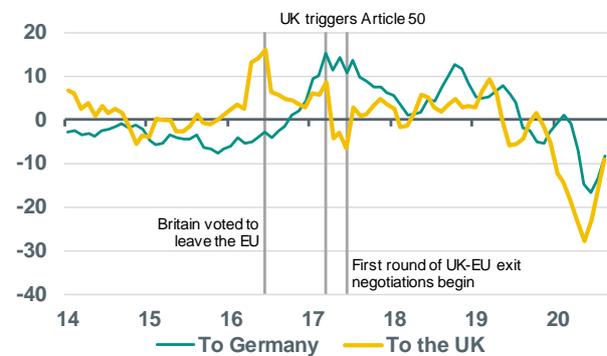
Dutch export to the UK, % of total exports



Source: Statistics Netherlands (CBS)

#### Drop amplified by the Covid-19 pandemic

% change yoy, 6m rolling average



Source: Statistics Netherlands (CBS)

### The input-output models suggest that Brexit will lead to a 0.7% decline in GDP in the coming years

The input-output models take into account all the short-term direct and indirect effects on the trade of goods and services caused by the border frictions. Moreover, they consider the *sectoral composition* of the Netherlands. The degree to which a good will be affected by higher NTBs depends on the price elasticity of that particular good.<sup>3</sup> Oil and gas, and communications devices such as telephones are [the largest](#) export products (in terms of export value in euros) to the UK. Oil has a low price elasticity. If the price goes up, demand barely changes. This does not apply to telephones: when prices go up, demand goes down. Using these price elasticities for different goods that the Netherlands exports to the UK, this model can estimate the macro impact on trade by Brexit.

Together with the University of Leuven we have [found](#) that, even with a trade deal, Brexit will cost the Dutch economy around 4.5 billion euros (0.7% of GDP) over the next few years.<sup>4</sup> The job losses in the Netherlands due to Brexit will amount

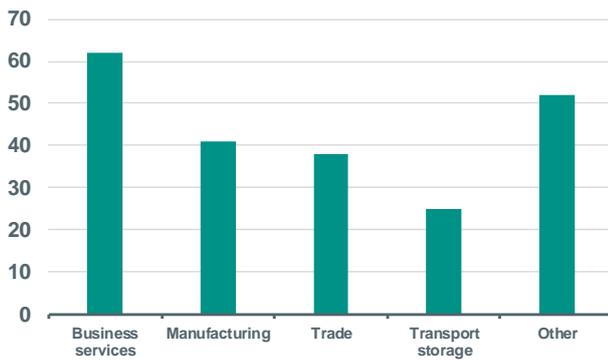
<sup>3</sup> The price elasticity estimations are based on 2019 data and therefore do not include any Covid-19 effects.

<sup>4</sup> For the methodology of the input-output model see [here](#).

to around 17,700. To put this figure in perspective, there are currently 413,000 unemployed (4.4% of the labour force), meaning that Brexit would cause the unemployment rate to rise to 4.6%.<sup>5</sup>

### Business services jobs on the line

Employment related to exports to the UK, labour years (x 1000), 2016



Source: Statistics Netherlands (CBS)

### Positive side effects are not incorporated into the model's results

We have already witnessed a reallocation of activity away from the UK to EU 27 countries, including the Netherlands. For example, in 2019 the European Medicines Agency (EMA) relocated from London to Amsterdam, thereby boosting the pharmaceutical cluster. According to [research](#), the Netherlands is also attractive for service companies in the financial sector, including boutique trading firms, many of which are high-frequency traders, financial market infrastructure facilitators and FinTech companies. While these reallocations are not necessarily leading to large increases in employment in the Netherlands, they may have a positive network effect. Indeed, this is a positive effect of Brexit we expect over the longer term. Other companies may decide to relocate to the Netherlands and there is evidence that these networks tend to spur innovation. Moreover, trade diversion is not taken into account in the model results. Dutch exports to the UK may find different export destinations over time, although the literature shows that these effects are typically low compared to the first-order trade effects. These potential positive side effects of Brexit are extremely hard to quantify and may only materialize over several years. They were therefore not included in the input-output model.

### Negative effects, such as reduced FDI, were also not included and may exceed the positives

Apart from the consequences for trade, Brexit could also trigger changes in investment behaviour. In the long run, trade and foreign direct investment (FDI) go hand in hand. Deep trading relations increase the likelihood that firms will invest in the trading partner's economy. These effects on FDI flows, although less impactful than first-order trade effects, are important to consider when assessing the impact of Brexit.

### Dutch FDI to the UK on a downward trend

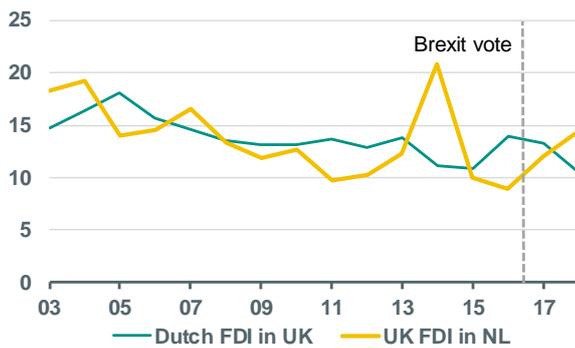
The close trade relations between the EU and the UK are also evident in the FDI flows. The UK is a popular destination for Dutch outward FDI. This reflects the correlation between FDI and trade as well, given that the UK is also a top exporting market for Dutch firms. The left graph below shows that these flows are significant but have declined since the Brexit vote in June 2016. Currently, Dutch FDI to the UK stands at 10% of total FDI, down from 14% at the start of 2016. There is a broader trend of EU firms withdrawing from the UK market, which leads to lower outward FDI from EU countries to the UK, as companies anticipate NTBs and reduced access of UK firms to the EU's single market. It is important to note, as illustrated by the right graph below, that these trends since the Brexit vote in 2016 are less apparent in, for instance, FDI

<sup>5</sup> For a sectoral breakdown see [here](#)

flows between the Netherlands and Germany. This implies they are a result of Brexit. Dutch FDI to Germany also declined slightly, but since this started in 2014, it is likely driven by other longer-term factors.

**FDI flows between the UK and the Netherlands**

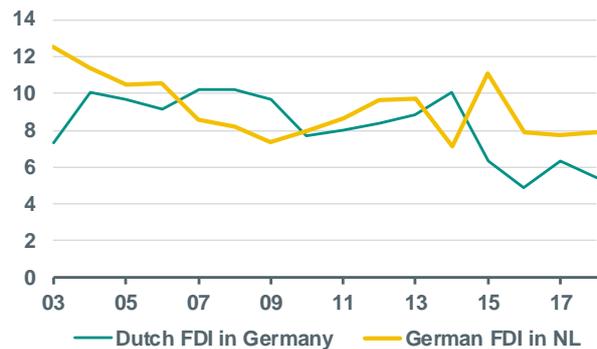
Shares of total Dutch inward and outward flows, 2003 to 2018



Source: Dutch Central Bank (DNB)

**FDI flows between Germany and the Netherlands**

Shares of total Dutch inward and outward flows, 2003 to 2018



Source: Dutch Central Bank (DNB)

**FDI from the UK to Europe will decrease, but this will be dampened by relocation investments in the short run**

UK firms may try to secure European market access by investing abroad. Most of these investments are done to relocate production from the UK to a country within the Single Market, circumventing the increased costs to trade. This can explain the rise in UK FDI to the Netherlands after the Brexit vote as shown in the graph above. We expect this trend to continue. When it comes to supply chain integration, we anticipate a decrease in investment in the UK to diversify production in global value chains (GVC). Because of nontariff barriers, companies have less of an incentive to include these UK-based firms in their supply chains.

Ultimately, however, this shift in production might mainly benefit low-wage countries within the EU and not necessarily the Netherlands. An example of this is the automotive industry. Should automakers decide to relocate, the most likely destination would be Eastern Europe. In this respect, the Netherlands may only benefit from service companies and the relocation of administrative branches, such as corporate headquarters, which are less capital intensive and therefore not accompanied by large FDI flows.

**The most substantial loss will ultimately be in the long term**

All in all, the Netherlands will face short-term losses amounting to around 0.7% of GDP due to a demand reduction resulting from administrative burdens, longer waiting times at the border, and other disruptions. However, more substantial losses for the Netherlands will occur in the long term. These will result from economic adjustments caused by regulatory divergence, which will structurally increase trade costs between the UK and the Netherlands, but also indirectly via trade with other European countries. Relocation effects and effects on FDI will be less impactful but must also be taken into account.

These longer-term effects will lead to a lower growth potential for the Dutch economy. There is a vast body of literature that suggests trade is one of the driving factors for GDP per capita growth. From that perspective, Brexit is a step in the wrong direction. For instance, less competition from UK firms may temporarily benefit Dutch companies in the short term. But from firm-level evidence we know that reduced competition lowers innovation and thereby decreases supply-side efficiency. Still, our analysis does suggest that while hard to quantify, the effects on longer-term potential growth will be relatively small in GDP terms— and much smaller than for the UK. Finally, Brexit – as well as the trade tensions between the US and China – seem to be part of a broader trend of deglobalization. Should this trend persist, it would especially hurt small open

economies such as the Netherlands. The precise ways this this would affect the Netherlands are unclear, but the outcome would be a downward adjustment of the Dutch growth trend in the future.

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