Prospects

20 January 2017

UNITED KINGDOM – So ambitious it could prove unrealistic

- **On 17 January, UK PM Theresa May clarified the broad objectives, but not the details, of her government's plan for the Brexit. The UK will leave the Single Market and the customs union. It will seek a comprehensive free trade agreement (FTA) with the European Union and ambitious trade deals with third countries. May also promised a parliamentary vote on the final terms of the Brexit.**
- **In our opinion, May's ambitions amount to 'cherry-picking' in many respects, which will likely be rebuffed by the EU27. The tone of her speech was not particularly conciliatory. To discourage "punitive" negotiations, May threatened with explicit willingness to use the freedom of the World Trade Organisation (WTO) to cut corporate taxes and set a competitive policy environment.**
- **We continue to believe that the UK will likely manage to gain partial access to the Single Market involving tariff-free trade in most sectors of goods, but not in services. In particular, we expect the financial sector to lose its 'passporting' rights at the end of the two-year period.**
- **Working out the transitional arrangement(s) will be the key element of the negotiation process. In our view, the financial sector could preserve access to the Single Market for some activities during the transition period through equivalence recognition.**

The UK government's plan: wishful thinking, and still cherry-picking

UK Prime Minister, Theresa May, shed further clarity on the government's objectives regarding the Brexit and the path to achieving them, understandably without revealing the details of her negotiating strategy. PM May announced 12 objectives "that amount to one big goal: a new, positive and constructive partnership between Britain and the European Union." Nevertheless, overall, there were no big surprises in her speech and uncertainties remain still regarding key elements of the government's strategy.

The key objectives of the British government

Exit from the Single Market

Exit from the common commercial policy

Control of immigration from Europe

Control of laws

A new, comprehensive, bold and ambitious free-trade agreement with the EU

A new customs agreement with the EU

Cooperation with the EU on crime, terrorism and foreign affairs

Maintaining the common travel area with Ireland

A phased process, delivering a smooth and orderly Brexit

New trade agreements with other countries

Control of immigration rules out Single Market membership

There was no deviation from the "red lines" previously announced by May (control over immigration from the EU and exclusion from the European Court of Justice). As expected, the UK will not seek to remain a member of the Single Market as it would be incompatible with the four fundamental freedoms. This also lowers the probability of a scenario like that of Norway (European Economic Area or EEA membership).

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Ambition for a "truly global Britain" leads to a rejection of customs union membership

The UK will also abandon full customs union membership as it would prevent it from negotiating its own trade deals with third countries. The PM is explicitly aiming to avoid the drawbacks that come with customs union membership, which are the common commercial policy and external tariff. May wishes to negotiate "a completely new customs agreement", which will be "as frictionless as possible". The position of PM May on the exact form of the new customs partnership remains unclear. She suggested an associate membership of the EU customs union or signing up to some elements of it. This could be interpreted as 'cherry-picking' and therefore difficult to obtain.

A clear commitment to negotiating a free trade agreement (FTA)

The UK government is committed to negotiating "a new, comprehensive, bold and ambitious free trade agreement" with the EU, aiming to keep "the freest possible trade in goods and services" with the EU. Starting from scratch could be avoided, according to the PM, as she wishes to maintain elements of the current Single-Market arrangements in certain areas, such as in the automobile industry or the financial services sector.

A "smooth and orderly" path to a hard Brexit

Regarding the time frame for the negotiations, May's objective is to reach an agreement on the "future partnership by the time the two-year Article 50 process has concluded". She also proposed a "phased process of implementation" involving "interim arrangements" in the various sectors and matters (eg, immigration controls, the future legal and regulatory framework for financial services, etc). May made it clear she wants to "avoid a disruptive cliff-edge", delivering a smooth and orderly Brexit.

A lot of open questions remain

May's speech was welcomed by the markets, judging by the surge in the GBP. Its merits were the clarity it brought to the government's objectives and the firm commitment of the UK government to pursue a continued free trade agreement with the EU – which is obviously good for businesses. However, it did little to lift the uncertainty regarding the most complicated and touchy questions, such as the future of the City of London's passporting rights or how to conciliate the aims of Scotland to remain in the Single Market.

While the PM ruled out an "unlimited transitional status", she did not explain how long the implementation period would last. She did not clarify what the UK's position relative to the EU would be during the implementation phase. Continued free trade with the EU is a priority for May, but it will be subject to negotiation and will depend on the willingness of the EU27 to provide it. To discourage "punitive" behaviour from the EU27, May explicitly threatened to use the freedom provided by the WTO to put in place a low-tax regime to attract investment.

Scotland's position remains in the dark

Finally, May's objective to leave the Single Market is contrary to the wish of the Scottish government to remain in the EU. May wants to deliver a Brexit that works for the whole of the United Kingdom, but she has not clarified how she will respond to Scotland's wishes. She was more explicit on Northern Ireland's position, announcing that "a common travel area" would be maintained with the Republic of Ireland. However, how this would be articulated vis-a-vis the immigration controls from the EU remains an open question.

A good deal for the UK or no deal at all

May announced that the final deal with the EU will be submitted to a vote in both Houses of Parliament. However, she did not clarify what would happen if the final deal did not pass the vote in Parliament. She made it clear that "no deal for Britain is better than a bad deal", raising the possibility of the UK leaving the EU on default WTO rules. While Parliament will get a vote on the final deal, that will not offer any possibility of a reversal of Brexit or a renegotiation. If Parliament does not approve the final deal, the UK would be facing a 'cliff edge' exit into WTO rules.

A maximalist list of wishes that could prove unrealistic

To sum up, May's speech had the merit of clarifying the kind of partnership the UK wants with the EU and explicitly ruling out Norway-style membership of the European Economic Area. However, the plan looks too ambitious in our view – a maximalist list of wishes that could prove unrealistic. It does little to reduce the uncertainty regarding the ability of the UK government to achieve its objectives by the end of the negotiations. Furthermore, the tone of the speech was not particularly conciliatory, May having threatened retaliation if the deal is not good for the UK. Hence, the worst-case scenario of WTO rules, though not our central scenario, has strengthened in likelihood, in our view.

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What next? Delays still cannot be ruled out

Parliamentary involvement comes with the risk of delays to the process

We expect Article 50 of the Treaty on European Union (TEU) to be triggered by the end of Q117 as promised. However, there are still potential obstacles ahead. First, the government is facing several legal cases, among which the key one is the Supreme Court's ruling on whether and how Parliament needs to be involved in triggering Article 50 TEU. The decision is imminent, although the precise timing is still unknown.

The Supreme Court is widely expected to uphold the decision of the High Court and to announce that Parliament has to be consulted before the government can invoke Article 50 TEU. The Supreme Court is also expected to decide whether the devolved Parliaments should have a say in the Brexit process, in which case the risk of blockage will be high.

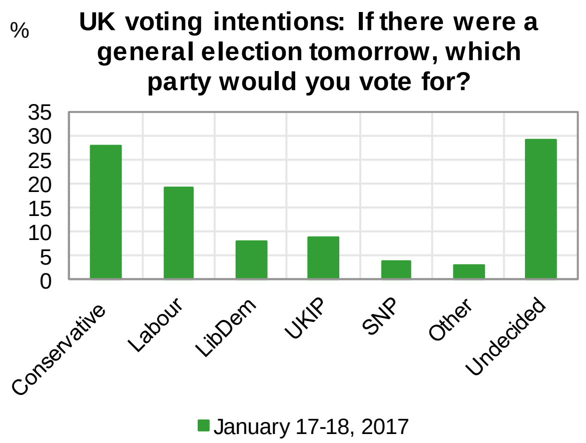
However, if the Supreme Court rules against the government, a legislation bill will need to be debated and approved by Parliament. We believe that the House of Commons will approve it relatively quickly[1]. However, Parliament can still require the government to reveal more details of its strategy; or it could attach conditions to May's plan. Even though it is unlikely to block Article 50 for long, this parliamentary process can potentially delay the invocation of Article 50 TEU.

Risk of an early election remains

Secondly, if Parliament is too slow to approve the bill or attaches too many conditions to it that the government is unwilling to accept, the PM could be tempted to call early elections ahead of the start of formal negotiations. Such a scenario has the merit of avoiding the risk of elections during the Brexit negotiations and will likely reinforce May's popular mandate for implementing Brexit.

Polls suggest that the most likely outcome of an early election would be an increased majority for the Conservative Party. According to the latest YouGov poll, Labour garners only 25% of voting intentions, far behind the 42% of the Conservative party. Meanwhile, polls conducted after May's speech on Brexit show that a majority of the public support the sort of Brexit she is seeking to achieve. The public preference for Theresa May as a Prime Minister relative to Labour leader, Jeremy Corbyn, looks to have increased further since her speech.

[1] On 7 December 2016, the UK Parliament voted overwhelmingly (461 MPs out of 650) in favour of Brexit and endorsed PM May's timetable for beginning talks before the end of March 2017.



Source: YouGov

For an early election to happen, May would have to overcome the Fixed Term Parliament Act (FTPA), which is not an insurmountable hurdle in our view[2]. If an early election were to take place before June 2017, the government would still be able to exit the EU before the next European elections in June 2019. Finally, the proposed Parliamentary vote on the final deal also leaves open the possibility of a government defeat in early 2019 and snap elections.

Our scenario: difficult negotiations ending with reduced access to the Single Market

The scenarios of FTA and WTO have strengthened in probability

May's speech made it clear that the UK government is committed to negotiating a bespoke deal with the EU, whereby the UK abandons participation in the Single Market in favour of partial access to the Single Market through a FTA[3]. At the same time, however, the probability of WTO as a default solution has strengthened as well, not only due to the short time frame and the difficulty in reconciling the extremely distanced positions of the UK and the EU, but also due to the explicit willingness of the PM to adopt the WTO rules if she does not obtain a good deal.

Therefore, May's speech has reinforced the probability of both an FTA and WTO scenario at the expense of EEA membership. Our view remains that we will avoid the worst-case scenario

[2] The FTPA states that an early election is only possible where the government has been defeated in a vote of no confidence and no government is subsequently formed after 14 days, or a two-thirds majority in the House of Commons votes in favour of new election.

[3] Single Market participation is very different from a free trade area or agreement. The Single Market goes further in reducing non-tariff barriers and costs by requiring a 'level playing field' of rules across national boundaries. See IFS (2016) The EU Single Market: The Value of Membership versus Access to the UK

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of WTO, as both the UK and the EU have an economic incentive to avoid disruption in key sectors and supply chains (for more explanation of our scenarios see UK and GBP in times of 'hard Brexit').

The FTA that the UK aims to agree with the EU will need to be approved by the EU Parliament and ratified by the national parliaments of all 28 current member states and in some cases by regional parliaments (like the Canadian FTA in Belgium). The negotiations will probably last five to ten years. Therefore, the FTA is unlikely to take effect before the mid-2020s, making transitional arrangements essential in order to avoid a cliff-edge. In our view, the FTA is likely to involve tariff-free trade in most sectors of goods but no longer provide the UK with Single-Market access for services.

Transition arrangements will be crucial in order to avoid a cliff-edge

The key element of the negotiations will be to agree on transitional arrangements in order to cover the period between the formal exit from the EU (early 2019) and the final FTA coming into force (mid-2020s). Whether the transitional arrangements will be negotiated in parallel with the 'divorce' and at an early stage of the separation process is a key question for the economic agents. From a purely legal point of view, a transitional deal seems consistent with Article 50 TEU, which states that the withdrawal treaty should take account "of the framework for its future relationship with the Union". Understandably, UK-based companies are asking for early transition guarantees. May's objective is also for an agreement on the future relationship to be concluded in a two-year time frame and for interim arrangements to be phased in.

The need for transition terms also offers EU negotiators some leverage. A delayed transition deal would maximise the chances of relocating activities and investment away from the UK. According to press reports, EU negotiators see a transition deal as "an optional extra that can be discussed if and when Britain meets certain conditions: honouring an extra bill of up to EUR60bn (2.5% of GDP) and agreeing on the outline of future relations". In our central scenario we expect the UK and the EU ultimately to agree on transition terms, but likely at a late stage in the process and after having made significant progress on the divorce issues. In 2017, the busy political agenda in the EU makes such progress rather unlikely.

No more passporting rights for the financial sector post Brexit, but a transitional agreement likely

Although May failed to reveal details about her objectives for the financial sector, she seems willing to accept the idea that concessions in terms of access to the Single Market in that area are inevitable. We believe that the most realistic scenario implies that UK-based financial companies will likely lose their passporting rights to the EU upon exit from the Single Market[4]. From the European point of view, a situation whereby a big offshore centre operates freely within the Single Market but escapes EU supervision and regulation is simply ruled out. None of the existing models of relationships with the EU provides passporting rights, except the three members of the European Free Trade Association (EFTA) that participate in the EEA – Norway, Lichtenstein and Iceland. However, for the UK's leading international financial centre, EEA membership would imply bearing the risk of regulation that may at some point become unfavourable without having the possibility of influencing it.

Still, for the transition period (until possible bespoke agreements are concluded), the EU and the UK may agree on Single-Market access for the financial sector based on 'recognition of equivalence'. Currently, UK legislation is equivalent to EU legislation. In theory, therefore, the UK and the EU could agree relatively quickly on continued access to the Single Market for the financial sector provided that the following conditions are met: the UK accepts all the European *acquis* and all the future legislation that comes into force. While this solution may guarantee a continuation of the status quo for some time, it is unlikely to be a viable solution over the long term. Any minor departure from EU rules over time would automatically put Single-Market access at risk. This year, we are likely to see more economic agents preparing for this trip into the unknown and putting a 'Plan B' in place. ■

[4] The passporting regime enables banks and investment companies authorised in an EEA (European Economic Area) state to provide services in other EEA states via a branch or provide services across borders without requiring further authorisations or meeting local regulations.

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