LSE Continental Breakfast 8: ‘follow’, ‘unfriend’ or ‘take a break’? Three Brexit scenarios envisaged

‘Follow’, ‘unfriend’ or ‘take a break’? Reporting on LSE Continental Breakfast discussions held under Chatham House rules among Italian and British economists, policy-makers and the public in Rome in early February 2018, ***Marina Cino Pagliarello (LSE)*** *looks at the economic and political consequences of the three options still open to the UK. She then outlines the possibility of a Brexit that is ‘lost in transition’ due to the apparently irreconcilable demands on each side.*

The clock is ticking down. Almost two years after the referendum, the whole Brexit process is at risk of remaining an empty box. Even though the severe and sudden negative effects anticipated by the so-called ‘project fear’ did not materialise, there is considerable uncertainty around the long-term consequences. Theresa May’s government faces several unresolved political constraints likely to determine the shape of any final agreement. Three potential outcomes are in play:

(i) the UK following a, more or less, flexible EU-oriented agreement model;

(ii) an ‘unfriend’ situation, with a consequent WTO agreement model;

(iii) ‘take a break’, namely postponing the agreement, which might have important implications for the survival of the government itself.

Indeed, one thing is clear: a successful and speedy Brexit delivery is crucial for Theresa May’s political survival.

Short-term economic consequences of Brexit

What happened to the UK economy after the referendum? Even though the economic outlook appears less severe than originally forecast by the Treasury, with current low unemployment rates, and net exports benefiting from the global recovery and the lower pound, several worries and vulnerabilities are accumulating.

To begin with, UK productivity growth is continuing to slow down; the growth rate has fallen since the first quarter of 2017 and UK is lagging behind major EU economies, such as Germany and France. This stagnation is exacerbated by low business investment, due to the uncertain outcome of the negotiations. One of the most visible short term effects of Brexit is banks and other financial services beginning to relocate staff, with Dublin and Frankfurt competing for them. The stock market has also underperformed, with an estimated drop in value of UK-oriented firms listed on the London Stock Exchange of about 20-25% and a clear divergence between companies oriented to the UK and those with an international base. In this respect, regional disparities are also growing, with London by far the most productive area in the UK. According to the “Preparing for Brexit” study commissioned by the Mayor of London from Cambridge Econometrics, this trend is expected to continue whatever the eventual exit scenario.

At the same time, the fall in the exchange rate has added more pressures to household consumption, as they suffer decline in their spending power that might also decrease their savings. According to the Financial Times’ Annual Survey of economists, the majority believe that there will be little or no improvement in UK productivity for 2018 and the Economic Policy Uncertainty Index – measured through the share of articles in the FT and Times discussing key words ‘economics’, ‘policy’, and ‘uncertainty’ – estimated that Brexit raised UK Economic Policy Uncertainty of 200 points on average. This is a significant figure, especially considering that the Great Recession raised the Economic Policy Uncertainty by 100 points.

In the long term, the economic outcomes are much more uncertain and depend on the post-exit trade models and on what kind of economic policies will be adopted by the UK government after the end of the transition period in 2020. In this respect, one thing is clear, given that the EU is the biggest UK trade partner, any reduction of trade will surely lower UK living standards.

'Follow' – or soft Brexit

Under a 'follow' scenario, with the UK joining a free trade area with the EU, similar to Norway (hence enjoying full access to the Single Market with no tariffs on trade but without being a member of the customs union), reduced trade will lower productivity and increase the costs of Brexit to a loss of 6.3% of GDP, about £4,200 per household per year. Indeed, according to LSE Centre for Economic Performance predictions, in this scenario the average UK income is estimated to fall by 1.3% corresponding to a reduction of £850 per household. Regarding non-tariff barriers, intra-EU trade costs are estimated to fall 20% faster than among other OECD countries, with a consequent fall in the cost of non-tariff barriers within the EU of 5.7% in the next ten years. Meanwhile, the current UK budget contribution to the EU according to HM Treasury (2013) is around 0.53% of GDP. Under a scenario in which the UK remains in the EEA, the UK contribution will fall by 17%, corresponding to 0.09% of national income.

However, a 'follow' scenario could be politically toxic for the UK, as it would mean losing control of highly sensitive areas such as migration while simultaneously accepting all the regulatory obligations (as Norway does) designed to reduce non-tariff barriers within the Single Market, without any say in their design. An alternative would be the adoption of a Swiss model, with the UK not being in the EEA – and hence without free trade in services – but negotiating bilateral agreements with the EU while adopting all the regulations covering those parts of the Single Market in which it participates. However, a Swiss solution would ultimately be detrimental to the UK economy, given its comparative advantage in the financial services sector. Additionally, the Swiss model is also a rather conflictual one due to various political sovereignty issues.

'Unfriend' – or hard Brexit

Another post-exit model would be to default to WTO trading rules, without the UK negotiating a new trade relationship with the EU and trading according to the WTO 'most favoured nation' (MFN) system. In this respect, there is little doubt that the greater the obstacles to EU market access, the larger the projected losses and higher trade costs to the UK economy will be, with the emergence of several costs such as custom clearance, border checks and rules of origin costs. Current predictions estimate the costs of this form of Brexit to a loss of 9.5% of GDP in the long-run, with a lowering of household incomes by 2.6%, corresponding to an average of £1,700 per household. High-value manufacturing export sectors (for example pharmaceuticals, cars and chemicals) would be those the most exposed to economic losses.

Under this scenario the UK would be excluded from future EU trade deals, such as the proposed EU-US Transatlantic Trade and Investment Partnership (TTIP) and the economic partnership with Japan, that have been estimated to lower prices by 0.4% through the US agreement and 0.2% in the case of the Japanese one. Outside the Single Market, the UK would be open to greater regulatory loosening, backing out from agreements such as the Renewable Energy Strategy and the entitlement to 20 days paid annual leave within the Working Time Directive. The cost of these regulations (identified as a total of 56) is assumed to be 0.9%.

'Take a break'

Another option would be to postpone the agreement, although in view of the forthcoming European elections in 2019 that might further complicate the negotiation process. On the one hand, the end of the Commission's mandate suggests the existence of an institutional limit in terms of the timeframe for the negotiations. On the other, delaying the transition period might enable the EU to design a tailor-made agreement that might also serve as a template for other Member States in a future multi-speed EU.

However, though this scenario might gain time and frame future relations in a more sustainable way, it could be politically explosive for Theresa May. Public opinion is very focused on the key question of "when is Brexit?" and less keen on understanding technocratic reasons as justifications for another delay. May's position is exacerbated by the need to keep the government cohesive by promising to leave the Single Market and the Custom Union while remaining the EU's 'best friend' in a still highly ambiguously framed partnership. Any concessions to the EU in sensitive domains, such as migration, would surely bring a major rebellion within the Conservative party.

Although opinion polls reveal that voters have not really changed their minds since the referendum, but rather have formed a new sense of identity around "Leavers" and "Remainers", public opinion is nevertheless swinging towards holding another vote on the final terms of the agreement. Indeed, a recent Guardian/ICM survey found a quarter of those who voted Leave would like to have another referendum when the final deal is on the table. As a result, and for all these reasons, an unstable political climate could further foster an increased sense of political conflict and an antagonistic relationship between the "us" – UK – and "them" – the European Union.

Furthermore, according to Michel Barnier, a 'special' deal is not on the agenda, meaning the UK will not be allowed to cherry-pick the most beneficial aspects of the Single Market. Given all these uncertainties, it is easy to imagine a scenario where Brexit seems to be incomplete for an extended period of time, and becomes still more confusing for an increasingly divided, uncertain and concerned public. A more likely scenario might be that rather than an explicit break, we see a protracted set of negotiations in which it is less clear when and how Brexit will occur.

Brexit: 'lost in transition'?

A February UK position paper seemed to indicate the possibility of a longer transition period in order to get a better trade deal. But that would depend on putting the European Commission's basic principles into practice, with decisions on several critical questions – such as the budget, EU citizens' rights and, above all, the thorny Irish problem. At the core of the Irish issue is the impossibility of reconciling three demands: (i) no border between Northern Ireland and Ireland; (ii) no border between Northern Ireland and UK and (iii) the UK not being in the custom union. Put simply, as long as the UK intends to leave the customs union, the Irish question cannot be solved. Indeed, though both Barnier and the Brexit secretary David Davis appear to agree that it can be negotiated at a later stage, they seem to overlook how politically explosive it is, given the government's dependence on the unionist party DUP to push through parliamentary votes. This could be the factor that brings the government down. Until the EU and the UK search for common ground on how to reconcile their agendas, a 'lost in transition' scenario appears the most likely.

This post represents a report on discussions, and does not represent the views of the Brexit blog, nor the LSE.

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