

The road to nowhere? Prospects for a post-Brexit trade deal

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The Brexit negotiations continue towards an inevitable showdown, most probably at the EU Summit in December 2018. Faced with a choice between the Withdrawal Agreement (WA) and a ‘no-deal’ scenario, the United Kingdom will – most likely – choose not to commit economic suicide. The transition period, which will be included in the WA, will buy some time to negotiate the post-Brexit relationship. However, the next phase of negotiations will not be any easier: the UK and the EU will find it virtually impossible to agree on a trade deal. As a consequence, at the end of the transition period, the cliff edge will loom again. But there is an alternative – not to leave the Single Market and Customs Union after all.

BACKGROUND – WHAT LONG-TERM FUTURE RELATIONSHIP?

A deep and special relationship?

Ever since the UK voted to leave the EU on 23 June 2016, the question what the long-term economic relationship between the UK and the EU will look like has been on everybody’s mind. But progress has been slow. The EU has insisted on sequencing – determining the exit modalities before the discussion on the future relationship – and has made it clear that the UK cannot have its cake and eat it too, i.e. having the benefits of membership while leaving the Union. Although the UK had stated that it aimed for a “deep and special relationship”, any tentative proposal from London has been (and will continue to be) challenged by an opposite faction of the Conservative Party. The latest ideas put forward in the so-called ‘Chequers proposition’ appear to break EU red lines such as the indivisibility of the Single Market and are thus very unlikely to materialise.

At the same time, London has set two crucial red lines: first, the UK will exit both the Customs Union (CU) and Single Market (SM). Second, EU regulations and jurisdictions will cease to apply. While in the past few months there has been an intensive domestic debate on how the UK can stay as close as possible to the CU, so far these UK red lines have not changed. From an EU perspective, this implies that the future relationship will have to be defined by a trade deal, similar to the bilateral agreements concluded with Japan or Canada. Economically, such trade deals are significantly inferior to membership of the Single Market, as they are more limited in scope – broadly excluding services – with integrated markets not being the default.

A frictionless border with Northern Ireland?

An exit from the CU and the SM also creates significant dilemmas regarding the border between the Republic of Ireland and Northern Ireland. Both the EU and the UK have committed to keeping this border frictionless without physical infrastructure. But so far the UK has failed to come up with a viable solution that is compatible with its red lines. The so-called backstop, which the EU insists on including in the WA, would see Northern Ireland effectively remaining in the CU and SM – implying a customs border in the Irish Sea – if the UK cannot come up with an alternative solution that guarantees a frictionless border.

Many in the UK see this outcome as politically unacceptable. For this reason, the UK Government has been looking into possible customs arrangements for the UK as a whole, as well as regulatory alignment. The partial proposals have so far failed to convince the EU27, in part because they involve agreeing on and creating new and untested governance arrangements.

Thus, unless the UK changes its red lines, the negotiations will focus on a free trade agreement. In any case, the talks on the details of the future relationship have to start after Brexit since Brussels can only engage in trade discussions with third countries. The only reference to the future relationship will be in the political declaration, which is merely a statement of intent.

STATE OF PLAY – THE REMAINING HURDLES

To get to the negotiations on the future relationship, the UK will have to accept the WA, including the backstop. Post-Brexit, it foresees a transition - or standstill – period until the end of 2020, in which all the provisions of the Customs Union and the Single Market will continue to apply, but the UK will no longer have political representation in the Union's institutions. Any agreement on the long-term relationship will have to be concluded before the end of the transition period, although there might be the possibility of a limited extension (one year or so) if it is built into the WA. However, even then, there would be little time to negotiate a trade deal.

There is still the possibility that the process will be altered or stopped by Westminster. There is currently no majority for a hard Brexit. But time is running out. Prime Minister May will probably be able to force through the WA when the UK faces the choice between that agreement or no deal at all, which would be economically and politically disastrous for the UK. Theresa May will need to rely on the votes of the Conservative Party, which means that she will probably not offer a soft Brexit given the strength of the Eurosceptic wing within her party. But even if the UK moves closer to a soft Brexit, the only place to include an aspiration for a closer relationship would be in the political declaration. The EU27 might well be willing to accommodate such a change in political direction as long as it does not imply a weakening of EU principles, such as the indivisibility of the Single Market. It will then be up to the negotiations on the long-term relations to deliver. They will, however, be much harder than most commentators seem to expect.

PROSPECTS – TOWARDS THE CLIFF EDGE ONCE AGAIN

Beyond Brexit: getting more, not less complicated

If the WA is agreed, the post Brexit transition period will be the time in which to negotiate the long-term relationship, starting from the aspirations set out in the political declaration that accompanies the WA. For many, this will be a relief, expecting that negotiations will advance more quickly once the Article 50 issues are out of the way. But this is unlikely to be the case. Presciently, in October last year, Angela Merkel noted that “the second stage [...] is undeniably going to be more complicated than the first stage”.¹

The process will start by setting the final goal of the negotiations, i.e. the landing zone that is crucial in defining the negotiation process. It is easy for both sides to agree that there should be a deep and comprehensive trade deal, together with a customs partnership. But this does not imply that the negotiations will produce a Norway+ agreement. As long as the UK red lines (leaving the CU and the SM) and those of the EU27 (the benefits of the SM and the CU can only be granted to countries fully committed to both and respecting all obligations such as Freedom of Movement) the most integrated solution the negotiations can reach is a Canada+ arrangement. In other words, the only workable solution appears to be an ambitious and far-reaching free trade agreement. But even if it is the best and most comprehensive trade deal the EU has ever struck, it is still a long way short of being inside the Single Market. And it is far from certain that both sides can agree on such a trade deal.

Agreeing on a disintegration deal

One of the critical challenges is time. Negotiating a comprehensive and ambitious agreement will take longer than the 21 months of the transition period.² Even an extension of the transition by a year or so will probably not be enough, especially since the beginning is likely to be slow: in 2019, the upcoming changes at the helm of EU institutions (Parliament, Commission, and Council) are expected to delay substantive progress.

But time is not the only problem. There are other reasons why concluding a free trade agreement will be challenging:

1. First, on the EU side, the negotiations will become more technical, driven by different negotiation teams for each topic (e.g. trade, security, justice and home affairs). The experienced EU negotiators will be subject to much less political pressure to compromise. They will also benefit from a much stronger mandate to deliver on the specific objectives of each member state, which will amount to a long wish list containing many politically tricky issues for the UK, including for example Gibraltar or fisheries. Conversely, there will be vested interests in the EU that will put pressure on the negotiations to broadly exclude certain sectors, for example, Financial Services. Furthermore, the EU may impose constraints on the UK's ability to set its own policies post-Brexit as the EU could see the latter as threatening the level playing field, i.e. fair and open competition post-Brexit.

2. Second, the scope of the negotiations will be much broader given the breadth and width of the existing UK-EU relationship. Tactical exclusion of certain sectors

¹ <https://www.theguardian.com/politics/2017/oct/20/brexit-trade-talks-more-complicated-than-first-phase-angela-merkel>

² For example, CETA, the Canada-EU deal, took seven years to negotiate.

or issues, usually a vital tool in trade, is not possible. Moreover, there are many cross-cutting issues, such as data transfers or currently joint regulatory institutions, which will play a significant role given the intricacy of the UK-EU relationship. It also extends to level playing field provisions, where the EU is likely to demand more from the UK than from other trading partners.

3. Third, there is also a big world out there. Any privileged and integrated relationship between the EU and the UK will have repercussions on their respective trading with third parties. In a nutshell, under the WTO's Most Favoured Nations provisions, special privileges afforded to one country must be provided to all trading partners that have comprehensive trade agreements with the EU or the UK. Besides, maintaining access to EU markets will impose limitations on the UK's trade deals with other third countries.

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Any deal will have to be ratified by both sides. If it is a comprehensive trade deal, i.e. a mixed agreement, it will entail a complicated EU ratification process, with a requirement for unanimity even down to regional parliaments in some countries (e.g. Belgium). Any UK government will struggle to convince Westminster that such a trade deal is the only option on the table. For many, especially on the soft Brexit side, it will look like a terrible deal when compared to the *status quo*. But the Brexiteers are also likely to balk at such a one-sided agreement. And for Northern Ireland, it could well imply the backstop coming into force.

Between a rock and a hard place

This dilemma puts significant pressure on the UK, with a post-transition default outcome of 'no trade deal' with all the asymmetric costs this implies. Even if failing to sign a trade pact at the end of transition is not as disastrous as leaving without a WA now (as

more contingencies can be put into place), for the UK, the economic costs would still be enormous. On the EU side, costs would be much lower. While there would be economic interests pushing for a deal on the long-term relationship, for any of the EU27, there might also be a countervailing incentive to torpedo the whole deal if their interests are not delivered. Disunity among the 27, which arguably would have helped the UK in the Article 50 negotiations, thus becomes an impediment for reaching a deal.

No trade deal at the end of transition is an unacceptable option. Business leaders will explain that it will cost jobs and growth when integrated supply chains become impossible. Even the possibility of no trade deal will have a significant impact, leading to sharp and painful reductions in business investment, trade and, ultimately, growth and jobs. And there will be little evidence to suggest that the alleged benefits from Brexit, especially concerning international trade, are likely to materialise. Consequently, the supporters of a soft Brexit on both sides of the political spectrum will continue to threaten the majority of the Conservative government.

The Northern Ireland issue remains unresolved as well, with the backstop looming if the UK cannot find a highly integrated customs and regulatory solution that would ensure a frictionless border (such as being inside the SM and CU). With no trade deal, a frictionless border becomes impossible, implying a customs border between mainland UK and Northern Ireland after the transition. Such an outcome is unacceptable for the DUP that provides the votes to maintain Mrs May's majority.

A changing wind?

There remains only one possible solution: staying in the SM and the CU, i.e. putting a "Norway+"³ arrangement back on the negotiation table. It offers minimal economic disruption after the transition and ensures that the NI border remains frictionless.

It would require, however, a fundamental change in the UK political debate since it would virtually break every red line of the Brexiteers, from accepting Freedom of Movement of people to relinquishing the possibility of an independent commercial policy. In essence, it would imply becoming a rule-taker. Even if it were dressed up as a 'special and unique' arrangement, it would demand a momentous change in British politics.

For the moment, many voices across the political spectrum argue strongly against this outcome. Brexiteers claim that this does not represent a real Brexit. Corbyn and others in the Labour Party fear that such a deal would constrain the UK in its domestic policies. But there are already signs that positions are

³ Here defined as an economic deal that ensures the UK remains effectively in the Single Market and the Customs Union.

starting to shift towards a softer Brexit in light of the threatening prospect of a 'no trade deal' cliff edge.

A cross-party alliance supported by business and trade unions could argue that, given that Brexit has happened, a soft landing in the form of Norway+ is the best possible option to minimise economic costs.

In March 2019, Brexit will have become a reality. The British government will have delivered on the result of the referendum. After Brexit, there could be a general inclination to maintain the *status quo* and put an end to the upending of the UK's economy. A cross-party alliance supported by business and trade unions could argue that, given that Brexit has happened, a soft landing in the form of Norway+ is the best possible option to minimise economic costs.

This shift in the political wind could be triggered when the need for an extension of the transition period becomes apparent. If the UK has to ask for an extension, it will highlight that the trade negotiations are not advancing as fast as they should. The cliff edge would, once again, put pressure on the social and economic expectations of businesses and workers alike. Controversially, any extension of the transition would commit the UK to contribute more to the EU budget, demonstrating that the costs of maintaining economic integration are much less significant than those implied by no deal or a hard Brexit. At that point, the most compelling argument could be to preserve the *status quo* for the long term.

Be prepared

Even if the wind changes, concluding a Norway+ deal will not be easy. Some of the barriers noted above, however, will become less difficult: an existing institutional and legal framework would merely have to be adapted. But doing so would still take time.

That's why preparations for such a scenario must start now. Neither the European Commission nor the UK Government can start the drafting of such a solution until it is officially back on the table. Civil society, business and think tanks must take the lead. Since it is the only feasible path to avoid the prospect of not having a trade arrangement at the end of the transition period, it is worth investing now to minimise economic disruptions for both the UK and the EU27.

Will this be a long-term solution? Probably not. It is hard to believe the UK would remain as a permanent rule-taker, even if it will wield its soft power effectively. But the Norway+ option offers a solution if the UK becomes dissatisfied with its status: the application for full membership of the European Union. Maybe, in the long run, membership of the EEA might provide a soft interlude for the UK to regain membership in future. Currently, the Norway+ option remains the sole scenario that could stop the Brexit process from becoming ever more destructive and painful for all concerned.

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The BrexitForum@EPC looks at the implications and potential consequences for those who will find themselves outside the Single Market but seek ways to influence its direction in the future as well. EPC analysts and other experts are providing insights and expertise with a view to helping them prepare for the post-Brexit era. Findings from discussions and related publications will provide participants with a better understanding of the UK's future relationship with the EU.