CONTINENTAL BREAKFASTS

The LSE Continental breakfasts are one element of a wider academic programme that aims to understand and inform the process of agreeing Britain's future relationship with the rest of Europe. The breakfasts are private, off-the-record meetings for a select group of distinguished individuals from around the world. They bring together LSE's most renowned academic experts with a diverse group of insightful and influential people to explore key issues shaping the European political landscape.

Meetings are held under Chatham House rules, so that opinions expressed may be reported but not attributed. These seminar-style events typically open with short presentations from two experts, one of which is usually a member of the LSE faculty, followed by open discussion among the group.

In these write-ups, issues raised in the discussions are collected into an essay including references to relevant research and exploring some questions in more depth. The authors are encouraged to elaborate and reflect, so they should not be read as an unvarnished record of the discussion.

Rupture: The business consequences of a breakdown in the Brexit negotiation

London, February 22, 2018 **Written up by Angelos Angelou**

The seminar focused on discussing the potential implications that a breakdown of the BREXIT negotiations would have for UK businesses. The overall message was that such a breakdown – i.e. a "no deal" outcome- would have severe implications for British businesses and the financial community.

A "no deal" outcome would be an economic disaster for most UK businesses. This is so primarily because almost 90% of total British exports would be affected by tariffs, costing a total of £40 billion. In addition to this amount the imposition of tariffs would have spill over effects for other sectors, like the food and drink industry that is estimated to suffer 20% of extra costs (CBI 2016). At the same time a potential breakdown of the negotiations would entail the exposure of UK businesses to increased exchange rate risks. The term "exchange rate risks" refers to the effect of unexpected exchange rate variations on a firm's value. (Papaioannou 2006: 4). In the aftermath of BREXIT, the pound dropped more than 10% against the US dollar and continued its declining course for the following days until it reached its lowest level against the dollar for the last 30 years, at $1.3 to £1 (The CityUK 2016a: 16). In the event of a no-deal the uncertainty over the economic relationship between the UK and the EU may lead the pound to a new low. Such an outcome would entail losses for multinational firms that are based in the UK since they are more exposed to exchange rate volatility, due to their international character (Papaioannou 2016: 4). It would also entail risks for UK firms that have international operations. While a further fall of the pound may offset some of the new tariffs that they will be facing, their production costs might also rise given the higher import cost of raw materials and the relative unattractiveness of British wages for foreign workers (Research & Information service of NI Assembly etc.2016:47). Moreover, in the event of a no-deal, British consumers would see their purchasing power eroded due to import tariffs. In addition to tariff-related costs a "no-deal" outcome would lead to the imposition of non-tariff barriers (like "rules of origin" regulations), that would end up costing three times more than the above-described tariffs. Non-tariff barriers would make British businesses less competitive since they would deprive them from the ability to conduct prompt and low-cost transactions with the rest of the EU. All in all, such trade-limiting outcomes might lead the UK per capita income to fall by 6.3%-9.5% (Dhingra and al. 2016).

The problems related to tariff and non-tariff barriers would be even more acute for businesses operating between the Republic of Ireland and Northern Ireland (Research & Information service of NI Assembly etc.2016: 47-48). Such enterprises have developed their operational model upon the assumption that cross-border transactions can be conducted promptly and with minimal cost inside the European Single Market (Centre for Cross Border Studies 2016). If the BREXIT negotiations end in a standstill these business plans will have to change radically due to the emergence of a hard border (Research & Information service of NI Assembly etc.2016: 47-54). Apart from the obvious economic implications of such a development, the dynamics on which the peace agreement has been based may change since the economic interdependence between the two sides will start declining (Research & Information service of NI Assembly etc.2016: 25-28). The fear of a hard border, and its subsequent economic and political implications, has incentivized prominent figures on the British side to argue in favor of the closest possible alignment between EU and UK standards (Parker and Barker, 2018).

In addition to the imposition of trade barriers, the possibility of a negotiation breakdown also increases the uncertainty over the status of EU workers in British firms. The rights of EU citizens that are employed in Britain are not guaranteed if the EU and the UK fail to reach a final deal (House of Commons Library and etc. 2016: 105-106). Increased uncertainty over the employment status of EU citizens may lead to substantial outflows of skilled labour. Such a development would be negative for the overall growth capacity of the UK economy, since EU migrants are generally younger and more educated compared to UK employees. Consequently, they tend to raise capital productivity via knowledge spill overs and higher human capital stock (Wadsworth and al. 2016).

Moving to the financial services sector, the implications of a 'no deal' are bound to be significant. This is primarily because all financial service providers will lose their passporting rights, i.e. the ability of a firm that has been licensed by one EU member-state to provide cross-border services to other EU member-states without getting additional authorization from the local regulators. By not being in the European Single Market (ESM), UK financial firms will not be allowed to conduct financial operations inside the ESM (House of Commons Library and etc. 2016: 40). "Passporting" has allowed many of the world's leading financial institutions to operate in the EU with low bureaucratic and economic costs. As UK Trade and Investment has noted, the UK has attracted the biggest number of headquarter-based investments in the EU (UK Trade and Investment 2015, The CityUK 2016a: 18). A no deal would signify that all UK-based financial firms would immediately lose their "passporting" rights and, potentially face third-country rules. Facing such a set of rules usually means that the respective country has partial access to the single market, while the type of access is almost unilaterally decided by the Commission and can be ceased or changed at any time.

If the UK ends up with a third country status the economic impact is estimated to be significant. Around 50% of the UK's EU-related economic activity- with a total worth of 20 billion £-, 35,000 jobs, and around 3-5 billion of tax revenues will be under threat (Oliver Wyman 2016: 2). Being downgraded to a third-country status also implies that the UK will be left outside all EU decision-making centers and will end up being a rule taker, meaning it will lose any source of political or technical leverage over issues of financial governance and regulation (Howarth and Quaglia 2017:161, Moloney 2018: 63). To add insult to injury the EU, and especially the European Parliament, appears to be unreceptive to the idea of a bespoke deal vis-à-vis financial regulation. This is also evident from the fact that the relevant EU authorities (ESAs and ESMA) that are responsible for the regulation of the financial markets are powering up in order to cope with the challenges that will arise if the UK falls under the status of a third country (Moloney 2018: 72-73, 106-107). Moreover, a number of other European financial centers like Amsterdam, Dublin, Frankfurt, Paris and Madrid have positioned themselves as the next centres for passporting-based activities (Moloney 2018: 82). This would also mean that the UK would have to follow the EU preferences vis-à-vis financial regulation (Kern 2018: 132). These preferences are most likely to move in the other direction to the respective UK preferences on the issue. Britain, along with other EU countries with substantial international presence and stronger capital markets (e.g. the Netherlands) has been advocating for a style of EU governance that is supportive of enhanced market access, liberalization and open market substitutes instead of intervention. Opposing these views are countries like France, Spain and Italy. They usually favour a more interventionist approach and are supportive of further regulation. Given that the UK will cease being part of the former group we may see the further empowerment of the latter coalition and hence a stronger shift towards further regulation (Moloney 2018:67-68).

Another major concern for UK firms, both in finance and in manufacturing, has to do with the legal limbo that will be created if the BREXIT negotiations break down. This is so because a number of international deals that have been signed by the EU on behalf of the UK will stop covering British firms. Replacing these deals, especially in the field of finance, would require much time and effort, with a characteristic example being the EU-US international agreement on derivatives contracts (House of Commons Library and etc. 2016:39-41). Given that the UK derivative market is the biggest one in Europe, it is evident that a no-deal will have immediate and substantial economic implications for this market (Lannoo, 2016).

Last but not least, uncertainty over the outcome of the negotiations also appears to affect negatively the amount of investment and growth in Britain. As Michael Ellington and Costas Milas (2016) have argued investment uncertainty has adverse implications for an economy's productivity. The uncertainty that followed the referendum result and the current uncertainty about the state of the negotiations are potentially delaying investment and therefore also the recovery in UK productivity. Current investment dynamics appear to support this hypothesis. While during the last few months there has been a GDP rise in the UK, the positive state of the global economy would have justified an even bigger increase. At the second quarter of 2016 it was estimated that UK GDP rose faster than expected amounting to 0.6, with services and production driving this trend (The CityUK 2016a: 15). On the other hand, construction has contracted, while consumer confidence and, subsequently, consumer spending also fell by 0.3. in 2017 (Office of National statistics 2017). The fall of consumer spending is of particular importance since, until before the referendum, consumer spending was driving GDP growth (The CityUK 2016a: 15). All in all, it can be argued that the possibility of a 'no deal' is acting like a handbrake to the growth momentum of the British economy.

Given the uncertainty over the outcome of the BREXIT talks and the difficulty that the two parties have to agree on a transition deal, most UK businesses have started making contingency plans (Oliver Wyman 2016: 16). Around 60% of British companies already have such plans in place, of which 10% have already taken some practical steps (e.g. moving personnel that may be affected by a 'no deal'). Another 25% of these companies are expected to take similar steps in the near future. It is important to note that if a transition deal is not in place by March 2018, the managing directors of most UK-based companies have a legal obligation to take pre-emptive actions, including moving out of the country, given the very visible risks that would be in sight (New Financial 2016).

The EU partners and the UK government both appear to understand that a no-deal entails grave implications for both sides. In particular, regarding the field of financial regulation it is quite possible that the two parties will take steps towards the establishment of a transitional status quo that will protect their existing systems of financial regulation. In order to facilitate the overall process, European and UK businesses are actively working to provide evidence-based suggestions on how a mutually beneficial deal might look. At the same time, UK businesses are urging both parties to make compromises.

From the business perspective, the negotiators' first and foremost priority should be the establishment of a "transition" deal that would mitigate, even partially, the current uncertainty. It is important to establish a clear roadmap for the transition phase with clear conditions and rules that would allow businesses to shape stable expectations (Oliver Wyman 2016:15, CBI 2016). Such a deal should be in place by the end of March 2018 and it should be answering a number of policy questions mapping out the general shape of the EU-UK relationship, whether the UK will be in the customs union, which EU regulations will the UK incorporate in its own legal order and how compatible will be the British and the European financial system.

For the UK business community, the ideal deal would grant barrier-free access to the European Single Market (CBI 2016). However, seeing the current state of the negotiation the most realistic and, also optimal, solution, seems for the UK to be in a customs union with the EU. That would allow businesses to avoid many tariff and non-tariff barriers and would also allow the government to control the free movement of people (Springford 2016). Moreover, looking at similar current deals, like the one between EU and Turkey, one could see that the quid pro quo that may be required from the UK for such an option would be far less burdensome in comparison to the one that would be required if it were to stay in the Single Market after BREXIT. For example, such a deal would not have to cover all economic sectors (in the EU-Turkey deal agricultural products are excepted), it would not require the UK to pay any fees to the EU and, most importantly, it would not require the UK government to accept freedom of movement. On the other hand, Britain would have to align its trade policy with the EU's, while not having any say in it (Clifford Chance and CBI 2017: 21).

For the financial sector a positive BREXIT deal should ensure that EU and UK regulations are as closely aligned as possible and that UK financial firms have access to the Single Market, retaining their passporting rights (The CityUK 2016b). The conditions to reach such a deal are already in place since the latest developments in the EU have led to a more centralized EU system of financial regulation – a trend that will be intensified with Brexit (Moloney 2018: 85, 98). Hence it would be simpler for the UK to conclude a single comprehensive deal with all EU member-states. One mechanism via which the compatibility of the two industries can be ensured is via the establishment of British subsidiary companies in continental Europe; which would allow for a system of managed divergence. Such a system, though, would entail costs since establishing subsidiaries requires abiding by the requirements of the respective member-state. Hence, British companies would still need to comply with the corporate and market governance regulations of the respective country and its respective capital requirements. Of course, such a development would also have negative implications for the European financial market, since it will lead to increased fragmentation and higher refinancing costs for local EU banks (Lannoo 2016).

An alternative to the option of managed divergence would be the establishment of a system of equivalence. The system of equivalence, which the EU has granted to certain third countries, offers the possibility for non-EU firms to access the EU market provided that the regulatory regime of their country of origin is equivalent to the EU regime (Lannoo, 2016). Such an option would imply that the UK would still need to follow EU regulations while it has no influence over these standards. Furthermore, the regime of equivalence would only partially cover the field of financial services- for example it will not apply to the field of asset management, lending and deposit-taking. It is also important to note that the process of granting equivalence to a third country is a highly politicized one. Its approval is generally political, and the European Commission can decide and revoke the regime of equivalence unilaterally whenever it sees fit (Howarth and Quaglia 2017: 162, Kern 2018: 140-141). Last but not least another solution that has been brought up in the public debate, has to do with Britain's participation in the European Economic Area (EEA). By participating in the EEA, UK-based firms would still be able to use passporting since they would still have unrestrained access to the Single Market. However, for such a solution to apply it would be necessary for the EEA and the EU to agree on the powers of the European Supervisory Authorities. At the same time the UK would not be a member of the customs union - meaning that its businesses would be subject to burdensome rules of origins regulations - and would not have any voting rights in the EU institutions. Moreover, the UK would still need to follow EU rules. Such an option is politically less feasible since it would require the four freedoms- of movement of goods, services, labour and capital- to remain in place and hence the British government would be unable to limit the free movement of people, which it has declared is its priority.(Howarth and Quaglia 2017: 160, Kern 2018: 115).

A “no-decision” deal or a breakdown of the negotiations might seem an appealing option for numerous politicians on both sides. This is so because from the British side the pro-leave politicians would prefer to see a breakdown of the negotiations or a no-deal outcome if they cannot substantially control the free movement of people. Meanwhile, EU politicians would like to avoid giving the UK access to the single financial market, including passporting, without getting any substantial concessions. Such a deal would be seen as the kind of ‘pick and choose’ that has been ruled out by EU negotiators (Howarth and Quaglia 2017: 162). Seeing this dynamic the UK business and financial community appears determined not to allow the negotiations to break down, since that would be the worst outcome for them. Subsequently, they have formulated a careful and perhaps less vehement campaign of public advocacy in order to get their desired deal. This strategy is in stark contrast to their pre-referendum tactic, where a number of enterprises and business corporations joined the Remain campaign and produced evidence-based justifications on why the UK should stay in the EU (Howarth and Quaglia 2017:158). Seeing the limited effectiveness of this strategy, the UK business and financial community chose a subtler approach in order to avoid driving public opinion against their preferred deal due to the popular discontent that usually accompanies business-sponsored proposals.

All in all, the final deal should strike a fine balance between access to the European market and border control. In that sense it is bound to be an agreement unlike any other that we have seen until now (The CityUK 2016a :3, CBI 2016). Following this admission, drawing from the respective agreements between EU and Norway and EU and Canada has limited analytical value. Businesses in the UK need a more secure environment to operate in and for this reason they need guarantees that the transition phase will be managed properly and that a final deal will be reached.

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