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.

The economic consequences of Brexit and future agreement scenarios: 'follow', 'unfriend' or 'take a break'?

Based on meetings in Rome, February 2, 2018

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The clock is ticking down. Almost two years after the referendum with the official exit date approaching in March 2019, the whole Brexit process is at risk of remaining an empty box. Even though on a short-term horizon the severe and sudden negative effects anticipated by the so-called 'project fear' did not materialise (Begg, 2018a), there is considerable uncertainty around the long-term consequences, with Theresa May's government dealing with several still unresolved political constraints likely to determine the shape of any final agreement. Drawing upon a debate among Italian and UK economists and a public panel attended by policy makers as well, the following essay analyses the economic consequences of Brexit in the short term, and then turns to the economic consequences and political implications of three potential future agreements: (i) the UK following a, more or less, flexible EU-oriented agreement model; (ii) an 'unfriend' situation, with a consequent WTO agreement model; or (iii) 'take a break', namely postponing the agreement, which in turn might have important implications on the survival of the government itself. Indeed, within the political uncertainty on the Brexit future deal, 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 gradually accumulating.

To begin with, UK productivity growth is continuing to slow down; the growth rate fell from a quarterly average of 0,5% to just over 0,3% since the first quarter of 2017 and UK is lagging behind major EU economies, such as Germany and France (Begg, 2018b; Begg, 2017a). This stagnation is also exacerbated by low business investment, due to the uncertain outcome of the negotiations (Begg, 2018a). 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. (FT, 17th January 2018). In this respect, regional disparities are also growing and exhibiting a huge geographical division with London being the most productive area in the UK. According to the "Preparing for Brexit" study commissioned by the Mayor of London from Cambridge Econometrics (2018), this trend is also expected to continue whichever is the eventual exit scenario.

At the same time, the fall in the exchange rate has added more pressures to households' consumption, as they are suffering decline in their spending power that might also decrease their savings (Begg, 2018a). According to the Financial Times' Annual Survey of economists, the majority of them believes that there will be no or little improvement in UK productivity for 2018 (FT, 1st of January 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 (Baker, Bloom and Davies, 2016).

However, the economic consequences of Brexit under a more long-term perspective are much more uncertain and they 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 (Dhingra et al. 2016).

'Follow' or the 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 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 (Dhingra et al. 2016). Indeed, according to the predictions of the LSE Centre for the Economic Performance, in this scenario, the average UK income is estimated to fall by 1.3% corresponding to a reduction of £850 per household (Dhingra et al. 2016). 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, UK contribution will fall by 17%, corresponding to the 0,09% of national income (see also Dhingra et al. 2016).

However, a 'follow' scenario could be politically toxic for the UK, as it would mean losing control in highly sensitive areas such as migration while simultaneously accepting all the regulatory obligations as Norway does, being compelled to adopt wholesale all policies and regulations designed to reduce non-tariff barriers within the Single Market without any say in their design. Another 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 a detriment to the UK economy, given its comparative advantage in the financial services sector (Dhingra et al. 2016). Additionally, the Swiss model is also a rather conflictual one due to various political sovereignty issues around being essentially compelled to copy EU law and allow free movement of people or else face trade restrictions (Bolet, 2017).

'Unfriend' or the hard Brexit

Another potential 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 (Dhingra et al. 2017) . 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 (*Papalexatou, 2017).* 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 (Dhingra et al. 2106). High-value manufacturing export sectors (for example pharmaceuticals, cars and chemicals) would be those the most exposed to economic losses (Legrain, 2018).

One implication of this scenario for the UK is that it would be excluded from future EU trade deals, such as for instance 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 (Breinlich et al. 2016). 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 pain annual leave within the Working Time Directive. The cost of these regulations (identified as a total of 56) is assumed to be 0,9% (Dhingra et al. 2016; Crafts, 2016).

'Take a break'

Finally, another option would be postponing 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 time-frame for the negotiations. On the other, delaying the transition period might also enable the EU to design a tailor-made agreement that might also serve as a template for other Member States in a future multispeed EU. However, even though this scenario might help to gain time and frame the future relations in a more sustainable way, it could nevertheless 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, with May's position 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. Additionally, any concessions to the EU in sensitive domains, such as migration, would surely bring a major rebellion within the party and could be political suicide for Theresa May.

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" (Brexit and public opinion, 2018), public opinion is nevertheless swinging towards holding another vote on the final terms of the agreement. Indeed, a recent Guardian/ICM survey reports that one-quarter of those who voted Leave would like to have another referendum when the final deal will be officially on the table (The Guardian, 26th January, 2018). 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 that the UK will not be allowed to cherry-pick the most beneficial aspects of the Single Market to make a trade deal with the EU (Prospect magazine, December 2017). Therefore, given all these uncertainties, it is easy to imagine a scenario where Brexit seems to be incomplete for an extended period of time, and hence becomes still more confusing for an increasingly divided, uncertain and concerned public. This suggests that 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, thus bringing further challenges in terms of political sustainability.

Brexit: 'lost in transition'?

A very recent UK position paper seems to indicate the possibility of a longer transition period in order to enable a better trade deal between the EU and the UK (FT, 21st February 2018). Indeed, at the current moment, only a set of principles has been agreed, with the European Council guidelines of December 2017 setting transition arrangements which could be characterised as 'benefits without governance', namely the UK required to apply the EU acquis; participating in the Single Market; and being subjected to the ECJ jurisdiction without being part of EU institutions and decision making processes.

However, these principles need then to be translated into practice with decisions on several critical questions, such as the budget, EU citizens' rights and, above all, the thorny Irish question. 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) UK not being in the custom union (Begg, 2017b). Put simply, as long as the custom union exit is on the agenda, the Irish question cannot be solved. Indeed, though both Barnier and Davies seem to agree that the Irish question can be negotiated at a later stage, they seem to overlook the fact that this is perhaps the most politically explosive issue given the government parliamentary dependence on the unionist party DUP. In other words, this could be the factor that brings the government down. In the end, until the EU and the UK search for common ground on how to reconcile their different agendas, a 'lost in transition' scenario appears to be the most likely one.

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