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Brexit – decisions, decisions…

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Highlights

- **TIME IS RUNNING OUT TO AVOID A NO-DEAL BREXIT**
- **BREXIT DELAYED BY A FEW WEEKS, WITH TWO POSSIBLE OPTIONS**
  - If the Commons passes the withdrawal agreement this week, Brexit date will be May 22, marking the start of a transition period.
  - Otherwise, the Brexit date will be April 12. The government will have to decide if it will hold European elections.
- **UNCERTAINTY DRAGGING ON GROWTH**
- **LEAP INTO THE UNKNOWN IN EVENT OF NO-DEAL BREXIT**

Almost three years after the United Kingdom voted to exit the European Union in a referendum (Brexit) and just days away from the initially slated March 29 deadline, uncertainty still prevails. The British Parliament has twice rejected the withdrawal agreement resulting from lengthy negotiations between Brussels and London, fueling fears that the UK may crash out of the EU in a no-deal Brexit scenario. The UK Prime Minister Theresa May has had to ask the European Council for a short extension to give the country some more time to try to break the deadlock, with the deadline now pushed back to April 12. The time has come for the country to make a decision, but time is running out if the government wants to avoid a no-deal Brexit, which would have severe consequences for the British economy. In this report, we will outline recent events and look back to the various stages that have brought the country to the current political crisis point. We will seek to understand why Westminster rejected the deal that was so lengthily and painfully negotiated by the UK government and the European Union, looking into the crucial stumbling block – the Irish border. Meanwhile, we will also see that while the UK has not effectively exited the EU yet, Brexit has already had a significant effect on growth in the country. Lastly, we will discuss the extent of the shock that a no-deal Brexit would have on the UK.

Where do things stand?

Brexit is a divisive issue for both the British government and the country's people as a whole, as reflected by the current political chaos surrounding the issue and the massive protest march that took place in London last Saturday, calling for a people's vote. A petition also features on the Parliament's website, calling for Article 50 to be revoked and for the UK to remain in the EU: it attracted more than 5 million signatures in the space of just five days, setting a new record. The United Kingdom is in the throes of a real political crisis. Parliament originally had until March 29 to vote for the withdrawal agreement that was reached by May's government and the European Union in November 2018. This would allow for an orderly withdrawal from the bloc and avoid a no-deal Brexit whereby the UK would crash out of the EU without an agreement, putting a swift and sharp end to 46 years of economic integration with the European Union. If the withdrawal agreement is not ratified by the deadline, a no-deal Brexit would be the default option, according to Article 50 of the Treaty of Lisbon, which governs a Member State's exit from the group.

The risk of this scenario increased after the Houses of Commons twice voted overwhelmingly to reject the withdrawal agreement – first on January 15 with 432 votes against vs. 202 for, and subsequently on March 12 with 391 votes against vs. 242 for. Meanwhile, Parliament's approval of a motion ruling out a no-deal Brexit on March 13 is no guarantee that it can be avoided, as it has no legal clout. So, with the March 29 deadline fast approaching, Theresa May was forced to request an extension to June 30 to try to find a way to break the deadlock.

The European Council subsequently agreed to delay Brexit with certain conditions attached and a choice between two possible scenarios:

- If the withdrawal agreement is approved by the House of Commons this week, the extension will be until 22 May, the new Brexit date.

- If the withdrawal agreement is not approved by MPs, the extension period will run until 12 April and the UK would then have to hold European elections if it wants to request a longer extension. The UK government would have to inform the European Union of how it wishes to proceed by April 12 in this scenario.

The dates were chosen by the European Council to take on board requirements for the forthcoming European elections, which are due to take place between May 23 and 26. The June 30 deadline that Theresa May requested coincided with the end of current MEPs' terms, but this date would have raised legal and political problems, according to the European Commission, which is why the Council put forward the other two dates: May 22 is the day before the European elections, while April 12 is the final date for countries to launch preparations to organize these elections.

What happens now?

As European Council President Donald Tusk noted, all options are still on the table until April 12 i.e. deal, no-deal, long delay or revoking Article 50 whereby the UK would remain an EU member, although this last option is unlikely, as it would challenge the referendum result. However, the Court of Justice of the European Union ruled in December that the UK could unilaterally revoke its decision to leave the EU, even without consulting the other Member States.

Will the Commons vote through the withdrawal agreement this week?

If the House of Commons approves the withdrawal agreement this week, the Brexit date would be pushed back to May 22, giving Parliament time to wave through the withdrawal legislation required, while also enabling the European Parliament to approve the withdrawal agreement and enshrine it in European law. The UK would then leave the European Union in an orderly fashion on May 22, marking the start of a transition period lasting until December 31, 2020 with the option of a one-time extension. During this period, the trading relationship between the UK and the EU would remain unchanged while the countries negotiate their future relationship. The UK would no longer sit in European institutions and would not take part in its decision-making processes.

The chances of the withdrawal deal being approved in Parliament look slim after it was already overwhelming rejected twice over. Some MPs indicated over the weekend that they would vote for the deal if the Prime Minister were to resign, but regardless of who steps into May's shoes, the outcome would probably remain the same. Divisions run deep and no-one seems to want to take the PM's place at such a critical time. A third meaningful vote is also further hampered by the Speaker of the House's announcement on March 18 that the agreement could not be put to the vote for a third time unless there were significant changes to the deal, while the European Union has insisted time and time again that no other deal is on the table. If the government finds a way around this technicality, a third meaningful vote may still fail to take place as Theresa May has made it clear that she would not hold a vote without sufficient support. Meanwhile, opposition leader Jeremy Corbyn has stated that he would vote against, as would the Northern Ireland's DUP MPs (Democratic Unionist Party), who prop up May's government by providing her with a slim Parliamentary majority, and who she has tried to win over to her cause.

Possible indicative votes on several options

If a third meaningful vote does not take place this week for want of sufficient support, or in the event that the deal is rejected again, the House of Commons could hold a number of indicative votes on a range of potential options in order to decide how to proceed after April 12. These could include an early general election, a second referendum, revoking Article 50, soft Brexit or a no-deal Brexit, but there is no guarantee that any of these options can command a majority.

If the withdrawal deal is not approved, the UK will have to inform the European Council of its intentions by April 12

If the UK decides to hold European elections, it could request an additional extension from the EU, with the European Council deciding the response. However, Theresa May is reluctant to take part in these elections, which is entirely logical given than the UK voted to exit the EU.

In the event of a further extension, the government could hold a second referendum, but the outcome is far from certain: there is no guarantee that the Remain camp would win and there is a risk of further dividing the country and prolonging the current uncertainty to boot. Yet a second referendum could be legitimate given the false claims made during the 2016 referendum campaign on the supposed drawbacks of belonging to the EU and the need to take back control. At this stage in proceedings, the British people now have clearer visibility on the issues raised and the potential impact on the economy. However, Theresa May has stated that she is opposed to a second referendum, so an early general election would probably have to be called to be able to organize a fresh vote. This second referendum could offer a choice of Brexit as outlined by the withdrawal deal negotiated with Brussels vs. no Brexit.

Another option would be for the UK to call a general election to then rule on a fresh agreement with a soft Brexit scenario i.e. maintaining close ties with the European Union. However, in this scenario, it would be difficult to form a new government with a clear majority.

The government could also decide that it will not hold European elections and opt for a no-deal Brexit, which would be the default option if the Commons does not vote for the withdrawal agreement by April 12 anyway, and if there is no request for a further extension.

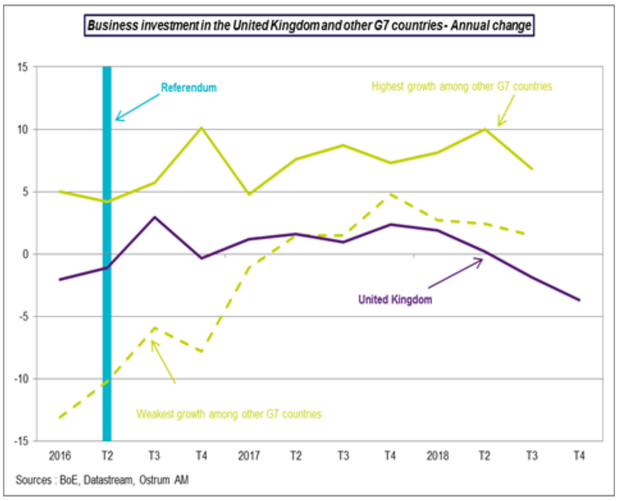
Why did the House of Commons reject the withdrawal agreement twice?

The main stumbling block in the withdrawal agreement drafted after negotiations between the UK and the EU is the so-called backstop on the border between Northern Ireland and the Republic. The agreement provides for a default option to maintain an open border between Northern Ireland, which is part of the UK, and the Republic of Ireland, an EU Member State.

What exactly is the backstop?

The backstop is a position of last resort to maintain an open border on the island of Ireland once Brexit is actually effective. Trade between the UK and the EU is currently frictionless as a result of the single market, but when the UK bows out of the EU, the country should no longer have access to the single market, so trade barriers – whether tariff barriers or non-tariff related – will develop to a greater or lesser extent depending on the future trade relationship that has yet to be negotiated. Goods traded will be subject to checks at the border between the EU and the UK to ensure that they comply with a certain number of regulations. But this begs the question of reinstating the physical border and its infrastructure between Northern Ireland and the Republic of Ireland. This move would not only hinder the movement of goods and people, it would also endanger the stability of the 1998 Good Friday agreement (Belfast agreement), which put an end to the Troubles that plagued the country for 30 years.

The withdrawal agreement therefore provides for a backstop to keep an open border in the event that no alternative arrangements are found to manage the



movement of goods and people at the end of the transition period. There would be no tariffs, quotas, or border controls between the European Union and the UK apart from fishing and aquaculture. The UK would remain in the customs union and Northern Ireland would stay in the single market to avoid a return to a hard border with the EU on the island of Ireland. The UK would apply certain EU rules as regards legislation on merchandise, health standards on veterinary controls, rules on agricultural production and sale as well as on VAT and state subsidies.

The backstop is designed to be temporary and is intended to be fully or partly replaced when alternative arrangements to resolve this issue are found, and both the EU and the UK have pledged to do their utmost to come to an agreement on this by July 1, 2020.

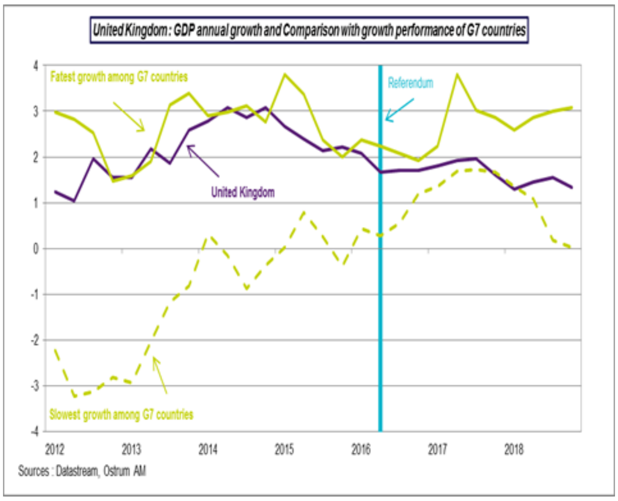
Why is the backstop hindering signature of the withdrawal agreement?

The backstop is designed as a temporary position of last resort, but it has led to fears that the UK would remain permanently tied to the European Union, forcing the country to comply with certain rules without having a say in the decision-making processes. Northern Ireland would also be treated differently to the rest of the UK, which the DUP party deems unacceptable. It is felt that the backstop refutes the results of the referendum, when a majority voted to take the UK out of the single market and the customs union and thereby take back its sovereignty: this is an anathema to hard Brexiters – but also to Remainers – as it would mean the UK applying EU decisions without sitting in its institutions and taking part in decision-making.

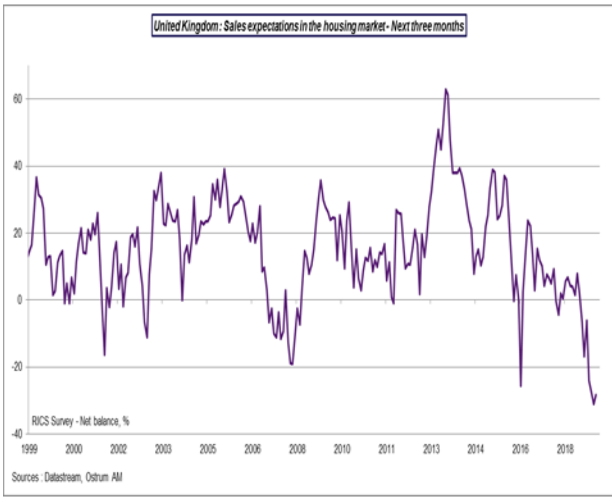
Theresa May tried to secure assurances from the EU that the backstop would be temporary, to get the withdrawal agreement through Parliament and ensure an orderly exit, but the 27 refused to re-open negotiations on the agreement. However, on March 11, the EU gave legally binding last-minute guarantees, reducing the risk of the UK remaining indefinitely tied in a customs union with the EU against its will, although not ruling it out completely. Under the terms of this new add-on, the UK could only unilaterally put an end to the backstop if it could be proven that the EU had not negotiated in good faith to find a better solution. The changes to the agreement did not set an end date for the backstop. However, these fresh assurances were deemed insufficient by the UK attorney general.

What impact will Brexit have on growth?

The UK has not yet left the EU, but growth in the country has already taken a significant hit and this can clearly be seen on the chart below. Before the referendum, growth in the UK was among the highest in the G7 countries, but it slowed sharply since then and is now among the weakest.



There are two main reasons behind this trend. Firstly, investment in production has decreased. Business leaders have become more cautious due to ongoing uncertainty on the future relationship with the European Union, which is the UK's main trading partner, and the consequences this could have on the economy. Investment has slowed severely and contracted right throughout 2018 for the first time since the world financial crisis in 2008/2009, falling 3.7% yoy in the fourth quarter of 2018, with the referendum playing a major role in this as shown in the chart below. Growth in British companies' investment fell below the figure for other G7 countries from 3Q 2018 onwards, pointing to an impact from concerns over Brexit, prompting business leaders to remain cautious.



The second reason is that households have suffered a drop in purchasing power following the surge in inflation. Sterling was a focal point for investors' fears at the time of the referendum result, plummeting severely as the effective exchange rate on the pound (average exchange rate weighted for the country's main trading partners) shed close to 10% in the space of two days and 16% between June 23 and October 17, 2016. It then stabilized at a low level and is now almost 10% lower than on June 23, 2016. This drop in the currency automatically triggered a rise in prices on imported goods and pushed up inflation, which surged from 0.4% in June 2016 to 3.2% in November 2017, before easing to 1.9% in February 2019. This strong swell in inflation dented household purchasing power in the UK and hindered their spending.

Since the start of the year, households' and companies' concerns have gained ground as the House of Commons rejected the withdrawal agreement, creating uncertainty and heightening the risk that the UK will crash out of the EU without a transition period.

Companies – in particular SMEs – have not fully prepared for this possibility, as noted by the governor of the Bank of

England Mark Carney, and they are now making hasty arrangements. The latest PMI/Markit survey revealed a record increase in companies' commodities inventories in February, as they prepare for potential severe supply difficulties and shortages on certain goods. Household surveys have also deteriorated since the referendum despite a buoyant labor market, with unemployment at only 3.9%, its lowest since 1975. Household confidence has declined more markedly since the start of the year with fears of a sharp downturn in the economic situation.

The RICS (Royal Institution of Chartered Surveyors) survey on the UK residential real estate market also reveals a swift deterioration in the sales outlook for the next three months, as January and February figures came out at the lowest point since records started, while the outlook for prices on the real estate market also nosedived.

A lengthy delay to Brexit would prolong this period of uncertainty and impede household and corporate investment, thereby denting growth.

What would happen in the event of a no-deal Brexit scenario, the default option?

A no-deal scenario would send shockwaves through the economy

A no-deal Brexit would trigger a more dramatic plunge in growth in the UK than during the economic and financial crisis in 2008, further exacerbated by the fact that companies have not prepared for this scenario, as shown by projections from various bodies such as the IMF, Bank of England, UK government, etc. According to the Bank of England's estimates, GDP would contract by 8% in 2019 vs. the first quarter of this year, a steeper decline than the 6.25% drop in GDP at the height of the crisis in 2008. The impact would be long-lasting, as in 2023 GDP would be 7.25% short of the figure projected in November 2018, which tallies with figures from the IMF and the government.

Trade between the UK and the European Union would be governed by WTO rules, which means border tariffs on goods traded, as well as non-tariff barriers. The burden would also be on the UK to prove that the country's goods comply with a certain number of European health, technical and environmental standards.

In this scenario, the UK would also no longer have privileged access to countries that it had previously enjoyed trade agreements with when it was an EU Member State, and WTO rules would also apply, leading to a hike in border duties on products traded with these countries. This will include trade with Canada, Mexico, Japan and South Korea, unless the UK manages to sign bilateral agreements with these countries.

These trade barriers would be particularly damaging as the EU is the UK's main trading partner, and they would also hamper direct foreign investment. The UK was able to attract investors looking for a gateway into the single market, but this will no longer be the case. Nissan recently announced that it was cancelling production of its new SUV model in the UK due to increased uncertainty on the country's future relationship with the EU, and Honda is also set to close its site in the UK. Meanwhile, multinationals that are part of integrated supply chains across the EU could well shift their operations to the continent, with Sony recently announcing that it will relocate its European head office from the UK to the Netherlands, and Airbus recently stating that it would leave the UK in the event of a no-deal Brexit.

- In this scenario, the decline in trade and investment would rapidly hit productivity.
- Sterling would plummet due to the deterioration in economic activity and as a result of investors' fears. According to Bank of England projections, the risk premium could lead to a 25% collapse in the pound, which would send the price of imported goods soaring.
- Inflation would also accelerate – with an additional impact from rising border duties – potentially reaching a peak of 6.5% in early 2020 according to the BoE. This would mean a loss in households' purchasing power.
- More sluggish growth would prompt business leaders to cut back staff numbers, and unemployment could hit 7.5% in early 2020.
- Uncertainty would dampen household and business confidence, prompting them to cut back investment and weakening domestic demand.
- Real estate prices could plunge 30% according to BoE estimates.
- In the long term, potential growth would be slower, dragged down by lower capital accumulation and weaker growth in the working population after a drop in the number of people arriving from the EU.
- The UK has a high current account deficit equating to 5% of GDP in the third quarter of 2018. This makes the country dependent on foreign capital inflows to finance its economy, but in the event of a no-deal Brexit, the term premium that investors would require on sovereign bonds could rise by 100bps according to BoE estimates.

- This would subsequently have a knock-on effect on other financial markets, thereby further affecting the economy. The BoE may cut interest rates to avoid dragging on growth.

Sectors most affected by a no-deal Brexit

Chemicals and transport would be the hardest hit, while automotive would also be particularly affected as it is highly integrated into the European production supply chain. Agriculture would also be fettered by trade restrictions, while financial services would also suffer severely as the UK will lose the so-called European passport system, whereby companies registered in the UK have access to clients across the EU. Lastly, sectors that employ more labor from the EU would be particularly affected by restrictions on the free movement of people, i.e. agriculture, food, hotels and restaurants.

The consequences of a no-deal Brexit on euro area growth would be more restricted

According to IMF projections, a no-deal Brexit would slice 1.5% off European Union growth in the long term as compared with a situation without no-deal Brexit, while the equivalent figure for the UK would be 8%. In the event that the UK leaves the EU with a free trade agreement (low border tariffs but increase in non-tariff barriers), the impact on EU growth would be more moderate at 0.8% over the long term.

Countries that conduct the most trade with the UK will be the most affected, and Ireland is by far the most impacted given its strong trade with the UK (drop in output of close to 4% as compared to a no-Brexit scenario according to the IMF), followed by the Netherlands, Denmark, Belgium and the Czech Republic (drop in output of around 1% for each country according to the IMF). The impact is close to half this amount in Germany and would be slight in France, Spain and Italy according to IMF estimates.

Conclusion

The days ahead will be decisive for the UK. Time is running out to avoid the country crashing out of the EU with the ensuing hefty consequences for growth in the country. Theresa May has been granted an extension by the European Council, which she will use to try to ensure the UK's orderly withdrawal from the EU on May 22. This week she will endeavor to convince MPs to vote for the withdrawal agreement negotiated with Brussels, which will be no mean feat after the two massive against votes. If there is insufficient support to organize a third meaningful vote or if Parliament rejects the withdrawal agreement again, the deadline for Brexit will be April 12, by which time the UK will have to inform the European Council of its next intended moves. If the country decides to hold European elections, it can request an additional extension. So, there are several potential scenarios now open: an orderly withdrawal for the UK with a withdrawal agreement that is still to be defined, a second referendum with an uncertain result (orderly Brexit or no Brexit), revoking Article 50, which will cancel Brexit, although this looks unlikely, or a no-deal Brexit. In the midst of all this, there is one certainty: the UK economy has already been hit by fears surrounding Brexit and this situation will only be made worse by a request for a further extension – which would pave the way for a fresh extended period of uncertainty – or by a leap into the great unknown as a result of a no-deal Brexit.

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