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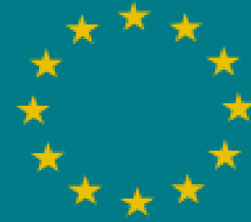
Out or About?

ASSESSING THE BREXIT PATHWAYS



In the first of our bulletins on the impact of Britain's vote to leave the European Union, Frontier's Gus O'Donnell looks at the choices facing policymakers and businesses throughout Europe. Is a "hard" or "soft" Brexit most likely? And which sectors of the economy will be most affected?

Since the turbulence that followed the British electorate's decision (by a 3.8% margin, on a 72% turnout) to leave the European Union, the markets have factored in a "soft" Brexit and stabilised somewhat. That is to say, they seem to have assumed a new British Prime Minister will aim to keep open access to the single market even if she or he has to give some ground on immigration.

It is not hard to see why economic logic takes us that way. But with the leadership election in the governing party only just under way, and with complete turbulence in the main opposition party, it is early days to tell if the markets are calling this right, or - as with the referendum itself - are in for another shock. As policymakers in London and other capitals try to peer through the murk, this bulletin examines the impact of different choices.

The Prime Minister has decided not – for now – to trigger Article 50 of the Lisbon Treaty, which triggers the two-year exit machinery. He has set up a team in the Cabinet Office (headed by a Permanent Secretary, Oliver Robbins) to explore options and inform his successor's negotiating strategy. Meanwhile, "BIS" – the Department for Business, Innovation and Skills – will have to be reinvented as a proper Department of Trade. (If there is any certain outcome to the Brexit vote, it is a substantial expansion in the civil service.)

The previous Coalition Government carried out a "Balance of Competences Review" that explored in detail how the EU affected the whole spectrum of UK policy. Critical areas such as agriculture, tax policy, science and innovation, environmental policy, employment and social policy may see significant policy change when the UK is no longer required to adopt EU law. Meanwhile, any change in free movement of labour might also affect the ability of public services to recruit and retain skilled staff.

What about Parliament? It seems likely to insist on debating the UK's Brexit strategy before Article 50 is triggered. Since the majority of members of both Houses were "Remainers", this will no doubt be a stormy event. Moreover, some constitutional lawyers are arguing that Article 50 cannot be triggered without an Act of Parliament – whose passage would be more than stormy. Even if this turns out not to be necessary from a legal perspective, it may nonetheless be politically essential.

None of this is likely to happen until we have a new Prime Minister and Cabinet. And the first task for the Chancellor in this Government will be to prepare for the Autumn Statement, when the Office of Budget Responsibility will have to publish a new UK forecast. Though everyone is likely to deny that it is an "emergency Budget", it will not be easy. It's unlikely that the OBR will disagree with the Governor of the Bank of England, that while the effects of Brexit on inflation may be ambiguous (a weaker pound and a weaker economy acting as counter-balances), the effects on growth are clear, and Brexit will weigh on the economic prospects for the UK for some time.

The prospect of lower growth and a worse deficit have already led George Osborne to abandon his aim of reaching a fiscal surplus. Ahead of the vote, the Institute for Fiscal Studies estimated that Brexit would deliver a net hit to public finances of £20-40 billion per year by 2019-20. Outside the EU,

the UK will have more freedom over tax and spending choices, but the forecasters will almost certainly tell the Government it has a bigger hole to fill.

What happens next?

Already, a number of Conservative influential voices have said Article 50 should not be triggered before the end of the year. This delay is infuriating some members of the EU. But when the trigger is pulled, the clock starts ticking. If no agreement is reached within two years of its activation (unless there is unanimous agreement amongst the 27 remaining members of the EU to keep negotiating) then trade between the UK and the EU will be governed by the rules of the World Trade Organisation. The UK and the EU would apply to each other the same trade arrangements that they apply to other countries in the world that do not have a preferential trade agreement with the EU. There are many reasons this is unlikely to be attractive to either, but especially the UK.

The first is the loss of duty-free access for goods which would likely lead to goods exported from the UK to continental Europe and vice versa becoming more expensive, benefiting exporters of such goods from non-EU countries – motor vehicles, agricultural products and clothing would be particularly hard-hit in this regard. The second is the effect on trade in services – by far the largest sector of the UK economy. Here, the barriers that would go up are harder to quantify, because many are regulatory in nature. The loss of access in financial services and aviation would be particularly serious (see below). And while free movement of people is often seen as a "price" to be paid for access to the single market, it is often an integral part of facilitating trade in services.

This explains the hunt for other arrangements. Realistically, the only alternative that would give the UK conditions for trade in goods, services and investment comparable to what it has had in the EU is some variant of the "Norway option" – membership of the European Economic Area. A "Canada-style" free trade agreement would not provide the same access, notably for services, and Turkey's free trade arrangements are limited to goods. Switzerland has a series of bilateral agreements, but not completely free trade in goods or services.

Under the Norwegian model, the UK and the EU would commit to the freedom of movement of goods, services, capital and people, essentially replicating current arrangements on these fronts. The main difference is that the UK would be free to apply its own tariffs to the rest of the world. These tariffs could not exceed what the EU has committed to at the WTO, since the UK inherits these commitments. It could, however, reduce or eliminate these tariffs. It could also negotiate free trade agreements with the rest of the world.

The main challenges for the UK would lie in reconciling this "soft Brexit" model with campaign pledges.

- **First, so far as repatriation of powers is concerned**: the UK would regularly need to update laws and regulations to ensure these are in line with the "*acquis communautaire*", in which it would of course no longer have a say.
- **Second, so far as the EU budget is concerned**: the UK would have to continue to make contributions to the EU budget (as does Switzerland under its own bilateral model).
- **Third (and most difficult), as far as immigration is concerned**: the EU has made clear that the free movement of people is a *sine qua non* of access to the single market, and (to date) no country has achieved access to the single market without respecting this principle. Quotas or Leave's much-favoured points-based system are *prima facie* incompatible with the principle.

The main challenge for the EU would be the risk of the Norwegian model being seen as a 'win' from exiting the EU, strengthening demands for further exit referenda. This will have to be balanced with the economic losses of member states from either a harder Brexit model or the reversal to the WTO rules. The outcome is difficult to predict at this stage, but any agreement will require a qualified majority, which would strengthen the bargaining position of member states that prefer the harder Brexit/WTO rules model.

All in all, the Norway model looks more like "Brenegotiation" than "Brexit". But if that can be swallowed, there are possibilities. On immigration, for example, Switzerland – which accepted the

free movement of people even without getting the full bucket of single market access – has lately been pushing for a safeguard mechanism, following a referendum of its own in 2014 urging quantitative controls on immigration.

Devil in the detail

With years of negotiations in prospect, businesses are all struggling to understand the sectoral repercussions as well as the general economic risks. Since irritation with "Brussels" and its perceived regulatory zeal drove at least part of the Brexit campaign, it might be thought that the referendum vote would offer a Conservative Government in particular an opportunity to lighten the burden of sectoral regulation or at least remake it to fit better with the needs of UK businesses and consumers. By the same token, since Britain has so often been a nay-sayer in Brussels, it might be thought that the Commission would seize the opportunity to move regulation further in the direction desired by the rest of the EU. But the task is, on both sides, undeniably complicated.

Take, for example, the regulatory regime that affects all sectors of the economy. At first glance, it might seem that Brexit will have few implications for competition policy either in the UK or the EU. The UK could be described as having an "EU-plus" regime that covers the same areas as the European Commission, but with additional powers to conduct market investigations. Moreover, the analytical frameworks and tools used by the UK's Competition and Markets Authority (CMA) to assess mergers and potential breaches of competition law bear many similarities to those used by the European Commission.

But scratch deeper and a different picture begins to emerge. For merger, cartel and abuse of dominance cases, there is a possibility that companies trading in both the EU and the UK would face simultaneous investigation by both the European Commission and the CMA. Firms in such situations would face not only more paperwork, but also the risk of "double jeopardy". Then there is the question of whether UK and European competition policy – hitherto closely aligned – will begin to drift apart over time. While details are sketchy, French President François Hollande has already floated the idea that some EU competition rules need 'adapting' in a new post-Brexit regime. But he may well face opposition to such changes from member states that have traditionally been more aligned to UK principles.

In those parts of the economy subject to special regulatory regimes, it may prove even more challenging to realise the benefit of any new flexibility that Brexit could provide. Our specialists have been looking at a selection of those sectors that may be most affected by the change.

Financial services

This is the sector most fearful of adverse effects, from a loss of access to European markets (unless "passporting" can be maintained) to the risk that recession and falling property prices might swell credit losses. The fall in commercial property funds illustrates both the fears of an economic downturn and concern that London's position as Europe's leading financial centre may be under threat. British institutions have benefitted not only from their own access, but from acting as intermediaries. The fall in bank shares has also put in jeopardy the Government's proposed sale of shares in Lloyds Bank and RBS.

UK-based banks are better capitalised and prepared to deal with such a downturn than they were before the financial crisis. But profitability will be hit, as well as the banks' ability to raise capital, as will the availability of credit in the economy. And UK-based banks are not, of course, the only ones to have suffered. The more fragile of Europe's financial institutions have also seen the shock effects of Brexit.

The City of London faces great uncertainty, not least because the UK's system of financial regulation is highly integrated with the EU's (which, until the Brexit vote, was presided over by a British Commissioner for Financial Services). Of course, there were still some distinctions: the UK negotiated exclusion from monetary union measures as part of the UK Prime Minister's pre-referendum package. However, the UK will have to redesign a great deal of financial regulation. While in some areas at least, this may be for the better, there are, in the meantime, a number of

European directives in the process of implementation. The due date for the second Markets in Financial Instruments Directive (MIFID II), January 2018, is within any conceivable two-year Article 50 period.

Meanwhile, the European Parliament's adoption of the second payment services directive (PSD2) means that UK-based banks are already planning for fundamental changes in digital data access in 2019. The UK has until now played a key role in the European Securities and Markets Authority (ESMA), but this is an EU authority from which Britain may well be withdrawing. The warnings by financial institutions to transfer jobs out of London have quietened down, while their boards wait to see what happens. But meanwhile, the French Government has been upping the pressure for European financial centre functions to be transferred to Paris.

Point to note: an urgent task for the UK Government must be to decide what approach British-based businesses and British regulators should take to the pipeline of EU regulation, reconciling the need to fulfil legal obligations with the avoidance of enforcing complex regulations that may soon be rescinded. And the key issue of "passporting" needs to be addressed urgently.

Energy

For the UK – a net importer of energy – the most obvious short-term effects are likely to arise from a reduction in demand in line with slower economic growth, and – despite oil price weakness – a rise in domestic energy prices arising from the depreciation of sterling (down to a 30-year low). Meanwhile, greater uncertainty is likely to lead investors to require a higher return on investment in new plants to replace Britain's fleet of ageing power stations. With weakness in the euro, other EU member states may see similar (although much less pronounced) demand and currency effects. However, EU energy policy is unlikely to change much in response to Brexit.

In the UK, higher household energy bills may reignite concerns over affordability. That would put pressure on the new Government to reduce taxes on energy (something that it will be easier to do outside the EU, but will do nothing to repair public finances or encourage energy saving).

Two ministers from opposing referendum camps, Amber Rudd and Andrea Leadsom, have made reassuring noises about the need to meet Britain's national long-term carbon targets. But the pressure on public finances and increased market uncertainty will give cause for concern to the renewables lobby.

While EDF has signalled that it still intends to build a new nuclear reactor at Hinkley Point, a final investment decision will not be taken until the autumn, and the troubled project may yet face further delay, not least as elections loom in France. And uncertainty over Britain's access to the single market is also likely to delay progress on new inter-connectors that would otherwise have allowed the UK to plug itself into the wider European grid.

Point to note: clarity over energy policy post-Brexit is essential to bolster investor confidence, at a time when a step-up in investment in generating capacity is urgently needed.

Telecoms

The economics of the telecoms sector is governed by an EU-wide regulatory framework. Even if the UK regulator, Ofcom, continues to apply its basic principles, the final agreement between the EU and the UK may give the UK more freedom to deviate from some rules, such as those relating to the structural separation of vertically-integrated telecoms operators.

However, Brexit also reduces Ofcom's ability to influence the EU framework. Changes in trade arrangements for services could adversely affect the position of UK-based companies in relation to sales of communications services to large multinational corporates. And UK consumers will have to wait and see whether the EU's roaming charge regulations will continue to apply to them.

Meanwhile, demand for telecommunications services tends to be more sensitive to an economic slowdown than demand for some other infrastructure-based services. This, coupled with uncertainty

around access to European funds, could in turn affect fibre roll-out – a measure on which the UK is already lagging behind other main competitor nations.

Point to note: the Government and Ofcom must take action to ensure no delay in investment to support the development of telecoms infrastructure during the period of uncertainty following the Brexit vote.

Retailing, Food, and Agriculture

Most major retailers operating in the UK are likely to have taken some pre-referendum steps to hedge against the most obvious risk of a Brexit vote – a fall in sterling, driving up import prices. Their commercial teams need to be sure they have visibility of the cost impact in the coming weeks, what their contractual positions are, and what risk they continue to be exposed to. Meanwhile, buying teams have to be prepared to flex prices where needed, and must have a plan on pass-through. The scale of sterling's decline means that getting the cost/price mix wrong could prove very expensive very quickly.

Even if Brexit does not result in the imposition of reciprocal EU tariffs, it is far from clear whether the UK will make any different choices with respect to European standards operating in the sector – such as those governing food safety, labelling and product certification – or whether the terms of a trade agreement will preclude any changes. Meanwhile, a "hard" Brexit would require the renegotiation of reciprocal trade agreements with third-party countries, from which retailers also import substantial proportions of their goods.

At the luxury end of the retail sector, the fall in sterling may have more positive effects, stimulating more "shopping tourism" from countries such as China – provided shocks to financial markets do not trigger a further slowdown in global growth, and measures to control immigration do not frighten off tourists.

For supermarkets and other food retailers, these uncertainties will be compounded by the impact of Brexit on agriculture, currently the largest recipient of EU funds, and also in some parts of the industry highly dependent on migrant labour. Meanwhile, Britain's shrunken fishing industry has high – probably unrealistically high – hopes that freedom from European agreements will transform its prospects.

Point to note: retailers need to continue to be alert to the impact of exchange rate volatility on their businesses, as markets react to changing political moods with respect to the nature of the best Brexit pathway. The Government needs to give clarity with respect to its approach to standards, and to ensure Britain's immigration rules do not discourage "shopping tourism".

Aviation

In an industry based on international connectivity, Brexit will have significant implications – for both air passengers and airlines. In the short run, the impact will largely be felt by UK consumers and operators, as the depreciation of sterling makes travelling abroad more expensive and puts upward pressure on fuel costs and fares. But leaving the EU also raises questions over the traffic rights that enable UK airlines to operate within the EU and further overseas. It must be a priority for the UK to negotiate continued membership of the European Common Aviation Area (ECAA), which permits any airline of a member to operate services between any other member state.

Without this, all routes operated between third countries by UK-based airlines such as easyJet would be at risk – a development that would affect a broad cross-section of European travellers. In principle, any of the signatories of the ECAA could object to continued UK membership, including perhaps states whose airlines have fared badly in competition with the likes of easyJet. There is also the question of bilateral air service agreements between the EU and third-party countries, in particular transatlantic traffic rights. Given these uncertainties, it is not surprising that the share prices of easyJet and IAG took a post-referendum hit.

In the meantime, the ever-delayed Heathrow decision has been another casualty of the uncertainty following the Brexit vote, having inevitably been delayed until the formation of a new Government. It

remains to be seen what priority it receives after that event, but this must depend in part on what commitments the leadership candidates are cornered into giving.

Point to note: establishing the UK's continued membership of the ECAA is essential to the health of the UK airline industry and to preserve the options available to all European air passengers wishing to travel to or from the UK.

Water

Although a number of companies operating in this sector are non-UK owned, its essential domesticity means fewer direct consequences. But the sector is subject to extensive environmental regulation and health standards, many agreed at EU level. It seems unlikely that the UK would want to roll many back – particularly those governing bathing water or drinking water, where any reduction in standards would be strongly resisted by environmental campaigners.

However, if the regulators handle the changes carefully, withdrawal from the EU could give the UK more leeway to think about the proportionality of its regulations, taking account of the costs as well as the benefits. This could open up opportunities to finesse regulation in particular areas where its social value may be harder to establish. Ofwat (the water regulator for England and Wales) may also become more inclined to challenge water companies as to what is really "required" under environmental legislation when assessing their costs for the purposes of its price reviews.

Point to note: regulatory flexibility in this sector could, if used carefully, be an advantage. But environmentalists will be on the watch for any lessening of standards.

Manufacturing

In theory, UK manufacturing is the main beneficiary from the depreciation of sterling that followed the Brexit vote, depending on the extent of their dependence on imported raw materials. Differential share price performance since the Brexit vote, with the FTSE 100 index of largely international businesses recovering to pre-vote levels, illustrates the market's understanding that exporters have a good deal to gain, at least when profits are expressed in sterling.

But the outcome of political decisions with respect to the Brexit pathway will critically affect the extent to which they face higher tariffs, while these same uncertainties may delay capital spending and discourage inward investment.

Point to note: clarity on the Brexit pathway is essential to enable the UK to help gain the maximum benefit from the depreciation of sterling.

Conclusions

These sectoral examples illustrate the difficulties involved in seizing the opportunity to remake regulation to fit Britain's preferences, without creating greater complexity for companies operating internationally. They highlight the urgent need both to set clear courses for domestic policy and to choose Britain's Brexit pathway, as soon as a new Government is in place. While many politicians may wish to delay pulling the Article 50 trigger until the UK's negotiating strategy is clear, a long list of policy issues cannot be left without exacerbating the risk of falling investment and a transfer of business elsewhere.

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