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 Chairman, Gus O'Donnell looks at the choices facing policymakers and businesses throughout Europe. Gus served as UK Cabinet Secretary under three different UK prime ministers before he joined Frontier in 2013. He has extensive experience in British and European politics and policy making, and handled numerous crisis situations during his time as Cabinet Secretary. In the following Gus considers whether a "hard" or "soft" Brexit is 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 might lead the UK down such a route. But it's too early to tell if the markets are right to be making such an assumption, or – as with the referendum itself – are in for another shock The early signs are that the EU will aim for a tough negotiation strategy to maximize the deterrence effect of the UK's decision, perhaps spurred on by the prospect of elections in the Netherlands, France and Germany next year. And in the UK itself, the leadership election in the governing party has just been completed, with turbulence in the main opposition party. As policymakers in European capitals try to peer through the murk, this bulletin examines the impact of different choices.

The UK has decided not – for now – to trigger Article 50 of the Lisbon Treaty, which activates the two-year exit machinery. Prime Minister David Cameron has set up a team of civil servants to explore options and inform his successor's negotiating strategy. Meanwhile, the EU has also established a taskforce that will support the negotiation.

What about the British 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.

One of the first tasks for Philip Hammond, the Chancellor in Theresa May's new Cabinet, will be to prepare for the Autumn Statement. Though he has denied this will be an "emergency Budget", it will not be easy – particularly since this Statement will coincide with economic forecasts published by the UK's Office for Budgetary Responsibility (OBR). 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 (with a weaker pound and a weaker economy acting as counter-balances), Brexit will weigh on the growth prospects for the UK for some time.

The prospect of lower growth and a larger deficit have already led Britain's new Government to abandon previous plans for reaching a fiscal surplus by 2020. 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?

Britain's new Prime Minister Theresa May has suggested that Article 50 should not be triggered until the end of the year. This delay is infuriating some other EU Member States. But when the trigger is pulled, the clock starts ticking. If no agreement is reached within two years of its activation (and unless there is unanimous agreement amongst the 27 remaining EU Member States to keep negotiating), then trade between the UK and EU will be governed by the rules of the World Trade Organisation (WTO). In this scenario, the UK and the EU would apply to each other the same trade arrangements that they apply to other countries that do not have a preferential trade agreement with the EU.

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There are many reasons why this outcome is unlikely to be attractive to either side, 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 affected in this regard. The second is the effect on trade in services – by far the largest sector of the UK economy and one with a significant export surplus. Here the barriers that would go up are harder to quantify, because many are regulatory in nature. The loss of access could be particularly serious for financial services and aviation (see below). And while free movement of people is sometimes 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, only some variant of the so-called "Norway option" – membership of the European Economic Area (EEA) – would give the UK and the rest of the EU conditions for trade that would be comparable to the status quo. 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 and is negotiating with the EU over movement of labour.

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. The UK could, however, reduce or eliminate these tariffs.

The main challenges for the UK would lie in reconciling this "soft Brexit" model with referendum 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*" (the accumulated body of EU law), 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), so far as immigration is concerned:** the EU has made clear that the free movement is a prerequisite of access to the single market, and indeed (to date) no country has achieved access to the single market without respecting this principle. Quotas, or a points-based system of the kind suggested by some Brexit supporters, would be 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 in other Member States. 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 of EU Member States, which would strengthen the bargaining position of Member States that prefer the harder Brexit/WTO rules model.

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All in all, the Norway model looks more like "Brenegotiation" than "Brexit". But if that can be swallowed, there are possibilities for compromise. 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 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 British Government an opportunity to lighten the burden of sectoral regulation or 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 European 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, competition policy rules, which affect all sectors of the economy. At first glance, it might seem that Brexit will have few implications for these rules in either 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 Commission.

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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 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. French President François Hollande has already floated the idea that some EU competition rules need 'adapting' in a new post-Brexit regime – though he may still 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 for the UK to realise the benefit of any new flexibility that Brexit could provide.

Financial services

This is the sector most fearful of adverse effects in the UK, from a loss of access to European markets 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.

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 the more fragile of Europe's financial institutions – such as Italy's troubled banks – 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 that of the EU. The UK will have to redesign a great deal of financial regulation at a time when a number of European directives are in the process of implementation. 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.

Points to note: an urgent task for the new 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. EU-based banks with activities in the UK may equally need to respond to the possible need to operate under two separate regulatory regimes – one for the UK and one for the EU.

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 country.

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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 decision on expanding airport capacity in the London region – one of Europe's congestion hotspots – has been another casualty of the uncertainty following the Brexit vote, having inevitably been delayed until the formation of a new UK Government.

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.

Telecoms

The economics of the telecoms sector is governed by an EU-wide regulatory framework. Even if UK regulator, Ofcom, continues to apply its basic principles, the final agreement between the EU and 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 European consumers will have to wait and see whether the EU's roaming charge regulations will continue to apply when travelling between the UK and the remaining Member States.

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 Britain's fibre roll-out programme – a measure on which the UK is already lagging behind other main competitor nations.

Points to note: the new UK 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. The UK will likely see reduced influence in shaping the new EU telecommunications regulatory framework.

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 plant to replace Britain's fleet of ageing power stations. With weakness in the euro, other EU member states may see similar (although less pronounced) demand and currency effects.

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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 will be easier to do outside the EU, but will do nothing to repair public finances or encourage energy saving).

The pressure on public finances and increased market uncertainty will give cause for concern to the renewables lobby. Even if EU energy policy is unlikely to change much in response to Brexit, Europe will still face administrative challenges – for example, in relation to updates to EU climate targets and the EU's emission trading regime to take account of the smaller Union, were the UK to remove itself from these elements of EU wide energy policy.

While French investor 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. 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.

Points 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. The knock-on impact of any change in the UK's participation in climate- and CO2-related policies and regimes will also need to be clarified.

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. For retailers in the rest of Europe, currency movements may provide an immediate opportunity to offer UK-sourced products at more attractive prices.

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. Retailers and suppliers trading in or with the UK will need to keep a close eye on the development of regulations and agreements that may affect them.

For UK 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.

Points 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 new UK Government needs to give clarity with respect to its approach to standards, and to ensure Britain's immigration rules do not discourage "shopping tourism". Evolving standards and trade agreements will be relevant for those in – and dealing with – the UK.

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 these manufacturers face higher tariffs, while these same uncertainties may delay capital spending and discourage inward investment.

Point to note: clarity on the Brexit pathway will affect the UK's longer term ability to gain from the depreciation of sterling.

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Conclusions

These sectoral examples illustrate the uncertainties and challenges faced by not only UK firms, but also EU companies active in the UK, trading with the UK, or in competition with UK companies. They also highlight the urgent need to choose Britain's Brexit pathway now that a new UK Government is in place. While many British politicians may wish to delay pulling the Article 50 trigger until the UK's negotiating strategy is clear, a long list of unresolved policy issues will likely exacerbate the risk of falling investment and a transfer of business elsewhere.

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