Brexit: questions, dangers, opportunities for Europe

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Abstract
Until the 23 June 2016 referendum, the European integration was characterized by continuous development, progress, and deepening. The possibility of a disintegration had, however, been opened up by the Treaty of Lisbon in 2007. As the latter having been drafted with the idea that Article 50 would never be used, there is a lack of in-depth schemes to allow the Brexit process to be smoothly managed. In such a situation, much depends on whether the negotiating parties have the necessary trust in each other and intent to optimize their future relationship. Today, it is quite unpredictable where negotiations will end up. But wherever they'll end up, lessons could already be drawn from why they had started and how they are being conducted. Concerning the future, as a 'cliff-edge' scenario would cause enormous harm to both the UK and the EU, the only reasonable guiding principle for them should be to act in accordance with the economic and social well-beings of the people they represent: i.e. to put aside perceived political interests, and focus on protecting jobs and businesses.

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JEL Classification: *F02, F13, F15*

1. Introduction

The day of the Brexit referendum (23 June, 2016) undoubtedly represents a milestone in the history of the European Union: after decades of deepening and enlarging, this was the first time people of a sovereign member state decided to leave the integration. It is not yet clear whether Brexit means a turning point – in that it will trigger a process of disintegration – or provide an opportunity for the remaining EU27 to engage in a stocktaking exercise and consider alternatives for Europe's future.

Our aim with this paper – after giving a short literature review – is to highlight the main risks associated with the significant differences in the UK's and the EU' approach to the withdrawal negotiations on one side, and what such differences could lead to, i.e. a no-deal scenario, on the other. By using the critical analysis method and drawing from across the spectrum of economic activities the examples of car industry and financial services, identified as two of the sectors being among the most sensitive to changes in UK-EU trade relations, we demonstrate that a no-deal scenario would be a disaster, and a hard-Brexit would result in a lose-lose situation for both sides. To avoid this, we suggest to take the most sensitive sectors away from the general scope of the future agreement and negotiate a special deal for them.

1.1 Literature

Literature on the consequences of Brexit started to surge well before the referendum, and the momentum continues to this day. A common feature of all these contributions is that they have been producing estimates without knowing anything about how the future relationship between the EU and the UK will look like. Hence their tendency to focus on some headline outcomes like an X or Y percentage fall in economic growth, household income, foreign trade or business investment by a given year (typically by 2030). These papers depart from the assumption that the UK will, under any scenarios, inevitably suffer from Brexit. They usually consider three different scenarios: a 'soft' or optimistic one, under which the UK would maintain substantial access to the single market (Norway or Swiss model); a 'hard' or pessimistic one, with no deal at all at the end of the Article 50 negotiations whereby trade between the UK and the EU would fall back to WTO terms; and a 'semi-hard' one, lying somewhere in between the two extremes (Dhingra et al. 2016; Schoof et al. 2015).

Some early analyses on Brexit even contained guesses on both short and longer term, the latter being devoted to the three above scenarios, the former predicting uncertainties, holding back spending decisions and deterring FDI (Kierzenkowski et al. 2016). The short run guesses did not really come true. An illustrative example of the relationship between econometric models and reality was when the Bank of England had to upgrade its forecasts for UK GDP growth for 2017 significantly for the second time in just six months, due especially to the resilience of consumer spending following the vote for Brexit: shortly after the referendum, in August 2016, it predicted the economy would expand just 0.8 per cent in 2017, while in its revised forecast, in February 2017, it said GDP would grow 2 per cent (Bank of England, 2017).

Another type of literature that developed since the Brexit vote consists of sectoral analyses which, like the general ones, know nothing about the nature of the future relationship between the EU and the UK. But since they are based on the worst case scenario, they have at least the advantage of giving serious warnings to decision-makers about the risks a no-deal scenario would entail. (For a more detailed account, see Chapter 3)

As for the literature dealing with disintegration, the paper of Vollaard (2008) concludes that the patterns of integration and disintegration being not evenly distributed across the region, it seems unlikely the EU would fall apart into Westphalian states. Auer (2010) argues that the attempt to move towards a more federalist Europe, as before, is no longer feasible, as populism and ethno-centric nationalism are emerging in Europe *not despite* but arguably *in response* to its elites' cosmopolitan agenda. Webber (2014) suggests that the future of the integration is highly contingent upon the rise of anti-EU movements and Germany's attitude. In this context, it is discouraging to see how much the economically resurgent Germany is clinging to that the Eurozone is managed according to its priorities. To the extent that Berlin tries to assert its influence over EU policies, resentments against Germany may increase in other members.

As for the author's publications on Brexit, following the referendum in June 2016, he and her colleague were amongst the first to provide a detailed analysis of the background to and the context of the Leave vote (Somai & Biedermann 2016). Their paper reviews the deeper societal and economic reasons behind the British choice to quit the EU. They conclude that increasing income and wealth inequalities, growing anti-elite sentiment in British society, and first of all a British approach to the rule of law that is fundamentally different from the continental one have contributed to the final result of the referendum, rather than immigration which, non the less, had a significant impact on employee's pay level in certain sectors and regions.

2. The main danger

Among the risks associated with Brexit the worst one is related to the difference in the parties' approach to the negotiations. As a matter of fact, it was clear from the outset that views of the British government and the Commission differ significantly as to what topics and in what order negotiations should be conducted on, and what could be considered to be a final output. In order to illustrate this danger of divergence between their approaches, it is worth recalling some of the parties' pre-negotiation statements.

From the guiding principles for Brexit talks, set out first in Prime Minister Theresa May's so-called Lancaster House speech (in January 2017) and confirmed in the British Government's White Paper (a month later), it was clear that Westminster formulated their strategic goals with the intention of maintaining many fundamental elements of the status quo and the closest possible tariff-free economic and trading relationship between the UK and the EU in the future. It would involve providing certainty and clarity for businesses through ensuring free trade with European markets, protecting workers' rights, promoting the UK's excellence in science and innovation, maintaining the 'mini-Schengen' regime of the British Isles (UK, Ireland, Channel Islands and Isle of Man), etc. According to the White Paper, Westminster is being interested in delivering a smooth and orderly exit from the EU on the basis that, unlike most trade negotiations, the parties have initially got the exact same rules, regulations and standards. So, talks should not be about bringing together two totally divergent systems but about managing the continued cooperation between the UK and the EU (May 2017; UK Government 2017).

By contrast, documents reflecting the EU's approach to Brexit negotiations – European Council Guidelines (Consilium 2017a) and Directives (Consilium 2017b) – showed that the Commission was not focusing on how to ensure the closest possible relationship with the UK after Brexit, but was up to something else. As for illustration, here are two quotations:

- 'A non-member … cannot have the same rights and enjoy the same benefits as a member'
- '… the four freedoms of the Single Market are indivisible and … there can be no "cherry picking".' (Consilium 2017a, p. 3)

While the first statement is difficult to argue with – especially as a non-member can obviously not take part for example in decision-making about working out EU-regulations, developing EU-policies, and cannot participate in talks about the future of the EU with the same rights as a member – the second one seems to be much more problematic. The premise whereby the EU's single market – freedom of goods, capital, services, and labour – are indivisible, has no economic foundations. Theory even suggests that the four freedoms can be substitutes. This is particularly true for trade and migration, as the quantity of work embodied in a country's imports have much the same effect on local wages as if those products and services were being produced by immigrant workers. It is, however, correct to say that trade and migration may also happen to be each other's complements rather than substitutes. Just think of exports that are often accompanied by supporting services. So, by trying to restrict free movement, the UK also restrict trade. But this is hardly a reason for the EU to cause further damage on both sides by imposing trade barriers through a hard Brexit (Kohler-Müller, 2017).

One of the main differences that have emerged between the EU and the UK concerns the interpretation of Article 50 of the Lisbon Treaty. According to paragraph 2, '… the Union [the EU] shall negotiate and conclude an agreement with the State [the UK], setting out the arrangements for its withdrawal, *taking account* of the framework for its future relationship with the Union.' In the Commission's interpretation this means that first a withdrawal agreement is to be reached, and then it comes to discuss about future relationship (see '*phased approach*' in Consilium 2017a p. 1; and Consilium 2017b, p. 4). By this logic, it would first be established the amount the British should have to pay as an exit bill – the amount that the EU claims the UK must pay in order to settle its outstanding financial obligations – and only then can talks start on the details of how UK businesses might have access to the European single market. In the meanwhile, the British are of the view that in case of no agreement, all EU law will cease to apply and they would be subject to no enforceable obligation to make any financial contribution at all (House of Lords 2017, p. 3). Similarly, it may seem pointless from the EU perspective to force an early agreement on the avoidance of a hard Irish border, including any physical infrastructure or related checks and control, as long as nothing can be known about the arrangements that will regulate bilateral trade.

Although the British government's interpretation of Article 50 has always been quite different from that of the Commission – considering that '*taking account*' means a simultaneous rather than sequential approach – it did not, however, refrained from discussing certain issues (notably citizens' rights, Irish border, financial settlement, relocation of EU agencies from Britain) earlier than other ones (mainly future relationship). The difference in the parties approach to the negotiations can best be shown by the fact, that according to EU Guidelines it was up to the European Council to determine whether sufficient progress has been achieved before allowing the negotiations to proceed to the second phase. But never and nowhere had been said about what should be considered *sufficient progress*.

In the light of the above, it was an almost unexpected event when, in early December 2017, negotiators adopted a joint report on the progress they had made in the first phase of the talks, even if, due to the European Council's own caveat that *nothing is agreed until everything is agreed* (Consilium 2017a, p. 3), commitments set out in the report are not at all binding. Everything depends on whether the parties can come to a compromise about their future trade relationship during the second phase of the negotiations. Nevertheless, it is a bad omen for the future that on the very day (15 December 2017) when the European Council decided to move to the second phase of the negotiations, it also supplemented its negotiating directives in a way which has been highly debatable from a British viewpoint. Concerning the so-called transition period – aiming at facilitating for both citizens and businesses to adapt to the changes entailed by Brexit – it puts the UK on unequal footing:

- as for the obligations, the UK should be regarded as if it were still a member state ('*the acquis*' … as well as '*any changes*' … to it having '*automatically apply to and in the UK*);
- but as for the rights, the UK would '*no longer participate in or nominate or elect members of the*' … EU '*institutions, nor participate in the decision-making or the governance of the*' … EU '*bodies, offices and agencies*'. (Consilium 2018, pp. 6-7)

This would oblige the British government to accept that free movement from the EU27, as well as the supremacy of EU law and the competence of the Court of Justice of the EU would continue during the whole transition period. The UK would even be prevented to become bound by any international agreements, unless authorized to do so by the EU (Consilium 2018, p. 7). It is not only something which seems totally unacceptable for the British government, i.e. of changing from being an important rule-maker to being a simple rule-taker nation, but also something that literally contradicts paragraph 3 of Article 50 ('*The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement*'.)

Among the risks associated with Brexit, an overestimation – in theory by both sides, but in practice especially by the EU – of their perceived political interests, and putting these interests before the real social and economic interests of the peoples they represent, is probably the worst thing that could happen. If negotiators fail to recognize this danger, it is quite possible that parties may not reach an agreement by the 29 March 2019 deadline, or walk away from the negotiating table earlier. Such a scenario would, however, cause enormous damage to the economies on both sides, particularly to internationally embedded sectors.

3. Sensitive sectors

The dismemberment of the value chain – i.e. the segmentation of the production of a product into different stages and the distribution of these segments among various countries in pursuit of greater efficiency and maximizing profit on the basis of differences in factor endowments of the countries – does advance specialization, but also heightens the interdependence of different markets.

In this context, Brexit puts value chains in a particularly delicate position. What seems to be clear since UK's Prime's Lancaster House speech (May, 2017) is that the fundamental reasons behind Britain's desire to pull out from the European Union – e.g. gaining back control over laws (ending the jurisdiction of the European Court of Justice (ECJ)) and borders (ending free immigration of persons from the EU) – will prevent the UK from continuing to participate in either the Single Market or the Customs Union. Since none of the EU's existing trade agreements with third countries can, without endangering Britain's interests, be applied to Brexit – for there is no way to run an autonomous trade policy; or borders cannot be easily crossed; or the agreement does not apply to agricultural and food products and/or services; or access to the EU markets is conditioned on a large amount of money to be paid into the common budget; or the jurisdiction of the ECJ is not ended; or a combination of all the above (Stojanovic & Rutter, 2017, p. 25) – it is no wonder the UK Government is seeking a bespoke arrangement with the EU, which would include both an 'ambitious and comprehensive Free Trade Agreement (FTA) and a new customs agreement' (UK Government, 2017, p. 35).

The probability of obtaining such a bespoke arrangement is, however, compromised by two problems. The first one derives from the fact that the more comprehensive and deeper the agreement, the greater the chances for the UK side to lose control over laws and regulations – while the British are just at pains to get it back again. The second one has already been mentioned: it comes from the EU negotiating guidelines whereby a non-member – who is not even willing to accept the bloc's four freedoms (notably the free movement of persons) – cannot expect to "cherry pick" what it likes and wants from the European integration.

The only way out of this situation lies – at least for sectors where a sudden change in the status quo would involve the greatest financial and social damage – in trying to take them away from the main body (the general scope) of the future agreement and negotiate a special deal for them. Naturally, this method only works if both parties get something out of it. Now, let us present here two such sectors: the automotive industry, a special treatment of which would be in the interests of both the UK and the EU 27, but with more damage prevented for the latter; and the financial services sector, for which the opposite is true.

3.1 Car industry

Car manufacturing is one of the most globally integrated industries in the world. As for its weight in the UK, it employs directly 0.5 percent of the national workforce, contributes approximately 1 per cent of the GDP, accounts for 12 percent of total exports of goods, and invests a yearly amount of 2.5 billion pounds into R&D expenditure (all data are for 2015). If, however, the UK withdrawal were being done under a cliff-edge scenario, EU's WTO-tariffs on vehicles (10% for cars and 2.5-4.5% for parts) would put British exports at an immediate competitive disadvantage. Add to this the cost of customs checks at the border (€100-150 per car) and a further 6 percent for the administrative and compliance costs of trade with the Union, to imagine delays and other damages such change would involve to the both *lean* and *just-in-time* production system of the automotive industry (SMMT 2016).

It's, however, not only the British car industry that would be seriously damaged. According to a recent study (Deloitte, 2017), if constructors passed all costs incurred by Brexit on to consumers, price for a car in the UK would increase by €3,700, and by as much as €5,600 for the ones manufactured in Germany (45% of German exports being premium models). As a result, the British market would shrink by 550,000 vehicles (-19%), of which 255,000 units (>46% of the decline) would have to be suffered by German constructors alone. In short, a cliff-edge scenario for Brexit would, by putting 18,000 jobs at risk, have a similar negative effect on German automotive industry as did the financial crisis in 2009.

All the above can, of course, be avoided if Brexit talks were conducted in the spirit of mutual goodwill. This should surely be a precondition not the least because the automotive industry – due to costs related to the technological constraints inherent in it – can '*only take (re-)location decisions once in the 7-year lifecycle of a new product*' (PwC, 2016). If there is no chance for a comprehensive free trade agreement being concluded by the leave date, one should perhaps look for a temporary sector-specific solution – e.g. by transforming UK production sites into special economic (i.e. duty-free) zones – in order to remove uncertainty for the industry and make sure that the investment cycle remains unbroken until a lasting solution can be found.

3.2 Financial services

The financial services industry directly provides 7 percent of the British GDP, and employs 1.1 million people. When related professional services (i.e. management consultancy, legal services and account services) are added, these data reach 11.8 percent of GDP and 2.18 million people or 7.4 percent of UK labour force. The larger 'industry' contributes Ł67 billion in taxes (or 11% of total UK tax receipts) and generates a trade surplus of Ł72 billion per year (all data are for 2014). Annual revenue from financial services are about Ł200 billion, of which 46-49 percent comes from domestic market, 21-23 percent relates to the EU, and the remaining 30-31 percent to the rest of the world (UK Parliament, 2016a, p.12).

The single biggest risk to the UK's financial services sector posed by Brexit comes from the uncertainty about whether and to what extent British businesses could retain access to the European single market. Ideally, they need two pieces of information: what the UK's future relationship with the EU will look like and what will be the bridge arrangement between leaving and getting to that relationship. In the absence of clarity, firms may preempt uncertainty by restructuring or relocating on the basis of a worst-case scenario. But not only the City would suffer, as one cannot with impunity (i.e. without the risk of increasing costs and complexities) unpick a highly developed ecosystem such as exists in London. The City has evolved over decades into what the profession recognizes as the world's leading financial center where hundreds of banks and thousands of different financial services companies are available to consumers, investors and businesses, and the significant interconnectedness of the different service providers enables the business sector to enjoy the efficiencies of scale stemming from the effect of compression, i.e. having all their transactions be packaged together, and having it all sitting on a single trading venue. In this environment, the concentration of capital, infrastructure and knowledge permits the companies to profit from the advantages of cost efficiency under unique conditions (UK Parliament, 2016b, pp. 5-11).

So, should the Commission attempts for example to repatriate the clearing of euro-denominated derivatives to the Eurozone, it will not only put at risk thousands of jobs in the

UK, but also increase the cost of trading for banks by several tens of billions of euro across a 5-year period following Brexit, i.e. a lose-lose situation for both the UK and the rest of the EU. The calculation is based on the assumption that fragmenting LCH’s (London Clearing House, the world’s largest clearing house) pool of interest-rate derivatives would change the price of every swap – the most commonly used type of contract – by one basis point (Hadfield, 2017).

As the financial services sector is becoming more and more globally organized – major players already responding to the Financial Stability Board, Basel, IOSCO and Dodd-Frank, etc. – and passporting rights might, in the foreseeable future, be replaced with globally regulated equivalence systems, it would be a workable way out of the Brexit dilemma, if the negotiating parties were reconciled themselves to the trend of globalization. Here again a more flexible approach could lead to a mutual recognition of each other’s regulatory regimes.

4. Conclusion

The process of the Brexit negotiations so far (slow progress and provisional solutions to certain chapters) show that the parties formulate their positions on the basis of fundamentally differing interests. The British want to change the EU-UK relationship only as much as they think to be necessary considering the results of the exit referendum and the essential points of the exit campaign, i.e. taking back control over laws and borders, and restricting contribution to the common European budget. However, the Commission, enjoying the confidence of the French-German tandem, and insisting on the dogma of the inseparability of the four freedoms, wants a significantly more distant relationship with the UK. It fears that if the British could arrange their withdrawal from the EU with no or minimal harm caused to their economy, i.e. an exit not deterrent enough to stop other member states from reconsidering their own situation within the club, this could lead to the total decomposition of the European integration.

Today, it is quite unpredictable where Brexit negotiations will end up. At any rate, it is scary to see how big the gap between the positions of the negotiating parties (presented in Chapter 2) still remains. Arising from the loss of a military and nuclear power, and the biggest advocate of liberal thoughts, damages to the EU, at least in the long run, could certainly appear at ideological, political and geopolitical level (Ševčíková, 2016). As for the economic level, the examples of car industry and financial services were chosen in this paper to demonstrate how a cliff-edge withdrawal of the UK from the EU would on either or both sides cause serious damage. Naturally, the list of the economic activities is much longer. One can for example mention the meat industry which would face the highest (on average close to 50%) tariffs of all sectors under WTO rules, consequently, leading to a greater disruption to trade flows than that caused by the Russian import ban in 2014, and a loss of at least 32,000 in the EU27 (UECBV 2017). Or, the fishing sector, one of the more contentious and complex question of which being the access to fisheries resources and repatriation of responsibility for regulation within the UK’s 200 mile Exclusive Economic Zone (EEZ), having in mind that, yearly, EU27 boats catch seven times more fish by weigh (and five times by value) from the UK EZZ than UK boats do from the EU27 EZZ (Phillipson & Symes, 2018).

On the basis of the above, as neither party would benefit from an economic downturn in the other, negotiations should, in theory, focus on protecting jobs and businesses in the whole region, and thus head towards the best possible future relationship between the United Kingdom and the European Union. Unfortunately, as there is no guarantee such an optimistic scenario will happen, further research should be conducted in a wider range of sectors.

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