April 2017

# Brexit: The Road to Exit

On March 29, 2017, British Prime Minister Theresa May officially submitted the paperwork to trigger negotiations that will ultimately see Britain exit its current relationship with the European Union. This process is quite involved and will play out over the next two years. Throughout this time, it's quite possible that negative headlines may rear their head from time to time as negotiations become constructive or adversarial. This article provides some background on the current situation and serves as a reference point to help answer questions that may arise as the exit process grows more involved.

### What is the European Union?

The EU is a political and economic union between 28 European countries. It was formed after World War II (WWII) ended, initially consisting of six countries which made up the European Coal & Steel Community (ECSC) as part of the reconciliation between Germany and France. The ECSC was designed to foster economic cooperation, with the expectation that countries which trade and rely on each other are more likely to avoid conflict. Later, the European Economic Community (EEC) was created and formed the basis of today's EU. While initially designed as an economic union, the EU now oversees several issues including climate, environment, health, external relations, security, migration and human rights. In 1993, the name changed from EEC to EU in order to reflect integration beyond purely economic ties.

### What is the single market?

The single market refers to the collection of countries that have agreed to the free transfer of people, goods, services and capital. EU citizens can study, work, live and retire in any EU country, and shop all over Europe without additional tariffs. The single market allows companies to build factories, stores and head office locations outside of their primary country of incorporation and provides them access to the entire EU – nearly 500 million individuals. The sheer magnitude of this market has attracted foreign investment and led to increased competition.

### What is the Schengen area?

Under the Schengen agreement, individuals can move freely from one country to another without border controls or visas. The idea of this agreement is to enable free movement, allowing the working population to travel, live or work in any member state. Currently, the Schengen area consists of 26 nations, most of which are members of the EU. The UK is not a member of the Schengen area. On the flip side, there are a handful of countries that are not members of the EU but nevertheless are part of the Schengen area, such as Norway and Switzerland.

### What is the difference between the European Union and Eurozone (euro area)?

The Eurozone or euro area refers to a sub-group of 19 European Union countries which share a single currency, the euro. As a result, economic policy is more closely coordinated, with the countries sharing monetary policy as determined by the European Central Bank. The goal of having a common currency is to deepen economic ties and integrate economies, making it easier for companies to conduct cross-border trade and locate production facilities without needing to consider fluctuating exchange rates. Several countries, including the UK, have opted out of participation in the Eurozone and as a result maintain their own currency and monetary policy.

## What is Article 50?

Article 50 is outlined in the Treaty of Lisbon. It falls under European Union law and sets out the process by which member states can withdraw from the European Union. This process was officially triggered on March 29, 2017 when UK Prime Minister Theresa May wrote a letter to the President of the European Council, notifying the EU of the UK's intention to leave the EU. Following on from this letter, the two jurisdictions have two years to negotiate the terms of Britain's withdrawal, which can be extended with unanimous consent.

## Why did Britain vote to leave the EU?

The answer to this is complex and follows a long renegotiation of Britain's membership conditions and ultimately a referendum where voters decided they wanted to exit the EU. Calling the referendum was part of former-Prime Minister David Cameron's re-election promise in May 2015, but it stems back to concerns around Britain's level of influence in the EU and whether their economic interests are adequately addressed. In addition, concerns around the influence Eurozone members have on decisions that impact the entire European Union reared their head. As an example, the Eurozone used an EU-wide pool of assets to fund the bailout of Greece, and while the Eurozone has promised to make all non-Eurozone countries whole, concerns that EU interests are being overlooked persist.

The European sovereign debt crisis has led some individuals to suggest that further integration of Eurozone countries is necessary in order to better coordinate and address economic conditions. Each nation manages their own fiscal and tax policies, and national markets exist for energy and transportation. The financial services sector is a particular focus, as the creation of a banking union could allow the EU to supervise financial institutions, regulate financial products and manage capital rules. However, many nations have concerns about the loss of independence that could occur as a result of this integration, and Britain itself was wary about additional EU regulations and the implications they might have for London's position as a financial hub. Since November 2014, the Eurozone has had a "qualified majority", meaning it has the ability to make decisions with other Eurozone members which may impact other members of the EU. This brought to light a concern that if non-Eurozone members felt their interests were not being protected, they may have to choose between joining the Eurozone and leaving the EU altogether.

The debate was also part of a global trend in which we've seen a movement away from centrist economic policies toward skepticism of free trade and immigration, leading to decelerating globalization. It stemmed from the financial crisis and the rising inequality and slow growth environment that followed, as well as increasing isolationism. The main result of this trend appears to be shifting economic policy, away from growth maximization and toward the distribution of that growth.

## How will the negotiation process work?

The next EU summit is scheduled for April 29, 2017, and it is expected that talks may begin at that time. New terms that govern the relationship between Britain and the EU will need to be agreed upon, and key topics will include the amount the UK will pay to leave the EU, the conditions under which EU citizens can remain in the UK and vice versa, guidelines around the future freedom of movement, and most importantly, the nature of their trading relationship. In terms of the amount the UK will need to pay to leave the EU, this would involve payments for programs committed to before the UK voted to leave. Estimates vary widely, and could fall within a range of €25B-€73B depending on how negotiations resolve themselves.

In addition, the UK is currently governed by EU law as it relates to business practices. The exit process will involve determining the new rule of law in Britain, and how that applies to businesses that have offices in the UK but are incorporated under EU law.

Once a deal is struck, it will be presented to each EU member's national parliament for approval, and ultimately must be approved by a qualified majority of EU member-states. While both the European Parliament and British Parliament reserve the right to veto, the British Parliament cannot make any amendments to the deal, making it a "take it or leave it" contract. Britain will also be required to negotiate trading relationships with other countries, including the U.S., Canada and Australia.

## What are the potential outcomes of this process?

Britain will want to negotiate favourable trading terms, particularly as 45% of its exports go to the EU. However, these negotiations could prove difficult. The EU is likely to bargain aggressively as the UK leaving the EU sets a bad precedent for other countries that remain. As a result, there is a strong incentive for the EU to show other countries they will suffer on their own if they were to exit.

There are a variety of models that Britain could turn to in order to develop new relationships. These include:

- **Norway model:** Britain could join the European Economic Area (EEA), which includes countries like Norway, Iceland and Lichtenstein. This would allow it to retain access to the single market, but without a vote over EU rules on the single market that it would be obliged to implement. However, under this model Schengen rules would apply, and UK borders would be open for the free movement of individuals and labour.
- **Swiss model:** Switzerland has partial access to the single market through 20 major and 100 minor bilateral agreements with the EU. These require Switzerland to follow EU law related to the single market. Crucially, Switzerland’s agreements don’t cover services (which could include financial services) – an important distinction for Britain. In this model, Schengen rules would also apply.
- **Turkish model:** Through this model, Britain would be able to access the single market for goods only, and still be subject to EU trade rules and regulations. A key drawback is that under this model, the UK could not negotiate their own trade deals with other countries.
- **Develop a new free trade agreement:** In developing a new agreement, Britain would need to negotiate a new trade agreement with the EU. Many look to Canada’s recent free trade deal with the EU as a model for what Britain could accomplish, though as discussed it’s possible these negotiations could prove difficult. Indeed, Canada’s trade deal was developed over the course of seven years – well beyond the two years that are currently in place.
- **WTO relationship:** Without any of the above options, Britain would be left with a WTO (World Trade Organization) relationship with the EU, ultimately leading to new tariffs.

If there is no agreement within the two year timeframe, the trading relationship with the EU will default to WTO standards. The tariffs applied under this relationship vary depending on the good being exported, and range between 2% and 41% for the country’s top exports.

**WTO tariffs for Britain's top exports**

| | Exports 2016 | Average tariff |
|---|---|---|
| Machinery | £50.7B | 2% |
| Vehicles | £30.4B | 8% |
| Aircraft | £15.5B | 3% |
| Beverages | £6.9B | 4% |
| Iron and steel | £3.7B | 2% |
| Cereals | £2.3B | 41% |
| Tanning, dyeing extracts | £2.1B | 8% |

Sources: Economic and Social Research Institute and ONS U.K. Trade, 2017
Source: Bloomberg

## What are the potential economic and financial impacts?

The major concerns centre around greater uncertainty for businesses, the economy and the political landscape. It's also possible another Scottish referendum could be triggered, whereby Scotland would decide whether to remain in the UK. Britain's Treasury Department determined that leaving the EU could reduce GDP by 6.2% after 15 years through constrained economic activity and higher trade barriers while various economic models suggest that Britain could see a 2%-plus hit to economic output as multinational corporations may decide to build their factories and develop head offices elsewhere in the EU. The terms of a deal could also indicate whether the UK has set the stage for other countries to exit. The EU is likely going to want to be tough on negotiations in order to dissuade this outcome, particularly as negotiating an exit from the common currency is significantly more complex than solely exiting the EU.

As Theresa May wrote in her letter to the EU, the UK is exiting the EU "but not Europe, and wants to remain committed partners and allies." She has called on both sides to "negotiate constructively and respectfully, putting citizens first in the spirit of sincere cooperation." Ultimately, the EU doesn't want to punish Britain for this decision, but will want to draw a hard line that prevents the UK from receiving a better deal outside the EU than it received inside. At this point, much will depend on the years of negotiation that will now take place and the relationship that is subsequently established.