

CURRENT IMPASSE IN BREXIT NEGOTIATIONS AND FUTURE OUTLOOK

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BREXIT NEGOTIATIONS DEADLOCKED AS TIME RUNS OUT

The negotiations on the United Kingdom's withdrawal from the European Union (Brexit) are approaching a climax. The Brexit negotiations began on June 19, 2017 after the UK made the decision to leave the EU in a referendum held on June 23, 2016 and then submitted notice of its intention to leave the EU to the European Council on March 29, 2017 (Figure 1). Under Article 50 of the Treaty of Lisbon, a country that decides to leave the EU shall leave two years after submitting notice of its intention to leave even if it is unable to conclude a withdrawal agreement, unless there is unanimous agreement of all member states to extend the negotiation period. As such, the UK and EU are negotiating on the assumption that the UK will leave the EU on March 29, 2019, which will be two years after the UK submitted its notice.

The Brexit negotiations are composed of the following three discussions: (1) the terms of withdrawal : including payment by the UK of its liabilities, securing the rights of citizens of both the UK and EU, and managing the border between the Republic of Ireland and Northern Ireland; (2) the future relationship: this could include a comprehensive FTA after the UK's withdrawal; and (3) the transition period: this is the relationship in the period after withdrawal until the future relationship can be finalized. Of these, official discussions on the "future relationship" cannot be launched until after the UK's withdrawal from the EU, and discussions are being seen as no more than preparatory.

In talks on the "terms of withdrawal", a framework agreement was reached in December 2017 on matters including the UK's payment of a EUR 41.4 billion settlement (as estimated by the UK's Office for Budget Responsibility), maintaining the level of rights of both UK and EU citizens, and avoiding a hard border between the Republic of Ireland and Northern Ireland (however, further discussions are to be held on the details). In talks on the "transition period", a framework agreement was reached in March 2018 in which the UK would remain in the EU's single market and customs union until the end of December 2020 and would be able to maintain the current business environment, on condition that the UK loses its rights to influence EU policy decisions.

Since April 2018, talks have focused on the outstanding issues in relation to the terms of withdrawal and the transition period, and preparatory talks have been held on the future relationship. On the question of avoiding a hard border between the Republic of Ireland and Northern Ireland, the UK and the EU agreed to include in the withdrawal agreement measures to be introduced in the event that the UK is unable to come up with a detailed policy during the transition period (the so-called "backstop"). However, compromise on the details of this policy has not been possible, and this has caused the negotiations to stall.

The negotiations have met with difficulties because of fierce infighting over Brexit in the UK's ruling Conservative Party between the so-called "hard Brexiteers" and "soft Brexiteers". The hard Brexiteers prioritize controls on immigration and restoring sovereignty over the economic benefits of access to the single market, whereas the soft Brexiteers prioritize the economy while allowing a certain level of immigration control and aim to maintain maximum access to the single market. The May administration lost its majority in a general election held in June 2017, and the administration is being propped up through a "confidence and supply" agreement with Northern Ireland's Protestant conservative DUP (Democratic Unionist Party). As the draft final agreement with the EU

should be approved by the UK parliament, the UK government has been forced to carry out negotiations in a way that balances the hard Brexiteers and soft Brexiteers. For this reason, the UK has been unable to build a consensus on its negotiating policy or make any bold concessions to the EU.

Figure 1 Background to Brexit Negotiations

	Significant events	Talks on withdrawal terms	Talks on transition period	Talks on future relationship
2016				
June 23	Decision to leave EU made in UK national referendum			
July 13	Start of Theresa May administration			
2017				
March 29	Prime Minister May submits notice of intention to withdraw to European Council			
June 8	Conservative Party loses majority in UK general election	Prime Minister May somehow manages to remain in government through a "supply and confidence" agreement with the DUP, but is forced to negotiate in a way that balances the conflict within her party between "hard Brexiteers" and "soft Brexiteers". She has been unable to set out a clear negotiating policy or concessions to the EU, and this has been one reason for the stalled negotiations.		
June 19		Brexit negotiations start		
		First phase of negotiations focuses on the "withdrawal terms"		
December 14-15	European Council summit	Framework agreement is reached in the first phase. From January 2018, negotiations enter the second phase, which focuses on the "transition period" and "future relationship".		
2018				
March 22-23	European Council summit		Intensive discussions held from January to March on "transition period" in second phase	
			Framework agreement reached on "transition period"	
		Remaining issues are dealt with and legal text is put into the "withdrawal agreement"	Remaining issues are dealt with and put into legal text (agreement on transition period to form part of the "withdrawal agreement")	Preparatory discussions held on "future relationship"
June 28-29	European Council summit	June 2018 European Council summit was set as deadline for making progress on the backstop for the issue of the hard border of Northern Ireland in the "withdrawal terms". However, no progress is made.	No serious issues remain between the UK and the EU in discussions on the "transition period"	The "framework agreement" on the future relationship will be announced as a "political declaration" to be attached to the "withdrawal agreement".
July 12	Prime Minister May announces "Chequers" plan setting out negotiating policy on the "future relationship"			Shift in direction towards a slightly softer Brexit limited to "goods"
September 19-20	Informal meeting of European Council	The United Kingdom rejects the backstop proposal of Northern Ireland remaining in the EU's customs union, and neither side appears willing to compromise.		There was a certain level of approval from the EU for the UK's negotiating policy, but the EU also demanded revisions to the framework on economic relations, which it claimed would not work well.

Source: Created by Mitsui & Co. Europe based on materials published by the EU and UK government, etc.

CHEQUERS PLAN FOR NEGOTIATING POLICY ON FUTURE RELATIONSHIP HAS NOT BEEN A GAME CHANGER

In the Brexit negotiations on the “terms of withdrawal” and the “transition period”, the EU said that nothing is agreed until everything agreed – all the agreement reached so far will be scrapped if the EU and the UK fails to conclude negotiations on all fronts, including the already agreed framework of the transition. Companies that had welcomed the framework agreement on the transition period reached in March 2018 are again becoming increasingly wary of a “no deal” situation.

On July 12, 2018, Prime Minister May announced a white paper known as the Chequers plan for the negotiating policy on the “future relationship”. The plan was put together after a twelve-hour special cabinet meeting with the aim of making a breakthrough and accelerating the negotiations (Figure 2). Particular attention should be paid to the fact that the UK would agree to EU rules, although limited to goods, and aim for a “free trade area for goods”. This was a shift of direction towards a relatively “soft” Brexit.

Figure 2 Chequers Plan for Negotiating Policy on UK’s “Future Relationship” with the EU

Item	Details
Goods	<ul style="list-style-type: none"> Regarding goods, accept a common rulebook with the EU and establish a “free trade area” for goods between the UK and EU (including agri-food as well as industrial products) Introduce a “facilitated customs arrangement”. The UK would (on the EU’s behalf) impose the EU’s tariffs and customs checks on imported products destined for final consumption in the EU (and require the EU to carry out similar measures), thereby removing the need for customs procedures when reexporting from the UK to the EU or vice versa. The UK would apply its own tariffs and customs checks on imported products not intended for consumption in the EU, which the UK would decide after it has left the EU. In implementing the policy, the latest information technology would be used to identify the final consumption destination of the product. The UK would leave the EU’s Common Agricultural Policy and Common Fisheries Policy.
Services	<ul style="list-style-type: none"> Regarding services, the UK would introduce new rules that diverged from EU rules. This would mean that the UK and EU would not be able to maintain current levels of access to each other’s markets. Regarding finance, because the UK would be leaving the Single Market, it would lose its “passporting rights”, which allow branches to be established and services to be provided in any other countries within the region if a license is acquired in an EU country. “Equivalence assessments” currently applied to third nations outside the EU would be introduced, with enhancements on matters such as assessment procedures, revocation of accreditation, and dispute resolution.
People	<ul style="list-style-type: none"> The freedom of movement of people would end. A reciprocal system would be built for travel for business and tourism, and to support study.
Trade policy	<ul style="list-style-type: none"> The UK would carry out an independent trade policy, including the conclusion of FTAs, etc. with non-EU countries. It would consider participating in the TPP.
Contributions to EU budget	<ul style="list-style-type: none"> Vast contributions to the EU budget would end, with the exception of participation (without voting rights) in specialist bodies in highly-regulated industries (EMA, ECHA, EASA).
Dispute resolution, etc.	<ul style="list-style-type: none"> A shared institutional framework would be built to interpret and apply agreements reached between the UK and EU. Rulings of the CJEU (Court of Justice of the European Union) would be taken into consideration in fields where common rules with the EU were applied. A shared institutional framework would be built for “dispute resolution”.

Source: Created by Mitsui & Co. Europe based on “The future relationship between the United Kingdom and the European Union” issued by HM Government of the UK.

Meanwhile, the UK government has decided not to accept EU rules on “services” and it will not be able to maintain the current level of access. In relation to finance specifically, the Chequers plan represented a backward step. The UK government abandoned its previous proposal for “mutual recognition of rules” by the UK and EU, and put forward a plan to introduce an “enhanced equivalence”. An equivalence arrangement is a system through which the European Commission grants the financial institutions of third nations outside the EU the ability to operate freely within the EU region if it deems that the third nation has financial regulations equivalent to the EU. Countries such as Japan and the United States have obtained equivalence for multiple financial regulations. The system has problems from the perspective of the third nation, such as unpredictability. For example, approval is a unilateral measure implemented by the EU, and it can be withdrawn at short notice. The UK aims to introduce a system with improvements on matters such as assessment procedures, revocation of accreditation, and dispute resolution.

These proposals gained a certain level of approval from the EU as a way of opening a path to constructive debate. However, during negotiations carried out based on the Chequers plan at the end of July, the EU expressed concerns about the proposed “facilitated customs arrangement”, including the idea of the EU allowing a non-member country to collect tariffs and apply trading rules. At an informal meeting of the European Council held in September, the President of the European Council, Donald Tusk pointed out the need for revisions, commenting in respect to the Chequers plan that “the suggested element for economic cooperation will not work, not least because it risks undermining the single market”. The UK also proposed establishing a one-year customs partnership after the conclusion of the transition period as a proposed backstop to avoid a hard border between the Republic of Ireland and Northern Ireland. However, this received a critical response as “cherry-picking” because (1) it was a short and time-limited measure and (2) the UK would be outside the EU’s common trade policy. There appears to be no way of accelerating the negotiations.

FUTURE PROSPECTS

If we look ahead and consider the coming year or slightly thereafter, in terms of the prospects for agreeing the withdrawal terms and successful ratification, as well as what the details of any agreement on a framework for the “future relationship” might be, the following four scenarios can be assumed.

Scenario (1) Orderly Brexit (likelihood – high)

The EU’s backstop proposal for avoiding a hard border between the Republic of Ireland and Northern Ireland is for Northern Ireland only to remain in the EU’s customs union. This would be hard for the May administration to accept from the perspective of the integrity of the UK. There are large differences between the two sides, and reaching a final agreement on the terms of the withdrawal at the European Council summit in October 2018, as initially planned, will be almost impossible (Figure 3).

Under this scenario, as uncertainty about the future increased, there would be a major slowdown in economic conditions in the UK, fluctuations in the financial and exchange markets, and a rapid increase in pressure on the government and parliament from households and businesses to avoid a “no deal”. The EU is also aware of how serious the negative impact would be in the event that negotiations break down, including turmoil in corporate and economic activities. It would soften its negotiating position with the UK, and as both sides made concessions a final agreement would be reached at the last moment possible in view of the ratification process, which would be the European Council summit in December 2018.

Figure 3 Important Brexit-related Dates and Points of Interest

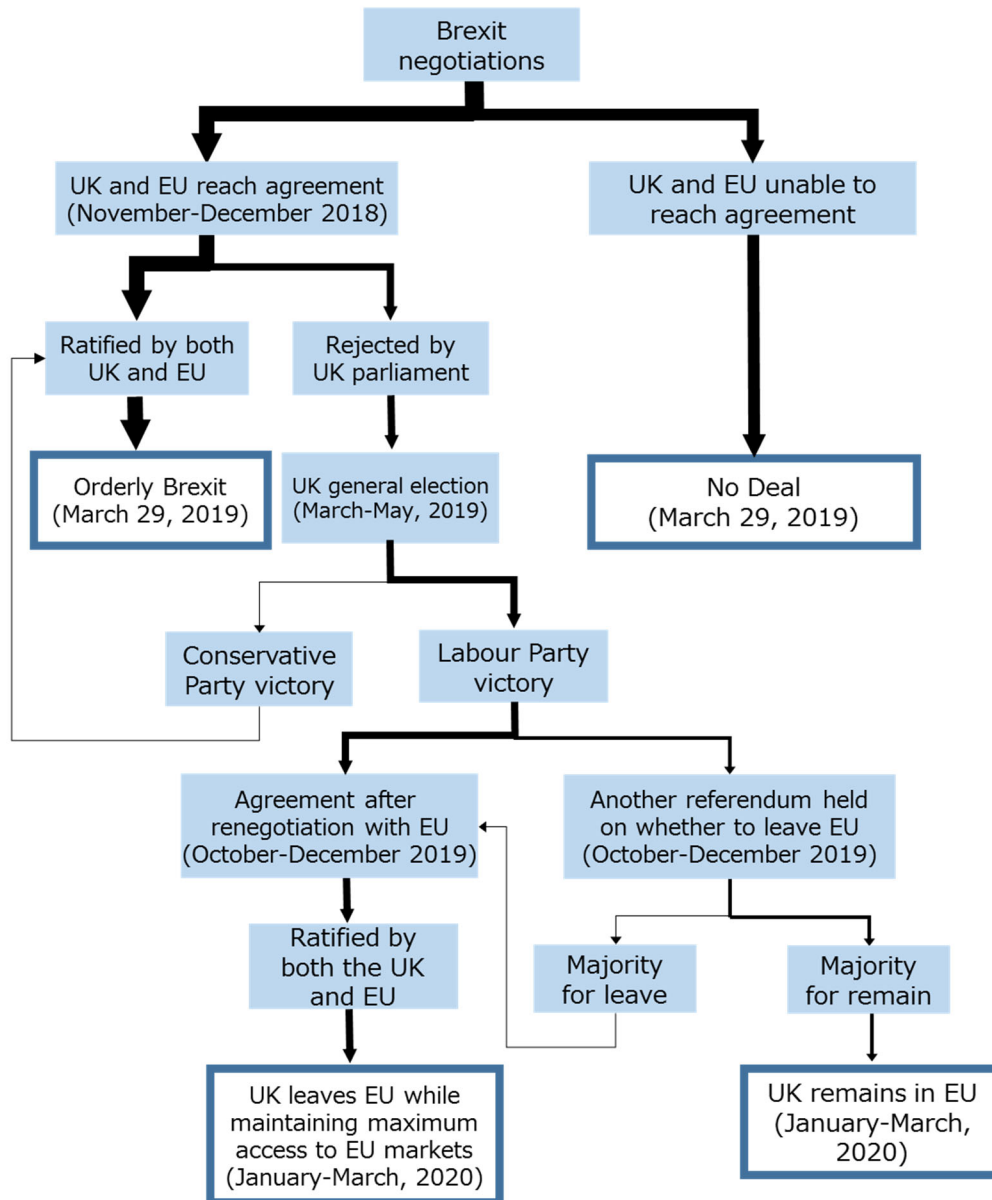
October 17-18, 2018	European Council summit	<ul style="list-style-type: none"> ➤ In view of the ratification procedures in both the UK and EU (the approval of the UK parliament, the European parliament, and the European Council of Ministers are all required), the October 2018 European Council summit was seen as the effective deadline for the negotiations for (1) final agreement on the “withdrawal terms”; and (2) the framework agreement on the “future relationship”. However, this has effectively been abandoned because of the deadlocked negotiations.
November 17-18, 2018	Extraordinary European Council summit	<ul style="list-style-type: none"> ➤ In the case that maximum progress is deemed to have been made at the October European Council Summit, the EU will decide to hold an extraordinary summit of the European Council in November, and aim to reach a final agreement.
December 12-14, 2018	European Council summit	<ul style="list-style-type: none"> ➤ Judging from the state of negotiations, a realistic option would be to reach final agreement at the December summit of the European Council.
January 21, 2019	Deadline for agreement under the UK’s European Union Withdrawal Act	<ul style="list-style-type: none"> ➤ In the case that agreement cannot be reached on the “withdrawal terms” by this date, the UK government may submit a “new negotiating policy” to the House of Commons, which may debate the policy and propose amendments to the government. ➤ The question of whether such amendments would be binding on the government will be judged by the Speaker.
March 29, 2019 11PM (UK time)	UK leaves the EU	<ul style="list-style-type: none"> ➤ This is the deadline for EU withdrawal negotiations under Article 50 of the Treaty of Lisbon (two years will have passed since notification of the intention to withdraw). The negotiation period may be extended through the unanimous agreement of the European Council. ➤ If the “withdrawal agreement” comes into force, the transition period will begin simultaneously (up to December 31, 2020). Detailed discussions will then begin on the “future agreement”.
May 23-26, 2019	European Parliament elections	<ul style="list-style-type: none"> ➤ Preparations for the European Parliament elections are being carried out on the assumption that the UK will not be participating. However, in the event that the negotiation period is extended beyond the election dates there will be issues concerning the UK’s participation in the election without an assumption of serving a full term (five years), and how to handle the UK’s participation in medium-term policy making, such as the budget.
December 31, 2020	End of the transition period	<ul style="list-style-type: none"> ➤ Even in the case that the “transition period” is entered through conclusion of a withdrawal agreement, it is thought that reaching detailed discussions on the “future relationship” will require around five years. It seems likely that the transition period will need to be extended.
May 5, 2022	UK general election	<ul style="list-style-type: none"> ➤ Under the Fixed-term Parliaments Act, the Prime Minister does not have the power to dissolve Parliament, but in view of the current chaotic state of Brexit negotiations, there is a possibility of an early general election being fought over Brexit.

Source: Created by Mitsui & Co. Europe based on materials published by the EU and UK government, etc.

In order to obtain approval of the final agreement by the UK parliament, it would be necessary to obtain support from members of the opposition because there are more than twenty hardcore hard Brexiteers in the Conservative Party who have declared that they will rebel. The Labour Party, which is the largest opposition party, has divided opinions on how the UK should leave the EU and its processes, and Prime Minister May would succeed in winning votes from some members of the Labour Party. The “withdrawal agreement” would be ratified, and the UK would leave the EU on March 29, 2019 and enter the “transition period” (Figure 4).

The framework agreement on the “future relationship” would likely be based on making revisions to the Chequers plan as the draft proposal. The UK and the EU are aligned on aiming for zero tariffs and no quantitative limit in goods trade. However, the UK has clearly stated that it will be leaving the customs union, and even if customs checks were simplified they would need to remain in place. Regarding services, the Chequers plan sets out that the UK would not harmonize with EU rules, and that it would not be possible to maintain the current level of mutual access. Regarding finance, according to the Chequers plan, the UK would seek to obtain “enhanced equivalence”. “Equivalence” is applied in an identical way to all third nations, and there seems very

Figure 4 Brexit Timetable for the Coming Year and Later



Note 1: This assumes that the two-year negotiation period set out under Article 50 of the Treaty of Lisbon is extended if a general election or second referendum is held.

Note 2: The thickness of the chart lines shows the likelihood of each event (thicker means more likely).

Source: Created by Mitsui & Co. Europe

little likelihood of the UK alone being offered special treatment. On immigration controls, Prime Minister May officially announced her post-Brexit immigration policy on October 1, 2018. The UK would offer no preferential treatment to EU citizens, and would prioritize highly-skilled workers, while seeking to limit workers with low skills. It seems likely that this will be the basic direction taken by the UK as it introduces immigration controls.

As a general rule, most companies are likely to be making arrangements with this scenario as the base case.

Scenario (2) No deal – disorderly Brexit with no agreement – (likelihood – medium)

Under this scenario, as a result of a relatively modest slowdown in economic conditions from now until early 2019, there would be relatively little pressure from the public on the government and parliament for an “agreement”. Prime Minister May would continue to struggle to balance hard Brexiteers and soft Brexiteers, and would remain unable to make bold concessions. The EU would refuse concessions and maintain a firm negotiating position in the expectation that the UK would eventually give in completely. As a result, the time limit

would be reached with the two sides unable to come to a final agreement, and the UK would be forced into a “disorderly Brexit” with no agreement on either the withdrawal or future relationship.

There would be a strong likelihood of the UK and the EU taking minimum measures to avoid major economic disruption, including measures on immigration and the transfer of personal data, and an aviation treaty, etc., but trade between the UK and other countries would be forced to switch to a WTO most-favored nation basis.

For the UK economy, from the end of March 2019 onwards capital expenditure would be expected to fall because of a reduction in both exports and imports caused by chaotic customs checks and increased tariffs, and because of a more negative business mindset and reduced inward direct investment. Soaring import costs because of a weaker pound and increased tariffs would accelerate inflation, and lead to a fall in real incomes. An adverse assets-effect caused by a crash in share prices and house prices would compound the situation, leading to a fall in personal consumption, and the economy would fall into stagflation.

In terms of the impact on business activities, supply chains crossing the UK and EU would be impacted by the chaotic customs checks, and there is a risk that production lines would be forced into suspensions, as pointed out by the Society of Motor Manufacturers & Traders (SMMT) and Airbus. Financial institutions would be forced to bring forward the plans for large-scale relocations of functions and personnel from London to continental bases that they had initially planned to carry out during the “transition period”.

Scenario (3) Soft Brexit – Withdrawal maintaining maximum access to EU markets – (likelihood – low)

This would be a similar scenario to the “orderly withdrawal scenario” in that there would be a major slowdown in economic conditions in the UK and a rapid increase in pressure on the government and parliament, and at the same time the EU would soften its negotiating position, leading to both the UK and the EU making concessions and reaching a final agreement. However, Labour Party leader Jeremy Corbyn would use the party conference and other opportunities to get Labour MPs behind his party’s strategy of seeking a general election by rejecting the final agreement on the withdrawal terms. The Conservative Party would fail to compensate for the rebel MPs in its own party by bringing Labour MPs onside, the final agreement would be rejected by parliament, and a general election would be held on the issue of Brexit. In view of the UK’s need to establish a government after the general election and considering a renegotiation process, the European Council would decide to extend the negotiation period by one year. European parliament elections in May 2019 are being prepared on the assumption of the UK’s withdrawal, and extending the negotiating period beyond election day would bring a range of problems, but the EU would agree to extend the negotiation period based on strong hopes for the new administration and to avoid the chaos of no deal. The general public in the UK would be unhappy with the Brexit negotiations that had been carried out by the Conservative Party government. The Labour Party, which has remained close to the Conservative Party in opinion polls, would win the largest number of seats as the party that supports remaining in the customs union and maintaining maximum access to the single market, and establish a stable government with the cooperation of the Liberal Democrats and other parties. The Labour government would then renegotiate with the EU on the basis of a framework agreement on the “future relationship”. The EU would welcome a new government that sought a relatively unchanged relationship economically, and the deal would be ratified after reaching an agreement relatively smoothly.

The framework agreement on the “future relationship” would differ from the “orderly withdrawal scenario” in terms of customs checks for goods, access to the EU market for services, and the strictness of immigration controls. A customs union would be concluded for goods. The UK and EU would not impose tariffs, limit volumes or implement customs checks, and seamless trade would be maintained. Regarding services, harmonization with EU rules would be achieved to a large extent, and this would secure access to the single market at a similar level to the current arrangements. Regarding immigration controls, the Labour Party has stated that it would not impose any numerical targets, and immigration controls would go no further than the introduction of emergency measures in the event of a rapid increase in immigration.

Scenario (4) Holding another referendum and remaining in the EU (likelihood – very low)

This scenario would be the same as the “soft Brexit scenario” in that the “withdrawal agreement” would be rejected by the UK parliament, a general election would be held, and a Labour Party-led government would be established. However, under this scenario market turmoil would lead to a major reappraisal among the British public of the negative economic impact of Brexit, which had hitherto been underestimated, leading to a noticeable increase in “Bregret”. The Labour Party administration would be encouraged by public opinion to hold a second referendum on the question of remaining or leaving the EU, and “remain” supporters would win (Figure 4).

There is a strong possibility of an “ordinary withdrawal”. But it is necessary to follow the state of negotiations and to be flexible

The UK economy achieved year-on-year annualized growth of 1.6% in April-June 2018, but this figure was boosted by one-off factors such as a rebound from the cold weather in January-March and the Football World Cup held in June. However, the underlying UK economy is not strong, as suggested by an ongoing decline in capital expenditure. Looking forward, increasing uncertainty around the Brexit negotiations is expected to weigh on household and business confidence and lead to a weaker pound. Weak real GDP growth of around 1% year-on-year is forecast. Wariness among companies about the possibility of no deal is rising rapidly, and lobbying of the government has been intensifying.

The EU is also coming to recognize the negative effects that would result from a breakdown in negotiations, including the reestablishment of a hard border between the Republic of Ireland and Northern Ireland, the loss of the settlement payment from the UK, and the chaos in corporate and economic activities. Regarding the backstop proposal to avoid a hard border between the Republic of Ireland and Northern Ireland, Prime Minister May has spoken about new proposals and EU Chief Negotiator Michel Barnier has hinted at amendments to the EU proposals for using IT to simplify customs clearance. The two parties appear to be inching towards a compromise.

Opinions have been voiced that there is a risk that the “final agreement” will not be approved by the UK parliament. However, it seems very likely that the “withdrawal agreement” will pass with a small majority for the following reasons: the framework agreement on the “future relationship” will be nothing more than a “political declaration”, and up to a point it will be possible to use vague language to reach a compromise that convinces both soft Brexiteers and hard Brexiteers; in view of the closeness of the levels of public support for the Conservative Party and Labour Party, many Conservative MPs are likely to want to avoid rejecting a withdrawal agreement because of their fear of a general election; and there is also likely to be a certain number of abstentions from the opposition parties out of concern for economic chaos, etc.

In summary, the most likely of the four scenarios is an “orderly withdrawal”. “No deal” is not currently the main scenario, but close attention should be paid to the fact that its likelihood has been increasing recently. The next most likely scenario is a “soft Brexit”.

Regarding the possibility of holding another referendum and remaining in the EU, which has been a hot topic in the mass media, it is only a little over two years since the June 2016 referendum was held, and there is a close split among the public between support for and opposition to holding another referendum. In addition, Prime Minister May is firmly opposed to the idea. As for the Labour Party, it passed a motion at its party conference in September 2018 to the effect that the party would seek a general election in the event that the final agreement is rejected by parliament but that the party “must support all options remaining on the table, including campaigning for a public vote”. However, opinion in the party is divided, and party leader Jeremy Corbyn is ambivalent about the idea of another referendum. Overall there appears to be an extremely low likelihood of another referendum being held.

Nevertheless, the likelihood of each scenario will change greatly depending on future political and economic changes in the UK and political changes in the EU. Companies are paying close attention to these factors and

the state of the negotiations, and it will be necessary to respond flexibly with a sense of speed on the questions of whether and when to implement contingency plans in preparation for no deal.

Note: The original Japanese report was written in October 2018.