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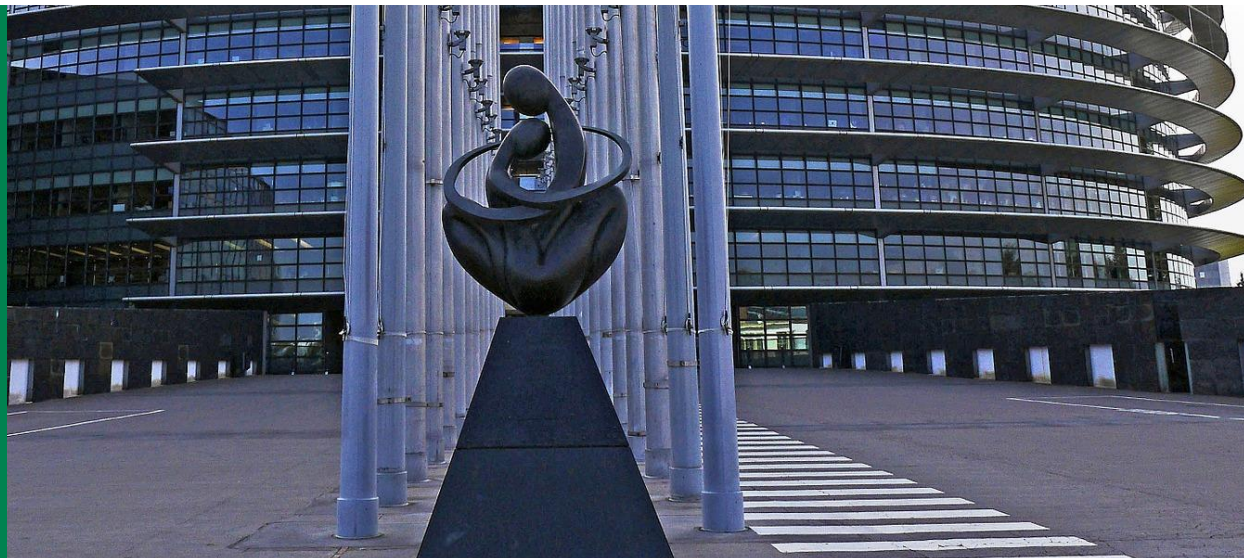
The Road to Brexit, December 2016



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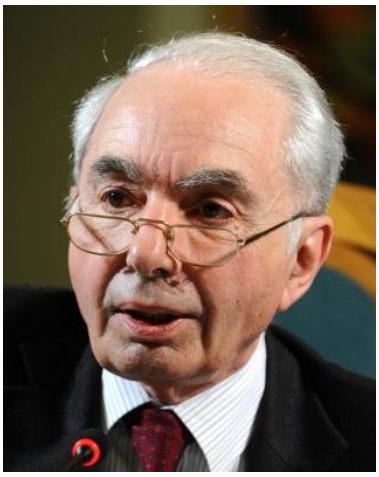
The Process of Leaving the EU

Triggering Article 50

The formal process of leaving the EU is legislated for by Article 50 of the Treaty on European Union (TEU). Invoking Article 50 gives notice to the EU that the UK intends to leave and marks the beginning of a negotiation period during which the UK attempts to agree the terms of its exit. Unless an extension is granted by unanimous agreement of the European Council, the UK officially leaves the EU two years after the date on which Article 50 was triggered, regardless of whether or not a deal has been successfully negotiated.



Giuliano Amato

The article's author, Giuliano Amato, has claimed that Article 50 was never meant to be used and was inserted into the TEU to placate the British Government. As such, the procedural necessities of Article 50 stack the balance of power heavily in the EU's favour.

In particular, any withdrawal agreement will have to be negotiated with and approved by the European Commission, receive consent from the EU Parliament in the form of a simple majority, and potentially be ratified by each member state. The final part of this process saw Canada's free trade agreement with the EU (Ceta) held up by Wallonia, a regional Parliament in Belgium. This does not bode well for the UK as its ideal trade agreement would likely be significantly deeper and more complicated than Ceta and will be negotiated in a more hostile environment.

In Focus: What happens once the UK has left?

Brexit has massive implications for UK law. Currently the European Communities Act 1972 (ECA) automatically gives legal authority to all EU law and grants it supremacy over UK law. After decades in the EU, many of the laws and regulations that now operate in the UK originate from the EU. In order to prevent legislative chaos as Britain extricates itself from the union, Theresa May has announced the Great Repeal Bill. This will do three things.

First it will repeal the 1972 European Communities Act, formally seceding Britain from the EU and ending the supremacy of EU law. Second it will transpose all existing EU law into domestic UK law. It may appear counterintuitive to embrace all EU law having voted to leave the union but, in doing so, Parliament will be able to modify or repeal any elements of EU law in a timescale that is practical for the UK's legislators. Finally, the Great Repeal Bill will determine delegated powers for the Government's ministers to enact aspects of the UK's withdrawal agreement. This will be the most controversial part of the Bill as it will transfer powers from Parliament to the executive so that it can carry out the terms of a deal that may well have received limited Parliamentary scrutiny.

[1] Photo of Giuliano Amato courtesy of Niccolo Caranti, resized

The Process of Leaving the EU

When will the PM trigger Article 50?

At the Conservative Party Conference, Theresa May indicated that she intends to trigger Article 50 in late March 2017. This is because a number of crucial elections take place across Europe at the beginning of next year. As the UK will be seeking ratification from member states as well as negotiating with the EU, it is important that the UK knows who is in charge in each member state.

Recent developments have put this proposed timetable at risk, however. The Government is currently fighting a court case brought about by anti-Brexit campaigner Gina Miller. On 3 November, the High Court ruled that Article 50 must pass through the Commons and Lords, giving MPs and peers the ability to table amendments and vote on the legislation. The UK Government is appealing the decision and the case is currently before the Supreme Court[2] with a decision expected early in the New Year.

The UK Supreme Court, Court 1

If the High Court's decision is upheld, Parliament will theoretically have the power to vote down the legislation and prevent Article 50 from being triggered. This outcome is extremely unlikely however as the Conservatives have a majority in the House of Commons and many Labour MPs represent constituencies that voted heavily for Brexit. The Government can expect more of a battle in the House of Lords where they do not have a majority and where the members are not beholden to a constituency. Despite this, peers are unlikely to oppose a Bill that has been passed by the Commons, especially if it receives a large majority.

A more likely outcome of the court case is that Brexit is delayed by the legislative process. The Government will attempt to fast-track the legislation – early reports in the media suggest that the Government has drafted a three line Bill which it intends to force through in two weeks – but the Government may be defeated on the programme motion which sets out the timeline for the debate. There is precedent for this; one of the coalition Government's first major defeats was on the programme motion for the House of Lords Reform Bill 2012 after a significant number of Conservative rebels voted against the motion, despite agreeing with the substance of the Bill, because they felt that not enough time had been allocated for debate. Again, the Government can expect more difficulty in the House of Lords which does not accept time restraints, and who like to flex their legislative muscles when the opportunity arises.

[2] Photo of the UK Supreme Court, courtesy of Rwendland

Models for Brexit

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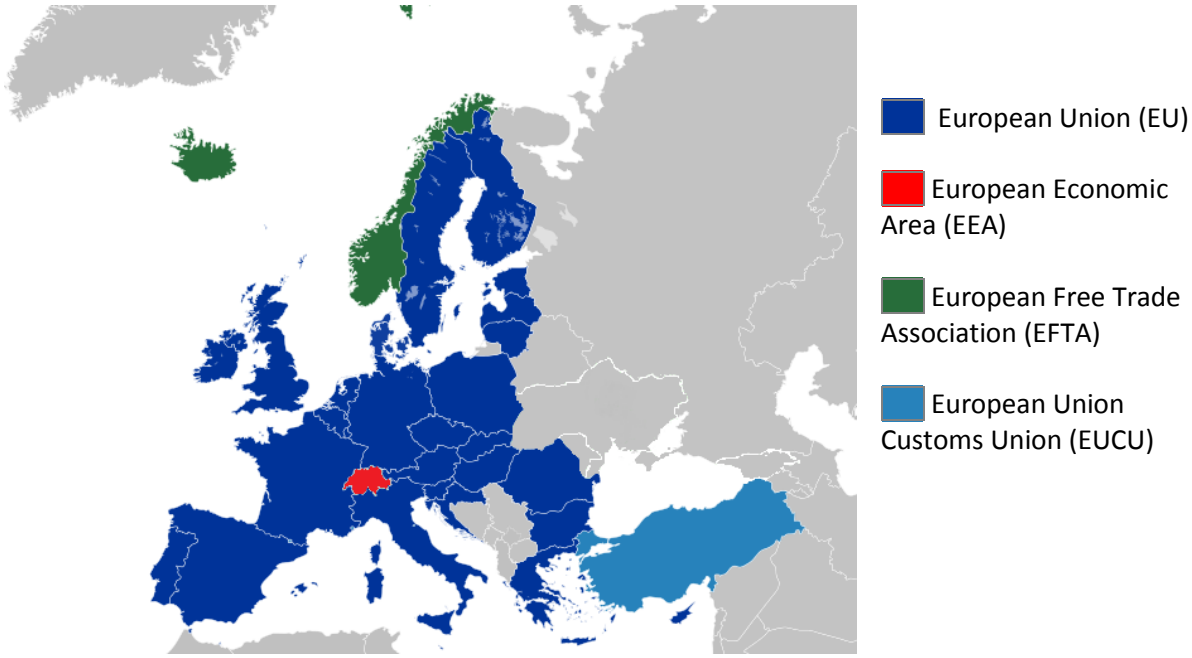
Once Article 50 has been triggered, the UK begins the arduous process of extracting itself from the EU. There are a number of examples of states that trade with the EU that the UK may look to as models for coexistence after Brexit.

The 'Norway Model' - membership of the European Economic Area (EEA)

EEA membership would represent the smallest departure from the EU. Membership of the EEA provides access to the EU's internal market but requires adherence to the vast majority of EU regulations, including free movement of people, without any ability to influence or vote on those regulations. If Britain were to adopt this model, it would also be expected to continue paying in to the EU's budget. The Norway model does entail some significant freedoms, particularly regarding control over agricultural subsidies and fisheries, as well as the ability to negotiate bilateral trade deals elsewhere in the world, but in most regards it represents little change to Britain. As a result, the Norway model will not appeal to the portion of the British electorate who voted for Brexit as it does nothing to curb immigration and leaves the EU in control of significant areas of legislation.



The 'Switzerland Model' - membership of the European Free Trade Association (EFTA)

Switzerland has selective access to the EU single market governed by a series of bilateral agreements and is a member of EFTA, a regional trade association which also includes Iceland, Liechtenstein, and Norway. If Britain pursued the Switzerland model it would have greater freedom over its laws than under the Norway

[3] Map of European trade agreements, courtesy of Kolja21

model and would be required to make smaller EU budget contributions. Its single market access would still be conditional on the free movement of people however.

Due to the ad hoc nature of the bilateral agreements, the success of the Switzerland model would be dependent on which areas of the single market were covered by the deal. Switzerland, for example, has not negotiated single market access for many services, including the banking sector, which would be disastrous for the UK as services make up almost 80% of its economy and banking makes up a large proportion of this.

	Access to Single Market			Requirements		Influence
	Goods	Services	People	Financial contribution	EU rules and legal system	EU rules and regulation
UK (current)	✖	✖	✖	✖	✖	✖
Norway	✖	✖	✖	✖	✖	✖
Switzerland	✖	✖	✖	✖	✖	✖
Canada	✖	✖	✖	✖	✖	✖
WTO	✖	✖	✖	✖	✖	✖

✖ Full integration
✖ Partial integration
✖ No integration

The 'Turkey Model' - membership of the customs union

The UK could leave the single market but maintain a level of integration with the EU by remaining a member of the customs union after Brexit. Membership of the customs union would see Britain participating in the EU's external tariffs and benefiting from tariff-free trade of industrial goods within the EU. The customs union does not cover services, which would leave the UK's banking sector exposed, meaning that the UK would have to negotiate further single market access in addition to the customs union. The participation in external tariffs would also prohibit the UK from striking its own free trade deals with other nations, preventing it from becoming the "agile" trading nation that Theresa May envisages. Given that the Government has created a new Department for International Trade whose purpose would be defunct under in the customs union, it seems unlikely that the Government will pursue the "Turkey Model" approach.

The 'Canada Model'- Comprehensive Economic and Trade Agreement (Ceta)

Ceta was signed at the end of October, concluding a near-seven year negotiation. The deal will see tariff-free trade on almost all goods traded between Canada and the EU but it excludes the liberalisation of many services, including banking. Unlike single market access agreements negotiated by European states, Ceta's freedom of movement clauses focus mainly on the movement of business people.

There is much to commend a variation of the Canada model to the UK, and David Davis, the Secretary of State for Exiting the EU, has described it as "the perfect starting point for our discussions with the

commission". However, achieving a Ceta-like trade deal would be a long and complicated process; one that is almost certainly unachievable within the two-year timescale dictated by Article 50. In addition, Ceta benefitted from political good-will on both sides. The UK's negotiations will be much more fraught as the EU will be reluctant to let the UK get too favourable a deal in a bid to discourage other nations from seceding. Therefore the Canada model likely represents a longer term objective than is made possible by Article 50 and would have to be facilitated by a transitional arrangement.

The 'World Trade Organisation (WTO) Model' - total exit from the EU

If the UK fails to negotiate a withdrawal agreement by the time the two year negotiating period has expired, it is generally assumed that the UK will default to WTO rules.

Comprised of 164 members and responsible for 95% of world trade, the WTO provides a forum for international trade regulation. Among its functions, the WTO limits the size of import tariffs and sets tariff-rate quotas on a country-by-country basis. After Brexit, WTO membership would provide the UK some protection against punitive tariffs from the EU and a level of access to the EU market.

Despite the prevailing view that WTO membership is a guaranteed default, exiting the EU also has implications for the UK's existing WTO membership. The UK is a part of the WTO both individually and as part of the EU. This means that Britain will have to renegotiate its relationship with the WTO following Brexit. In particular the UK will have to agree new country-specific commitments that were previously covered by the EU's membership of the WTO.

At the same time, the EU will also be renegotiating its own membership of the WTO to reflect Britain's exit. Since the WTO is likely to prioritise its negotiations with the EU as the larger trading bloc, the UK will likely be in a position where it has left the EU before it has been able to agree new WTO commitments. It is therefore not yet clear what the "default option" actually means.

The Outlook for Britain

While these models for trade with the EU post-Brexit based provide useful context for understanding Britain's options, Britain is a very different country from the above examples.

In particular, Britain's integration with the EU runs far deeper than any non-member state. The UK is the first country to secede from the EU, so its eventual trade deal will be judged with regards to what it has lost compared to maintaining full membership. Secondly, Britain's economy is heavily reliant on the services sector, far more so than any of the other states that have trade deals with the EU. Therefore the UK's priorities will be different. Finally the artificial deadline of two years negotiating time imposed by article 50 places severe restraints on what it is possible for the UK to achieve. As a result, Britain will likely target a transitional arrangement, keeping many aspects of EU membership early on, but moving towards a more complex trade deal in the future.

Negotiations

The EU referendum posed a single, yes/no question: "Should the United Kingdom remain a member of the European Union?" Interpreting the outcome of the referendum in light of the simplicity of this question presents a major problem for the Government.

As evidenced by the variety of models described above, there is no set destination for Britain after Brexit. It could be argued that the electorate voted simply to repeal the 1972 European Communities Act and now the nature of that exit is the exclusive domain of the UK Parliament. However, in the climate of distrust towards politicians and the widespread rejection of establishment politics epitomised by the result, it would be unwise for politicians to ignore the motivations behind the leave vote.

Therefore, Parliament's task is to unpick the myriad of reasons why people voted leave and design a UK model for Brexit that addresses these issues but also safeguards the economic future of the country. Clearly, this is a gargantuan task involving many competing interests and positions. Unsurprisingly, Theresa May has been so far been reticent about her negotiating priorities.

A Soft or Hard Brexit?

Britain's exit from the EU has been cast as a binary choice between single market access and immigration controls. EU leaders have been clear that Britain cannot retain its single market access and place limits on the free movement of people. Therefore the first and most fundamental question that Theresa May will have to answer is whether the UK intends to take control of its borders and forego single market access in a "hard Brexit", or maintain its access and accept everything that comes with it, including free movement of people, budgetary contributions and jurisdiction of the European Court of Justice.

Many leave voters argue that there is a clear mandate for a hard Brexit; the referendum result represents a rejection of all the EU's institutions, including the internal market. Therefore any "Brexit-lite" would fail to deliver this mandate. There is some evidence that senior Conservatives support this view. Boris Johnson has backed "Change Britain", a campaign group calling for a hard Brexit, along with his former cabinet colleague Michael Gove. Writing for *The Sun*, Johnson argued that "Brexit means Brexit and that means delivering on [the electorate's] instructions and restoring UK control over our laws, borders, money and trade."

Theresa May has also strongly hinted that reducing immigration will be her priority. At the Conservative Party Conference in October, Theresa May said that she would like a deal which gives "British companies the maximum freedom to trade with and operate in the Single Market" but was clear that "we are not leaving the European Union only to give up control of immigration again. And we are not leaving only to return to the jurisdiction of the European Court of Justice."

Negotiations

However, continued access to the EU's internal market is a clear priority for business leaders in the UK, particularly those in the City. A letter from the CBI to Government following Theresa May's election described single market access as "vital to the health of the UK economy, especially to our manufacturing and service sectors"[4]. These all take advantage of barrier-free exports to the EU and the banking sector in particular benefits from passporting, the ability to trade across the region without separate authorisations.

Theresa May can also expect pressure to remain in the single market from the significant minority that voted remain in the referendum, especially as they are over-represented in Parliament. The Labour Party, Liberal Democrats and SNP will all be pushing hard to expose fractures in the Conservative party and single market access is an easy opportunity for them to do so. Although the Conservative government have been tasked with delivering Brexit, 185 of 328 Conservative MPs voted to remain meaning that there will be significant sympathy for a soft Brexit among the ruling party.

In Focus: Passporting

The UK's financial services sector is world leading and protecting its dominance will be a priority for the Government during Brexit negotiations. Some 20% of the City's business revolves around cross-border delivery of services to customers in the EU. Under current arrangements, this trade is facilitated by "passporting" which allows banks, insurers, and asset managers to trade freely across the EU without separate authorisations from individual administrations. This arrangement is extremely attractive to international institutions who base their European operations in the UK.

In a speech to the British Bankers' Association summer reception, Chancellor of the Exchequer Philip Hammond sought to provide reassurances, saying "access to the single market is crucially important to your industry...I know and understand the importance of passporting."

A report from the Legatum Institute think tank highlighted the level of interdependence between the UK and EU financial services markets, with 726 EEA insurance firms possessing passporting rights into the UK, compared to 220 UK firms with passporting rights into the EU, suggesting a high degree of mutual interest in reaching an arrangement.

For example, in place of passporting, the UK could negotiate much the same rights through an equivalence regime. This would mean that the UK, as a third country, could access the single market in specific areas if its regulations were deemed 'equivalent' to those of the EU.

If the UK were to go it alone, some commentators remain confident that the existing dominance of the UK's financial sector, combined with the ability to design a more liberal regulatory framework after Brexit, will help Britain to continue attracting global business.

[4] http://www.cbi.org.uk/news/cbi-signs-open-letter-to-government-on-brexit-negotiations/

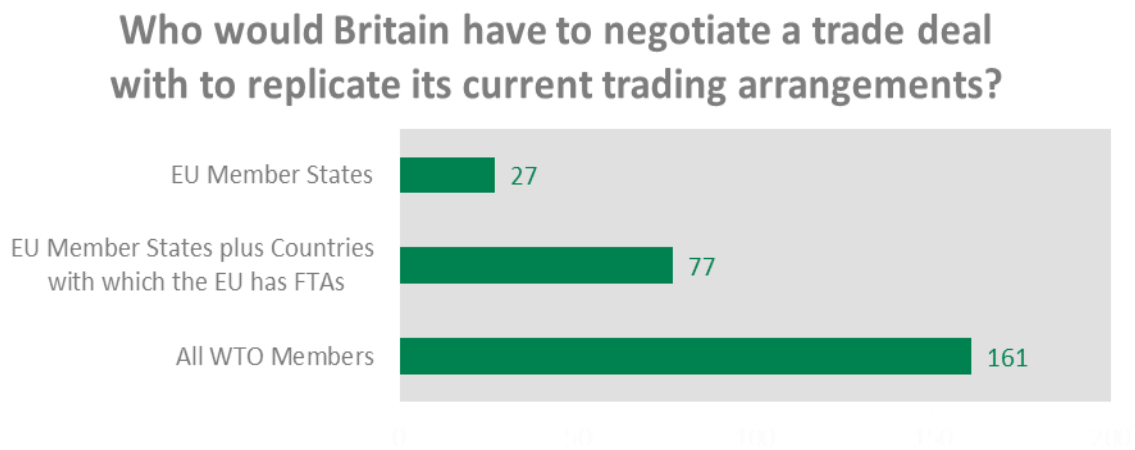
Negotiations

How will the EU approach negotiations

The continent is currently in the grips of an unprecedented wave of Euroscepticism. While Britain is the only country to have voted to leave the EU, there are significant Eurosceptic movements in a number of other countries. In a June poll, a majority of respondents in France, Hungary, the Netherlands, Austria, and Finland said that they would like to see a referendum on the EU in their country.

2017 sees elections in three of these countries – France, Hungary and the Netherlands – and, although the far right did not win in recent elections in Austria, the Eurosceptic elements in each can expect to make significant gains in influence. In France, the National Front's Marine Le Pen is in the running to be President and the Dutch general election is a battle between two right wing parties, Geert Wilders' PVV and Mark Rutte's VVD, rather than the traditional contest between left and right.

In the context of these elections and the ongoing refugee crisis, the EU will be wary of contagion – further secessions from the Union. As a result, the EU will not want to be seen to be giving Britain too favourable a deal. Joseph Muscat, the Prime Minister of Malta, the next country to inherit the EU Presidency in January, has warned that the EU will not compromise on free movement of people for single market access saying "we are all going to lose something but there will not be a situation when the UK has a better deal than it has today." The Guardian and Independent have also reported that European leaders have reached a 27 nation consensus that pursuing a hard Brexit will be the best way to arrest the contagion.



However, such an unequivocal position may prove unrealistic. While a punitive deal may seem attractive to the EU on the surface, it does not take into account the high degree of mutual dependence between the EU and the UK: a deal that hurts Britain will hurt the EU as well.

Britain's sizeable trade deficit with the EU means that the UK is an important market for the EU. If the UK were to leave the union it would represent the EU's largest non-EU export market. Any tariff barriers between the two markets would have ramifications for the EU as well as the UK. Individual member states will find it difficult to condone punishing the UK when they consider the additional costs that businesses in their country have to bear in the event of a hard Brexit. The EU will have to walk a thin line between protecting their economic interests in the UK and preventing contagion. This is further complicated by the fact that the ideal balance will be different for each of the member states within the European Union.

Negotiations

In Focus: The EU's negotiating team

Once Article 50 is triggered, the spotlight will move to those tasked with negotiating the UK's exit from the EU. The British team will be led by Secretary of State for Exiting the European Union, David Davis, and his team of junior ministers. They will be joined by DExEu's most senior civil servants, including Anthony Phillipson, Director of Trade and Partnerships and a seasoned diplomat.

But what do we know about the European Union's negotiating team?

Michel Barnier, the Chief Negotiator appointed by the European Commission, is a keen federalist, and was once described by the *Daily Telegraph* as the "most dangerous man in Europe" due to his comments in 2010 suggesting that fiscal union in the Eurozone will lead to closer "political union". Barnier has insisted that Britain will have to accept freedom of movement "without exception or nuance" if it wants to retain access to the single market. With a long career in both French and European politics, he is likely to be a difficult partner for the British.

Barnier will be joined by Guy Verhofstadt, a former Belgian Prime Minister. Though described as a "baby Thatcher" as a young politician, Verhofstadt now occupies the centre ground of European politics and is strongly federalist. In reaction to his appointment, Nigel Farage asserted that the EU had "declared war" on Britain, with the UKIP leader calling the Belgian an "EU nationalist". Having previously commented that Cameron and Farage were "rats abandoning a sinking ship", Verhofstadt is unlikely to give ground easily, especially when it comes to the free movement of EU citizens.

With the Barnier/Verhofstadt axis in place, and with Barnier already commenting that the UK will be unable to 'cherry pick' the Brexit deal that it wants, the gauntlet has been thrown down.

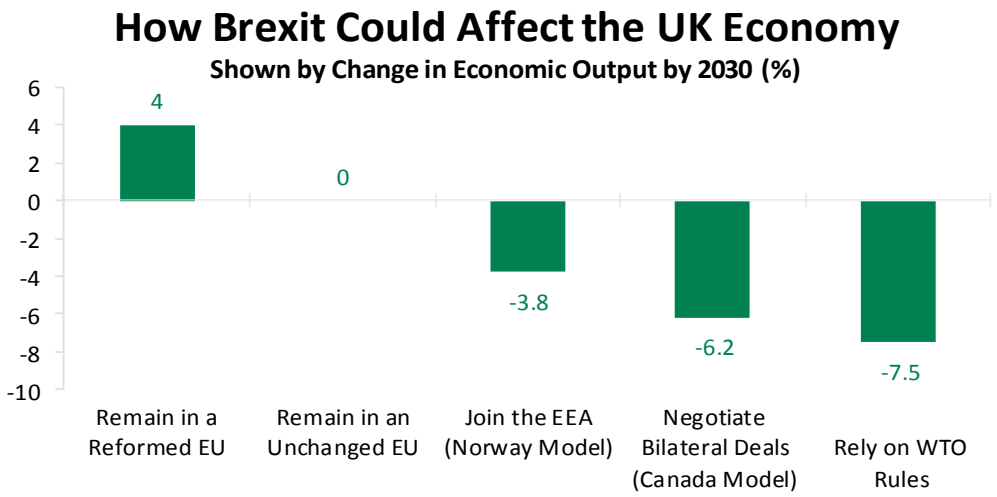
Trade

One of the key promises made by leave campaigners was that Brexit would allow Britain to look outwards, beyond the European Union, further trade with more vibrant markets elsewhere in the world. Theresa May clearly sees this as a priority and has established a new Government Department for International Trade.

The department is headed by Dr Liam Fox who has already visited countries including Bahrain, the United Arab Emirates, India, and the USA in an effort to promote British trade across the world. Theresa May has also personally visited a number of countries, including India. The Government will be hoping that increasing trade with countries such as these will help cover the shortfall of any trade lost as a result of Brexit.

The Impact on Existing Trade

Despite the optimism of leave campaigners, part of the attraction of Britain to international business has been its membership of the EU. This message was delivered in no uncertain terms by the Japanese Government in an open letter to Britain outlining its demands for Brexit. Japan has a large stake in the UK, with almost half of its direct investment to the EU flowing to the UK making it the UK's sixth largest foreign investor. The passage of its goods and services throughout the EU are facilitated by the UK's access to the internal market, making the UK an ideal place for Japanese businesses to set up their base of operations. As such, Japan is anxious to maintain as much of the status quo as possible. In particular, the open letter recommends retaining single market access, maintaining free movement of people, and remaining a member of the customs union. It also highlighted that the financial services passport is especially important to Japanese financial services operating in the UK.



If some semblance of the status quo is not maintained, or the consequences of change not ameliorated, the Japanese Foreign Ministry warns that Japanese businesses may have to relocate their businesses to elsewhere in Europe. These concerns will undoubtedly be shared by other major investors into the UK,

though no other has yet expressed those concerns as publically. However, it is important to recognise that the Japanese Government does not necessarily speak for its business community. Since the Brexit vote, the biggest single investment into the UK was from the Japanese company, SoftBank, with a £24bn proposal to acquire Britain's largest technology firm, ARM Holdings. It therefore remains to be seen whether the Japanese Government's pessimistic predictions will prove accurate.

New trade deals

Hard Brexit proponents argue that, regardless of the potential loss of business from firms using the UK as a gateway into the EU's single market, there is a greater potential for new business resulting from new trade deals made possible by Britain's exit from the customs union. The UK Government will be looking in particular at new trade deals with major economies including the USA, India, and China.

In the run-up to the EU referendum, President Obama warned that the UK would be "at the back of the queue" when it came to negotiating a new Free Trade Agreement (FTA). Since Trump's election, a quickly negotiated FTA with the US looks more likely as he publically supported Brexit and is generally considered an Anglophile. However, Trump has expressed his desire to renegotiate the North American Free Trade Agreement "NAFTA" and, if he proceeds, this could delay UK-US negotiations significantly.

India is a clear priority for the UK Government. After the Brexit vote, then-Business Secretary Sajid Javid made India his first port of call to discuss building a stronger trade relationship. India is eager to attract more investment, particularly in manufacturing and infrastructure, so may prove amenable to trade negotiations. However, new UK visa restrictions that make it harder to transfer foreign workers to the UK will be a point of contention. In addition, the EU's protracted, eight year negotiations with India over an FTA should be considered a warning to the UK Government, both in terms of timescales and because negotiations have been held up by a failure to agree on trade in services, which are of crucial importance to the UK.

Of all the world powers, China has been one of the most proactive in reaching out to the UK to cement its relationship after Brexit. The country's ambassador to Britain, Liu Xiaoming, has publically stated China's intention to do more business with Britain post-Brexit. However, he strongly hinted that these plans would be contingent on the success of the Hinckley Point C nuclear power plant project, which represents China's largest single investment in Europe and makes provision for further Chinese nuclear infrastructure in the UK. This demand highlights the asymmetric balance of power between the two nations: China needs an FTA with the UK a lot less than the UK does with China. Nevertheless, both sides will be hoping to leverage the possibility of an FTA against the EU – the UK for a favourable withdrawal agreement and China as a reaction to the possibility of punitive measures from the EU following the conclusion of anti-dumping measures in December.

There is clearly potential for expanding trade with third countries following the UK's exit from the EU. However, questions remain over the extent to which these agreements will be able to mitigate the potential loss of business resulting from leaving the EU. In the short term especially, FTAs do not offer much solace due to the complexity of negotiations.

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