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#BREXIT

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BREXIT: POTENTIAL SCENARIOS AMID TURBULENT WATERS

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At the turn of the summer of 2018, we are in turbulent Brexit waters. The only clear fact is that the United Kingdom (UK) intends to exit the EU on 29 March 2019—two years after the British government triggered Article 50 of the TEU. Beyond the effective withdrawal from the EU, a transition period agreed between the two parties should allow the *status quo* to prevail until December 2020 (i.e. participation of the UK in all EU policies and financial contribution to the EU budget) except that the UK will have no more participation nor say in EU institutions and agencies. The transition period will provide for a much needed delay to negotiate the details of the new post-Brexit relations.

The EU 27 has however cautiously required that a common understanding of the future relationship must be added to the withdrawal agreement before its ratification by March 2019[1]. While the level of detail of this framework is not specified, failing to agree on a common understanding would force the UK to leave the EU without a deal for withdrawal and transition. This scenario, often described as "cliff-edge Brexit", would imply chaos and uncertainty.

Until March 2018, the European Commission succeeded in steering an orderly withdrawal of the UK. First and foremost, it preserved the cohesion of the EU 27, by staying firm on the sequencing of the bilateral talks, and the indivisibility of the four freedoms in the Single Market as a clear red line for the post-Brexit EU-UK relationship. The UK had to comply with EU 27 conditions for the withdrawal and the transition period.

Developments in early July have demonstrated clearly that the Brexit talks are above all a domestic negotiation in the UK, featuring a persistent and deep divide over the practical meaning of the withdrawal in public opinion, in the Conservative Party, as well as in Theresa May's cabinet. Developed under increasing pressure by an already significant decrease in foreign direct investment and calls from the business community to maintain close economic ties with the EU, Theresa May's 12th July 104-page long "white paper" represented a first substantial attempt to engage in an increasingly pressing discussion over the future economic and security partnership with the EU.

Based on this document and previous rounds of domestic and bilateral negotiations, what can we expect in terms of the future trade relationship, which will be the backbone of future relations? How do scenarios differ with regard to the security dimension, which the British government presents as the second big pillar of the future relationship? The security partnership put forward by the UK covers a broad range of policy areas including internal security and development cooperation. Here,

1. http://www.consilium.europa.eu/media/34594/background-gac-art-50-en.pdf

we focus on the core of the EU's Common Foreign and Security Policy, namely security and defence. This area represents the anti-thesis of trade policy as EU decision-making has always been intergovernmental. It is also an area where cooperation has important implications for citizens and businesses on both sides of the Channel.

While two main scenarios—"Brino" (Brexit in name only) and "no deal"—prevail, an extension of the negotiating period may be needed if the domestic British spasms delay the crunch moment that would allow putting together a realistic framework for the future relationship. Meanwhile, EU-UK agreements on security and defence can be concluded before the end of the transition period. An upgraded version of the Norway-EU security partnership could be a piece of good news among hard-fought economic negotiations. However, a hard, and particularly a cliff-edge Brexit will have significant implications for defence-industrial cooperation, which could poison talks on the more political side of the security partnership.

1. Potential scenarios for post-Brexit trade relations

1.1 "Brexit in name only"

The UK white paper's proposal has given a decisive push in the direction of minimum trade frictions between the UK and the EU 27, with a broad alignment on EU legislation. Priority would be given to:

- Free trade for all goods, including agri-food products based on no tariffs and an alignment on the EU rulebook, to protect the existing integrated supply chains and 'just-in-time' processes.
- A "Facilitated Customs Arrangement" (FCA)—based on technologies not yet available on shelves—intended to allow the UK to keep an autonomous trade policy with other third countries: if tariffs differ, the UK would collect tariffs on EU-bound goods on its behalf.
- The end of the freedom of movement but no visa would be requested for short business stays, tourists and students, in addition to mutual recognition of qualifications.
- The end of European Court of Justice (ECJ) jurisdiction over the UK and a new joint committee established instead.

In other words, it would keep the UK in the Single Market for goods alone and in "a" Customs Union (CU), without the external dimension of "the" Customs Union of the EU, which provides the European Union with the competence for trade policy with third countries. It would also resemble an extension to the whole of the UK—at least for goods—of the "backstop" solution put forward by the EU 27 for Northern Ireland (to avoid the return of a border between the latter and the Republic of Ireland, which would compromise the Good Friday agreement, Northern Ireland would remain in the Customs Union and the Single Market, while politically remaining part of the UK).

While trying to square the circle, the proposal is obviously less respectful of the EU 27 red lines starting with no cherry-picking in the Single Market and trade rules (e.g. the rule of origin constraints) than of the UK's well-known post-referendum red lines. The many incompatibilities of May's white paper with the EU's legal framework have been signalled by the European Commission while trying to avoid fuelling the UK's domestic political crisis, and a leadership challenge that might leave the EU with a negotiating counterpart that would likely be harder to handle than Theresa May.

With so many questionable grey zones, there is no meaningful assessment of the proposal's impact on business at this stage, except that it is going in the right direction. Unilateral alignment on the EU rulebook would lead to fewer physical inspections on goods than no alignment. But there would still be significant trade friction, in particular in the service sector making up 80% of the UK economy; and the proposed customs arrangement looks *a priori* like a bureaucratic nightmare.

While the white paper's proposal comes somewhere between the option of membership in the European Economic Area (EEA)—estimated as having the lowest negative impact on post-Brexit UK economy (see table 1)—and a Free Trade Agreement, it would still correspond to a rough average loss of 3% in GDP over 15 years. The political question at this stage is whether it is the extreme limit to which the Prime Minister could push the Conservative Party or whether it is a first step taking the UK on a gradual journey to "Brino", closer to the UK remaining completely in the Single Market.

TABLE 1 ■ Impact assessment of three post-Brexit scenarios[2]

SCENARIOS	LOSS IN GDP GROWTH (over the next 15 years)
"No deal" scenario (WTO regime)	-8%
Comprehensive EU-UK FTA	-5%
EEA membership	-2%

The analysis assumes in all scenarios that the UK will conclude a trade deal with the US that would benefit GDP by about 0.2% in the long term.

1.2 "Hard Brexit"

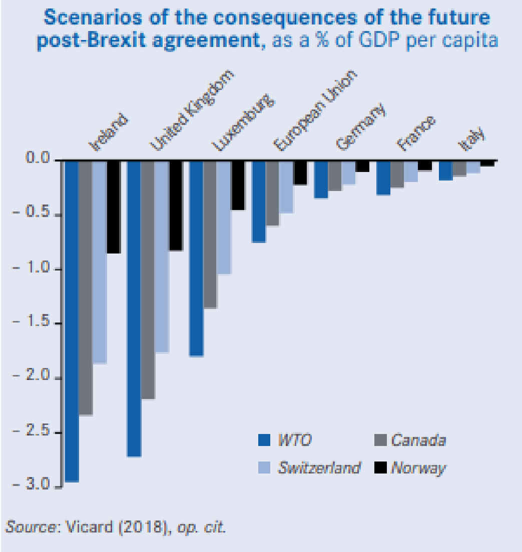
While a "Brino" scenario is making its way, the alternative is the risk of having the UK falling off the cliff-edge and crashing out with "no deal" on March 29, 2019. In this case, it would become a third country once again and, in the absence of an agreement, it would have to comply with the conditions negotiated at the WTO to access the Single Market for goods (tariffs, and in some agricultural areas, quotas) and services; conditions which are, by definition, much less favourable than the current Single Market system.

Customs controls would have to be restored between the UK and the EU 27 to ensure that imports and exports fully comply with the reversion to the higher WTO tariffs and to inspect the certifications required by the presumed end of regulatory alignment between the UK and the EU. The mobilisation of the technological and human resources required to restore these controls is a major challenge in itself. The accumulation of logistical problems, the additional supply delays, the increase in customs tariffs and new non-tariff barriers resulting from the end of regulatory alignment with the EU would seriously undermine bilateral trade. This would be a scenario of trade chaos, with congestion and bottlenecks at borders, thus impeding the proper functioning of value chains. It would go along with a much more severe drop in foreign direct investment than at present.

Such a hard Brexit would have consequences on UK trade with EU third countries as well: the UK would leave the EU with no grandfathering or replication of the many current EU FTAs, leaving the expected "global Britain" without trade policy, and relying only on WTO terms. With less access to the EU Single Market, the attractiveness of the UK economy for new FTAs with third countries would rely on deregulation: something that would pull the UK away from its main export destination, the Single Market, and that would hardly be acceptable for UK citizens. In addition, as evidenced by research in economics, distance negatively impacts trade between two countries[3].

This "no deal" scenario is not a strategy. It would result from an ultimate political crisis. Contingency planning from the business community, although costly in many sectors, should remain a must in order to be ready to face the highly disruptive consequences that it would have. A recent estimate of the impact of different post-Brexit scenarios on several member states shows how much harder the "no deal/WTO" scenario would be for the British economy than for countries like France and Germany. Yet, the expected hit requires serious anticipation.

2. "EU Exit Analysis - Cross Whitehall Briefing", House of Commons Exiting the EU Committee, 29 January 2018.
3. "Brexit meets gravity", Paul Krugman, New York Times, July, 10, 2018.



Vicard V. (2018) : "Une estimation de l'impact des politiques commerciales sur le PIB par les nouveaux modèles quantitatifs de commerce", Focus du CAE, No.22, July.

1.3 "British spasms"

The "Brexit dream", as Boris Johnson called it, is running up against reality. Yet the white paper momentum may not suffice to tame the Conservative Party divisions and to prevent new internal spasms. As there is currently no clear majority in Parliament for any of the two previous scenarios, an increasing full-scale leadership challenge could prevail before a final withdrawal agreement is reached, that is before the 18-19 October EU Summit, or at the very latest in early 2019 to leave time for ratification before 29 March 2019. If the Labour Party was to come to power, it could have new priorities while not overcoming sharp divisions in its own ranks, fuelling as many uncertainties. After the July turbulences, a rejection of any final withdrawal agreement by Westminster cannot even be excluded.

Following the votes on amendments to the Customs Bill and the Trade Bill in the House of Commons in mid-July, with rebels on both sides, Conservatives and Labour, any new political convulsions before the EU and the UK reach an agreement, and of course a late rejection of the agreement by the British Parliament, would rather increase the probability of a "hard Brexit" over a "Brino".

Continuous "British spasms" could then lead the UK to unilaterally revoke Article 50 with the intention of triggering it again shortly afterwards. Legal experts continue to discuss the feasibility under EU law and it would probably need to be settled in front of the European Court of Justice. It could alternatively lead to an extension of the process of Article 50 by a unanimous approval from the EU without the need for a European Parliament vote.

In any case, it may well be necessary to consider a more realistic length of the transition period going beyond December 2020 to complete the negotiation. Any extension of the transition to one, two or more years would go along with an ad hoc UK financial contribution to the EU budget (an approximated 15 billion euros per year).

2. Post-Brexit defence cooperation

Reflecting its intergovernmental character, the EU's Common Foreign and Security Policy represents an exception regarding transition arrangements: The Acquis' provisions (e.g. European legislation) will cease to apply once a bilateral agreement with the UK is concluded. Agreements can thus be concluded before the end of the transition period. The implications can be twofold: progress in security and defence could (to a limited extent) compensate for tensions in the economic domain (scenarios 1 and 2). But the latter could also negatively affect security-related negotiations (scenario 3). Key items for the negotiation include modalities of political consultation, participation in EU operations and missions as well as capability development.

2.1 "Norway Minus": adapting an existing model

Similar to the Norwegian model, the EU and the UK could agree on a combination of biannual formal consultations and more informal consultations on issues of common concern with the European External Action Service and the working groups of the EU Council. Close communication channels would clearly be of mutual interest as would be an agreement on the exchange of classified information.

Continued UK participation in EU military and civilian operations would also be mutually beneficial and could be based on a Framework Partnership Agreement. Norway is one of 18 countries that have concluded such an agreement with the EU. However, the key issue is that their influence on EU decision-making is limited. Contributions of third countries to EU operations and missions are generally "without prejudice to the decision-making autonomy of the EU". Opportunities for more informal decision-shaping are also restricted. Third country contributors are brought in late in the planning process and are only granted full access to EU-issued documents once their participation has been approved by the Political and Security Committee (PSC).

Defence research and capability development is the most important area for the UK. It has Europe's largest defence budget and its expenditure for defence research and development represents around 40% of the EU's total. The UK is thus wary of being shut out of EU defence industrial initiatives. Similar to Norway and others, it could participate in projects and programmes of the European Defence Agency on the basis of an Administrative Arrangement. The more controversial issues are the UK's participation in the Permanent Structured Cooperation (PESCO) and the European Defence Fund (EDF).

In late 2017, 25 EU member states (all except for the UK, Denmark and Malta) signed up to PESCO to deepen cooperation on military capabilities through binding commitments and projects. As the EU is in the process of formulating the conditions for third country participation, red lines are emerging. PESCO members agreed that third countries can be invited "exceptionally" to participate in projects if they "provide substantial added value" and if the Council in PESCO format (i.e. 25 member states) unanimously agrees.

Under the EDF, the Commission proposes spending a total of €13bn over 2021-27 from the EU budget to incentivise collaborative investment in defence research and capability development as well as joint procurement. It should provide a total of €4.1bn for joint defence research (research window) and €8.9bn to co-finance (20%) the collaborative development of prototypes (capability window). According to the regulation on the EDF proposed by the Commission, only companies located in and controlled by EU member states or associated countries can benefit from funding. Associated countries are members of the European Free Trade Association (EFTA) which are members of the European Economic Area (EEA)—currently Norway, Iceland and Liechtenstein. Unless the UK joins EFTA and the EEA, it would have less access than Norway (→ "Norway minus"). The draft regulation formulates a narrow loophole: "Legal entities established in the Union that are controlled by a non-associated third country or a non-associated third country entity can be eligible if relevant and strict conditions relating to the security and defence interests of the Union and its member states are fulfilled". If the EU sticks to these red lines, the UK would be a rare guest in PESCO and EDF projects.

2.2 "Norway Plus": a scalable defence partnership

The UK has repeatedly called for a security partnership that, while based on existing models, goes beyond them. The EU underlines its determination not to discriminate between third countries, but it could take Brexit as an opportunity to upgrade existing options for third country cooperation in security and defence. Indeed, the EU's High Representative for Foreign Affairs and Security Policy announced, in May, working on an upgraded partnership framework.

Such a framework could follow a performance-based logic. The underlying idea would be that a third country is granted access to informal decision-shaping as long as it subscribes to EU values and commits to making a substantial contribution to the EU's security and defence policy. This logic would be in line with Michel Barnier's statement of November 2017 that "any voluntary UK participation in European defence will confer rights and obligations in proportion to the level of this participation".

For participation in EU missions and operations, the balance between rights and obligations could be spelt out in an "enhanced Framework Participation Agreement". As suggested by the British white paper, the UK could provide specific expertise, intelligence, personnel, specialist assets, and operational enablers for EU operations. In return, it would be granted earlier access to operational planning and receive more regular ad hoc invitations to informal sessions of the PSC. PESCO members could decide to lower the political entry barriers by making participation conditional upon a unanimous vote by project participants rather than the whole PESCO Council. Enhanced partners could receive regular (rather than exceptional) invitations.

Applied to the EDF, a performance-based logic could imply a pay-to-play scheme for third countries. The UK would thus be invited to specific projects and pay its own share. However, as the restrictive line of the Commission draft EDF regulation indicates, this is controversial and would likely be perceived as cherry-picking. Alternatively, the EU could create a special associate status for the UK based on regular financial contributions. In light of Norway's contribution to the EU's Preparatory action on Defence Research (the precursor of the EDF research window), the UK's contribution could amount to 17% of total EDF funding or roughly €255 million per year[4].

2.3 "Hard Brexit": when security meets prosperity

The probability of a "hard Brexit" scenario is much lower in the area of security and defence policy than in trade. Cooperation is largely intergovernmental; both sides agree that close cooperation is mutually beneficial; and the issue is more shielded from "domestic spasms". However, as the EDF shows, there are areas where defence issues are closely linked to competitiveness—where security meets prosperity and thus the Single Market.

A "hard" or "cliff-edge" Brexit concerning trade would impair defence-industrial cooperation. It would push some European companies to relocate to other states to maintain access to the Single Market, EU funds and the EU-wide supply chains. In a Risk Assessment memorandum of June 2018, Airbus warned against a "no deal" Brexit, which would force it "to reconsider its footprint in the country, its investments in the UK and at large its dependency on the UK"[5]. The company currently has four major engineering and manufacturing facilities in the UK with 14,000 employees and supports more than 110,000 jobs in the UK supply chain. It estimates that a "no deal" Brexit would cost it €1bn weekly.

These could be seen as purely economic issues. However, the bitter row on the UK's participation in the EU's €10bn Galileo navigation system illustrates potential political implications. The UK wants to maintain access to Galileo, including its encrypted part, and continue to bid for contracts. British companies have developed much of Galileo's encryption technology. While access to the encrypted part could be granted on the basis of a defence and security agreement, the Commission sticks to established rules, which exclude third country companies from the program's development. The UK white paper underlines that Galileo should be "a core component of the future security partnership" and warns that "an end to close UK participation would be to the detriment of Europe's prosperity and security and could result in delays and additional costs to the programme".

Theresa May repeatedly underlined that the UK's commitment to European security is unconditional, but such rows, which would potentially unfold under a new political leadership, could poison negotiations on the more political side of the security partnership.

Conclusion

Few months ahead from the next European Parliament elections, which raise concern about a potential increase of populist voters,

4. Béraud-Sudreau, Lucie, "UK participation in the EDA and the new EU defence package in the context of Brexit", The International Institute for Strategic Studies (IISS)/German Council on Foreign Relations, June 2018.
5. Airbus, „Brexit—Risk Assessment", 21 June 2018.

EU and member state officials will be particularly cautious not to let any common understanding of the post-Brexit relations alter the EU fundamental legal principles and a level playing for economic actors. Yet, while trying to keep the UK engaged in the negotiation of a common understanding of the future relationship, the EU 27 cannot be blamed for the British domestic divisions. The leverage of continental Europe over those internal debates is limited. Shrinking delays before the formal exit of the UK may just increase the pressure and the risk of more British political spasms. While the main focus of the Brexit debate is on its economic impact, the danger of spill-over from economic to other political domains, including security matters, could however contribute to mobilising British public opinion towards "everything but the 'no deal'".

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