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#BREXIT

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#TRADE

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TRANSITION: THE HITCHHIKER'S GUIDE TO THE BREXIT GALAXY

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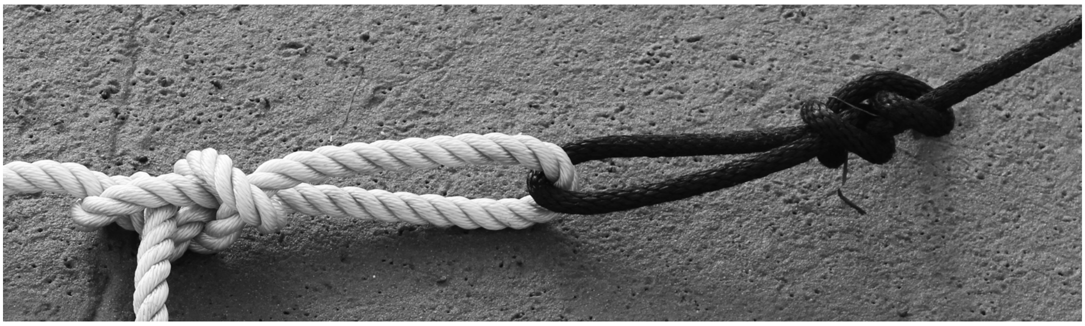

Executive summary

Brexit will enter into force on 29 March 2019. Without an agreement on the terms of future relations between the European Union and the United Kingdom, the UK will revert to accessing the EU single market under WTO rules and reestablishing customs controls. This scenario is known as a "fall from the cliff-edge", as tariff and non-tariff barriers will penalise companies significantly. The current lack of preparation for this return to customs controls would result in bottlenecks at borders, thus impeding the proper operation of value chains.

This scenario of economic chaos cannot be ruled out as the UK government, beleaguered by a long Socratic maieutic, is stalling in making clear its priorities between recovering its sovereignty and losing its access to the single market. Both parties have therefore agreed to prepare a transition period which offers stability for an additional 21 months, until December 2020. The terms of this agreement were defined by the EU-27 to maintain the status quo, though the United Kingdom will no longer take part in decisions on the European Union's future.

This policy paper analyses the terms of this transition: the arrangements of this uncomfortable asymmetry which are still under debate (free movement of people, possible recourse mechanism for the UK to protect its interests, etc.) as well as the policy areas for which a post-Brexit agreement must be found now, without waiting for the transition to come to an end (civil aviation, ring-fencing of the UK contribution to the EU's framework programme for research and innovation, etc.). Added to this is the challenge of transitioning all free trade agreements signed by the EU with third countries. Negotiations are moving from bilateral to trilateral aspects. Lastly, a transition of limited duration would be relatively easy to negotiate if it mainly consists of maintaining the status quo ahead of the development of the future UK-EU relations into a steady state of operation. It will prove more delicate and could become a Brexit purgatory if a longer transition period has to be envisaged.

The stakes at play during this transition can only be appreciated by considering the British dilemma and the complex choice they will have to now make to avoid a long transition. It is only when London decides on the level of regulatory convergence it wishes to maintain with the EU that negotiators will be able to begin to draft a post-Brexit agreement and prevent the no deal scenario which may still be possible at the end of the transition.

INTRODUCTION

As we address the manifold challenges of the United Kingdom's departure from the European Union, the complex nature of Brexit is becoming clearer by the day. Not forgetting the 759 treaties that the UK will have to renegotiate with 168 countries worldwide[1], Brexit allows us to take stock of the extent to which the UK and all Member States have become interlinked and interdependent over half a century of integration, be this in terms of citizens, research networks, food safety, European value chains, transport logistics, intra-European trade or legal and security cooperation.

The UK's departure from the EU is a technical and legal challenge. Yet the main obstacle in the talks between London and the EU-27 is political in nature and is a result of the very slow rate at which the reality of Brexit is sinking in across the country and of the British government's lack of clear priorities. The many ambiguities and contradictory statements made by ministers and political leaders are sustaining unrealistic views of the possible outcomes of Brexit.

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> BREXIT CAN ONLY BE HARD

The first of these unrealistic aspirations is that of a soft Brexit. Attempts to mitigate negative repercussions do not mean that a soft Brexit is an option. For the first time in the EU's history, the task is not to organise convergence with the EU – through membership, partnership or regulatory alignment – but rather divergence. The most die-hard Brexiters hope to reap the benefits for the United Kingdom in the long-term. However, while the British government's official position[2] remains “no longer being members of the single market or the customs union” following the transition period, Brexit can only be hard and the debate is now focused on possible nuances of hard.

It remains to be determined what London's trade-off between restored British sovereignty and the loss of access to the single market will be. The British will either deviate from European standards, to the benefit of their legal autonomy, sacrificing their preferential access to the single market, or will give the single market priority and align their standards and regulations with the EU, thus sacrificing their legal autonomy(while maintaining some form of border controls), as practiced by countries in the European Economic Area.

The EU-27 have clearly stated that the United Kingdom cannot do both. On 19 December 2017, the EU-27's chief Brexit negotiator, Michel Barnier, stated that “there is no place 'for financial services' in any single trade agreement” – a key point for the City of London. This calls for realism and a departure from the “constructive ambiguity” which characterises the British debate.

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> A LONG PERIOD OF SOCRATIC MAIEUTIC BROUGHT ABOUT BY A RESHUFFLE OF THE DOMESTIC POLITICAL ARENA

The more the British gain in terms of sovereignty, the higher the economic cost will be. Conversely, the more they attempt to limit the economic cost, the more they will have to align themselves with European regulations, without being able to influence them. Defining a compromise that is politically acceptable and economically viable, appears only to be possible at the expense of a long period of Socratic maieutic brought about by a reshuffle of the domestic political arena.

This complex situation and hesitations have led both parties to concur on the need for a transition period to achieve agreement on the future relationship between the United Kingdom and

1. These 759 agreements include 295 bilateral trade agreements, 202 regulatory cooperation agreements (ranging from competition policy to data sharing), 69 agreements concerning fisheries, 65 on transport (mainly aviation), 49 on customs controls, 45 on nuclear power, and 34 on agriculture. Paul McClean, “After Brexit: the UK will need to renegotiate at least 759 treaties”, Financial Times, 30 May 2017.
2. Position presented by Theresa May in her Florence address dated 22 September 2017, and of which the European Council took note in its Guidelines dated 15 December 2017, paragraph 7.

the EU-27. This period could be short and relatively easy to negotiate if it involves maintaining the status quo ahead of the development of the future UK-EU relations into a steady state of operation. This transition would, however, prove to be more complex and may well become the purgatory of Brexit if a long period is envisaged.

1 . A NECESSARY TRANSITION PERIOD

It has taken 9 months following the British government's triggering of article 50 of the TEU – and 18 following the referendum of 23 June 2016 – to reach a provisional agreement on the main issues raised by the UK's withdrawal (status of citizens and financial commitments). Nonetheless, the question of the Irish border has not been settled yet, beyond the mutual objective of not restoring borders[3] imposing physical controls between the Republic of Ireland and Northern Ireland[4].

We can now see that this already sensitive first step was much easier to take than the reaching of an agreement on the future relations between the UK and the EU-27, as the British government's prevarications and the internal tensions within the parties and the UK Parliament continue to confuse matters regarding the UK's priorities.

Officially, such a post-Brexit deal may only be finalised and signed when the UK becomes a third country, on 29 March 2019. On this same date, however, the lack of a post-Brexit agreement would have such a negative impact on the UK's economy and, to a lesser extent, on that of the 27 Member States that a transition period is absolutely necessary.

This period will be used to specify the terms of an agreement on the basis of the framework for the future relationship that article 50 of the TEU requires to be set out in the withdrawal agreement and which can be discussed between Brussels and London as soon as the European Council has adopted the negotiation directives for this partnership.

1.1 The slow Socratic maieutic of Brexit negotiations

1.1.1 Anything but the "fall from the cliff-edge"

The "fall from the cliff-edge" scenario reflects the UK's situation on 29 March 2019. As it becomes a third country of the EU once again, in the absence of an agreement on the future trade relations between the UK and the EU-27, the country would have to comply with the conditions negotiated at the WTO to access the single market for goods (tariff 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 to ensure that imports and exports comply fully 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 these logistical problems, the increase in

3. Aziliz Gouez, "Ireland on the rocky road to Brexit", Policy paper No. 210, Jacques Delors Institute, November 2017.
4. "In the absence of agreed solutions, the United Kingdom will maintain full alignment with those rules of the Internal Market and the Customs Union which, now or in the future, support North-South cooperation, the all-island economy and the protection of the 1998 Agreement. [...] In all circumstances, the United Kingdom will continue to ensure the same unfettered access for Northern Ireland's businesses to the whole of the United Kingdom internal market." Communication from the Commission to the European Council (Article 50) on the state of progress of the negotiations with the United Kingdom under Article 50 of the Treaty on European Union."

A SCENARIO OF TRADE CHAOS

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, as the current lack of preparation of administrative and private players for this eventuality could cause congestion and bottlenecks at borders, thus impeding the proper functioning of value chains. This would also have an impact on foreign direct investment[5], as demonstrated by the current concerns expressed by the USA and Japan – two major investors in the UK.

A significant impact on the British economy

The negative impact of this scenario would naturally vary according to the economic sector and to which side of the border one is on. The shock would be even more brutal for the British economy because the UK is even more dependent on trade with the EU than the EU-27 is with the UK, with the exception of some Member States, in particular Ireland and the Netherlands, for which the share of trade with the UK is particularly high.

The Rand Corporation estimates that the UK's GDP would be reduced by 4.9% ($140 billion) over 10 years, while for the EU the loss would only be 0.7% of GDP[6].

The estimation of the British government's Department for Exiting the European Union (DExEU)[7] even forecasts a loss of GDP growth of 8% over 15 years. The estimates of the Scottish government are roughly comparable as they conclude that in 2030 the Scottish GDP would have fallen by 8.5% in the WTO scenario (as against 6.6% in the CETA+ scenario and 2.7% in the Norwegian scenario)[8].

For Swati Dhingra, professor of economics at the LSE, a no-deal departure from the EU would result in a 30-40% drop in EU-UK trade over ten years.

TABLE 1 ▪ The Cost and Benefits of Leaving the EU: Trade Effects

SCENARIO	HORIZON	TOTAL UK EXPORT	TOTAL UK IMPORT	EXPORT TO EU	IMPORT FROM EU
Optimistic	Short run	- 5%	-6%	-14%	-13%
	Long run	-9%	-8%	-25%	-22%
Pessimistic	Short run	-14%	-14%	-36%	-34%
	Long run	-16%	-16%	-43%	-38%

***Short run horizon is 1 year after Brexit and long run horizon is 10 years after Brexit.**
Swati Dhingra et al., "The Cost and Benefits of Leaving the EU: Trade Effects", LSE/CEP, 2017, p32 (Table A.6)

WTO schedules of concessions: a leverage for third countries

The return to WTO commitments with third countries could also prove to be more complex than expected for the British government. While it is a full member of the WTO, the UK must still agree with the EU and all other WTO members on its own schedules of concessions, i.e. its trade regime with regard to WTO members, when it will have departed from the EU. The UK

5. FDI Markets notes that in the 10 months since the referendum, foreign direct investment is down 34.4% in value terms from the figures recorded for the same period a year earlier. Jacopo Dettoni, "Brexit, the UK and FDI: one year on", FDI Intelligence, 15 May 2017. The April 2016 report of the LSE, "The impact of Brexit on foreign investment in the UK", by Swati Dhingra, Gianmarco Ottaviano, Thomas Sampson and John Van Reenen, estimated that Brexit would cause a 22% fall in FDI in the UK over the next decade. On 8 February 2018, Japan's ambassador to the UK, Koji Tsuruoka, stated upon leaving Downing Street that no Japanese company could continue operations in the UK if the British economy was no longer profitable. http://www.bbc.com/news/business-42994603
6. Charles P. Ries, Marco Hafner, Troy D. Smith, Frances G. Burwell, Daniel Egel, Eugeniu Han, Martin Stepanek, Howard J. Shatz, "After Brexit: Alternate forms of Brexit and their implications for the United Kingdom, the European Union and the United States", Rand, December 2017.
7. Alberto Nardelli, "EU Exit Analysis – Cross Whitehall Briefing", January 2018.
8. Scottish government, "Scotland's place in Europe: People, Jobs and Investment", January 2018. Kirsty Hughes, "Scottish Brexit study lays challenge for Tories and Labour", January 2018.

IT MAY DISRUPT THE DELICATE BALANCE OF THE CURRENT QUOTAS

and the EU already agreed in early October 2017 on a splitting of tariff quotas for agricultural products set on the basis of average trade flows over the last three years. However, the other WTO members, who would be easily satisfied with the alternative option of the UK continuing with the EU's schedules of concessions, may prove to be warier of the splitting option. Seven countries (Argentina, Brazil, Canada, New Zealand, Thailand, Uruguay and the USA) have already opposed this splitting, objecting that there were not consulted and that it may disrupt the delicate balance of the current quotas[9]. While other WTO members may also wish to obtain new concessions from the UK, all these negotiations will have to be dealt with at the same time as those launched with the EU.

The political risk

The British government's current inability to clarify the priorities of the future British trade policy and the trade relations it wishes to maintain with the EU does not allow us to rule out the possibility of this extreme cliff-edge scenario, particularly as it is championed by hard-line Brexiters who want to ensure above all the UK's definitive exit from the EU. In addition, the possibility that Theresa May's leadership may be contested by her own party would result in a suspension of negotiations for several months, while the negotiation schedule is already very tight.
Lastly, the vote on 13 December 2017 in the House of Commons imposing a new vote[10] on the final withdrawal agreement further heightens the possibility of a "no deal" scenario in March 2019 should the fights between factions within the Tories and Labour prevail over compliance with the Brexit legal calendar. The European Commission has thereby called on the 27 Member States to prepare themselves for such a scenario.

THE IDEA IS TO CREATE SOME BREATHING SPACE TO SOLVE THE DILEMMA OF REGULATORY CONVERGENCE.

Since the Brexit referendum, relatively few companies have redirected their strategies, leaving the UK or stopping some business activities in the country (Deutsche Bank, Barclays Bank, Diageo, Goldman Sachs, Lloyd's of London, Microsoft, etc.). Yet the wait-and-see attitude of the initial months is now giving way to growing pressure in the entire economic sector to get the British government to avoid this extreme "no deal" scenario, starting with negotiating a transition period which affords them greater visibility, at least in the short term. The idea is to create some breathing space to solve the dilemma of regulatory convergence.

1.1.2 The dilemma of regulatory convergence

The British government's current objectives[11] are a legitimate response to the concerns expressed by the majority vote in the referendum. Yet the economic cost of Brexit will be determined by whether London decides to keep them all as red lines in the negotiation or to compromise on some of them, giving priority to maintaining access to the customs union and/or the single market (see in appendix 1 the restrictions imposed by these red lines on the choice between various post-Brexit partnership models).

Cost assessments are becoming increasingly precise and are now considered as a major variable in UK debate, leading the EU-27 negotiator to urge London to clarify its priorities. The epicentre of this choice is the dilemma of regulatory convergence. More than a possible return to customs tariffs, currently at a weighted average of less than 5% worldwide, it is a return to non-tariff barriers resulting from regulatory divergence which would penalise companies the most in their bilateral trade.

Dependence on the single market

Let us remember that almost half of the UK's trade is conducted with the EU. The UK imports

9. http://im.ft-static.com/content/images/ec0a64b2-a95f-11e7-ab55-27219df83c97.pdf
10. Particularly as it will be able to introduce amendments on specific aspects of this agreement.
11. The end of free movement of people, of a substantial contribution to the EU budget, of the CJEU's jurisdiction over the UK, regulatory autonomy and the control of trade policy.

> IT IS THE RETURN TO NON-TARIFF BARRIERS RESULTING FROM REGULATORY DIVERGENCE WHICH WOULD PENALISE COMPANIES THE MOST IN THEIR BILATERAL TRADE.

€380 billion in goods and services from the EU-27 and exports €280 billion (180 billion in goods and 100 billion in services, of which financial services account for one quarter).[12] The single market is a strategic destination for UK exports, in terms of market size and its consumers' purchasing power. British companies are also highly integrated in intra-European value chains and are dependent on their European suppliers for the provision of intermediate goods. The substitution of imports of European goods with locally produced goods is not immediate. It may generate an additional cost and in some cases face problems of a break in technological expertise caused by comparative advantage and specialisation. The substitution of European goods with imports of goods from third countries further afield may also come up against issues of compliance with rules of origin (RoO) negotiated in preferential agreements, which impose a percentage of local production.

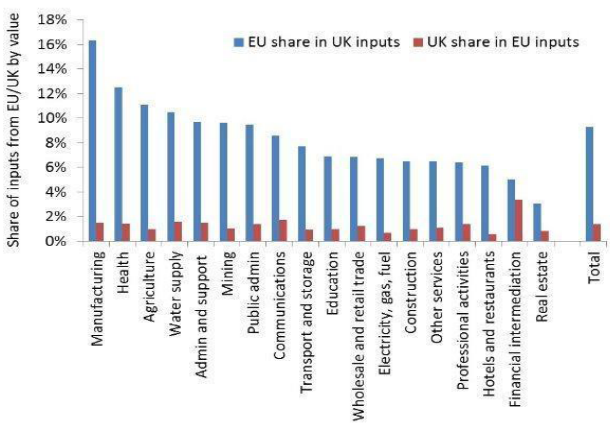
Compliance with the rule of origin

All European preferential agreements include a bilateral cumulation of origin. Materials originating in country A which are processed in country B are considered to originate from country B when the end product is intended for export to country A. A free trade agreement, however, does not generally include a diagonal cumulation clause of the rule of origin between three or more countries.

The bilateral agreement between the EU and South Korea does not provide for this. The CETA between the EU and Canada provides for a limited cumulation with the USA if the TTIP negotiations – currently suspended – should reach an agreement one day.

If the UK wished to maintain the same access to the single market for goods using Korean components, it would have to negotiate a diagonal cumulation of origin with the EU and South Korea. In addition, it would also have to prove that these British goods actually originate from the UK to the extent required by the rules of origin. At the moment the EU only accepts a diagonal cumulation of origin on the basis of an alignment of third countries on its rule of origin and only in two cases: as part of the pan-Euro-Med area[13] and with the Western Balkan countries[14].

FIGURE 1 ■ Share of inputs from EU (for UK) or from UK (for EU) by value



Source: Peter Levell, *Firms' supply chains form an important part of UK-EU trade: what does this mean for future trade policy?*, Institute for Fiscal Studies, 8 January 2018.

12. *Brexit. L'UE entre jeu politique et enjeux réglementaires*, La lettre de l'ASF, issue 172, January, February, March 2017 (in French).
13. This area concerns the EU, Turkey, the European Free Trade Association (EFTA) consisting of Iceland, Liechtenstein, Norway and Switzerland; the Faroe Islands and the countries which have signed the Barcelona Declaration (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the Palestinian Authority of the West Bank and the Gaza Strip).
14. Peter Holmes, Michael Gasiorek, "Grandfathering Free Trade Agreements and Rules of Origin: What might appear bilateral is in fact trilateral!", UK Trade Policy Observatory, 27 September 2017.

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> INTERNATIONAL TRADE, INCLUDING SERVICES, CANNOT ESCAPE GRAVITY BASED ON GEOGRAPHIC PROXIMITY.

The difficulty in opening up the services market

Geographic proximity strengthens the single market's appeal for UK exports and imports, despite the steady decline in transport costs (down 11% between 1986 and 2006) which facilitates access to markets further afield. As highlighted by John Springford and Sam Lowe - respectively Deputy Director and Research Fellow at the Centre for European Reform - international trade, including services, cannot escape gravity based on geographic proximity[15]. Distance reduces the volume of trade by as much: +10% distance reduces the trading of services by 7%[16], while, it should be remembered, services account for 80% of activity in the UK economy. Above all, intra-EU service provision has increased by approximately 60% since the creation of the single market, a magnitude which cannot be compared with the profits derived from free trade agreements (FTA) signed with third countries[17].

The opening of the services market remains notoriously limited in these agreements, although the timid progress of Doha's multilateral agenda on this issue has led to some progress in services liberalisation in the 118 preferential agreements which were notified to the WTO in 2014[18]. The Trade in Services Agreement (TISA), currently being negotiated between 23 members of the WTO representing 70% of global services trade, is the most ambitious in this field. The EU brings its full weight to bear here, with the opportunities from the regulatory alignment implemented as part of its single market. It remains to be seen which form of additional leverage the UK will use with third countries to negotiate a greater opening of their services market.

The interdependence of goods and services

In addition, the increasing interdependence of the goods and services sectors should be kept in mind as connectivity between production systems is growing and with it the share of added value from services in the added value of manufactured goods. This is estimated at 20% to 47% across all sectors[19]. Goods and services are increasingly interlinked and indivisible in trade. It has become difficult to split a production chain over two separate categories corresponding to different trade regimes.

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> THE UK SERVICES SECTOR IS HIGHLY DEPENDENT ON EUROPEAN VALUE CHAINS FOR MANUFACTURED GOODS.

Yet, as reminded by Springford and Lowe, the UK services sector is highly dependent on European value chains for manufactured goods: the UK Trade Policy Observatory estimates that the added value of domestic services incorporated in British manufacturing exports exceeds £50 billion per year, equivalent to the amount of UK financial services exports. The prospect that ambitious FTAs with third countries covering trade in services could offset the losses resulting from Brexit, is therefore tenuous. With Brexit we fully recognise European regulatory leadership, known as the "Brussels effect"[20].

If the UK wished to diverge from diverge from EU regulations in some sectors, adopting those of another large key market, such as the USA, would still be more meaningful than to adopt a British regulation sui generis, governing solely the UK market.

No negotiations on EU regulations

The various existing models of partnerships between third parties and the EU – together with varying conditions – aim for gradual convergence with the EU. For this very reason the UK

15. John Springford, Sam Lowe, "Britain's services firms can't defy gravity, alas", Insight, CER, 05 February 2018.
16. Keith Head, Thierry Mayer, John Ries, "How remote is the offshoring threat?", European Economic Review, Volume 53, Issue 4, May 2009, Pages 429-444.
17. Monique Ebell, "Assessing the Impact of Trade Agreements on Trade", National Institute Economic Review, 1 November 2016.
18. Pierre Sauvé, "Towards a Plurilateral Trade in Services Agreement (TISA): Challenges and Prospects", World Trade Institute, University of Bern, 7 March 2014.
19. Alessandro Antimiani and Lucian Cernat, "Liberalizing Global Trade in mode 5 services: How much is it Worth?", Chief Economist Note, DG Trade, European Commission, 4 July 2017.
20. Alan Beattie, "Why the whole world feels the 'Brussels effect'", *Financial Times*, 16 November 2017.

believes that, in April 2019, it could not reasonably be considered a third country like any other since it will leave the EU in a situation of full regulatory alignment. There can therefore be no opting for an "off-the-shelf" model for the future relations between the UK and the EU-27.

Yet, as the foundation of European economic integration is the single market, Brussels does not intend to weaken the cohesion between the 27 Member States by negotiating an *ad hoc* model which would allow for cherry picking and a partial access to the single market, thus creating a precedent which could tempt other Member States swept up by centrifugal forces. Michel Barnier stated on 19 December 2017 that EU regulation is a whole: "We will not accept from the other side, regulatory competition against social rights, against environmental rights, against consumer rights and against fiscal regulations ... or against financial stability".

Equivalence in terms of financial regulation: a unilateral concession

Let us remember that outside the single market, the UK could not unilaterally implement mutual recognition of norms and standards with the EU. The decision to grant a system of equivalence, which would allow financial institutions in a third country subject to similar legislation to enjoy access to the single market, is entirely up to the European Commission. This is a political decision and right now an important card for the EU-27 in Brexit negotiations, especially as the European approach to financial services favours financial stability, in terms of regulations, supervision and the application of European standards. For the European Commission equivalence is not a tool to liberalise international trade in the financial services sector but an instrument to manage the cross-border activities of market players in a healthy and prudential framework. The Commission proposed on 13 June 2017 a reform of the supervision of central counterparties which strengthens the procedure to grant equivalence.

In addition, the equivalence system does not provide a long-term solution. The Commission may reconsider its decision at any time. This would naturally oblige the UK to ensure constant alignment with any new financial services regulation, without having taken part in the EU legislative process[21].

The most favoured nation clause

Lastly, the EU would be limited by the most favoured nation clause (MFN)included in some free trade agreements (FTA).This clause - with a few exceptions - compels the EU to extend the more advantageous conditions obtained in future FTAs to countries with which it already has an FTA. In the case of the CETA, this could mean that concession made to the UK concerning services – including financial services – must be extended to Canada[22].

It's "regulatory convergence", stupid!

Following months of contradictory positions, the British debate has suddenly refocused on the key issue of regulatory convergence in the discussions raised in early December 2017 by issue of the Irish border. The scenario of a possible shift of the Irish trade border to the maritime border (following the "Macau" or "Hong Kong" scenario) would have the twofold merit of preserving the Good Friday Agreement and Northern Ireland's membership of the UK.

As it is unlikely that a regulatory alignment between South (Republic of Ireland) and North (Northern Ireland), and between West (Northern Ireland) and East (UK) would be compatible with UK-EU regulatory divergence resulting from a departure from the single market (if S=N and W=E, then S=E), this border shift would leave Northern Ireland the possibility of remaining economically in the single market while continuing to be a part of the UK politically.

21. Peggy Bracco Gartner, Jouke Tegelaar, "Brexit: Will third country regimes in EU financial services legislation save the City of London?", Leiden University, 15 May 2017.
22. Joe Owen, Alex Stojanovic, Jill Rutter, "Trade after Brexit. Options for the UK's relationship with the EU", Institute for government, December 2017, p34.

This option, which has the advantage of not reviving thirty years of Irish conflict, was rejected last December by Unionists who saw it as a ploy by Theresa May to join the single market by the back door and reminded her of the commitment - made upon forming the coalition government with the DUP in June 2017 - to preserve the UK's integrity. British government's interest in this scenario triggered a chain reaction which brought back the key challenge of regulatory alignment to centre stage. Three tweets were sent on 4 December in less than an hour: from the Mayor of London, Sadiq Khan, the Scottish First Minister, Nicola Sturgeon, and the Welsh First Minister, Carwyn Jones, stating their wishes that London, Scotland and Wales respectively could also retain their access to the single market (although a majority of Welsh voters were in favour of Brexit).

Michel Barnier's ultimatum given in London on 9 February with a view to finalising the Brexit agreement, announced a legal framework keeping Northern Ireland in the Customs Union if Downing Street fails to present an alternative proposal.

> "THE QUESTION OF THE ECONOMIC COST OF BREXIT MUST NOW BE ADDRESSED.

The British debate, focused so far on taking back control/sovereignty, must now address the economic cost of Brexit by refering to the assessments of the negative effects of post-Brexit scenarios. Here, the importance of a transition period, the complex nature of the British decision on the Brexit deal and with it the unknown duration of the transition is even clearer.

1.2 Fifty shades of trade friction: what kind of hard Brexit for companies?

With the exception of the "no deal scenario", feared on both sides of the Channel, all the other models would maintain the absence of customs tariffs, at least for manufactured goods, or otherwise for agricultural products highly dependent on support schemes which have every reason to diverge. Thus, the decisive issue would rather be the return of non-tariff barriers made up of technical regulations and standards, sanitary and plant-health specifications, service regulations, etc., up to rule of origin restrictions. Not to mention the return of possible so-called "trade defence" measures (anti-dumping and anti-subsidy duties and safeguard clauses).

Two models are of particular interest to the European Commission - and are undergoing more specific impact assessments - as they represent the two extremes, in terms of adverse effects on companies, of the range of alternative models London can choose from. The first is the Norwegian model, the least hard, and the second the CETA model, the hardest after the WTO scenario. Between the two, the cases of Ukraine and Switzerland also demonstrate variable shades of trade frictions. Yet while Brussels is urging London to clarify its post-Brexit priorities, the British government's difficulty in coming to terms with negotiating a free trade agreement is inciting British analysts to explore alternative differentiated regulatory convergence or ad hoc customs union options.

1.2.1 The Norwegian model: the least hard

> "THE SO-CALLED "NORWEGIAN" MODEL WOULD BE THE ONE TO HAVE THE LEAST IMPACT ON COMPANIES.

Not very compatible with the current UK red lines[23], with the exception of a restored independent trade policy, the so-called "Norwegian" model of member countries of the European Economic Area (EEA) would be the one to have the least impact on companies. Full alignment with single market legislation would allow any British or European company to trade goods (with the exception of agricultural and fisheries products) and services without customs tariffs. Freedom of movement would also reassure UK companies with regard to a lack of manpower in certain sectors. Maintaining the UK's participation in the Horizon 2020 programme, and by the same token in European research networks, would protect UK and EU-27 companies' innovation potential in the same measure. This model also includes agreements regulating competition policy, consumer protection and education.

23. As it requires a financial contribution, freedom of movement, regulatory alignment and CJEU supervision.

However, if this model is applied, UK companies would have to ensure compliance with EU rules of origin. As EEA member countries do not form a customs union with the EU and each has its own independent trade policy, border controls are maintained: exporters from these countries must be able to prove the origin of their products and comply with preferential criteria, thereby not conducting trade diversion. IT systems, joint control zones and authorised economic operators (AEOs) simplify these controls. Yet if the customs control system implemented between Sweden and Norway is considered the most advanced worldwide, the circulation of most goods takes an average amount of time ranging from 3 to 9 minutes, with additional delays during busy periods. Conversely, lorries currently take a few seconds to clear the UK port of Dover and it is estimated that an additional time of 2 minutes due to customs controls would result in 17-mile queues.

It should also be noted that EEA members do not take part in the Common Agricultural Policy or the Common Fisheries Policy.

According to the British government's estimate, this scenario would result in UK GDP losses of 2% over 15 years[24].

1.2.2 The Ukrainian model: the challenge of the regulatory ecosystem

In the case of Ukraine, one must distinguish between what the deep and comprehensive free trade agreement (DCFTA) allows in theory, since its provisional entry into force on 1st January 2016, and in practice, as it is in no way comparable with the level of integration in the single market. While the DCFTA is a means of not subjecting goods to customs tariffs, the scope of regulatory alignment remains limited to the possibility – still theoretical at this stage – of an agreement on conformity assessment and acceptance of industrial products (ACAA) which would cover a broad list of sectors: in other words, something that is still reasonably comparable to what is found in the EU's free trade agreements.

Above all, with regard to trade in services it should be noted that regulatory alignment is not sufficient for financial services to have access to the single market. Access is based on a full ecosystem of regulations, supervision and administrative and legal implementation, set up by the three European supervisory authorities[25] – an ecosystem which cannot be recreated outside the EEA. Furthermore, the EU retains the option of unilaterally suspending financial services access on financial stability grounds should it be deemed necessary. This DCFTA therefore only provides financial services with a highly theoretical access to the single market.

In addition, while restrictions are in place with regard to the movement of people (work permits are required), procurement contracts are open on all levels and participation in various European programmes (H2020, transport, environment, employment, consumer protection, etc.) and in various European agencies is possible.

1.2.3 The Swiss model: no bilateral agreement for services

The complex nature of the plethora of bilateral agreements governing EU-Swiss relations seems to invalidate this model from the outset. It should be noted, however, that while the access of Swiss goods exports to the single market is still the most similar to that of EEA companies (including for the rule of origin which would also be applicable), there is no bilateral EU-Swiss agreement for services. This means, therefore, that Swiss financial services do not enjoy access to the single market.

Moreover, these three models, Norwegian, Ukrainian and Swiss, provide substantial access to

24. Alberto Nardelli, "EU Exit Analysis – Cross Whitehall Briefing", January 2018.

25. The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

the single market which is conditioned by the adoption of European regulations, not only by economic sectors but also across the board (environmental regulation, or regulations on data protection and public subsidies, etc.).

1.2.4 CETA +: a mere trade agreement

The bilateral agreement between the EU and Canada, CETA, which provisionally entered into force in September 2017, is presented as a new-generation free trade agreement, with broader aspects on top of the removal of customs tariffs as it also concerns procurement contracts, intellectual property protection and services to some extent.

A CETA + version going beyond the concessions granted to Canada which still maintain residual tariffs for some sensitive agricultural products could ensure the removal of customs tariffs for most goods. It would also keep access to procurement contracts on all levels open. On the other hand, the lack of regulatory alignment with the European acquis would allow the UK partial, or even broad regulatory divergence. The mutual recognition of conformity assessments would therefore not be applicable to all sectors. Non-tariff barriers and certification checks would be restored to trade, with a significant additional cost for value chains.

Moreover, CETA only partially covers services (mutual recognition of qualifications, maritime transport, portfolio management, etc.). Commitments vary according to the four modes of provision[26]. While CETA is less restrictive in terms of services than the Swiss model, it does not grant a financial passport and maintains the local licence requirement, which remains the main barrier to cross-border financial services.

A CETA+ version which would provide the UK with greater openings for services would be an important concession from the EU. This is particularly the case as, as stated above, the CETA's MFN clause would require the same concession to be granted to Canada[27] and to other countries with whom an FTA includes the same clause[28]. This is currently a major obstacle in Brussels granting such a concession.

The UK government estimates that this scenario would generate a 5% drop in UK GDP growth over 15 years[29] . In addition, as with all negotiations for the EU's various FTAs, those for the CETA were long (5 years)[30].

TABLE 2 ▪ Impact assessment of three post-Brexit scenarios[31]

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.

The impact of the economic cost of the models presented has led British analysts to explore an alternative model of differentiated regulatory convergence.

26. Cross-border supply (mode 1), consumption abroad (mode 2), commercial presence through a subsidiary or office (mode 3) and presence of natural persons (mode 4).
27. Polly James, Chris Bryant, "Post-Brexit Financial Services deal - Are the EU's hands tied by its Canadian deal?", 6 September 2016.
28. South Korea, Singapore, the Caribbean islands and Japan.
29. Alberto Nardelli, "EU Exit Analysis – Cross Whitehall Briefing", January 2018.
30. See length of negotiation and implementation of EU FTAs: Vincent Vicard, Simon Weber, "Quelle période de transition pour l'après Brexit ?", Billet du CEPII, 15 February 2018.
31. Impact assessment from the British government entitled "EU Exit Analysis - Cross Whitehall Briefing" which was leaked by BuzzFed News. Alberto Nardelli, "This Leaked Government Brexit Anlysis Says the UK Will Be Worse Off in Every Scenario", 29 January 2018.

1.2.5 Differentiated regulatory convergence

Prior to their suspension, the aim of the TTIP negotiations between the EU and the USA was not to reach full regulatory alignment, but to consider regulatory cooperation for US standards which ensure the same level of precaution as EU standards. Could the EU now offer the UK less mutual recognition than it had been planning with the USA?

> "A COMBINATION OF INDEPENDENCE, EQUIVALENCE AND SUBSERVIENCE

Inspired by the principle of a new regulatory framework for the UK, mentioned by Theresa May during her speech in Florence, Robin Niblett, director of Chatham House[32], suggests the scenario of a "sensible Brexit" which would be a combination of independence, equivalence and subservience to EU regulationThis model is structured around three baskets[33].

The UK could:

- Take back regulatory control in sectors which have little impact on bilateral trade (such as workplace safety, air and water quality),
- Adopt its own rules where the country has a comparative advantage and regulatory expertise, such as for financial services and climate change mitigation, etc., while ensuring that the level of precaution of its rules is equivalent to that of European legislation. Should the UK diverge from EU regulations in these sectors, it would lose access to the single market.
- Commit to full alignment with EU regulations in the sectors which are heavily dependent on the single market (agricultural produce, pharmaceuticals, chemicals, aviation, cars, … perhaps competition policy, including State subsidies) but with British courts enforcing EU rules.

This scenario would ensure that the British recover their sovereignty in some areas, while British regulators would guarantee the same level of precaution set by European standards. Nevertheless, it assumes that Europeans would trust UK regulators to prevent any risk of additional regulatory divergence: a trust which may well not be enough glue to keep the system together and which would require a complex control and dispute settlement system. From the outset, this option comes up against the intractable challenge of determining which regulations are essential for the functioning of the single market. Can environmental or social standards now be considered optional? The single market's coherence and integrity would be called into question by such a model.

1.2.6 A partial customs union

More recently, the UK debate focused further on the benefits that the UK could glean as a last resort from an *ad hoc customs union*[34] with the EU, enabling it to partially preserve an independent trade policy.

The EU's customs union with Turkey is highly restrictive for Turkish companies as it only covers manufactured goods and notably excludes all services and agricultural products. Processed agricultural goods enjoy the pan-Euro-Med system of rule of origin cumulation. Yet as transport services are not included in the customs union, Turkey faces logistical border control issues which cause lorry backlogs snaking back miles.

A letter from the Chancellor Philip Hammond sent to the UK Parliament's Treasury Committee hinted at the possibility that the UK may remain in a customs union with the EU which would cover the trading of goods, while allowing the UK to negotiate trade agreements for services. A clause of the *Taxation (Cross-border Trade) Bill* allowing the British government to establish a

32. Robin Niblett, "Finding a Sensible Brexit", Chatham House, 12 December 2017.
33. Joe Owen, Alex Stojanovic, Jill Rutter, "Trade after Brexit. Options for the UK's relationship with the EU", Institute for government, 18 December 2017. Denis Staunton, "UK looking for allies - but what about Ireland's friends in the EU?", 22 January 2018.
34. Peter Holmes, "Staying in the Customs Union: Neither Soft Nor Simple", Scottish Centre on European Relations, Comment, 11 July 2017.

new customs union with the EU on the basis of a fast-track procedure has also been debated in the UK Parliament since 9 January.

On 21 January 2018, a statement by Carolyn Fairbairn, Director-General of CBI, the main UK business organisation, called for a comprehensive customs union between the United Kingdom and the European Union.

Samuel Lowe and John Springford specified what would be known as the "Jersey option" giving the UK the option of being in a customs union with the EU and in the single market solely for goods[35]. This option implies that the UK would apply the same EU external tariff and would comply with single market rules for all agricultural products and manufactured goods. To ensure this access to the single market, the UK would have to accept EU regulations on State subsidies as well as environmental and social standards in order to avoid unfair competition between EU and British companies. An oversight mechanism would have to be set up to ensure that the UK enforces EU rules, in addition to a tribunal to settle disputes. Lastly, the EU would demand a financial contribution intended for the development of the least advanced Member States. The United Kingdom would be free to negotiate free trade agreements for services and investment with third countries in complete independence.

"THE DEVELOPMENT OF INTERNATIONAL TRADE IS STILL SHOWING HIGH LEVELS OF RESISTANCE TO THE OPENING OF THE SERVICES MARKET.

Unless the question of the Irish border is already settled by the prior continuation of Northern Ireland in the Customs Union (as stated above), the key advantage of this arrangement would be to remove the need for physical border control infrastructure between the Republic of Ireland and Northern Ireland. The main hurdle for the UK would once again be that the development of international trade is still showing high levels of resistance to the opening of the services market. The UK's ability to negotiate such preferential agreements in these areas which are more ambitious than the EU's current FTAs remains thus very hypothetical. This would probably come at a cost of deregulation that the EU-27 are unlikely to accept and against which they would attempt to protect themselves in the negotiation of future bilateral relations.

Moreover, the UK's leeway in future trade negotiations with third countries would be significantly limited by the inability to grant additional concessions on customs tariffs for goods, which remain the tradition leverage employed by developed countries to obtain preferential access to the services markets of emerging or developing countries. It remains to be seen, in such scenario, whether the EU would be willing to accept restrictions to the free movement of people, which seems unlikely due to the indivisibility of the four freedoms of the single market.

The time required to explore the various models only stresses the risk that the addition delay of 21 months granted by the transition would be insufficient. This timeframe is cut down to 15 months if the time required to ratify an agreement is factored in. Can we then reasonably stand by the principle of a short transition period?

35. John Springford, Sam Lowe, "Holding out hope for a half-way Brexit house", 22 January 2018.

2 . ONE OR "TWO" TRANSITION SCENARIOS?

2.1 Negociation terms

2.1.1 Negotiation under conditions

Article 50 of the TEU, which sets out the principles for a Member State's withdrawal from the EU, does not specify any transition period following the date of departure. The withdrawal agreement negotiating directives did not yet empower the European Commission to negotiate such a transition. The guidelines of the European Council dated 15 December 2017 state that transitional arrangement will be part of the withdrawal agreement. They also specify in paragraph 6 that "an overall understanding of the framework for the future relationship [...] should be elaborated in a political declaration accompanying and referred to in the Withdrawal Agreement". The 27 Member States thereby plan to adopt negotiating directives on the future bilateral relations following the transition period during the European Council of 22-23 March 2018.

The negotiating directives adopted unanimously on 29 January 2018 by the EU General Affairs Council clarify the terms of a transition that would ensure the maximum amount of possible continuity of the current situation for individuals and companies. Undertaking complex negotiations on the transition period would only eat up the, already limited, time and energy of both parties to minimise negative impact post-Brexit.

A prerequisite for negotiating this transition remains the legal translation of the agreement reached on the first phase of negotiations on the basis of compliance with the European Council guidelines dated 15 December 2017. It should be noted that the resolution of the Irish border issue is closely associated with the overall post-Brexit partnership on which the UK and the EU must agree.This could well be the last element to be negotiated, reminding that despite a necessary sequencing of negotiations, "nothing is agreed until everything is agreed".

The negotiating directives dated 29 January[36] provide that:

- The UK will become a third country from 30 March 2019, but will continue to participate in the single market and the Customs Union, and in the EU's various programmes and agencies, without being represented within EU institutions and bodies and, as a result, without taking part in decisions.
- The Union acquis will continue to apply in full to the UK and any changes made to the acquis should automatically apply to the UK.
- All EU regulatory, budgetary, supervisory, judiciary and enforcement instruments and structures, including the competence of the European Court of Justice, shall apply.
- The UK will continue to contribute to the EU budget as it does today.
- The free movement of people will be maintained: European citizens can continue to live and work in the UK during the transition period and the UK will continue to take part in current security measures.
- The transition period should not last beyond 31 December 2020.

The Commission position paper dated 7 February 2018 states that the UK shall abstain from

36. Annex to the Council Decision supplementing the Council Decision of 22 May 2017 authorising the opening of the negotiations with the United Kingdom of Great Britain and Northern Ireland for an agreement setting out the arrangements for its withdrawal from the European Union - Supplementary directives for the negotiation of an agreement with the United Kingdom of Great Britain and Northern Ireland setting out the arrangements for its withdrawal from the European Union, XT 21004/18 ADD 1 REV 2, 29 January 2018

any initiative which is likely to be prejudicial to the Union's interests in the framework of any international organisation, agency, conference or forum of which the United Kingdom is a party in its own right (UN, WTO, G7, G20, etc.)[37].

Paragraph 3 of article 50 provides for an extension of the two-year negotiation period of the withdrawal agreement, subject to a unanimous vote in the European Council in agreement with the UK. This would allow full representation in EU institutions, rather than having to envisage the UK becoming what some call a "vassal state" during a "copy and paste" transition period, with the UK as norm taker excluded from drafting European legislation. However, the UK's public opinion may label this as an attempt of the British government to avoid an exit from the EU. At the same time it would be difficult for the EU-27 to accept the UK on the road to Brexit continuing to play a long-term role in the decisions which will affect the EU's future, with a new European Parliament in the spring of 2019 which would still have seats for British MEPs.

2.1.2 Saving some time, but not too much

> A TRANSITION AGREEMENT WILL BE MORE DIFFICULT TO ACCEPT IF THE PERIOD IS LONG.

If both parties agree on any point at this stage, that would be the need to keep the transition short. For the European Commission, the aim is to ensure that the negotiations of the next budget, the Multiannual financial framework (MFF) for the 2021-2027 period, to be launched in the spring of 2018, are not affected by the outcome of Brexit. For UK public opinion, a transition agreement will be more difficult to accept if the period is long. Above all, the aim is to avoid getting stuck in what Theresa May herself called a "permanent political purgatory"[38].

That said, this directive leaves little room for what the British government calls an 'implementation' more easily than a transition. This unilateral semantic choice was made intentionally so that the UK's effective withdrawal from the EU, on 31 March 2019, may still mean that the UK government will take back control in certain areas despite the transition period, according to a principle of differentiated implementation.

Speaking during a visit to China on 16 December 2017, Philip Hammond highlighted this constructive ambiguity in which the UK government is leading its public opinion: "We won't technically or legally be in the customs union or in the single market, but we're committed as a result of the agreement we've made this week to creating an environment which will effectively replicate the current status quo, so that businesses can carry on trading with their commercial partners across the EU as they do now"[39].

2.2 The "status quo for 21 months" scenario

The Commission's negotiating directives establish a clear framework for the transition, which was further clarified with the position paper published on 7 February 2018. A legal construct based on principles, the EU offers little room for manoeuvre in the negotiation. However, if the transition is an irksome passage that the British must unwittingly accept, dialogue between London and Brussels must continue on various outstanding issues.

2.2.1 Outstanding issues

The bone of contention: free movement of EU citizens

The rights of European citizens arriving in the UK during the transition period is a divisive issue. The EU negotiating directives state that the indivisibility of the four fundamental freedoms

37. European Commission, "Transitional Arrangements in the Withdrawal Agreement", Position paper TF50 (2018) 30, 7 February 2018. Jacopo Barigazzi, David M. Herszenhorn, Charlie Cooper, "EU toughens Brexit transition demands", 06 February 2018.
38. Theresa May, Lancaster house address, 17 January 2017.
39. Joe Watts, "Theresa May insists she will try to sign new trade deals before Brexit transition is over", 18 December 2017.

oblige the UK to treat Europeans settling in the UK during the transition period in the same way as those who arrived prior to Brexit day. EU citizens who settle in the UK during the transition period must therefore be entitled to the same residence rights as those who arrive before 29 March 2019.

> FOR THE BRITISH PUBLIC, THE COUNTRY'S EXIT MUST ALREADY BE TANGIBLE IN APRIL 2019.

London has already expressed its reluctance, using the term 'implementation' to mean that, for the British public, the country's exit must already be tangible in April 2019. Especially with regard to the end of freedom of movement for people, a key factor in the Brexit referendum vote. The UK government is not opposed to the principle of free movement or to Europeans working and settling freely in the UK during the transition period, but is insisting that there must be a different treatment for those arriving prior to Brexit day and those arriving afterwards, in accordance with the terms of the agreement made in December 2017 on the first phase of negotiations. This guarantees that on Brexit day, all EU citizens having lived legally in the UK for 5 years will obtain the right to permanently reside in the country, while maintaining the same access to public services as today. Those who will have lived in the country for less than 5 years will have to legally resided in the UK until they have completed the 5 year period and they can apply for permanent residence. As a result, the application of these conditions for the duration of the transition period would allow EU citizens settling in the UK until the last day of the transition period the option of entitlement to UK residence for the next 5 years and, possibly, the right to permanent residence. The UK government's position, expressed by Theresa May in Florence and by David Davis during his Teesport speech on 26 January 2018, aims specifically to avoid such a scenario.

If the UK accepts that freedom of movement is upheld during the transition period, it is requesting that the terms of the December agreement do not apply to the transition period. Instead it wishes to set up a registration system that will allow it to better plan for its future public services, and prepare for its future immigration system. The UK could then split EU citizens into two categories: those who arrived prior to 29 March 2019, protected by the terms of the December agreement, and those who arrived afterwards who remain exposed to the possible restrictions of a new British immigration policy. This arrangement is deemed discriminatory by Brussels, but could nevertheless be subject to bilateral negotiation.

The uncomfortable asymmetry of the rule taker

During the transition, all new directives adopted by the EU will have the same direct effect in the UK as in EU Member States. The primacy of EU law remains. The UK will be obliged to apply all new agreements signed by the EU without taking part in the bodies created by these agreements. The UK will not attend meetings of committees referred to in article 3 (2) of Regulation (EU) No 182/2011, or Commission experts groups and other similar entities or the agencies or bodies where Member States are represented.

The UK's exclusion from all institutions and bodies representing the EU implies the British commissioner stepping down, and British ministers being excluded from the various formations of the Council. As regard to the seats of British MEPs, the European Parliament has adopted a proposal aimed at distributing 27 seats among 14 EU Member States which are currently slightly under-represented (the remaining 46 seats would constitute a reserve for possible future enlargements of the EU, or retained to keep the Institution smaller). The Council must still vote unanimously for the proposal to be approved. A further implication of this loss of representation is the fact that the UK Parliament and the Bank of England will lose their authority as national parliament and national bank respectively in EU procedures. Westminster would thereby lose its power to check for compliance with the principle of subsidiarity which it currently enjoys over Commission's legislative proposals, through the "yellow card" and "orange card" system, through which national parliaments can compel the Commission to review a legislative proposal.

The only role that Europeans are willing to envisage for the UK in the legislative process would be that of an observer and only in exceptional cases (for example for questions concerning individual acts to be addressed to the United Kingdom, or to United Kingdom natural or legal persons). The EU negotiating directives only provide for the possibility of consultation, without voting rights, on the allocation of fishing quotas and on the common foreign and security policy. London may, however, attempt to mitigate this asymmetry by extending this consultation to other issues.

> THERE IS A MUTUAL FEAR THAT THE SYSTEM COULD BE EXPLOITED TO THE ADVANTAGE OF ONE OF THE PARTIES.

If the UK's status of rule taker during the transition is generally established, there is a mutual fear that the system could be exploited to the advantage of one of the parties. Against the possibility that the EU may benefit from its power as rule maker to adopt legislation against British interests, the British negotiator, David Davis, has requested that a mechanism be set up to voice British concerns with regard to draft directives.

The EU, fearing that the UK will not apply new EU legislation when it does not suit the country — and may be tempted to take advantage of the length of any proceedings launched before the European Court of Justice — wishes to set up a sanction mechanism which limits the UK's access to the single market. This unilateral recourse should heighten British misgivings.

Bridges

While Brussels has reminded that nothing is agreed until everything is agreed, some areas may require advance cooperation which is beneficial to both parties.

This is the case in particular for civil aviation: a sector which, unlike others, cannot rely on the WTO regime in a no deal scenario. Civil aviation is structured around bilateral agreements between countries. Today, UK airlines can operate flights to an EU Member State and between EU Member States because the UK is a member of Single European Sky and the European Aviation Safety Agency (EASA). In exiting these two systems, the UK would have to negotiate new agreements with the EU and third countries who have signed agreements with the EU so that air traffic is not suspended. The reverse is also true for EU flights to the UK. Furthermore, under the Single European Sky framework, intra-European flights are only authorised for airlines with predominantly European shareholders. An airline such as Iberia, with a majority owned by British Airways within the holding company IAG, could no longer operate flights between Seville and Madrid.

The transition period would delay the ever more tangible risk of a cliff-edge scenario, maintaining the status quo. However, airlines publish their flight schedules one year in advance. One year prior to the end of the transition period, British and EU airlines would therefore need visibility over the legislative framework governing air traffic between the EU and the UK. A no-deal scenario in this sector would cause serious disruptions to flight plans. It could also result in bankruptcy for some airlines. The very real possibility that no agreement is struck before the end of the transition period, that is before April 2019, means that an *ad hoc* agreement must be found for civil aviation.

> THE UK'S PARTICIPATION TO THE H2020 FRAMEWORK PROGRAMME AND ITS SUCCESSOR SHOULD BE SECURED.

The need for such an *ad hoc* agreement could also apply in other areas in which an end to EU-UK cooperation would not make sense due to it being mutually beneficial to both parties and it having no impact on national sovereignty. This is the case for the H2020 framework programme for research and innovation and its successor. The UK's participation should be secured now in order to avoid undermining European scientific cooperation networks by a return to bilateral cooperation with the UK: a system which is significantly less effective, as the experience of the last few decades shows. No fewer than 16 third countries already take part in the programme.

Lastly, cooperation in the fields of security and defence is also of mutual interest and special attention should be paid to the creation of an *ad hoc* agreement. The European Commission has already considered the possibility of such an agreement entering into force during the transition period (fast-forwarding). Thus, in the areas currently covered by the common foreign and security policy, the implementation of Brexit would be tangible by replacing the clauses of EU treaties with clauses of a bilateral agreement[40].

2.2.2 The UK and third countries: a trilateral challenge

An additional risk in the cliff-edge scenario

A related issue of the negotiation of a transition agreement concerns the UK's status in the 759 international agreements which have been signed by the EU and which apply to the UK, starting with all the trade agreements the EU has signed with third countries, which accounted for 11% to 15% of UK exports in 2015.

As Michel Barnier reminded on 20 December 2017: "Legally speaking, mechanically, the day after the U.K. has left the EU institutions, the U.K. will no longer be covered by our international agreements".

> "IT WOULD BE UNREALISTIC TO RENEGOTIATE ALL THE EU'S TRADE AGREEMENTS FROM SCRATCH BY MARCH 2019.

As it would be unrealistic to renegotiate all the EU's trade agreements from scratch by March 2019, each one having required several years of negotiation, the UK's trade with these countries runs the risk of once again being subject to the less favourable and multilateral WTO regime. It would increase the negative impact of leaving the single market. Let us take the example of the EU-Japan FTA which has just been finalised and which may enter into force provisionally prior to March 2019. The UK could not profit from this, while the UK market's appeal for Japan would become at a stroke two times less: whereas Japan currently applies WTO rules with the EU and would benefit in the future from the preferential conditions provided by the FTA, the UK would have partially lost the appeal it enjoys today thanks to its access to the single market.

In addition, if, in accordance with the EU negotiating directives, the UK remains in the single market and the customs union during the transition period, the integrity of the Customs Union must be guaranteed by the UK's continued participation in the current FTAs. These same directives provide that during the transition the UK may not enter into agreements with third countries without the EU's authorisation. Otherwise, any concession by the UK of preferential tariffs to third countries which are more favourable than those granted by the EU would undermine the very principle of the Customs Union (unless implementation is delayed).

Avoiding the Turkish regime

If the transition period for withdrawal from the EU does not come with an equivalent transition period for withdrawal from FTAs, the UK would find itself in an asymmetrical regime with third countries, similar to that of Turkey. As a member of the Customs Union, the UK would be obliged to maintain the same EU common external tariff with regard to third countries, although third countries would not have to comply with this obligation. In other words, exporters in third countries with whom the EU trades under preferential conditions could access the UK market under the same conditions as today, without the reverse being true.

British companies are not the only ones concerned. European companies, which are part of the same value chain as British companies, would be affected by the UK's exit from the current rules of origin regime of these FTAs, which determine, for each product, the percentage which must originate from the exporting country to enjoy preferential tariffs. If, when leaving the EU, the British content of European exports is no longer considered as "EU" content, some products may no longer enjoy preferential access to the third country in question and as a result would have to pay a higher tariff[41].

40. Nicole Koenig, "Towards Norway Plus? EU-UK defence cooperation post-Brexit", Blog Post, Jacques Delors Institut-Berlin, 7 February 2018.
41. While the Turkish case limits the impact of the rule of origin issue through the country's membership in the pan-Euro-Med cumulation of origin area.

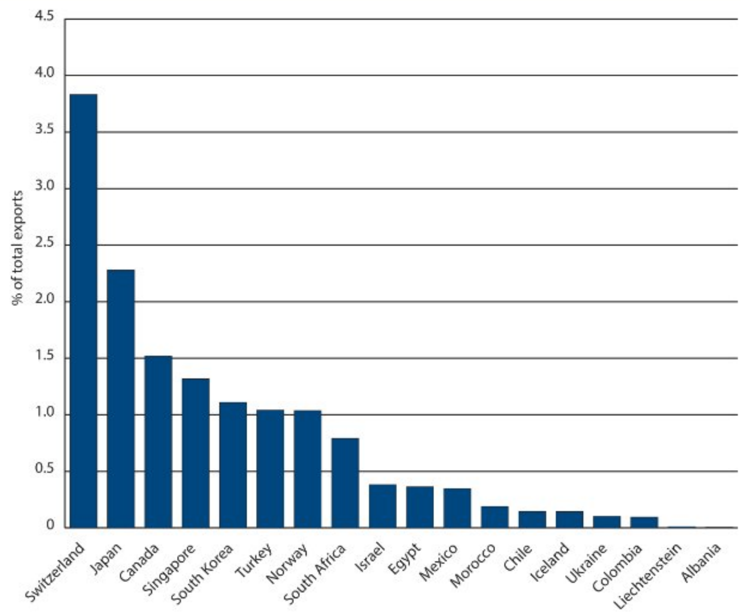
Grandfathering

It would therefore be in the UK's and the EU's mutual interest to maintain the status quo during the transition period, allowing the UK to continue to benefit from these agreements, and not merely being constrained by their obligations. One mean of achieving this would by the principle of acquired rights, known as grandfathering[42], which would imply that the clauses of these agreements would remain applicable to the UK, even after its exit from the EU.

The grandfathering of international agreements would allow these agreements to continue to apply to the UK and in third countries concerned, the latter accepting to consider the UK to be a signatory of these agreements via the EU during the transition period. In this framework, the UK and the EU would still be considered as a single entity. A technical note from the UK government dated 8 February 2018[43] tends to favour this option rather than the alternative, which implies translating the same terms of these agreements into new bilateral agreements between the UK and third countries.

Neither option is a mere formal procedure. For the first option, the EU's "green light" on the UK remaining in these agreements after 29 March 2019 does not suffice. Consent must also be obtained from the third countries who have signed these FTAs via an exchange of letters or a protocol to be incorporated into the treaty in question. In this case, third countries may be tempted to negotiate more favourable conditions of access to the UK market in a new bilateral agreement which would come into effect at the end of the transition period. Following on from pressure already felt from Chile, South Korea and South Africa, other countries may make this transition more difficult.

FIGURE 2 ▪ Percentage of total UK exports to EU FTA partners



Source: Geographical breakdown of the current account, The Pink Book: 2017, ONS.
Notes: As of publication the agreement with Singapore is yet to be ratified, and the agreement with Japan yet to be signed. Both are expected to be finalised prior to the completion of the proposed Brexit transition period.

42. Peter Holmes, Michael Gasiorek, "Grandfathering Free Trade Agreements and Rules of Origin: What might appear bilateral is in fact trilateral", UK Trade Policy Observatory, 27 September 2017.
43. Technical note: International agreements during the implementation period. 8 February 2018.

The second option is certainly even more complex. The idea of copying and pasting the texts of existing treaties between the EU and third countries, replacing the name "EU" with "United Kingdom", into new international agreements and signing them one minute after the UK's exit from the EU (29 March 2019 at 11 p.m.), is not as easy as it may seem.

The issue of rules of origin is, once again raised. Let us take the example of the free trade agreement between the EU and South Korea in which the rules of origin require a vehicle exported to South Korea to have at least 55% EU content. Only 41% of the value of a British vehicle is actually produced in the UK. By replicating the same rules of origin in a bilateral agreement between the UK and South Korea, British cars would no longer enjoy preferential access to the South Korean market because their European components would be calculated as foreign, not local, content.

Tariff quotas are also an issue. FTAs impose a quota limiting the number of units for some products which may enter the market tariff-free or with a preferential tariff (for example, a quota of Moroccan tomatoes may be imported in Europe, or a quota of European cheeses which may be exported to Canada). Should the EU quota be continued in the new bilateral agreements between the UK and third countries, or should it be renegotiated with the third country in accordance with the volume of UK-third country trade on a given date – which would also have to be agreed upon? Such renegotiations would result in the EU and third countries reassessing their current quotas.

These two issues already indicate that a copy and paste of FTAs currently in force into bilateral agreements between the UK and third countries would require trilateral negotiations and amendments (between the EU, the UK and third countries) which could very well extend over the deadline of March 2019.

Furthermore, the replication option further increases the risk of the UK having to make concessions to third countries as the new FTAs may well apply even beyond the transition period.

In leaving the EU, depending on the new EU-UK partnership, the UK will become a market with lower levels of appeal for third countries than that of the vast EU single market. As a result they may not be willing to make the same concessions to the UK as those granted to the EU as they will be accessing a more limited market. Or, they may demand a greater price for maintaining the same concessions. It all depends on the leverage of third countries. While countries with less leverage over the UK may accept a replication of concessions made to the EU, countries with greater leverage may be tempted to revise these concessions to their advantage.

> "THIRD PARTIES WILL THEMSELVES WANT TO WAIT IN THEIR ASSESSMENT OF THE NEW EU-UK PARTNERSHIP BEFORE COMMITTING IN BILATERAL NEGOTIATIONS.

Moreover, it is not only the UK which would be unable to simultaneously renegotiate the 40 EU FTAs, within a timeframe which would still allow the ratification or provisional entry into force of these agreements before the end of the transition period (i.e. in practice 15 months, to leave time for ratifications, as noted above). Third parties will themselves want to wait in their assessment of the new EU-UK partnership before committing in bilateral negotiations.

Some specific trade agreements will also entail additional difficulties. Could the UK replicate an agreement which provides for the free movement of people like the EU-Switzerland bilateral agreement?

Lastly, if third countries were willing to replicate the existing agreements without changing them, their internal ratification process, which can take several months, does not rule out the risk of a no deal scenario.

The EU's key role

The EU will certainly have a key role to play – using all the weight of its position – to convince its trade partners to accept the option of grandfathering without further negotiation for the duration of the transition. The UK could then use the transition period to replicate FTAs into new bilateral agreements.

If this involves preserving the current terms of the agreements, with the exception of strictly necessary technical amendments (as stated above), the UK and third countries concerned would have the option of revising these agreements in accordance with their respective interests at a later stage. Besides, the fast development of international trade dynamics requires a regular revision of existing FTAs, such as the agreement between the EU and Mexico which is currently being revised.

Finally, the rules of origin issue may be resolved by introducing a diagonal cumulation clause into these agreements. In this way, three or more countries which have all signed bilateral FTAs between themselves may, in compliance with rules of origin, consider the goods originating from any of these countries as domestic. In the case of vehicles in a possible FTA with South Korea, the introduction of a diagonal cumulation clause in such an agreement would allow the UK to qualify European content in its cars as local, and thereby enjoy preferential treatment. This negotiation between the UK and third countries would therefore include a trilateral dimension involving the EU.

Mixed agreements

Mixed agreements negotiated and signed by the EU but also ratified by Member States remain a legal conundrum[44]. Legal experts are yet to concur on the UK's status following Brexit with regard to these agreements, which account for most trade agreements to date[45]. They have been ratified by the UK according to British case law which does not differ to that provided for in agreements signed solely by the UK. Will they still be valid for the UK following the transition period? The argument of inapplicability is also put forward by legal experts and seem to be predominant in London and Brussels.

Going beyond FTAs, the question of the UK's application of all international agreements following Brexit does not concern the UK alone. The United Kingdom and the EU have a mutual interest which calls for trilateral dialogue efforts with all partner countries which should be launched as quickly as possible, without waiting for the end of negotiations on the transition period.

This outline of questions, which must be clarified in the negotiation on the transition, does not negate the main objection to the current commitment to a short transition: is a short transition realistic and what would be the implications of a "long" transition? This question is particularly important as mixed agreements require ratification by all Member States and therefore additional timeframes.

2.3 The "long transition" scenario

> "POLICY EXPERTS AGREE THAT THE TRANSITION COULD EVEN BE LONGER.

In stating in its resolution dated 13 December 2017 that the transition period should not exceed three years, the European Parliament was considering a transition which would already exceed the 21 months that the EU-27 are currently allowing. The Irish Tánaiste (deputy head of government) Simon Coveney has spoken about 5 years. Trade policy experts agree that the transition could even be longer, due to the complex means of implementing any trade option for the post-Brexit period, not to mention all the other aspects of bilateral relations which must still be settled.

44. It should be noted that unlike the FT, which estimates that the UK will have to renegotiate 759 international agreements signed by the EU, a report of the British Parliament estimates that there are 746 exclusive competence agreements and 229 mixed competence agreements. Vaughne Miller, "Legislating for Brexit: EU external agreements", Briefing Paper, No. 7850, 5 January 2017, p3.
45. As the bilateral agreement between the EU and Japan does not include a dispute settlement mechanism for investments, it would most likely be considered to be an exclusive competence agreement.

If it is decided to "give it time" to avoid a cliff-edge scenario at the end of the 21-month transition period, an extension clause should be discussednow. This would do away with the healthy pressure that a short timeframe puts on the UK government to clarify its trade policy priorities and would allow a post-Brexit partnership agreement to be negotiated. It would also mean that a higher contribution to the EU budget, a fact which will receive little support from the British public, as the idea would be considered as a pretend "status quo" without voting rights, and which is more expensive.

2.3.1 What would be the contribution to the 2021-2027 budget?

Assuming that the extension of the transition renews the terms of the initial transition agreement, a British contribution to the new multiannual financial framework for the 2021-2027 period would have to be adapted.

As a separate issue to the new 2021-2027 budget, the EU-27 will also have to renegotiate an agreement on the EU's own resources. Will they have to include a clause concerning the possible extension of the Brexit transition period and would they be willing to maintain the UK rebate? The latter part of this question is highly doubtful.

> "A LONG TRANSITION MAY THEREFORE MEAN THAT THE UK MAY HAVE TI PAY A SUBSTANTIALLY HIGHER AMOUNT.

It should be remembered that this rebate negotiated by Margaret Thatcher in 1984 implies that 66% of the UK's net contribution to the EU budget of the previous year is returned to the UK. The UK's current contribution to the EU budget is 14% pre-rebate and 12.5%-13% post-rebate. It has enabled the UK to recover approximately an annual amount of €6 billion in recent years. A long transition may therefore mean that not only would the UK no longer be entitled to take part in EU decision-making, but may have to pay a substantially higher amount.

In addition, the UK's contribution to the Common Agricultural Policy and the cohesion policy during the extended transition period may be particularly difficult to calculate as the terms of these policies will be subject to long and fierce debate between the EU-27 for the post-2020 multiannual financial framework.

The alternative for the UK would be that, like member states of the EEA, its contribution may be calculated on the basis of gross national income and negotiated programme by programme, with a specific contribution allocated to reducing disparities between EU Member States outside of the EU's general budget.

2.3.2 Compatibility with the WTO

Could a 21-month transition and even more a longer transition raise an issue of compatibility with the WTO? It could not be considered as a provisional agreement under the terms of article XXIV of the GATT, as such a provisional agreement is part of a permanent free trade or customs union agreement, of which the content is known upon notification of the so-called provisional agreement.

The transition agreement would be a type of regional trade agreement. As with any agreement of this kind, it would need to be notified to the Regional Trade Agreement (RTA) transparency mechanism.

2.3.3 Sequencing of negotiations and ratification

The European Commission continues to set the pace as regards the sequencing of negotiations. While Brussels is still specifying the terms of the negotiating directives for the transition period[46], the European Council of 23 March 2018 should adopt new negotiating directives for the future partnership agreement.

In addition, as regards the ratification process, Brussels and London have agreed on the princi-

46. European Commission, "Transitional Arrangements in the Withdrawal Agreement", Position paper TF50 (2018) 30, 7 February 2018.

THE WITHDRAWAL AND TRANSITION AGREEMENT DOES NOT REQUIRE RATIFICATION BY THE EU'S NATIONAL AND REGIONAL PARLIAMENTS.

ple according to which the transition agreement will be part of the withdrawal agreement covered by article 50. This would mean that for the EU-27, ratification would be conducted at the European Parliament and the European Council under "super qualified majority" (corresponding to 72% of the 27 Member States and at least 65% of the EU population). Unlike the final partnership agreement, the withdrawal and transition agreement does not require ratification by the EU's national and regional parliaments.

However, one could contend that, as the transition agreement would continue the terms of the UK's membership of the EU – subject to amendments – it would rather enter into the scope of article 218 TFEU allowing the negotiation of a free trade agreement and requiring ratification by national and regional parliaments[47]. An analysis of the German Bundestag views the issue along these lines[48]. Would the duration of the transition period, should it prove much longer than the target of 21 months, contribute to validating this legal interpretation?

CONCLUSION

While the prospect of a transition agreement is more tangible, companies consider that this constructive step towards a post-Brexit agreement avoids a no deal scenario and allows them to avoid contingency planning. At this point in time, it is easy to see that a transition period may only result in postponing the possibility of this risk. In wanting the UK government to clarify its priorities for the partnership agreement by October 2018, the EU-27 are favouring a sequencing of negotiations which strives to avoid a transition running over several years and which does not keep the United Kingdom in a Brexit purgatory which deprives the country of sovereignty more than ever. This solution should suit Theresa May's government.

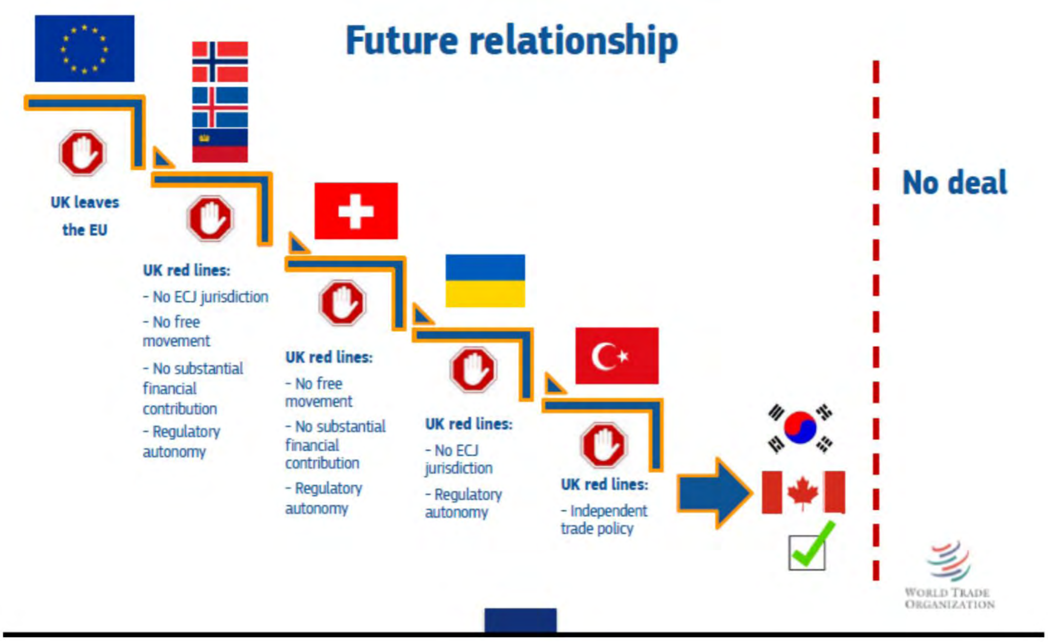
WILL THE PRESSURE THE EU-27 IS PLACING ON THE UK GOVERNMENT SPEED UP ITS INTERNAL SOCRATIC DEBATE OR CONTINUE TO PRECIPITATE A POLITICAL CRISIS?

However, the UK has little room for manoeuvre in the negotiations as the European Union is a legal construct based on principles. While the EU-27 are working towards an orderly withdrawal of the United Kingdom, they have no control over the internal tensions and debates of British political parties, which are a major stumbling block in the process. The conditions for a transition agreement imposed by the European Union remain a hard nut to swallow for the British public. The question remains open to see if the pressure the EU-27 is placing on the UK government will speed up its internal Socratic debate or will contribute to precipitate a political crisis, resulting in solutions that are currently unavailable due to their incompatibility with various red lines.

A solution to the system of equations governing Brexit, so far untraceable, remains more than ever dependent on the outcome of the current rampant political crisis in the UK. The transition period may postpone some deadlines, but it will not be enough to cut the Gordian knots of Brexit. The key milestone is now the British parliament's vote on the withdrawal and transition agreement. An outcome which is currently uncertain.

47. Kenneth Armstrong, John Bell, Paul Daly, Mark Elliott, "Implementing Transition: How Would it Work?", Centre for European Legal Studies/Centre for Public Law, Cambridge University, October 2017.
48. Janosch Delker, "EU parliaments could get vote on Brexit, say German officials", *Politico*, 25 April 2017.

APPENDIX 2 ■ Restrictions imposed by the British government's current red lines on the choice of a post-Brexit partnership model.



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