Special Report

United Kingdom – The path to a final Brexit deal is now clear, but hurdles remain

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1. Introduction and timeline

On 29 March 2017, nine months after its referendum on EU membership, the UK triggered the official mechanism to leave the EU. Article 50 of the Lisbon Treaty allows two years for the exiting country after which it automatically leaves the Union. One year of this has passed, and one year remains. In this report we look at what has been agreed on the future relationship so far, and the path to a final deal. As it stands, the UK will cease to be a member of the EU on 29 March 2019. Table 1, below, shows key dates in the process.

Table 1: Brexit timeline

Referendum period	18 February 2016	Announcement of referendum.
	23 June 2016	UK votes to leave EU.
	17 January 2017	Theresa May Lancaster House speech.
Notification period	29 March 2017	Theresa May invokes Article 50.
	31 March 2017	Draft guidelines for negotiations are sent to EU leaders by the European Council.
	8 June 2017	Theresa May's Conservatives lose majority in the snap UK General Election.
	19 June 2017	Brexit negotiations begin.
	22 September 2017	Theresa May Florence speech.
	15 December 2017	EU leaders agree 'sufficient progress' and move to second stage.
	2 March 2018	Theresa May Mansion House speech.
done	23 March 2018	EU leaders agree draft Withdrawal Agreement.
	28-29 June 2018	EU summit.
	18-19 October 2018	EU summit - aim to have reached "political declaration" on future relationship.
	October 2018 - March 2019	Ratification of Withdrawal Agreement alongside political declaration (votes in European Council, European Parliament, and UK Parliament).
Transition period	29 March 2019	The UK leaves the EU at 2300 GMT. The 21-month transition period starts.
	TBC	Ratification of final treaty (unanimous consent in Council and national governments).
	31 December 2020	The UK's transition period ends.
New UK/EU relationship	1 January 2021	The UK is free to commence independent trade deals.
	5 May 2022	Next scheduled UK General Election.

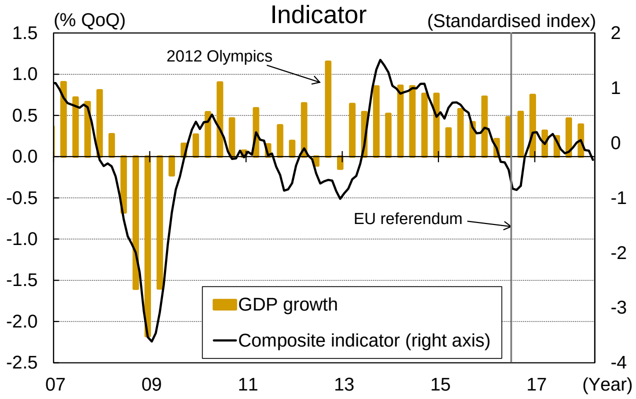
Source: European Council, UK Parliament, Bloomberg, Reuters, MUFG Bank Economic Research Office

2. The economy

Economic activity has held up relatively well despite the shock of the referendum result. There was an initial dip in confidence but growth was resilient and has remained positive (Chart 1). This is largely because private consumption has not fallen as many economists expected. Firms are more cautious, though. Business investment has weakened, increasing by only 3.2% between Q2 2016 and Q4 2017 (the average equivalent six-quarter change between 2011 and 2015 was over 8%).

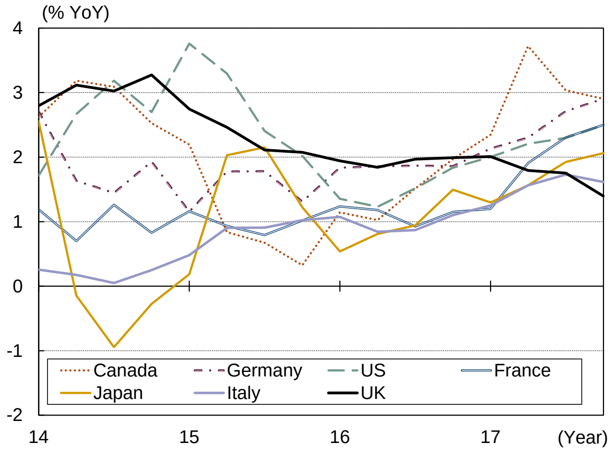
Overall, the picture is one of resilient but underwhelming growth. This may have been worse if it were not for the synchronised global upswing. Indeed, the UK has fallen from the top of the G7 growth rates to the bottom (even much-maligned Italy grew faster in Q4 2017 – see Chart 2). Perhaps some of this move is due to 'catch-up' following the UK's prior outperformance but it seems highly likely that the Brexit vote has contributed to lower growth figures.

Chart 1: GDP Growth and Composite Confidence Indicator



Note: The composite indicator is constructed using standardised survey measures weighted according to GVA shares.
Source: IHS Markit, EC, MUFG Bank Economic Research Office

Chart 2: G7 GDP Growth Rates



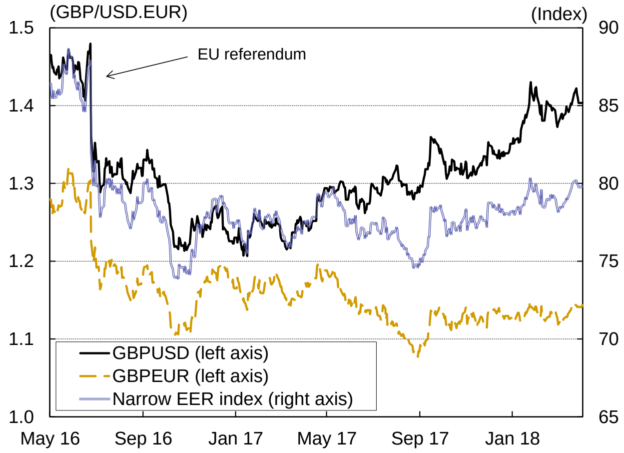
Source: OECD, MUFG Bank Economic Research Office

One of the more noticeable, and immediate, effects of the vote has been a depreciation in sterling of over 10% in trade-weighted terms (Chart 3). Subsequently higher import prices have caused a sharp uptick in CPI inflation from 0.3% YoY in May 2016 to 3.1% YoY in November 2017 (Chart 4). This then slipped back to 2.7% YoY in February 2018 but, as we wrote in a recent report on UK inflation[1], inflation is likely to remain above the BOE's target of 2% YoY, at least until the end of 2018. While sterling has recovered somewhat against the dollar, what the pound does against the euro is more important for the trade-weighted index (the euro area has a weight of 47.6% in the BoE's narrow measure, while the US is just 19.4%). GBPEUR has been relatively steady for several months.

[1] See "Import price effect to fade but inflation likely to stay above target" (http://www.bk.mufg.jp/report/ecoeu2018e/BTMU-Economic-Brief-UK20180219.pdf)

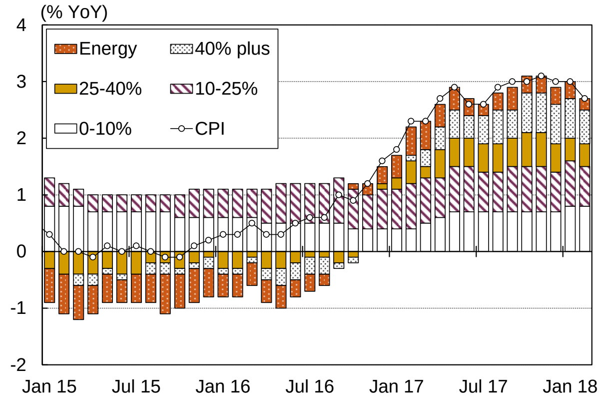
There has been scant evidence of a boost to trade despite the weaker pound. The average contribution of net exports to quarterly GDP growth since Q3 2016 has been slightly negative.

Chart 3: Trade-weighted Sterling and Pairings



Source: Bank of England, ONS, MUFG Bank Economic Research Office

Chart 4: Contributions to CPI by Import Intensity



Note: The contribution figures are rounded to 1 d.p. and may not sum exactly to the % YoY rate.
Source: ONS, MUFG Bank Economic Research Office

3. Negotiations

Against this backdrop, negotiations formally started on 19 June 2017 (delayed by the snap UK General Election). By December 2017, the European Commission deemed that "sufficient progress" had been made in each of the "three priority areas of citizens' rights, the dialogue on Ireland / Northern Ireland, and the financial settlement" in the first round of talks.

- It has been decided that EU citizens resident in the UK and UK citizens resident in the EU will have the same rights after the UK leaves the EU.

- A financial settlement has been agreed. The exact final cost cannot be calculated but the UK government estimates it will be around 40-45bn EUR (35-39bn GBP). The UK will contribute to the 2019 and 2020 EU budgets, remain liable for some contingent liabilities (such as pensions), but receive back 3.5bn EUR capital that has been paid into the European Investment Bank.

- The UK is committed to avoiding a hard border on the island of Ireland.

Following this preliminary agreement, negotiations moved on to a transitional agreement and the future relationship between the EU and the UK. We look at each in turn.

4. Transition

A draft transition deal was first presented by EU chief negotiator Michel Barnier and his British counterpart, David Davis, on 19 March. It was formally approved by the European Council at the summit later in the month.

The transition period (or "implementation period" as the UK government prefers to call it) will start on March 29 2019 when the UK will leave the EU. It will last 21 months, ending in December 2020. The main points are:

- The UK will no longer participate in the decision-making process of the EU.

- The UK will retain all the advantages and benefits of the Single Market, Customs Union and EU policies.

- The UK will have to comply with all EU regulation and continue to contribute to the budget for 2019 and 2020.

- EU citizens moving to the UK, and vice versa, will have the same rights as those who arrive before the UK leaves the EU on 29 March 2019.

- The UK is free to pursue trade negotiations with third parties – but any agreement can only come into force from 1 January 2021.

- A "backstop" agreement that Northern Ireland will remain in a customs union with the EU. Michel Barnier said that "the backstop will apply unless and until another solution is found." The draft text states that any agreement should address "the unique circumstances on the island of Ireland, avoid a hard border and protect the 1998 Agreement".

The agreement means that, apart from having no say in decision making, the UK will effectively remain in the EU until the end of 2020. Businesses will have more time to prepare for the new relationship (and not have to adapt to new regulation in March 2019, and then again 21 months later).

It is important to note that "*nothing is agreed until everything is agreed*" (as stated in the European Council (Article 50) guidelines for Brexit negotiations). The transition deal is not binding until an accompanying political declaration on the framework of the future UK/EU relationship has also been settled.

However, the agreement of a transition deal removes some uncertainty over the medium-term and is likely to be positive for investment and hiring decisions. Moreover, to our minds, there has been enough progress to minimise the risk of a cliff-edge Brexit. Talks have so far been amicable (largely because the UK has fallen into line with the EU where necessary). The divorce bill and the rights of EU citizens in the UK, which were priorities for the EU, have also been settled. The roadmap to a final deal now seems clear – but there remains a lot to agree.

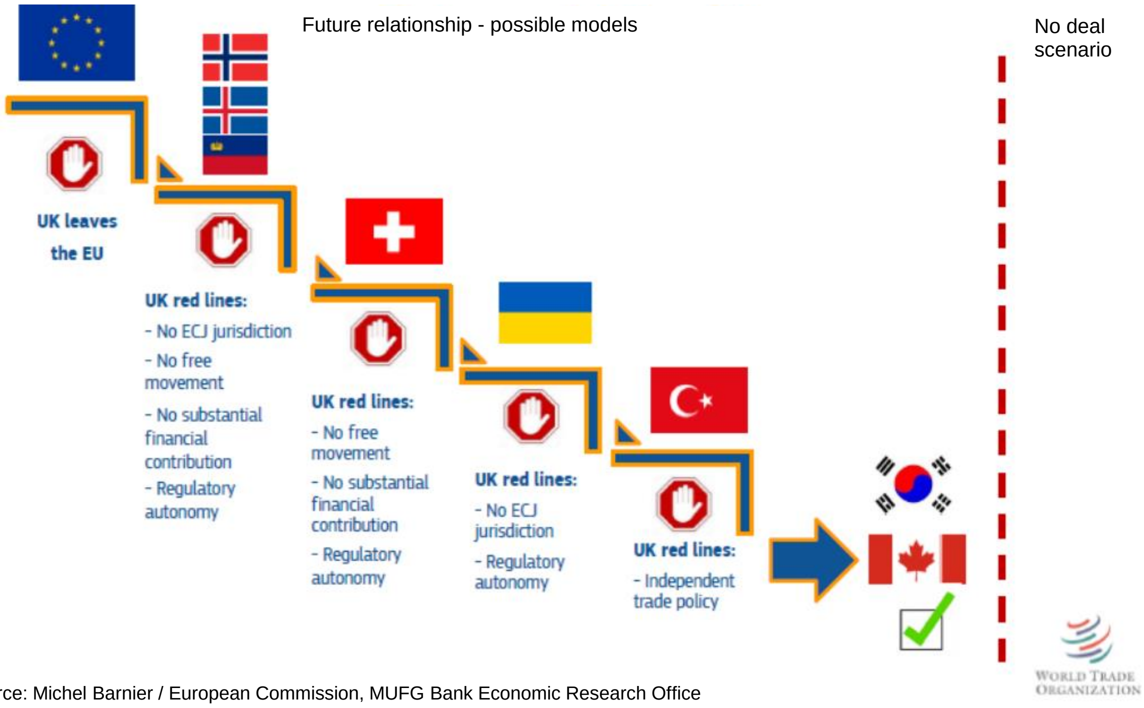
5. Future relationship

Following on from the draft transition agreement, the EU hopes to have a political declaration on future relations with the UK agreed by October this year. This will then be presented alongside the Withdrawal Agreement which will undergo a ratification process (see Box 1 below). More technical aspects of the agreement will be worked on throughout the transition deal. The final Treaty will need to be ratified (more thoroughly) by the end of 2020.

(1) CETA framework
A trio of key speeches from Theresa May (Lancaster House, 17 January 2017; Florence, 22 September 2017; Mansion House, 2 March 2018) has narrowed down the UK government's aims for the post-Brexit relationship. The UK has presented clear red lines (no European Court

of Justice jurisdiction, no free movement, no substantial financial contribution, regulatory autonomy, independent trade policy). The result is that a free trade agreement, like the one agreed between the EU and Canada, seems the only plausible model. This was well summarised by Michel Barnier in a single slide (Diagram 1).

Diagram 1: European Commission Slide



Source: Michel Barnier / European Commission, MUFG Bank Economic Research Office

Barnier said that "the UK is closing the doors on itself, one by one, and the only possible model that remains is that of a free trade agreement." Donald Tusk, President of the European Council, elaborated on this in March this year with some important quotes:

> *"Theresa May confirmed that the UK will leave the Single Market, leave the customs union and leave the jurisdiction of the ECJ (European Court of Justice). Therefore, it should come as no surprise that **the only remaining possible model is a free trade agreement**. I hope that it will be ambitious and advanced – and we will do our best, as we did with other partners, such as Canada recently – but anyway it will only be a trade agreement."*
>
> *"I propose that we aim for **a trade agreement covering all sectors and with zero tariffs on goods**. **Like other free trade agreements, it should address services**."*
>
> *"This positive approach doesn't change the simple fact that because of Brexit we will be drifting apart. In fact, **this will be the first FTA in history that loosens economic ties**, instead of strengthening them … It will make [trade] more complicated and costly than today, for all of us. This is the essence of Brexit."*

Tusk also said that "the EU cannot agree to grant the UK the rights of Norway with the obligations of Canada" and that "a pick-and-mix approach for a non-member state is out of the question". Indeed, for the most part, the UK has had to accept the EU's position during most of the first stage of the negotiations. If the EU retains the upper hand during the remaining negotiations then the final deal is likely to resemble the EU's agreement with Canada which was signed in October 2016.

The EU-Canada Comprehensive Economic and Trade Agreement (CETA) is the most ambitious free trade agreement (FTA) that any country has negotiated with the EU. It removes 98% of tariff lines between the two parties. This will rise to 99% after seven years. Only products that comply with the EU's regulation and standards can enter the Single Market. CETA also allows EU companies to bid for public procurement contracts in Canada. It is worth noting that it took seven years to agree, including a two-year ratification process.

Despite this, it falls well short of replicating the sort of market access that the UK has under its EU membership. The main issue with a CETA-type agreement for the UK is that removes most friction from goods trade, but not for services. This is important for the UK. Services account for almost 80% of the UK's economy, and 37% of UK service exports went to the EU in 2016. The future of regulation and oversight of services will form a key part of the negotiations between now and October. The UK will push for a 'CETA plus' type arrangement. Such an FTA would be a loosening of existing ties rather than starting from scratch which means an agreement should be quicker to agree but also more comprehensive.

(2) Financial services

Financial services in particular are likely to be central to the negotiations. In 2017, financial and insurance services contributed 6.5% of the UK's total Gross Value Added (London alone accounts for around half of this). Over one million people are employed in finance and insurance (3.2% of total in 2017). The UK had a total trade deficit of £29bn in 2017 – but a surplus in financial services and insurance of around £70bn. The sector is also a major contributor to tax revenue.

A continuation of 'passporting' which allows UK companies to sell financial services across the EU seems unlikely. This is set to end with the transition deal in 2021. Instead, there could be be an 'equivalence' arrangement in which the EU will allow financial services to be carried out beyond its jurisdiction if the regulatory set-up can be deemed equivalent to those in the EU. To our minds, an agreement on this should be possible. The UK's regulation tends to match, if not exceed, that of most EU countries in terms of stringency. The UK was a driving force behind the new MIFID II regulation, for example, and is unlikely to want to roll back regulation post-Brexit.

However, equivalence falls well short of the status quo. The EU would be able to revoke it just 30 days' notice. Any deal is likely to cover significantly fewer services. And the gap may widen further; the Commission wants to push on with the development of a capital markets union in Europe.

The EU, recognising the importance of financial services to the UK both politically and economically, may try to drive a hard bargain. Any deal may be late in the process. For London, we expect any movement of resources to the continent will be gradual. The transition deal will delay the enacting of banks' contingency plans and there is no clear alternative financial centre in the EU. However, the eventual outcome of Brexit on European financial services seems likely to be a fragmented and less efficient system.

(3) Irish border
The Irish border issue will loom large over negotiations. With the delicate history of contested sovereignty in mind, the UK has said there will not be any type of physical border infrastructure after Brexit. But the puzzle of how to do this without being in any type of customs union seems hard to solve. There are 200 crossing points on the meandering 500km border. According to a European Parliament study, an estimated 3.1 million passenger vehicles, 170,000 trucks and 250,000 commercial vans cross the border every month. 23,000 people cross the border on their daily commute.

The UK has stated that it cannot accept the backstop option included in the draft withdrawal agreement which effectively creates a border in the Irish Sea and has Northern Ireland considered "part of the customs territory of the [European] Union". The UK does, though, accept the need for a backstop to be included. The European Commission has stated that the onus to find a solution lies with the UK. It is expected that the UK will present proposals to deal with the problem (likely to involve technology such as number plate recognition, barcode scanning and smartphone apps to reduce paperwork) before the June EU summit. This may be important. Given the tight deadline to conclude the exit deal, and the UK's unwillingness to accept the backstop option, markets may react unfavourably if the UK's border proposal seems unfeasible. More likely, though, is proposal which lacks details but buys time.

(4) Other topics
A broad deal on goods should be relatively straightforward using CETA as a template. The issue of the Irish border, in particular, and trade in services are likely to be much more complicated. These are not the only topics on which the EU and the UK must find agreement. Issues such as security and defence, aviation, healthcare, education, research funding, fishing and even space technology will be discussed as 45 years of close collaboration are unpicked. And then, if an agreement is reached, the ratification process will be lengthy (see Box 1). The UK has generally yielded to the EU's demands, though, so EU approval may well be smooth.

Box 1: The ratification process

The EU hopes to have a "political declaration" on future relations agreed by October this year. This would leave five months to ratify the Withdrawal Agreement. The overall ratification process will not be simple. It can be divided into two:

1) **The Withdrawal Agreement** (of which the draft text has been released, colour-coded to indicate which sections are final) is designed to cover areas that can be agreed at an EU-wide level. This means that it has to be approved by the European Parliament and a 'super-qualified' majority of 20 countries out of 27 in the Council – which have to represent at least 65% of the EU27 population. The Agreement will be presented alongside a **political declaration** of the future relationship which will result from Michel Barnier's team's negotiations with the UK.

2) The EU's power to conclude international agreements are limited to certain policy areas, however. The **later treaty on the future relationship** with the UK will have ramifications at a national level (a 'mixed' agreement in EU jargon). Therefore it will require ratification not only by the European Council – but by *each member state* of the

EU27 as well. On top of this, the approval of the European Parliament will also be required. Note the agreement of the transition period under the Withdrawal Agreement moves the deadline to the end of 2020.

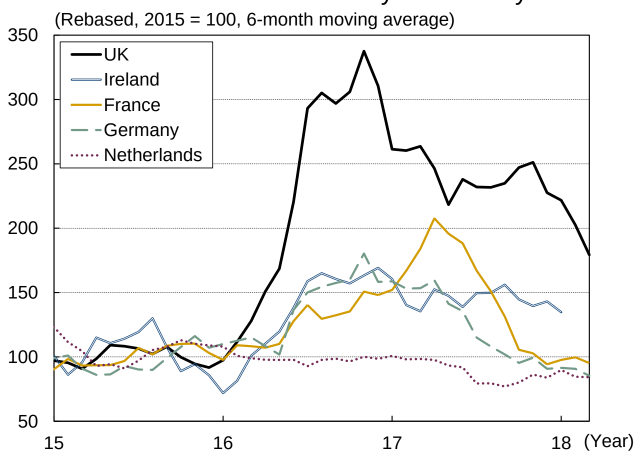
Mixed agreements typically take much longer to ratify than EU-only agreements. Some national governments also require the support of regional parliaments. The government of Wallonia, the French-speaking region of Belgium, delayed the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada in 2016. Eventually Wallonia was given last-minute concessions and approved the agreement.

In the UK, Theresa May has said there will be a “meaningful” vote on the deal in Parliament. It is likely to be a vote that covers both the Withdrawal Agreement and the future relationship declaration. If MPs vote to reject these then there may not be enough time for any amendments before 29 March 2019. The unappetising prospect of the UK crashing out with no deal may mean that UK MPs are very likely to vote in favour.

6. UK politics

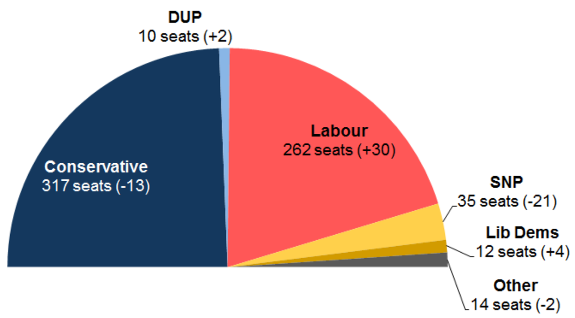
Domestic politics add an extra dimension to the UK’s negotiations. Uncertainty remains high (Chart 5). Theresa May lost her already-slim majority after calling an ill-judged snap election in June last year (Chart 6). The gamble backfired and the Conservatives had to rely on the support of the 10 Democratic Unionist Party (DUP) MPs from Northern Ireland with a ‘confidence and supply’ arrangement in which they agree to support the government in important votes but do not hold any ministerial roles.

Chart 5: Economic Policy Uncertainty



Source: www.policyuncertainty.com, MUFG Bank Economic Research Office

Chart 6: June 2017 Snap Election Results



Note: The numbers in parentheses show the change in seats numbers from the May 2015 General Election. 'Other' includes Sinn Féin which do not take seats in parliament. Owing to their "confidence and supply" deal with the DUP, the Conservatives have a current working majority of 13.

Source: UK Parliament, MUFG Bank Economic Research Office

Already faced with the onerous task of balancing the demands of her ‘leave’ and ‘remain’ MPs, this outcome weakened Theresa May considerably. To our minds, internal divisions within the Conservative party are likely to become increasingly stark as the final deal becomes apparent. The UK has made a lot of concessions to the EU during negotiations so far, and it is likely that more will be necessary. May is likely to have to communicate to the ‘leave’ side in particular that some of their wishes have not been met (the EU will probably retain some regulatory oversight, for example). This would increase internal tensions within the Conservative party. In particular, the European Research Group, a band of around 60 Tory ‘leave’ MPs led by the influential Jacob Rees-Mogg, may start to become increasingly troublesome to May if they sense the final deal leaves too much power in Brussels.

Despite increasing tension it is unlikely that May will be ousted as prime minister for several reasons:

- There is no obvious replacement. In the past there has been a clear candidate waiting in the wings, but this is not the case at the moment.

- The process could be long-winded. If a motion of no confidence in May as Tory leader is passed then Conservative MPs whittle down a list of possible replacements to two, which is then voted on by Conservative members. This could take up to three months – and the timeframe to reach a deal by October is already challenging.

- It would present policy risk: ‘leavers’ may not be happy with a prime minister from the ‘remain’ camp, and vice versa.

- Pressure for another election could increase. The labour party would claim that the public did not vote to have this leader for four years.

Brexit Secretary David Davis has said that parliament will be given a ‘take-it-or-leave-it’ vote on the final deal. On the face of it, any deal is likely to be less palatable to either the ‘leave’ or ‘remain’ camp. But we expect the vote will be held very close to the exit date and MPs will not want to block any deal as it could cause additional and significant uncertainty for UK businesses.

Meanwhile, Labour, the main opposition party, has been deliberately vague, trying to balance the wishes of its irritated ‘remain’ supporters without alienating its historical core of working class voters who tended to vote ‘leave’. The party clarified their position in a key speech in February this year. Leader Jeremy Corbyn, who has never been an ardent enthusiast of the European Union, said:

> “*Labour would seek a final deal that gives full access to European markets and maintains the benefits of the single market and the customs union … to negotiate a new comprehensive UK-EU customs union to ensure that there are no tariffs with Europe and to help avoid any need whatsoever for a hard border in Northern Ireland*”

He was also clear that freedom of movement of people would end (ruling out any Norway-type EFTA arrangement), and the UK would not be a “rule taker”. However Corbyn did suggest that the UK would negotiate any trade deals alongside the EU. In this sense, referring back to Michel Barnier’s slide (Diagram 1), the Labour model would be one step up and to the left from the Canada option (similar to Turkey or Ukraine). The Confederation of British Industry (CBI) welcomed Labour’s proposal. We also note that Labour (and other parties opposed to Brexit such as the Lib Dems) wants to add a clause to the Withdrawal Bill that removes the possibility of ‘no deal’. This may happen over the next few weeks.

7. Conclusion

The UK economy has failed to collapse since the EU referendum in June 2016, but it has underwhelmed. The agreement of a transition period until the end of 2020 may boost activity. The transition period will be 'Brexit in name only'. Nothing will change, except the UK will not participate in any EU decision making. Firms that had been cautious since 2016 may have more confidence to invest and to hire. There is unlikely to be much support to the economy from fiscal policy, though, and monetary policy looks set to tighten.

Beyond transition, the road map towards a final relationship is clearer. The potentially thorny issues of EU citizens' rights in the UK and the exit bill have been settled. The aim now is to have reached a political agreement on the exit deal by the October 2018 EU summit. An FTA similar to CETA, which would be a loosening of existing ties but with mostly frictionless trade, should be relatively straightforward to achieve. The UK government's so-called 'red lines' of no free movement of people, no substantial financial contribution, maximum regulatory autonomy, and the possibility of independent trade policy will be upheld.

The Withdrawal Arrangement and accompanying political declaration on the future relationship will then go through the ratification process. Given the UK has more or less accepted everything the EU has demanded so far, we hope that there will be little opposition in the European Council or Parliament.

Tensions may be higher in the UK Parliament. As we approach a final arrangement, it will become clear to different groups what compromises have been made. The UK wants to maximise its regulatory autonomy but the European Court of Justice could well retain some oversight, for example. 'Leave' MPs are likely to become increasingly noisy, but we expect Theresa May will remain as Prime Minister. Later, when the deal is presented at parliament, the unpalatable option of crashing out with no deal means we expect MPs will vote in favour of most arrangements.

In the short-term, the main hurdle to overcome is the Irish border issue. The EU expects the UK to present a solution by the June summit. It is likely to involve using technology to track movements instead of any large-scale infrastructure. If this seems unrealistic or unworkable then markets may react unfavourably. Nonetheless, we expect some sort of compromise to be reached, perhaps purposefully vague (like the December announcement) to buy time. The fallback option will be a border in the Irish Sea with Northern Ireland remaining in a customs union with the EU.