Fog in the economy

Jonathan Portes takes a look at what some of the potential Brexit outcomes could mean for the future of the UK economy and finds that none of the paths that currently look likely bode well for investment and growth

It has been just over a year since the UK voted to leave the European Union. A lot has happened in the UK since then – a Conservative Party leadership contest, a lengthy legal and political dispute before the UK sent the formal notification of withdrawal from the EU under Article 50, and then a general election, the result of which has upended British politics yet again. Meanwhile, the broader European scene has been equally eventful. Those in the EU who want to respond to Brexit and Trump with a move towards greater integration have been reinvigorated by the surprise election of Emmanuel Macron, by the much less surprising, but equally important, likely re-election of Angela Merkel, and signs of – finally – a sustained economic recovery in the eurozone.

But the formal discussion between the UK and the EU about the terms of Brexit have only just begun. So far, the two sides have been largely talking past each other. That will change over the next few months as serious negotiations get under way. So what are the possible outcomes, and what would the economic implications be?

The Commission has said that negotiations on the Article 50 process – the mechanics of Brexit – must precede negotiations on the future UK-EU relationship. But this does not mean a full and final deal is necessary before any negotiations on the future relationship. A possible timetable, if things go well, is that there could be a deal in principle on the two biggest issues – the UK's financial liabilities and the status of EU citizens currently resident in the UK (and vice versa) – by October or November of this year. This would allow negotiations to begin on the future relationship.

The UK strategy is to deal with the citizens' rights issue – what happens to EU citizens living in the UK and UK citizens elsewhere in the EU – as quickly as possible, before moving on to the politically harder questions about money. It tabled its written response to the EU proposals on 24 June. However, coming two months after the EU's own proposals, and being clearly inferior to them (from the point of view of those affected both in the UK and EU), it got a fairly cool reception, although it probably does provide the bare minimum needed not to be perceived as an insult. The key differences – the role of the European Court of Justice and the "acquired rights" of EU citizens under the free movement directive – are capable of being resolved by establishing some sort of new, independent tribunal to oversee implementation. But this will take some time and require both sides to make significant concessions. This means there is little prospect of an early agreement.

Meanwhile, there has been no progress as yet on the other major political issue of the Article 50 talks, the financial settlement, which seems much more likely to be a deal-breaker. The UK has not as yet set out its negotiating position, tabled detailed proposals, nor even said when it will do so. The intemperate remarks of Boris Johnson recently – swiftly contradicted by David Davis – do not exactly inspire confidence either domestically or in Brussels. EU officials and politicians follow the British political debate and are well aware that there is no consensus within the UK cabinet, let alone the country as a whole.

One area where the UK position is evolving rapidly – as the prime minister and Brexit secretary confront the realities of the negotiation – is around "transition" arrangements. Earlier this year, the prime minister's flagship speech on Brexit at Lancaster House proposed an "implementation phase", with a set of sector-by-sector agreements. This never appeared realistic; how do you negotiate phased implementation until you know what you are implementing?

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Moreover, why would it be in the interests of the EU to adopt such an approach? It was always likely that the EU would say that any transition would have to look much like the current arrangements, with us continuing to pay and to abide by all single market rules. There seems to be an increasingly strong view on both sides that this is both the most likely and least disruptive outcome.

So how could the discussions play out? There is still much talk about a "hard" or a "soft" Brexit, as if there were only two alternative scenarios. But if the negotiations continue on the current track, there are at least four:

A smooth Brexit

All goes according to the prime minister's original plan. We manage to have both Article 50 and the terms of the future trading relationship sealed and delivered by March 2019, with, where required, agreed transitional arrangements to ensure implementation is smooth. This always seemed improbable, for both practical and political reasons. It now seems close to impossible.

Transitional Brexit

The Article 50 deal is agreed. Discussions begin on a trade deal and are progressing well, or at least have not broken down; so both sides agree on transitional arrangements, or at least some sort of standstill provisions where little or nothing changes, in order to bridge the gap to a full deal. This is broadly what the CBI recently proposed, commanding broad support across UK business, and probably represents the best that could be hoped for from an economic perspective. There would be little or no visible change on Brexit day, and businesses and government would have time to adjust to new arrangements.

Cliff-edge Brexit

The Article 50 deal is agreed, but the trade discussions go nowhere: either they break down, or they have made little progress. So there is nothing to transition to. Meanwhile continuing the UK's single market membership and/or free movement of workers is unacceptable to one or both sides. So on 29 March, 2019 the UK becomes a "third country", with no special relationship of any kind with the EU. WTO rules will apply. This remains quite a probable outcome. This would be a major shock to the UK economy, with exporters and importers facing new tariff and regulatory barriers, supply chains disrupted, and almost certainly major administrative difficulties as new customs and immigration controls are introduced.

Chaotic Brexit

The Article 50 talks themselves break down entirely, or fail to reach an agreement within the deadline, over citizens' rights, money, or perhaps some other issue. On Brexit day the UK ceases to be a member of the EU – but, politically and legally, all the outstanding issues remain unresolved. The economic consequences of this would be literally incalculable. Just a few of the possible issues that might arise include the status of air transport between the UK and the Continent, the legal status of EU citizens in the UK and Britons elsewhere in the EU, and the restoration of a "hard border" between Northern Ireland and the Republic. Self-evidently this would be a disaster for the UK and very damaging for the rest of the EU. It remains unlikely, but more likely than pre-election, and certainly not impossible.

How has the surprise outcome of the UK election changed things? The main impact so far has been to weaken Theresa May's control both over the terms of the debate and her own Ministers.

This has two effects, which may pull in different directions. First, it makes it much more likely that the UK will accept an extended transition period on terms dictated by the EU, under which much continues as normal; as noted above, there is a significant constituency in the UK for this. But, on the other side, it makes a breakdown in negotiations more likely; the prime minister's ability to make the concessions that will be necessary to reach any deals (for example, on money) has

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been considerably weakened. There may well come a point at which she feels that her best political alternative is a breakdown. Moreover, it is far less attractive for the EU27 to make concessions to a prime minister who may not be able to deliver her own party and country.

All this assumes that the prime minister continues in office and, although weakened, in control over Brexit policy. But this is far from certain. In particular, a severe economic downturn – not probable, but far from impossible – could lead to a major change in the UK political context. In that case, the range of possible scenarios increases even further, and in particular the possibility of the UK seeking a new arrangement that looks much closer to membership of the European Economic Area and Customs Union for an indefinite period. Brexit means Brexit? Maybe, but one year on it is less clear than ever what Brexit will actually mean. ■

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