Brexit Update

Walking the tightrope – a European view on Brexit
Walking the tightrope – a European view on Brexit

With one year to go until the UK leaves the European Union (EU), the finer details of Brexit are finally starting to unravel. A high level agreement was reached on the terms of the UK leaving the EU as of 29 March 2019, the conditions for a transitional period until the end of 2020 have been preliminarily agreed, and the EU has committed itself to negotiation guidelines on the future relationship between the EU and the UK.

What can we learn from the process so far and what can we expect of the end game? How should businesses prepare? And is there still a risk that no agreement will be reached after all? Below is our analysis from a European perspective.
Current state of affairs

The Exit Deal

In December 2017 a high level agreement was reached on the first phase of the negotiations relating to three topics: 1) the Brexit ‘bill’ of payments to be made by the UK to the EU, 2) citizens’ rights and 3) arrangements between Ireland and Northern Ireland. Over the past months, this high level political agreement has been worked out in more detail, and under significant time pressure, a preliminary agreement has now been reached on parts of the exit deal. This Withdrawal Agreement needs to be finalised in the coming months and ratified before the end of March 2019. So, what can we learn from the Withdrawal Agreement?

First, we note that the current agreement aligns very closely with the initial negotiation guidelines drawn up by the European Council a year ago. In other words, the EU has moved very little on its initial negotiating position leaving little room for the UK to influence negotiations. This for one shows that the EU has the upper hand in the negotiations.

Second, the EU-27 has managed to keep to its negotiating position because it has remained united in the negotiations vis-a-vis the UK. This is important because should this unity falter, the dynamics of the negotiations may change. The fragmented political landscape in the UK, has to some extent enabled the EU to stay united vis-a-vis an internally divided interlocutor.

The Transitional Arrangement

As part of the Withdrawal Agreement, over the past weeks a much awaited transitional arrangement has finally been agreed between the EU and UK. This agreement stipulates that the UK will remain in the internal market and customs union up until 31 December 2020, i.e. 21 months after the Brexit date. It means that business activities will not be impacted during this period, but it does not say anything about the end state.

During the transitional phase, all fundamental freedoms of the EU will remain applicable in the UK, meaning among other things that there will be free movement of people to and from the UK. EU citizens settling in the UK in this period will enjoy the same rights as while the UK remained a member of the EU. An important concession from the EU side however is that during the transitional period, the UK will be given the freedom to negotiate and conclude new trade agreements.1

The transitional agreement is welcomed both by the EU and UK. It is helpful as a means to buying time to agree on a new trade relationship between the EU and the UK and to giving people and businesses more time to prepare for the impact of Brexit post-2020. Nonetheless, the transitional arrangement of course also means that the uncertainty surrounding Brexit is further extended.

1 To come into effect from 1 January 2021.
The next step in the negotiations is the new trade relationship between the EU and the UK - admittedly one of the most important issues for businesses on both sides of the English Channel. Although technically not part of the exit process, both parties aim to agree on a political declaration in the early autumn of 2018, in order for it to be part of the ratification process of the Withdrawal Agreement and in time for the UK’s actual exit from the EU on 29 March 2019.

Much has been said about the potential models for a new partnership arrangement including EEA membership, a Turkish model or a Swiss model and so on. Our view is, however, that given the red lines of the UK government (no internal market, no customs union etc.), and the intention of both parties to reach an agreement given the significant trade flows, the only reasonable solution would be an EU-UK Free Trade Agreement (FTA).

Taking into account the lessons learned in the earlier phases of the negotiations, and the limited time available to reach an agreement, we believe it is fair to expect that the new relationship will be comparable to the recent EU-Canada FTA. Furthermore, we think that the chance of success for the UK government to allow for some industries to retain unrestricted access to the EU markets, is minimal. Once the UK leaves both the internal market and the customs union, trade in goods and services can no longer be frictionless and both tariff and non-tariff barriers will come into play. While often downplayed, this is the one certain and inevitable consequence of Brexit.

So, when can businesses expect clarity on the new trade deal between the EU and the UK? While negotiations are increasingly being conducted under time pressure, a high level agreement is not expected before September/October 2018. Even this seems a challenge given the number of items to be discussed. As a comparison, the texts of the EU-Canada FTA counts close to 1,600 pages excluding appendices. Adding to this complexity, the UK’s wish for the deal to be ‘bespoke’, meaning the inclusion of non-standard elements like services, will likely not make talks any easier nor allow for a fast track negotiation.

The ambition of both parties is to have the details of the new relationship worked out and approved before end of the transitional period, with the new rules being applicable from 1 January 2021.
A note of caution...

While recent developments have been positive, EU negotiations follow the principle that ‘nothing is agreed until everything is agreed’. Hence the current agreements are still preliminary.

There are some sensitive items on the table, and there are downside political risks, both in the UK and in the EU. Any agreement on the new relationship needs to be agreed not only by the main negotiators, but also by the EU-27 national (and in some cases regional) parliaments, as well as by the UK parliament.

Despite all progress, and our main scenario being a free trade agreement between the EU and the UK, there are still downside risks that could result in the UK exiting the EU without any agreement on either 29 March 2019 or 31 December 2020.

This would mean a fallback to World Trade Organisation (WTO) terms of trade between the EU and the UK. Businesses would be wise to also prepare for this highly disruptive scenario.

The effect on the economy

A relatively small number of studies looks at the impact of Brexit on the EU economy. Although these studies make different predictions, there is consensus on the overall impact: Brexit is expected to have a moderate impact on the EU economy.
Brexit is expected to affect the UK proportionally more than the EU-27. The highest impact is expected just after the split, i.e. after the end of the transitional period. The OECD, for example, shows that Brexit will lower the GDP of the EU-27 by close to 1 percent in 2020. This will mainly be a result of a sharp decline in UK import demand. This negative impact is expected to magnify in case of a larger sterling depreciation against the euro or in case of deeper confidence shocks in the EU economies.

Though, the negative impact of Brexit is expected to level out in the next decade. In figure 3 we compare the predictions for 2030 by Bertelsmann and Oxford Economics. Both studies predict a moderate impact of Brexit on the EU-27 economy: a loss in GDP in the range of 0.10 - 0.58 percent. In euros this implies an average impact on the aggregate GDP of the EU-27 in 2030 of circa €80 billion. This is comparable to the size of the economy of Slovakia, one of the smaller economies of the EU.

There is also consensus on the main reason for the expected decline in GDP: a decline in UK import demand. Figure 4 shows that countries such as Belgium, Germany and the Netherlands have a relatively high percentage of export destined for the UK, thus facing a higher exposure to the impact of Brexit.

Similarly, Brexit is expected to particularly impact certain sectors across the EU-27, including automotive, agriculture and food and drinks (see also figure 5). For example, in Germany, a scenario where there is no agreement and a fallback to WTO rules will likely affect the automotive industry the...
most. A study by Bertelsmann estimates that the value added in this sector will decline by 2 percent in case of a fallback to WTO rules.\(^5\) Also, Belgium and Austria mainly export road vehicles to the UK. In 2016, exports by the automotive industry had a value of around 7.8 billion euros in Belgium and of 480 million euros in Austria.\(^6\)

In the Netherlands the export of agricultural products will likely experience the strongest negative impact in case of a fallback to WTO rules. Agricultural products exported from the Netherlands to the UK had a value of 6.7 billion euros in 2017.\(^7\)

**The effects on business**

For businesses, we have started to see the uncertainty caused by Brexit kicking in. As the day when the UK will no longer be part of the EU looms closer, Brexit becomes a relevant factor for companies when considering locations for new investments or head offices. A Council decision in June 2017 already decided to relocate the only two London-based EU agencies, the European Banking Authority and the European Medicines Agency to Paris and Amsterdam respectively, thus indicating that the EU accepts the point of no return, and that where decisions are to be made, those will be made by the remaining EU-27 member states.

In this context, however, there has not yet been a significant shift of functions from the UK to the EU. In our view this is partly because the UK will remain a very interesting local market in its own right, but also because some things are still uncertain at this moment. That said, we expect the movements from the UK to the EU to increase as the end game becomes clearer.

**Our analysis of the possible scenarios for a future relationship takes into account ‘red lines’ on both sides, and indicates that in either of the two possible scenarios the UK will leave both the internal market and the customs union. Businesses should therefore already start planning for these consequences.**

---

\(^5\) Bertelsmann (2015), *Brexit—potential economic consequences if the UK exits the EU*

\(^6\) The Atlas of Economic Complexity, Center for International Development at Harvard University (2016)

\(^7\) Statistics Netherlands (2017), 10% of Dutch agricultural exports destined for UK
Trade and customs:

The most important now, is to understand that things will be different post-Brexit and that UK access to the EU market, and vice versa, will be lower. Likewise, Brexit will also impact trade with third countries through the classification of origin of goods. Post-Brexit components from the UK will be classified as third country goods, and the final product may thus not be classified as originating from the EU-27, hence losing the zero-rate in countries with which the EU-27 have free trade agreements. To mitigate effects businesses should:

- Identify the potential increase in customs duty and non-tariff barriers (admin costs) for raw materials, parts or finished goods under the two likely Brexit scenarios: an EU-UK FTA or a fallback to WTO terms of trade.
- Identify potential operational risk areas in EU sales/distribution models, including the time aspect of ‘just in time’ deliveries. For example, are the current sales models are still viable post-Brexit? Can you continue to operate customs warehousing or would you need to identify alternative models?
- Identify additional statutory compliance requirements, i.e. new VAT registrations and import duties covered under the Senior Accounting Officer Regime.
- Hold informed discussions with the board/senior executives and external stakeholders (customs brokers, freight agents) to understand and mitigate impacts on the company’s operating model and additional costs. Consider alternative operating model scenarios and associated multifaceted issues to mitigate Brexit impacts.
- Apply for Trusted Trader status (Authorised Economic Operator) in order to minimise border impacts. PwC can support businesses in this process.

People and immigration

Once the UK is no longer part of the internal market the immigration status of employees across both the EU and UK will be affected. Businesses will need to consider the pipeline of skills and talent within the labour markets that they operate in, and, in turn, assess how this would impact medium- to long-term business goals. To mitigate effects businesses should:

- Identify affected employees and assist with confirming their status in the UK/EU-27, as well as with relevant employment and data protection laws.
- Update and implement robust global mobility policies, processes and employee communications.
- In order to maintain a strong pipeline of skills and talent, explore new talent pools if required, to support future business growth and an agile workforce.

Economics, tax and policy

UK growth is slowing due to lower consumer spending growth and the drag on business investment from Brexit-related uncertainty. In terms of the EU, Brexit will likely have a rather more moderate impact on the economy. Nonetheless, to mitigate economic effects businesses should:

- Assess the impact of various scenarios for economic growth on your business. How rapidly would you be able to adjust to a slowdown and how are you monitoring the market to provide an early warning?
- Assess the total impact on your cost position and market competitiveness from a weaker pound sterling. What plans have you got in place to manage volatility in the value of sterling?
- Assess any adverse impact or opportunities from differing tax regimes in the UK and in the EU. For example in the area of direct taxation, where harmonisation is high on the agenda of European policy makers, the difference between the UK and the EU tax system may be significant.

Some key takeaways for business: