United Kingdom

Brexit update

On 31 January 2020, the United Kingdom will officially leave the European Union and all of its constituent institutions. Brexit will therefore happen officially if not in fact, as, during a so-called 'transition' period set to end on 31 December 2020, the British economy will remain a full part of the single market and the European customs union. Goods, services and capital will continue to move freely into and out of the EU, which will continue to have legal and regulatory authority. True separation will only come at the end of this period, once the framework of the future relationship has been settled. As has been the case for some time now, this final step does not look easy to achieve.

Winning 43.6% of the vote and 365 of the 650 seats in the House of Commons, the Conservative Party led by Prime Minister Boris Johnson was the big winner in the 12 December 2019 general election. There are therefore no more parliamentary obstacles to a separation of the United Kingdom and the European Union (EU).

On 19 December 2019, MPs voted by 358 to 234 in favour of the Brexit Bill, that enshrines the Withdrawal Agreement between the United Kingdom and the EU in law (see Box). Ratification is likely to follow, after debate in the House of Lords and assent by the Queen, which is a formality. Votes in the European Parliament (by simple majority) and then the Council of Europe (by qualified majority) will follow, for the legal withdrawal to take place at midnight (Paris time) on 31 January 2020. The United Kingdom will then officially leave all of the EU's institutions (Parliament, Court of Justice, Commission and so on) but will not immediately leave the single market, the rules of which it will continue to follow throughout the transition period which is expected to run until 31 December 2020.

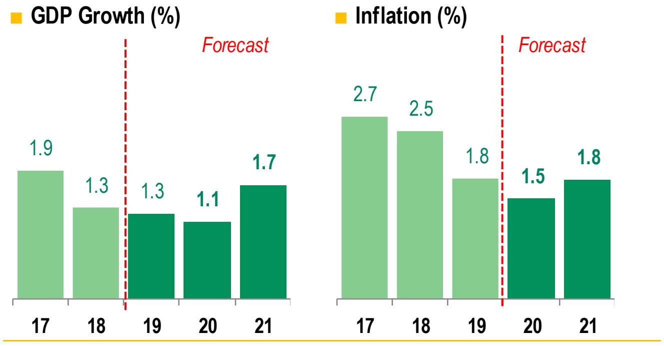
A red line that runs straight into a wall

By this deadline, the UK and EU are supposed to have set the framework for their future relationship and to have completd their effective separation. However, many European observers believe that the eleven month-period available to achieve this is too short. The Withdrawal Agreement includes the possibility of extending the transition period, but this has been formally rejected by Mr Johnson, who has included the 31 December 2020 date in UK law. The radical line adopted by the Prime Minister, with a full withdrawal (leaving both the single market and the customs union) to be completed rapidly, will be hard to hold.

First, because it will encounter significant political resistance. The UK's first past the post electoral system means that supporters of a 'hard' Brexit have taken control of Parliament, despite receiving a minority of the votes cast in the election. Alongside the Conservative victory in the House of Commons, the other standout feature of the 12 December election was the surge in support for nationalist parties in Norther Ireland, Wales and Scotland; these parties are generally opposed to Brexit and in favour of their countries remaining in the EU.

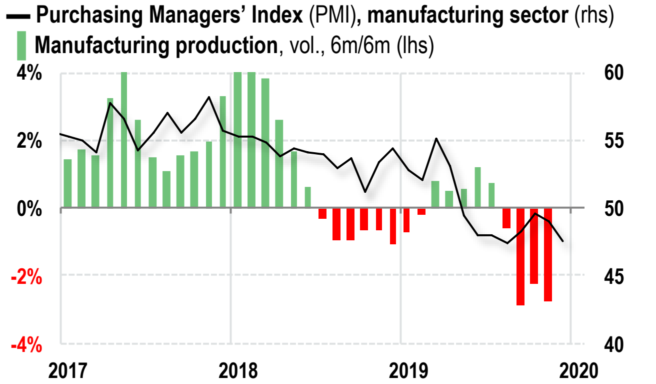
Secondly, because sooner or later a return to reality will be inevitable. Across all areas, from industry and agriculture, via energy and transport to data exchange and beyond, the links between the UK and EU are governed by a vast corpus of legislation and regulations consisting of around 600 structures.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Industry in recession



Source: Markit, ONS

These require the mutual respect of standards (technical, employment, health, environmental) and laws (geographical indications, intellectual property and so on). The task of undoing all of this only to replace it on a case by case basis with tariff or cooperation agreements will be onerous and complex. It promises tough negotiations with the EU, whose chief negotiator, Michel Barnier, has repeatedly stressed that he will not accept any agreement that risks the creation of unfair competition from the UK. But this is not the only task that lies ahead. By going it alone, the UK will also have to renegotiate, with 168 different parties, all of the trade treaties (there are 236 in total) that the EU has agreed with third countries.

The most difficult part of the whole process – defining Brexit in concrete terms – is, therefore, still to come, to the extent that the relief that may come from ratification of the WA could be short-lived. As we approach 31 December, the risk will clearly be that, for lack of time or ambition, the UK and the EU end up separating without an agreement. In this case, World Trade Organisation (WTO) rules would apply, which is in no-one's interest.

The economy is slowing down

The final months of 2019 saw a continued slide in business climate indicators, as the industrial recession strengthened its grip (Figure 1). The economy as a whole probably stagnated over the fourth quarter, with growth for the year of 1.2% on average. This was in line with the European average, as the euro zone economy also slowed and Germany flirted with recession. However, it looks a more modest performance when seen in the light of the trend in sterling[1], whose fall in value would normally be expected to boost activity.

However, the exchange rate elasticity of the UK's international trade is considered to be low[2]. Net exports did not increase in 2019, making a negative contribution to growth. Clearly, imports in anticipation of Brexit could have played a role in this, but the UK has also seen a deterioration in its cost competitiveness. Actions to increase the minimum wage are not the main cause of this. Even though it was described as historic, the increase announced by Mr Johnson (6.2% in April) does little more than continue the process of making up for lost ground that began under David Cameron. This has sought – but not yet achieved – the restoration of purchasing power losses suffered by workers after the 2008 crisis[3]. Its diffusion effect is highly dependent on the state of the economy; it ceases to be significant above the first quintile of the income distribution (NIESR, 2018)[4].

The weakening of the competitive position is in reality due above all to the slowdown in productivity growth, which has been particularly marked in the UK over the past decade[5]. It seems unlikely that Brexit will provide the solution to this problem.

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[1]Between December 2015 and December 2018 the pound fell 20% against the euro and 16% in nominal trade-weighted terms. Source: *Bank of England*

[2]See for example Bussière M., Gaulier G. and Steingress W. (2016) *Global Trade Flows: Revisiting the Exchange Rate Elasticities*, Banque de France, Working paper n°608, November

[3]Between the first quarter of 2008 and the first quarter of 2015, the index of real weekly wages (fixed and variable) across the economy fell by 11%. It has since recovered, but at the end of 2019 was still around 3% below its pre-crisis level.

[4] National Institute of Economic and Social Research (2018), *National Minimum Wage and National Living Wage impact assessment: counterfactual research*, February.

[5]Since 2009, average annual growth in hourly labour productivity has been 0.5% in the UK, compared to 1% in the euro zone. Source: Eurostat.

3- The main provisions of the Withdrawal Agreement

On 17 October 2019, the UK Prime Minister, Boris Johnson, and the 27 EU Heads of State or Heads of Government, agreed a Withdrawal Agreement. This incorporated the bulk of the previous version agreed by Theresa May in November 2018 (but never ratified), with the major differences relating to Northern Ireland, where the previous text was heavily revised. In summary, under the WA:

*1/ **A transition period will run from the date of withdrawal** until 31 December 2020, to allow the UK and EU to negotiate their future relationship. During the transition period, the UK will no longer be a member of EU institutions but will have continued access to the single market; it will follow the rules of the market (which, most notably, means that it will be unable to conclude trade agreements with third countries) and will remain subject to rulings from the European Court of Justice.*

*2/ **The status of foreign residents is secured.** The 4 million EU citizens resident in the UK, and the 1 million UK citizens resident in the EU on the withdrawal date, will be free to remain and continue their activities, and will have their rights guaranteed (in terms of access to healthcare, education, employment, receipt of pension benefits, family reunification and so forth).*

*3/ **The UK undertakes to settle its financial liabilities to the EU**, under multi-year commitments made (the 2014-2020 budget, for European projects, etc.). Although the WA does not specify an amount (the final amount will depend on the terms of the agreement on the future relationship), UK sources estimate the financial settlement at around EUR40 billion.*

*4/ **Northern Ireland will have special status,** in order to satisfy the requirements of the 1998 Good Friday Agreement and avoid the reintroduction of a hard border with the Irish Republic. In contrast to the provisions of the original WA, Northern Ireland will be able to form its own customs union with the rest of the UK after the transition period (that is to say it will apply UK tariffs). The 'backstop' that would have kept the EU and the UK in a single customs territory on a temporary basis has thus been removed, but not without significant concessions and restrictions. Northern Ireland will therefore continue to apply European customs rules for those products coming into its territory that could then be exported to the single market. With an open border between the North and the Republic, this will inevitably result in the introduction of controls on imports from Great Britain or third countries. Northern Ireland will also continue to follow EU rules in a number of areas such as agriculture, energy (it will remain in the single market for electricity), state aid and the application of VAT. This protocol will apply for renewable 4-year periods. It will be subject to the control of a joint UK and EU commission, with the Northern Irish Assembly having a say on renewal.*

Source: European Commission