# Risks to Brexit Trade Talks Pronounced as UK, EU Approach Next Phase

**A significant breakthrough on any fundamentally different framework for trade and institutional relationships between the UK and EU remains unlikely before March 2019, according to Scope Ratings, even after today's EU sign-off advancing negotiations. Instead, significant underlying issues will exert continued force on policymakers to soften the Brexit approach.**

The agreement outlined last Friday for consideration at this week's EU summit, including a methodology for estimating the Brexit bill and equivocal promises on the issue of the Irish border, will come back in doubt should trade talks turn south. Given the delays and struggles experienced during what was expected to be a comparatively easy first stage, what the more challenging phase two may look like is an open question.

In this regard, the 'creative ambiguity' used to pave over the Irish border issue to advance talks could come back to upset proceedings, feeding into political and regional tensions within the UK. And, while Theresa May's government worked hard to reach the tentative agreement, the victory is somewhat pyrrhic, given the concessions the UK had to make.

On the basis of last week's agreement, the European Council green lit the start of phase two of negotiations, which will concentrate on the shape of the UK and the EU's future relationship alongside a transitional arrangement to smoothen the exit process. This next phase is expected to launch in early 2018, with the clock ticking down to the current exit date in March 2019.

In its Public Finance Outlook for 2018, Scope expressed its belief that there was little chance of any substantive breakthrough before the March 2019 date on any new framework for trading and institutional relationships, including customs and migration arrangements, "…except one that rather resembles that which already exists."

Scope's view on this accounts for the fact that the remaining window for negotiation is narrower even than the 15 months before 29 March 2019, as the EU and the UK Parliament will need time to approve any agreement reached before the exit date. Moreover, as phase two talks start, the UK and the EU are starting from incongruent positions on trade and transition – discrepancies which will complicate proceedings.

Overall, the advancement of talks to phase two does not alter the view Scope expressed in August when we affirmed the UK's AA sovereign rating with a Negative Outlook, reflecting the impact of the exit process from the European Union, the effect of associated uncertainty on macroeconomic conditions, alongside a weakened policy framework.

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## A preliminary divorce deal

A tentative deal struck

The tentative deal on the first phase of divorce terms reached last Friday came a few months behind schedule but nonetheless marked an important achievement for Prime Minister May. Under the terms of the non-binding agreement:

i. The UK will contribute to EU budgets in 2019 and 2020 – after the current exit date from the EU in March 2019;

ii. The UK will contribute its share of financing of EU budgetary commitments outstanding as of 31 December 2020;

iii. The UK will contribute its share of financing of the EU's liabilities incurred before 31 December 2020;

iv. Regarding EU citizens' rights, UK courts will have due regard to relevant decisions of the European Court of Justice (ECJ), including a mechanism so that UK courts can ask the ECJ questions of interpretation during the eight years after Brexit;

v. The UK will propose a solution for keeping the Irish border open.

Phase two negotiations to launch in 2018

Given delays and hardships experienced during the comparatively easy phase one (concluded near nine months after Article 50 was invoked), what the more challenging phase two may look like is an open question.

## A trilemma on the Irish border

Irish conundrum paved over, but will rearise during phase 2 talks

While the question of how to resolve the Irish border has been temporarily shelved, it will return in the second phase of talks. This is because last week's deal fudged the question of how to concurrently satisfy three conflicting points:

i. No border between Northern Ireland and the Republic of Ireland;

ii. No regulatory differences or customs points between Northern Ireland and the rest of the UK;

iii. That the UK should have the freedom to define its own regulatory regime, one different from that of the EU.

The manner in which this fundamental trilemma was momentarily dispatched – with a tentative commitment to no hard borders – implies that the UK will ultimately need to ensure a degree of regulatory equivalence presumably for the whole of the UK with the EU. This is because of the contradictory task that Prime Minister May has of satisfying Irish interests, in view of an effective veto that Ireland holds over a final agreement, while keeping onside Northern Ireland's Democratic Unionist Party (DUP) – which boosts the Conservative's minority government in the UK Parliament, and is firmly committed to the union between Northern Ireland and the rest of the UK.

DUP party head Arlene Foster has already warned May about proceeding with the phase one agreement in its present form given the issues that still need to be resolved, and implied that the DUP could still vote down any final deal that it finds unpalatable.

## Resistance from the regions

An inherent conflict with the dissenting regions of the UK

As importantly, tensions surrounding the Irish border issue brought back into the spotlight other fissures that have existed along regional lines. Shortly after news broke that an agreement might convey implicit 'special status' for Northern Ireland – possibly permitting retention of access to the single market and/or customs union – Scotland, Wales and London publicly voiced their own interest in a similar arrangement allowing them to retain close economic links with Europe.

The majority of citizens in Scotland, London and Northern Ireland voted for remain in 2016's referendum, and the divisions outlined the still prodigious institutional challenges that the UK government faces in bringing about a hard exit from the European Union. Regional preferences for a softened approach have been expressed via threats of veto (including of the so-called 'EU Withdrawal Bill') and in the case of Scotland, the latent warning of a second independence referendum.

It remains difficult to envision how these regional objections might be addressed under any plan that includes a full exit from the single market and customs union. But, the apparent solution – by maintaining the UK's single market status and ensuring regulatory alignment – is also anathema to a Brexit camp that hopes the UK can repatriate regulatory control, governance over borders and the ability to strike free trade agreements with third parties.

This underlying conflict between the May government's commitment to the union of the UK's constituents and the government's assurances it will carry out the promised Brexit remains a fundamental source of tension as we enter 2018, and the thorny resolution may well exacerbate instability within the UK government.

## May's tenuous post

**May's margin for error is narrow**

The disputes over the kind of Brexit that the UK wants have also exposed the Prime Minister's precarious position. In October, former Conservative Party chairman Grant Shapps reported about 30 party rebels who wanted leadership change. This number appeared to rise to up to 40 Tory MPs in November. With the threshold at 48 signatories needed to force a confidence vote (which, if lost, leads to a fresh Conservative leadership contest), May's margin for error is narrow.

In addition, lawmakers in the House of Commons, including members of the Conservative Party, this week overruled the government's intent by voting to amend the EU Withdrawal Bill so that it guarantees Parliament a 'meaningful vote' on the final deal. This alteration raises questions on whether May can gather the necessary majority to back her government's vision of Brexit.

**A future Tory leadership contest and/or early parliamentary elections are possible**

The sustained pressures on the minority government, which is now characterised by internal dissent, conflicts with Parliament over the latter's role in the withdrawal process, and a destabilising turnover in major cabinet positions, keeps the possibility of a leadership change in the spotlight. If dissenters trigger a Conservative leadership contest, a defeat for May could lead not only to a new prime minister, but also a change in approach to Brexit, although to what extent is unclear.

An early parliamentary election is not precluded down the road – given the minority government's dependence on tentative support from the DUP and mounting tension created from the pursuit of unrealistic Brexit promises. Scope believes the significant underlying pressures and disproportionate costs of a no-deal Brexit will exert continued force on policymakers to soften the Brexit approach and/or extend the negotiation horizon.

## Phase two incoming

**Alternate expectations entering phase two talks**

Entering phase two, the UK has said that it wants a bespoke trade deal with the EU that leaves the trading partnership with the bloc 'virtually identical' to the current arrangement. However, internal preparations within the EU in advance of future talks have focused on a Canada-style deal as the starting reference point. The EU's argument that such an arrangement is the best offer available assumes the UK's red line that it wishes to exit the single market and customs union.

**CETA as the EU's starting point on trade…**

Canada's Comprehensive Economic and Trade Agreement (CETA) with the EU, which came into force provisionally earlier in 2017 – more than eight years after negotiations started – is considered one of the most ambitious of all EU trade agreements. But, although it removes 98% of tariffs on goods, it doesn't cover trade on certain food items, and crucially, many services – which make up nearly 80% of the UK economy.

While the UK's departure point of already zero tariffs and harmonisation with EU standards reduces the complexity of negotiations compared with the starting positions in traditional trade talks, the timescale necessary to conclude any hypothetical Canada-style deal remains lengthy. Moreover, the long-run economic costs to the UK of a CETA-style arrangement, which reimposes customs checks, excludes 'passporting' rights for UK-based banks, alongside possible intrinsic contradictions of any such arrangement with agreements made in phase one (like on the Irish border), cloud the picture.

David Davis has stated that the UK wants a 'Canada plus plus plus' trade deal with the EU, involving the best of Canada's arrangement plus the best of Japan and South Korea's alongside "the bits that are missing, which are the services." But, obviously, such an option is not available unless the UK fundamentally changes its guiding intentions in exit talks.

**… moreover, transitional state talks won't be simple.**

In addition, phase two talks will involve deliberations around the transitional arrangement. The EU intends to agree on its negotiating stance on this aspect in January. According to draft guidelines, the bloc's pitch is that the UK remain 'a member' of the single market and the customs union through a 21-month changeover period to 31 December 2020, to align with the end of the current EU budget timeframe. During this phase, the UK would observe European rules, but lose voting rights.

But, the UK is unlikely to find this proposal acceptable. Moreover, the discussion to come around a transitional framework runs into the dilemma that it remains unknown what it would be transitioning to, given the lack of consensus on the end-state. Also, any agreement on the changeover will be 'in principle' – and come into effect only if there is a final deal. As such, any transition agreement would remain tentative, and may not ease significant trepidations and contingency preparations in the business community relating to the post-March 2019 environment.

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