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While the Clock Continues to Tick, Brexit Positions Continue to Evolve

Since the June 8 election in Britain, which saw the Prime Minister lose her majority in Parliament, there has been much speculation as to whether the British government would continue down the road of a “hard” Brexit or would move to a softer version of the “no deal is better than a bad deal” position that dominated the headlines for much of the spring. In the past few weeks, while continental Europe focused on other issues and vacations, the political class and the media in Britain were left to read between the lines as competing visions of Brexit, with a heavy dose of political maneuvering in the Conservative Party, emerged from the Cabinet.

On August 15, the British government issued the first of a promised series of policy papers, this one (in many respects, aspirational) proposed that Britain join a new form of customs union described as a “continued close association.” This untried arrangement with the EU customs union, which would mirror the customs union of which Britain is a member by virtue of its status as a member state of the EU, would be limited in time. In response to the many commentators who expressed surprise (in some cases bordering on derision), or who questioned the value of the approach, the lead British Brexit negotiator David Davis noted, “You will find it difficult sometimes to read what we intend. That’s deliberate. I am afraid in negotiations you do have constructive ambiguity from time to time.”

In light of the election and the developments that followed, we highlight below the competing positions and the context in which these positions are evolving.

Yet Another Electoral Surprise

When Theresa May surprised the country on April 19 by calling for a snap election, she fully expected to augment her party’s small majority in the House of Commons and gain a public mandate for her Brexit policy. That policy would call for Britain’s departure from the single market, the customs union and the jurisdiction of the European Court of Justice. It would reduce immigration levels from 588,000 (as recorded in 2015) to the tens of thousands.

For the first few weeks of the seven-week campaign, the Prime Minister seemed set to deliver. Opinion polls in April gave Conservatives an approximately 20-point lead over Labour, which would have raised the party’s majority from 12 seats to around 100. Over the seven-week campaign, the focus on the campaign trail moved away from Brexit and evolved into one about local issues. Education, the National Health Service and security concerns dominated headlines and manifestos, and government efforts to

project an image of a “strong and stable” government able to deliver a “hard” Brexit fell victim to criticism, following the terror attacks in Manchester and London, of austerity-driven cuts in the country’s various police forces. On the morning of June 9, however, the unexpected possibility of a hung parliament became a reality.

Neither Labour nor the Conservatives reached the 326-seat threshold needed for a majority in the lower house. Instead of gaining 100 additional seats, the Conservatives lost 13. It was an embarrassing performance for the Tories, who had structured their campaign around the Prime Minister and her vision of Brexit. Though they remain the largest party, it was the first time Conservatives had lost seats in the House of Commons in 20 years. The Conservatives were forced to enter into an alliance with the socially conservative Democratic Unionist Party (DUP) of Northern Ireland.

Theresa May’s partnership with the DUP was the first inkling that a soft Brexit might be the only realistic scenario. The DUP’s desire for a frictionless border with Ireland was viewed as putting pressure on the Prime Minister to adopt a softer touch, particularly with regard to her call to control immigration and leave the single market. The DUP is seen as a controversial choice as partner to the Conservatives, due in part to tensions in Northern Irish politics this year. Since March, the region has been without a power-sharing government, as neither the unionist nor nationalist parties can agree to form a coalition. The Good Friday Agreement, one of the major political developments in the Northern Ireland peace process, states that the region must be governed by a coalition of politicians from both sides. It also stipulates that the administrations in Dublin and London must be impartial to the region’s local politics, a requirement that Theresa May will be hard-pressed to ensure. Former Conservative Prime Minister Sir John Major, who helped start the peace process in the 1990s, voiced concerns that a partnership could compromise Westminster’s impartiality and put power-sharing talks at risk. The peace process, he says “isn’t certain, it is under stress. It is fragile.” Sinn Féin, the largest nationalist party in Northern Ireland, has issued similar warnings.

As the previously scheduled formal start of the Brexit negotiations kicked off two weeks after the election, it was clear that, rather than strengthening the Prime Minister’s hand in the Brexit negotiations, the election had seriously weakened it. Not only did the outcome of the election call into question popular support for a hard Brexit, but the math raised the specter that the government would be unable to pass the legislation necessary to implement any Brexit deal, including what had been termed the Great Repeal Bill (now formally known as the European Community (Withdrawal) Bill), by which EU laws applicable today in Britain would become British laws.

Some commentators have noted that there are probably more Remain members of Parliament now than before June 8. There is also plenty of evidence of internal divisions among both the Conservatives and Labour, which may deprive both the Eurosceptics (who support a hard Brexit) and the supporters of Remain (who would support a soft Brexit) of a majority in the House of Commons. That may, in turn,

make it easier for the House of Lords, where it is believed there are a greater proportion of supporters of Remain, to reject a hard Brexit.

Those seeking to understand the political state of play, and who do so through the lens of US politics, will be surprised that, in the face of the most significant negotiations to be undertaken by Britain in the post-war years, which were launched on the basis of a 52%-48% vote, there is no effective opposition espousing the Remain position. That said, Labour may be softening its position on leaving the customs union and the single market. While the Labour party membership appears to be strongly Remain, as are the trade unions, the leadership is more Eurosceptic. Two senior Labour politicians (Keir Starmer, the shadow Brexit secretary, and John McDonnell, the shadow chancellor) are reported to want to keep open the option of staying in the customs union and the single market. They seek tariff-free access for goods and services. That said, the shadow trade secretary says leaving the EU means leaving both the customs union and the single market.

While on the surface, much of the discussion is around hard Brexit versus a softer version, those espousing the latter may view the election results as a basis for revisiting the Brexit project. It is noteworthy that an increasing number of commentators, though only a few political voices to date (among them though, Lord Kerr, the former diplomat who drafted Article 50, and more recently David Miliband, a former Labour foreign secretary), have raised the prospect of a second referendum, highlighting the view that among the 52% there was an internal tension between those who voted to leave in order to control immigration (and so today would fall in the hard Brexit camp) and those who would be willing to subsume full control over immigration to maintaining free trade arrangements with the EU. Calls to date for a second referendum have been met by Brexiteers with a combination of economic arguments (the strong employment figures, for example, since June 24, 2016) and political arguments (the will of the 52% must be respected; voter backlash could lead to civil unrest).

The Formal Negotiations Get Underway

Though the government did begin talks on June 19 as planned, it did so with no coalition and no legislative agenda in Westminster. Notwithstanding this uncertainty, four days after the election, Brexit secretary David Davis reiterated the government's pre-election position: "It's outside the single market but with access. It's outside the customs union but with a customs agreement. It's taking back control of our own laws and borders."

Fast forward to the end of July, following the second round of formal negotiations, and Michel Barnier, the Brexit negotiator, was reported to have told ambassadors to the EU that the British government has been unable to provide sufficient clarity on its positions during the last weeks of talks, underscored by the reported failure of the British to provide clear position papers on the key issues. A number of commentators have noted that the EU team seems far better prepared and appears to be far better briefed than its British counterparts.

As Michel Barnier noted, “the clock is ticking.” The EU Council (representing the member states) is due to decide at the end of October whether “sufficient progress” has been made on citizens’ rights, the so-called “divorce bill” and the border with Ireland so that negotiations can commence on the future trade relationship. Separately, the European Parliament has indicated it intends to issue its own views as to whether sufficient progress has been made, and Guy Verhofstadt (the European Parliament’s coordinator on Brexit) has publicly reiterated that there must be progress on all three of the preliminary issues before the future trade relationship can be discussed.

An Emerging Consensus in the Cabinet?

While the Prime Minister was away for a three-week holiday, her Chancellor Philip Hammond, taking the view that “literally nobody” wants a post-Brexit migration “cliff edge,” cobbled together what he characterized as a “broad consensus” on seeking an “off the shelf transition” deal with a three-year transition period during which the status quo would remain intact. This may well have reflected both the view that the election results should be read as a failure to endorse the Prime Minister’s hard Brexit plan, and a realistic appraisal that a bespoke deal could not be crafted in the time available.

The chancellor posited a “standstill” transition period followed by an “implementation phase” while a new trade agreement was put in place. The transition period could well mean continued single market and customs union access, continued free movement of people, continued budget contributions to the EU and oversight other than by courts in Britain (perhaps by a tribunal similar to the one that adjudicates disputes involving the European Economic Area); for their part, European negotiators are particularly interested in learning what the British have in mind in terms of the conditions of any transitional arrangement.

With the clock ticking, certainly from the perspective of EU negotiators, there is logic to simply maintaining the status quo (that is continuing the *acquis communautaire*, being the existing EU legal regime), rather than dedicating significant time and resources to fashioning a bespoke set of arrangements and running the risk of significant opposition and, possibly, court challenges. Any such transition period also would mean that Britain could not sign any new trade agreements until after 2022. Note that the next election in Britain is scheduled for June 2022. Presumably during this period, Britain would have no voting rights on EU matters.

Commentators questioned whether the rumors of a transitional arrangement meant that Philip Hammond had gained the upper hand vis-à-vis the three Brexiteers (David Davies (whose formal title is Secretary of State for Exiting the European Union), Liam Fox (International Trade Secretary) and Boris Johnson (Foreign Secretary)). Some pro-EU Conservatives began to voice concerns about the unspecified concessions that may have been made to get the support of the Brexiteers. That having been said, as the new Liberal Democrat leader Vince Cable noted, a transitional arrangement may simply delay the day of reckoning by three years: “An extreme Brexit in 2022 rather than in 2019 is still an extreme Brexit.”

That at least was the news the last week of July. By the end of that week Liam Fox had cast doubt on the broad consensus. Others were reported to have suggested that the Chancellor merely was trying to undermine the Prime Minister while she was on vacation. The Chancellor was also busy tamping down rumors that the government would seek to compete for business post-Brexit by becoming a low-tax, low regulation jurisdiction.

This past weekend, Liam Fox and Philip Hammond, in a joint article in the *Sunday Telegraph*, wrote that, “We are both clear that during [a transition period, or as some ministers are calling it, an implementation phase] the UK will be outside the single market and outside the customs union.” In theory, this would allow Britain to negotiate trade deals with non-EU countries. They went on to say, “We want our economy to remain strong and vibrant through this period of change. That means businesses need to have confidence that there will not be a cliff-edge when we leave the EU in just over 20 months’ time.”

The article, however, failed to address the fundamental practical issue, which is that any such arrangement needs the assent of the EU27, and a transition arrangement outside both the customs union and the single market is unlikely to provide a basis for an agreement that will be acceptable to the EU27 while providing Britain with additional time to soften the adverse impacts of Brexit. The article did not say how long the transition period is to last and what concessions the British will have to make to gain the approval of the EU27. Moreover, many commentators noted that there is insufficient time to negotiate a bespoke arrangement that addresses both tariff and non-tariff barriers. Leaving the customs union or the single market is likely to require significant investment in IT systems and hard sites at borders and ports (which today do not exist) to accommodate post-Brexit customs checks and customs declarations (with one report stating that based on current levels of trade with the EU, 255 million customs declarations will be needed in two years, up from 55 million today).

Just shy of two weeks before the next round of Brexit negotiations (which start on August 28), on August 15, the government published “Future customs arrangements: a future partnership paper.” The paper lays out two options: (a) a “highly streamlined customs arrangement” based on technology-driven solutions and (b) a “new customs partnership,” which the paper notes would be “unprecedented as an approach and could be challenging to implement.” To avoid any “cliff-edge” as Britain moves from its current relationship as an EU member state to whatever new relationship is agreed with the EU27, the paper suggests a “continued close association” with the EU customs union, “which could involve a new and time-limited customs union between the UK and the EU [customs union], based on a shared external tariff and without customs processes and duties.” The paper does not specify which option the government prefers.

As some commentators noted, even if EU negotiators were prepared to accept an interim arrangement, there remains the challenge of negotiating the terms of the transition, which could be as difficult and painful as agreeing to the new permanent arrangement. And all this would have to be addressed in the 14 months before the EU27 internal processes need to commence.

The Devil Remains in the Details

Any transitional arrangement will have to be approved by the EU27. More importantly, under the current negotiating posture of the EU27 (which various EU spokespersons underscored in the hours following the release of the paper, together with reminders of Michel Barnier's view that frictionless trade is not possible outside the single market and customs union), this transitional arrangement can only be addressed once substantial progress has been made on the three key preliminary issues. Reaching agreed positions on each of these issues could take some time, as each is complex, has significant collateral consequences and triggers a range of emotional responses. Some commentators noted, incidentally, that it was a mystery as to why the government would release a position paper on the customs union at a time when the three key preliminary issues are front and center.

Of the three key issues, the fate of EU citizens and the future of immigration dominated the headlines at the end of July. In sum, there is concern that with the continued uncertainty, an increasing number of EU citizens will leave Britain. The issue touches on a range of industries and has very real consequences for a significant number of people living in Britain. The Office for National Statistics reports that in at least 18 key specialist industries, EU workers represent over 20% of the workforce.

Uncertainty has been compounded by the absence of a single authoritative voice on the issue of citizens' rights. During the transition period, EU nationals will need to register after Brexit, when free movement of people will cease, according to a junior minister who works for the Home Secretary. His boss, the Home Secretary, was more nuanced saying free movement would end, but that arrangements similar to those in place today would remain in effect during the transition period. Separately, the Cabinet seems to have concluded that free movement would continue during the transition period. In the midst of contradictory statements, the Home Secretary announced that she had set up a Migration Advisory Committee, immediately drawing criticism (particularly from the business community, which is heavily reliant on EU citizens) that the government has squandered valuable time by waiting more than a year to set up the committee, which incidentally is due to report only in September 2018. To put this issue into context, note that the vast majority of the EU citizens living and working in Britain are not on any UK government database.

As for the "divorce bill," David Davis in one radio interview appeared to rule out agreeing to a number this year when he stated that, "There won't be a number by October or November."

At the end of July, Michel Barnier warned that that the British government's hope of securing "frictionless trade" is not possible "outside the single market and customs union." It was reported that Oxera Consulting had concluded (at end of July) that Britain would suffer significant border delays costing more than £1.0 billion annually as a result of the imposition of customs checks, though the report also notes that the figure is conservative as it does not take account of the need for extra customs staff, sites needed for trucks awaiting customs clearance, congestion associated with the stacking plan, and potential lost

jobs if companies relocate. Some academic studies show that even a soft Brexit (joining the European Economic Area, like Norway) would have an adverse impact on trade and GDP for Britain (with a lesser impact on the EU27), while defaulting to World Trade Organization rules only would have a far greater adverse impact for Britain.

Also, in late July, an Oliver Wyman study concluded that Brexit has the potential to increase costs for banks by 4% and capital requirements by 30%. These conclusions follow the deadline set by the Bank of England for submission by banks for their worst-case assessments of a hard Brexit.

While Brexit dominates the headlines in Britain, the European press is not so preoccupied. The optimism surrounding the election of Emmanuel Macron as President of France (and, in so doing, turning back the tide of populism), as well as the potential for a Franco-German effort to reform the EU, commands more attention than the Brexit negotiations. Eurozone growth is reported at the fastest rate since the financial crisis, with noticeable divergence between the Eurozone and Britain. That is not to say that Brexit is being ignored on the continent; witness for example the competition among continental cities to host the European Medicines Agency and the European Banking Authority, which will relocate due to Brexit.

Concluding Thoughts

In the weeks since the election, EU negotiators have had to contend not only with what they describe as a lack of preparedness on the part of the British negotiating team but they also have to confront the acrimony aimed not at them but acrimony within the British government over Brexit strategies. This is viewed by some ultimately as a manifestation of a power struggle over who will replace Theresa May in a Conservative Party leadership contest, which struggle has been unleashed by the election results. Time is of the essence as the Conservative Party conference takes place in October, followed a few weeks later by an EU summit at which the Brexit strategy in theory needs to be fully articulated.

For the business community, and in particular financial institutions and other service providers who today rely on EU “passporting,” the clock is also ticking. Business is reported to have a better working dialogue with the government, enhanced by the formation of 18 working groups organized along sector lines, though one hears complaints regarding confusion over coordination and concern over the myriad of technical issues that need to be addressed, with each sector likely to face different challenges. Not surprisingly then, the priorities and therefore the positions of the business community are not uniform. In the meantime, a number of banks and insurance companies, and more recently a bond trading platform, have disclosed their contingency plans, with various continental cities identified as potential sites for relocated operations. With the progress (or lack thereof to date) top of mind, the sense that the UK could crash out of the EU may well prompt an increasing number of businesses to activate their contingency plans.

To the extent businesses view any transitional arrangement as beneficial, they may well need to be prepared for sequencing that sees the three core issues addressed first, with the transitional arrangements being addressed only in the final weeks. Not surprisingly, there may well be tactical reasons for the EU negotiators to extend the period of uncertainty, as that can only increase their leverage and, in the meantime, prompt an increasing number of contingency plans to be triggered.

In so many respects, the ball is in the court of the British government – in terms of articulating both a vision for Britain’s relationship with the EU27 in the medium- to long-term and the means of achieving that vision. This needs to be done for domestic consumption as well as to serve as a basis for negotiations, failing which Britain risks crashing out of the EU March 29, 2019.

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