LSE Continental Breakfast 7: the business consequences of a breakdown in exit negotiations

The seventh Continental Breakfast seminar at the LSE, held under Chatham House rules, focused on the potential implications that a breakdown of the Brexit negotiations would have for UK businesses. The overall message was that the consequences of such a breakdown – a "no deal" outcome – would be severe. ***Angelos Angelou (LSE)*** *reports on the discussion.*

A "no deal" outcome would be an economic disaster for most UK businesses. This is primarily because almost 90% of total British exports would be affected by tariffs, costing a total of £40bn. The imposition of tariffs would also have spillover effects for other sectors, like the food and drink industry, which the CBI estimated would suffer 20% in extra costs. Meanwhile, UK businesses would be exposed to increased exchange rate risks (the effect of unexpected exchange rate variations on a firm's value).

In the aftermath of the vote, the pound dropped more than 10% against the US dollar and continued to decline until it reached its lowest level against the dollar for 30 years, at $1.30 to £1. In the event of no deal, uncertainty over the economic relationship between the UK and the EU might lead the pound to a new low. This would entail losses for multinational firms based in the UK, since they are more exposed to exchange rate volatility, as well as risks for UK firms with international operations. While a further fall in the pound might offset some of the new tariffs they will be facing, their production costs might also rise given the higher import cost of raw materials and the falling value of British wages to foreign workers.

The site of the future Crossrail station at Canary Wharf, London. Photo: Nick Moulds via a CC-BY-NC-SA 2.0 licence

Moreover, in the event of no deal, British consumers would see their purchasing power eroded due to import tariffs. The imposition of non-tariff barriers (like "rules of origin" regulations), as well as tariff-related costs, would end up costing three times more than previously. Non-tariff barriers would make British businesses less competitive, since they would deprive them of the ability to conduct prompt and low-cost transactions with the rest of the EU. All in all, UK per capita income could fall by 6.3%-9.5%.

For businesses in the Republic of Ireland and Northern Ireland, the impact would be even more acute. They have hitherto operated on the assumption that cross-border transactions can be conducted promptly and with minimal cost inside the European Single Market, without a hard border. The dynamics of the peace agreement may change since the economic interdependence of the two sides would decline. This has led some to argue for the closest possible alignment between UK and EU standards.

The status of EU workers in British firms would also be uncertain. The rights of EU citizens employed in Britain are not guaranteed if the EU and the UK fail to reach a final deal. Skilled labour could leave as a result. EU migrants are generally younger and more educated compared to UK employees and tend to raise capital productivity via knowledge spillovers and higher human capital stock.

Financial services

Under 'no deal', all financial service providers will lose their passporting rights (the ability of a firm that has been licensed by one EU member state to provide cross-border services to other EU member-states without getting additional authorisation from the local regulators). Since they would not be in the Single Market, UK financial firms would not be allowed to conduct financial operations there. Passporting has allowed many of the world's leading financial institutions to operate in the EU with low bureaucratic and economic costs. The UK has attracted the largest number of headquarter-based investments in the EU. Facing 'third-country' rules usually means partial access to the single market, while the type of access is almost unilaterally decided by the Commission and can be ended or changed at any time.

'Third country' status would put around 50% of the UK's EU-related economic activity (with a total worth of £20bn), 35,000 jobs, and around £3-5bn in tax revenues under threat. The downgrade would probably leave the UK outside all EU decision-making centres, meaning it will lose any source of political or technical leverage over issues of financial governance and regulation. The EU, and especially the European Parliament, appears to be unreceptive to the idea of a bespoke deal *vis-à-vis* financial regulation: indeed, the relevant EU authorities (ESAs and ESMA) that are responsible for the regulation of the financial markets are powering up in order to cope with the challenges that will arise if the UK falls under the status of a third country. Moreover, a number of other European financial centres like Amsterdam, Dublin, Frankfurt, Paris and Madrid have positioned themselves as the next centres for passporting-based activities. The UK would have to follow EU preferences for financial regulation. Britain, along with other EU countries with substantial international presence and stronger capital markets (like the Netherlands) has been advocating for a style of EU governance that is supportive of enhanced market access, liberalisation and open market substitutes instead of intervention. France, Spain and Italy, on the other hand, usually favour a more interventionist approach and are supportive of further regulation.

Legal limbo

A number of international deals signed by the EU on behalf of the UK will stop covering British firms. Replacing these deals, especially in the field of finance, would require much time and effort, with a characteristic example being the EU-US international agreement on derivatives contracts. Given that the UK derivative market is the biggest one in Europe, no deal will have immediate and substantial economic implications.

Investment and growth

Investment uncertainty has adverse implications for an economy's productivity. The uncertainty that followed the referendum result and the current uncertainty about the state of the negotiations are potentially delaying investment and therefore also the recovery in UK productivity. Current investment dynamics appear to support this hypothesis. While GDP has risen in the UK over the past few months, the positive state of the global economy would have justified an even bigger increase. At the second quarter of 2016 it was estimated that UK GDP rose faster than expected, amounting to 0.6, with services and production driving this trend. On the other hand, construction has contracted, while consumer confidence and, subsequently, consumer spending also fell by 0.3% in 2017. (Before the referendum, consumer spending was driving GDP growth.)

Given the uncertainty, most UK businesses have started making contingency plans. Around 60% of British companies already have such plans in place, of which 10% have already taken some practical steps (e.g. moving people who may be affected by no deal). Another 25% of these companies are expected to take similar steps in the near future.

The shape of a deal

For the UK business community, the ideal deal would grant barrier-free access to the Single Market. However, the most realistic aspiration is for the UK to be in a customs union with the EU. A customs union deal would not have to cover all economic sectors (in the EU-Turkey deal, agricultural products are excepted), it would not require the UK to pay any fees to the EU and, most importantly, it would not require the UK government to accept freedom of movement. On the other hand, Britain would have to align its trade policy with the EU's, without any say in it.

The conditions to reach a positive deal are already in place, since the EU now has a more centralised system of financial regulation – a trend that will be intensified with Brexit. Hence it would be simpler for the UK to conclude a single comprehensive deal with all EU member-states. One mechanism to ensure the compatibility of the two industries is through the establishment of British subsidiary companies in continental Europe, which would allow for a system of managed divergence. This would entail extra costs, because British companies would still need to comply with the corporate and market governance regulations of the respective country and its capital requirements. Of course, such a development would also have negative implications for the European financial market, since it will lead to increased fragmentation and higher refinancing costs for local EU banks.

An alternative would be a system of equivalence, which the EU has granted to certain third countries. It offers the possibility for non-EU firms to access the EU market provided that the regulatory regime of their country of origin is equivalent to the EU regime. This would imply that the UK would still need to follow EU regulations while having no influence over them. Furthermore, the regime of equivalence would only partially cover the field of financial services – for example, it will not apply to the field of asset management, lending and deposit-taking. It is also important to note that the process of granting equivalence to a third country is highly politicised. The European Commission can decide and revoke the regime of equivalence unilaterally whenever it sees fit.

Another solution would be for Britain to remain in the European Economic Area (EEA) UK-based firms would still be able to use passporting, since they would still have unrestrained access to the Single Market. But it would be necessary for the EEA and the EU to agree on the powers of the European Supervisory Authorities. At the same time the UK would not be a member of the customs union – meaning that its businesses would be subject to burdensome rules of origins regulations – and would not have any voting rights in the EU institutions. Moreover, the UK would still need to follow EU rules. Such an option is politically less feasible since it would require the four freedoms – of movement of goods, services, labour and capital – to remain in place.

For some politicians, no deal or a breakdown of talks still looks like an appealing option. Some Leavers would prefer it to a failure to control freedom of movement. EU politicians would like to avoid giving the UK access to the single financial market, including passporting, without getting any substantial concessions. Determined to avoid this, the UK business and financial community has formulated a careful campaign of public advocacy for their desired deal. This strategy is in stark contrast to their pre-referendum tactic, where a number of enterprises and business corporations joined the Remain campaign and produced evidence-based justifications on why the UK should stay in the EU. Since that strategy was ineffective, the business and financial community chose a subtler approach in order to avoid alienating public opinion.

Any final deal should strike a fine balance between access to the European market and border control. In that sense it is bound to be an agreement unlike any other that we have seen. Drawing conclusions from the agreements between the EU and Norway and the EU and Canada therefore has limited analytical value. Businesses in the UK need a more secure environment, and guarantees that the transition phase will be managed properly and that a final deal will be reached.

This post represents an account of a discussion held at the LSE, and not the views of the Brexit blog, nor the London School of Economics.

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