Lorenzo Codogno

LC Macro Advisors Ltd

Founder and Chief Economist
+44 758 3564410
lorenzo.codogno@lc-ma.com

Visiting Professor at London School of Economics
L.Codogno@lse.ac.uk

Fifty shades of Brexit

Seminar organised by Adam Smith Society

Milan, 26 February 2018

United Kingdom divided by age and education

How Britain voted

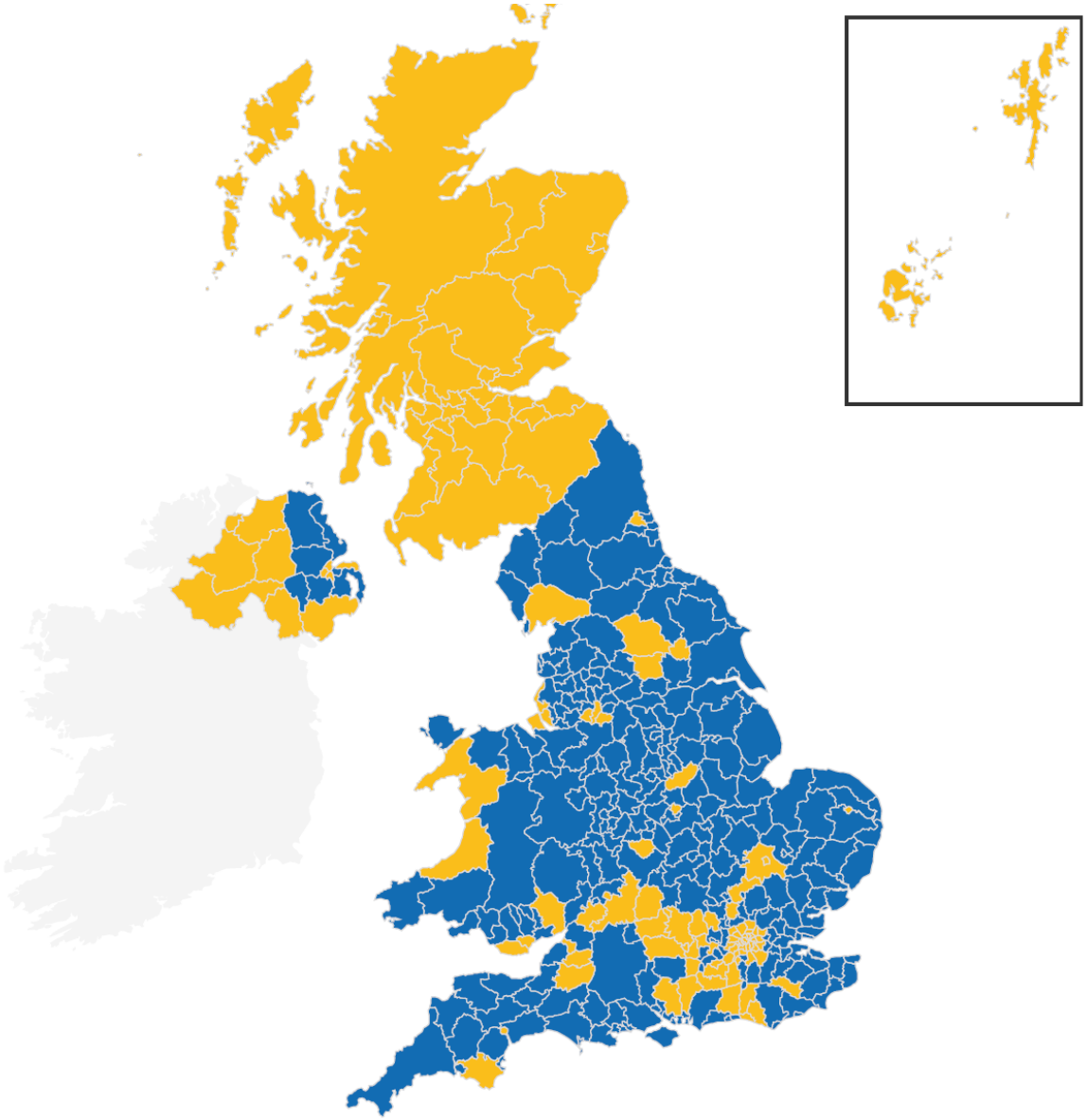
Older people with fewer formal qualifications most likely to have voted Leave

		Remain	Leave
2015 vote	Conservatives	39	61
	Labour	65	35
	Liberal Democrat	68	32
	UKIP	5	95
	Green	80	20
Age	18-24	71	29
	24-49	54	46
	50-64	40	60
	65+	36	64
Education	GCSE or lower	30	70
	A level	50	50
	Higher below degree	48	52
	Degree	68	32

YouGov | yougov.com

June 23-24, 2016

A geographically divided United Kingdom



HM Treasury's assessment before the referendum

- **Long-term impact (15y):** Britain was expected to be less open and productive, and permanently poorer by the equivalent of £4,300 per household by 2030.

- **Short-term impact (2y): damaging effects on both the demand side and the supply side of the economy: "transition effect" + "uncertainly effect" + "financial conditions effect"** (assumptions: monetary policy fixed, fiscal policy = automatic stabilisers).

- "Baseline scenario" and "severe shock scenarios" were both expected to **push the economy into a recession, but it did not happen or at least not yet.**

Two scenarios: shock and severe shock

Immediate impact of a vote to leave the EU on the UK (% difference from base level unless specified otherwise)

	Shock scenario[a]	Severe shock scenario[a]
GDP	-3.6%	-6.0%
CPI inflation rate (percentage points)	+2.3	+2.7
Unemployment rate (percentage points)	+1.6	+2.4
Unemployment (level)	+520,000	+820,000
Average real wages	-2.8%	-4.0%
House prices	-10%	-18%
Sterling exchange rate index	-12%	-15%
Public sector net borrowing (£ billion)[b]	+£24 billion	+£39 billion

[a] Peak impact over two years. Unemployment level rounded to the nearest 10,000. [b] Fiscal year 2017-18.

Two scenarios: modelling inputs

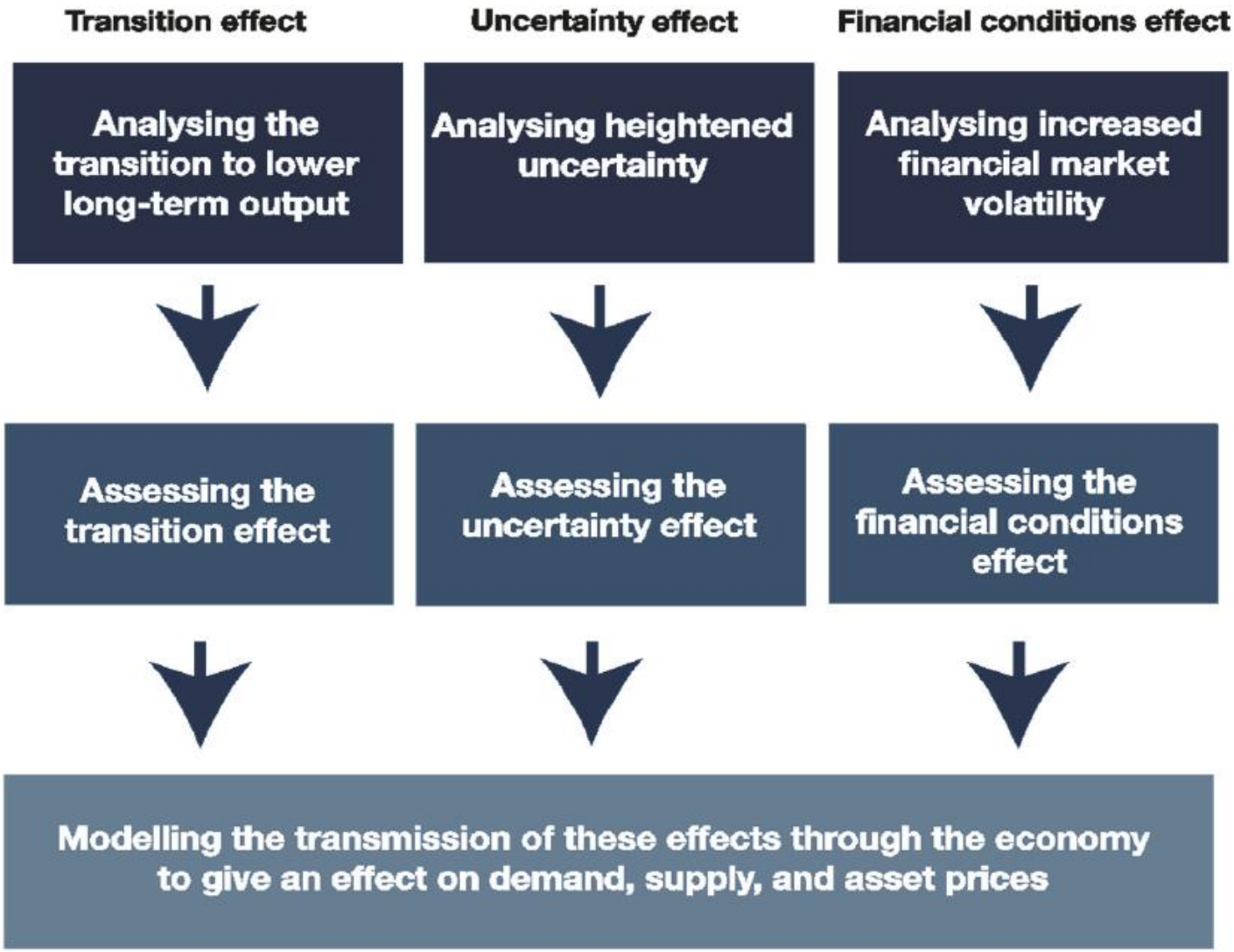
Table 2.B: Summary of modelling inputs

	Shock scenario	Severe shock scenario
Transition effect	Central estimate of the negotiated bilateral agreement alternative phased in over 15 years	Central estimate of the WTO alternative phased in over 15 years
Uncertainty effect	+1 standard deviation	+1.5 standard deviations
Financial conditions effect		
Corporate borrowing rates	+130 basis points	+200 basis points

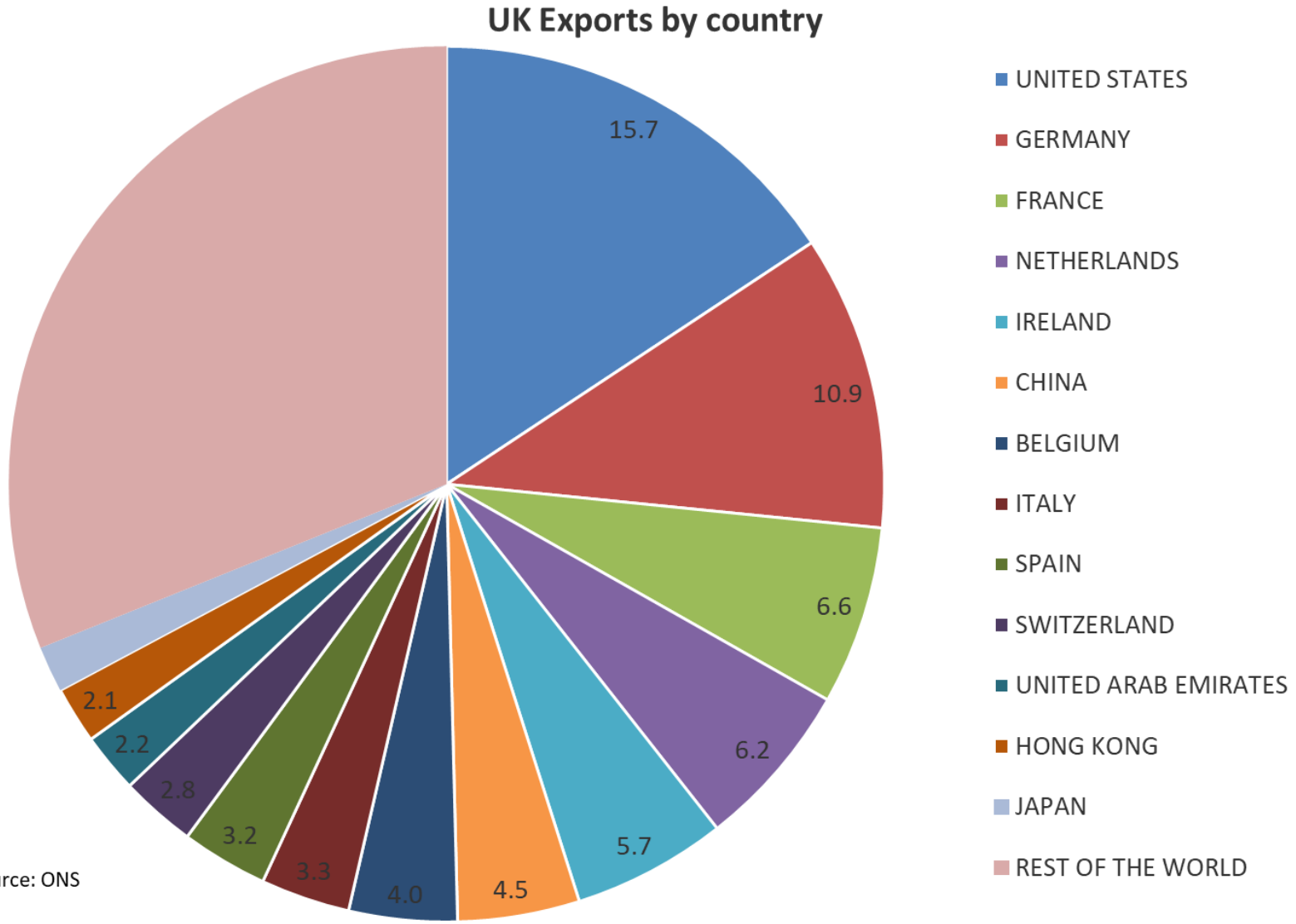
12 *Budget 2016,* HM Treasury (2016).

13 NiGEM is developed and maintained by the National Institute of Economic and Social Research. NiGEM is used, to different degrees, by over 40 organisations including the IMF, the OECD, the Bank of England and the European Central Bank.

HM Treasury's assessment

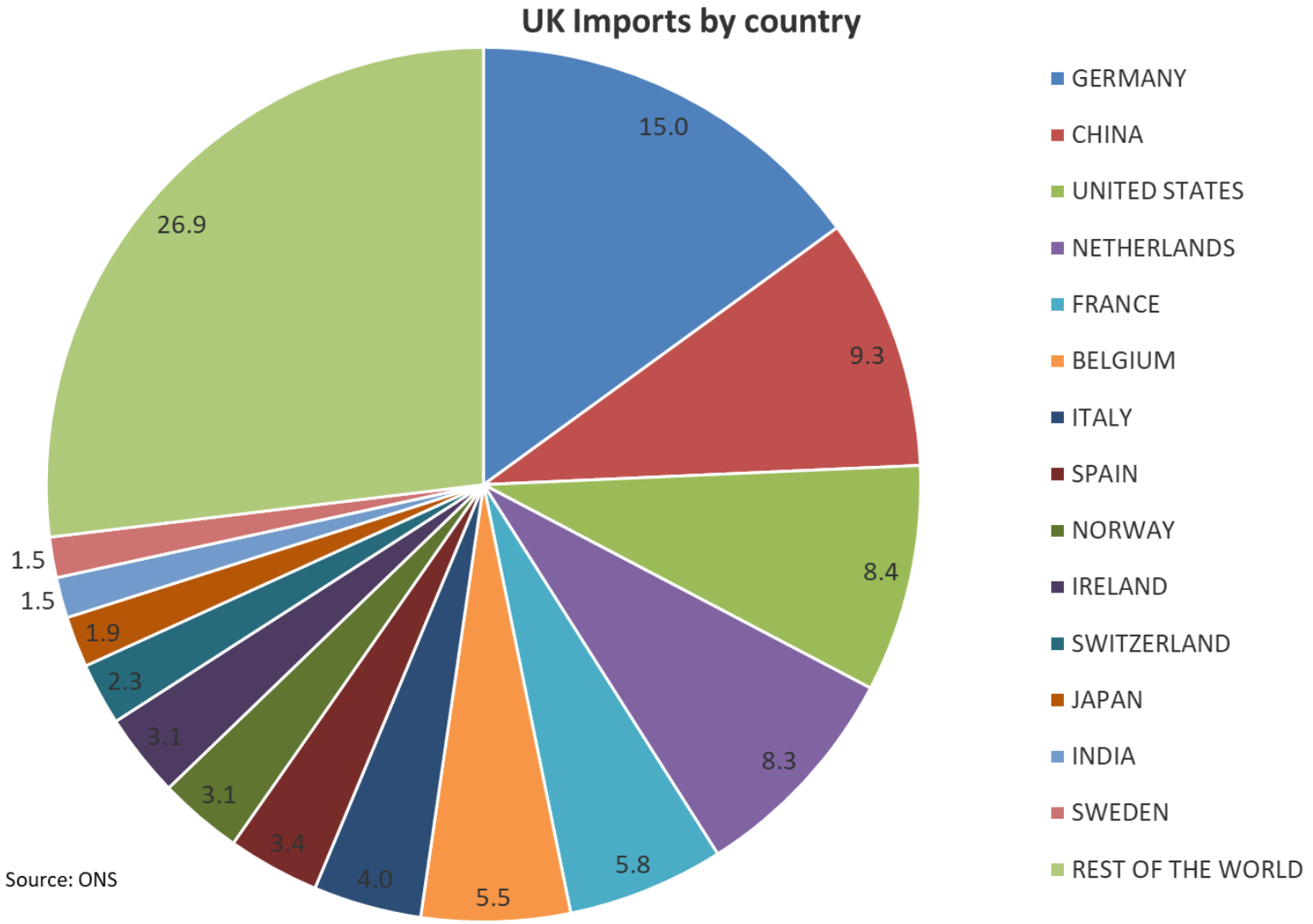


A lot of exports to the US and diversified



Source: ONS

Germany is the first exporter to the UK



Source: ONS

Renegotiating trade agreements not easy/quick

- The EU accounts for 47.9% of **UK exports** and for 55.2% of **UK imports**. The composition of UK imports is skewed towards goods (access regulated by WTO rules), while exports towards services (EU single market).

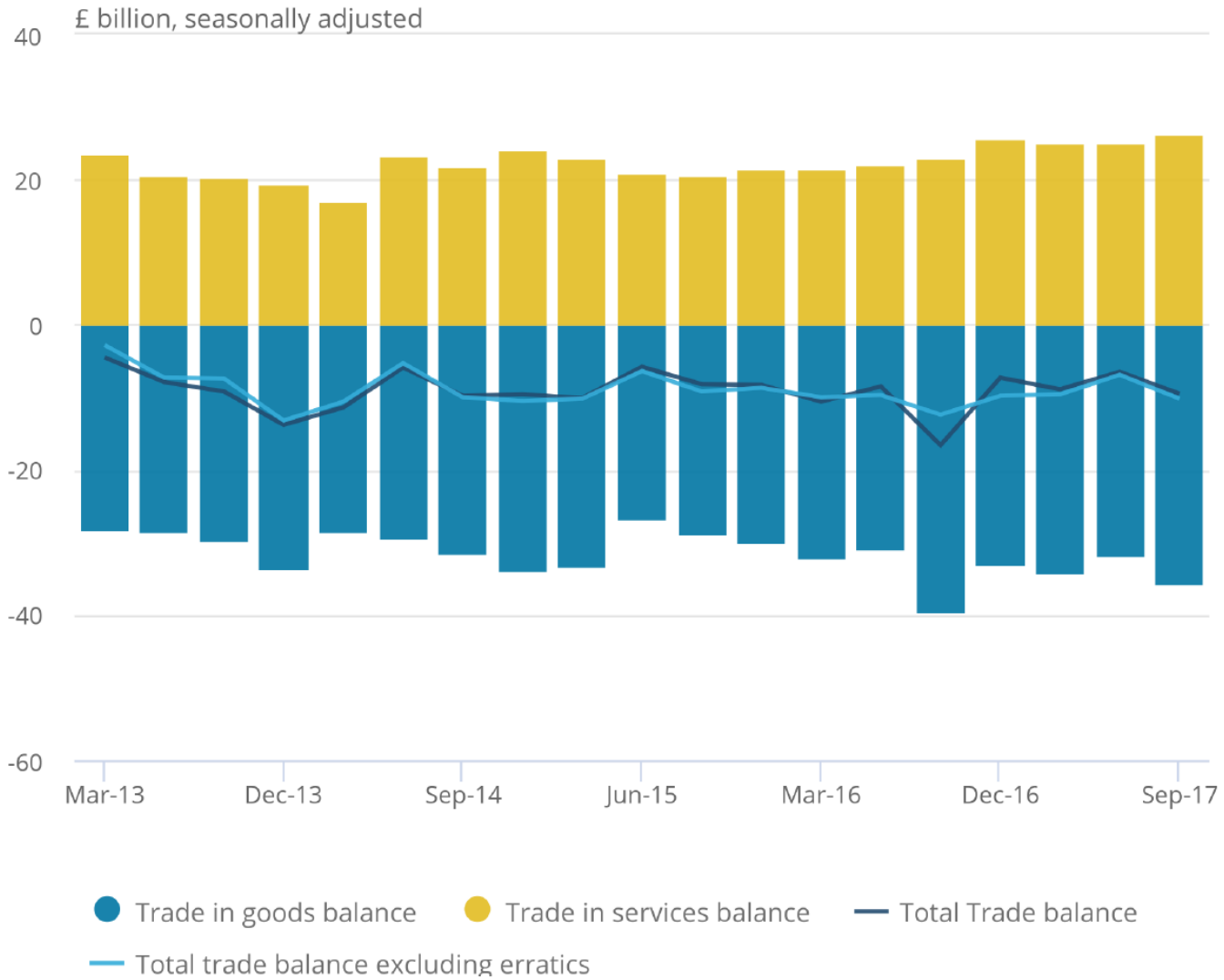
- UK-EU trade is only a small portion for the EU but a big chuck for the UK. The UK lost a **bargaining chip**.

- **Trade Treaties** with the rest of the world will no longer be valid and have to be **renegotiated**. At present, there are **PTAs** (Preferential Trade Agreements) with more than 50 countries, with **85% of UK trade falling under these PTAs**. Re-negotiating trade agreements will not be easy and will take long time.

Renegotiating trade agreements not easy/quick

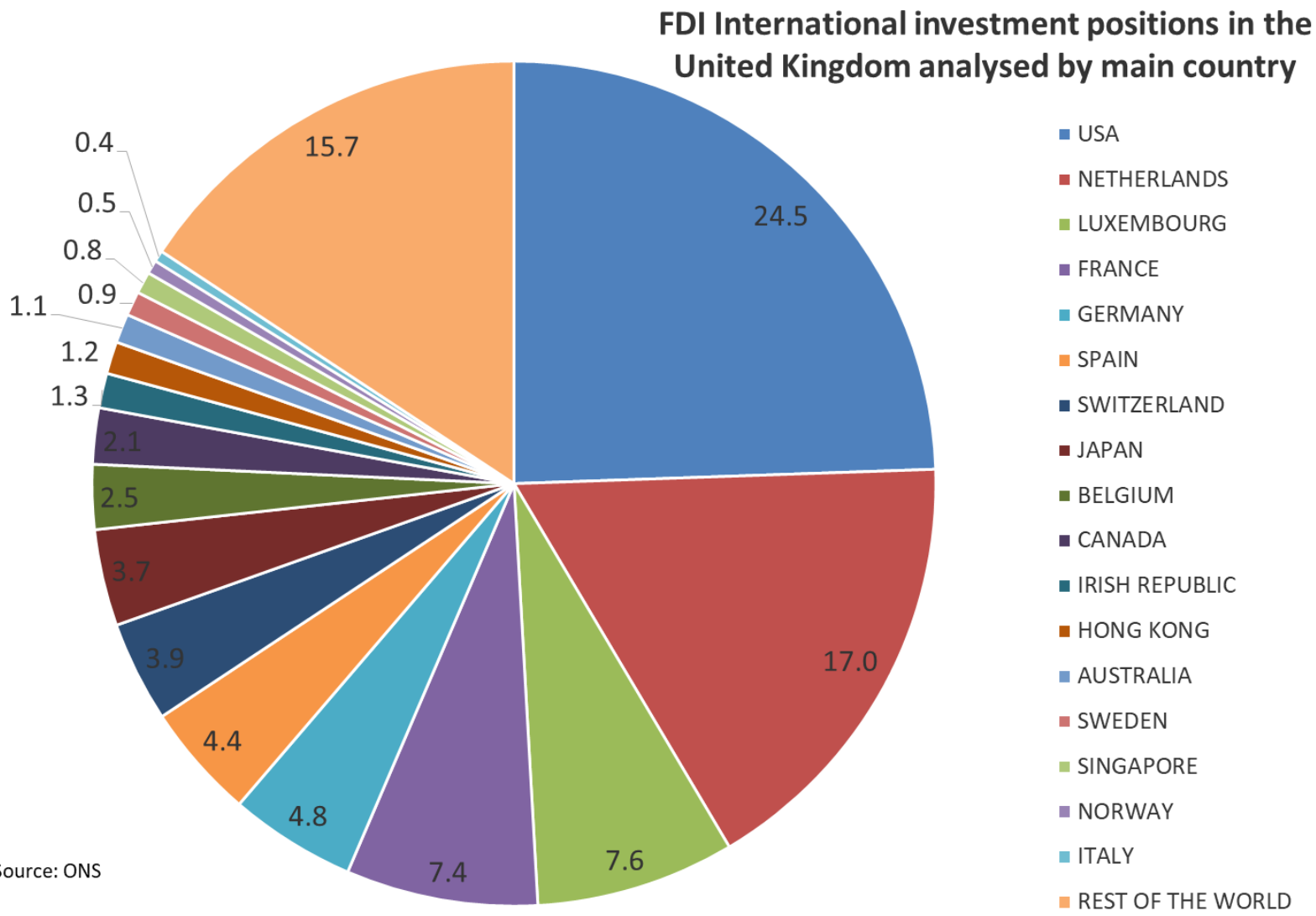
Economist.com

Surplus in services is vulnerable



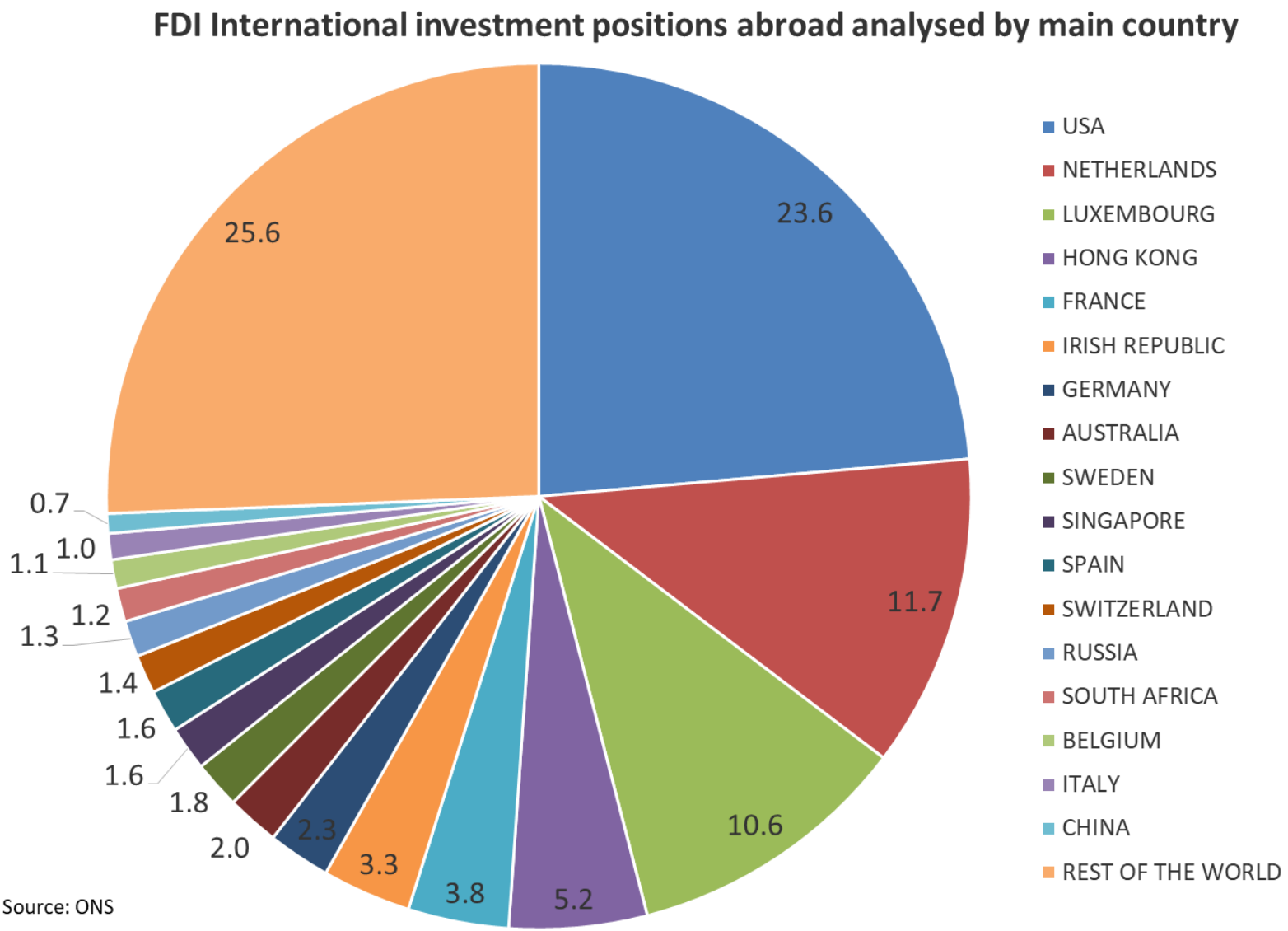
Source: ONS

UK is a leading destination for FDI



Source: ONS

Well diversified outflow of FDI

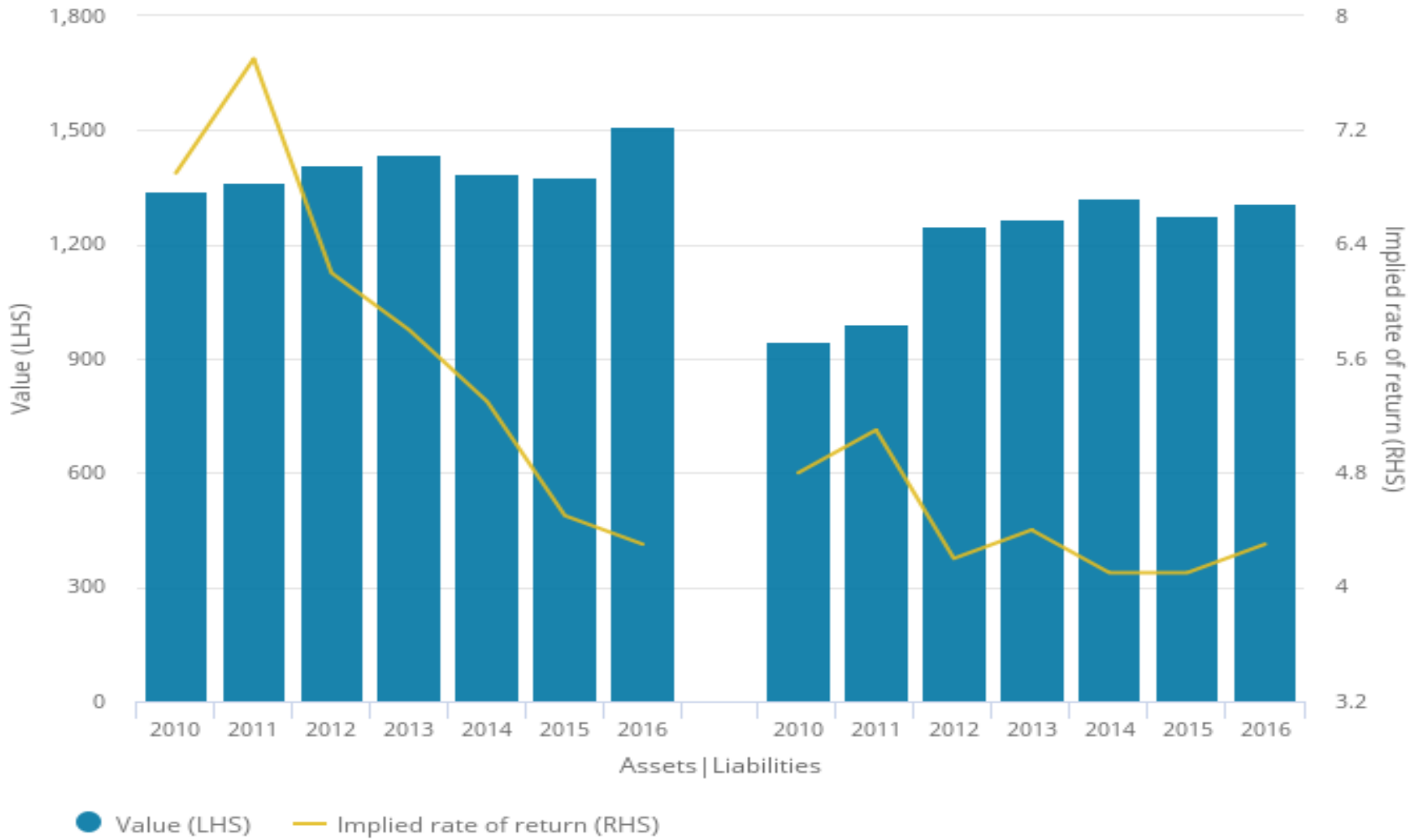


Source: ONS

FDI inflows: UK is a record country

- The UK is the **leading destination for FDI** into the EU, with the largest number of projects, the largest net inflow, and the largest stock.
- Stock of FDI= £1.03tn (~60% of GDP, 59% EU); inflow £27.8bn; earnings £52.3bn.
- Investment from '**quasi-tax heaven countries'** is strong. 1/4 of the flows into UK are in **financial services**, 1/7 in Retails & wholesale trade, and the rest is well diversified.
- Will the UK remain as appealing and as open as in the past?

FDI: return on investment is getting slimmer



Source: Office for National Statistics

The process so far (1)

- **23 June 2016:** Referendum victory of the "No" camp.
- **24 June 2016:** Cameron resigned as Prime Minister.

The process so far (2)

- **13 July 2016:** Theresa May became Prime Minister: “Brexit means Brexit”.
- **July 2016:** New ministries for Brexit and International trade set up.
- **November 2016:** Legal case against Government’s attempt to trigger Article 50 without Parliament’s approval.
- **17 January 2017:** First detailed speech from PM May on Brexit.
- **24 January 2017:** Supreme Court finds against the Government. Parliament must vote on Article 50.

The process so far (3)

- **1 February 2017:** House of Commons votes 498:114 in favour of "European Union (Notification of Withdrawal) Bill" allowing Government to trigger Article 50.

- **2 February 2017:** White Paper published.

- **16 March 2017:** Notification Bill passes through Parliament.

- **29 March 2017:** Triggering of Article 50; notice to withdraw, and "there is no turning back".

29 March 2019: Bye bye baby EU!

The two-year timeframe of out in Article 50 TEU ends on 29 March 2019

Is it possible to put the genie back in the bottle?

- **Petition to UK government:** “Re-hold EU Referendum allowing 16 and 17 year olds to vote”.
- **Petition to Mayor of London Sadiq Khan:** “Declare London independent from the UK and apply to join the EU”.
- **Petition to UK Parliament:** “London to remain part of the European Union”. “Re-do the referendum” (close result ,75% turnout). “Stop all Petitions trying to make us hold another referendum”.
- **Bottom line:** politically difficult to move the clock back, although probably not technically impossible. Risks in the process remain high.

Preparatory work for the “divorce”

- **29 April 2017:** Political guidelines for Brexit negotiations approved by the European Council without discussion: setting the framework for the negotiations and the EU's overall positions and principles.
- **19 June 2017:** Negotiations with EU of the Withdrawal Agreement to start the “divorce” officially began (David Davis vs Michel Barnier). Negotiations under Art. 50 will be conducted as a single package.
- **29 June 2017:** Statement by the European Council, close partnership in the future based on a balance of right and obligations, preserving the integrity of the Single Market, the four freedoms are indivisible.

Boris Pangloss, the new Pollyanna?

"My vision for a bold, thriving Britain enabled by Brexit"
15 September 2017, The Telegraph

“It does not mean we are turning our back on Europe”

Florence 22/9/2017:

“Prime Minister Theresa May set out how the UK will be the strongest friend and partner to the EU after we leave the EU”

Preparatory work for the “divorce”

- **11 September 2017:** “Great Repeal Bill” of the 1972 European Communities Act passed second reading in Parliament. It ends the legislation that gives European Union law supremacy in Britain. 20,000 pieces of EU law to be translated into the UK statute book.
- **15 December 2017:** European Council's guidelines.
- **20 December 2017:** European Commission recommends draft negotiating directives for next phase of the Article 50 negotiations.
- **29 January 2018:** The European Commission receives the mandate to begin negotiations with the United Kingdom on transitional arrangements

Withdrawal agreement under the spotlight

- According to the European Parliament, the **withdrawal agreement and any possible transitional arrangement(s)** should enter into force "well before the elections to the European Parliament of May 2019“.

- **First phase:** (1) Agreement on the so-called **“divorce bill”,** i.e. financial settlement; (2) Agreement on **rights of EU citizens** living in the UK and vice versa; (3) Agreement on the border with **Northern Ireland**.

- **Second phase:** Covering the **post-Brexit relationship** between the EU27 and the UK, will begin “as soon as the European Council decides that sufficient progress has been made in the first phase towards reaching a satisfactory agreement on the arrangements for an orderly withdrawal”.

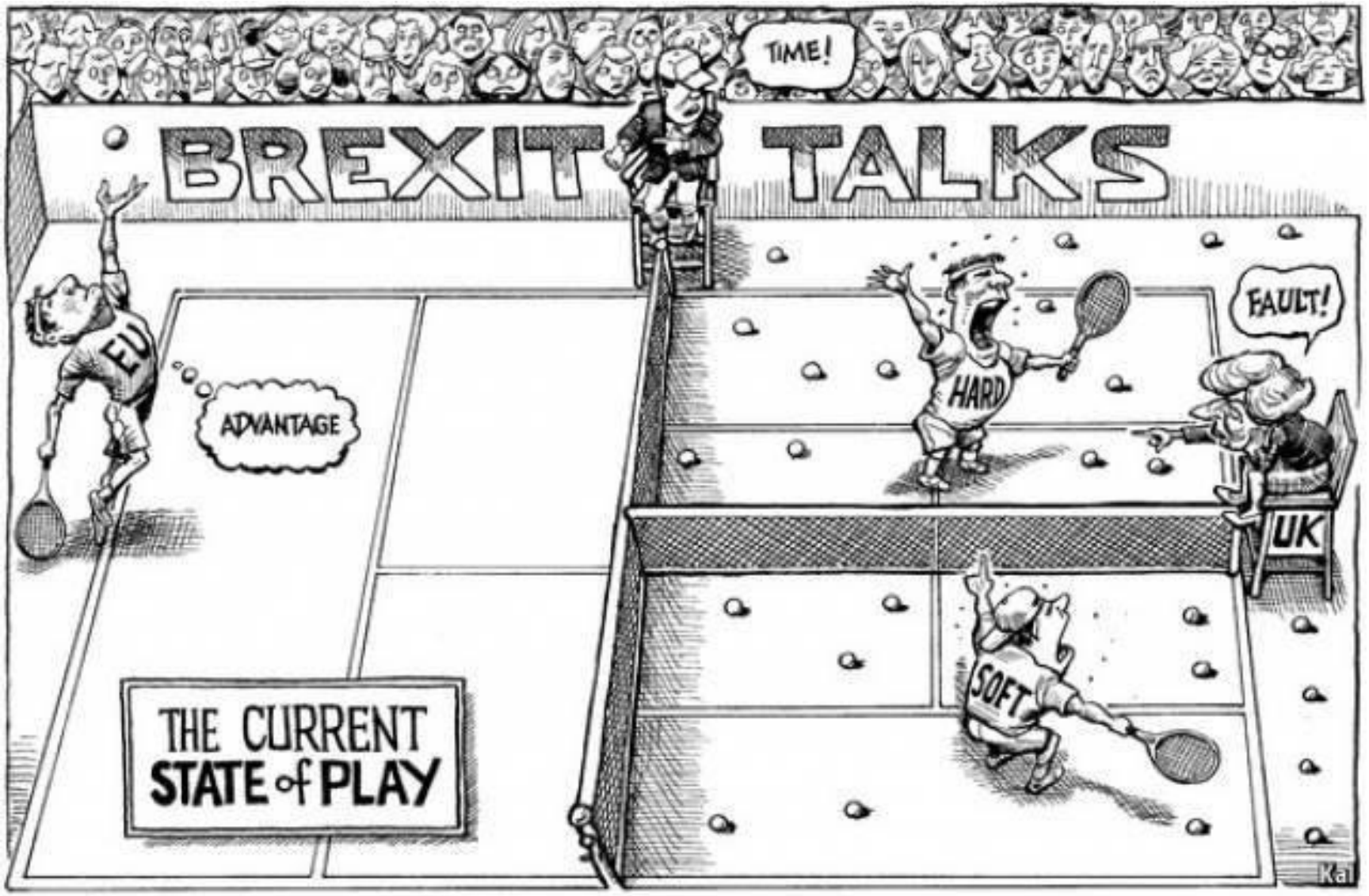
Negotiating principles: transition period

- There should be **no "cherry picking":** The UK will continue to participate in the Customs Union and the Single Market. The Union acquis should continue to apply in full to and in the UK.

- Any changes made to the acquis during this time should automatically apply to the UK. All existing EU regulatory, budgetary, supervisory, judiciary and enforcement instruments and structures will apply, including the **competence of the ECJ**.

- The UK will be a third country as of 30 March 2019. As a result, it will **no longer be represented in EU institutions**, agencies, bodies and offices. The transition period needs to be clearly defined and precisely limited in time. The Commission recommends that it should not last beyond **31 December 2020**.

Brexit talks: playing a different game



Economist.com

A tight schedule

- Withdrawal agreement: A breakthrough at the **22-23 March European Council?**
- **End of 2018:** Withdrawal Agreement in its final form.
- **Early 2019:** Ratification of Withdrawal Agreement by member states.
- **Early 2019:** vote on Withdrawal Agreement in UK Parliament: Yes/No.
- **By 29 March 2019:** Brexit (unless extended).

Would an association agreement be acceptable?

- Risk of **reduced trade flows**, if trade agreements were to change substantially, and thus lower productivity and economic growth.
- EU manufacturing would still have unlimited access to the UK market courtesy of **WTO rules**, but the UK would have to **negotiate access to the single market for its services industries (mainly regulations)**.
- Association agreements (Norway): (1) all EU single market standards and regulations are effectively accepted **without any host-country input in the decision making process**, (2) all relevant pieces of EU legislation are **converted into domestic legislation** without consultation with domestic voters, (3) UK would continue to contribute to the **EU budget**. Would that be acceptable?
- **Canada+++**?

Assessing the current situation

- **Transitional/Final arrangements:** Delivering a smooth exit from the EU requires transitional arrangements and lengthy legislative activity in the UK. Final trade arrangements with the EU still unclear.
- **UK government in disarray:** Doublethink (act of simultaneously accepting two mutually contradictory beliefs as correct).
- **Risks:** (1) no deal (WTO) and disorderly exit, (2) approval in Parliament, (3) EU Parliament approval and ratification by member states, (4) Tory blow-up, (5) cliff-edge drop in confidence.

Transition: benefits without governance

- According to the European Council guidelines (12 December 2017) and negotiating directives, the requirements are:
- **Transition arrangements** UK applies all **EU acquis** and keeps participating in the Single Market, for a limited period.
- **EU law continues** to apply.
- UK no longer part of the **EU institutions and bodies.**

The level playing field concept

- EU27 interest to shape negotiating position, taking into account the UK's unique **"proximity/market size"** mix, but no give up **principles**.
- EU's strong negotiating position: for the UK, import dependency on EU amounts to **7.7% of total supply chain**, while it is only 1.0% for the EU.
- Three pillars: 1.**Substantive provisions**, 2. **Enforcement mechanism**, 3. **Dispute settlement system**.

Substantive provisions: no race to the bottom

- Robust **State Aid** provisions, anchored in EU and international law.
- **Taxation**: UK no longer bound by acquis communautaire on taxation, EU law-based rights, obligations and benefits cease.
- **Taxation risks**: Targeted UK tax measures to attract investment and business. Principle of non-lowering of existing standards, but limited legal/political restrictions to prevent this.
- **Environment & Labour**: Avoid risk that the UK reduces labour and social protection. Avoid a ‘race to the bottom’. Non regression clause (Japan’s FTA). Joint commitment to high level of protection.

Enforcement & dispute settlement

- Long-term engagement: **incentives and systematic dialogue**.
- **Logic of reciprocity**. Need for consistent information and data. Access to information, public participation in decision-making.
- Commitment to **transparency and monitoring** based on EU and international standards.
- A possible tailor-made agreement?

… are the EU and the UK on the same page?

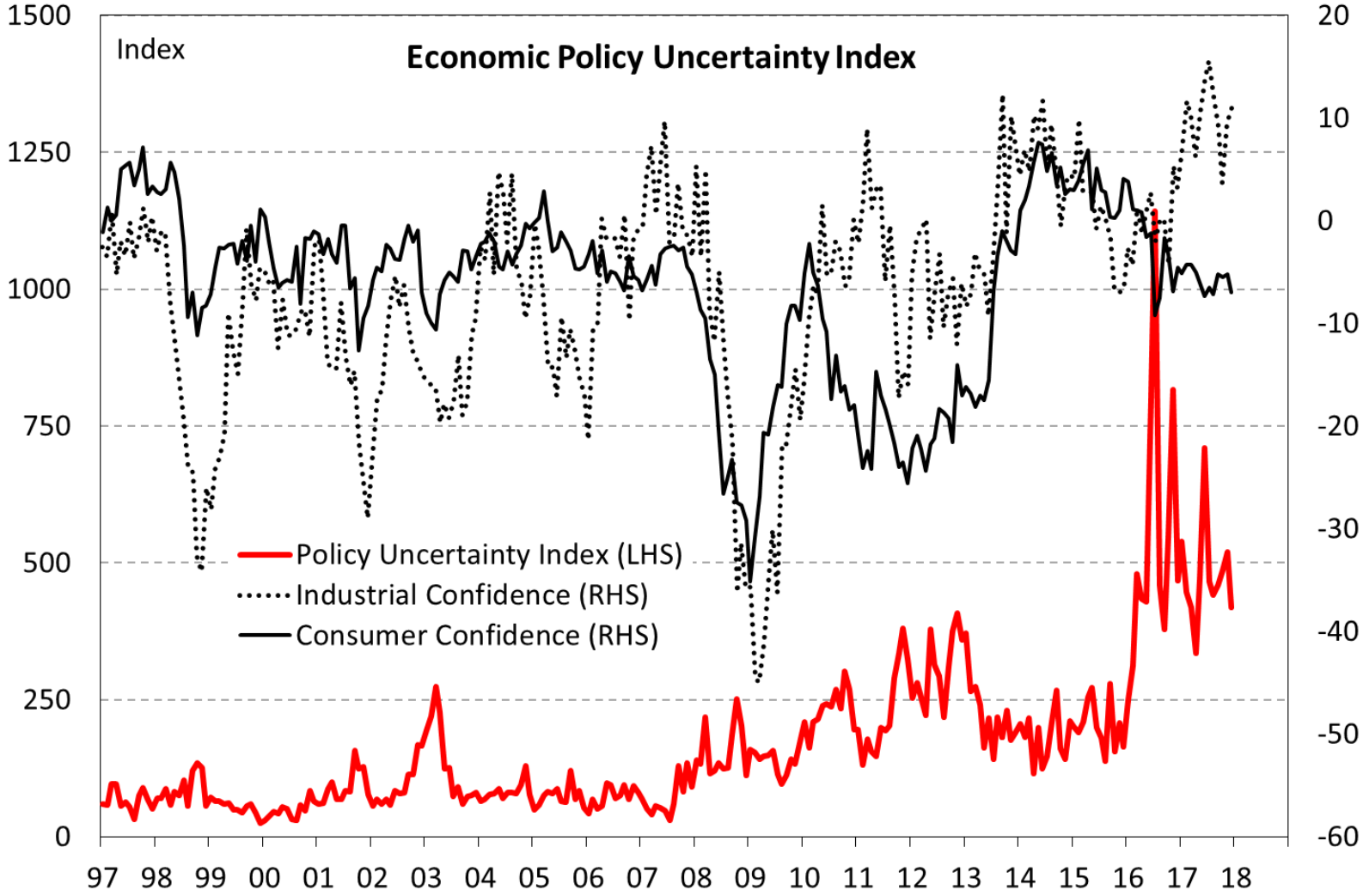
Business migration?

- **Uncertainly also for the EU:** Huge no confidence vote on the future of the EU. Would the EU really attract businesses from the UK?
- **Financial industry:** Some businesses will inevitably go (for financial stability), but London attractiveness as a European or global centre is unlikely to change. Skills and knowledge would remain in the UK. Search for a 'EU financial passport'?
- **But there are risks:** Markets moving to Dublin? Frankfurt? Paris? Luxembourg? Amsterdam? New York? Not the opposite of what happened for monetary union. The devil is in the details of regulation.

Flexible and resilient, but also somewhat fragile

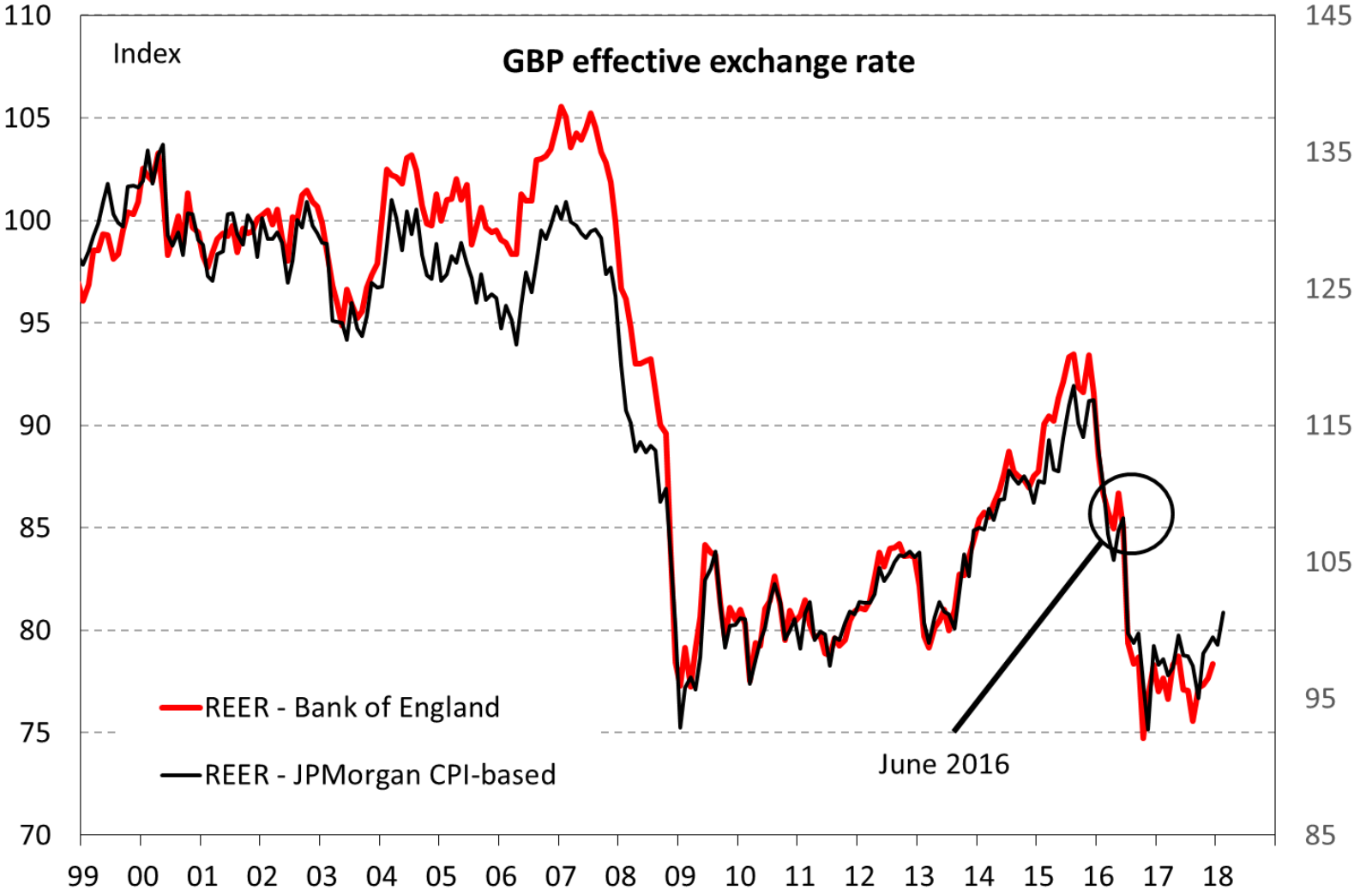
- **GDP** has slowed vs Eurozone.
- Valuations of UK-oriented firms in the UK stock market is about 20-25% lower. The **stock market** has overall underperformed.
- **Net migration** has been falling, especially that of Non-EU citizens.
- **Labour productivity** is at a standstill. Huge geographical divisions, with London outpacing the rest of the country.
- **Unemployment rate** is a record lows and more diversified job creation.
- Reduced real disposable income: Household tend to smooth their consumption through **lower net saving ratio**.

Uncertainty is a time-bomb killer



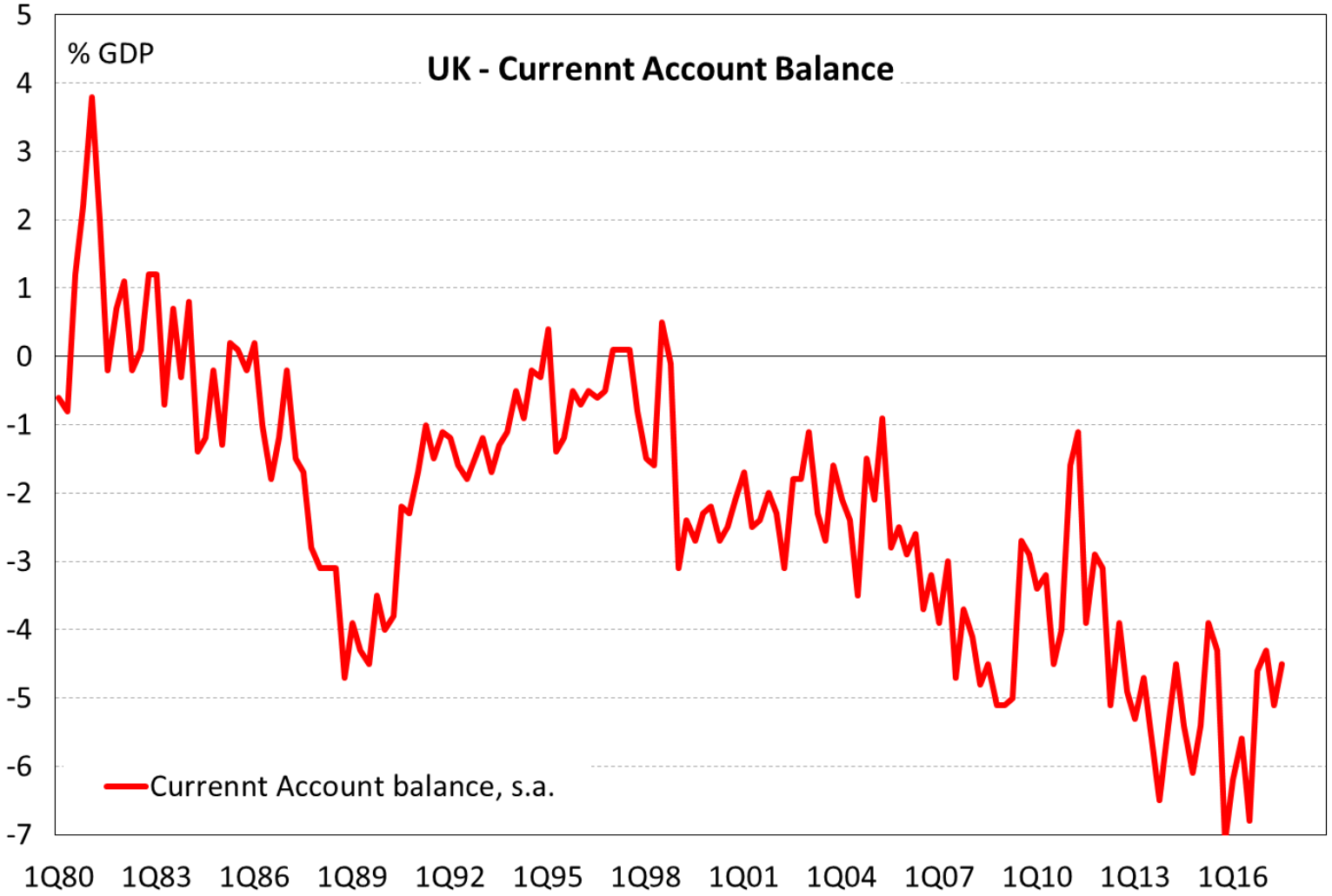
Source: "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

Can the exchange rate be a buffer?



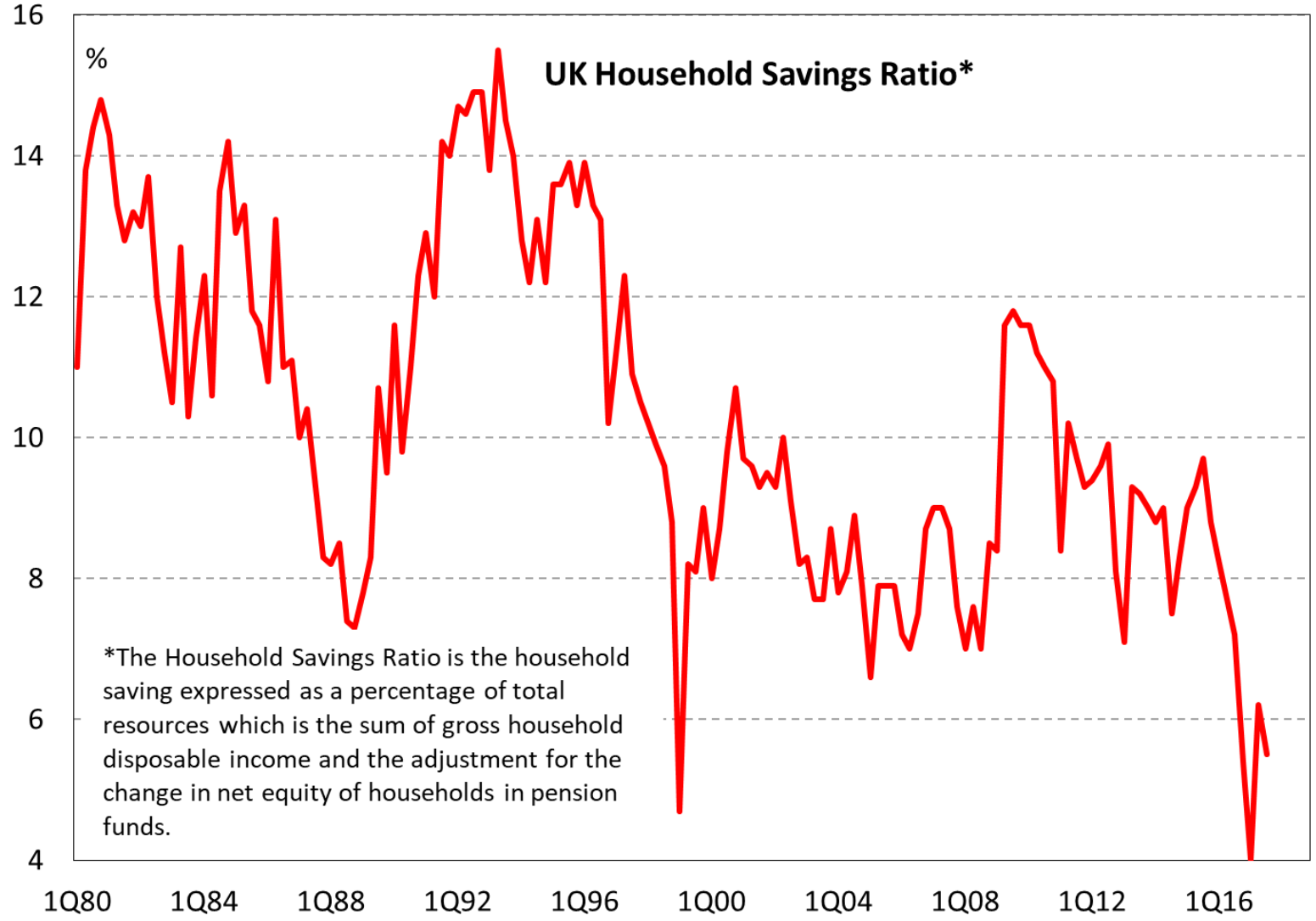
Source: Datastream Thomson Reuters, Bank of England, LC-MA calculations.

The UK external position remains vulnerable



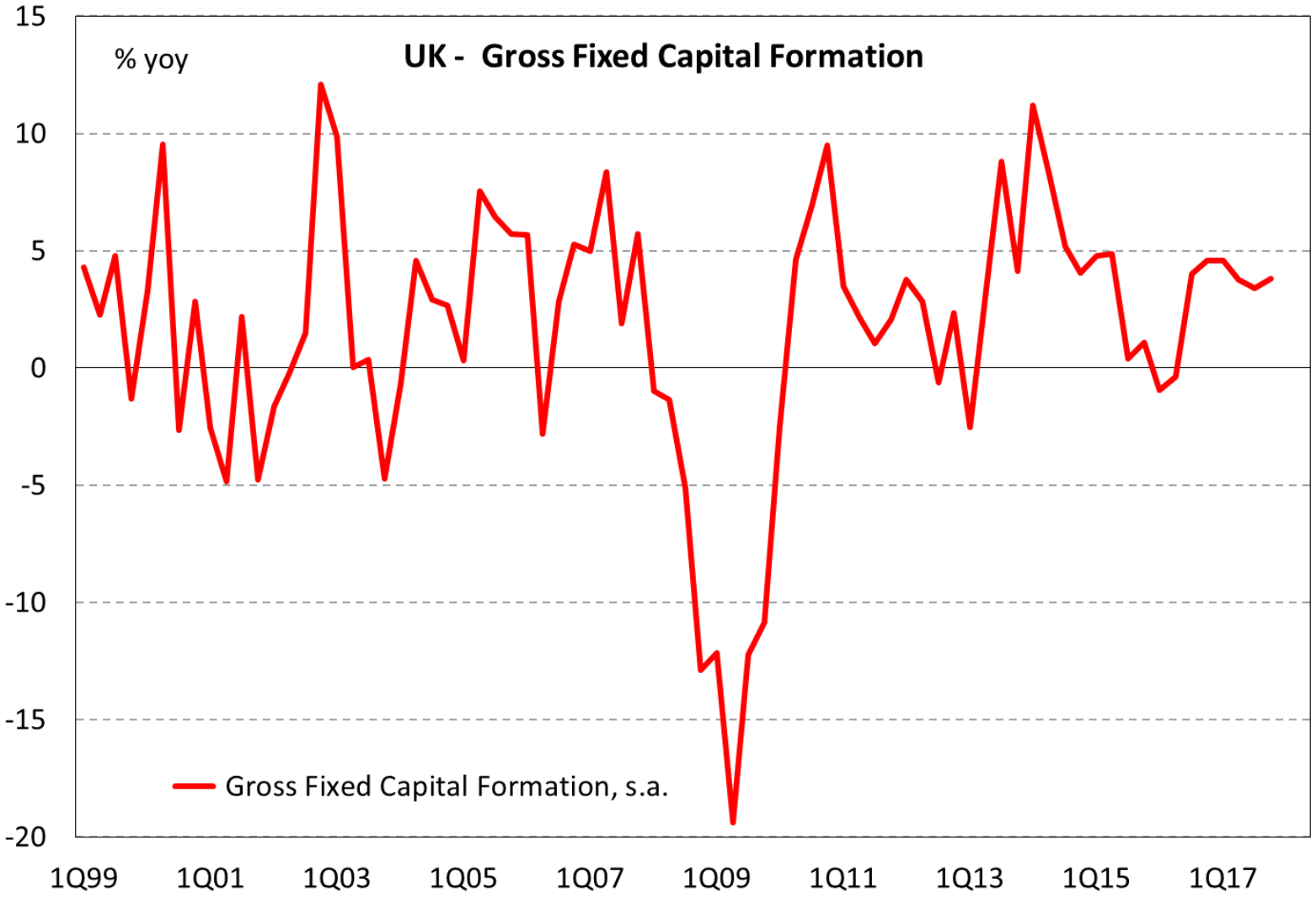
Source: ONS, Thomson Reuters Datastream

UK propensity to save at historical lows



Source: ONS, Thomson Reuters Datastream, LC-MA calculations.

Investment activity risks declining



Source: ONS, Thomson Reuters Datastream, LC-MA own calculations

The three basket approach: “managed divergence”

- First, one that represents all those industries, such as aerospace and automotive, that ministers believe might **wish to preserve full alignment with EU rules**.
- Second, a basket in which ministers will seek **an agreement with the bloc on shared goals**, possibly affecting consumer rights, animal welfare and environmental protection, but where those goals will be reached by different means.
- And finally, one that covers those sectors that the government wants to **distance sharply from EU regulation**, such as fisheries or agriculture. This, we are now informed, is part of a strategy of “managed divergence”.

Everyone thinks they got what they wanted