

ECO FLASH

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Brexit, phase 2

Catherine Stephan

- The European Council found that Brexit talks between the UK and the European Commission had advanced sufficiently to launch a new phase of negotiations.
- The definitive withdrawal agreement must include the terms for the transition period as well as a policy statement defining the framework for the future trade relationship between the UK and the EU.
- The EU wants a framework similar to its trade agreement with Canada, which reflects the UK's desire to leave the Single Market.
- The UK wants a trade agreement that includes the services sector.

At the summit meeting of 14-15 December 2017, the European Council¹ esteemed that Brexit talks between the UK and the European Commission had advanced sufficiently to launch a new phase of negotiations on the transition period and the future relationship between the UK and the EU.

In the first phase of negotiations that began on 17 June 2017, the UK and the European Commission managed to reach an agreement on three key issues for the Europeans: 1) the rights of EU citizens residing in the UK and UK citizens living in the EU, 2) the unique circumstances of Northern Ireland, and 3) the financial settlement.

Phase 1: a minimal agreement on withdrawal terms

Protection of EU and UK citizens

On 8 December 2017, negotiators for the European Commission and the UK government issued a joint report recalling the UK's commitment to ensure that European legislation would be respected for EU citizens, and their family members, residing legally in the UK before the withdrawal

¹ The European Council comprises the heads of state and government of the EU.

date from the EU, or before the end of the transition period, which should continue to see the free movement of persons. They will be entitled to benefit from healthcare, pensions and other social security benefits. British expats residing in the EU will enjoy the same prerogatives. The joint report also stipulates that administrative procedures must be simple and not very costly for EU citizens residing in the UK.

UK legislation must be modified accordingly. In particular, it must integrate the rights of European citizens by making direct reference to the withdrawal agreement. UK courts of law must take into account the jurisprudence of the EU Court of Justice (CJEU) after the UK's withdrawal date from the EU, and for a period of eight years after the section on protecting citizens' rights has taken effect. It must also take into account pertinent CJEU rulings after the withdrawal date or through the end of the transition period. The agreement also allows for the UK government and the European Commission to appear before the CJEU and the UK courts of law when necessary.

Maintaining cooperation between the Republic of Ireland and Northern Ireland

Ireland was the subject of fierce debate during the first phase of negotiations on the terms of the UK's withdrawal from the EU. The Prime Minister, Theresa May, had to address the concerns of the DUP unionists (Democratic Unionist Party), to whom she owes her slim majority, thanks to their 10 seats in the House of Commons.

The Northern Ireland Peace Agreement of 10 April 1998, also known as the Good Friday or Belfast Agreement, is the keystone to any agreement between the UK and the EU, but compliance creates a source of ambiguity.

The UK considers Northern Ireland to be an integral part of the country, and in this respect it is committed to let no new regulatory obstacles arise between Northern Ireland and the UK. The UK will continue to ensure that companies from

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Northern Ireland will have free and unconditional access to all of the UK's internal market.

At the same time, the UK is also committed to avoiding a hard border, including any physical infrastructure or checks and controls, between the Republic of Ireland and Northern Ireland. The UK is committed to respecting Ireland's integration within the European Internal Market and Customs Union, and to preserve Northern Ireland's participation in its internal market. In the absence of an EU-UK trade agreement, the UK is committed to the alignment of its rules to those of the European Internal Market and Customs Union². North-South trade would be disrupted if UK regulations differed significantly from that of the EU, and thus the Republic of Ireland. Similarly, it is necessary to preserve the Common Travel Area (CTA) between the UK, Ireland, the Isle of Man and the Channel Islands, which reduces border controls for UK and Irish citizens. The effects of this agreement in principle, which prevails over any future trade agreement that might be concluded between the UK and the EU, remain ambiguous. This ambivalence has caught the attention of the other UK regions. The UK's intention to facilitate cooperation between the north and south, and thus with the EU, has attracted the attention of Scotland and London, which would like to benefit from the same prerogatives as Northern Ireland.

Understanding on the financial settlement

After tense discussions, the UK and the European Commission finally managed to settle their dispute over the financial settlement. They made a list of its components, determined the principles for calculating its value, and defined the payment terms. They also agreed on the arrangements for the UK's continued participation in the programmes of the EU's 2014-2020 Multiannual Financial Framework until their closure, as well as in several European funds. As a result, the UK will continue to contribute and participate in the European budget through 2020. The UK will also have to contribute its share of the financing of EU budgetary commitments outstanding, called "*Reste à liquider*" or RAL. The UK must also provide the European Investment Bank (EIB) a guarantee for an amount equal to its callable capital at the time of its withdrawal. This guarantee will be decreased in line with the amortisation of the stock of EIB operations.

According to this methodology, the UK will have to pay between EUR 40 billion and 60 billion. Yet no official figures have been released. The calendar and exact amount of the payments will not be determined until the moment when the UK effectively withdraws from the EU.

Phase 2: negotiations on the future relationship promise to be very tough

The UK and the EU managed to reach an agreement on other issues such as police and judicial cooperation, European cooperation on the civil nuclear programme Euratom, and the free movement of goods placed on the market before the withdrawal date.

Yet the UK and the European Commission must still provide details and translate their respective commitments into legal

terms before a definitive withdrawal agreement can be reached. This should also include the terms of the transition phase and should be joined by a policy statement defining the contours of the future trade relationship between the UK and the EU. All of these issues will be covered in the second phase of negotiations.

A transition phase of nearly two years

The EU and the UK seem to have agreed that the transition phase would last nearly two years, starting on 29 March 2019. Yet some of the EU's demands have raised some objections from the British. During the transition phase, the EU wants the UK to continue respecting European law and the jurisdiction of the CJEU, but without being allowed to participate in the decision-making of the EU's institutions, bodies and organisations. The UK must also automatically apply any modifications to benefits. The UK would continue to participate in the Internal Market and Customs Union, and would have to respect the indivisibility of the Single Market's four freedoms: the free movement of goods, services, capital and persons. It would also have to comply with the EU's trade policy.

Dissension over the contours of the future UK-EU trade relationship

In March 2018, the European Council is to adopt its guidelines on the future trade relationship with the UK. During the second phase of negotiations, the UK and the EU will only be able to define the broad principles of a trade agreement. The details of the agreement can only be ironed out and signed once the UK has officially withdrawn from the EU.

Yet the process of simply defining a framework is bound to require tough negotiations. The European Commission and the UK government have expressed conflicting points of view. The EU wants the framework to be similar to the trade agreements that the EU concluded with Canada and Japan, given the UK's intention to withdraw from the Customs Union and the Single Market.

A trade agreement similar to the EU-Canada Comprehensive Economic and Trade Agreement (CETA), which provisionally took effect on 21 September 2017, might meet some of the UK's expectations. It does not include the free movement of persons, unlike the EFTA/EEA³, and it ultimately calls for the elimination of virtually all customs duties on industrial products, the elimination of numerous non-trade barriers, and the mutual recognition of conformity assessment certificates in a number of fields. Moreover, an agreement similar to CETA would facilitate the temporary entry of certain types of skilled workers to the UK and the EU. This agreement would also guarantee greater deregulation of the services market.

Yet the UK is more ambitious. It wants a trade agreement that would do more for the services sector. CETA only makes a limited contribution to this sector. Such an agreement would not provide UK financial services with access to the European passport, which means they would not be able to market their

² Northern Ireland negotiated a regulatory alignment rather than the lack of regulatory divergence, which would have required recognising the rules of the European Internal Market.

³ The European Economic Area (EEA) comprises the EU member states and three of the four members of the European Free Trade Association (EFTA), namely Iceland, Norway and Liechtenstein. EFTA encompasses Iceland, Norway, Switzerland and Liechtenstein.

products throughout the EU⁴. Yet the services sector is vital for the UK. It accounted for nearly 40% of UK exports to the EU during the first three quarters of 2017. It is also the only line on the current account that generates a surplus, thanks mainly to financial services (see chart).

The negotiations promise to be tough, especially since the UK and the EU must reach a definitive withdrawal agreement by October 2018 in order to give the Council of the European Union as well as MPs from the European and UK parliaments' time to approve it. They will also have very little time to negotiate a trade agreement. The transition phase is slated to end on 31 December 2020, the closure date of the 2014-2020 multiannual budget. European elections in 2019 also risk disrupting negotiations.

It might be possible to negotiate a trade agreement much more quickly than usual for this kind of partnership. For years now, the UK has already been trading freely with the EU, and it has already integrated European legislation. Yet negotiating a future trade relationship in the span of only two years will be a very difficult task, given the lead time that is generally necessary to conclude such agreements. A CETA-like trade agreement would first have to be approved by the national parliaments. This is necessary for mixed agreements, which include measures other than specific trade measures, such as the Investment Court System (ICS), which is designed to resolve disputes between States and investors. Ratification of an exclusively trade-related agreement would "only" require the approval of the EU Council and the European Parliament, which have exclusive powers over this area within the EU. It is thus likely that ratification of an EU-UK agreement similar to CETA would also have to be approved by the member states, further extending the time necessary to complete such an agreement.

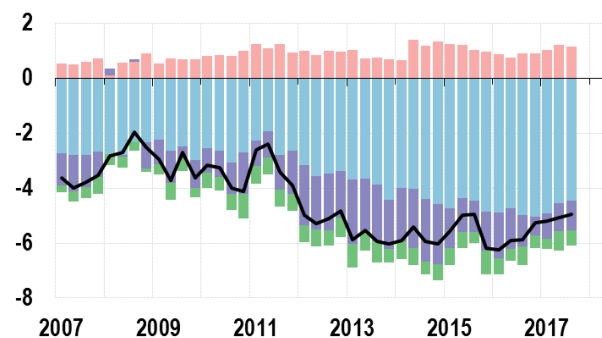
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■ Balance of trade surplus for services between the UK and the EU

Current account balance – Trade between the UK and the rest of the EU, % of GDP

■ Goods ■ Services ■ Primary revenue ■ Secondary revenue
— Current account balance



Chart

Source: ONS

⁴ The European passport, also called the "single authorisation", authorises banks, payment institutions, electronic payment systems and investment and insurance companies in the European Economic Area (EEA) to market their products and services, and for financial companies to freely set up business anywhere in the EEA once they have obtained authorisation from the relevant authorities in their home country.

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