

## Focal Point

# Brexit: Painful negotiations with a modest result ahead

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- The UK deliberately missed the end-June deadline to seek an extension of the Brexit transition period. Thus, by the end of this year at least a rudimentary agreement will be necessary or trade will fall back to WTO rules.
- Both sides agreed to intensify stuck talks. The stalemate is due to opposing underlying views: While the UK sees its Brexit dividend in breaking free from EU rules, the EU fears that the UK will undercut its regulations to get a competitive advantage. The implementation of the Northern Ireland backstop could also further complicate talks.
- We see a (weak) compromise still more likely than not as a hard Brexit shortly after the Corona crisis would be detrimental to both parties, and most so to the UK. However, both sides need to substantially move which is by no means guaranteed.
- Chief EU negotiator Barnier issued a deadline for a deal by end-October in order to get it ratified by year-end. PM Johnson is pushing for much progress to be done in July, but we see the “hot” phase to truly start after the summer break in August, creating additional uncertainty for markets.

In a recent high level meeting, PM Johnson notified the EU that the UK will not ask for an extension of the Brexit transition period. In accordance, he opted to forego the end of June deadline. This decision does not come as a surprise. Legally, the final exit by end-2020 had already been incorporated in the UK Brexit legislation. Politically, leaving the EU has become the UK Conservative Party’s defining narrative. Accordingly, PM Johnson repeatedly voiced this position before. Even the Covid-19 crisis could not change his approach.

**How much time is left?** Thus, the transition period will – most likely<sup>1</sup> – end on December 31, 2020. This is just eleven months after the UK’s formal exit on January 31, i.e. ten months behind the originally envisaged time frame. De facto, the time left is even more limited. EU chief negotiator Barnier sees the end of October 2020 as a deadline in order to enable all EU members to ratify the deal. In case the agreement involves areas like security, energy and transport it will be a “mixed agreement” and national (plus possibly some regional) parliaments will need to give their consents. Otherwise, the EU will have the “exclusive competence” and only the EU Commission needs to sign and the EU Parliament to ratify the agreement. Compared to what is typically needed for a trade deal, time is extremely scarce. The EU-Canada CETA agreement, which

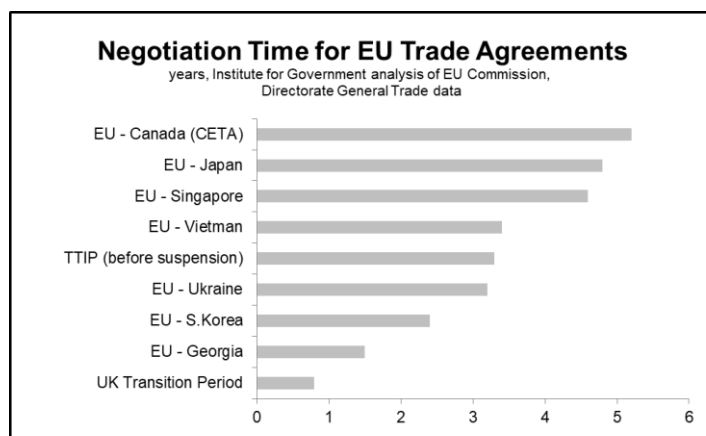
<sup>1</sup> There is still speculation that the exit could be postponed if necessary, relying on the following arguments: Current UK legislation could be changed by a simple law. Second, both parties could agree on lengthening the deadline by a fresh agreement, although such a move could face substantial legal hurdles. Third, a political U-turn by Boris Johnson cannot be fully excluded. Negotiations cannot rely on any of these scenarios.

### EU-UK timeline

Jan 31, 2020	UK exits EU and transition period begins
June 4	4th round of EU-UK negotiations without result
June 15	EU-UK high level video meeting (Johnson, von der Leyen, Michel, Sassoli)
June 18-19	EU Summit (recovery fund)
end-June	Start of intensified EU-UK talks
June 30	Deadline for extension of transition period (dropped) Deadline to concluding agreement on financial services and fisheries
Oct 15-16	EU Summit
end-Oct	EU deadline for trade agreement (in order to have it ratified by year-end)
Dec 10-11	EU Summit
Dec 31	End of transition period (unless extended)

the UK often cites as a blue-print, took eight years. Moreover, other factors also play a role. The Covid-19 outbreak has put the post-Brexit agreement on a backseat. At the EU level, the recovery fund will absorb the highest attention as it might be an important step into deepening the EU fiscal integration. In addition, the fund is meant to be incorporated into the EU’s 2021-2027 budget which typically requires lengthy talks and difficult compromises anyway.

**Why are negotiations stuck?** In stark contrast to the urgency of making steps forward, negotiations were stuck even after four rounds of meetings in H1. The underlying reason is mutually incompatible aims: The UK’s primary objective is to restore independence from the EU, politically and economically. Accordingly, the UK is not prepared to accept constraints on its ability to diverge from EU rules.



Breaking free from EU rules is also a prerequisite to garner trade agreements with third parties, which had been advertised as a key advantage by the Brexit campaign. At the same time, the UK aims at an as much unrestricted access to the Single Market as possible, while the EU offers such access only under special conditions (see below). The EU fears that the UK could unilaterally change its standards to gain an unfair competitive advantage. On top, it could serve third parties (according to their future FTAs, notably with the US) as a trade platform to enter the EU market.

Against this background of incompatible views, EU chief negotiator Michel Barnier summarized talks in early June as: **“the truth is that there was no substantial progress”**. A high level video meeting on June 15 (PM Johnson, EC President von der Leyen, Council President Michel and EP President Sassoli) intended to give negotiations fresh momentum by intensifying talks. However, we see PM Johnsons claim that an agreement by the end of July would be possible as overly optimistic. In fact, we expect the „hot phase“ to start only after the summer break in August.

**Comprehensive agreement vs patchwork of deals?** So far, both sides stuck to their negotiation platforms. The UK aims at a **“comprehensive free trade agreement”** like with Canada, Japan or South Korea. These agreements largely remove tariffs without requiring strong alignment with EU rules. The trade deal should not only cover goods but also minimize barriers to services. Beyond trade, the UK proposes separate agreements on e.g. fisheries, security, aviation or nuclear cooperation. It also insists on developing independent policies on immigration, competition, the environment, social policy and data protection. The UK wants to be treated **“appropriate to a relationship of sovereign equals”** regarding governance and dispute settlement and rejects EU **“supervision”** in a post Brexit deal.

What is the EU willing to agree? Brussels offers the UK full access to the EU single market but only under conditions.

EU-UK Trade Implications Compared					
	Trade in Goods	Trade in Services	Financial Services	Regulatory Standards	Level Playing Field
EU Member	full	full	full	full	full
Canada Plus Plus	full	substantial	substantial	strong cooperation	strong cooperation
Canada (CETA)	full	limited	very limited	limited to trade items	loose
WTO	tariffs	no/tariffs	no	no	no

Adopted from Capital Economics

As EC President von der Leyen put it, zero tariffs and quotas against zero dumping. Reaching a level playing field is a cornerstone of the EU negotiation mandate. It had already been enshrined within the non-binding political declaration on the future relationship, signed by the UK government. The guidelines also call for **“robust”** guarantees. Beyond narrow trade, the EU wants as close as possible a partnership including fisheries, law enforcement and criminal justice, foreign policy, security and defence. A new governing body should oversee the full partnership which the UK rejects. The EU wants a single all-encompassing agreement instead of a series sector deals. <sup>2,3</sup>

**Possible ways to overcome the main obstacles:** As the platforms suggest, both parties differ on a long list of issues. These are the most important ones. <sup>4</sup>

**Level playing field:** A level playing field and regulatory alignment are closely intertwined. As the UK currently has the same standards as the EU, London could either cut back on current standards or fall back on future tighter EU regulations. This regards a broad range of issues like social and employment matters, state aid, competition, environment, climate change, and relevant tax matters. Accordingly, possible solutions differ:

a) Environmental and social standards: Michael Gove has suggested that the UK might accept a non-regression clause. This would be a commitment not to reduce the levels of protection after exit, but not extend them to future tighter rules. The EU accepted such an approach in other cases before. Taking them as a blueprint, it could serve as a line of compromise in a range of environmental and social topics, but not regarding competition policy.

b) State aid: Regarding subsidies, Brussels wants EU law to continue to apply also in the future (so called **“dynamic alignment”**). State aid is in the heart of the EU’s competition policy. After Brexit, the EU proposes that enforcement would lie with an independent British authority. This body should nevertheless work closely with the EU Commission. Disputes would be cleared via an independent arbitration panel. But as it would be ultimately EU law, the European Court of Justice’s (ECJ) jurisdiction on these matters would be binding. The UK declared the latter unacceptable. An EU-UK compromise could instead focus on the effectiveness of the UK’s state aid regime. Instead of relying on the same rules, the attention would shift to comparable outcomes but via different means. Disputes could still be settled via arbitration. In case of a breach, the EU would retain the right to re-impose tariffs as enforcement mechanism. However, UK chief negotiator David Frost rejected this route recently.

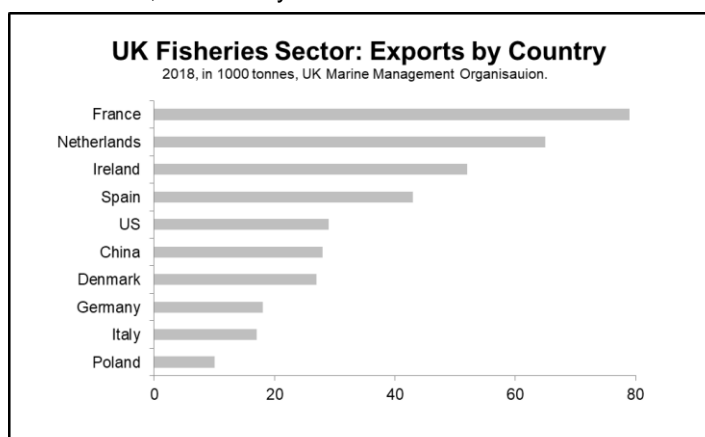
<sup>2</sup>In the political declaration it is stated: *“Given the Union and the United Kingdom’s geographic proximity and economic interdependence, the future relationship must ensure open and fair competition.”* Against this background, the EU accuses the UK to backtrack on previous commitments. However, the political declaration was non-binding.

<sup>3</sup>We limit ourselves to the economic aspects, but the **EU mandate** is much wider. It encompasses a *“new partnership between the Union, and Euratom where relevant, and the United Kingdom that is comprehensive and covers the areas of interest outlined in the Political Declaration: trade and economic cooperation, law enforcement and judicial cooperation in criminal matters, foreign policy, security and defense and thematic areas of cooperation.”*

<sup>4</sup>We do not discuss here issues like rules of origin, preferential treatment, audio-visual services, government procurement, transport, data protection, recognition of professional qualification which all have made to the press as addition areas of disagreement.

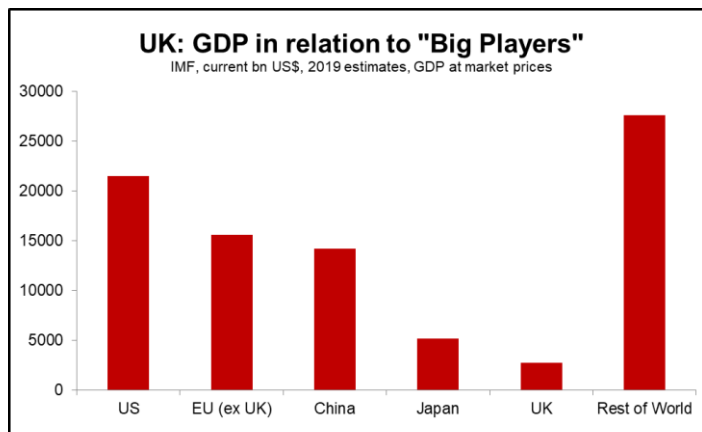
**Dispute mechanism:** The dispute mechanism is another key sticking point in Brexit talks. The EU wants the different fields of cooperation (trade, social security, justice, aviation, ...) to be governed in a unified framework. This would also host the dispute settlement process and include provisions for political dialogue and the evolution of the agreements over time. By contrast, the UK prefers distinct agreements, keeping policy fields separately. The UK fears that a breach of the deal in one area could allow retaliating within another field. By contrast, the EU sees cross retaliation as stabilizing the whole agreement. A possible compromise could lie in tying only those topics together that have an inherent connection.

**Fisheries:** The economic relevance of the fishery sector is small (e.g. 0.12% to total UK output). This is in stark contrast to the emotionally highly charged dispute on access to fishing waters. The UK intends to get free of the EU's Common Fisheries Policy and act as an "independent coastal state". It intends a system of yearly negotiations over the total allowable catch and shares (similar to Norway). By contrast, the EU basically wants to maintain existing conditions. Within the political declaration, it was specified that both sides "will use their best endeavours to conclude and ratify their new fisheries agreement by 1 July 2020". This has already failed. Although the UK has some leverage regarding this topic, this is limited by the fact that the UK is also highly dependent on EU markets to sell its catch. Knowing this, the EU has reiterated that there will be no trade agreement without an agreement on fish. Any compromise is likely to involve some reciprocal deal in another sector, most likely in financial services.



**Financial services:** On financial services, the UK's proposal follows the CETA deal, seeking to allow the cross-border supply of financial services. Within the Single Market, this was guaranteed by the passporting rights. CETA instead relies on equivalence: Financial firms outside the EU can conduct business within the Single Market without being subject to EU regulations, provided the EU determines that the legal and regulatory system of the third country to be 'equivalent'. However, the EU can revoke its decision with 30 days' notice. Like in fisheries, the EU and UK agreed last year that they would make "best endeavours" to complete the assessments by June 30. This deadline was also missed. Without equivalence, financial firms in the UK will be cut off from the EU market. However, banks and others have already prepared by building subsidiaries within the EU while the transfer of staff seems to be lagging. Looking ahead, fisheries and financial services could well be combined to find a compromise.

**Backstop:** The EU has also been alarmed at UK comments suggesting there will be no checks between Britain and Northern Ireland. The EU feared the UK trying to wriggle out of its obligations of the Withdrawal Agreement. However since mid-May, the UK government has confirmed there will be checks on goods entering Northern Ireland from the rest of the UK, after Johnson had denied it before. However, the issue remains that these checks will not be ready and implemented by year-end. This would imply an open flank in the EU external frontier. The EU sees the UK as ill-prepared which will likely further poison the negotiations.



**Conclusions:** The EU and UK have taken steps to intensify the talks. This shows that there is political will on both sides to compromise. The political determination will prove decisive. A failure would unavoidably lead to significantly negative economic consequences (with the UK to suffer more than the EU), immediately on the heels of the Covid-19 crisis. Subsequently, voters would likely question uncompromising stances of politicians responsible for such an unfavourable outcome. Moreover, Europe would find itself further marginalised in a world increasingly dominated by the US-China clash. A compromise will certainly include a give and take, equilibrating UK's sovereignty claims vs EU fears of being undercut. On the EU side, simple safeguards (non-regression clause) will play a large role, but in core policy fields (like competition) sanction mechanisms (the right to introduce tariffs) will likely be added to ensure compliance. The EU can "give" in terms of shifting its focus from identical rules to comparable outcomes, respecting thereby the UK's aspirations for sovereignty. The EU can also step back from a unified governance approach to a more limited scope. Fisheries and financial services offer fields of a cross-sectoral compromise.

However, we do see the risk that UK's Conservative Party could largely misjudge its economic and political relevance compared to the bloc. Thus a positive result is by no means guaranteed. Currently, positioning is still dominating the political scene. This will probably change after summer with the deadline approaching. Policy will likely only move amid tightening time constraints. Unfortunately, last minute compromises will likely eat up the time for a broader agreement, allowing only a rudimentary trade deal. Other topics (e.g. security, aviation, data) will then probably be governed by current EU practices until both sides would strike a new agreement at some point in the future.

# Imprint

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