

30 November | 2018

UK-EU WITHDRAWAL AGREEMENT

ARE WE CLOSER TO THE ORDERLY DIVORCE?

MARTIN LOBOTKA, (+420) 777 027 165, MLobotka@42fs.com, Research@42fs.com

Withdrawal agreement has been agreed between UK and EU, but one that is so humiliating for UK that...

...it is stillborn, with little supporters behind the May's close ones willing to vote for it.

The 1Q19 will thus very likely be a very chaotic quarter, a terra incognita for markets and businesses.

The Brexit endgame is near. After 29 months since referendum in the UK on the membership of the European Union, time which was spent mostly on infighting among the Tories who couldn't decide whether the referendum is the blessing (as Eurosceptic European Research Group of Rees-Mogg would have you believe) or disaster sprung on a nation that has to, in the name of democracy, be delivered (as May seemed to believe), the EU and UK announced last weekend that withdrawal agreement (WA), together with the political declaration outlining the post-Brexit arrangements, have been signed [↗](#). And although the signing this last weekend was, as The Guardian put it, "*funeral masquerading as baptism*", an apt description of a deal disliked by almost everyone in UK and hence almost certain to not pass in the UK Parliament on December 11, let us waste few pages of this text going through what the WA really is about. If for nothing else than to show how "well" a lesser country contemplating the exit from the Union would do in the subsequent negotiations with the Union.

What is the withdrawal agreement?

It is a tome that runs to almost 600 pages, so you're right to assume it is not an easy read. Fortunately for non-lawyer analysts, parts can easily be skipped, being full of technical dense euro-legalese. The agreement does not cover

every aspect of the post-Brexit relationships, not by a long shot: that is for the subsequent agreement(s) to fix. WA does cover what is necessary for orderly withdrawal of UK from the European union. These include

- a) **citizens' rights** (mainly the guarantee that everyone who'll be in UK at the end of transition period can stay there for the rest of their natural life under same conditions as if UK remained in EU, and so can their relatives);
- b) **separation issues** (i.e. necessary measures to ensure smooth wind-down of applicability of current rules, for example continuing legal protection of geographical indications or rules governing the transit of goods at the end of transition period);
- c) **divorce money** (a.k.a. financial settlement or making sure UK pays what it promised to when inside EU),
- d) **governance** (for example, dispute resolution mechanism for disputes arising out of WA),
- e) **transition period** (i.e., how will things look like in the immediate future, that is in the next 2-4 years),
- f) **three Protocols** (on Ireland / Northern Ireland, on Gibraltar and on Sovereign Base Areas in Cyprus, of which, obviously, the first one is by far the most important part of the WA).

So, what happens after March 29, 2019?

About the only thing close to certainty at the moment is that UK will exit the European Union. But, *were* the WA to be approved by UK (and, but that shouldn't be a problem, by EU27 countries), **the two-year transition period** will begin. The transition period is expected to last until December 31, 2020 (Article 126) but can be

30 November | 2018

extended, by Joint Committee (Article 164) for “up to one or two years” (Article 132). But this extension can only be done once, and it must be agreed no later than July 1, 2020, i.e. some 6 months before the end of transition period. During the transition period, UK will de facto, but not de iure, be the member of the EU, with a “small” caveat: it will be a rule-taking country (a member of single market, customs union and subject to Court of Justice of the European Union, among other things) with no representation at EC, Parliament or Court of Justice, to name just the few agencies and bodies from which UK will be absent. And it will also not be participating in the meetings of the Member States.

The transition period’s sole raison d’être is to buy time to find the permanent arrangement that will fix the EU-UK relations permanently. This subsequent agreement, whatever its form (FTA, for example), will somehow have to solve the Northern Ireland border conundrum (which, as will be seen below, is now a can kicked down the road in the Protocol on Ireland) and, as many in the UK still hope, will replicate most of the benefits of EU membership without any costs associated with it.

How likely it is that the permanent arrangement will actually be found in the given timeframe?

This is almost guaranteed to **not** happen. History shows that trade negotiations are mind-bogglingly complex, involve many steps (EC says as many as 30 stages need to be gone through in an ordinary trade negotiation ↗) and take long time to actually happen (time that, at the multinational level, seems to be getting longer ↗). That is true, moreover, in circumstances when countries that negotiate display basic level of competence. Since UK signally failed in this aspect in the recent Brexit negotiations, having taken over a year to actually understand it can’t have a cake and eat it and two years to articulate its position, the

trade deal will be much harder to achieve in 4 years.

By way of example, **EU-Canada trade deal negotiating phase lasted 7 years**, and the whole thing was in making for over 20 years – and that was a deal where services didn’t play a prominent role (as they are bound to do in any UK-EU negotiations). When **Greenland** withdrew from the EU, it **took three years to negotiate the deal** – and pretty much the only thing that was being negotiated were fish ↗. Some deals don’t even make it to the final stage: deal between US and EU (TTIP) collapsed. And when they make it to the final stage, the process of ratification is complicated, as almost 40 legislatures (all national parliaments and some regional ones) have to approve it: recall how Wallonia almost killed the CETA deal with Canada this time two years ago. ↗

UK-EU negotiations are going to be at least as hard as the TTIP and CETA negotiations, and quite likely harder. Why?

First, services: these form crucial part of UK exports and financial services are the major component of this. Since WA provides only for the basic access of UK financial firms to EU on the basis of “equivalence” rather than on much firmer concept of “passporting” ↗ that UK firms will have enjoyed up until Brexit, and because of the **fear of divergence** of Britain from standards of the EU (which Brexiteers all but promise), the new arrangement that EU would be OK with will be hard to agree on.

Second, the long prior common history makes for a **lot of vested interests and red lines** that are guaranteed to poison the negotiations: this is not like starting from scratch with New Zealand. See, trade deal negotiations haven’t even started and Macron already makes it clear that totally insignificant economic industry that is aquaculture is going to be the problem ↗ and Spain says the Rock ↗ must be excluded from UK-EU talks. Things like this

30 November | 2018

that we haven't heard of for 40 years and for good part didn't even know exist will start springing up as soon as trade deal talks get underway.

Third, level playing field will be all but required by EU and all but excluded by Brexit Britain. The resulting opposite demands will be almost impossible to reconcile: while EU will worry about big economy at its doorstep undercutting EU internal market by lower standards, it will be anathema to Brexiteers, who promise the Singapore-on-Thames, to stick to the EU standards they've fought hard last decade(s) to get rid of.

What happens if there is no trade deal struck during the transition period?

This is where things get very interesting. And where tempers fly. And what the sticking point was in the WA negotiations. Seeing the competence and preparedness of the UK negotiating team (illustrated poignantly for example here ↗), the EU in the very beginning identified three areas where that progress was to be made soon was insisted on: financial settlement, citizens' right and Northern Ireland border. First two made it to the main body of WA relatively easily & relatively early, the last one was which much of last year negotiations revolved around. This is the (in-)famous "backstop" (to ensure that the hard border at the island of Ireland will not return, whatever the future) that everyone'd been talking about before the WA was agreed. And one that is now the separate Protocol in the WA.

So, provided that agreement on the future relations, whatever the form, **will not be reached before the end of transition period** or when the agreement is reached but such that the necessity of border controls between (now extra-EU) Northern Ireland and (still-in-EU) Ireland remains, **the backstop kicks in**. The backstop would be unlike any existing model of EU-third party relations, but would impose some onerous conditions on UK.

The most onerous one, and one which must make Brexiteers' blood boil over, is that the backstop will cease to apply only provided that *"European Union and UK decide jointly within the Joint Committee*

that the Protocol, in whole or in part, is no longer necessary to achieve its objectives" (Article 20, page 329 of WA). In other words, **UK cannot leave the backstop unilaterally unless EU consents**. If this does not illustrate clearly how small country (Ireland) that is inside the EU can wield much larger power than big country (UK) that is outside of EU, nothing will.

Although the Protocol tries to soften this de facto vassalage of UK by stating (Article 1, p. 306) that *"the objective of the Withdrawal Agreement is not to establish a permanent relationship between the Union and the United Kingdom"* and that *"the provisions of ... Protocol are therefore intended to apply only temporarily"*, the fact that it is almost impossible to not have a border on the island of Ireland while having, at the same time, UK that is completely sovereign (i.e., outside of single market, customs union and remit of CJEU) leads a **lot of people to feel that the "temporary backstop" will be as temporary as temporary stationing of Soviet troops after 1968 invasion** ↗... And this, to me, is a very correct assessment.

During the backstop, **EU and UK will constitute so-called single customs territory** (Article 6 of Protocol, p. 309 of WA), an arrangement that eliminates the need for tariffs and rules-of-origin checks between EU and UK (and, thus, between Northern Ireland and Ireland) for everything except fish. UK will have to align tariffs and custom rules with whatever European Union decides. This has few implications that are not to Brexiteers' liking: UK cannot strike any trade deal with any other country that would involve removal of tariffs, but whatever benefits will flow from, say, FTA entered into between EU and third party (say, non-tariff advantages) will not automatically flow to UK (as these benefits apply only to EU members).

30 November | 2018

During backstop, too, UK will have to adhere to **level playing field conditions** (on a non-regression basis, i.e. promising not to lower standards). These include the EU rules on state aid (Article 12, p. 316), agriculture and environment (Article 10, p. 316), labor and social protection (Article 4, p. 307), competition, taxation etc. All disputes arising from these areas where the dispute is about EU law concept will have the CJEU as the ultimate arbiter (where the dispute is about something else, there is a dispute settlement mechanism built in WA). CJEU remit for disputes concerning the EU law concepts is valid not only during the backstop but (obviously) also during the transition period.

Since Northern Ireland will, on top of being in the single customs union, also remain, as a rule taker, in the single market (i.e., will adhere to EU standards on goods, rules on veterinary controls, marketing, VAT, Union Customs Code etc.), what was avoided on the island of Ireland moved to the North Channel. In other words, although *“the EU and the UK have agreed to carry them in the least intrusive way possible”* **there will be checks on goods between UK and Northern Ireland (EU)**.

What did UK get in return for all of this humiliation? Well, distant possibility of striking deals that architects of Brexit think might take 50 years to show benefits ↗ (provided, of course, that these trade deals won't, at least during backstop, include tariffs...) and the elimination of free movement of labor. This was the reddest of May red lines and one that makes her say Norway option (membership of customs union and EEA, but with four freedoms intact) is not possible. Slamming the doors shut to migration was – is – clearly the driving force of the Brexit negotiations, even if November 28, 2018 Office for National Statistics data ↗ showed UK still chooses to welcome non-EU migrants with open

arms ↗ (net migration from non-EU is highest since 2004) and government silently relaxing restriction on non-EU doctors... ↗

Ok, does WA stand any chance of actually making it through the UK Parliament?

As said above, it does, but it is very low one. As of this date, by one count ↗ over 100 Tories (out of 316 in the House of Commons) stated their opposition to the above-described deal on various grounds ranging from it being not enough of to it being too much of a Brexit. The unionist Democratic Unionist Party, party that is giving the government its slim majority in the Parliament, is against any divergence between Northern Ireland and Ireland, averring that they'd vote against WA as one man. Labor party is also are against WA because it weaponized the issue to force the general elections it hopes to win while offering no alternative to WA: their six conditions for supporting WA ↗ set out back in 2017 are internally so contradictory that no Brexit deal can satisfy them. I mean, how can any deal where UK leaves the EU and “takes back control” deliver *“the exact same benefits as UK currently has as member of the Single Market and Customs Union?”* This have-cake-and-eat-it approach was what Tories, under the influence of fantasy of British greatness and uniqueness, originally came into the negotiations with, only to be disabused of that notion very quickly.

Ok, but what happens if WA does not pass?

Nobody knows. The pre-vote atmosphere is thick, with May saying the deal is the only option on table and Tusk doubling down saying that that there will be no negotiation even if Article 50 is extended ↗. In other words, no deal (=hard Brexit) or no Brexit at all. But this is surely just the pre-election posturing, pre-election arm-twisting to force the recalcitrant MPs to swallow the WA. If they don't, as seems to be certain, all bets are off and nobody in the whole world knows which of the myriad of scenarios will happen then. There can be amendments to the May's deal that may change the deal itself, there can be vote of no confidence triggered by Tories, there can be

30 November | 2018

general election, there can be second referendum, there can be cancellation of Brexit, there can be re-vote on May deal akin to re-vote on Emergency Economic Stabilization Act of 2008 ↗ (with pound fall being the abyss MPs will stare into instead of DJIA plunge 2008 Congressmen stared into) etc. **One thing is known, though: if May deal's fail, it will hell-of-a-ride, in markets, society, coffeehouses, Parliament and pubs, in the 1st quarter of 2019.** Brace yourself.

30 November | 2018

DISCLAIMER

This publication has been prepared by 42 Financial Services Czech Republic (further referred to as '42 Financial Services' only). This report is for information purposes only.

Publications in the United Kingdom are available only to investment professionals, not private customers, as defined by the rules of the Financial Services Authority. Individuals who do not have professional experience in matters relating to investments should not rely on it.

The information contained herein has been obtained from public sources believed by 42 Financial Services to be reliable, but which may not have been independently justified. No guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose.

This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument or any other action and will not form the basis or a part of any contract.

Neither 42 Financial Services nor any of its affiliates, its respective directors, officers or employers accepts any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of this document or its contents or otherwise arising in connection therewith. Any opinion, estimate or projection expressed in this publication reflects the current judgment of the author(s) on the date of this report. They do not necessarily reflect the opinions of 42 Financial Services and are subject to change without notice. 42 Financial Services has no obligation to update, modify or amend this report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate.

The past performance of financial instruments is not indicative of future results. No assurance can be given that any financial instrument or issuer described herein would yield favorable investment results.

42 Financial Services, its affiliates, principals or employees may have a long or short position or may transact in the financial instrument(s) referred to herein or may trade in such financial instruments with other customers on a principal basis. 42 Financial Services may act as a market maker in the financial instruments or companies discussed herein and may also perform or seek to perform investment banking services for those companies. 42 Financial Services may act upon or use the information or conclusion contained in this report before it is distributed to other persons.

This report is subject to the copyright of 42 Financial Services. No part of this publication may be copied or redistributed to persons or firms other than the authorized recipient without the prior written consent of 42 Financial Services.

By accepting this report, a recipient hereof agrees to be bound by the foregoing limitations.

Copyright: 42 Financial Services Czech Republic, 2018.

All rights reserved.