Road to Brexit

The Customs Union Puzzle and U.K. Economy

DECISIONPOINT™ by WNS

ROAD TO BREXIT: THE CUSTOMS UNION PUZZLE AND U.K. ECONOMY

The Brexit process has seen several twists and turns since we came out with our Brexit series. The European Union (EU) and the United Kingdom (U.K.) were finally able to reach a crucial transition agreement since Brexit talks began, bringing a much-needed sense of relief to both the negotiating parties. However, vital details of the final agreement, such as the Irish border, mutual consensus on the final shape of the customs union arrangement and convincing a deeply divided U.K. cabinet are some of the grueling challenges facing the Brexit settlement process. With less than a year to go for U.K.'s exit from the EU, we assess the hurdles on the way as the Brexit dialogue enters its final stages and study the Brexit impact on the larger U.K. economy.

THE TRANSITION DEAL

Britain secured the economic reward of a 21-month Brexit transition on March 19, 2018, offering the EU concessions over sovereignty in exchange for stronger assurances that a cliff edge Brexit will be avoided in 2019.[1] The extension in effect of Britain's participation in the single market and customs union until December 31, 2020 provides companies with an extra 21 months to prepare for the final exit from the EU. It also gives governments time to plan for Brexit-related changes to Britain's customs, immigration and regulatory systems. The agreement was especially vital for businesses in order for them to avoid taking immediate investment decisions for a possible hard exit on March 29, 2019.[2]

What Guarantees does the Deal Provide?

In practical terms, the deal means that the rights of citizens and businesses remain largely untouched between Brexit day and the end of 2020. The free flow of goods, capital, services and people would continue under EU law.[3] The deal also provides accuracy on how transition will function. The U.K. remains bound by obligations of the EU law, but loses many of its political rights. The text of the agreement clarifies some freedoms the U.K. would enjoy immediately after Brexit, including how the U.K. will be able to enter trade negotiations without breaching its obligations to the EU.[4]

1. Article by Financial Times, 'UK and EU agree “decisive step” with 21-month Brexit transition,' March 2018
2. Ibid
3. Ibid
4. Article by Financial Times, 'What difference will the Brexit transition make?' March 2018

What are the Key Risks to the Transition Deal?

The transition deal depends on a full withdrawal treaty being agreed and ratified before Brexit day. Crucial areas of the Brexit process, such as governance of the treaty, judicial and police co-operation, data sharing, ownership of nuclear material, and status of protected goods such as champagne and Scotch whisky, are in need of mutual agreement.[5]

However, the Irish border still remains the single largest threat to the transition deal. The draft fallback plan, which proposes the creation of a border along the Irish sea rather than one on the island of Ireland, has been rejected by the U.K.

Is the Duration of the Transition Flexible with Regard to Potential Changes?

The deal, in effect, cannot be amended with regard to the time of U.K.'s exit from transition. It has been explicitly stated in the agreement that the transition ends on December 31, 2020. However, this part of the deal will be open for further negotiations, since most EU states, if not all, would like to rethink whether the transition would in fact be complete within the allotted time frame.

5. Ibid

CHOICE OF CUSTOMS UNION MODELS FOR THE U.K. AND EU

In our previous Brexit publications, we discussed two possible Brexit scenarios – Soft Brexit and Hard Brexit. However, with alternative customs union models and partnerships being proposed by both the sides over the last few months, we analyze the probable models for both the parties to choose from.

Exhibit 1

Customs Union Models for the U.K. and EU

Customs Union Model	Highlights	Current Status	Impact
Pre-Brexit EU Customs Union	▪ All members of the customs union apply the same set of tariffs on goods imported from outside the EU ▪ Inside the customs union, goods move 'tariff-free' between its members ▪ Limited ability of Member States to pursue bilateral Free Trade Agreements (FTAs) with non-EU countries ▪ Rules of origin checks applicable on exports to EU from outside the customs union	▪ Currently in place between the U.K. and EU	▪ Can be complex for goods assembled in more than one country, in sectors such as automotive manufacturing, aerospace, packaged goods ▪ Introduces additional bureaucracy and delay in cross-border trade
Temporary Customs Arrangement – U.K.'s 'Backstop' Plan	▪ Elimination of tariffs, quotas, rules of origin and customs processes ▪ Application of the EU's common external tariff (CET) at the U.K.'s external border, alongside the Union Customs Code (UCC) ▪ U.K.'s rights to negotiate, sign and ratify FTAs with rest of the world partners to continue unamended ▪ To be implemented only after completion of the final Withdrawal Agreement between the U.K. and EU	▪ Published by the U.K. government as a 'backstop' plan to prevent the emergence of a hard border between Ireland and Northern Ireland ▪ Rejected by the EU ▪ Inadequacies include unanswered key questions, issue of full regulatory alignment not addressed and being time limited	▪ Elimination of tariffs and rule of origin will ensure smooth functioning of supply chains across sectors, such as manufacturing, aerospace engineering, processed and packaged goods, pharmaceuticals
'Max Fac' Customs Union	▪ 'Highly streamlined customs arrangement' ▪ Ensure businesses declare goods for import or export and	▪ Consensus view is that implementing 'Max Fac' will be impossible by the time a new U.K.-EU customs arrangement is	▪ 'Max Fac' will consequently result in something described as 'as frictionless as

	provide Her Majesty's Revenue and Customs (HMRC) with the required documentation ▪ Allow goods moving between the U.K. and the rest of the world to travel via the EU, without paying EU duties ▪ Bilateral implementation of a technology-based solution for roll-on, roll-off ports ▪ Reduce time and costs of complying with customs administrative requirements	needed in Jan. 2021	possible,' but does not guarantee the promises of 'no physical infrastructure' and 'no hard border' ▪ Could result in an indefinite transition period if the required technology is not ready by the end of the transition period
New Customs Partnership	▪ U.K.'s import regime to align precisely with the EU's external customs border ▪ U.K. to apply same tariffs as EU ▪ Introduction of a 'tracking mechanism', where imports to the U.K. would be tracked until they reached an end user ▪ Introduction of a 'repayment mechanism', where imports to the U.K. paid whichever was the higher of the U.K.'s or the EU's tariff rates ▪ Traders to be refunded for the difference between the two rates in cases where the goods were sold to an end user in the country charging lower tariffs	▪ In theory, this model appears to satisfy the U.K. red lines and the EU-U.K. stand on avoiding a hard Irish border ▪ However, it has been dismissed by the EU because of the short timescale involved, and added costs and delays for traders and the Member States with regard to implementation	▪ The U.K. cabinet unanimously decided on the partnership as being 'unworkable' ▪ The partnership might result in the U.K. staying within the EU, thereby betraying the basic tenets of Brexit
Separate Customs Union	▪ Described as a 'bespoke, partial customs union' ▪ To include all industrial goods and some limited number of processed agricultural goods ▪ No rules of origin checks ▪ EU would be setting the external tariffs for the U.K.	▪ Has been rejected by the U.K. as being against the purpose of Brexit	▪ Would let other countries sell more into the U.K. but make it tougher for the U.K. to sell more in other countries ▪ Not compatible with an independent trade policy that the U.K. would want to pursue post-Brexit

Source: WNS DecisionPoint™ analysis based on research from U.K. Parliamentary Research service and HM Government's technical note on the temporary customs union

THE BREXIT VOTE IN THE HOUSE OF COMMONS

On June 20, 2018, the British Prime Minister (PM) survived the crucial 'meaningful vote', winning 319 votes to 303. Had she lost the vote, it would have empowered the British parliament to steer the course of Brexit in the event of a deal not being reached. This win in the House of Commons will ensure some degree of domestic political certainty in the U.K. while it continues its customs union negotiations with the EU.

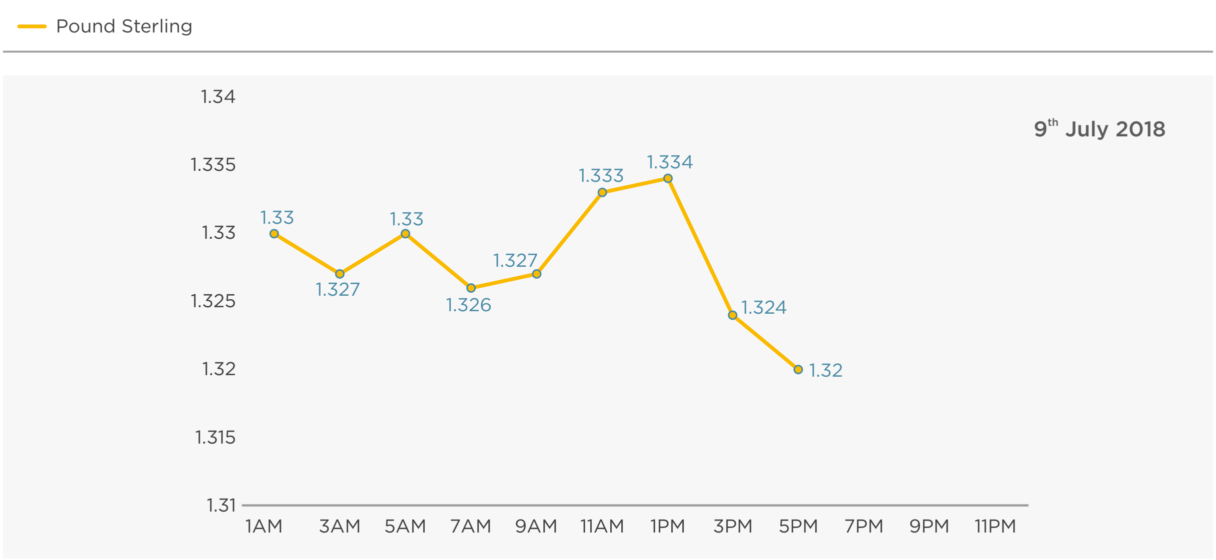
THE CHEQUERS PACT AND ITS POLITICAL AFTERMATH

The U.K. PM held a day-long cabinet meeting at her Chequers residence on July 7, 2018, in an attempt to coerce her cabinet into backing a new vision for a softer Brexit. The meeting was regarded as successful, with news reports emerging that the PM had managed to unite her cabinet, including Eurosceptic members, into supporting her new Brexit plan.

However, the celebrations lasted for less than 48 hours. In a dramatic development, David Davis, the Brexit secretary and the key negotiator for the U.K. with Brussels, known to be a hard Brexiter, tendered his resignation shortly after midnight on July 9, 2018, in what is seen as his opposition to the PM's soft Brexit plan. In another blow to the government, Boris Johnson, Foreign Secretary and another hard Brexit supporter, resigned from the government within 24 hours of Mr. Davis's departure. The two exits were viewed as a challenge to the PM's leadership and raised concerns over the stability of the government and whether the PM would be able to steer the government in what is seen as the most critical phase of the Brexit process.

Exhibit 2

Pound Sterling Slipped below USD 1.32 after Boris Johnson's Resignation



Source: Financial Times; WNS DecisionPoint™ Analysis

The Pound Sterling slipped to an alarming low against the dollar on July 9, 2018[6] as investors grappled with the foreign secretary's resignation and its potential impact on Brexit plans. The Pound sank to its lowest level shortly after the two resignations were announced. The currency had earlier gathered strength on the successful conclusion of the Chequers meeting and the possibility of a soft Brexit.

What was seen as a threat to the PM's leadership was quickly thwarted with the appointment of two cabinet secretaries as replacements for the departing ministers and the first meeting of the reshaped cabinet. The ministers agreed to step up the 'no-deal' planning in the event that Brussels makes demands that the U.K. may not accept. There were no cabinet resignations and the PM's critics failed to deliver the signatures of 48 Tory Members of Parliament needed to raise a vote of no confidence in her leadership.[7]

THE NEW SOFT BREXIT PLAN

On July 12, 2018, the U.K. government published a 98-page white paper detailing its plans for departure from the EU. The document set out plans for an 'association agreement' between the U.K. and EU, which is defined as a treaty between an EU and non-EU country that creates a framework of cooperation between them.[8] While the document outlines a tight relationship with the EU with regard to goods and the Irish border, it calls for a looser relationship with regard to services, specifically the City of London and Financial Services. The table below summarizes the key takeaways from the document.

Exhibit 3

U.K.'s Proposed Economic Partnership with the EU

Goods Including Agri-food	▪ No tariffs on any goods ▪ Frictionless trade at the border ▪ Common rulebook for all goods
Participation in EU Agencies	▪ U.K.'s continued participation in EU agencies that provide authorizations in key sectors – European Chemicals Agency, The European Aviation Safety Agency and the European Medicines Agency – accepting their rules and contributing to costs
Facilitated Customs Arrangement	▪ Removal of customs checks and controls between the U.K. and EU
Financial Services	▪ New economic and regulatory arrangements for financial services ▪ Arrangements will not replicate the EU's passporting regimes ▪ U.K. and EU to control their own markets
Services and Digital	▪ The U.K. and EU will not have current levels of access to each other's markets

Source: WNS DecisionPoint™ Analysis based on HM Government's paper 'The Future Relationship Between the United Kingdom and the European Union,' July 2018

6. Article by Financial Times, 'Sterling dips below $1.32 in wake of Johnson resignation' July 2018
7. Article by Financial Times, 'Theresa May stabilises government as Tory Brexiters seethe,' July 2018
8. Explainers by Institute for Government, U.K., 'What is an association agreement?'

HOW DO THE BREXIT SCENARIOS LOOK NOW?

In the light of recent political developments at Westminster and the U.K.'s new proposal for Brexit, we assess the key Brexit scenarios that could take place in a few months from now and the political risks attached to those.

Exhibit 4

Brexit Scenarios

Brexit Scenario	Goods	Services	Timing	Political Risk
Chaotic 'No Deal'	▪ Gradual establishment of a hard border in Ireland ▪ Tariffs, customs checks and regulatory arrangements applied at all of U.K.'s borders ▪ EU decides on making strict checks at the border	▪ Trucks and flights at risk of being grounded ▪ EU to decide on a grace time for services to reach	▪ If disagreements are not resolved by Christmas, this will be the most likely scenario	▪ Blame game between Brexiters and Remainers ▪ The EU accuses Britain of defaulting on its debt payments as relations become acrimonious
Hard Brexit After Transition	▪ No frictionless goods-only agreement ▪ Customs border at the Irish Sea at the end of transition in 2021 ▪ Customs declarations and regulatory checks for goods crossing the Irish sea ▪ Hard border at Strait of Dover without tariffs	▪ Some arrangements for transport services ▪ Restrictions on financial services trade	▪ The U.K. signs a withdrawal agreement in late 2018 and FTA in 2020	▪ The U.K. government loses its Northern Irish allies as the new customs procedures are unacceptable to Northern Ireland ▪ The U.K. government accuses EU of using dubious tactics
Customs Union After Transition	▪ Smooth flow of industrial goods, with more checks than those that exist today ▪ Delays for agricultural products at the border	▪ Transport services agreement is signed ▪ Restrictions on other services trade, including financial services	▪ The U.K. leaves the EU in 2019 after signing a withdrawal agreement ▪ The U.K. signs an FTA with the EU in 2020	▪ The Democratic Unionist Party disapproves the establishment of an Irish border ▪ Conservative Brexiters furious at the loss of U.K.'s ability to sign goods trade deals

Exclusive Goods Single Market Access	▪ Frictionless trade in industrial, food and agricultural goods	▪ Restricted access to the single market in comparison to present day ▪ Better than other non-EU members	▪ U.K. leaves the EU in March 2019 with a withdrawal agreement in place ▪ Signs a comprehensive set of treaties with the EU in 2020	▪ Brexiters are betrayed as this is 'Brexit in name only' ▪ The Irish border issue is resolved ▪ EU27 raises concerns on the concessions given to U.K.
Norway Plus	▪ Frictionless trade in industrial, foods and agricultural goods	▪ Services trade to continue in its present form	▪ U.K. leaves the EU in March 2019 with a withdrawal agreement in place ▪ Britain signs an EEA-style agreement and remains in the customs union at the end of the transition period January 2021	▪ Defeat for the U.K. PM and the Brexit referendum

Source: WNS DecisionPoint™ Analysis based on article by Financial Times, 'The Five Scenarios for Brexit Britain,' July 2018

THE U.K. ECONOMY'S PERFORMANCE SINCE THE BREXIT REFERENDUM

The Sterling fell sharply in the months following the Brexit referendum. This provided a temporary boost to the U.K.'s exports and services sector, but was a major factor in creating inflation worries for the overall well-being of the U.K. economy as well. In the following sections, we analyze and forecast key performance indicators of the U.K. economy amidst growing Brexit deal uncertainty.

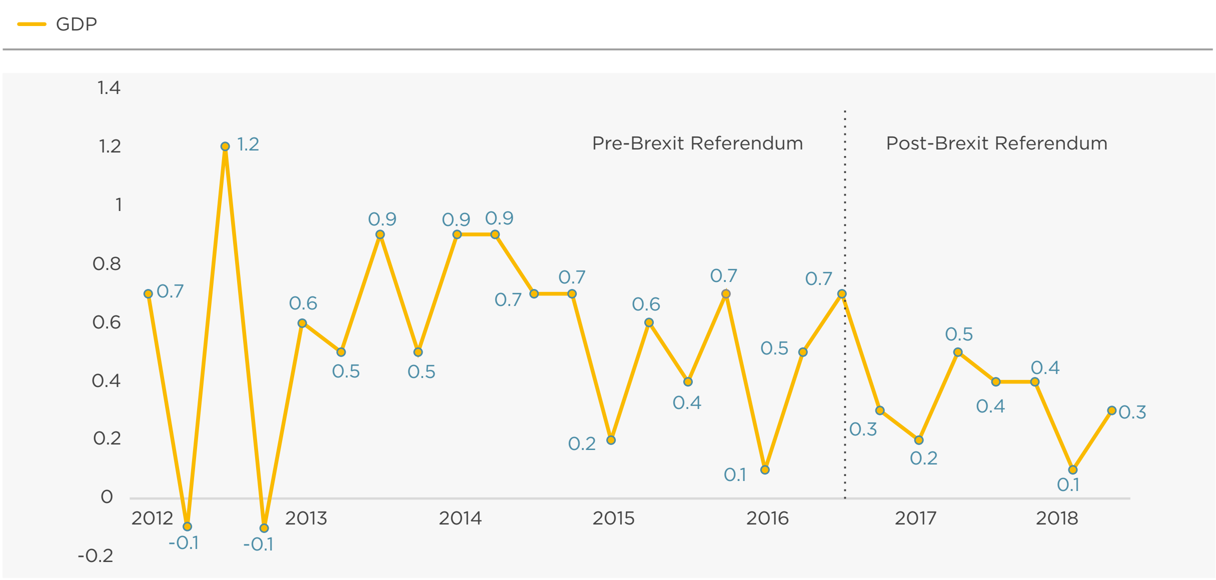
U.K. Economic Growth

The U.K.'s Gross Domestic Product (GDP) growth was modest during 2017. The primary drivers of growth were net trade and investment, with movement away from consumption. The depreciation in the Sterling, brought on by the EU referendum, weighed in negatively on real incomes, and hence consumption during 2017.

A slight dip in GDP growth was witnessed in 2018 Q1, from 0.4 percent in 2017 Q4 to 0.1 percent.[9] Adverse weather conditions and snowfall in February and March 2018 were primarily responsible for the downtrend. However, mature estimates suggest an upward revision of up to 0.3 percent in GDP growth.[10] According to the Bank of England (BoE), GDP growth is projected to remain around 0.4 percent for the remainder of 2018, with the underlying drivers of growth displaying positive upward momentum.

Exhibit 5

U.K. GDP Growth and Forecast

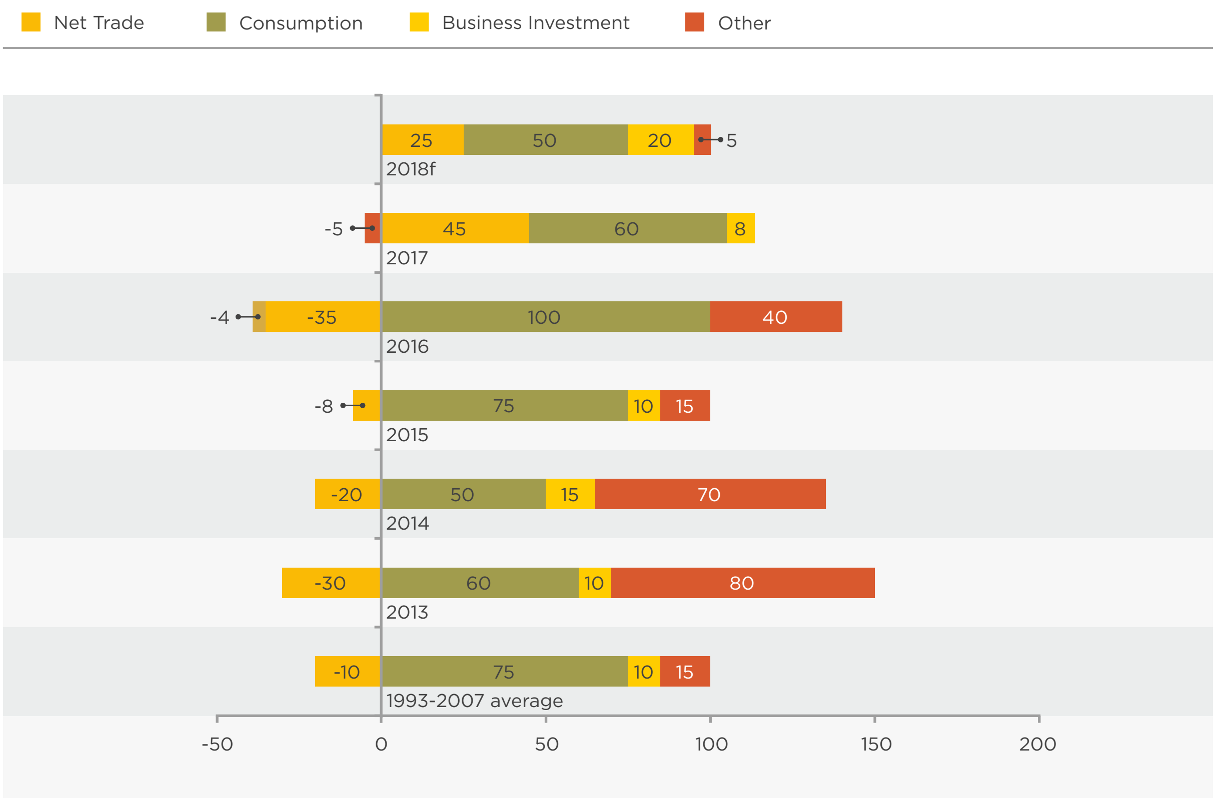


Source: ONS and Bank of England Calculations; WNS DecisionPoint™ Analysis

9. Bank of England Monetary Policy Summary and minutes of the Monetary Policy Committee meeting, June 2018
10. Bank of England Inflation Report, May 2018

Exhibit 6

Share of GDP Growth by Expenditure Component



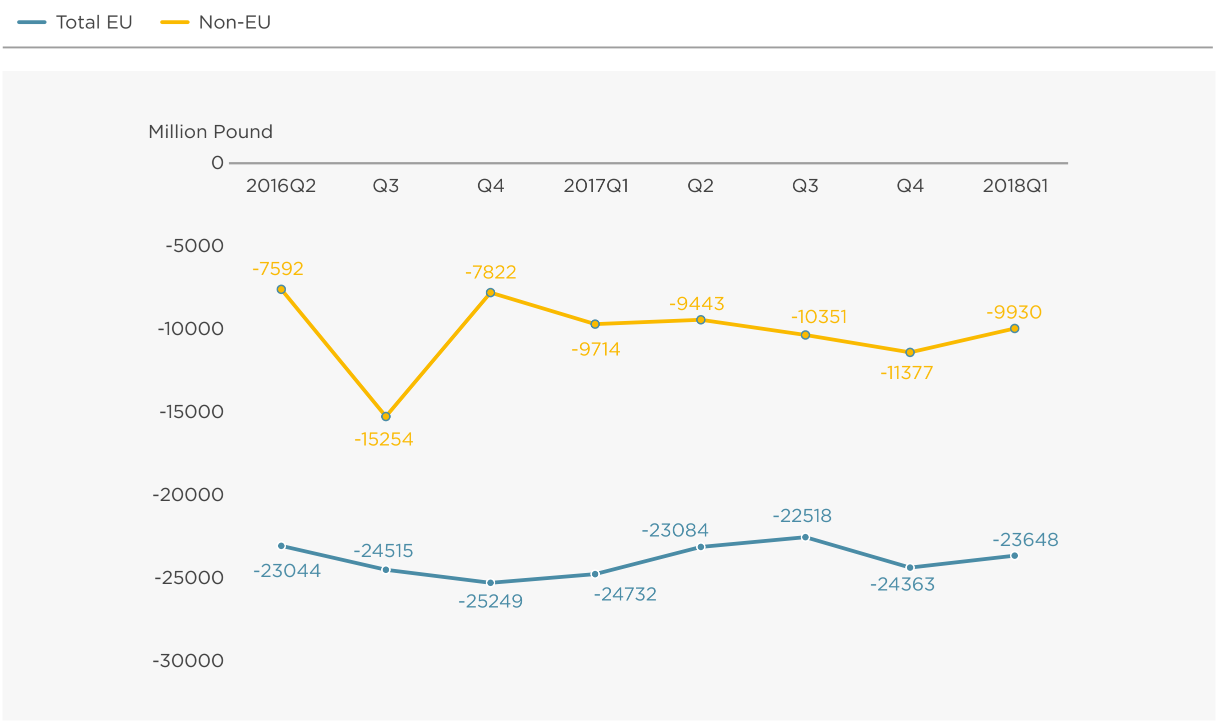
Source: Bank of England data and forecast; WNS DecisionPoint™ Analysis. Other calculated as residual, includes housing investment, government consumption and investment, changes in inventories, statistical discrepancy.

Net Trade and Business Investment

Strength of global growth, together with a sharp depreciation of the Sterling in recent months, has helped boost net trade and business investment in the U.K. Strong external demand for U.K. goods and services, along with an increase in profit margins on those exports in Sterling terms, should give the much required boost to producers and supply chain businesses to invest in capacity and expand production. Higher import prices triggered by the fall in Sterling should encourage consumers to substitute imported goods with domestically produced goods and services.

Exhibit 7

U.K. Trade Balance in Goods



Source: ONS; WNS DecisionPoint™ Analysis

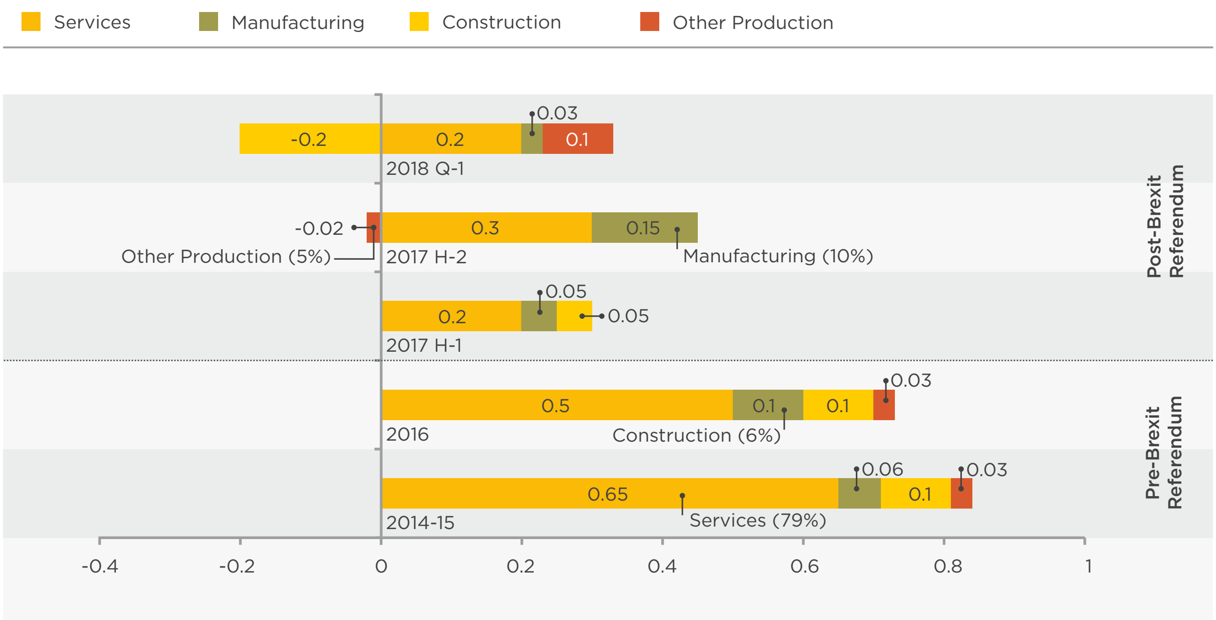
The U.K. ran a larger trade deficit in goods with the EU compared to the non-EU countries in the first three months leading up to April 2018. Falling exports of goods and services led to a widening of the trade balance in 2017 Q4 and 2018 Q1. Over 2017, net trade contributed positively to GDP growth, helped by a narrowing income deficit, reflecting a rise in the net rate of return on foreign direct investment in the U.K. Outlook for net trade in the U.K. will widely depend on global growth trends in 2018 and the response of supply chain processes and businesses both in the U.K. and abroad to the tone and direction of Brexit negotiations, the final Brexit deal and associated movements in the Sterling.

With limited spare capacity for firms to expand domestic production for import substitution and boost exports, additional investment to boost production capacity will be a requirement. However, the last two quarters have witnessed muted growth in business investment in the U.K. While snowfall and adverse weather conditions in the first two months of 2018 are partially responsible for this, the EU referendum and the consequent uncertainty brought on by the final outcome of the Brexit negotiations have taken a major toll on business investment.

Overall, business investment should continue to grow at the current rate throughout 2018-19, with downside risks caused by the Brexit talks.

Exhibit 8

Contributions to Average Quarterly GVA Growth by Output Sector



Source: Bank of England; WNS DecisionPoint™ Analysis. Figures in parentheses are weights in nominal GDP. Other Production includes utilities, extraction and agriculture.

A slowdown in investment had a spillover effect across manufacturing and construction output, with both sectors experiencing sharp contraction in the months leading up to April 2018. Manufacturing output fell by 1.4 percent in April compared to the previous month. A slowdown in export growth, as well as the end of big infrastructure projects such as London's Crossrail, reduced production at the start of 2018.[11] Construction output rebounded in April 2018, but only by 0.5 percent, leaving the sector 3.3 percent smaller than it was a year ago. The slowdown in output was driven by weak global demand growth, persistently weak domestic demand and slowing export growth.[12]

The services sector was the only glimmer of hope in an otherwise dismal array of data, after activity in the sector expanded at its fastest rate in three months since May.[13] However, the outlook for this sector is largely dependent on clarity on the Brexit outcome, with strategic sectors such as financial services and airlines carefully hanging in balance awaiting certainty on their fate as Brexit takes effect in March 2019.

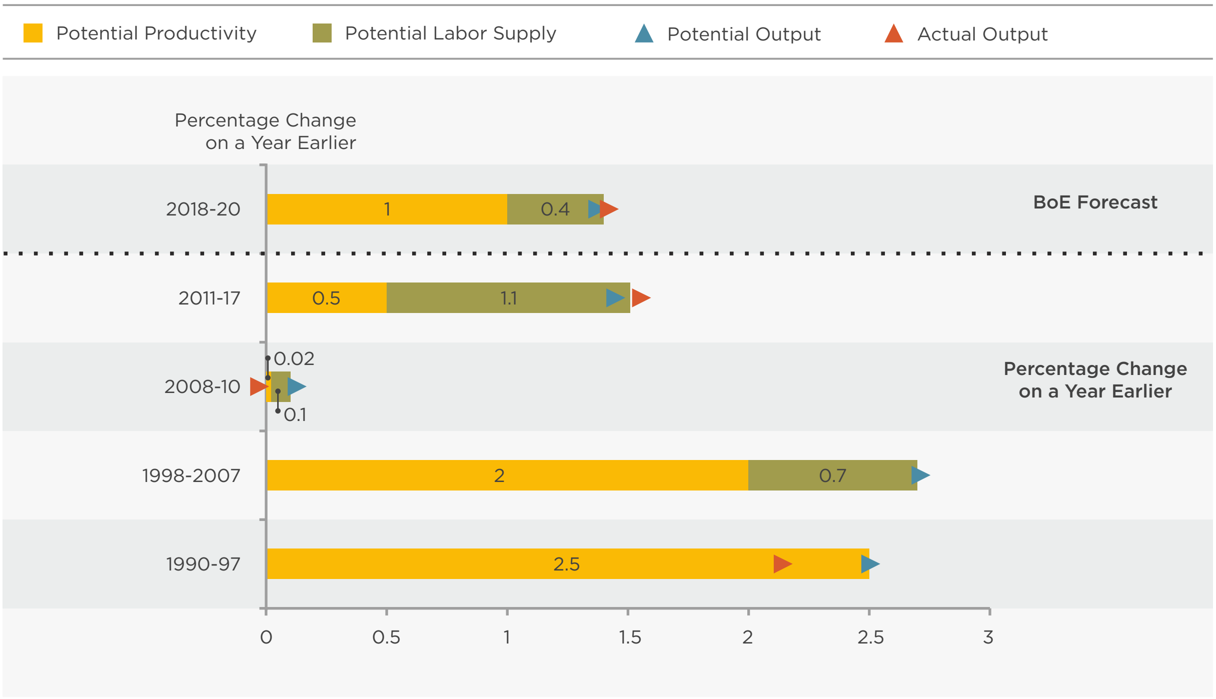
11. Article by Financial Times, 'Manufacturing output falls at fastest rate since 2012', June 2018
12. Ibid
13. Article by Financial Times, 'Economy set for rebound after fast service-sector expansion', June 2018

Supply and Labor Productivity

The outlook for economic growth, to a large extent, is determined by the evolution of demand and potential supply growth. Supply, in turn, is determined by labor productivity.

Exhibit 9

Estimated Potential Output growth



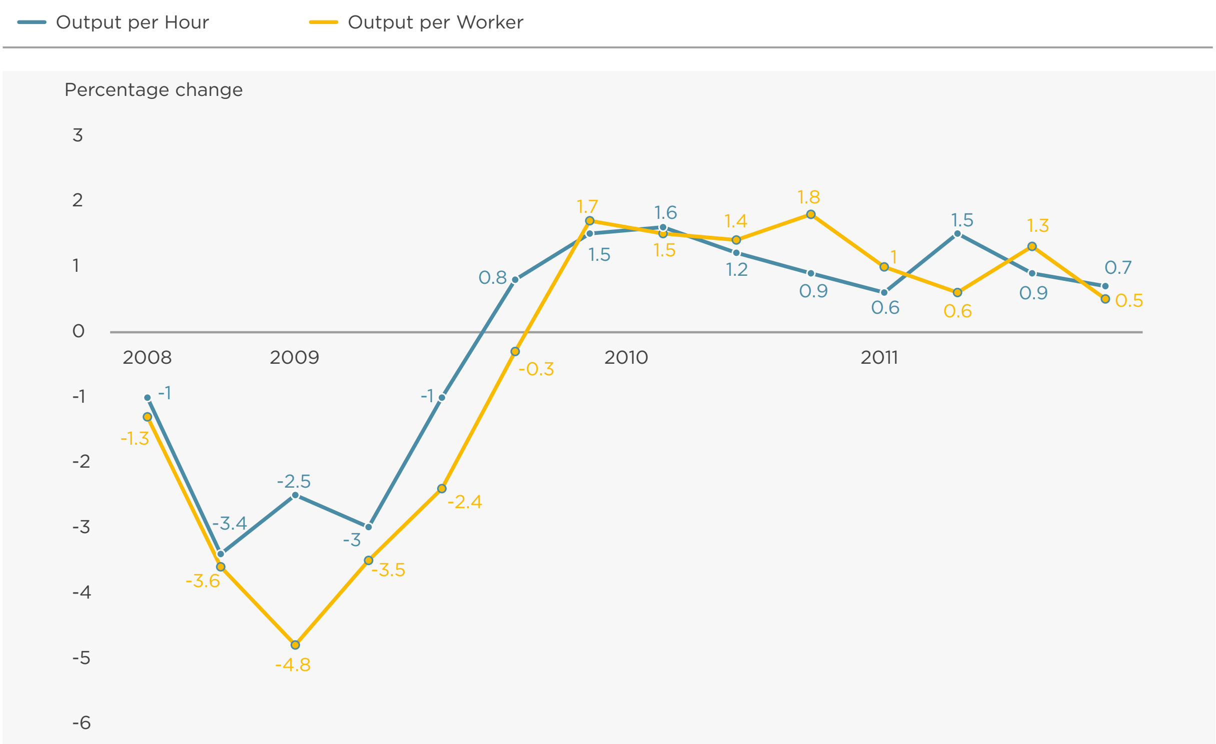
Source: Bank of England data and forecast; WNS DecisionPoint™ Analysis. Annual Averages. Actual Output is chained-volume measure.

The sharp fall in hours worked in 2017 H2 provided a temporary boost to hourly productivity growth during that period. However, average hours worked can be volatile from one quarter to the other. Growth in output per worker, which is more stable than hours worked, has been persistently weak, and was around 0.5 percent in 2018 Q1. On both measures, productivity growth has been way short of pre-crisis stages.[14]

14. Bank of England Inflation Report, May 2018

Exhibit 10

Measures of Labor Productivity



Source: WNS DecisionPoint™ Analysis based on ONS data. Figures for whole U.K. economy

The standard growth-accounting framework suggests that majority of the weakness in productivity growth has been caused by a slow growth in the level of capital stock per worker – the resources, equipment and technology to produce output. This, in turn, is a direct impact of muted business investment growth through 2017, which lingered on in the first few months of 2018.

A minor, though integral, cause of the weakness in labor productivity can also be attributed to the weakness in efficiency with which labor and capital are utilized, known as total factor productivity. The shortfall has been observed in a few key sectors, such as manufacturing, financial services and insurance services.

Broader global trends have also affected the sector disproportionately. For instance, growth in global trade is accompanied by productivity gains due to higher economies of scale and increased competition, and so productivity within the manufacturing sector, which is interconnected to global supply chains, has suffered a decline since the crisis.

Outlook for labor productivity is largely dependent on the pick-up in business investment and key sectors such as financial services and manufacturing, which in turn will be shaped by the Brexit outcome. Any fallout in the final Brexit deal after the transition will imply slowdown in investment and shift in significant business operations from the U.K. to the EU for financial services and manufacturing, signifying loss in investor confidence.

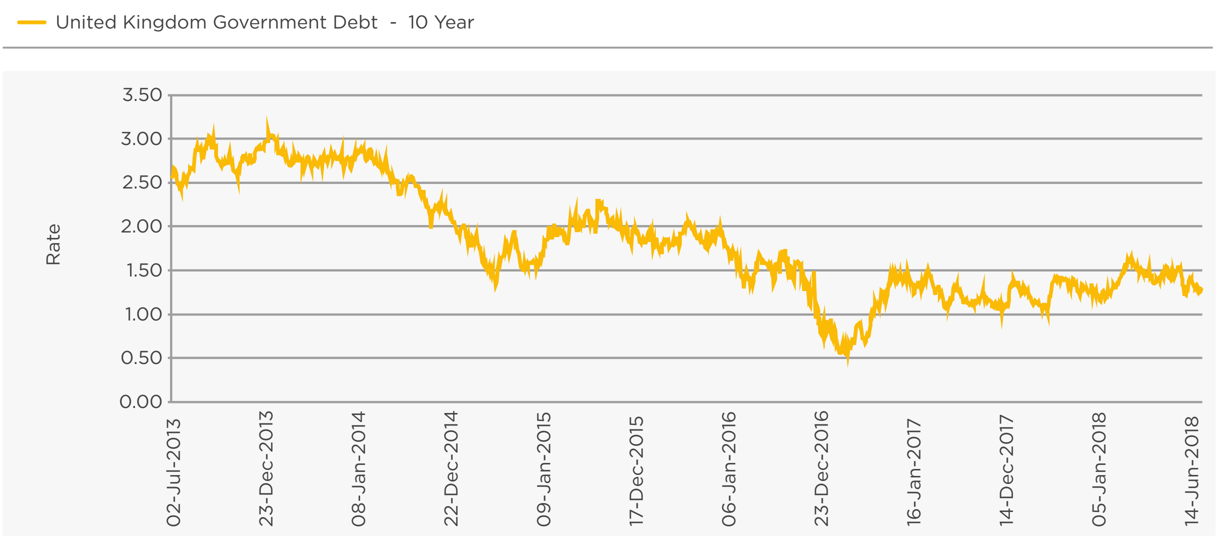
A hard Brexit or disagreement over a suitable customs union arrangement will result in significant tariffs, and increased input and business costs for the manufacturing sector, and a loss of 'passport' license for the financial services sector to conduct cross-border operations. These will have significant negative implications for labor productivity.

U.K. Bond Yields

The U.K. ten-year gilt has been trading in a yield range of between 1 and 1.5 percent since autumn 2016. Gilt yields are well off their mid-February highs as investors' expectations of rate rises have dissipated in recent months after the BoE decided to maintain the current bank rate at 0.5 percent in the wake of disappointing growth data.[15]

Exhibit 11

United Kingdom Government Debt - Interest Rate Profile

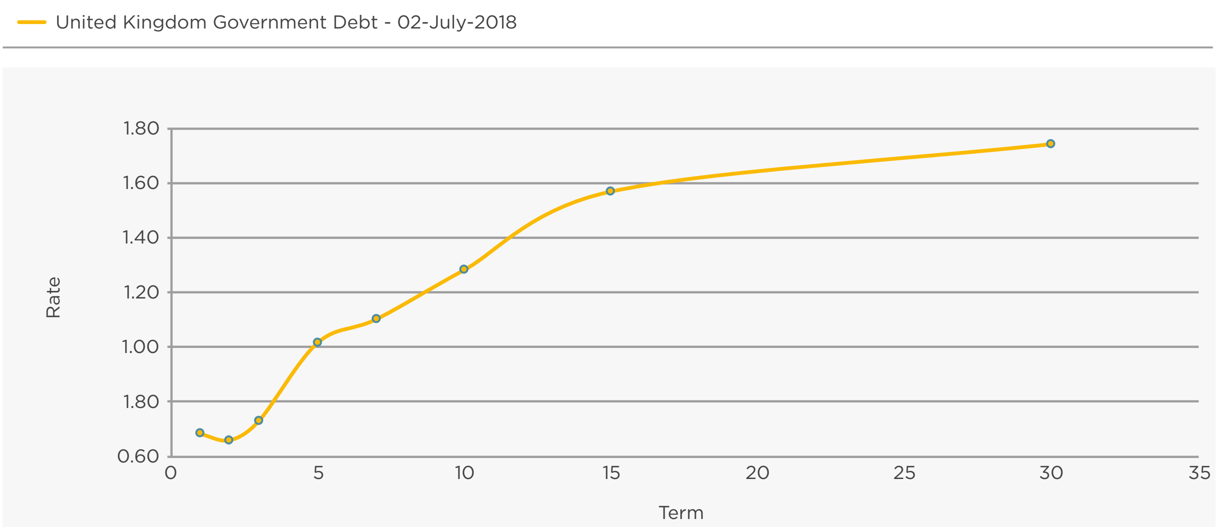


Source: Capital IQ

15. Article by Financial Times, 'Low gilt yields show there is room for higher UK public spending,' June 2018

Exhibit 12

United Kingdom Government Debt - 02-July-2018



Source: Capital IQ

Demand from pension funds and other institutional investors for ultra-long-dated U.K. debt has resulted in an inverted yield curve, with 50-year paper yielding less than 30-year bonds. The U.K. has sold less debt since the 2016 EU referendum than initially expected, as forecasts of an immediate economic dip failed to materialize. The U.K. government borrowing in 2017-18 beat official forecasts with GBP 42.6 Billion of net new debt raised in the financial year, down from GBP 46.2 Billion the previous year.[16]

A key question for investors contemplating the supply outlook is whether gilt prices currently include a Brexit uncertainty premium. The persistently low yields result from Britain's subdued economic performance, which lowered the expectations of a near-term rate rise.[17]

The future impact of Brexit on U.K. yields is still unclear. Weaker growth will depress yields, but supply chain interruption and a fall in Sterling following a hard Brexit will fuel inflation, which will push up yields via the prospect of rate rises. So if expectations of a smooth Brexit were to deteriorate, the future direction of yields would be tough to determine.[18]

16. Ibid
17. Ibid
18. Ibid

CONCLUSION

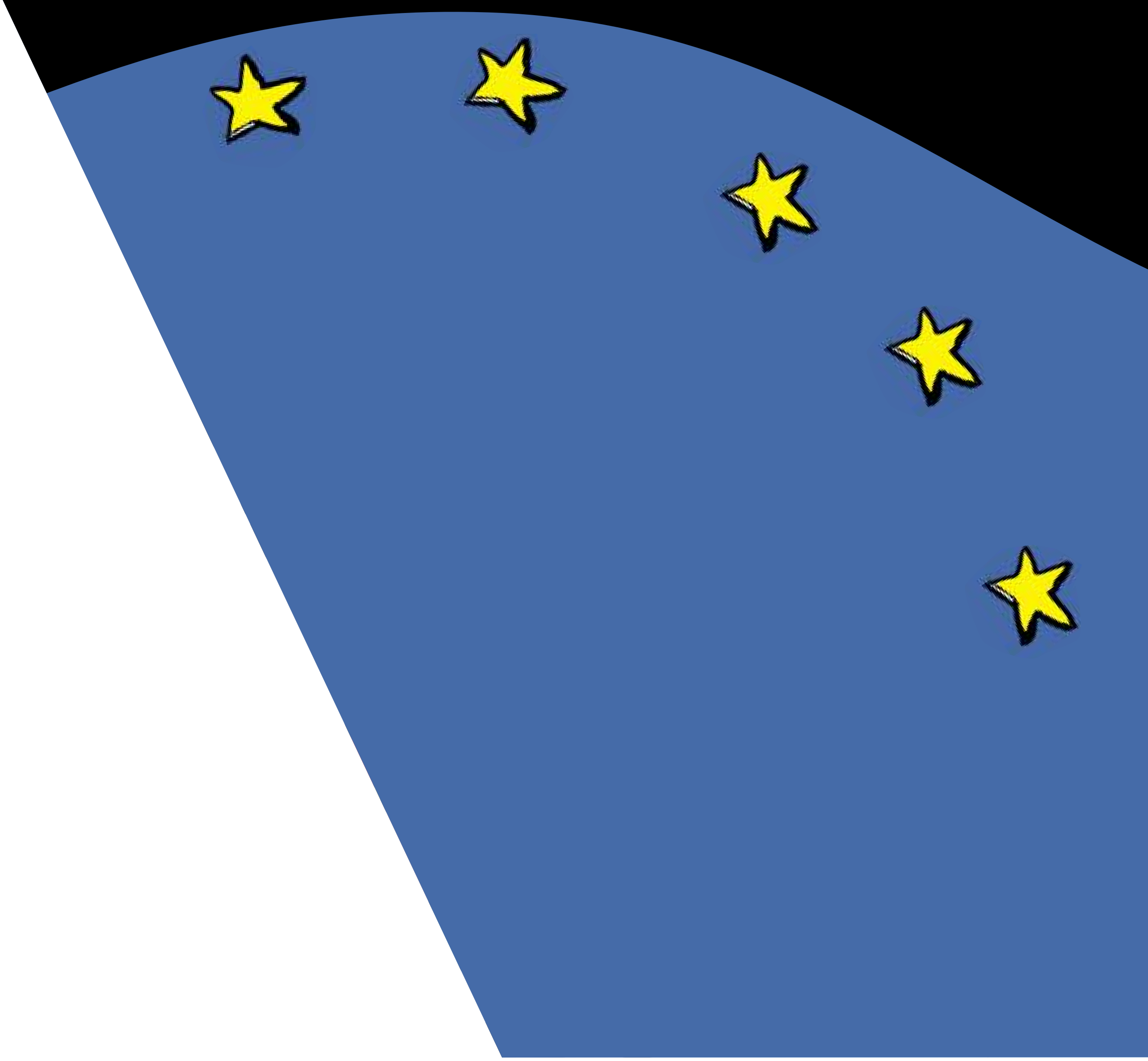
While the transition agreement signed earlier this year thwarted the uncertainty with regard to the U.K.'s exit from the EU in early 2019, the subsequent discussions on which trade model to follow post-transition has left both sides in confusion, eroding consumer and investor confidence in the larger British economy. Disagreement on the future of the Irish border remains a thorn in the U.K.'s side, and could derail any plans of an orderly Brexit.

The future of U.K.'s economic performance is largely dependent on the most suitable customs union arrangement between the two regions. If the U.K. has to improve its pace of business investment and subsequent GDP growth, it has to fasten the pace of Brexit talks and agree on a suitable Brexit deal with the EU to prevent a hard landing for the U.K. economy.

About DecisionPoint

Making key decisions that improve business performance requires more than simple insights.It takes deep data discovery and a keen problem solving approach to think beyond the obvious. As a business leader, you ought to have access to information most relevant to you that helps you anticipate potential business headwinds and craft strategies which can turn challenges into opportunities finally leading to favorable business outcomes.

TM WNS DecisionPoint™, a one-of-its kind thought leadership platform tracks industry segments served by WNS and presents thought-provoking original perspectives based on rigorous data analysis and custom research studies. Coupling empirical data analysis with practical ideas around the application of analytics, disruptive technologies, next-gen customer experience, process transformation and business model innovation, WNS aims to arm you with decision support frameworks based on 'points of fact.' Drawing on our experience from working with 200+ clients around the world in key industry verticals, and knowledge collaboration with carefully selected partners including Knowledge@Wharton, each research asset comes up with actionable insights with the goal of bringing the future forward.



DECISION POINT™ by WNS

A credible insights hub for companies looking to transform their strategies and operations by aligning with today's realities and tomorrow's disruptions.

Email: **perspectives**@wnsdecisionpoint.com
Website: wnsdecisionpoint.com

@**WNS**DecisionPt

WNS DecisionPoint

WNS DecisionPoint