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Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 203 465 2672

UK-EU TALKS – SAME CHALLENGES, LESS TIME

Berenberg Macro Flash

The other big risk: Looking beyond the coronavirus recession, the UK – and to a lesser extent the EU – still face the risk of a disorderly hard Brexit from the EU's Single Market at the end of 2020 if negotiations between the two sides do not result in a trade deal. Economic risks posed by the coronavirus may persist for the whole of 2020 if we are unlucky. Although it is not our base case, a disorderly Brexit could tip the UK back into recession in early 2021 in a still fragile economic environment.

So little time, such a big set-back: After losing almost two months to the pandemic, David Frost (chief UK negotiator) and Michel Barnier (chief EU negotiator) resumed their talks via videophone on 15 April. They have little more than seven months to come up with a resolution ahead of the crucial EU summit in early December 2020 – just a third of the initially envisaged 21 month timeframe. For the foreseeable future, the negotiations will continue via videophone. Beyond the obvious coordination challenges, the lack of face to face interaction eliminates the opportunity for the often-critical diplomatic breakthroughs that come by way of informal side channels - private interactions in corridors and the like.

The upcoming deadline: Negotiators will hold three rounds of talks ahead of the EU summit on 18-19 June. While we do not expect any major progress in these talks, they may – or may not – play a role in the UK decision whether or not to request the one- or two-year extension to the transitional period that the EU27 would almost certainly be ready to grant. According to the Withdrawal Agreement, any extension must be agreed by 1 July. Agreeing an extension after this deadline would not be easy (although not impossible). It would require either a legal re-interpretation of the withdrawal agreement or some other political fudge.

The case for an extension: Providing more time for talks would raise the chance of an eventual deal. But that would not be guaranteed, even with a two year extension, though. The EU-Canada free trade deal (CETA) took four years to negotiate (May 2009 until October 2013). Still, at a minimum, an extension would reduce the risk of a disorderly hard Brexit by providing both the UK and the EU more time to come up with plans to smooth the UK's exit from the single market in any outcome. In key areas like financial services, many countries have already prepared National Emergency Brexit Legislation (NBELs) to help cushion the impact in case of a disorderly Brexit. A longer transition would provide more time to extend and expand such provisions in the UK and across the EU.

The case against an extension: EU leaders largely favour an extension for the reasons outlined above. However, the UK's official position, as outlined last week, is that the UK will not ask for an extension of the transition period. Whether this is simply political posturing or a final position remains an open question. Three reasons underpin the UK's position: 1) a longer delay may not increase the chance of a deal if differences are fundamental; 2) remaining in the EU customs union would prevent the UK from signing trade deals with other countries; 3) Prime Minister Boris Johnson does not want Brexit to take up a large chunk of his first full term. Under the current very unusual and unforeseen circumstances, Johnson probably would not have much trouble convincing his party to accept a temporary delay. Equally, amid the massive post-corona monetary and fiscal stimulus, the disruption of a hard Brexit may be less noticeable than it would have been otherwise. Whether or not the UK asks for an extension is a coin toss, in our view.

Key issues in negotiations: While both sides share similar aims for the final trade deal – namely a free trade agreement covering goods with some minor agreements for services and finance – some big bones of contention remain. The EU demands that the UK accepts strong level playing field provisions, including agreeing to partly shadow EU rules, and grants extensive fishing rights to EU vessels. The UK has said it will not sign up to any deal in which it became a de facto 'rule taker'. Fishing, despite being economically insignificant, is apparently politically and symbolically very significant for the UK government. For a more detailed analysis of these key issues see UK-EU trade: what to expect from the tough talks ahead.

Base case unchanged: In the end, we expect both sides to strike a bare-bones agreement for trade in many goods and for some other issues and to manage the transition to World Trade Organization (WTO) rules for other key sectors not covered by the trade agreement with some temporary interim agreements to avoid the dreaded "cliff edges". An extension would make this 'orderly ' semi-hard outcome much more likely. If the UK does not ask for an extension, talks in H2 2020 will likely focus more on provisions to manage the exit in a smooth way to avoid the dreaded cliff-edge over which all sectors might fall at the same time – thereby making the hard Brexit less disorderly. In such an outcome, the two sides may agree some temporary fudge that provides more time to negotiate the trade deal in goods. For instance, the UK may agree to not deviate too much from EU rules for goods trade initially and hence allow the status quo in goods not to change much while negotiations on a final trade deal continued. A disorderly hard Brexit, i.e. no deal and no smoothing mechanism to turn one big cliff-edge into a series of smaller cliff-edges, remains a remote tail-risk, in our view, even with the shortened time frame.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com