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THE ECONOMICS OF BREXIT: A GERMAN VIEW

Berenberg Macro Flash

We see a 35% risk of Brexit. The British 'in or out' EU referendum on 23 June poses the top economic and political risk for Europe this year. Germany would love the UK to stay in the European Union. The UK is simply part of Europe. Managing relations with the UK is much easier in the established framework of the EU than it would be on an awkward bilateral basis. Beyond making economic and political sense for all sides (except for Vladimir Putin and some other interested politicians), a vote to stay in the EU would also avoid a host of potential complications that could stem from a Brexit. But beyond *The politics of Brexit* which I discussed in a separate message, what might be the economic impact of Brexit on the continent? And how far would Germany go to offer the UK good terms of access to parts of the Common Market after a Brexit? I address these issues in the message below.

A SHORT-TERM SHOCK

As a highly open economy that specialises in the export of cyclical goods such as high-end machines and cars, Germany tends to be affected by any spike in global or European uncertainty more than most other countries. A potentially turbulent Brexit could thus dampen the near-term outlook for German investment and exports noticeably. Instead of expanding at an annualised clip of around 1.6% in 2H 2016, German growth may slow to less than half that rate. Other Eurozone countries would, on average, not do better than that. Fortunately Germany tends to be good at overcoming short-term shocks. As long as a Brexit does not cause the remainder of the EU to unravel, the direct impact of a Brexit would be brief. I would expect German and Eurozone growth to rebound back to its trend rate by the end of 2017.

GERMANY'S ECONOMIC SELF-INTEREST

In case of Brexit, Berlin would try to limit the economic damage which would stem from the resulting uncertainty about the future of Britain, the EU and the future economic relations between them. Negotiating acceptable terms of divorce would be part of that, including an arrangement that contains uncertainty and does not disrupt economic relations too much. Nonetheless, Germany would probably not spend a lot of political capital within the EU to secure at least half-favourable terms for the UK post-Brexit.

- For Germany, the UK is just one of many important neighbours, and a slightly more distant one than France and Poland. In case of a Brexit, Berlin would have to attach even more weight to the interests of, say, the proverbial Polish plumber and to French reservations about the clout of the City of London than it did in discussions with the UK so far.

- Berlin believes that it has already bent over backwards to help David Cameron secure a special status for Britain in the EU. If British voters rejects that deal on 23 June, Berlin would not want the EU to offer a deal that is more palatable to British EU sceptics. Instead, political logic would demand that the deal will be and must be seen to be significantly worse for Britain than the deal which the UK had secured as a member of the club.

- Germany's economic self interest is obvious: the country exports goods rather than services. For goods, the UK is Germany's top export destination outside the Eurozone after the US. Germany earns 3% of its GDP in selling goods to the UK. To put this into perspective: Germany exports as much to the UK as it does to its immediate neighbours Poland and the Czech Republic taken together. German imports of goods from the UK amount to less than half of the value of its goods exports to the UK. German receipts

from selling services to the UK are just 19% of its earnings from selling goods to the UK. On services, Germany runs a small deficit with the UK of around €4bn per year, which is dwarfed by a German surplus on goods of €55bn.

FREE ACCESS FOR GOODS, NOT FOR SERVICES
Post-Brexit, expect Germany to push for a rapid new deal with Britain that preserves free trade in goods. But why should Germany spend any political capital to convince France that financial institutions in London should still be treated as onshore rather than offshore post-Brexit? Regulations matter more for services than for goods. And the way in which financial and other services are regulated tends to be politically sensitive. Even Germany, arguably the most free-trade oriented of the major EU countries, would see little point in preserving the dominance of the City of London for euro-denominated financial products. Chances are that any post-Brexit deal with Britain would severely constrain the ability of Britain to export services to the EU unless, point by point, the UK accepts the regulations for such services which the EU will impose without any British input into the design of such rules. In addition, for any restriction that Britain would want to place on the free movement of labour, the EU-27 would probably come up with an offsetting restriction on UK access to the EU-27 market for services.

London is a great place. Its pool of highly qualified professionals, its established networks and the convenience of the English language would secure a strong position for the City of London in global financial markets even after Brexit. But relative to what the City of London is and could be as an onshore financial centre for Europe, its future as a mere offshore provider of financial services to Europe would be rather constrained.

Of course, restrictions on UK access to the EU market for services would hurt both sides. However, for Germany and other EU members, the damage would likely be far smaller than for the UK. For the EU-27, the efficiency losses from more restricted UK access to the EU market for services would be mitigated by the likely diversion of business and investment away from the UK and into the EU-27.

A LESS LIBERAL EU?
Germany values the UK in the EU as a liberal counterweight against the more statist traditions of France. By and large, the British influence helps to shape EU regulations the right way. Over time, a Brexit might lead to a slightly less liberal regulatory regime for parts of the services market in the EU. This might possibly turn into a minor drag on trend growth in the long run. However, we should not overdo this point. First, regulations are not easy to change, especially in the multi-nation EU. After Brexit, the EU rulebook would likely remain virtually unchanged anyway. The absence of the British voice would only affect the future gradual evolution of the rules. Second, portraying the UK as a liberal voice within the EU, while correct, lacks a bit of nuance. The impression in Berlin is that, when it comes to guarding their own petty protectionist interests, UK negotiators can be at least as effective as French guardians of their domestic special interests.

Note that Germany pays even more into the EU budget than the UK. It runs a fiscal surplus nonetheless. Germany sees its net contributions to the EU budget as an investment into the stability and development of its European neighbours. That rich non-EU members such as Switzerland and Norway also pay a fee for access to the EU single market strikes Berlin as normal. A post-Brexit UK would still have to pay up if it wants to trade with the club. As the major net contributor to the EU budget, Germany would want to see to that.

After a British vote to leave the EU, Germany's top political priority would be to strengthen the cohesion of core Europe. If Germany and its European partners manage contain the risk that other countries might want to leave the EU as well, the economic impact of a Brexit on Germany would be brief and fairly modest. But that is a big "if".

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