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UK UPDATE: CONSEQUENCES OF THE UK-EU BREXIT CLASH

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WHAT SHOULD WE TAKE AWAY FROM THE EARLY UK-EU HEADBUTTING?

Why can't we be friends? The recent comments from senior EU officials about Britain's 'delusions' over what can be achieved during the Brexit negotiations indicate the stark difference between the starting positions of the UK and the EU. While Britain wants free trade in goods, services and capital without many strings attached, other EU members see the EU as a much more complex economic and political project. Issues such as the free movement of labour within the EU and the fiscal support for less prosperous regions that led to Brexit in the first place will serve as points of contention during the negotiation. Migration, and the Brexit cash settlement, remain the key concerns. These differences must be bridged if negotiations are to succeed.

While exploratory talks may have got off to a bad start, it is still early days. The headlines about the May-Juncker dinner and other similar Brexit related issues may not necessarily provide an accurate read through into the likelihood of a final deal. As a hard-Brexit would be costly for both sides, especially the UK, there is plenty of scope for pragmatism to prevail.

GETTING PAST THE UK ELECTION IS KEY

Even though Britain triggered Article 50 in late March, setting off the two-year countdown to settle Brexit, the start of real negotiations is some two months away. Britain will elect a new government on 8 June before talks can begin in earnest. May's Conservatives are the only major party promising to deliver a complete exit from the EU. The Conservatives are some 20 points ahead of all other parties in opinion polls – see chart. If all constituencies that voted Brexit now vote Conservative, May could increase her working majority to 87 seats from her current 17. For now, taking a hard line is in her domestic political interest. We look for continued posturing and jibes right up until the election. After she wins the election, May will have more scope to compromise. Despite the current noise, we expect the UK to gradually become more flexible as negotiations progress. We still see a good chance that the UK and EU27 will agree a post-Brexit transitory arrangement that will lead to a trade deal a few years later.

In our base case, we expect the UK and EU27 to agree on a deal for preferential market access that covers almost all goods and some services, with the UK losing its EU financial services passport and some other similar privileges. Such a Brexit would reduce the UK's long-term potential growth rate to 1.8% pa from its pre-Brexit rate of 2.2%. A "harder" or "softer" Brexit relative to our base case would imply a bigger or smaller negative impact on trend growth, respectively. In case of a hard Brexit, long-term trend growth could fall to as low as 1.5% pa. While this would hurt badly, it would put the UK on par, in growth terms, with the current Eurozone average.

An increased majority for May after the election will provide her more scope to compromise and engender more good will between the UK and the EU when official negotiations begin. Whether May will use it as an opportunity to do that is a different matter.

UNCOMFORTABLY HIGH RISK OF A HARD BREXIT

For the EU, the difference in costs between a soft and hard Brexit seem small. That Britain is leaving the EU is a setback for the EU as a whole. The loss of Britain's pro-market centre-right influence on the block opens the up the possibility that the centre-left dominates EU politics. While this may potentially cause the



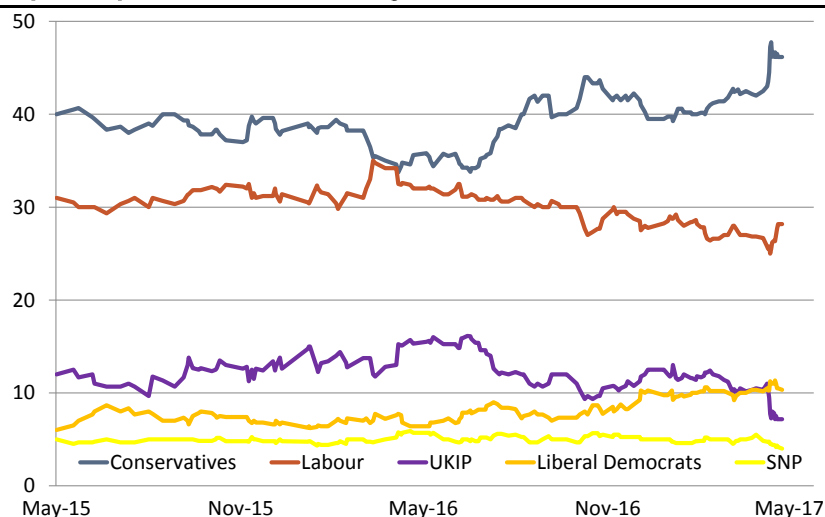
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bloc to turn towards more regulation, rules and protectionism, the most prominent centre-left leaders in the EU, France's Emmanuel Macron and Italy's Matteo Renzi, seem to be reformers rather than regulators. The nature of Brexit will not change the balance between liberalisers and regulators in the EU27. As the EU27 GDP earns only 3% of its GDP by exporting to the UK, the EU can live with the damage that a hard Brexit would do to the UK economy and to EU27 exports to the UK. While Britain may value a trade deal above all else, the EU27 will seek to preserve the cohesion of the 27, and will not bend its other principles, even if Britain sees these as secondary. As the perceived economics costs of Brexit for the EU27 are small, the EU position will likely be less flexible than the position the UK needs to adopt in order to clinch a trade deal in the end.

Meanwhile, the election could end in Britain hardening its position further. More than before, the selection of Conservative constituency candidates will be driven by their Brexit views. Grass-root Conservatives are likely to be more pro-Brexit than the average voter. While more seats for the Conservatives will serve to dilute extreme Brexit views on both sides, we expect Conservative MPs to be more pro-Brexit, on average, after the vote. For the hard-line Conservative Brexiteers, who see EU membership as a negative economic influence on the UK, and have visions of the UK becoming a type of Singapore-on-Thames, the economic costs of a hard-Brexit seem trivial. Some such MPs would genuinely prefer a hard-Brexit. Meanwhile, increased control for the prime minister will give her more freedom to exercise her judgement on the UK's EU exit. May's hard-line views on EU migration suggest that she also harbours some hard-Brexit tendencies.

For our more information and our key views on the upcoming UK election and Brexit negotiations please see: [Brexit: key issues as Britain heads for the exit](#) (28 March 2017) and [How Brexit could affect the UK general election](#) (20 April 2017).

Opinion polls for the next UK general election



Support for political parties in %, rolling average of most recent polls. SNP: Some data points include voting intentions for Plaid Cymru. Source: National opinion polls, Berenberg calculations



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