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THE STATE OF BREXIT: SPELLING OUT THE RISKS

Berenberg Macro Flash

Disclaimer: Our base case remains a continued modest economic expansion over the medium-term and a semi-soft Brexit with a UK-EU transitional trade arrangement covering goods and many services beginning in March 2019. For more information please see this note from 20 June 'Analysing Brexit: the options and outlook'. But after two weeks of watching events unfold from afar, it seems to me that the UK domestic political scene is going from bad to worse. It is therefore prudent to spell out the risks this presents as plainly as possible.

PARLIAMENT IN RECESS, BUT ECONOMY GETS NO BREAK FROM POLITICS

With the House of Commons in recess until the 5th of September, we have little hope that the UK government can settle its differences over what it wants from Brexit before the end of the summer break. Meanwhile, the Brexit clock is ticking. The risk that the UK could sleepwalk out of the EU without a serious follow-up arrangement hangs like a sword over the economy. Before the Brexit negotiations had begun, Brexit minister David Davis had warned that the timetable of the Brexit talks would be the 'row of the summer'. But Davis agreed to the EU's scheduling – divorce talks before trade – almost immediately, during the first round of negotiations in June. Instead of a debate between Brussels and London, the row of the summer is the one between the pragmatists and hard-core Brexiteers within the UK's Conservative Party. Pragmatic factions in the UK government would prefer to concede most of the EU's divorce demands in order to swiftly move onto post-Brexit trade talks. Hard-line Eurosceptics – who do not see major costs from Brexit – would prefer to play hardball with the EU27 instead.

The next round of Brexit negotiations is set for 28 August. Theresa May will be on holiday for the next three weeks. The UK may thus be unable to make much progress on the key terms of divorce, the Brexit bill and the rights of EU citizens in the UK at the upcoming round of negotiations. The UK government might not even settle its differences over Brexit until the Conservative Party conference in October. Speculation that prime minister May could resign at the party conference may prompt the frontrunners for the next prime minister - pro-EU Chancellor Philip Hammond and Eurosceptics Boris Johnson (foreign minister) and David Davis (Brexit minister) - to stick firmly to their erstwhile positions for the next few months. Especially Johnson and Davis might not want to be accused by the Tory rank-and-file of having given in to any EU demands by that time. Such party politics may make it hard – though not impossible - for the UK government to establish a consensus on Brexit in time for the Brexit talks set for 18 September and 9 October.

We see a clear tail risk that the UK will not get its act together in time to agree the key elements of Brexit and at least a transitional post-Brexit trade deal with the EU within the two year period that is set to end in March 2019. Markets could thus begin to seriously consider the prospect of the UK, distracted by its own bickering, walking over a Brexit cliff-edge in 2019. A hard Brexit would reduce long-term trend growth to 1.5% from 2.2% pre-Brexit. Crashing out of the EU without a transitional arrangement could add a major short-run demand-side shock to that. This is by far the biggest single risk facing the UK economy for the next two years.

PLAYING FOR TIME – A TRANSITIONAL DEAL REMAINS OUR BASE CASE

The recent UK snap election that ended in a hung parliament has raised the influence of the more pragmatic members of parliament (MPs) within the Conservative party. In time and after a prolonged period of confusion and public fighting between key Conservative MPs, the UK will likely agree to most of the EU's terms of divorce in order to prevent a messy exit. This can allow the UK and the EU to work toward a transitional arrangement in 2018 that would come into force when Brexit actually happens on 29 March 2019. We expect this agreement to cover trade in goods and many services excluding sensitive financial services. Over time, this arrangement will probably solidify with minor changes into the final terms for post-Brexit trade between the UK and the EU. In this outcome – our base case – we predict that UK trend growth will be 1.8% instead of the pre-Brexit 2.2%.

While critical differences remain on the details of a transitional deal, the key Brexit players in Theresa May's cabinet – trade secretary Fox, foreign minister Davis, and chancellor Hammond – all favour a transition period to ensure a smooth exit. Their major sticking point is whether the UK should try to remain inside the EU Customs Union during the transitional phase. Pro-EU chancellor Hammond favours prioritising EU trade even after Brexit and thus wants the UK to remain inside the Customs Union during the transition. But remaining inside the EU Customs Union prevents the UK securing trade-deals with non-EU countries. Unsurprisingly, Eurosceptic trade minister Fox wants the UK out of the EU Customs Union during the transitional period beginning in March 2019.

THE UK IS MISSING OUT ON THE GROWTH SPURT IN THE REST OF EUROPE

Despite political chaos, the UK economy continues to remain resilient. Amid major short-term volatility, retail sales data project a modest expansion in real household demand, the labour market continues adding jobs at a healthy rate, and industrial producers are benefitting from the more competitively valued sterling exchange rate and stronger global demand. Data due on Wednesday will probably show real GDP expanded by at least 0.3% qoq in Q2, up from 0.2% in Q1. With trend real GDP growth of around 0.45% qoq, the economy is still coping reasonably well with the enormous political risks hanging over the UK.

However, the UK's economic performance could have been much better without the Brexit vote and its political fallout. Since the Lehman recession, the UK has sat comfortably at the top of the G7 growth league. But whereas growth has accelerated significantly so far this year in continental Europe and many emerging markets, the UK is missing out. While the downside risks from the Brexit vote have not yet played out in a major way, the uncertainty stemming from Brexit is leading to caution in all areas of spending and policy that have long-term implications. The UK would probably be growing at 2.5% or above this year were it not for Brexit, with strong gains in real wages and more business investment. Instead, we forecast a modest expansion of 1.7% this year and 1.6% next year.

WHO SAYS THERE IS NO SUCH THING AS A FREE LUNCH?

The UK's current political and economic strife is entirely self-inflicted. By reducing future rates of growth in migration, trade and investment with its biggest market, the EU, Brexit will lower the UK's long-run growth potential. The weaker sterling reflects that markets have reduced their long-run estimates of the UK's future income growth. Markets have, in a way, started to impose this long-term outcome on UK households already. By squeezing real incomes, the fall in sterling has curtailed the means by which UK households can live.

If the UK is ready for it, here would be a free lunch: The more the UK restricts free movement of labour after Brexit, the more the EU27 will restrict the UK's access to the Single Market. If the UK takes a liberal approach to migration, it can retain access to the large supply of skilled workers from the EU while preserving a high level of access to the biggest common market in the world.

The confused British debate is dominated by those who see a liberal migration policy with the EU as the price for a trade-deal. In economic terms, this is wrong. There is no economic trade-off between the alleged costs of migration and the benefits of trade. Instead the UK faces a choice between the costs from restricting both or the benefits from having both. The UK currently attracts the right types of economic migrants from the EU. EU migrants in the UK have high levels of labour market participation and they are mostly well educated. They raise both total and per-capita real GDP. If the UK decides to place heavy restrictions on EU migration, it will suffer from cutting its supply of labour and losing its privileged access to the single market.

Let us end on a high note. Most the costs of Brexit endured so far can be reversed. By promising to maintain current rules on migration with the EU with no more than a few Norwegian-style safeguard clauses, the UK would open the door to a comprehensive trade-deal with its biggest market. Meanwhile, if the UK continued to commit to sound supply-side and fiscal policy, a sufficiently liberal approach to non-EU migration, and straightforward post-Brexit trade-policy with non-EU countries of promising to cut tariffs and barriers like-for-like with any willing trading partners, markets would quickly raise their long-term expectations for UK trend growth and price out the risk of a hard Brexit. This would lead to an appreciation in sterling and a partial reversal of the loss to real incomes UK households have endured since the Brexit vote. None of this requires any input from the EU. The UK's conundrum can only be solved at home. Let us hope that, after the summer recess, parliamentarians return with clearer – albeit sun-burnt – heads, and that the UK can start to put its best foot forward again – to re-assert its well deserved reputation for pragmatism and level-headedness.

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