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BREXIT UPDATE: A PREDICTABLE BUMP IN THE ROAD

Berenberg Macro Flash

STUCK IN THE MUD, FOR NOW

No surprise. Reports about the third round of Brexit negotiations in Brussels this week between chief EU negotiator Michael Barnier and UK Brexit minister David Davis suggest that the two sides are at a standstill. Once again, the EU claims that the UK is unorganised and wasting time. Heading into this third round, which began on Monday, the UK had planned to discuss the proposals for future UK-EU trade detailed in the government white papers published over the summer. Meanwhile, the EU had sought to stick to the pre-agreed schedule and pin down the details of Brexit first: the tally for the UK's financial obligations to the EU it committed to as a member, citizens' rights, and the Irish border question. While Britain had already agreed to the EU's ordering of the talks - Brexit before trade - the UK claims it has complied with the EU's request for 'sufficient' progress on Brexit so that trade talks can begin already. Naturally, the EU disagrees.

The likely outcome will be that the UK and the EU will not make much progress in this round of negotiations. Expect a somewhat tense atmosphere between Mr Barnier and Mr Davis at tomorrow's press conference that brings the third round of talks to a close. The lack of progress under major time constraints highlight the key risk, an unintentional cliff-edge Brexit in March 2019 - simply because the UK and the EU cannot come together on key issues. To understand why the talks are stuck in the mud, we must identify the two sides' differing perspectives and priorities:

HOW THE EU SEES IT

As the UK is around four times more exposed to the EU27 economy than the EU27 is to the UK economy, the EU is negotiating from a position of strength. The EU does not see major risks to its economy from a hard Brexit. While the EU has argued for a transitional period to smooth the exit, preserving preferential access to the UK market plays no major role in EU27 discussions about Brexit. The EU27's priority is to safeguard the political cohesion of the group of 27. That means ensuring the rights of its citizens living in the UK are protected, and minimising the direct costs to its members from the Brexit divorce. Until Barnier can take a 'satisfactory' UK commitment on the Brexit divorce back to the EU27, he will refuse to move on to trade talks. The UK might not like this, but this is how trade deals work - the bigger partner typically sets the terms. No doubt the UK will find a similarly uncompromising stance when it gets around to negotiating trade with the US and China.

Because 27 countries find it difficult to agree on major changes, the EU27 will neither decide to deliberately 'punish' the UK nor to offer generous terms to it. The common denominator among the EU27 is that no deal for a country that has filed for divorce can be as generous as the terms available to EU members or to countries that might hypothetically still want to become members in the future (such as Norway or Switzerland). To some extent, the EU27 sees the deals it has struck with Norway and Switzerland as engagement presents that will not be available for a divorce settlement with the UK. Whether the UK then chooses a status that is close to but worse than the current position of Norway or Switzerland, or that of Turkey, will be mostly up to the UK. The table (below) includes the key elements of the current off-the-shelf models for trade with the EU. In the final row, we show the UK's long-term growth rate, *ceteris paribus*, in each model.



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HOW THE UK SEES IT

The UK position is more complicated than that of the EU. Because the Brexit vote was so narrow in the first place (52% for Brexit), the UK remains divided on the key issues. The majority of remainers want to avoid a hard Brexit at any cost. Meanwhile, the majority of Brexiteers want to avoid a hard Brexit too, but they do not fear it. Instead, some believe there are direct benefits from a hard Brexit. The very public infighting between key government ministers earlier this summer reflected these critical differences. But over the course of the summer, these differences have been largely resolved. Emboldened by PM May's failed election gamble which lost her party's majority, forcing a fragile cooperation with the Northern Irish DUP, the remainers have sought to remove the PM's earlier 'no deal is better than a bad deal' threat from the UK's bargaining strategy. It has worked. The key government ministers, Brexit minister David Davis, trade minister Liam Fox, chancellor Philip Hammond, and foreign secretary Boris Johnson, all agree: the UK will need to pay a divorce settlement upon exit, it will need a transitional period – probably three years – where the UK de facto remains inside the single market, and it should aim for a close trading relationship within the EU after Brexit.

But the alleged costs of EU membership and the free movement of people were key reasons why many UK citizens voted for Brexit in the first place. With the government already weakened by the election, it would prefer to present a framework for UK-EU post-Brexit trade alongside the divorce terms, thereby framing Brexit and the transitional period as necessary steps to a trade deal. Without the trade deal, agreeing the Brexit bill and a transitional period would look, to some UK voters, as simply more payment to the EU and a government set on delaying Brexit. This would embolden the anti-EU media that play a very prominent role in forming UK opinion on European politics. Conceding too early on Brexit could undermine the government's progress toward achieving its aims drawn from a hard fought consensus.

A SEMI-SOFT BREXIT REMAINS OUR BASE CASE, 30% RISK OF A HARD BREXIT

After some more delays, we expect the UK to agree to the EU's terms of divorce, probably before the end of the year. Moreover, with the help of time, and a change in the governments approach, the issue of EU migration can become a less important factor in the UK domestic political debate. As we have argued before, the more the UK insists on violating a fundamental principle of the EU, namely the free movement of labour, the less preferential the market access granted by the EU27 will be. Three key trends can mitigate this trade-off for the UK: (1) EU net migration is falling (see chart); (2) students are likely to be excluded from any future net-migration targets (roughly 1/3 of all net-migration); (3) the government will publish a report next year assessing the impact of net-migration (it should show a positive effect).

Over time, the UK government could find it easier to divert the Brexit debate from its current destructive focus on migration onto what really counts – a trade deal with the UK's major partner, the EU27. 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 in March 2019. We expect this agreement to retain preferential trade in most goods and some services. Over time, this arrangement will probably solidify into the final terms for post-Brexit trade between the UK and the EU. In this, our base case, Brexit could reduce trend growth to 1.8% from the pre-Brexit rate of 2.2%. In the case of a hard Brexit (30% chance), trend growth could fall to 1.5%.



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Possible options for UK post-Brexit economic relations with the EU

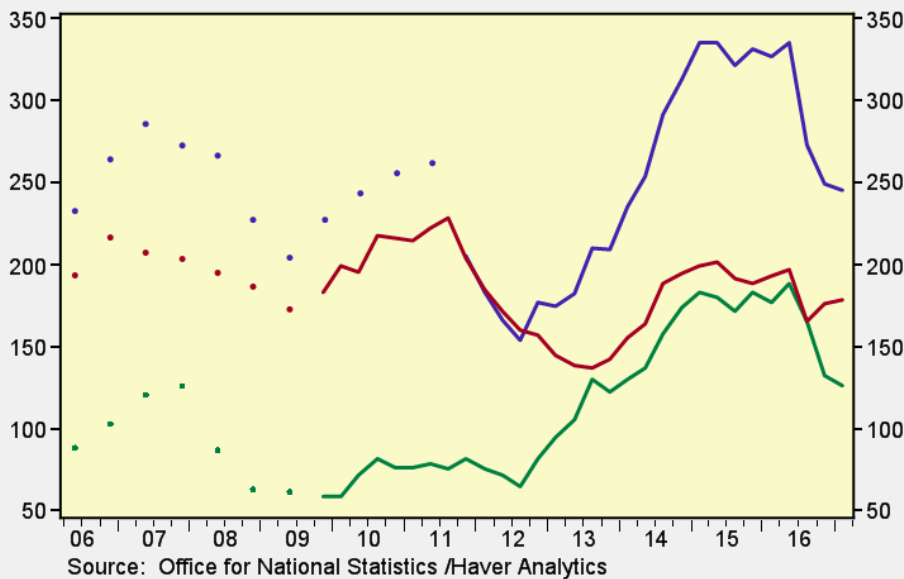
	EU member (current model)	European Economic Area (Norway model)	Bilateral agreements (Swiss model)	Customs union agreement (Turkey model)	Free trade deal (Ukraine/Canada model)	World Trade Organization (basic model)
Free trade within the area	Yes	Yes but farming excluded	Yes for most goods, no for farming and most services	Yes for most goods, no for farming and services	Yes for most goods, few services, no for farming	No
Open service markets and financial passporting within EU	Yes	Yes	Partial	No	No	No
Customs union with EU (no border checks)	Yes	No	No	Yes for most goods	No	No
Free to set external trade policy	No	Yes	Yes	No for most goods, yes for services	Yes	Yes
Covered by EU external trade agreements	Yes	No	No	Yes for most goods, no for services	No	No
Free movement of people	Yes	Yes	Yes	No	No	No
Votes on EU laws/regulations	Yes	No	No	No	No	No
Under ECJ jurisdiction ¹	Yes	Yes indirectly	Yes indirectly	Yes indirectly	Partial	No
Contribution to EU budget	Yes	Yes	Yes	Partial	No	No
Long-term trend growth (% pa)	2.2	2.0	1.8	1.6	1.6	1.5

¹ As the ECJ adjudicates on all Single Market issues, countries in customs union or agreements with the EU as well as EEA countries are indirectly under the jurisdiction of the European Court of Justice (ECJ). Source: HM Government "Alternatives to membership: possible models for the UK outside the EU", Berenberg



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UK: Migration Balance: Non European Union (EOP, Thous)
UK: Reason for Migration Balance: All Reasons (EOP, Thous)
UK: Migration Balance: European Union (EOP, Thous)



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