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

UK: MAY'S FLORENCE SPEECH – 4 TAKEAWAYS

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Nothing much new under the Florence sun: That UK prime minister May spent 45 minutes speaking on Brexit in sunny Florence today, while offering virtually nothing beyond what was leaked before, gave off the impression the UK didn't have just 18 months to settle Brexit and renegotiate new terms of trade with the EU. The lack of urgency to secure a concrete deal with its biggest market remains the biggest risk to the UK economic outlook. Markets might find some comfort in the promise that Britain will pay its dues and could de facto stay inside the single market for the two year transitional period, but as expected, there is still no detail on the key issues that could take the negotiations forward in a serious way. PM May stayed in the safe zone to minimise the risk of infighting within her cabinet ahead of her party's conference at the start of next month. As a result, the hard Brexit risk – 30% chance – still looms as large as before. Here the four key takeaways:

1. Transition and post-Brexit trade

May announced that she only wanted business to have to change to new rules once. She therefore suggested that the UK should de facto remain inside the single market for a transitional period of around two years, or as long as was needed. While she said free movement of people will continue during that period, EU citizens would have to register when they entered the UK. If this came to pass it would materially reduce the risk of a lumpy macroeconomic adjustment. But a critical point remains; the EU27 would have to first sign off such an agreement. On post-Brexit trade, May said that neither the Norway (European Economic Area) model or Canadian-style FTA (free trade agreement) would suit Britain as the former would too closely resemble EU membership and the latter would be inadequate. As the EU sees its economic links to the UK as fairly minor – c3% of EU27 GDP comes from exporting to the UK whereas 12% of UK GDP comes from exporting to the EU – the UK will find the EU is not as enthusiastic as the UK in seeking out a bespoke arrangement, to put it mildly.

2. Brexit bill, citizens rights and the Irish border

May moved the UK position modestly towards the inevitable: Britain will have to pay up. The offer of continued payment into the EU budget during a two-year transition period – which will amount to around €20 billion – marks a departure from previous prevarication on the issue. However, it only takes the UK halfway towards the €35-40 bn which the EU will almost certainly demand as a minimum to cover the UK's legacy liabilities during a post-Brexit-transition period and beyond. On the rights of EU27 citizens in the UK, and UK citizens in the EU, May's tone was more constructive than before, stating that the UK and the EU would require a mechanism for resolving disputes and UK and EU laws inevitably diverge going forward. On the Irish border, May reiterated past commitments toward there being no physical border after Brexit.

3. Is May trying to bypass the EU?

That May drew a comparison between the 'institution of the EU' and the 'family of European nations', and said it was up to European leaders 'to set the tone', was probably an attempt to encourage key members within strong trade links to the UK to lean on the European Commission to go softer on the UK. But as we have argued before, preserving preferential access to the UK market plays no major role in EU27 discussions about Brexit. May's attempt to bypass the European Commission stems for a misunderstanding often touted in the British press – that, for example,



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Germany may lean heavily on Poland to accept restrictions on the free movement of labour in order to preserve access for German carmakers to the UK market.

4. No deal possibly is worse than a bad deal

The line that ‘no deal is better than a bad deal’ that May has frequently used in speeches since becoming PM last year was not included in her speech today. And when asked by a journalist if this was still May’s view, she said somewhat reticently ‘will still think that’. Along with an overall more conciliatory tone than her 17 January Lancaster House speech, it suggests that the government’s strategy on Brexit has moderated somewhat from the hard-line approach taken before the election embarrassment earlier this year. Furthermore, May made an unconditional commitment to future co-operation on defence, security law and justice, suggesting that a joint UK-EU bill should be introduced to deepen existing commitments. While some hard-line Brexiters might accuse May of throwing away one of the UK’s best cards by making such a commitment, it sets a positive tone for future talks.

As always, the devil is in the details: Unless UK chief negotiator David Davis unexpectedly presents the EU27 at the next round of negotiations next week with detailed explanations that satisfy EU27 demands, the EU will not be willing to move on towards a discussion of post-Brexit trade relations at its upcoming summit on 19-20 October. Our base case remains unchanged. In time, and possibly after further delay, the UK will largely agree to the EU’s terms of divorce. After Brexit is settled, the UK and the EU can work towards a transitional arrangement in 2018 that would come into force when Brexit actually happens in March 2019. We expect this agreement to cover 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. This outcome could reduce UK trend growth to 1.8% from its pre-Brexit rate of 2.2%.

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Joh. Berenberg, Gossler & Co.
KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
Kallum.pickering@berenberg.com