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BREXIT UPDATE: WILL THERE BE A BREAKTHROUGH SOON?

Berenberg Macro Flash

SANTA MIGHT DELIVER A BREXIT GIFT AFTER ALL

Green shoots of progress: Reuters report that today EU diplomats are beginning the process of sketching out the terms of a Brexit transitional deal which could enable the UK to remain de facto within the Single Market for a further two years after March 2019. This follows reports by the Sunday Times at the weekend that UK PM Theresa May is prepared to pay the €60bn divorce bill outlined by the EU. The divorce bill is based on EU spending commitments agreed by the UK before the Brexit vote. While we do not expect the UK and EU to finalise Brexit (divorce settlement, EU citizens rights and Irish border question) and a transitional deal before the end of 2017, this 'soft' progress sets the stage for some concrete progress at the Brexit negotiations scheduled for December. We see a good chance that the UK agrees in principle the formula for the divorce bill set out by the EU by the end of the year. If this happened, it would reduce the market's perceived risk of a no-deal 'hard Brexit' scenario. It would likely have a positive effect on business confidence and the sterling exchange rate.

So far, Brexit is going a little better than expected. Keep in mind the early predictions by UK Brexit secretary David Davis. Davis had promised before the first UK-EU talks began that the order of the negotiations would be the 'row of the summer'. This never played out. After triggering Article 50 (the EU divorce process) back in March, Theresa May undertook the gamble of a general election to further increase her majority, and lost badly. The UK's hung parliament election result was partly a rejection of Theresa May's hard-Brexit vision. At any rate, it forced the Conservative-led government to face the facts of life a little sooner than we had imagined at the start of the year. The UK has already: (1) accepted the EU sequence for negotiations (divorce issues first, post-divorce trade relations later); (2) acknowledged in general terms that it will still have to pay into the EU budget in return for any privileged market access; (3) started to contemplate a transition period after formal Brexit on 29 March 2019 to allow time for a post-Brexit deal; and (4) admitted that the European Court of Justice will play a role in dispute settlements in any transition period. Notwithstanding the short time horizon to figure out Brexit, this represents real progress. These key elements can provide the basis for a sensible Brexit outcome.

BEYOND DIVORCE TALKS - WHAT WILL HAPPEN DURING THE TRANSITIONAL PHASE?

A transitional phase would offer the UK and the EU more time to decide post-Brexit trade relations. But just as in the divorce talks, expect the EU to dictate the terms for post-Brexit trade relations. As the EU27 GDP earns only 3% of its GDP exporting to the UK, the EU can live with the damage that a hard Brexit would do to its economy. As the perceived economic 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.

In the EU's strategy for post-Brexit trade, preserving preferential access to the UK market plays second fiddle to ensuring the political cohesion of the EU27 group and preserving the integrity of the Single Market. The UK is therefore likely to face a simple trade-off. 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. Whether the UK then chooses a status – based on its migration policy – that is close to but worse than the current position of Norway or Switzerland, or similar to that Canada will be mostly up to the UK. If the UK takes a liberal approach to migration policy, it can retain access to the large supply of workers from the EU while preserving a high level of access to the biggest common market in the world. Net migration from the EU has fallen sharply since the Brexit vote. As this is likely to continue over the coming years, the UK should find it politi-



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cally easier to accept something that resembles the current policy of free movement of people with the EU after Brexit.

POTENTIAL TIMELINE FOR BREXIT AND POTENTIAL OPTIONS FOR POST-BREXIT TRADE

EU chief Brexit negotiator Michel Barnier has said that UK-EU negotiations should be over within 18 months of the UK triggering Article 50 (October 2018) to give six months for the EU27 and European Parliament to ratify any deal. UK-EU talks will need to be wrapped up by September 2018. Approving the terms of divorce requires a qualified majority by the EU27 and a simple majority in the European Parliament. Depending on details, a deal on future preferential UK access to the Single Market may have to be ratified by all 27 EU members. UK PM Theresa May has promised to give parliament a vote on the final deal - although that vote cannot change the terms of the deal. UK parliament will have to like it or lump it - accept the deal or take the UK out of the EU without such a deal and thus have the UK trade with the EU27 on WTO terms i.e. go for a hard Brexit.

Faced with a choice between a deal on EU27 terms or no deal at all, in late 2018 we expect the UK to accept a transition deal (possibly similar to the Norway deal minus some financial market privileges) for 2 or 3 years (70% probability). Since it will be difficult to change such an arrangement very much, over time, this arrangement will probably solidify into the final terms for post-Brexit trade between the UK and the EU. In this base case, Brexit could reduce trend growth to 1.8% from the pre-Brexit rate of 2.2%. The key risk remains that the UK will opt for a hard Brexit with few follow-up arrangements for privileged access to the EU27 market (30% risk). In case of a hard Brexit, UK trend growth could fall to 1.5%. See table below for our impact analysis of Brexit on UK potential growth based on existing models for trade with the EU.

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Possible templates for post-Brexit UK-EU relations

	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

¹As 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

Source: Berenberg

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