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## **BREXIT UPDATE: MAY DOES NOT HAVE THE LUCK OF THE IRISH, DECEMBER BREAKTHROUGH STILL LIKELY**

### Berenberg Macro Flash

#### **NOT THERE YET**

Yesterday's headlines that London and Dublin had struck a deal on the Irish Border question turned out to be premature. At her lunch with European Commission president Jean-Claude Juncker, UK Prime Minister Theresa May reportedly offered to keep regulations in Northern Ireland aligned with those in the Republic of Ireland, and thus the EU, after Brexit in order to avoid a hard land border in Ireland. With the Brexit bill and citizens rights agreed already, settling the Irish question would have removed the final obstacle in the divorce talks to allow negotiations to advance to trade talks. But the Northern Irish Democratic Unionist Party (DUP), which the Conservatives rely on for a majority in the House of Commons, announced they would not support any arrangement where the rules governing trade in Northern Ireland differed from mainland UK.

#### **WHAT HAPPENS NEXT?**

Although the UK failed to meet the EU's requirement of 'sufficient progress' on the divorce at yesterday's lunch, both sides seem ready to work toward a new solution. Reuters reported that PM May said she expects a solution before the end of the week. Meanwhile, Irish PM Leon Varadkar has said Dublin will give May time work with the DUP before sitting down again with London to re-draft the language on the Irish border agreement, that is, as long as the implications are unchanged - no hard border. As the UK is Ireland's major trading partner in Europe, Dublin would ideally like no change to the current arrangement; i.e. to keep the UK inside the single market and the customs union. While not unthinkable, this seems unlikely, to put it mildly. The contradiction between the desires of the DUP and Dublin is the real crux of the problem. Because it is not obvious how this difference can be easily bridged, expect a temporary period of heightened uncertainty while Westminster works up a new offer.

#### **MOMENTUM MATTERS**

That London has dropped its hardline view on the Brexit bill - the most contentious issue on the UK side - and tried a solution, albeit an unworkable one, on the Irish question signals that London wants to move the talks forward. It still seems more likely than not that the UK and the EU will make the necessary breakthrough on the Irish question in order to move on to negotiations for trade and transitional arrangements at the 14 December EU summit. Progression to trade talks by the end of the year would underpin a further uptick in sterling and reinforce our above-consensus near-term growth calls for the UK of 1.8% in 2018 and 1.9% in 2019 (Bloomberg consensus 5 Dec - 1.4% in 2018 and 1.6% in 2019).

Our Brexit base case therefore remains unchanged. We expect the UK to accept by late 2018 a transition deal (possibly similar to the Norway deal minus some financial market privileges) for 2 or 3 years (80% probability). Since it will be difficult to change such an arrangement very much over time, major parts of this arrangement could 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 or opt for a hard Brexit with few



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follow-up arrangements for privileged access to the EU27 market (20% risk). In a hard Brexit, UK trend growth could fall to 1.5%.

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