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BREXIT UPDATE: MANAGED DIVERGENCE, CHERRY PICKING, LABOUR CUSTOMS UNION

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MANAGED DIVERGENCE AND THE THREE BASKETS APPROACH – WHAT IS IT?

UK prime minister Theresa May will outline the UK's strategy for negotiating post-Brexit trade ties with the EU in a speech later this week (probably Friday). Following her meeting with her cabinet late last week at her country residence at Chequers Court, UK press at the weekend reported that the UK government favours a strategy of 'managed divergence' with a so-called 'three-baskets' approach. In this model, the sectors where the UK is currently aligned with the EU27 as part of its membership in the single market and customs union would probably be divided as follows:

Basket 1: Sectors in which UK ministers want to preserve full alignment with EU rules;

Basket 2: Sectors which UK ministers will aim to establish and agree shared goals with the EU, but that can be achieved through different means;

Basket 3: Sectors where UK ministers want to fully diverge from EU rules.

Border checks and controls are required for goods not services. Therefore, if the third basket includes politically sensitive sectors such as agriculture and farming, which seems likely, this would create problems preserving the current borderless arrangement on the Irish Isle. As part of the mutually agreed divorce back in December, the UK pledged to prioritise the status quo in Ireland over leaving the single market and the customs union. While this 'three baskets' approach might be consistent with the UK government's aim to leave the customs union, it seems to contradict the UK government's policy to preserve the status quo in Ireland. While the UK has floated the idea of some type of digital border management system for the Irish border, it has not yet put forward any concrete solution. Remember, also, that the UK has a comparative advantage in services over goods. If basket 3 encompasses many services, which would allow the UK to strike a trade deal with say the US, this could come at a loss of preferential access to the EU market.

THE UK'S POLICY IS STILL AT ODDS WITH WHAT THE EU CAN AGREE

EU council president Donald Tusk said, in response to the press report about the UK's ideas, that the UK's suggested approach was 'pure illusion', and was a continuation of the UK's desire to 'cherry pick' parts of the EU it wanted to stay part of. As the EU27 earns just c3% of its GDP exporting to the UK (compared to the c13% for the UK in exports to the EU) preserving preferential access to the UK market plays no major role in EU27 discussions about Brexit. For the EU27, European integration is first and foremost a political project and not just a commercial concern. As its top priority, the EU27 wants to safeguard the political cohesion of the group of 27.

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 who might hypothetically still want to be become members in the future. Expect the EU to do no more than offer the UK a slightly modified and less attractive version of the kind of deals the EU already has in place with non-EU countries. Whether the UK then chooses a status that is close to but worse than the current status of Norway or Switzerland or similar to that of Canada with its mere association agreement with the EU will be mostly up to the UK.



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Unless the UK provides the critical details needed to prepare the ground for a future trade agreement, namely the UK's future policy on EU migration and some solution to preserve the seamless Irish border after Brexit, the EU will probably offer its own proposed framework for future trade. In such an outcome, we would expect the framework to resemble no more than a basic free trade-deal akin to the EU-Canada deal. If the UK wants to do better than that, it needs to come up with its own ideas fast.

THE CORBYN FACTOR

Meanwhile, the UK's main opposition Labour party, headed by far-left leader Jeremy Corbyn, have signalled their policy is to seek out some form of customs union with the EU, akin to the EU-Turkey agreement, as a way to preserve the status quo in Northern Ireland. While we see only a 15% chance of Labour getting to power before the next scheduled election in 2022, well past the time horizon when such a policy would matter, a more pressing question is whether such a policy would pass in parliament if it were put forward as a motion sooner? While this is not completely outside the realms of reality, it would require some Conservative MPs, or some Northern Irish Democratic Unionist Party MPs, to side with Labour on such a policy. This does seem unlikely but not impossible.

If enough defectors from the Conservative-DUP alliance helped to carry a Labour-led motion in Parliament that meant the UK would have to seek out a customs union agreement with the EU after Brexit, all hell would break loose in the Conservative Party, to put it mildly. It would risk splitting the party in two and could risk fresh elections. This risk is not negligible – hence our 15% chance of Corbyn in No. 10 before 2022. However, as we have argued before, the Corbyn threat is the glue that binds the opposing factions of government together. We think that both the Remainers and Brexiteers inside government would rather compromise on a second-best Brexit – relating to their own preferences - than risk losing power. As a result, should Labour put forward such a motion, we would not expect parliament to carry it.

DESPITE THE NOISE OUR OUTLOOK REMAINS UNCHANGED

After agreeing to transitional terms at the 22-23 March EU summit that de facto keep the UK inside the single market and customs union until the end of 2020, we expect the UK and the EU to sketch out some broad aims for future trade during the summer. As it stands, we see four potential scenarios:

Soft Brexit (30% chance): As roughly two-thirds of the members of the UK parliament are pro-EU, such a deal would probably get a majority backing in parliament. If faced with a choice between no more than a basic free trade arrangement covering only goods and a comprehensive “Norway-minus” deal, the UK could go for the later.

Semi-soft Brexit (45%): This is the most likely scenario. The UK stays close enough to EU rules for many goods and some services to avoid a hard border in Ireland. UK remainers could support a deal that keeps the UK partly aligned with the EU while the Brexiteers could back such an agreement as it would offer the UK some room to pursue its non-EU ambitions. The UK and the EU could probably find a solution to the Irish question – possibly a bespoke customs arrangement. It is possible that the UK simply finds a different name “customs arrangement” but stays de facto in the EU customs union for virtually everything that would otherwise have to be physically controlled at the Irish border.

No deal – hard Brexit (20%): With so many interests – and careers – at stake, the risk that talks could fail at any point remains serious.



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No Brexit (only 5% probability): The only possible route to a reversal of Brexit would be through fresh elections that ended up with either Labour, or some Labour-led coalition with the pro-EU Liberal Democrats and Scottish National Party, going for a second referendum that reversed the result of the first.

For more detail on our Brexit outlook please see [Brexit scenarios: now for the hard part](#).

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