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BREXIT UPDATE: TOUGH QUESTIONS REMAIN UNANSWERED DESPITE AGREEMENT ON TRANSITION

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Another step away from the cliff edge: After agreeing the terms of divorce in December, UK and EU negotiators took another step today towards a pragmatic outcome in which a no-deal hard Brexit can be avoided. At a joint press conference, EU head negotiator Michel Barnier and UK head negotiator David Davis highlighted the progress in the talks and presented an updated draft of the [Brexit withdrawal agreement](#). Among other things, Mr Davis and Mr Barnier announced that their teams had agreed the terms of citizens rights, the Brexit bill, and that they had agreed a time-limited transitional deal. Once again, the UK has largely accepted the EU27 position. The five key takeaways are:

- 1. Transitional deal until end-2020:** Mr Davis and Mr Barnier presented outlines of a transitional deal that would keep the UK inside the single market and EU customs union until the end of 2020 to give both sides time to finalise the details of their future trading arrangement which would take effect at the start of 2021. During the transitional period, the UK must meet all of the obligations that come with membership of the single market and customs union, but forfeit its EU member privileges – veto and voting rights - as these will cease when Brexit takes effect on 29 March 2019. According to the outlines of the transitional deal, the current rules governing the rights of UK and EU citizens will be preserved; the UK will be able to negotiate and sign up to non-EU trade deals that can take effect at the start of 2021 when the transitional period ends; and the UK will be consulted on decisions affecting the market made during the transitional deal, including things like fishing quotas on UK waters.
- 2. Nothing is agreed until everything is agreed:** The 130 page withdrawal agreement is colour-coded: the green parts are agreed by negotiators but may be subject to technical legal revision; the parts highlighted yellow are partially agreed - changes and drafting is still required; and parts that are white still need to be negotiated and agreed in future negotiations. Roughly two-thirds of the document appears to have been agreed by both sides. Despite the short time frame and often noisy public spats between UK and EU officials on the side-lines, the negotiating teams appear to be making good progress. Having agreed the divorce and transitional terms, the negotiators will spend the rest of the summer detailing the broad aims for a future trading relationship. Remember, none of what has been so far agreed has any legal basis unless the EU27 and the UK pass it through their respective parliaments and ratification procedures at the end of the negotiations. Because the Irish question remains unanswered, securing the final deal in the UK and EU parliaments is by no means a sure thing. We still see a 25% risk of a hard Brexit, linked to the risk that talks could collapse on the difficult Irish question.
- 3. The Irish vetoes:** On the EU side, the Republican of Ireland, backed by the other EU members, will not accept any future trade agreement that involves a hard border across Ireland. On the UK side, the Northern Irish Democratic Unionist Party (DUP), whom the Conservatives rely on for a slim majority in the House of Commons, would not support any arrangement where the regulatory status of Northern Ireland differed from the rest of the



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UK. How the UK's Conservative-led government finds a deal that satisfies the whole of Ireland while also taking the entire UK (N. Ireland plus mainland UK) out of the EU customs union remains an open question. The EU is not trading in a completely frictionless way in goods with any country that is not a member of its customs union. So far, the UK has agreed a legal backstop that will keep Northern Ireland in parts of the single market and customs union to avoid a hard border if no other solution can be found. As the DUP has already stated it would not support such an outcome, the UK is under pressure to either back down on its policy to leave the customs union or come up with a viable alternative, and quickly. This final hurdle is the biggest one facing the negotiators yet. For more information please see [Brexit tail risks loom larger than before](#).

- 4. Trade talks can begin in April:** At today's press conference, Mr Barnier said that trade talks could begin in April if the EU27 accepted the updated text on the withdrawal of the UK from the EU. Mr Barnier has said before that the EU27 will need six months to ratify the withdrawal agreement in time for Brexit in March 2019. Trade talks will therefore need to be over by October 2018 at the latest. This leaves almost seven months to the October EU summit to negotiate and agree the key elements for the future trading arrangement. The deal needs to include a solution to the Irish question, as well as other key issues such as the UK's policy on migration and willingness to accept some degree of indirect influence by EU institutions such as the European Court of Justice.
- 5. Brexit progress is positive for the UK's medium-term outlook:** At the March 22-23 EU summit later this week, EU27 leaders are likely to give a thumbs up to the updated withdrawal text by adopting the guidelines for the future UK-EU trading arrangement put forward by EU Council president Donald Tusk some two weeks ago. See [Brexit update: No cake or cherries in the EU's offer to Britain](#). Cable (GBPUSD) broke 1.40 today on the news that a transitional deal had been agreed. Nevertheless, by choosing to leave its biggest market, the EU, the UK is committing an act of economic self harm which will lower its future growth potential. In this sense, Brexit cannot be a success. However, the reduced uncertainty about the long-term UK economic outlook is a positive for markets and businesses. It supports our above-consensus calls for UK medium-term growth of 1.7% in 2018 and 1.8% in 2019 (Bloomberg consensus on 19/03/2018 is 1.5% in both 2018 and 2019).

Since we had expected the UK and the EU to agree to a transitional deal at the EU summit this month already, our four main scenarios for Brexit remain unchanged:

- No deal – hard Brexit (25%)
- No Brexit (10%): The only possible route to a reversal of Brexit would be through fresh elections that ended up with a Labour-led government scheduling a second referendum that reversed the result of the first.
- Semi-soft Brexit (40%): This remains 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 room to pursue its non-EU ambitions at least for services.
- Soft Brexit (25%): As roughly two thirds of MPs are pro-EU, a comprehensive deal to keep the UK in the single market and customs union for goods and many services could theoretically be backed by a majority backing in parliament. However, many Conservative MPs would vote



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against it. May is unlikely to negotiate such a deal which could trigger the collapse of her government.

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