



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

UK CUSTOMS DEBATE - TANGLED UP IN BL(EU)

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What has Bob Dylan got to do with the EU customs union? In his 1975 hit 'Tangled Up in Blue', Bob Dylan managed to perform in music what the cubist movement had achieved in art - to capture multiple perspectives in one coherent viewpoint. Now, UK Prime Minister Theresa May has to somehow achieve the same thing with Brexit - specifically, the Irish-border problem. In the end, we expect the UK and the EU to settle the Irish question and avoid a no-deal hard Brexit, probably through some fudge on the language of the final withdrawal agreement so that it can pass through both the EU and UK parliaments in time for Brexit in March 2019.

What is the key issue? So far, May has insisted that the UK will not remain in any form of customs union with the EU after Brexit in March 2019 beyond a temporary transitional period. This policy is mainly driven by the Brexiteers in her own party who argue that remaining in a customs union with the EU would significantly limit the UK's ability to strike future trade deals with non-EU partners. According to the EU, this policy contradicts another of May's promises, to avoid a hard border on the Irish Isle. The EU argues that the Irish border can be kept open only if some kind of customs union arrangement is agreed in order to prevent the need to check goods as they cross the UK-EU border.

Parliament is divided on the customs union question. The House of Lords recently introduced an amendment to the UK's 'EU withdrawal bill' to require ministers to report on what progress they have made to secure a customs union with the EU by October 2018 - five months before the UK is set to exit in March 2019. The amendment is not final. Both the House of Lords and the House of Commons must agree to the final wording of the legislation. However, the mere fact that the Lords have made the amendment means that the House of Commons must debate and vote on whether or not it should be government policy to pursue a customs union agreement with the EU. All major opposition parties - Labour, the Liberal Democrats and the Scottish National Party - will probably back keeping the UK in a customs union with the EU.

Will the Conservative Party crack? The stakes are rising inside the Conservative Party. Any small group of pro-EU rebel Conservatives could theoretically turn the Lords' amendment into law. The Prime Minister may struggle to keep her government together in such a turn of events. The British press in the past week have frequently reported on the rumors that key Brexiteers, including Brexit Secretary David Davis, threaten to resign if the UK goes for a customs union agreement while the hardline Brexiteers in parliament threaten to withdraw support for PM May. The Conservative Party is riding close to the cliff edge. In the end, we expect May to secure enough votes to reject the Lords' amendment. As we have argued before, the risk (20% likelihood) that Labour could come to power under far-left socialist Jeremy Corbyn remains a bigger threat to all key factions of the Conservative party than suffering their own modest disappointments on the precise shape of Brexit. However, as the House of Commons will have a final vote on the terms of Brexit anyway, the option for any group of Tory rebels to reject May's final version of Brexit remains wide open.

The Irish vetoes: Ireland has more export exposure to the UK than other EU economies. Although the Republic of Ireland may gain a little business from the UK after Brexit, especially in financial services as London loses its EU passport, Brexit presents a major risk to the Irish economy through less open trade with its biggest market. Irish Prime Minister Leo Varadkar wants to keep the UK in some form of customs union with the EU to preserve the current no-border arrangement with Northern Ireland. Brussels is behind



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Varadkar. On the EU27 side, he has a de facto veto on the Brexit deal. 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 also have a veto. The DUP would not support any arrangement where the regulatory status of Northern Ireland differed from the rest of the UK.

What happens next? Having agreed the divorce and transitional terms, the UK and the EU will re-start negotiations this week. Talks focussing on the broad aims for a future trading relationship are scheduled to last throughout the summer. Remember, no part 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.

What happens with the Irish-Border/customs arrangement could make or break the agreement. The potential solutions are:

- 1) **UK and EU customs union** (similar to the current arrangement) – This is not official government policy but backed by Conservative opposition parties and the EU.
- 2) **Customs arrangement** (UK government collects duties for the EU for goods passing through the UK but destined for the EU market) – This is May's favoured solution, but has been rejected as unworkable by the EU27.
- 3) **Maximum facilitation** (UK uses technologies such as cameras and barcodes to limit the frictions on UK-EU trade at the border) – This is the Brexiteers' favoured solution.

Fudge or bust: In the end, we expect the UK and the EU to find some compromise in order to pass the final deal before March 2019. This will probably come in the form of a fudge which extends the UK's membership of the customs union beyond the already agreed transitional period (end-2020) but gives both sides the option to re-negotiate the arrangement after some minimum period. The Brexiteers could agree to such a deal as it could allow the UK to eventually leave the customs union, for instance when technical facilities are available that could make options 2 or 3 workable. The EU and pro-EU factions of UK government could agree on a deal that they believe would eventually harden into the final terms. This is part of our base case for a semi-soft Brexit (40% chance) in which the UK stays close enough to EU rules for many goods and some services to avoid a hard border in Ireland.

Can May do a Dylan? With luck, yes. Whatever happens, it is shaping up to be yet another eventful summer in UK politics. Watch this space!

For more detailed on our Brexit scenarios please see [Brexit tail risks loom larger than before](#).



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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