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BREXIT: BACK TO THE DRAWING BOARD

Berenberg Macro Flash

May's chequers deal is dead: In an interview with the German newspaper FAS, head EU Brexit negotiator Michel Barnier stated plainly that the EU27 could not hand over control of its external border to a third country (referring to the UK outside the EU after Brexit). Barnier's interview followed consultations with EU governments. UK Prime Minister Theresa May's current proposal – dubbed the 'Chequers deal' – aims for a digital border between the Northern Ireland and the Republic of Ireland that would enable the UK to distinguish between UK and EU bound goods and, critically, set different tariffs on goods bound for the UK market while acting as tax collector for the EU. While we have argued before that the EU would not accept the precise arrangement outlined in the Chequers plan, the references to new technologies in Chequers cannot be squared with the EU position according to the statement by Mr Barnier. This pours cold water on any chance that UK diplomats thought they may have had on finding a tricky wording on the final agreement that could make it acceptable for the hardline Brexiteers in the Conservative Party.

The UK's choice: While Barnier's comments do not change the narrative and outlook we published last week, [see Brexit: deal likely after a noisy Autumn](#), that the EU27 has pronounced its verdict on Chequers implies that the UK needs to decide its choice among the options the EU27 could agree to. Barnier says: 'customs union or Canada style free-trade-agreement' (or Norway, which UK has rejected). In a way, this development simply adds to PM May's woes. Support within her party for the Chequers deal is dwindling anyway. The risk that hardline Brexiteers would not back her plans has loomed large from the start. PM May now has two options: 1) to try and unite as much of her party as possible around the EU's offer of a customs union and hope that she can get it through parliament, probably with some cross-party support; 2) or take a hard-line approach in upcoming negotiations with the EU – as this would probably set the UK in the direction of a hard Brexit, the risk of fresh elections would rise dramatically.

A political decision is needed: Our base case remains that, in the end, most Conservative MP along with some moderates from the Liberal Democrats, the Scottish National Party and the Labour Party will vote in favour of customs arrangement with the EU for goods that would keep the Irish border open (60% probability). However, the tail risks around this outlook are large (20% chance of a hard Brexit, 10% chance of a soft-Brexit, and 10% chance of no Brexit). The next most important date on the Brexit calendar is the Conservative Party conference (30 September – 3 October). It could prove to be moment of truth. Chances are that PM May will use the conference to try and unite her party. This will be a major challenge. The grass roots of the Conservative Party are harder on Brexit than the majority of her MPs. The risk is that PM May uses the conference as an opportunity to take a hardline stance towards the lack of progress in Brexit negotiations. If so, the risks around our base case would rise.



MACRO NEWS

Parliamentary arithmetic matters: The Conservative party relies on votes from the Northern Irish DUP (Democratic Unionist Party) for a majority in the House of Commons. As the DUP mainly cares about keeping the Irish border open, and ensuring Northern Ireland remains aligned with mainland UK rules and regulations, it may not remain in alliance with the Conservatives in a hard-Brexit scenario as that would undermine its key objective. As the Conservatives would not have a majority to govern without the help of the DUP, a failure on the part of the Conservatives to pass any final deal would significantly raise the chances of snap elections and a Corbyn-led government. We thus see a 25% chance that Jeremy Corbyn could become Prime Minister in either a Labour majority government or a coalition government. As Labour's current policy on Brexit is to negotiate a customs union, then something resembling our base case would likely prevail if Labour won an outright majority in a snap election (5pts). However, based on current opinion polls, it seems unlikely that Labour would manage to secure such a majority. Labour would likely need the help of either the very pro-EU Liberal Democrats (Lib Dems) and/or Scottish National Party (SNP) to govern. Our bet is that both the Lib Dems and SNP would only join Labour as a junior coalition partner if Labour either went for a soft Brexit (10pts) or a second referendum that could end in a no Brexit outcome (10pts). If our logic prevails, the Conservatives' real choice could be between remaining in power in a customs union style arrangement, or losing power and potentially seeing Brexit softened/reversed.

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