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BREXIT: ENTERING THE HOT PHASE

Berenberg Macro Flash

Ever since the UK narrowly voted in June 2016 to leave the European Union, the UK has hotly debated what kind of Brexit it wants. Last week's Salzburg summit has finally forced the UK to consider what kind of Brexit deal the EU27 may sign up to. As decision time is approaching, let us briefly recall the basics before considering potential outcomes.

BREXIT BASICS

- Against the wishes of the EU27, the UK has filed for divorce. Since the Brexit vote, preserving the cohesion of the EU27 has become the continent's top priority. As expected by some observers - but to the apparent surprise of Downing Street - the EU27 remains fairly united on Brexit issues. Repeated UK attempts to "divide and influence" have come to naught.
- The UK earns 12% of its GDP by exporting goods and services to the EU27 while EU27 exports to the UK are just 3% of EU27 GDP. The bigger EU27 is thus in a stronger position to shape any agreement on post-Brexit trade than the UK.
- The EU27 is not given to major policy innovations or abrupt policy shifts. Once the 27 sovereign nations have found a near-consensus on an issue such as Brexit, the EU largely sticks to that position.
- The 27 EU members do not want to be either very harsh or very generous to the UK. They would not be able to agree anyway which of these two attitudes to adopt. Instead, the EU27 has consistently offered the UK a choice of post-Brexit deals that are close to existing templates for economic relations between the EU and other non-members. The UK can opt for full membership of the single market ("Norway option"), a customs union, or a free trade deal ("Canada plus"). Some variations of such existing templates are possible, a completely new design such as a full "Chequers" that would disrupt the cohesion of the single market is not.
- Although big countries naturally have more influence than the minnows, the EU27 almost always respects the views of a small member claiming that a legitimate supreme national interest is at stake. Being most affected, Ireland has a de facto veto on the Brexit deal. The EU thus insists that the Irish border issue must be resolved in a way acceptable to Dublin.

THE UK DEBATE

The debate within the UK has so far yielded two major insights. First, the campaign claims of the less thoughtful Brexiteers such as Boris Johnson had little substance. Second, none of the various potential Brexit deals would have majority support among voters and in parliament on its merits. The only potential exception might be the "no Brexit" U-turn (see chart below) which is not on the menu, at least not under a Conservative government. It seems almost inconceivable that all Conservative MPs could jointly vote for one particular option. The same holds for a Labour party that is similarly divided, albeit along different lines. This week's Labour conference with an inconclusive paper that could be seen as a call for new elections, a customs union or perhaps a new referendum with an unclear question has shown that once again.

The question is what happens once the debate about potential scenarios is over and the UK government followed by the UK parliament face a binary choice between whatever imperfect deal the UK can strike with the EU - or no deal at all. We continue to see a 60% chance that the government and the current parliament will approve a Brexit deal negotiated between the EU27 and UK Prime Minister Theresa May in the next few months. Although some Conservatives will almost certainly vote against it, some opposition MPs will - given the dismal alternative - likely help it over the line. For the nature of the semi-soft Brexit that we consider most likely, see [Brexit: deal likely after a noisy autumn](#).



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Whatever deal May may or may not strike with the EU will leave a significant number of Tory MPs unhappy. Her position is thus at some risk. However, any potential Tory successor would face the same problem. Also, fear of turmoil that could bring Labour's hard left leader Jeremy Corbyn to power as well as fear of the impact of a no-deal hard Brexit can restrain some of the potentially rebellious Conservatives. Our base case remains that May can thus hang on to her job at least until Brexit has happened on 29 March next year.

A 60% probability for an orderly Brexit to be agreed by PM May and the EU27 leaves a huge 40% risk of more disruptive or radical outcomes ranging from a no-deal hard Brexit (20% risk) to a new referendum after potential new elections that might theoretically even be won by Corbyn. It would probably take some political change in London first to make a very soft Brexit (Norway option) possible (10% chance).

THE NATURE OF A POTENTIAL DEAL

The hot phase of negotiating the envisaged umbrella agreement for future EU-UK relations will start after next week's Conservative party congress. As discussed in our [update](#) last week, the talks could potentially be heading towards a fudge combined with a backstop:

First, the deal could be less detailed than the EU would have liked, leaving many issues to be settled in future negotiations during the post-Brexit transition period. This could allow May to claim that the final result could still be close to her Chequers plan (some elements of a customs union) while allowing other Conservatives to hope that it would be rather different (Canada plus).

Second, at the behest of Dublin, the EU will insist on a "backstop" guarantee that Northern Ireland will remain so closely aligned with the EU's regulatory and customs regime for goods after the transition period that border controls will not be needed along the Irish border. The EU will be very flexible as to how a customs and regulatory border between Northern Ireland and the UK mainland would be policed in case the backstop would have to be activated after the transition period. The EU has repeatedly pointed to the current veterinary controls in Larne harbour between Northern Ireland and the UK mainland. But do not expect Dublin and hence the EU to agree that, in order to avoid a hard land border, Ireland might leave the EU customs and regulatory area and align itself with the UK instead.

If and when the UK and the EU27 conclude the Brexit deal, both sides will likely emphasise that they do not expect the backstop to be activated as future talks on details of a post-Brexit trade arrangement would probably find a better solution.

THE TIMELINE

The EU27 wants to settle the issues in time for a special Brexit summit on 17-18 November in order to leave all sides enough time to ratify the deal ahead of the formal Brexit on 29 March 2019. The EU27 believes that, once the UK has taken the political decision to accept the Irish border backstop, all else could be negotiated fast.

EU deadlines do not need to be hard, though. The regular EU summit on 13-14 December may still be early enough. As long as the EU sees a serious chance that giving the UK a little extra time may help, negotiations might even drag on into early 2019. If a deal struck in early 2019 could no longer be ratified fast enough by the EU27, diplomats may find a temporary fix such as an agreement to already activate the "transition period" parts of a deal ahead of final ratification. But even then, all would have to be wrapped up well before the European parliamentary elections next May.



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WHAT IF?

The nightmare scenario of a no deal hard Brexit would have serious consequences. The UK economy could fall into temporary stagnation or worse, Eurozone growth would decelerate significantly for a few quarters amid grave uncertainty about industrial supply chains and future access to a major market.

We continue to see a 20% risk of a no deal hard Brexit. If and when the nightmare scenario becomes inevitable, we would expect a last-minute scramble to secure a series of stopgap mini-deals to avert the worst, that is to allow planes to fly, lorries to roll, medicines to be shipped etc.. But the EU27 may tie even some of those mini-deals to Britain's readiness to honour its binding financial commitments, often erroneously called the "Brexit bill". Life would go on, but it would be more miserable for all parties, with the smaller UK being hit more heavily by the disruption of long-standing ties than the bigger EU27.

UK voters no longer like Brexit: was the UK right or wrong to vote for Brexit?

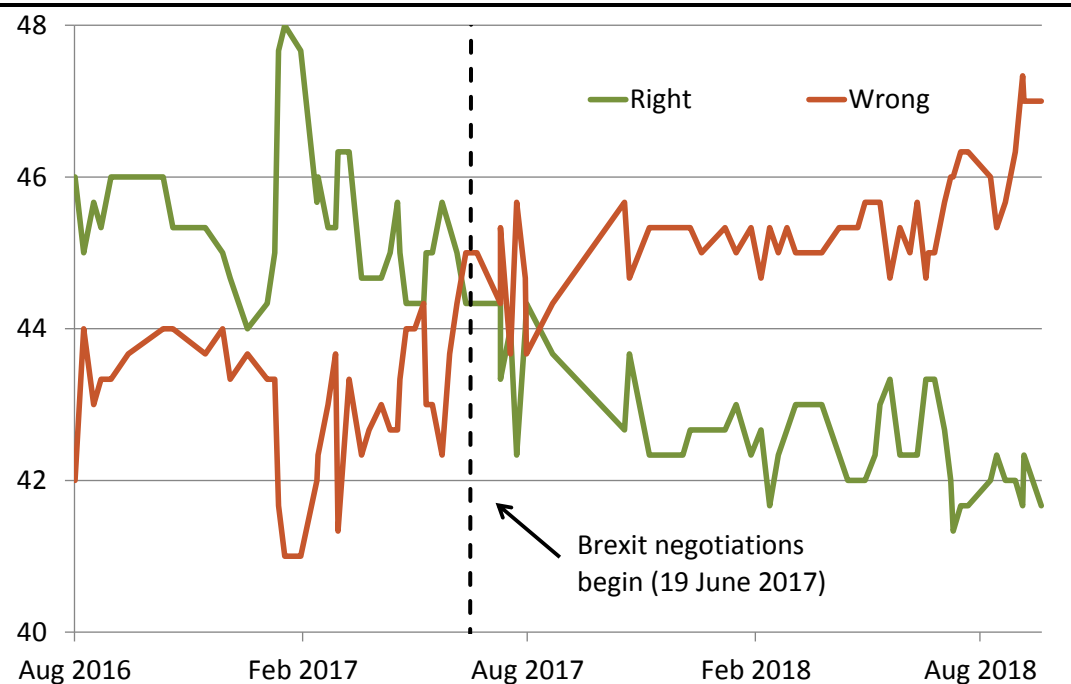


Chart shows opinion polls on the question of whether the UK was 'right' or 'wrong' to vote to leave the EU in June 2016. Three-poll average. Source: UK opinion polls.

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