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BREXIT: THE EUROPEAN ANGLE

Berenberg Macro Flash

Every day, observers spill a sea of ink on the latest contortions of the UK's Brexit debate. They pay less attention to the bigger player in the Brexit saga, the EU27. To some extent, that makes sense. Unlike the UK government, the EU27 has been quite consistent, united and predictable in its approach to Brexit. Still, it helps to consider the EU position occasionally. It shapes the range of options available to the UK.

BREXITEER ILLUSIONS

A few days ago, a soft-spoken pro-Brexit Tory MP made three points to me:

1. As the EU27 runs a surplus in its trade with the UK, the EU27 would have more to lose from a no-deal hard Brexit. Hence, the EU27 will cave in in the end.
2. The EU27 needs the services of the City of London. That gives the UK significant leverage.
3. The Irish border issue is just a red herring, resolvable by intelligent use of technology to allow Northern Ireland to stay fully aligned with mainland UK but deviate a lot from the Republic of Ireland without any need for border controls.

Without saying it quite that explicitly, the gentleman seemed to imply that it would only take a more determined pro-Brexit Tory leader to call the EU's bluff.

THE EU POSITION

Over the last three years, I have heard these arguments quite regularly in the UK. On the European continent, I've met very few people who see things this way, though. My own understanding of the EU position is somewhat different. For four reasons, the EU27 is unlikely to change its approach significantly, let alone to cave in:

1. The EU is about much more than commerce. As a result, the EU position is shaped by broader political considerations rather than narrow commercial interests. Preserving the political cohesion of the EU27 has become the continent's top priority.
2. In absolute numbers, more jobs in the EU27 depend on cross-Channel exchanges than in the UK. However, in relative terms, the much smaller UK is much more exposed. The UK earns c12% of its GDP by exporting goods and services to the EU27 whereas EU27 exports to the UK account for just c3% of EU27 GDP. The EU27 thus has the much stronger hand, as the result of the Brexit negotiations shows.
3. The EU27 is well aware that the City of London supplies vital services which no financial center in the EU could replicate in the foreseeable future. As a result, any final Brexit deal will come with a lot of cherry-picking. However, the big EU rather than the smaller UK will do the



picking, deciding which financial services can continue to be sold freely to the EU27 from London and which aspects of which services may face restrictions or may have to shift on-shore. That even holds for a no-deal hard Brexit. For example, the European Commission's contingency plans for a hard Brexit would allow a clearing of euro derivatives contracts through London for one extra year beyond 29 March 2019.

4. The EU27 empowers its smaller member states. To the surprise of Brexiteers who see the EU largely in commercial terms, the EU27 consistently puts what Ireland considers its supreme national interest above the commercial interest of industry in its other member countries. The EU27 uses its sheer size to let the Republic of Ireland shape the terms for the post-Brexit economic future of Northern Ireland even at the risk of complicating the overall post-Brexit EU-UK relations. If Theresa May wants to change the "Irish backstop", the permanent guarantee for no hard border in Ireland, she would need to convince Ireland's Leo Varadkar, not Angela Merkel and Jean-Claude Juncker.

As a result, the EU27 is highly unlikely to re-negotiate the current deal. The EU27 can offer kind words of "clarification" but not genuine concessions such as de facto dropping the Irish backstop. Of course, if the UK were to shift its approach dramatically and apply for the Norway-option (single market but not customs union) or full economic integration (single market and customs union), the EU would be ready to consider that and change the declaration on post-Brexit cooperation accordingly. But as long as Ireland maintains its position, any Brexit deal would have to keep Northern Ireland in the EU customs union and in regulatory alignment for goods with the EU27 unless and until an alternative is found which satisfies Ireland's demand to avoid a hard border.

EU CONSTRAINTS

Against the wishes of the EU27, the UK has filed for divorce. The EU27 would still welcome a change of mind in the UK. However, the EU27 will not go to great lengths to encourage such a U-turn in the UK.

No more special deals: Until the Brexit vote, the EU had granted the UK a succession of special concessions such as the budget rebate and opt-outs. On the morning after the Brexit vote, the EU attitude changed. The inclination to offer the UK further special deals is largely gone. Tony Blair's hope that the EU27 could be ready to severely restrict the free movement of labour in order to shift the UK debate in favour of "remain" in a potential new referendum looks overdone. Of course, as attitudes to migration are hardening in the EU27, the UK could – like other member countries – draw a clearer distinction than before between the unimpeded movement of labour and the less welcome immigration into the welfare system.

Patience is limited: Upon asking for divorce by triggering Article 50 of the EU treaty, the UK itself has set 29 March 2019 as the deadline. Until that day, the UK could unilaterally revoke its decision to leave the EU. If political developments in the UK suggested that the UK may change its mind and potentially decide to stay in the EU or go for a much softer Brexit, the EU could agree to extend the 29 March 2019 deadline by a couple of months. However, the EU elects a new parliament



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on 23-26 May 2019 which will start its work in July. By that time at the very latest, it would need to be clear whether that parliament does have members from the UK or not. A potential second UK referendum would thus have to happen well beforehand. Even holding the election to the EU parliament in late May without knowing whether or not the UK will stay in would be very tricky. After all, the number of parliamentarians which each EU27 country can select depends on the status of the UK: do seats have to be reserved for the UK or not? On current plans, 27 of the total 73 seats held so far by the UK are to be redistributed among 14 of the remaining 27 EU members that are currently underrepresented in parliament.

The well-oiled compromise machine of Brussels is good at getting around such tricky issues for a while. But any extension to the period of Brexit uncertainty beyond 29 March 2019 would have to be quite short, probably no more than a couple of months. Requiring unanimous agreement among the EU27, a request for a formal extension of the self-imposed deadline could make the UK vulnerable to additional demands from the 27 EU members (remember the Gibraltar debate ahead of the EU's 25 November Brexit summit?). As a hypothetical alternative to gain time, the UK may simply rescind its Article 50 notice and possibly file for divorce again if, for example, a new referendum were to confirm the initial "leave" vote later on. However, such a lengthy delay would be awkward as it would most likely require the UK to still hold the EU parliamentary elections on 23 May 2019 before deciding whether or not the country would actually send the parliamentarians to Brussels afterwards. None of these contortions would strengthen the UK's bargaining position. One way or the other, the UK should better make up its mind fast. Less uncertainty would also be helpful for the economic outlook on both sides of the Channel, and especially for the UK itself.

For our take on the UK's Brexit process, see [UK: Hard Brexit risk down, Corbyn risk up](#)

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