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BREXIT BASICS

Berenberg Macro Flash

Brexit will do some significant damage to the British economy. Greater London is the services capital of Europe. Today, companies take advantage of the great conveniences of Britain's light-touch regulation, its competent administration, its deep pool of qualified labour and the English language to offer their services across Europe from a British base. That role will be somewhat diminished by a hard Brexit. Of course, Britain can still do reasonably well outside the European Union if it gets its domestic policy choices right.

As we digest Theresa May's speech today, let us recall the basics:

Whether or not a country thrives is mostly the result of its domestic policy choices. Because of its light-touch regulations including a flexible labour market, the UK is one of the most dynamic economies in the Western world. The only major fly in the ointment is that the UK still has one of the worst fiscal deficits in the developed world despite years of comparatively strong growth. That suggests that some of this demand growth has been brought forward at the expense of the future through excessive government borrowing.

There is no significant evidence that EU membership has held back the UK in an economically meaningful way. Instead, the UK economy has done well within the EU, even somewhat better than Germany or Sweden on many counts.

Brexit will hurt. After the vote to leave on 23 June 2016, we reduced our call for future UK trend growth from 2.2% to 1.8% because the UK will attract less inward investment and fewer skilled immigrants and will need to run a tighter fiscal policy in the long run to offset the fiscal costs of slower trend growth. For that estimate, we assume that the UK will maintain almost unlimited access to the common market for goods while facing some restrictions for access to the EU services markets and lose passporting rights for UK-based financial institutions. If the actual Brexit turns out to be much harder than that, we would have to reduce our estimate of future UK trend growth below 1.8%. A trend growth rate of 1.8% would still leave the UK marginally ahead of Germany's 1.6%.

The UK could offset some of the Brexit damage through pro-growth reforms. See Kallum Pickering's – UK approaches a critical juncture – choices ahead - for details. But because the UK is already so lightly regulated in many areas, the scope for that is very limited except if the UK were to tackle its major domestic problems such as the restrictions on housing supply. Also, the political climate in the UK with its strong populist streaks (think UKIP, Jeremy Corbyn, Boris Johnson) does not suggest that the UK will embark on a massive deregulation drive soon, reducing "workers rights" and the like on a major scale. The "health and safety" regulations in the UK, which often go well beyond continental norms, instead show that the UK has its own penchant for sometimes overdoing the well-meaning regulatory zeal.

The UK has established its comparative advantage much more in services than in goods. Unfortunately, services are far more politically sensitive than goods. Negotiating trade deals on goods can be comparatively straightforward. The UK will find it easy to accept, say, the product specifications and norms for aircraft parts it will continue to supply to Airbus or for cars it exports to the EU. However, negotiating such deals for services can be much more complex. Even more so than in the case of goods, service talks are about regulations that reflect strong domestic political preferences. Getting "good" deals for the UK on services will be tough, to put it mildly. UK trading partners know that the UK cannot afford to drive a really hard bargain here because it needs to sell its services.

The notion that the UK could turn itself into Europe's Singapore, a rich free-wheeling low-tax service and trade centre at the egde of the continent, is largely fantasy. First, the UK is simply in the wrong time zone to be the services centre of Asia. It needs Europe as a major market. Second, the more the UK deviates from European norms, the more the EU will regulate and restrain its imports from the UK. Whatever the economic merits of tax dumping may be, the more the UK tries to be an offshore tax haven, the more will the EU see to it that the goods and services the UK offers will also stay offshore, that is cannot be sold easily in the EU.

The UK needs trade with the much bigger EU27 more than vice versa. Whereas the UK earns 12% of its GDP by exporting goods and services to the EU27, the reverse flow accounts for just 3% of EU27 GDP.

For the EU27, preserving its own cohesion is the absolute priority. Preserving preferential access to the UK market is nowhere near the top of priorities. The EU27 will take a hard line without wanting to genuinely punish the UK. If "Brexit means Brexit" (Theresa May), then "out means out" (Wolfgang Schaeuble).

Losing the UK's c€12bn net contribution to the EU budget would be somewhat unfortunate for the EU27. But relative to the size of the EU27 economy (c€12tn) the sum is small. With its fiscal surplus, Germany could easily take a little more than its fair share of that. If the UK wants to preserve any element of preferential access to the EU market, it will have to pay into the EU budget in return, just like Norway and Switzerland do.

To argue that the EU27 will suffer more from Brexit - and that the EU would thus want to offer the UK a sweet deal in order to reduce the supposed damage to the EU27 - is a typical "tail wags dog" delusion.

A Trumpian "great trade deal" with the US will do little more than to preserve the access to the US market which the UK enjoys at the moment.

The great City of London will remain an attractive financial centre. The real issue is whether it's future growth will be subdued rather than pre-Brexit spectacular and by how much the UK will have to slash the prices it charges for its services through a lower exchange rate.

With luck, the two-year negotiation period to be triggered in late March may suffice to settle the terms of divorce. But it is far too short to negotiate the future relations between the EU27 and the UK. Once the deadline approaches two years from now, the result could be a hastily arranged interim deal with some not very generous terms for the UK to make it acceptable across the EU27. The way Europe works, such an interim deal would then be difficult to change afterwards. The very fact that the EU27 finds it difficult to agree makes it unlikely for the UK to get much of a "bespoke" deal.

May's speech today is just the opening gambit for negotiations. Taking a tough line at the start is standard. If May plays her hand well, she will use the likely decline in net migration from the EU into a somewhat less attractive UK in coming years to soften her stance a little over time, hopefully preserving a significant part of preferential access to the EU27 market. If so, that would be good for both sides, for the UK even more than for the much bigger EU27.

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