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THE BREXIT BRIEF

Berenberg Macro Flash

Today, the UK will file for divorce from the European Union. This is the worst setback ever for the process of European integration that started with a six-nation coal and steel community in 1952. Over the last 12 months, we have written extensively about the potential impact on the UK and the EU. Below, we summarise our key views in 10 bullets:

Brexit is inevitable. After the two-year divorce process that starts today, the UK will leave the EU. David Cameron had called the Brexit referendum to paper over deep divisions within the Conservative Party in the UK. As backing down from Brexit would tear the Tory party apart, the Conservative government will execute the Brexit regardless of the outcome of the Brexit negotiations or any potential – if somewhat unlikely – shift in public opinion.

Brexit is an irony. For decades, the UK had proclaimed that it values the Common Market above all other aspects of European integration. The UK championed the Eastern enlargement of the EU and did not impose the usual seven-year transition period for the free movement of labour when Poland and other post-communist countries joined in 2004. Now, the UK is leaving the EU partly because it has come to dislike a key principle of the Common Market, the free movement of labour, which had brought the dextrous Polish plumber to the UK.

Brexit is expensive. Britain's Office for Budget Responsibility now expects UK public debt to be at least £100bn higher in fiscal year 2020-21 than it did before the Brexit vote. The UK will need to tighten fiscal policy over time to cover the gap. As the UK becomes less attractive for inward investment and skilled immigrants from the EU, we expect UK trend growth to decelerate from its pre-Brexit rate of 2.2% per year to 1.8% in case of a semi-soft Brexit and to 1.5% in case of a hard Brexit.

Brexit is not a serious blow to the large EU27 economy. The EU27 earn 3% of their GDP through exports to the UK. Losing preferential access to a somewhat less dynamic UK market can shave 0.02-0.04 percentage points off the annual rate of trend growth in the EU27. This can be partly offset by a modest gain in well-paid jobs. A larger share of the future growth in financial and some other tradable services in Europe will now happen on the European mainland rather than in the UK.

Brexit is a much bigger political headache for the UK than for the EU. For years, British politics will revolve around Brexit. For policy makers on the continent, dealing with Brexit is not among their top five priorities. First and foremost, the EU27 want to safeguard the cohesion of the group. At its core, European integration is a political project. Commercial interests will not shape the bargaining position of the EU27 over Brexit. Having often misread what is happening on the continent, the UK will now face a steep learning curve.

Brexit is not the beginning of the end for the EU. Although risks abound, Brexit is more likely to strengthen than to weaken the cohesion of the EU27. Being seen as soulmates of Nigel Farage or Boris Johnson does not win many votes on the continent, just like Putin, Trump and Erdogan are now provoking some pro-EU counter-reaction on much of the European mainland. The risk that Brexit will tear the UK apart looms larger than the risk that the EU27 may fracture. Even in the wake of the euro crisis, the only places that held referenda on leaving a union were Scotland in 2014 (exit from the UK) and the UK in 2016 (leaving the EU).

Brexit is not the end of the UK. This is a close call. But on balance, Scotland will probably not dare to leave the UK. At oil prices well below \$90 per barrel, the resulting hole in the Scottish budget would be too big to contemplate for the swing voters up North in a second referendum. Northern Ireland presents a thorny issue. However, both the Republic of Ireland and the UK have a vital interest in not inflaming passions in Northern Ireland through imposing a hard border while other European countries have no major stake in this particular issue. Chances are that ways can be found to defuse the problem. Europe can be pretty ingenious and flexible if and when it wants to be so.



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Brexit is fiendishly difficult. Agreeing on the terms of divorce including an exit bill for Britain will be noisy. Talks may easily stall for a while just on these issues. Negotiating agreements about future relations between the EU27 and the UK in time to get them ratified by 29 March 2019 will be almost impossible. Switzerland has 60+ bilateral deals with the EU, many of them rather complex. In the end, the UK will have to choose between some unsatisfactory transitional arrangements or a mini-deal that comes close to a hard Brexit.

Brexit is Britain's choice. The EU27 did not want the UK to leave. But after UK voters rejected the modest reforms offered to Cameron, the EU27 will insist that the future status of the UK relative to the EU27 will be less favourable than the status enjoyed by members or potential would-be members. It will be mostly up to the UK to choose from a menu of options such as a status close to but less favourable than that of

- **Norway** (common market, free movement of labour, paying into the budget - very unlikely),
- **Switzerland** (similar to Norway but much more complex - also very unlikely),
- **Ukraine or Turkey** or other associated countries,

or hardly any preferential market access at all (**hard Brexit**). We still see a slightly better than even chance that the UK will not opt for a hard Brexit. Any deal – or non-deal - will restrict the UK's current preferential access to the EU27 market for financial services.

Brexit is not the end of Europe as we know it. The UK will remain a vibrant and solid economy with a trend growth rate roughly on par with that of Germany even in the case of a hard Brexit. The UK will maintain close ties to other European countries even if forsakes the opportunity to influence the evolution of the European Union from within. The EU will not fracture but evolve into a more flexible club of clubs instead. Life goes on.

For a more detailed exposition of our views, see the reports on [Brexit](#) and [the future of the EU](#) or dial into our conference call on Monday, 3 April, at 15h BST/16h CEST/10h EDT. Standard International Access +44 20 3003 2666; Participant 75 02 23 6#; Password: Berenberg. Toll Free numbers: UK 0808 109 0700; US +1 866 966 5335; Germany 0800 673 7932; France 0805 630061; Switzerland 0800 800 038

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