

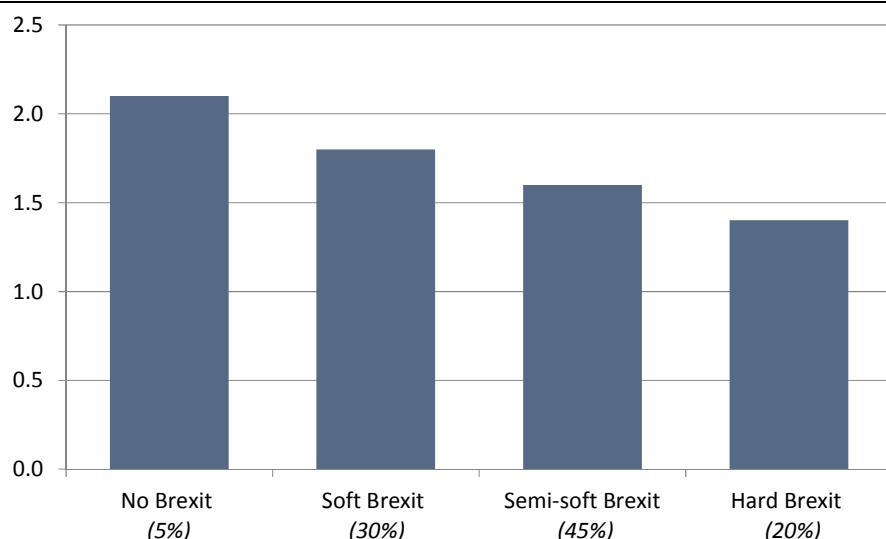
Brexit scenarios: now for the hard part

- **Round one over, two more ahead:** Nine months after the UK started the Brexit proceedings, the terms of divorce are broadly settled. The UK and the EU will now move on to negotiations for a transition period and future UK-EU trade. These must be completed by October 2018 to give the EU27 six months to ratify any deal. In this report, we consider the key issues for the upcoming negotiations and the likely scenarios for future UK-EU trade.
- **A future trade deal rests on the Irish border question:** The UK's aim to leave the customs union seems to contradict the need to preserve the status quo in Ireland. But as part of the mutually agreed divorce, the UK has pledged to prioritise the status quo in Ireland over leaving the single market and the customs union. While this provides the grounds for a potentially (very) soft Brexit, it also crosses key red lines of the Brexiteers. This contradiction will come to a head in the UK debate before the UK and the EU can settle on a framework deal for future trade.

The potential outcomes can be grouped into four Brexit scenarios

- **Soft Brexit (30% chance):** As two-thirds of the members of the UK parliament are pro-EU, such a deal would probably get a majority backing in parliament. If faced with a choice between no more than a basic free trade arrangement covering only goods and a comprehensive "Norway-minus" deal, the UK could go for the later.
- **Semi-soft Brexit (45%):** This is the most likely scenario. The UK stays close enough to EU rules for many goods and some services to avoid a hard border in Ireland. UK remainers could support a deal that keeps the UK partly aligned with the EU while the Brexiteers could back such an agreement as it would offer the UK some room to pursue its non-EU ambitions. The UK and the EU could probably find a solution the Irish question – possibly a bespoke customs arrangement.
- **No deal – hard Brexit (20%):** With so many interests – and careers – at stake, the risk that talks could fail at any point remains a serious one.
- **No Brexit (only 5% probability):** The only possible route to a reversal of Brexit would be through fresh elections that ended up with either Labour, or some Labour-led coalition with the pro-EU Liberal Democrats and Scottish National Party, going for a second referendum that reversed the result of the first.

Chart 1: Long-run UK growth in our Brexit scenarios (probability of each scenario in brackets)



Trend growth in UK real GDP under various Brexit scenarios, in % per year. Source: Berenberg calculations, see Table 1 for more detail on each scenario

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Round one over, two more ahead

Nine months after the UK triggered Article 50 of the Lisbon Treaty – setting in motion two years of negotiations on the UK's exit from the EU and future UK-EU relations – the first part, the divorce, is broadly settled. Both the UK and the EU are now working to legislate the joint divorce proposal which includes: 1) the Brexit bill; 2) the Irish border; and 3) the rights of EU27 citizens in the UK and of UK citizens in the EU27. We summarise the key points on pages 6-7.

Talks can move onto transition and trade now the divorce is broadly settled

According to chief EU Brexit negotiator Michel Barnier, the negotiations on the future relationship between the EU27 and the UK should be over within 18 months of the UK triggering Article 50 (October 2018) to give six months for the EU27 and European Parliament to ratify the deal. Approving the terms of divorce requires a qualified majority by the EU27 and a simple majority in the European Parliament. Depending on details, a deal on future preferential UK access to the Common Market may have to be ratified by all 27 EU members, though. In the UK parliament, both houses will get to vote on the final deal.

Both the EU and the UK parliament will need to vote on a final deal

This timeline implies no more than nine months, from now onwards, to agree the terms of a transitional deal and the general principles for future UK-EU trade. As the UK generates 13% of its GDP by exporting goods and services to the EU, what the UK and the EU agree in these short upcoming months will be critical for its long-term economic prospects. While there remains considerable uncertainty about the practical details of the UK's future partnership with the EU, the divorce agreement and the way in which the UK softened its position to clinch that deal sheds some light on the possible outcome.

No more than nine months to settle transition and trade aims

Transition and trade – the critical issues

The UK government's position toward Brexit and the negotiations has softened considerably since the UK triggered Article 50 in March 2017. We highlight three noteworthy examples. First, UK Prime Minister Theresa May started out by arguing that “no [Brexit] deal is better than a bad deal”. Second, UK Brexit minister David Davis had set out initially saying that the order of the negotiations would be the “row of the summer [2017]” – Davis wanted divorce and future trade talks simultaneously. Finally, UK foreign minister Boris Johnson, in addition to other prominent Brexiteers, stated that the UK should not pay anything to the EU upon exiting.

The UK's position toward Brexit and the negotiations has softened considerably

The UK upheld none of these positions. First, the UK accepted the EU's order of the negotiations – divorce before trade. Second, the UK promised to pay its pre-agreed commitments in full. The agreed formula will probably mean the UK makes a net payment of between EUR40bn and EUR60bn. This is remarkably close to the initial estimate by EU Commission President Jean Claude Juncker of EUR50bn and is well above UK Prime Minister May's initial offer of around EUR20bn. Finally, and most importantly, the UK has set out the conditions for a potentially (very) soft Brexit in its divorce proposals.

The UK has set out the conditions for a potentially (very) soft Brexit

The terms of a transitional deal have been broadly pre-agreed and accepted by both sides. The UK will de facto remain inside the single market and customs union and accept the conditions that go with it. Looking ahead, the key questions pertain to issues of future UK-EU trade relations. The most important component in the divorce agreement and the outlook for future trade relates to the Irish border. The UK has made promises on this issue that seem to conflict with the demands of the Brexiteers on migration and trade. For the UK to secure a comprehensive trade agreement, it will probably need to make further concessions.

The most important issue in the divorce agreement is the Irish border

The Irish question

The UK has made three commitments which matter for the Irish question: 1) to take the UK out of the EU single market and customs union; 2) to uphold the 1998 Good Friday Agreement; and 3) the guarantee no hard border or infrastructure in Ireland. The UK's aim to leave the customs union seems to contradict the need to preserve the status quo in Ireland unless the UK and the EU can agree a special arrangement. Note the 'special' is ambiguous and undefined. So far, the EU is not trading in a completely frictionless way in goods with any country that is not a member of its customs union.

The aim to leave the customs union seems to contradict the status quo in Ireland

What happens if these differences cannot be reconciled either in a conventional way (a customs union) or an unconventional way (special solution)? The UK adds the caveat that, if no special arrangement can be agreed to meet all three objectives, the UK “will maintain full alignment with those rules of the Internal Market and the Customs Union which, now or in the future, support North-South cooperation”. Leaving the single market and customs union does not take priority over preserving the Irish status quo. In other words, if the UK cannot figure out the Irish question, it will de facto stay in the single market and customs union.

If the UK cannot settle the Irish question, it will de facto stay in the single market

As we learned during the final days of the divorce negotiations, the solution whereby Northern Ireland could have its own arrangement with the Republic of Ireland is off the table. The Northern Irish Democratic Unionist Party (DUP), whom the Conservatives rely on for a slim majority in the House of Commons, would not support any arrangement where the regulatory status of Northern Ireland differed from the rest of the UK. While other parties in the Northern Irish parliament might find such an arrangement more palatable, any agreement which would treat Northern Ireland as different from other parts of the UK with respect to the EU could re-open politically charged questions about Northern Irish identity. This would be highly undesirable and thus will be avoided by the UK at almost all costs.

The regulatory status of Northern Ireland will not differ from the rest of the UK

As it seems, the UK has effectively committed itself to a soft(ish) Brexit by way of its promises to Ireland. We need to consider what this could look like. As a variety of possible solutions might satisfy the Irish border question, let us consider the two extremes across such a continuum: 1) as a maximum, the UK de facto remains inside the customs union and single market (or a good part of it); 2) or, as a minimum, the UK and the EU will agree a special customs arrangement that covers the goods that move around Ireland. This, in more detail, entails the following.

The UK has effectively committed itself to a soft(ish) Brexit

- **The softest possible Brexit:** The UK de facto remains in the single market and customs union – probably with some exclusions for specific financial services. This option could guarantee the status quo in Ireland would be preserved without exception. But such an outcome could be political dynamite in the UK. If the UK remained inside the major economic clubs of the EU, it would be seen as a U-turn on Brexit. The UK would not be able to negotiate its own external trade deals with non-EU countries, it would have to stick to EU rules and regulations without having a say on them, and it would continue to pay into the EU for the privilege of participating in its markets. All such conditions represent red lines for the Brexiteers. Then again, the UK’s stance has already softened considerable. This outcome is not unthinkable.
- **A special customs agreement:** The minimum arrangement the UK and the EU could agree to avoid a hard border in Ireland would be a bespoke UK-EU customs arrangement that covered the vast majority of goods that are usually exchanged across the Irish border. This deal would have to apply to the whole of the UK and would probably require the UK to match the EU’s external tariff in all markets covered – de-facto preventing the UK from being able to negotiate external trade deals autonomously for these markets. While this option would allow for frictionless goods, it presents its own challenges. The UK’s comparative advantage lies in financial services. After Brexit, the UK will want to seek new trade agreements with non-EU countries in this sector. However, any potential partners would want access to the UK market in the areas that they specialise in. Major developing nations like China and India, the likely targets for such future deals, would want to focus on trade in goods. If the UK established a special customs union with the EU, it would have to respect the EU’s common external tariff. This would limit the UK’s ability to offer something unique to the Chinas and Indias of the world in return for access to their markets for services.

The softest possible Brexit: to de facto remain in the single market and customs union

The minimum arrangement: a bespoke UK-EU customs arrangement

Avoiding new infrastructure at the Irish border while leaving the single market and customs union will not be easy. Even the closest external partners of the EU struggle on this count. The examples of the border between the EU and EFTA (European Free Trade Association) and the Swiss-EU borders illustrate this well. EFTA member Norway, which is part of the single market but not the customs union, still needs to control its border with Sweden. It tries to do so in a minimal way, but it has to do it nonetheless. Goods flowing between the two countries need to be declared so that they comply with certain regulations and rules of origin. There are some payments like VAT and duties. Likewise, Switzerland, with its stack of free trade agreements with the EU, has customs offices on its border with the EU that process and check commercial and transit goods, although not passenger traffic.

Even the closest external partners of the EU struggle to have frictionless trade

In a way, the UK has already acknowledged the extent of the challenges ahead and the possibility that they cannot be resolved. The divorce agreement hints at remaining close to, or inside, the single market and customs union. These conflicts in the UK's aims will come to a head in the British debate sooner or later. The critical question that remains is, therefore, whether the UK will be able to get such a fudge through its parliament in the end? This remains an open question.

The conflicts in the UK's aims will come to a head sooner or later

Free movement

Finally, we see one potential further complication. For the EU to even contemplate a trade deal that is comprehensive enough to settle the Irish question, the UK might need to continue to adhere to the principle of free movement of people with the EU – one of the most contentious issues in the UK debate.

The UK might need to adhere to the principle of free movement after Brexit

The EU's negotiating priority is to safeguard the political cohesion of the EU27. For the EU27, European integration is first and foremost a political project. Economic and commercial concerns will play second fiddle to the containing the political risks of a major member leaving the EU.

The EU's priority is to safeguard the political cohesion of the EU27

Entering the negotiations on the transitional agreement and future UK-EU trade, the EU will not be prepared to offer the divorcing-UK future trade terms available to EU members or to countries that might want to become members in the future. As a rule of thumb, the EU will likely set its offer of future trading arrangements against how much the UK plans to diverge from the rules, regulations and principles of the single market after Brexit.

The EU will set its offer based on how much the UK diverges from the EU

The UK is therefore likely to face a choice between a Norway style deal, minus many financial services, and a Canada style Free Trade Agreement (FTA), possibly with some customs arrangements. Something in between these two options would be most desirable to the UK, as it would be seen as a compromise to both the Remainers and the Brexiteers. To the EU, however, it would look like cherry picking by the UK – a clear red line. If the UK decided to place very heavy restrictions on EU migration, the UK might even struggle to agree a trade deal with the EU that could enable a workable solution to the Irish border question.

Scope for a trade deal with be partly related to the UK's future migration policy

Our base case

Until spring 2018 – agreeing the transitional deal

Between December 2017 and spring 2018, the UK and the EU will negotiate the framework for the transitional period. We expect the transition period to last around two years, with a slim chance that it could last three or more. If the transitional period lasts longer than two years, it would go over into the EU's next long-term budget which still needs to be agreed. This would prove challenging as it could re-open negotiations on the already agreed divorce bill.

The transitional period will probably last around two years

Key elements of the transitional deal are as follows.

- The UK will de facto remain inside the single market and the customs union and meet all the obligations required as a member – including the free movement of people. The UK will probably manage to retain its EU financial services passport with very few exceptions.
- As the UK will no longer be a member of the European Union at this point, its current rights as a member to participate in EU summits, vote on laws and hold a veto will end. The UK will become a de facto law taker to the EU, meeting all of the laws and regulations related to taxes and product standards while not having a say on them.
- The UK will likely lose its rights to the external trade deals with non-EU members it currently enjoys as an EU member. But while the UK remains inside the customs union it will not be able to ratify any non-EU trade deals. The EU will ensure that the UK cannot secure any significant early opt-outs, say on agriculture or fisheries.

The UK will remain in the single market and customs union during the transition

The EU will ensure that the UK cannot secure any significant early opt-outs

Summer 2018 – setting out broad aims for future trade

Chief EU negotiator Michel Barnier has said that negotiations should be over within 18 months of the UK triggering Article 50 (October 2018) to give six months for the EU27 and European Parliament to ratify the deal. If the transitional agreement is settled before spring 2018, talks on the framework for future trade could happen sooner.

The EU will need six months to ratify the final deal

At the most, the UK and the EU will not have much more than six months to sketch out broad aims for future trade. A couple of points are worth noting. 1) The EU cannot formally conclude any trade talks with the UK until the UK becomes a third country – this happens when the UK leaves the EU in March 2019. 2) It is likely that the UK and the EU will do no more than, at the most, agree the key principles for future trade.

The EU cannot conclude trade talks until the UK becomes a third country

October 2018 to 29 March 2019 – finalising Brexit

Approving the terms of divorce, transition and – probably – the general framework for future trade will require a qualified majority by the EU27 and a simple majority in the European Parliament. Depending on details, a deal on future preferential UK access to the Common Market may have to be ratified by all 27 EU members, though.

A deal may have to be ratified by all 27 EU members

Both UK houses of parliament will get a vote on the final deal. Although that vote cannot change the terms of the deal, after parliament passed a bill to ensure it gets a meaningful vote before Brexit is implemented, such a vote could happen early enough to theoretically send Prime Minister Theresa May and Brexit secretary David Davis back to the negotiation table if parliament does not like the final terms of trade with the EU.

Both UK houses of parliament will get a vote on the final deal

30 March 2019 and beyond

The UK will leave the EU on 29 March 2019 and enter into at least two years of transition towards the new future trading arrangement with the EU. The EU could potentially change its negotiations team when it comes to trade talks. Mr Barnier is only the EU's agreed negotiator for Brexit. The EU has a separate protocol for trade negotiations and could, in theory, appoint a new negotiator. It is likely, however, that the EU will reappoint Mr Barnier to lead the trade talks to allow for a smooth transition between the two sets of negotiations. During the transitional period the UK and the EU will hammer out the practical details of the trade framework agreed in the final round of the Brexit negotiations.

The EU will reappoint Mr Barnier to lead the trade talks

Just as during the Brexit negotiations, expect the EU to use its relative bargaining strength to set the order and pace of negotiations and to shape terms in its favour. In principle, this will mean mostly seeking to preserve the status quo in the sectors the EU believes it has a comparative advantage – mostly in goods. Expect the UK to lose out in areas of its comparative advantage such as financial services. The talks for future trade will likely conclude in early 2021, by which time the terms of trade in the key sectors agreed will continue more or less as before, while many of the sectors that are not covered will probably default to the common benchmark agreed by the World Trade Organization (WTO).

Expect the EU to use its relative bargaining strength to shape terms in its favour

Possible final outcomes

As argued in this report, it will be tough for the UK to meet its promise to preserve the status quo in Ireland while simultaneously leaving both the single market and customs union. As part of the mutually agreed divorce, the UK has pledged to prioritise the status quo in Ireland over leaving the single market and the customs union.

It will be tough for the UK to meet its promise to preserve the status quo in Ireland

Given that around two-thirds of the MPs in the House of Commons are pro-EU, a soft Brexit outcome would probably get a majority backing. Whether the hard-line Brexiteers would support the government afterwards is an open question. The Conservative-DUP alliance only has a slim seat majority. If Labour decided to try to vote down any final trade agreement, and a small group of hard-line Brexiteers in the Conservative Party joined them – unlikely but not impossible – the UK could still end up in a no-deal hard Brexit situation, or a trade arrangement that would be insufficient to preserve the Irish status quo.

Around two-thirds of the MPs in the House of Commons are pro-EU

Major uncertainties hang over the political outlook for the UK. If the UK opted for a hard Brexit, either before or after March 2019, all hell could break loose, to put it mildly. Such an outcome would bring the question of UK unity back into the fore, not just Scottish independence but potentially Northern Irish independence too as the viability of the 1998 Good Friday agreement would be seriously brought into question.

Major uncertainties hang over the political outlook for the UK

With so many moving parts and open questions still yet answered, we see four potential scenarios – detailed in Table 1 (below) – along with their associated probabilities and estimated impacts on UK long-term potential growth.

We see four potential scenarios for Brexit

Table 1: Possible scenarios for UK post-Brexit economic relations with the EU

	EU member/No Brexit	Soft Brexit	Semi-soft Brexit	Hard Brexit
<i>Probability</i>	<i>(5%)</i>	<i>(30%)</i>	<i>(45%)</i>	<i>(20%)</i>
Free trade within the area	Yes	Yes on almost most goods and many non-financial services	Yes for most goods but very few services	No
Financial passporting within EU	Yes	No – but with some potential for equivalence agreements	No	No
Customs union with EU (no border checks)	Yes	No	No	No
Free to set external trade policy	No	Yes in all markets not covered by the customs union	Yes in all markets not covered by the customs union	Yes
Covered by EU external trade agreements	Yes	No	No	No
Free movement of people	Yes	Yes with few exceptions	Some restrictions on EU citizens entering the UK labour market	No
Votes on EU laws/regulations	Yes	No	No	No
Under ECJ jurisdiction ²	Yes	Yes indirectly	Yes indirectly	No
Contribution to EU budget	Yes	Yes	Some	No
Long-term trend growth (% pa)	>2.0%	1.7-1.9%	1.5-1.7%	<1.5%

¹ As the ECJ adjudicates on all Single Market issues, countries in customs union or agreements with the EU as well as EEA countries are indirectly under the jurisdiction of the European Court of Justice (ECJ). Source Berenberg

No Brexit (5% chance): This is the least likely outcome. The only possible route to a reversal of Brexit would be from fresh elections that ended up with either Labour, or some Labour-led coalition involving the ultra pro-EU Liberal Democrats and Scottish National Party. Such an outcome could end in a second referendum, where a majority of UK voters, recognising that life will be worse outside of the EU, vote to remain in the EU and the EU accepts a reversal of Brexit. That the Conservative Party would call a second referendum on its own is as close to a zero probability event as one could imagine – it would likely split the party in two.

We think there is a 5% chance that Brexit will be reversed

Soft Brexit (30% chance): This is the second most likely outcome. As discussed above, a soft Brexit which de facto keeps the UK inside the single market and customs union would cross the major red lines for the Brexiteers. But the key Brexiteers – think David Davis and Boris Johnson – have already softened their stance considerably. This outcome is thus by no means unthinkable. As two-thirds of MPs are pro-EU, such a deal would probably get majority backing in parliament. If faced with a choice between an economically damaging basic free trade arrangement covering only goods and a comprehensive “Norway-minus” deal, the UK could go for the later.

We think there is a 30% chance of a soft Brexit

Semi-soft Brexit (45%): This is the most likely scenario. Given that the UK is likely to introduce some soft limits on EU migration such as stricter rules around the eligibility for benefits and social services, the EU will not be able to offer the UK a comprehensive trade agreement that goes much beyond free trade in goods and some services. Remainers in the UK could support a deal that kept the UK close to the EU while the Brexiteers could back such an agreement as it would offer the UK some room to pursue its non-EU ambitions. The UK and the EU could probably find a solution to the Irish question – possibly a bespoke customs arrangement. However, this will remain a major challenge.

We think there is a 45% chance of a semi-soft Brexit

No deal hard Brexit (20%): This is the second least likely outcome. After the recent progress in the negotiation and on the divorce terms we reduced our risk of hard Brexit to 20% (from 30% previously). But with so many interests – and political careers – at stake, the risk that talks could fall through at any point remains a serious risk.

We think there is a 20% chance of a no-deal hard Brexit

Key points of the divorce settlement

The official document published jointly by the UK and the EU disclosing the proposed terms of the Brexit divorce can be found [here](#). The key points are as follows.

Brexit bill

- The Brexit bill covers the UK's outstanding liabilities for the remaining time it is a member of the EU (March 2019) and up to two years after Brexit: 'the UK will contribute to, and participate in, the implementation of the Union annual budgets for the years 2019 and 2020 as if it had remained in the Union'.
- The estimates for this net-amount range between €40bn and €60bn. The bill ensures that no EU27 member has to pay extra or lose out on any budgetary commitments agreed while the UK remains an EU member.

The UK will probably pay a net-amount between €40bn and €60bn

Irish border

- The 1998 Good Friday agreement must be protected in all its parts. Meanwhile, the UK has committed to avoiding a hard border including any infrastructure or "related checks and controls" between Northern Ireland (UK) and the Republic of Ireland (EU27). These commitments must be "upheld in all circumstances, irrespective of the nature of any future agreement" between the UK and the EU. The UK aims to avoid a hard border by way of agreeing the overall EU-UK relationship. This implies that the UK may maintain a high degree of regulatory alignment with the EU post-Brexit. If this is not possible, the UK will propose a specific solution to the Irish Border question.
- As its key commitment, the UK promises that, if no solution can be agreed, it "will maintain full alignment with those rules of the Internal Market and the Customs Union which, now or in the future, support North-South cooperation, the all island economy and the protection of the 1998 Agreement". The UK will ensure that "no new regulatory barriers develop between Northern Ireland and the rest of the United Kingdom, unless, consistent with the 1998 Good Friday Agreement to settle the Northern Irish conflict, the Northern Ireland Executive and Assembly agree that distinct arrangements are appropriate for Northern Ireland. In all circumstances, the United Kingdom will continue to ensure the same unfettered access for Northern Ireland's businesses to the whole of the United Kingdom's internal market."

The UK has committed to avoiding a hard border in Irish

The UK prioritises the Irish status quo over leaving the single market

Citizens rights

- Around 1m UK nationals live inside the EU27 while around 3m EU27 citizens live in the UK. The agreement provides for "reciprocal protection for Union and UK citizens".
- The agreement allows EU27 citizens residing in the UK to become UK citizens while keeping most family reunion rights and most benefits rights enjoyed by UK citizens, such as claiming benefits if they move abroad.
- The UK has agreed to pay "due regard" to relevant EU court rulings on the citizens' rights covered in the agreements, and agreed that UK courts will seek instruction from European courts on "questions of interpretation" of the rights of the citizens covered in the agreement for up to eight years from the date the agreement begins.

The agreement provides for "reciprocal protection" of EU and UK citizens

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