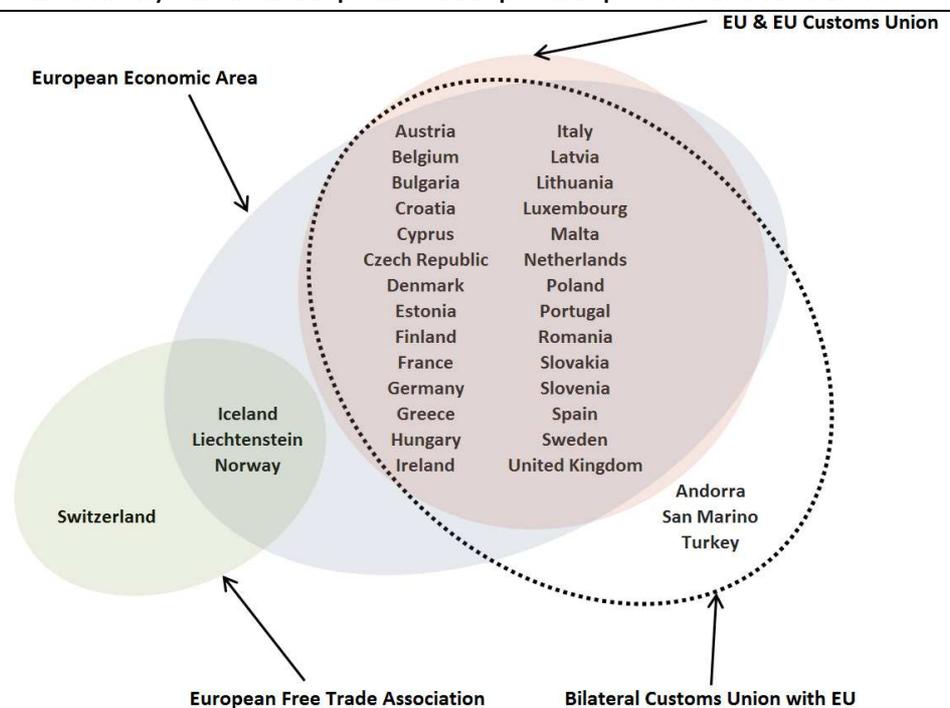


# Analysing Brexit: the options and outlook

Chart 1: The key clubs within Europe that could be potential options for the UK after Brexit



Source: Berenberg

- In this paper, we set out the key arrangements that the UK could theoretically negotiate for its post-Brexit trade with the EU. In the context of recent developments in British politics, we analyse the outlook for the Brexit negotiations.
- **Has the UK general election changed the Brexit calculus?** Probably, yes. Before the election, we saw a serious risk of a hard Brexit. But after the leading Conservative Party lost its majority some two weeks ago, that risk has receded. While the outlook is less clear than before, the chance of a soft Brexit has risen.
- **No British consensus on Brexit:** With no broad agreement on key issues like migration and which parts of the Single Market the UK should aim to access after Brexit, and with the Brexit clock ticking, the government needs to act fast to secure a consensus in parliament on its strategy. While hopes for a soft Brexit have risen, the concept is meaningless unless MPs can agree on a strategy to take the UK through the tough Brexit negotiations. Amid major differences between different groups and parties, that will probably be very difficult – but not impossible.
- **Watch out for the tail risks:** The distribution of risks has changed. Before, there was a serious risk of a hard Brexit. Now there is a stronger possibility that the UK is on a path, albeit a bumpy one, to a softer Brexit. But because the governing majority will be fragile, a number of tail risks need to be carefully watched: (1) fresh elections; (2) the UK running out of time before the terms of Brexit are agreed (the deadline is March 2019); and (3) a second EU referendum.
- **The UK’s future is in its own hands:** The EU27’s priority is to safeguard the political cohesion of the group. Preserving preferential access to the UK market plays no major role in EU27 discussions about Brexit. The more the UK restricts free movement of labour after Brexit, the more the EU27 will restrict the UK’s access to the Single Market. Whether the UK then chooses a status that is close to but worse than the current position of Norway or Switzerland, or that of Turkey, will be mostly up to the UK.

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## Trade with the EU – the different models

A summary of the different clubs and how they overlap is illustrated in the Venn diagram on the cover page (Chart 1). Table 1 (below) details the key features of the different models for the UK's post-Brexit trade with the EU.

**One big economy:** The Single Market is the world's largest international cooperative economic zone. It comprises the 28 members of the EU plus the four members of the European Free Trade Association (EFTA). The EU and the EFTA are separate organisations that co-exist side-by-side. Together, the EU and EFTA (except Switzerland) make up the European Economic Area (EEA).

All EEA members uphold the four freedoms of the Single Market: the free movement of goods, services, people and capital. As a member of the EU, the UK currently fully participates in the Single Market, with some privileges; in addition to full voting rights and influence over the rules of the Single Market, the UK has a permanent annual rebate on its payments to the EU budget, and has opt outs in several key areas, such as the euro, the Banking Union and the Schengen free-border area. No other country has this special status inside the EU.

All EU members are in the EU Customs Union. The EU Customs Union eliminates trade barriers on goods between member states, while setting a common external tariff on goods traded with non-EU countries. EFTA members do not participate in the EU Customs Union. Goods traveling between EFTA and EU countries face border checks. These checks can be costly and complicated. Producers are required to prove the origin of components used in the manufacturing process to ensure that products comply with all of the various overlapping trade policies, and “rules of origin”.

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

	World Trade Organization (basic model)	Customs union agreements (Turkey model)	Bilateral agreements (Swiss model)	European Economic Area (Norway model)	EU member (current model)
Zero tariff trade within the area	No	Yes on goods – essential areas like farming are excluded	Mostly goods – partial services	Yes but farming and fishing excluded	Yes
Free to set external trade policy	Yes	Yes	Yes	Yes	No
Votes on EU law	No	No	No	No	Yes
Free movement of people	No	No	Yes	Yes	Yes
Customs union (elimination of border checks)	No	Yes	No	No	Yes
Fiscal contribution to EU budget	No	Partial	Yes	Yes	Yes
Open service markets and financial passporting	No	No	Partial	Yes	Yes
Covered by EU external trade agreements	No	No	No	No	Yes
Under ECJ jurisdiction <sup>1</sup>	No	Yes indirectly	Yes indirectly	Yes indirectly	Yes
EFTA membership	No	No	Yes	Yes	No

Source: HM Government “Alternatives to membership: possible models for the UK outside the EU”, Berenberg

<sup>1</sup> As the ECJ adjudicates on all Single Market issues, countries in customs union agreements with the EU, bilateral agreements with the EU, and EEA countries, are indirectly under the jurisdiction of the European Court of Justice (ECJ).

As part of the EU Customs Union, EU members collectively negotiate external trade deals. The EU has over 50 such agreements. Only EU members participate in these agreements, which are not available to members of EFTA, even though they participate in the Single Market. By leaving the EU, even if only to join the EFTA, the UK will lose its access to these trade deals. Two-thirds of all UK trade is covered by the Single Market rules (trade with other EU members) and the EU's non-EU trade agreements. Unlike EU members, EFTA members can set their own external trade policies. It is, however, custom for EFTA countries to do this jointly.

Like EU members, EFTA states must stick to the rules of the Single Market but without a vote or veto on such rules, which are set by the EU. These privileges are only available to EU members. However, EFTA members do partake in a formal consultation process on EU laws. EFTA members also contribute to the EU budget, adhere to the principle of free movement of people, have limited access to the Single Market for farming and fishing, and do not have an automatic right to participate in wider EU cooperation on criminal justice and policing, nor do they have any influence over the EU's security policies. Similarly, EFTA members are not represented in the European Parliament, they do not attend the European Council, and they have no representation on the European Commission or have judges in the European Court of Justice (ECJ). EFTA citizens do not have rights to vote in EU elections or work in EU institutions.

The influence of EFTA members over the rules of the EU Single Market is limited. Although EFTA members are not obliged to adopt EU laws, they can be excluded from the parts of the market where they choose not to participate. Whereas the ECJ adjudicates on issues between EU members, a separate EFTA court deals with the compliance-related issues of EFTA members. Conflicts between EFTA and EU members are resolved via a joint EEA committee. Since the EU is much bigger than the EFTA, in most cases, the EFTA court follows the ruling of the ECJ.

Relations between Switzerland – an EFTA member – and the EU differ from those between the EU and other members of the EFTA. Switzerland participates in the Single Market, but it is not part of the EEA. The “Swiss model” is often floated as a possible alternative to EU membership for post-Brexit trade with the EU for the UK. Switzerland and the EU share advanced trading relations via a series of bilateral agreements. Switzerland enjoys less access to the EU Single Market than other EFTA members.

Switzerland's bilateral agreements cover mostly goods – except some types of agriculture – and a few services, such as insurance, public procurement and some professional services. Switzerland does not have full access to the Single Market for financial services and is not part of the financial services passporting area. Swiss banks must set up subsidiaries in the EEA in order to obtain passporting rights.

Unlike EFTA members, which automatically adopt new EU laws, Switzerland manually keeps its regulations in sync with EU law to preserve its access to the Single Market. In most other ways – such as budget contributions and maintaining of free movement of labour – Switzerland has the same relations with the EU as other EFTA members do. Critically, Switzerland can negotiate its own external trade deals and is not part of the EU Customs Union.

The two other, much more limited, options for UK-EU trade post-Brexit trade are: (1) a bilateral customs union; and (2) a free trade deal. Turkey and the EU have formed a bilateral customs union that covers industrial goods and processed agricultures. The types of goods covered by this agreement do not require checks at the EU-Turkey border. In such areas, Turkish tariffs must be aligned with the EU's external levies, and the products must meet EU regulations. Turkey can negotiate its own external trade deals but it is not covered by the EU's external trade agreements.

Finally, the most detached special relationship with the EU would be a free trade agreement. Such agreements simply outline the tariffs and quotas for different markets for goods and services. Countries wishing to sell to the EU under such agreements must comply with EU “rules of origin”. The EU has many free trade agreements with countries around the world. CETA (Comprehensive Economic and Trade Agreement) between Canada and the EU is probably the most well known. As bilateral agreements are often decided independently of one another, a deal that is similar to CETA may not necessarily be available for the UK.

## Which model could the UK go for?

As a thought experiment, let us imagine a world where the EU27 was not taking part in the Brexit negotiations. Instead, the UK simply had to decide between the already available “off the shelf” models for post-EU trade:

- **Option one:** EU membership (current arrangement)
- **Option two:** EFTA membership (Norway-type)
- **Option three:** bilateral agreement (Swiss-type)
- **Option four:** customs union (Turkey-type)
- **Option five:** WTO (no deal).

In this thought experiment, the UK cannot change the rules in any of these arrangements. They must be taken in their current form. This exercise is helpful for one major reason: as it happens, this closely represents the EU’s approach to the Brexit negotiations.

Because 27 countries find it difficult to agree on major changes, the EU27 will neither decide to deliberately “punish” the UK nor to offer generous terms to it. The common denominator among the EU27 is that no deal for a country that has filed for divorce can be as generous as the terms available to EU members or to countries that might hypothetically still want to become members in the future (such as Norway or Switzerland). To some extent, the EU27 sees the deals it has struck with Norway and Switzerland as engagement presents that will not be available for a divorce settlement with the UK. Whether the UK then chooses a status that is close to but worse than the current position of Norway or Switzerland, or that of Turkey, will be mostly up to the UK.

Back to the thought experiment: the UK intends on leaving the EU but has made clear that it will seek a trade deal with the EU. This eliminates options one and five from the start. This leaves open options two, three and four; a soft, medium and hard Brexit, respectively – to use the common phraseology. To see which one the UK could go for, we take a top-down look at the different levels of UK politics: cabinet, parliament and the public.

### **Cabinet**

- Only around a quarter of the current cabinet backed Brexit in last year’s vote, leaving three-quarters in favour of keeping the UK in the EU or going for a soft Brexit. **That excludes options three, four and five.**
- The three key Brexiteers in the cabinet – David Davis (Brexit Secretary), Boris Johnson (Foreign Secretary) and Liam Fox (Trade Secretary) – want to return sovereignty to the UK and enable the UK to strike trade deals independently of the EU. **That excludes options one and two.**
- Prime Minister Theresa May, who backed remain but has taken a hard stance on migration since taking office, has pledged to reduce net-migration to the “tens of thousands”. **That excludes options one, two and three.**

### **Parliament**

- Most non-Conservative MPs, predominantly the SNP and a core of ex-Blairite pro-business Labour MPs, want either no Brexit or a soft Brexit. They do not have the numbers – unless a large number of Tories defect – to prevent Brexit. They do, however, want the UK to remain closely integrated with the Single Market. **That excludes options four, five and maybe three.**
- A core group of eurosceptic Conservative MPs want a hard Brexit or something close. **That excludes options one, two and three.**
- A group of pro-EU Conservatives (plus the 13 Scottish Conservative MPs) want a soft-Brexit. **That excludes options four and five.**
- The likely Tory (317)-DUP (10) alliance has just enough seats to ensure a working majority (the magic number is 326). While the DUPs are pro-Brexit, they could demand a customs union agreement to avoid a hard border between Northern Ireland and the Republic of Ireland. **That excludes options two, three and five.**

## Public

- Only a narrow 52% of British voters, versus 48%, backed Brexit. Close to half of the country did not want Brexit in any form – for these citizens, **that excludes options two, three, four and five**. In Scotland and Northern Ireland, a majority of voters supported staying in the EU. Only voters in England and Wales had a majority in favour of Brexit.
- Polls regularly show that when voters are asked what their priorities are, they are often split down the middle over what they want from Brexit. Roughly the same proportion support ending free movement and leaving the Single Market as those that want to keep free movement and remain in the Single Market. Up to a quarter of those polled have no idea what they want from Brexit.

Our thought experiment yields a pretty dismal conclusion: more than half of the population – most of those that voted remain plus the Brexiteers that do not get the Brexit they want – may, in the end, be unhappy with the final form Brexit takes. The key point is that there is no obvious consensus on Brexit at any level of British politics. Following such logic, remaining inside the EU may actually be the option that maximises the proportion that gets their preferred outcome. But that will never happen, will it? Probably not.

The point of this thought experiment is not to predict, or indeed expect, that the UK will fail to agree on a strategy for Brexit. But it highlights the tough challenges in the UK that must be solved before productive talks with the EU can begin in earnest. Without a majority agreeing on what type of Brexit the UK should aim for, it cannot be deemed a political success, never mind an economic one.

With no clear consensus on the key issues at any level of British politics, and with the Brexit clock already ticking, three of the 24 months to negotiate have already been wasted – parliament needs to act fast. While hopes of a soft Brexit have risen since the hung parliament election outcome, the concept is meaningless unless MPs can form a consensus on key issues. That will very difficult, but not impossible.

## What about the EU27?

For the EU27, European integration is first and foremost a political project and not just a commercial concern. As its top priority, the EU27 wants to safeguard the political cohesion of the group. Preserving preferential access to the UK market plays no major role in EU27 discussions about Brexit. The idea – often touted in the British press – that, for instance, Germany may lean heavily on Poland to accept restrictions on the free movement of labour in order to preserve access for German carmakers to the UK market, highlights that parts of the British press know little about the political priorities in Berlin and elsewhere.

In the same vein, a future EU deal with the UK cannot be as generous as the terms offered to David Cameron, but rejected by British voters. The more the UK insists on violating two fundamental principles of the EU, namely the free movement of labour and the jurisdiction of the ECJ, then the less preferential the market access granted by the EU27 will be. This holds especially for the Single Market for financial services, where it is politically easy to hide outright protectionism behind arguments about a need to regulate all such services sold to EU27 citizens according to standards fully controlled by the EU27. As the EU27 believes that the UK has much more to lose from a hard Brexit than the EU27, the EU27 will not bend over backwards to avoid a situation in which both sides lose preferential access to each other's markets after Brexit.

Before negotiations on a trade deal can begin, the EU27 wants to agree the key parameters of an exit bill for the UK first. The EU has a number of reasons for that. First, making the UK pay its dues is probably the issue on which the EU27 can agree most easily before the more tricky negotiations about the future relationship between the two parties may start in earnest after the German federal elections in September. Second, the discussion about an exit bill illustrates to the domestic audience in the EU27 that leaving the EU would be costly. While the precise amount of the exit bill is negotiable – and will likely only be fixed at the very end – the EU27 will likely insist that the UK has to accept the principle that it must honour the financial commitments it made as an EU member.

As always, the EU27 can be ingenious and flexible when it comes to the details of any arrangement, including a transitional agreement to take effect upon the actual Brexit in April 2019. But the terms of any deal will be shaped by the common denominator among the EU27, namely a desire to safeguard the political cohesion of the union. Commercial interests will play no more than a secondary role.

## Is there a way forward? A bumpy road to a softer Brexit

Has the general election changed the Brexit calculus? Probably, yes. Before the election, we had argued that the UK faced a serious risk of a hard Brexit. A firm grip over the UK's Brexit strategy had enabled Prime Minister May to take the UK down the path that was her own interpretation of the UK vote. Despite backing remain in the Brexit campaigning, May's hard-line views on EU migration suggest that she harbours some hard-Brexit tendencies.

Before the election, we were concerned that the Conservative Party would really allow May to execute her threat of walking away from negotiations, the "no deal is better than a bad deal" threat. But after the Conservative Party lost its majority in snap elections some two weeks ago, few of its MPs are echoing such threats anymore. That is real progress. It can mean less scope for a messy fallout between the UK and the EU over the divorce settlement. Furthermore, key pro-EU Conservative MPs, including Chancellor Philip Hammond, are more active than before in pushing for an exit that puts the economy and jobs first. That makes a softer Brexit more likely.

Before the election, medium-term uncertainty was low, but the long-term economic risks from a hard Brexit loomed large. Now, the hung parliament has strengthened the pro-EU versus the EU-sceptic forces inside Westminster. While this raises the prospect of a softer Brexit, it has also increased medium-term uncertainty. If the Tories manage to rule with the Northern Irish Protestant DUP, as they are trying to do, the government will need support from virtually all Tory and DUP MPs to pass key votes in the House of Commons.

Together, the Conservatives (317 seats) and the DUP (10 seats) would only have a small working majority in the House of Commons (at least 322 are needed and possibly up to 326). Any small group of MPs could shift the balance of power. In a way this is positive, as such a group could hamstring the government if it disliked the direction the government was heading on Brexit.

The distribution of risks has changed. Before, there was a serious risk of a hard Brexit. Now there is a stronger possibility that the UK is on a path, albeit a bumpy one, to a softer Brexit. But because the governing majority will be fragile by construction, a number of political uncertainties loom larger than before: (1) fresh elections, (2) the UK running out of time before a deal can be made with the EU (deadline is March 2019), and (3) the possibility of a second referendum.

In such an uncertain world, establishing a base case is virtually impossible. With luck, the Conservatives will ask Prime Minister May to concede on the key parts of the Brexit divorce that are important for the EU, and let her take the flak before she gets the chop later this year. That would enable enough time before negotiations end in March 2019 for the UK and EU to agree a lengthy transitional period where the UK remains de facto inside the Single Market while the new terms of UK-EU trade are hammered out, leaving the next Conservative leader and Prime Minister with a free run at negotiating a trade-deal with the EU. This would be by far the best outcome for the UK economy.

Time is short and negotiations will be difficult. By late 2018, the UK could face a tough choice between a hard Brexit or accepting the potentially unfavourable terms – maintaining free movement of labour – of a transitional deal largely set by the EU27.

The more the UK restricts free movement of labour after Brexit, the more the EU27 will restrict the UK's access to the Single Market. If the UK takes a liberal approach to migration policy, it can retain access to the large supply of workers from the EU while preserving a high level of access to the biggest common market in the world. But if the UK decides to place heavy restrictions on EU migration, it will suffer badly from cutting its supply of labour and losing its privileged access to the single market.

In 2016, net migration from the EU into the UK fell for the first time in seven years. The decline was mainly driven by the fall in net migration from the eight eastern European countries that joined the EU in 2004. With luck (again), the recent falls in EU net migration to the UK will continue. That will make it easier for the UK to accept free movement.

A continued fall in net migration to the UK would make it easier for the UK government to divert the Brexit debate from its current destructive focus on immigration onto what really counts – a good trade deal with the UK's major partner, the EU27. That would be the pragmatic choice. But, then again, since the UK voted for Brexit in the first place, pragmatism has been sorely missing from British politics for some time.

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