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Brexit 1/2: A hard Brexit, but a smooth transition

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Theresa May finds herself between a rock and a hard place, trying to satisfy Brexiteers, Remainers and the EU27. We expect a deal to be reached, but it will not be as good as Theresa May thinks. The political storm will not disappear for years.

The 29 March 2019, when the UK will officially leave the EU, is moving closer and closer. So far, the bulletin from EU chief negotiator Michel Barnier has been that 80% of a Brexit deal has been agreed, including a transition period until end-2020, no border checks in Ireland and a so-called divorce bill (see table 1). However, the UK and the EU have made it clear that **"nothing is agreed until everything is agreed"**.

Thus, important issues remain to be solved before the Withdrawal Agreement and the Future Framework can be settled – agreements that officially are assumed to be finalised in October in order to give both the British and the European Parliament sufficient time to ratify and approve the documents before 29 March 2019. Unofficially, this deadline has been pushed to November because of the negotiations deadlock (see timeline below), although Barnier in the beginning of September expressed more optimism about the October deadline.

Figure 1: Brexit timeline

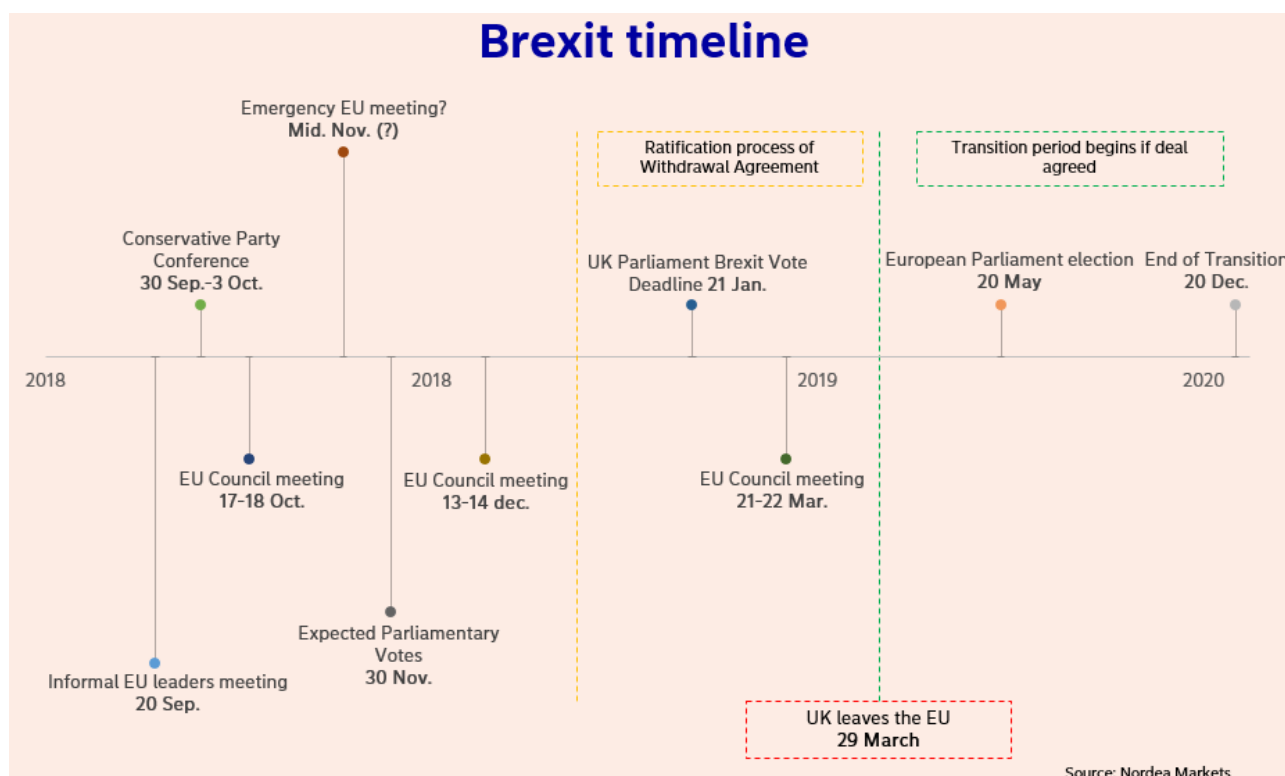


Table 1: Main agreements between the UK and EU so far

What have they agreed so far?	
Issue	Comment
1) Divorce bill	A calculation method has been agreed, with final numbers dependent on several financial and economic factors. Hence, the exact amount is unknown, but UK sources have said between GBP 35bn and GBP39bn. We will likely not know the exact number for several years.
2) Existing citizens rights	Existing EU citizens will keep their rights in the UK and vice versa
3) No hard border in Ireland	No border checks on the Island on Ireland, safeguarding the North-South cooperation, the all-island economy and the Good Friday Agreement
4) Transition period until end-2020	During the transition period, the UK will comply with EU rules as before, without the ability to participate in rule making. Northern Ireland will remain part of the Customs Union and the Single Market unless another solution is found. That would effectively move the British border to the Irish Sea*
5) Withdrawal Agreement is a package deal	Nothing is agreed until everything is agreed. Hence, none of the above will apply in the case of "no-deal"

Note: * This is the EU's interpretation of the Joint Report from December 2017.

If no agreement on the remaining 20%, then the "80% in place" doesn't matter

As outlined above, the EU and the UK agree on the Brexit process, i.e. *how* to reach a deal. However, as long as the *main content* is still not agreed, the rest does not matter. If no deal is reached before 29 March, the negotiation period can only be extended by a unanimous decision of the other 27 EU countries.

Below are the most crucial elements that are in the way of a deal:

1. The Irish border, including the "Backstop" plan

e-markets.nordea.com/article/45955/brexit-1-2-a-hard-brexit-but-a-smooth-transition

Nordea

2. The four freedoms in the Single Market: people/labour, goods, services and capital
3. The Customs Union
4. Jurisdiction of the European Court of Justice (ECJ)

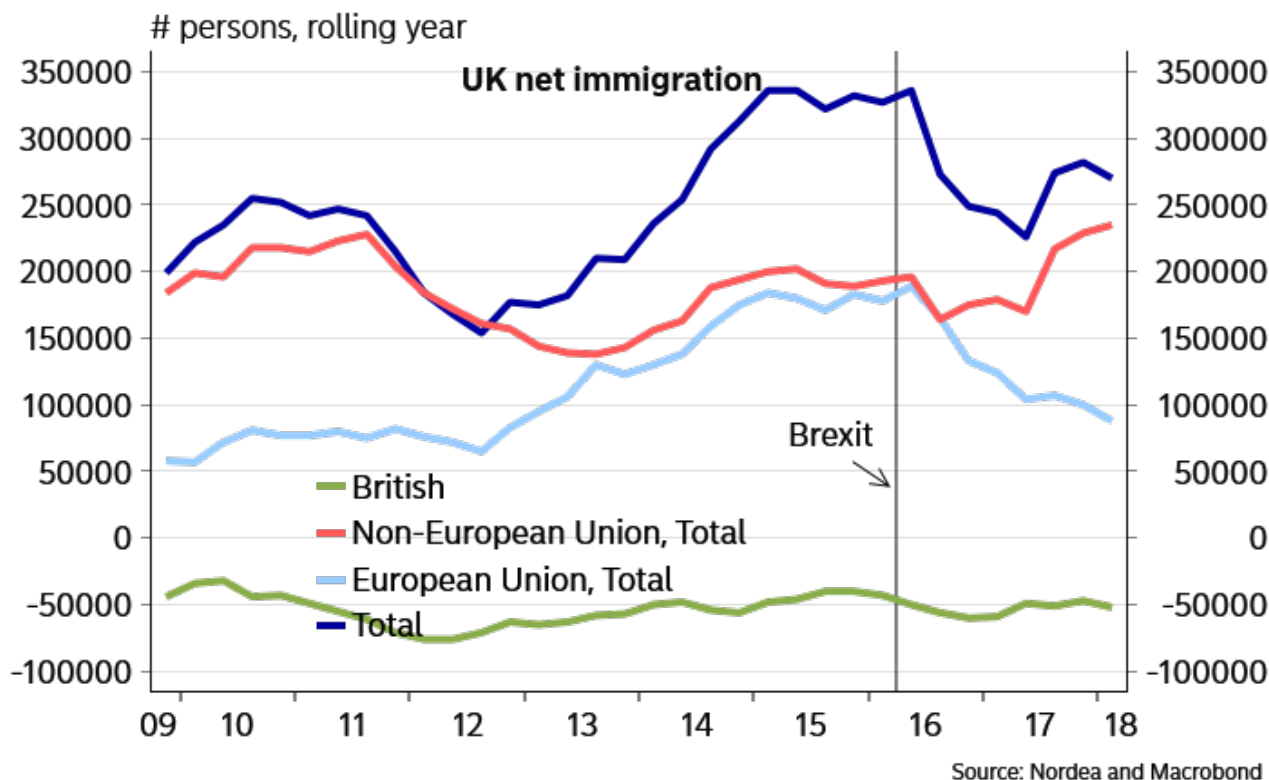
Of the above, the Irish border is the main obstacle. In particular, **the backstop plan** – which is a safety net plan in the case of no-deal - is essential, because the Withdrawal Agreement would be cancelled without it. Hence, if the backstop plan is not agreed, we would have a hard and possibly chaotic Brexit. Trades made with EU countries would be based on **WTO rules and at worst scarcity of crucial goods such as food and medicine could become reality.**

The two parties interpret the “backstop” plan differently as the EU’s version effectively keeps Northern Ireland in the Single Market and the Customs Union. The response from Theresa May has been that no British prime minister could ever accept such a proposal, as it would threaten the constitutional integrity of the UK.

Concerning the three other main issues, the UK government outlined in July its solutions in the so-called White Paper (aka Chequers Plan). In the White Paper, the UK proposes a **Free Trade Area (FTA)** in which only goods are traded without tariffs, while the **free movement of people and the participation in the Customs Union will end.** Instead of a Customs Union, the UK wants an **independent trade policy.**

However, both the Brexiteers and the EU have highly criticised the Chequers Plan. Former Brexit Secretary, David Davis, who is a frontrunner Brexiteer, stated that the plan is almost worse than staying in the EU, while EU negotiator Michel Barnier has allegedly proclaimed that the plan would be “the end of the Single Market and the European project”. Thus, the **EU believes that the UK government is cherry-picking** - especially in terms of the four freedoms in the Single Market, which the EU considers indivisible.

Chart 1: Ending free movement was a central part of the Brexit campaign. Ironically, the decline in net immigration after the referendum stems primarily from EU citizens, while non-EU immigration – which is controlled by the UK – is at all-time high levels.

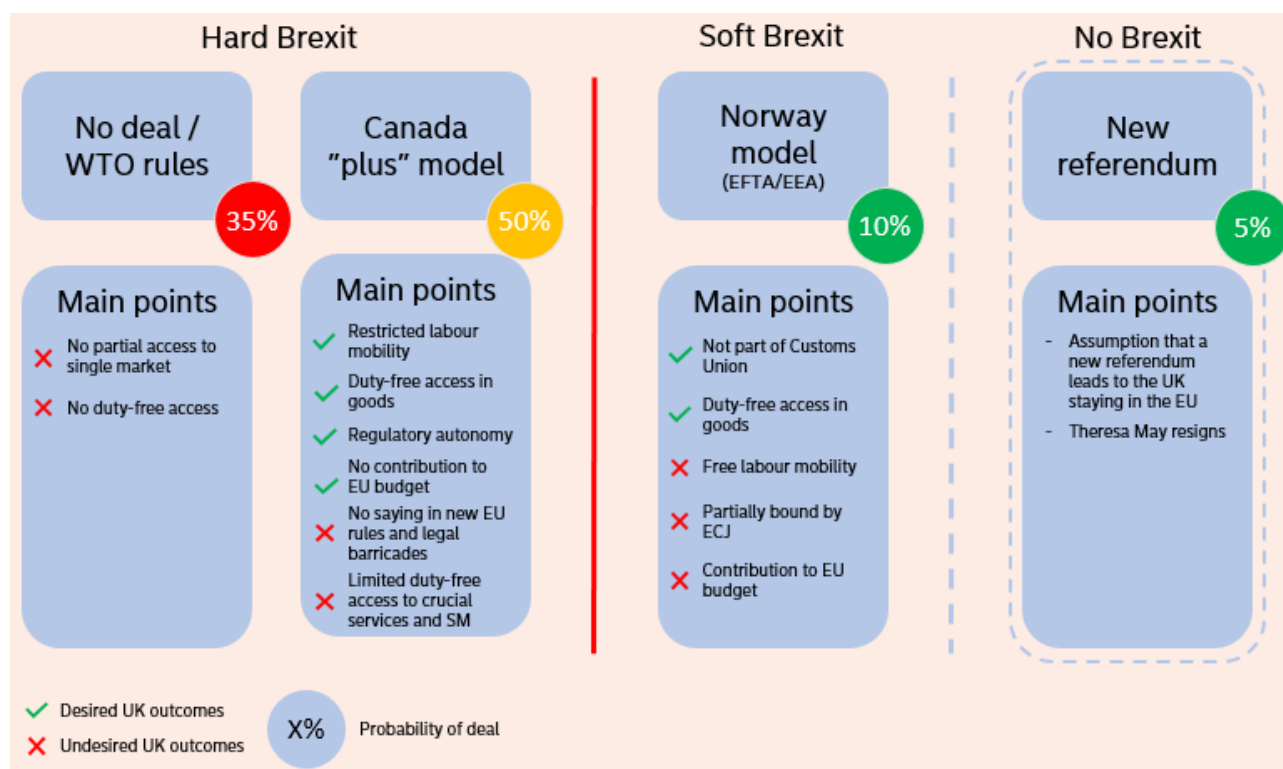


Prisoner’s dilemma: a hard Brexit outcome

Many Brexit solutions have been mentioned since the referendum. None of them have, however, come close to suiting all parties. In our opinion, one reason is that both sides have focused more on **standing up to political principles instead of finding the best solution from an economic perspective**. Thus, using a classic game theory analogy, the outcome will not be a Pareto Optimality, but a Nash Equilibrium (prisoner’s dilemma). For example, although the EU would economically be better off with a Chequers deal compared to a “no-deal”, the EU wants to send a message to the EU27 that the Single Market is a package deal, and exiting the EU has severe consequences. Accordingly, the EU (at least externally) prefers a harder Brexit than the Chequers plan.

Although there are many Brexit models – some of them hybrids of each other - we consider the **below four versions as the most likely ones**.

Figure 2: Brexit scenarios. We expect a hard Brexit, but with a smooth transition



As illustrated above, we think the **most likely outcome is a deal closest to the Canada (CETA) model**, but with some special add-ons (therefore the name Canada "plus"). Hence, we expect the UK to exit the Single Market and the Customs Union, but striking a free-trade agreement as well as improving provisions on areas such as security and services and (though limited on crucial services).

According to our definition, this is a **hard Brexit**. However, this is not a **"cliff-edge" Brexit**, meaning that we do not expect a disorderly Brexit - instead, we expect a **smooth transition**. Furthermore, given many details still left to be settled, we believe a vague agreement/statement, calling for further negotiations, will be released before 29 March 2019. Consequently, we do not expect the political storm hanging over Britain to disappear for several years.

We consider the Canada "plus" model a more likely outcome than a **soft Brexit** (Norway model or Chequers plan). Although Theresa May has said there will be no compromises on the Chequers plan, we expect the EU to be even more stubborn in the negotiations. Our view is based on the fact, that **the EU has the upper hand** in terms of trade flow, as the UK has much more to lose with about 45% of British exports going to the EU, whereas only 16% of EU (extra-EU) exports go to Britain. We also believe that **a Canada plus version could more easily be accepted by the UK Parliament**, namely the European Research Group (hardliner group within the Conservative MPs), than the Norway model / Chequers deal.

A two-stage, hybrid version of the Norway and Canada models has also been mentioned as a likely solution. In this model, the UK would continue its membership of the European Economic Area (EEA), while applying to become an associate member of the European Free Trade Association. Hence, the UK would initially get a trading relationship with the EU somewhat similar to Norway, but then **using that position of safety to negotiate a long-term agreement closer to Canada's**. Effectively this would mean more time to

define the future relationship, possibly with a new distant deadline, eg 2022. Although we do not see this as the most likely outcome as Tory-Brexiteers would smell a trap and put too much pressure on Theresa May, we do not rule it out. **Thus, the closer we get to March, both sides – and in particular Theresa May -will likely soften their stance and take a more pragmatic approach.**

In terms of a **“no-deal” scenario**, Marc Carney stated in the latest inflation hearing that markets see a 25% chance of a “no-deal” – a likelihood, which he thought was **uncomfortably high**, but a fair assessment of the probability. The British population, on the other hand, see the risk of a “no-deal” as plus 50%. We see the odds somewhere in between.

No second referendum – Brexit is happening

The last option is a second referendum. We, however, find this outcome **highly unlikely** as Theresa May has clearly rejected it (although she also ruled out a snap election last year), saying it would be a betrayal of the British democracy. Hence, we believe there is a **bigger chance of Theresa May resigning than calling a new referendum.**

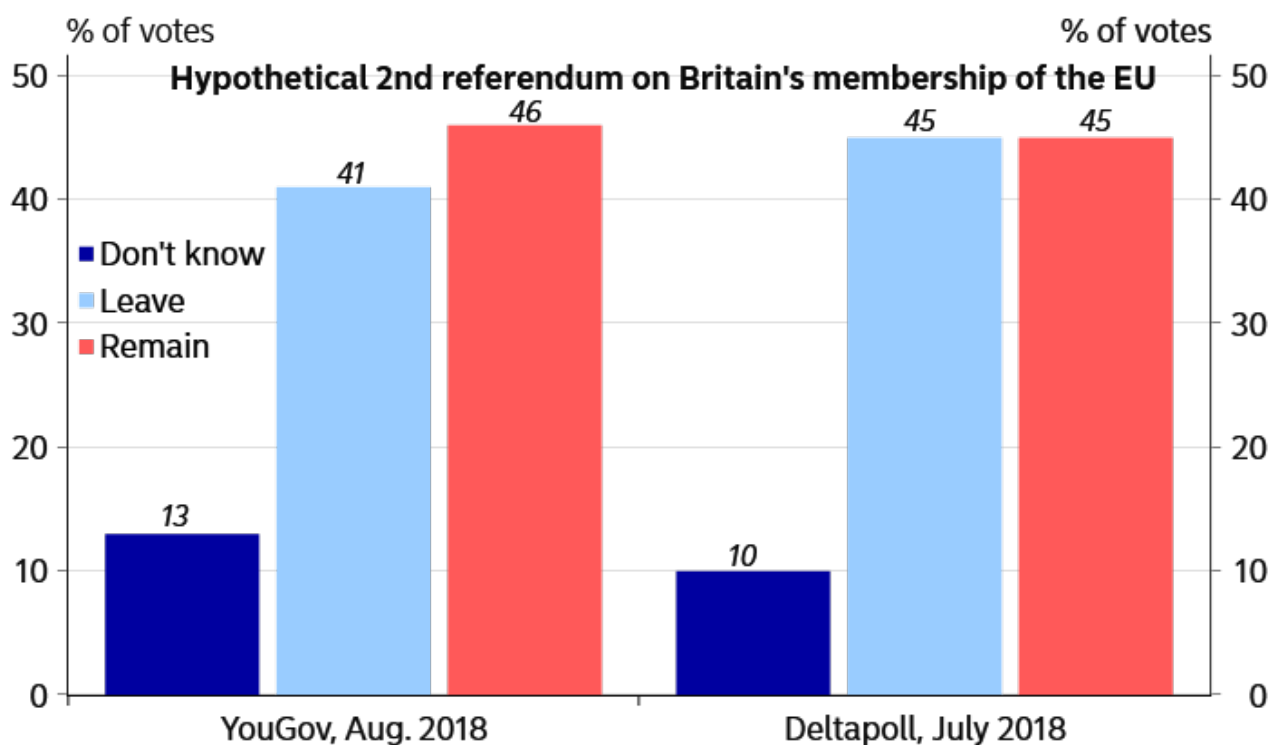
If Theresa May was overthrown internally in the Conservative party, the **most likely successor would be a Brexiteer** and consequently, we find it very unlikely that a second referendum would be supported by a Tory-led government.

Still, there are some MPs within the Conservatives who want a new vote (most notably Justine Greening) and could go against their own party. Looking at a **“People’s Vote” alliance** across parties, Liberal Democrats and Greens are in favour of a second referendum, whereas the Scottish National Party and Labour have not officially ruled out a new vote. We believe **the key to a second referendum** lies with the latter. If Labour leader Jeremy Corbyn decides to whip MPs for another vote, we could see Tory members beginning to rebel, forcing Theresa May to resign and accept another vote. In this regard, Labour’s annual conference 23-26 September could prove crucial.

However, it is very unlikely Jeremy Corbyn will back a new referendum. Earlier this year, Corbyn fired one of his shadow cabinet members, Owen Smith, for publicly supporting another referendum, and Labour has said that they prefer a new general election before a new Brexit vote.

Furthermore, the EU needs to unanimously accept the UK cancelling its article 50 procedure, and also the mere logistics of holding a new general election as well as a second referendum before 29 March makes a new vote unlikely. Lastly, the MPs will also be looking at the current public opinions. According to polls, there **is no clear majority** for another referendum nor backing a Bremain. **The British population is just as divided as the politicians.**

Chart 2: The British population is still divided on Brexit/Bremain



Source: YouGov, Deltapoll, Nordea and Macrobond

Irish unification will not happen before Brexit

Lately, there has been more talk about a unification of Ireland. Polls indicate that **if there is a hard Brexit/"no-deal" Brexit, Northern Ireland would vote for unification** with the Republic of Ireland – a right they have based on the Good Friday agreement. Supporting this idea is the fact that 56% of the Northern Ireland voters wanted to stay in the EU at the 2016 Brexit referendum.

However, while a hard Brexit increases the likelihood of a unification in the long run, we do not consider it plausible short term before 29 March. Hence, we do **not expect it to have a significant impact on the Brexit negotiations in the coming months.**

Bank of England reaction function and markets implications

See our publication [Brexit 2/2: Expect a bloodbath in a cliff-edge scenario. In any other case, buy GBP](#)

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