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Brexit Negotiations: Germany Must Make a Case for Free Trade with Britain*

The time has finally come. In a few days the British government will formally declare Britain's exit from the EU. The country's EU membership is expected to end in March 2019. The terms of Britain's exit and its future relations with the EU will be defined in the intervening period. If no agreement is reached, economic relations between the two parties will be governed by World Trade Organisation (WTO) rules. This would mean tariffs ranging from between five and ten percent on many goods, with far higher rates applying in some cases. Trade in certain services may even become impossible.

For business the uncertainty surrounding Brexit is a problem that will grow as the exit date in 2019 approaches. At the moment companies on both sides of the channel must face up to the prospect of tariffs applying as of 2019 or regulatory barriers arising that will endanger existing business models. If this risk cannot be dispelled, adjustments need to be made very quickly. The British economy is integrated into Europe-wide supply chains in a wide variety of ways; and it would be costly for both sides to restructure these chains now just to be prepared for the possibility that the negotiations fail to result in an agreement. To avoid such costs, it is important to outline the shape of future economic relations as quickly as possible. Thanks to its close trade links with Britain, the stakes for Germany are particularly high.

The negotiations will focus on three issues: trade in goods and services, the free movement of persons and Britain's outstanding contributions to the EU budget. There are "red lines", or political commitments limiting the scope for negotiations, on both sides. On the British side there are two red lines: the first is control over immigration from the EU. The second line is that the jurisdiction of the European Court of Justice should no longer extend to the United Kingdom. This rules out options like the Norway model for Britain remaining in the internal market. As far as the EU-27 is concerned, the red lines are less clear. There is widespread talk of the indivisible nature of the internal market's four basic freedoms, meaning that Britain repealing the free movement of persons would be incompatible with British banks continuing to operate in other EU countries under current conditions. Warnings are also frequently issued that there is to be no cherry-picking, although it is unclear what that actually means. If any deal is to be reached at all, it is clear that it will be a bespoke agreement specially tailored to satisfy the special conditions of Brexit. It is also clear that this agreement will reflect the interests of both sides.

As far as trade in goods is concerned the options are a customs union or a free trade agreement. For the EU a customs union would be more attractive, as it would give EU companies advantages in the

British market. The UK could not sign any independent free trade agreements with third countries like the USA, as it would be bound to common external tariffs. From a British point of view, that would be acceptable if British banks were to be granted continued access to the internal market, despite restrictions on immigration. The EU, however, would not want that. That is why the final outcome will probably be a free trade agreement with no common tariffs for third countries.

In the field of services the situation is more complicated. Britain has a stronger interest in reaching an agreement over free trade in services. Bank of England Governor Mark Carney has asserted that the risks of a restriction on trade in financial services inherent in a hard Brexit would pose a greater risk to the financial system of the EU-27 than to Britain, because European companies and states perform a large share of their financing operations via London. But it remains unclear whether this would still apply if it is announced now that other financing channels will have to be found as of 2019. It is safe to assume that London banks will open offices in Dublin, Frankfurt or Paris and that they will be able to offer a similar range of services to their present offering by using “back office” functions in London, albeit at a higher cost. Such deliberations will naturally be superfluous if trade in financial services is maintained, but this will only be allowed by the EU if Britain is willing to compromise on immigration. In principle it would be conceivable only to provide for a kind of emergency brake to be activated in the case of an excessively high wave of immigration and along similar lines to the Swiss arrangement. However, since limiting immigration played a central role in the Brexit referendum, the scope for compromise is limited.

The last point is the EU budget. The European Commission has unofficially talked about a “Brexit bill” of 60 billion euros. This bill covers various and partly contingent EU liabilities, including EU officials’ pension claims. The argument is likely to be particularly heated over this point, but an agreement will be reached. Agreements in other areas of negotiation may even be facilitated through compensatory payments.

The topic of the EU budget is particularly relevant to Germany as the EU-27 also needs to work out how the absence of Britain’s net contribution of 7 billion euros to its budget can be compensated for by 2019. Net recipients of the EU budget will call on Germany to pay more in the future.

At the same time, there will be calls on the EU side to punish the Brits for exiting and restricting the free movement of persons. This could be done by erecting high trade barriers. Germany should reject such calls and only accept a higher financial burden if the EU agrees to far-reaching free trade agreements for goods and services in its negotiations with the UK. Germany has a particularly strong interest in ensuring that integration between the British and European economies remains as comprehensive as possible, even in the period after Brexit. This is the only way for Germany to avoid becoming the main loser of the Brexit process, facing higher contributions to the EU budget and restricted trade with Britain.

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