Brexit hangs on Europe's fortunes

The deal Britain agrees will depend on conditions across the Channel

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At a glance:

- Eurosceptic parties likely to hold gains but not make breakthrough
- EU-UK agreement likely to be ad hoc free trade deal also covering services
- UK likely to need bridging deal to avoid tight deadline on talks

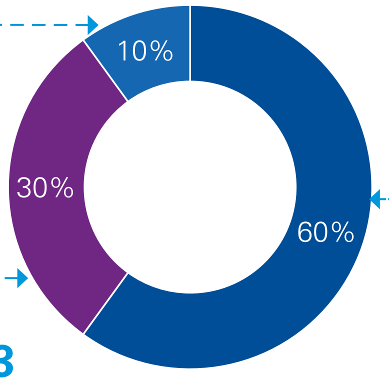
The eventual shape of the exit deal Britain signs with the European Union will depend as much on the dynamics within the EU27 as any decision taken in London. That makes the course of political and economic events on the Continent vital in forecasting the outcome of negotiations.

Here political risk consultancy Eurasia Group set out possible trajectories for the EU in the next two to three years — and the probability they ascribe to each scenario — before setting out what that could mean for the UK.

Scenario and impact summary

1

Upside scenario (10% probability)
EU and especially Eurozone states respond to Brexit by integrating more closely.
Brexit impact: EU leaders, free from the threat of further exits, are more likely to make concessions to the UK in negotiations.



2

Downside scenario (30% probability)
Several states leave the euro.
Brexit impact: EU leaders take a harder line in Brexit negotiations, causing greater disruption to trade and investment in the UK. Some kind of deal is reached, however, and the UK is not forced to fall back on existing World Trade Organisation agreements.

3

Baseline scenario (60% probability)
The EU does not fragment further, but is left vulnerable to the economic crises. Eurozone countries are particularly exposed.
Brexit impact: The UK can expect an agreement that mostly preserves its access to the single market but does not give it total control over EU migration.

1. Baseline scenario

No more exits; 'shallow' integration (60% probability)

In the run-up to French and German elections in 2017, and to a lesser extent afterwards, the EU27 take limited steps towards closer economic and political integration. Despite structural problems in the Eurozone, which get in the way of its ability to respond to economic crises, the integrity of the EU is sustainable unless it suffers severe economic or political shocks.

Eurosceptic parties hold on to recent gains, but it is unlikely they make a major breakthrough that leads to further exits. Brexit ensures EU referenda get more attention in several countries. But the likelihood of any actually taking place is low — only in a handful of countries, notably the Netherlands, is a UK-style referendum a remote prospect. Add to that stronger opposition, the very different contexts in those countries and the higher price of leaving (particularly for Eurozone countries), and the likelihood of another successful exit bid lower still.

Brexit implications

In this scenario, EU leaders want to avoid making a positive example out of Brexit. However, they balance this against the damage a messy separation or no deal at all would do to trade and investment. This is particularly the case in states that are still economically fragile after the financial crisis.

An agreement based on the European Free Trade Association (EFTA), giving the UK more or less unfettered access to the Single Market, would look a lot like full EU membership. The UK would have to contribute to the EU budget and accept free movement and the primacy of EU law. This is not politically feasible for either side, but especially in the UK given likely opposition from Brexit campaigners and would be vulnerable to rejection in any referendum on joining EFTA. The EU-UK agreement is more likely to be an ad hoc, comprehensive free trade agreement that also covers services. The extent to which Britain's dominant services sector had access to the Single Market will be a one of the main issues in negotiations and will have a significant impact on the UK's long-term economic future.

Even the most extensive free trade agreements do not typically give access to services markets, but public support for the agreement in the UK will be contingent on it granting greater control over immigration. This trade off is likely to dominate the negotiations: the more control over immigration, the less access UK firms get to the EU services market.

Timing is critical. Negotiating a free trade agreement in the two years set by Article 50 is a huge challenge, on top of which exit negotiations have to happen simultaneously. Extending the time is equally tough because it requires approval by all EU parliaments. Some kind of bridge agreement is likely to be needed to allow the UK continued access to the Single Market until negotiations are concluded, but getting one is not a given.

2. Downside scenario

Fragmentation risks re-surface (30% probability)

There's no immediate risk of other countries following the UK out of Europe. But despite the negative short to medium term impact of Brexit on the British economy, the vote to leave sets a precedent for Eurosceptic parties elsewhere.

Three factors fuel the risk of fragmentation:

- The challenge presented by refugees already in Europe with the possibility of new inflows from Syria and Turkey
- The increased likelihood and frequency of terrorist attacks in France and other countries
- A sputtering economic recovery

Against this backdrop, Eurosceptic sentiment in core EU member states and domestic political issues in a number of countries combine to block a quick and coordinated response to a possible future economic crisis.

Periphery Eurozone countries are especially vulnerable, especially Greece and Portugal. But Italy represents perhaps the biggest risk to Eurozone cohesion over the medium term. The country faces the possible collapse of its government after a referendum later this year, and the success of the Eurosceptic Five Star movement in 2018 elections. A Five Star administration wouldn't threaten Italy's euro membership directly, but would likely not be well received by the markets. Italy's economy would struggle to respond effectively to falling trade and investment.

More broadly, the EU would struggle to manage a new recession. If one or (more likely) several member states faced economic crises, bailouts, which are always a political challenge, would become even more testing, due to 'austerity fatigue' in periphery Eurozone members and 'bailout fatigue' in core states.

In a worst-case scenario these issues lead to the exit of one, or more likely, several member states from the Eurozone, the EU or both. A smaller but more economically and socially cohesive currency block is left behind.

Brexit implications

This scenario has major repercussions for the UK. If Eurozone recovery falters, potentially to the point of triggering another recession, there is even greater reason to avoid the disruptions to trade and investment that would result from a collapse in the talks.

A new Eurozone crisis makes EU membership less appealing for non-euro EU member states. As the prospect of their own exit becomes less remote they have cause to be more lenient to the UK.

But Eurozone countries, Germany and France most of all, have much louder voices in the negotiations. In Eurozone countries, difficult negotiations about the internal Eurozone crisis use up political capital. The need to counter Eurosceptic sentiment at home means there is less incentive to grant compromises to the UK. In the end, EU and Eurozone membership is a more significant national interest for these countries than the potential losses in trade and investment with the UK.

In addition, the EU Parliament and Commission, both inclined towards federalism, are heavily involved in the process and their desire to discourage further exits is reinforced in this scenario.

Overall then, a new EU crisis increases the risk that Brexit negotiations result in a less than optimal agreement. Although a breakdown in the process and reinstatement of the WTO regime would remain unlikely, the UK risks losing a greater degree of access to the EU Single Market, particularly on services. For instance, in addition to losing euro clearing licences, EU-based financial institutions could face losing passporting rights to operate in Eurozone countries.

3. Upside scenario

Deeper integration (10% probability)

In a more positive but less likely scenario, the EU responds to Brexit with greater integration, particularly in the Eurozone.

French and German elections in 2017 could lead to better coordination between these two core Eurozone members. With the next round of elections far off on the horizon, the leadership of both countries has the political space to advance contentious reforms to EU institutions, buoyed by sustained economic recovery.

We could see this scenario if the leaders of these countries recognise the long-term, structural threat to the integrity of the EU posed by Brexit. They respond by strengthening EU institutions to ensure that the union can continue to deliver growth, can respond efficiently to future economic crises and can improve quality of life for the majority of its citizens.

Under these circumstances, the UK is less of an impediment to greater security and defence cooperation. Eurozone states can also take critical steps to resolve structural issues in the Eurozone's economic governance — most significantly, completing a banking union and instituting the capability to unleash a sizeable counter-cyclical fiscal policy at an EU level — where some states subsidise others in response to crisis. That might look like a more 'political' EU budget or mutualised debt issuance for example.

Brexit implications

This scenario is not hugely different from the baseline in terms of its impact on Brexit negotiations, but is a little more beneficial for the UK.

Core Eurozone countries are potentially distracted by negotiations over advancing integration. But the scenario implies that the immediate risk of further exits is perceived to have receded, leaving EU leaders more inclined to make concessions to the UK (most significantly on free movement) to avoid damaging economic relations.

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