

Wolff, Guntram B.

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The implications of a no-deal Brexit: is the European Union prepared?

Guntram B. Wolff

Executive summary

GUNTRAM WOLFF
(guntram.wolff@bruegel.org) is Director of Bruegel

This Policy Contribution is a version of a note prepared for a hearing on Brexit of the Bundestag EU Committee, 14 January 2019. Without implicating, I would like to thank Zsolt Darvas, Maria Demertzis, Francesco Papadia, Jean Pisani-Ferry, André Sapir, Nicolas Véron and Thomas Wieser for ideas and comments. Antoine Mathieu Collin provided excellent research assistance.

THIS POLICY CONTRIBUTION, based on a note written for the Bundestag EU Committee, explores the possible consequences of a no-deal Brexit for the European Union and assesses preparations on the EU side. It also provides guidance on the optimal strategy for the EU, depending on the choices made by the United Kingdom.

OVERALL, A NO-DEAL Brexit would be disruptive in the short-term:

- There would be immediate very significant administrative and logistical challenges in trade. Preparations to reduce those disruptions are underway but are unlikely to be sufficient. But while Most-Favoured Nation tariffs will affect some sectors significantly, the macroeconomic effect on the German economy might not be huge.
- If the UK fails to honour its financial commitments to the EU, about €16.5 billion would be missing for the remainder of the current EU budgetary period. The gap could be filled thanks to the existing 'own resources' ceiling. The overall missing 'Brexit bill' would amount to about €45-50 billion.
- Not honouring financial commitments would be considered by the EU as akin to default and would likely lead to an uncooperative no-deal Brexit. It would be more disruptive than a cooperative no-deal Brexit, in which the EU and the UK cooperate on a number of pressing emergency files.
- The European Commission has issued a number of draft regulations to mitigate the effects of a no-deal Brexit, including on issues such as aviation and visas. These are comprehensive but would not offset the effects of a no-deal Brexit, which would be highly disruptive in some sectors.

THE EFFECTS OF a no-deal Brexit in the medium to long term are difficult to assess. A no-deal Brexit would lead to deterioration in long-term political relationships, which would make a new trade arrangement and other cooperation in the future less likely.

A SPECIFIC CONCERN is the situation in Ireland, which is also the most contentious part of the Brexit negotiation. If the EU wants to protect the integrity of its single market, a no-deal Brexit will mean the imposition of customs controls on the Irish border. The European Commission's draft legislation aims to preserve the peace process, but a hard border could provoke renewed violence.

THE OVERALL STRATEGIC direction the EU should take would be to increase the cost to the UK of a no-deal Brexit as much as possible (respecting ethical limits), while showing more flexibility over the political declaration and possibly the withdrawal deal itself.

1 Introduction

The United Kingdom submitted on 29 March 2017 the notification of its intention to withdraw from the European Union based on Article 50 of the EU Treaty. As a default, the United Kingdom will therefore become a third country on 30 March 2019 and cease to be a member of the EU.

I see four possible scenarios:

1. The UK exits based on the negotiated withdrawal agreement. This scenario is not further discussed in this Policy Contribution.
2. The UK leaves the EU without any agreement. This so-called no-deal Brexit is the core of this Policy Contribution (as per the Bundestag EU Committee's request).
3. The UK asks for an extension of the two-year Article 50 period, thus remaining a member of the EU until the end of the extension period. Such an extension would require the consent of the EU. Moreover, if the extension exceeds a few months, the UK would have to participate in the 2019 European Parliament elections.
4. The UK could decide to unilaterally revoke its Article 50 notification. The Court of Justice of the EU¹ has confirmed that this can be done without requiring the consent of the EU. It would mean that the UK would remain a full member of the EU under the current terms.

It is impossible to say at the time of writing which of these four scenarios is the most likely. But it is important to highlight that the current UK political situation is very volatile. I would therefore attach a significant probability to all four scenarios.

Given that a no-deal Brexit has a significant probability, it is important to carefully assess the consequences of a no-deal Brexit and plan for it. This Policy Contribution reviews the Commission's communication on the matter (COM(2018) 880 final; European Commission, 2018) and provides an assessment of the key issues of concern in case of a no-deal Brexit, from the point of view of the EU and Germany. The preparations are extremely complex, as is Brexit, which is why this Policy Contribution cannot fully review all aspects.

I do not assess the problems the UK would face in case of a no-deal Brexit. However, I would like to highlight that the impact of a no-deal Brexit on the British economy will be greater in terms of percent of UK GDP than the impact of a no-deal Brexit on the EU economy in percent of EU GDP. Still, this economic judgement should not be mistaken for a political judgement that the UK has a greater interest in the deal that is proposed at the time of writing. The deal is multidimensional and has many repercussions in terms of sovereignty that British politicians might decide to reject. The economic assessment therefore is insufficient for making a judgement on the likelihood of the UK parliament voting for the withdrawal agreement.

Preparations for a no-deal Brexit should be made by the EU institutions, national authorities and, equally importantly, by business and citizens. There have been numerous communications and warnings on being prepared for that scenario. The aim of these preparations should be to reduce the negative impacts of a no-deal scenario.

1 CJEU, Order of the President of the Court of 19 October 2018. *Andy Wightman and Others v Secretary of State for Exiting the European Union*. Expedited procedure. Case C-621/18. Available at <http://curia.europa.eu/juris/document/document.jsf?text=&docid=207041&pageIndex=0&doclang=en&mode=req&dir=&occ=-first&part=1&cid=129176>.

2 The implications of a no-deal Brexit: an assessment

A no-deal Brexit could take various forms. In one scenario, there will be a complete breakdown of all EU-UK cooperation. At some level, the EU has an interest in playing it very tough in a scenario in which the UK parliament decides not to ratify the agreement that was negotiated by its elected government with the EU. Such an act would certainly be seen as very unfriendly by the EU. The EU would therefore be reluctant to agree with the UK on ‘emergency’ measures. So a non-cooperative no-deal Brexit is quite possible. In another, perhaps more reasonable, scenario, the EU and the UK would still cooperate on some minimal issues. This is my baseline assumption for this section, but I stress that it would require the UK to honour its financial commitments to the EU.

2.1 EU budget impact

One of the politically immediately important questions will be the EU budget. If the UK leaves without honouring its financial commitments to the EU, the EU would politically be tempted to treat the UK as a defaulting counterparty. This has major political implications and could mean that the EU will not be ready to negotiate a meaningful relationship with the UK for some time.

In terms of the budget impact, the Brexit bill is estimated to be about €45-50 billion. For the currently ongoing Multiannual Financial Framework (MFF), the April 2019-December 2020 gap in EU budget is estimated to be €16.5 billion in total, or 0.064 percent of EU27 GNI under a set of assumptions². This amount will have to be transferred by member states to the EU budget, while an offsetting factor is the nationally-retained 20 percent of extra custom duty revenues from imports from the UK. No new legislation is needed to cover this gap, because in the current MFF’s overall own resources ceiling is 1.22 percent of GNI (ie the maximum amount of own resources which the EU may raise during a year), while the payment ceiling is 0.96 percent of GNI. The difference between the overall own resources ceiling and payment/commitment ceilings “provide room for manoeuvre in case of unforeseen needs and emergencies”³. To our knowledge, this relatively large (about 0.26 percent of GNI) margin has never been used. The €16.5 billion April 2019-December 2020 gap would have to be distributed among the member states according to their GNIs. Germany’s contribution for this period could increase by about €4.2 billion, while the extra customs duty revenue would offset about €0.2 billion, making the net cost €4.1 billion (after rounding).

Given that the size of the Brexit bill is small compared to the UK budget (for example, in 2020 it is 1 percent), but large compared to the EU budget (6.5 percent in 2020), the EU would justifiably consider the non-honouring of the UK’s financial commitments as a hostile act. **I would recommend to the EU and the Bundestag to refuse making concessions on emergency measures in the absence of a substantial financial contribution from the UK.**

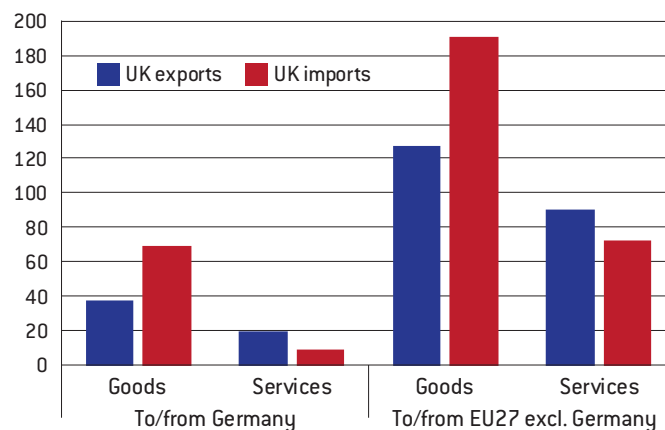
² See Darvas (2019). The key assumptions for the projections are: no UK contribution to the EU budget starting from 30 March 2019; no EU spending in the UK starting from 30 March 2019; the average tariff rate on imports from the UK will be the same as the average tariff rate on imports from non-EU countries; imports from the UK decline by 20 percent because of the no-deal Brexit; actual EU budget payments will be 100 percent of the MFF payment ceiling; other revenues will be €8.9 billion annually (average value for 2014-17). VAT and GNI-based contributions result as residual, using GNI shares as reflected in the European Commission’s November 2018 forecast, while the UK’s share of the EU28 VAT and GNI-based contribution is assumed to remain the same (11.1 percent) in 2018-2020 as it was in 2017 (this share, which is lower than the UK’s share of GNI (14.9 percent), reflects the UK rebate, which varies across the years). See also Darvas *et al* (2017).

³ See: http://ec.europa.eu/budget/mff/ceilings/index_en.cfm.

2.2 EU-UK trade relations

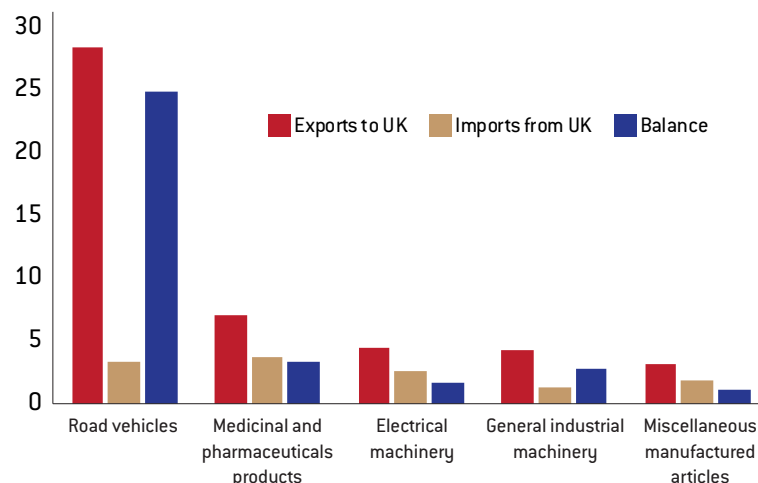
A no-deal Brexit has major implications for the trading relationship. Figure 1 summarises the current trading relationship between the UK and Germany and the rest of the EU (excluding Germany)⁴. The EU exports a total £341 billion to the UK of which £259 billion is goods and £81 billion is services. The German share of that is significant: exports of £69 billion of goods and £9 billion of services. This trade will be affected by Brexit in any case. But in a no-deal scenario, there is no transition, which means that customs and regulatory controls will need to be applied immediately. Moreover, in a no-deal scenario, there is no agreement in how the trading relationship could potentially evolve – much in contrast to the deal scenario, where a political declaration sets out ambitious goals for a trading relationship. The EU27 remains the most important trading partner for the UK.

Figure 1: UK exports/imports to/from Germany and the rest of the EU (£ billions)



Source: Bruegel based on Office for National Statistics, Pink Book 2018 (2017 data).

Figure 2: UK-German trade, key sectors (€ billions)



Source: Bruegel based on Eurostat, ComExt statistics. Note: data is end-2015.

⁴ National statistics do not account for the so-called 'Rotterdam effect,' according to which British trade with the Netherlands is artificially inflated by the fact that a significant proportion of trade with the continent passes through the port of Rotterdam (Ward, 2018). As a significant part of German exports are shipped through the Netherlands, the Rotterdam effect probably leads to an underestimation of Germany share of the UK's trade with the EU27.

The top five sectors exporting from Germany to the UK are road vehicles, medical and pharmaceutical products, petrochemicals, electrical machinery and other transport equipment (Figure 2).

In a no-deal Brexit, the United Kingdom will become a third country and the applicable tariffs will be WTO most-favoured nation (MFN) tariffs. The UK has already notified the WTO that it will apply the EU's MFN tariffs once it leaves the EU and there is no disagreement on that at the WTO. Table 1 gives an overview of the tariff rates that would be applied to British exports, for the top five trade sectors that concern Germany. **This data suggests a rather modest effect on overall German exports, but the effects would be relevant in specific sectors such as the car industry.**

Table 1: Tariffs applicable to the top five trade items in case of a no-deal Brexit

Product	German exports to the UK in value (€ billions)	Average tariffs applied under WTO MFN rules
Road vehicles	28.4	10%
Medical and pharmaceutical	7.2	0%
General industrial machinery & equipment	4.4	1.8%
Electrical machinery	4.2	2.5%
Misc. manufactured articles	3.1	2.3%

Source: Bruegel based on WTO tariffs profile 2018 and WTO tariff data.

A no-deal Brexit would immediately create significant logistical and administrative challenges. Dover, one of the main points of entry into the UK for lorries, reportedly does not have the capacity to introduce customs controls to keep the number of lorries arriving as high as currently⁵. This will immediately affect supply chains and it will take some time until replacement routes are established. Similarly, EU ports do not yet have enough personnel to ensure adequate customs controls. The European Commission (2018) therefore reminded member states to stand ready to ensure controls and, in our understanding, EU member states have hired personnel for customs controls, veterinary checks and sanitary and phytosanitary checks. Rules of origin for imports and exports from and to third countries would need to be applied, an administrative challenge for companies and EU and UK governments. Having said this, it is likely that for a period of several months, such practical questions would significantly affect trade relations. But it is also fair to assume that these logistical challenges would be resolved after some time and would not constitute a permanent barrier to trade.

There is disagreement at the WTO on the apportionment of tariff quotas included in the EU's WTO schedule. The EU has negotiated tariff quotas at the WTO, which would need to be divided between the EU27 and the UK. In the interest of maintaining clarity and predictability in the multilateral trading system, the EU and the UK sent a joint letter to the whole WTO membership on 11 October 2017 setting out the main rationale and principles envisaged for this apportionment. However, the negotiations with WTO members have not been concluded and some members disagree with the approach. The Commission has proposed a draft regulation (COM/2018/312 final) allowing it to take the necessary measures in relation to third countries. While such adjustment of apportionments has happened before when Croatia joined the EU, a no-deal Brexit will raise some uncertainties. In practical terms, the EU and the UK would apply the new apportioned quotas once the UK leaves, but later legal challenges at the WTO cannot be excluded.

5 "A live rehearsal of an emergency traffic system that will be put in place to prevent congestion in Dover in the event of a no-deal Brexit was described as "a waste of time" by drivers participating in the test in Kent" (7 January), according to The Guardian: <https://www.theguardian.com/politics/2019/jan/07/no-deal-brexit-rehearsal-tests-traffic-congestion-in-kent>.

The overall take away is that a no-deal Brexit would create significant short-term challenges for the trading relationship between the EU and the UK, which would be avoided with a deal. The longer-term impact depends on the political relationship and the terms of the future economic relationship. To assess the impact in the medium term would require measurement against a benchmark, such as an ambitious trading relationship as envisaged in the political declaration accompanying the withdrawal agreement. It is probably fair to assume that a no-deal Brexit would make it more difficult politically for the EU to engage in a trade negotiation with the UK. If the WTO's MFN tariff rates were to be applied, trade in specific sectors would be affected but overall the impact might be limited in terms of the macroeconomy⁶.

2.3 Ireland

The situation on the island of Ireland post Brexit remains one of the most difficult and contentious items of the Brexit negotiations. The most important point is the question of border controls in Ireland, which Irish observers argue could lead to new violent tensions on the island. Could this be prevented? The withdrawal agreement sets out a path, combined with a 'backstop', which would prevent the imposition of such a border, but is seen as strong interference in UK sovereignty by many in the UK House of Commons.

The Commission contingency measures can only alleviate some effects of a no-deal Brexit on Ireland. The Commission issued in December 2018 a draft regulation (COM(2018) 892 final) to ensure the continuation of the territorial cooperation programmes PEACE IV and United Kingdom-Ireland (Ireland-Northern Ireland-Scotland). The Commission has also suggested financial support for Ireland and a number of measures to improve transport logistics (European Commission, 2018). But these measures can only partly mitigate the effects of a no-deal Brexit. In terms of immediate logistical challenges, including in the areas of energy and transport, it would take time to build infrastructure. But more importantly, the Good Friday Agreement (Belfast Agreement) of 1998 was made possible by Ireland's and the UK's membership of the EU's single market, making it possible to end all border controls.

Paradoxically, while the main political motivation for the UK parliament to reject the withdrawal agreement might be the so-called backstop, a no-deal Brexit will lead to customs controls in Ireland that the backstop aims to prevent. Customs controls would be inevitable in a no-deal Brexit if the EU wants to preserve the integrity of its single market. In fact, once the UK is no longer in the customs union or the single market, customs checks will need to be enacted to preserve the integrity of the market and to apply EU law. The Irish government would be obliged to enforce EU law and control the borders and the UK government would also have an interest in enforcing its own border to ensure its sovereignty. **The EU and the UK might therefore be ready to go back to the negotiating table to prevent violence on the island of Ireland in case of a likely no-deal Brexit** (see also section 3, the conclusions).

2.4 Citizens' rights and visa policy

British citizens as EU citizens have a fundamental right to travel to any other EU country and even the right to work. As of 30 March, this right will cease to exist and UK citizens will become third-country nationals. The determination as to whether a third-country national is subject to or exempt from a visa requirement is laid down in Council Regulation (EC) No 539/2001. The United Kingdom government has declared its intention not to require a visa from citizens of the EU27 countries for short stays for purposes of tourism and business. The Commission proposes to amend the Council regulations to adjust the status of UK citizens when travelling to the EU (COM(2018) 745 final). The Commission proposed visa-free travel on the condition that the UK treats all EU citizens the same and grants them visa-free travel. I concur with the importance of requiring the UK to treat all EU citizens the same; however,

⁶ For an overview of estimates of trade effects, see German Council of Economic Experts (2018).

it is worthwhile noting that the EU has not been able to implement the same rule relative to the United States, which requires visas from some EU citizens but not from others. Rights of residence and the right of non-EU nationals to work are currently decided by EU member states. In our view, EU member states would be well advised to cooperate and define a unified position relative to the UK to help ensure a similar status for all EU citizens wanting to work and live in the UK. It would also be important, in our view, to distinguish between citizens already resident and those wanting to migrate. The status quo of residents should not be altered on either side in case of a no-deal Brexit. **An important interest for Germany and the EU more generally is therefore that the accumulated rights of their citizens in the UK should continue to be honoured, and that the EU and the UK should agree in a no-deal Brexit scenario to ensure cooperation in areas including social security rights and pension transferability.**

2.5 Financial services

On financial services, we consider that the most important contingency plans have been made. From conversations with major financial institutions across Europe, I can confirm that extensive preparations have been made to deal with a no-deal Brexit. In my judgement, financial instability on the EU27 side, given preparation by most market participants and the Commission's recently confirmed flexibility on issues such as derivatives clearing, is likely to be limited. Also, British authorities have implemented measures to safeguard financial stability. This does not mean that a no-deal Brexit will be without costs. The preparations themselves, and the reduced liquidity, represent costs, but financial stability concerns are likely to be limited. It is important that the Bank of England and the European Central Bank continue to have a strong relationship, working together to preserve stability.

2.6 Effects on specific sectors

A no-deal Brexit could have implications for a number of specific sectors but contingency planning will mitigate the immediate fall-out. For example, when it comes to aviation, a no-deal Brexit would mean that UK airlines can no longer operate flights in the EU, while safety rules would mean that flights between the EU and the UK would be affected. The Commission has proposed a regulation (COM(2018) 894 final) that would limit the fall-out from the UK's departure from the EU aviation safety system. If the regulation is approved, flights between the EU and the UK will be automatically allowed for a period of another 12 months. Nevertheless, British airlines will lose the right to operate intra-EU flights or flights to third countries via the EU⁷.

In my assessment, the Commission has done serious work in reviewing all possible sectoral effects and proposing emergency draft regulations and other measures⁸. The Commission has identified that road transport, customs, sanitary requirements, personal data, EU climate policy, visas and citizens' rights, and financial services might all require quick action.

⁷ There is even a debate about whether this will affect airlines such as Iberia, which is owned by Britain's IAG. See, for example, <https://www.ft.com/content/35ff12b0-1328-11e9-a581-4ff78404524e>.

⁸ See the Commission's list of legislative initiatives and other legal acts at https://ec.europa.eu/info/brexit/brexit-preparedness/legislative-initiatives-and-other-legal-acts_en.

3 Conclusions

A no-deal Brexit would be bad news for the EU as well as for the UK in the short term, compared to signing the withdrawal agreement. In this Policy Contribution, I have not quantified how much worse a no-deal scenario would be compared to signing the current deal. However, I have highlighted that a no-deal would be particularly bad for Ireland, because it would lead to customs controls on the island in order to protect the integrity of the single market. Moreover, I have highlighted a number of immediate quite disruptive challenges for trade, for specific sectors such as airlines and pharmaceuticals, and for people. The withdrawal agreement is a rather complex text, documenting the extent to which economic, societal and political relationships are affected by Brexit. Leaving all these relationships without any agreement is likely to cause significant short-term turbulence.

The longer-term trade and more general implications are difficult to assess as they require making assumptions about the future EU-UK relationship. As such, that longer-term relationship is less certain than it would be under the draft agreement with its annexed political declaration on the future relationship.

It is important to be prepared to reduce and mitigate the impact of a no-deal Brexit, also taking into account the highly uncertain political situation in the UK. The EU institutions, EU member states, business and citizens all have a role to play. But no preparation can satisfactorily solve the problem that Ireland would be confronted with.

One important question for the EU is whether it would be ready to modify the terms of the political declaration or even the withdrawal agreement to make its ratification more likely. So far, the EU has stated strongly it will be impossible to alter the deal that was agreed between the UK government and the European Commission negotiators (Juncker, 2018). From a strategic point of view, this is the communication that one would expect. In fact, one can think of the strategic situation in terms of a game-theory setting, a so-called chicken game. In a chicken game (Maynard-Smith and Price, 1973; Rapaport and Chammah, 1966), two cars run at high speed towards each other. The driver who blinks first and pulls to the side, loses. But if neither driver blinks, the cars hit each other and both sides suffer damage. Game theory suggests that the driver in the weaker car would blink first because he would suffer the greatest damage. Yet, game theory is based on an assumption of the rationality of the drivers, which might not necessarily be an accurate description of the political reality of Brexit. **I would therefore not exclude small modifications to the political declaration and possibly even the withdrawal agreement closer to the moment of a no-deal Brexit. The likelihood of such changes also depends on an assessment of the costs of no-deal Brexit on both sides.**

A no-deal Brexit would require the adoption of a number of emergency laws prepared by the Commission, but the key question is whether all legislation can be passed before 29 March. An important question is the timeframe for adoption of that legislation by the European co-legislators, the Council and the European Parliament. In the absence of any extension of the Article 50 period, the co-legislators would have to adopt the legislation before 29 March. This could be very challenging. Moreover, adopting these regulations immediately could change the dynamics of the vote on the deal in the UK parliament. In my assessment, the EU therefore has an interest in agreeing to a short extension of Article 50 in case of no agreement on the withdrawal agreement. A deadline might be the last scheduled meeting of the European Parliament, 18 April, prior to the European elections. Technically, the longest possible extension seems to be until June 2019, the latest moment the European Parliament could still meet and legislate in its current composition. An extension beyond that period would lead to complicated political choices in the UK as the UK would have to participate in the European elections.

The EU's readiness to cooperate on the proposed emergency measures to manage short-term frictions in case of a no-deal Brexit would likely depend strongly on the

UK's readiness to honour its financial commitments. Some files do not require cooperation under a no-deal Brexit. But it would be naïve to assume that non-cooperation would be cost free. Non-cooperation would significantly aggravate the costs of no-Brexit for both sides, but the costs would be particularly high in the UK. I have argued that the EU is right to take a strong stance on money. **Under a more reasonable scenario, I would expect cooperation on a number of key files such as visa rights, frictions on the Irish border and customs cooperation.** Member states, parliamentarians and EU institutions should be ready for no-deal emergency agreements, especially when it comes to areas in which human lives might be at stake, such as health cooperation or nuclear cooperation. Also in financial services, cooperation is highly advisable as a no-cooperation no-deal Brexit could increase financial stability risks. No matter what the UK's position is, the EU should aim to prevent the worst outcomes when it comes to human lives and financial stability.

The overall strategic direction I would advise the EU to take is to increase the cost of a no-deal Brexit as much as possible (while respecting ethical limits), while showing more flexibility on the political declaration and possibly the withdrawal deal itself. The EU and the UK have a long-term interest in being close partners. Departure of the UK without any deal would be a very bad signal to the world about the ability of the UK in particular and also of the EU to cooperate with strategic partners. It would be highly damaging in terms of the UK-EU (political) relationship. Highlighting this political cost of a no-deal Brexit should help convince the UK parliament to sign a deal. Nevertheless, all players should quietly make preparations at a technical level to prepare for no-deal.

The next six months could very well prove politically turbulent, with significant brinkmanship. It is of the utmost importance that the EU remains united. It is also important that the EU does not lose sight of its long-term strategic interests.

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