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UK POLITICAL UPDATE: HARD BREXIT HAS BECOME LESS LIKELY

Berenberg Macro Flash

The political reactions in the UK to the inconclusive election last Thursday suggest that a hard Brexit has become less likely. 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. Because the Conservatives (318 seats) and the DUP (10 seats) would only have a small majority (at least 322 and possibly up to 326 seats needed), any small group within government could hold the balance of power. This could leave the government hamstrung if any such group of MPs disliked the direction of Brexit. We therefore see three reasons why this election has increased the chance of a soft Brexit: (1) The 10 MPs from the DUP will seek to avoid a hard-Brexit that would lead to a hard border between Northern Ireland and the Republic of Ireland; (2) The 13 MPs from the Scottish Tories, headed by Ruth Davidson, want a Brexit deal that prioritises the economy and trade over migration; (3) pro-EU Conservative MPs who have remained mostly in the dark over the past year now feel emboldened that the public have rejected May's vision of a hard-Brexit. They could club together to influence the UK's Brexit strategy.

While the Tory-DUP agreement to cooperate is not yet officially confirmed, we expect that to happen in the next few days. Unlike the 2010 Tory-LibDem coalition, the Tory-DUP partnership will be softer. The DUP wants a 'confidence and supply' arrangement. This is weaker than a formal coalition and differs in one significant way, the DUP will likely only agree to cooperate with the Conservatives on a piecemeal basis, thereby maintaining their leverage as kingmaker.

May still in Downing Street, for now: After squandering her party's 17 seat majority in an election she did not need to call, Theresa May's credibility is badly damaged. Her days as head of UK government are probably numbered. But her party will likely keep her in charge until a working government has been formed. A leadership challenge too soon after a general election that ended in a hung parliament could propagate calls for another general election which the Conservatives would like to avoid as the left-wing Labour Party seems to have momentum on its side at the moment. As May kept her three Brexit ministers in place, Boris Johnson (Foreign Secretary), David Davis (Brexit Secretary) and Liam Fox (Trade Secretary), the first Brexit negotiations can begin as planned on 19 June.

EU27 hopes for soft Brexit: On the continent, most observers have taken the UK election result as a rebuke of Theresa May's hard Brexit rhetoric of the "no deal is better than a bad deal" kind. For example, EU Commission Öttinger has expressed hope that the UK may now agree to stay in the Customs Union and the Common Market, possibly by joining EFTA. To remain in the Common Market and thus maintain preferential access to the EU27 market (except for some financial products where regulators will insist that some activities have to be carried out under the direct sway of EU regulators), the UK would have to accept the free movement of labour and continue to pay into the EU budget like EFTA members do. Whether or not a Tory-led government could agree to that remains a very open question, though, to put it mildly.

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