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BREXIT: THE REAL CRISIS MAY BE YET TO COME

Berenberg Macro Flash

Parliament versus a hard Brexit

The latest defeat for the UK government at the hands of parliament is symbolically important. It suits our call that a hard Brexit is unlikely (20% risk) because the pro-EU majority in UK parliament will not stand idly by if the UK is on course to crash out of the EU on 29 March 2019 – see The safeguards against a hard Brexit . Before Christmas, parliament had inflicted several key defeats on government on Brexit legislation. The most important of these gives parliament a say in what alternative arrangement the UK should go for if it rejects Prime Minister Theresa May's deal. Yesterday, with the help of 20 Conservative MPs, parliament voted – 303 to 296 – to amend a finance bill to restrict government's powers to change tax law in the event that a hard Brexit occurred without the consent of parliament.

By law, the UK will leave the EU on 29 March 2019. If PM May cannot get her deal passed a hard Brexit becomes the default option unless parliament can come up with some alternative plan. Our bet is that the series of defeats for government shows that parliament would support an alternative to May's deal to prevent a hard Brexit. Exactly what this would be remains to be seen. But as a first step to getting there, the crisis may have to escalate further. As we wrote in our year ahead – see Global outlook 2019 - an unmanaged hard Brexit is the biggest near-term tail-risk for the UK and broader European economy.

Without a new partnership deal agreed in time for exit day, or at a minimum some policies to smooth the transition to WTO rules for UK-EU trade, the adjustment for the UK to its new reality could be wrenching. The UK would be at serious risk of recession. Markets know this. Both the UK parliament and the government seem committed to avoid such an outcome. However, as it stands, it is not obvious what option has a majority backing. If parliament is still at an impasse over how to handle Brexit by early February, the UK will not have to wait until the end of March before currency markets begin to make some of the necessary adjustment already. In the end, it may take a major crisis where markets, business and households panic about an impending hard Brexit crisis for parliament to act in the national interest. The UK may still have its TARP moment yet.

Assurances from the EU probably can not save May's deal

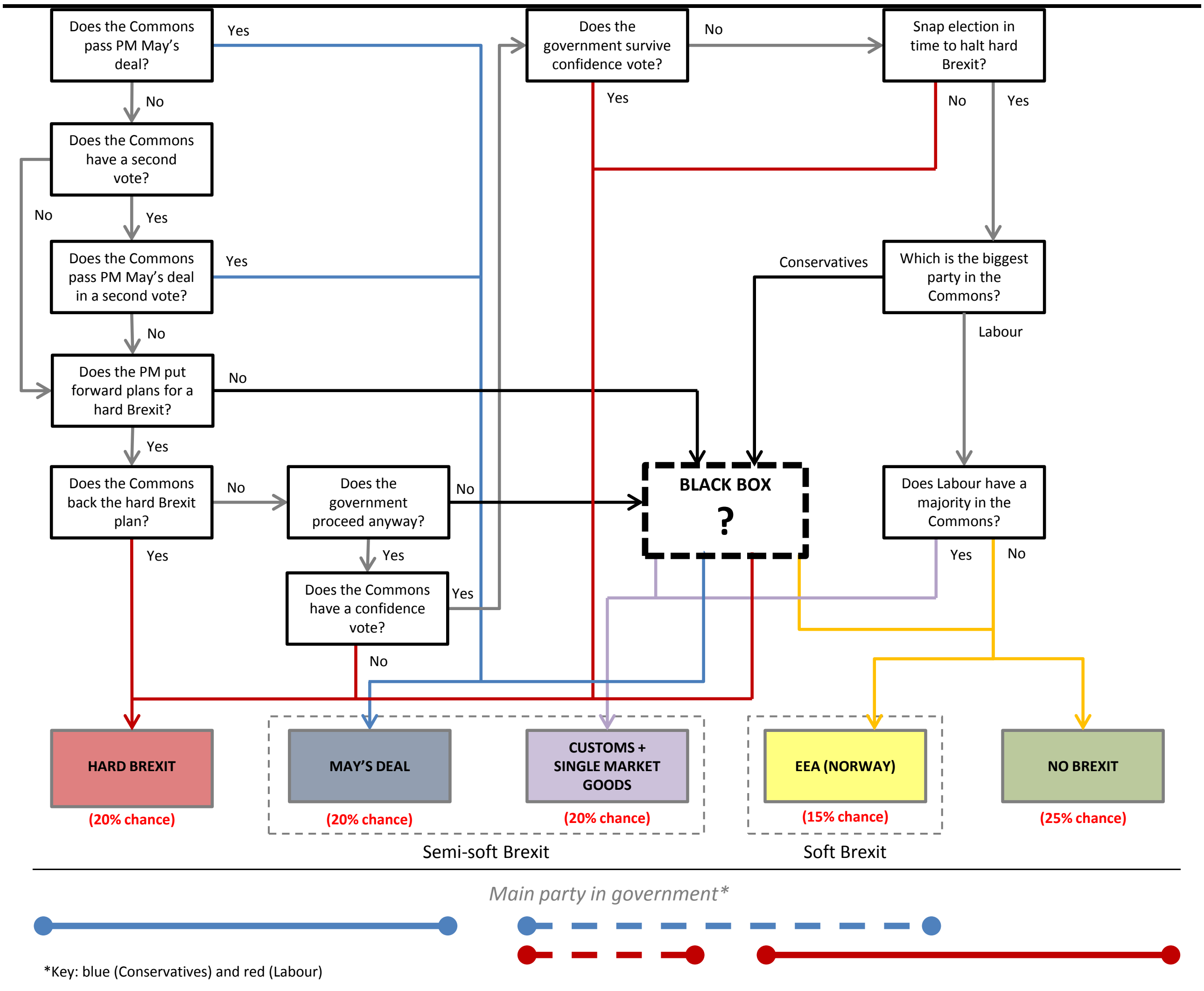
Irish Prime Minister Leo Varadkar said yesterday that the EU would be ready to provide new "written guarantees, explanations and assurances" on the Irish backstop. Unless these are legally binding and in the text of the withdrawal agreement (which the EU has said it will not re-open) it is hard to see how such assurances could turn the tide on May's deal which we put at a 20% likelihood. For different reasons, 30-40 hardline Conservative Brexiteers and 13 Northern Irish Democratic Unionist Party MPs are unlikely to support May's deal as it stands. The only real chance that May has of getting her deal passed would be if the pro-EU majority in parliament thought that her deal was the only way to prevent a hard-Brexit, hence the PM's motivation for delaying the vote over Christmas.

Although less likely than before, PM May could try to force a second vote on her deal shortly after a failed first attempt – scheduled for 15 January. Even though a group of very pro-EU Conservatives – maybe 20 – want to reject PM May's deal to make way for a softer Brexit, they, along with the moderate majority of Conservatives MPs – including PM May's own cabinet - would probably back her deal if enough opposition MPs or Conservative Brexiteers and the DUP could be brought on board. One risk to watch is that PM May continues to go back and forth between the EU and UK parliament in an attempt to extract concessions and pass her deal but ultimately fails. The more PM May runs the clock down the higher the chance becomes of a hard Brexit simply because there is not enough time to take the necessary steps to avoid it.

An extension to Article 50?
If PM May cannot get her deal passed, but parliament (including government) needs more time to process an alternative option to avoid a hard Brexit then the EU may agree to a short extension to the Article 50 two year negotiation window – currently due to end on 29 March 2019. However, the upcoming European Elections in May limit the length of such an extension to probably not much more than two months. The new European Parliament will commence on 2 July. Since the UK does not plan to hold European elections, any extension beyond the end of June would present a problem for the European Parliament if the UK remained an EU member at that point – since the UK would have no representation.

The black box problem – revisited
All Brexit outcomes are still possible. This uncertainty presents a challenge for financial markets. If Parliament votes down May's deal, the uncertainty will increase even further. Several scenarios become possible thereafter. Chart 1 outlines the possible scenarios to the Brexit endgame, incorporating where possible the various stages of the parliamentary process – for further analysis see 'Brexit scenarios – the black box problem' .

Chart 1: Brexit scenarios flowchart - the black box problem



Sources: UK Parliament, Berenberg

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