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## UK: THE FIRST DAYS OF JOHNSON - FOUR THINGS TO WATCH

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*Barring a massive surprise, Boris Johnson will be announced as the new leader of the Conservative Party later this morning (estimate 11.45am). He will replace Theresa May as Prime Minister (PM) of the UK tomorrow afternoon. In a way, there is a peculiar justice to this outcome: Johnson, the man who, perhaps single-handedly, swung the EU referendum result now has the job of delivering Brexit.*

Johnson will inherit the biggest political crisis in a generation. With a working majority of just three MPs in the House of Commons and his party struggling in the polls, the stakes could not be higher. His decisions in the coming weeks will have lasting effects on the UK, its economy and its standing in the world. To no small extent, the survival of the Conservative Party – once regarded by financial markets as the most sensible pair of economic hands in UK politics – is in his hands.

As Johnson takes the helm we see four key issues that markets should pay attention to in the first days and weeks of his premiership.

- 1. First speech:** In keeping with tradition, Johnson will deliver a speech outside Number 10 Downing Street shortly after the Queen names him PM and asks him to form a government – likely tomorrow. Exactly what Johnson will say is anyone's guess. The key focus should be any details revealing his strategy for Brexit. For much of the Conservative Party leadership race, he adjusted his Brexit rhetoric to suit his audience. This encouraged moderates and Brexiteers alike to project their hopes on Johnson. More recently, however, he has hardened his stance. [In turn, last week we increased our call on the hard Brexit risk to 40%](#). Last Monday he said that he would not accept the contentious Irish backstop as part of a Withdrawal Agreement (WA) in any form. Probably, this is just a negotiating tactic – an attempt to create space for a compromise by demanding the impossible in order to persuade Irish Taoiseach Leo Varadkar to accept a half-way deal, ie a time limit on the backstop. The eurosceptic wing of his party would probably swallow that, along with the rest of the Conservatives. But this is a high-risk strategy with a low probability of success. If the EU refuses Johnson's demand, moderate MPs will take measure to thwart a no deal. This would set the stage for a major showdown in parliament in autumn that could lead to a further Brexit extension, a snap election and/or second referendum. While Johnson may be forced to take a more pragmatic line eventually, we do not expect him to use soft words on Brexit in his first speech. In the not-unlikely event that he doubles-down and appears to harden his Brexit stance further, UK-oriented equities and sterling would likely react negatively.
- 2. UK opinion polls:** The outcome of a snap election would be highly uncertain. Latest polling points to a hung parliament with support divided between the Conservatives, Labour, the Liberal Democrats and the Brexit Party (Chart 1). The risk that the Conservatives would lose power, and thus control of the Brexit process, would be significant. This shifts the advantage to the Tory moderates who have threatened to bring down the government in order to tame Johnson if begins to set course for a hard Brexit. If the polls are unchanged once Johnson becomes PM then his incentive is to do what he can to avoid a hard Brexit. But if the polls turn in favour of the Conservatives that could change this dynamic. Much of the recent loss in support for the Conservatives is to the Brexit Party. Current support for the Conservatives is at c24%, down from 40% as recently as March. Current support for the Brexit Party is at c20%. Johnson is a known risk taker. If he finds that over the summer a hard line on Brexit helps the Conservatives regain support at the expense of the Brexit Party, moderate Conservative MPs could begin to fall behind Johnson and his Brexit strategy. While unlikely, if the polls went the right way for Johnson he could try his luck in a snap gen-

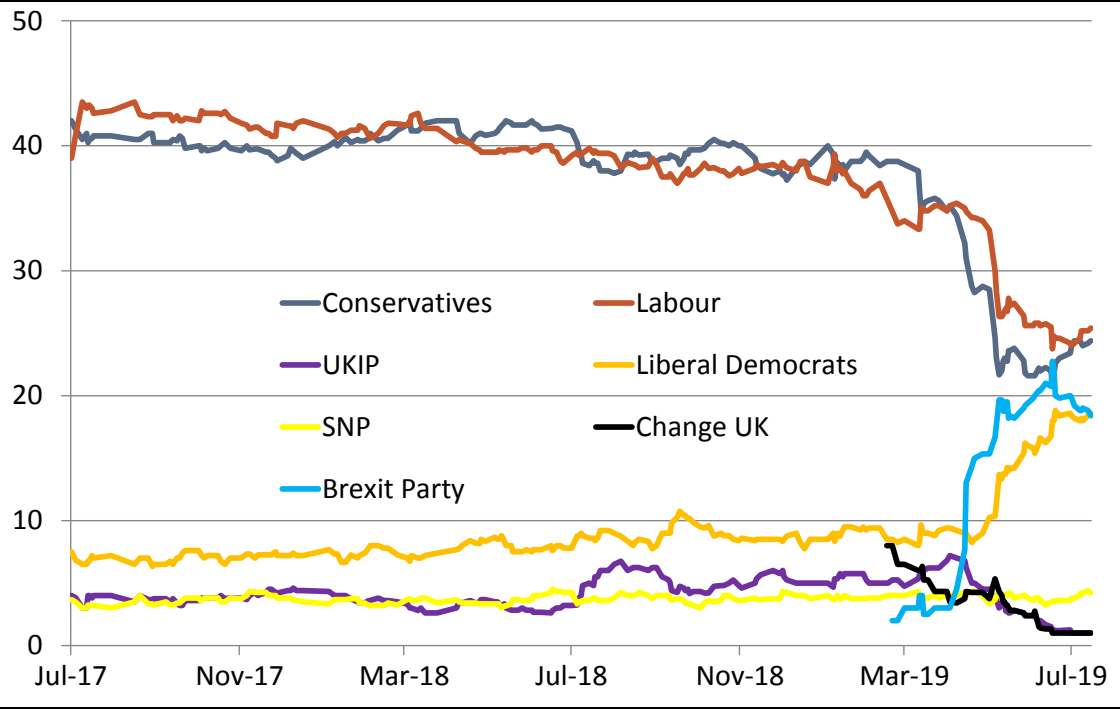


eral election later this year on the hope that increasing his majority would make delivering Brexit easier.

3. **Fiscal announcements:** Johnson has promised to lift the economy with a [large fiscal stimulus that combines cuts to income tax and national insurance plus some headline grabbing spending projects](#). While markets may respond well to the promise of a fiscal easing, we should keep in mind that Johnson will be constrained on how much he can deliver in the very near-term. First, there is the practical matter of parliament going away for summer recess on 25 July until 3 September. Johnson would need parliament to pass a major fiscal bill. Second, with his slim working majority in the Commons, Johnson may not have the numbers to pass a major fiscal bill even when parliament returns. Through the amendment procedure, such a bill could be used by moderate Conservatives to thwart a hard Brexit. Of course, the PM would not be completely powerless. For example, Johnson could, straight off the bat and without parliament, make a temporary cut to VAT or stamp duty. That would likely lift household spending and boost domestic demand in the near-term.
4. **The continental reaction:** Assuming Johnson and his team have some real plan – that goes beyond campaign rhetoric – to deliver Brexit on 31 October, he will likely make trips to key European capitals in the coming weeks. If Johnson's genuine issue is the terms of the Irish backstop then he need not travel further than across the Irish Sea to Dublin. So far, the other 26 members of the EU have united behind Irish Taoiseach Varadkar's demand that the backstop must be in the WA and must not be either time limited or involve some unilateral exit mechanism. [We expect EU leaders to reiterate the line that they would be willing to renegotiate the declaration on future trade that sets out the potential future relationship but not the WA](#). Although the other EU members have little stake in the "backstop" issue, they will continue to back Dublin. This puts the spotlight on Varadkar. If no other way can be found to obtain UK approval for the contentious WA, Varadkar may face a choice in late October between (i) a hard border in Ireland in six years' time, say after a transition period until late 2020 and a five-year time limit on the Irish backstop thereafter, or (ii) a hard border in six days' time in the case of a no-deal hard Brexit. In the unlikely case that Varadkar agrees to a time-limit for the Irish backstop at the last minute, the other 26 EU countries would go along with that.



Chart 1: Conservatives and Labour fall behind while the Brexit Party benefits from the Brexit mess



UK opinion polls for national elections. Three-poll moving average. 8 June 2017 election results: Conservatives (42.4%), Labour (40.0%) LD (7.3%), SNP (3.1%) and UKIP (1.8%). SNP: Some data points include Plaid Cymru. Source: National polls.