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BREXIT UPDATE: 5 QUESTIONS FOR THE COMING MONTHS

Berenberg Macro Flash

UK politics has fallen into crisis following the vote for Brexit last Thursday. The resulting uncertainty and market tensions could further dampen activity in the domestic economy in the near-term. Currently, there are more questions than answers. To discuss likely outcomes amid unprecedented uncertainty we focus on five key areas:

Who will become the next Conservative leader?

- We expect Boris Johnson to become the next Conservative leader and Prime Minister (PM). Secretary of State for Justice and prominent Brexit campaigner Michael Gove backed Johnson for PM over the weekend. This strengthens our assumption that Johnson would replace George Osborne with Gove as Chancellor if and when he wins. But first, Johnson will need to win a Conservative leadership contest.
- The strongest 'not-Boris' candidate is Home Secretary Theresa May. After Johnson, May is the next most likely candidate. Conservative MP's are roughly split down the middle on the issue of Europe. In the early stages of the process in which Conservative members of parliament vote to reduce the list of possible candidates to just two, May could look equally matched with Johnson. But we do not see May as the favourite for the final vote which goes to all Conservative Party members. Grass root members are mostly Europe sceptic. They will likely back Johnson.

Will the Labour Party replace Jeremy Corbyn?

- A third of the Labour Party's shadow cabinet resigned over the weekend. The en masse resignation has apparently triggered the start of a leadership race in the Labour Party. A vote of no confidence has already been tabled for today's meeting of the parliamentary Labour Party (this is the group of Labour members of parliament). If a challenger can get the required 20% of Labour MPs support that would trigger a leadership contest.
- Labour currently has 229 seats in the House of Commons. Therefore, each challenger would need the support of 46 fellow Labour MPs. The contest would probably take place at the next Labour Party conference in September. Corbyn has said that he would run again in a leadership race. Last year, Corbyn won a record 59.5% of votes. The doubling of party membership in the past year has been attributed to Corbyn. We think that there is a good chance that Corbyn would win again as long as he runs for leader.



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When the UK will trigger Article 50 and what happens then?

The referendum only gives government a popular mandate to withdraw the UK from the EU, it is non-binding. But politically, it is almost infeasible that parliament would ignore it. The process for withdrawal is as follows:

- Once the prime minister officially files for divorce, a period of negotiations about the UK's future relationship with the EU will begin. The formal procedure is set out in Article 50 of the Lisbon Treaty. The Prime Minister triggers article 50 by notifying the European Council that the UK intends to withdraw. The PM has the executive authority to trigger article 50 though she/he may want to put it to a vote in parliament.
- That opens a two-year window for negotiating withdrawal terms – a period that can be extended only with the unanimous support of all the member states. Any deal with the UK must be approved by a 'qualified majority' of 65% of member states. If the two-year period comes to an end with neither a deal nor an extension, the UK leaves automatically and trades with the EU-27 on the WTO rules.
- The UK need not trigger Article 50 immediately – the UK can decide when it is ready. Negotiations will likely take several years and until the formal Brexit the UK subject to its obligations of EU law.
- What does the UK need to negotiate now? (1) Withdrawal from the EU. (2) The new trade deal with the EU. (3) The terms of trade of its membership in WTO - the UK would probably also want to renegotiate the non-EU trade deals that it had through its EU membership.
- Where are the risks? Divisive politics in the UK will probably prevent this process from going smoothly. Parliament would have to take votes on some issues of the withdrawal eventually, such as if to repeal the 1972 European Communities Act which enables the incorporation of European Union law into the domestic law of the UK. The large majority of MPs currently favour staying in the EU. If they wanted a post-Brexit deal involving substantial continuing cooperation with the EU – perhaps akin to Norway's arrangements – they could potentially have the power to reject any deal that did not provide that.
- Late 2016 is probably the earliest time at which the UK will trigger Article 50. The new PM will need to set up her/his new cabinet, bulk up the foreign office and set up a new trade department. This will take time and could delay the start of withdrawal negotiations into 2017. The additional risk of snap elections could delay the process further. There is a small chance that the new PM may want to call a general election in order to secure mandate before proceeding with the withdrawal negotiations.



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Is there a chance that the UK will not vote to leave the EU?

- The chance of no-Brexit is low but not zero. The referendum result just gives the prime minister a mandate. Whether or not parliament goes against it really depends on how much momentum the anti-Brexit campaign gains and if any prominent Brexit campaigners publicly defect. An online petition against Brexit received over three million signatures at the weekend. Some backbench MPs have also spoken out in support of the idea. The Scottish National Party (SNP) leader Nicola Sturgeon has suggested that it might be possible as Scottish First Minister to veto a Brexit.
- The delay in triggering Article 50 to, possibly, the end of this year creates an opportunity for an anti-Brexit movement within parliament to gain ground. In light of the post vote fallout across markets, politics and the economy, the anti-Brexit movement might theoretically gain enough support to prevent a full blown Brexit. But our central expectation remains that the UK will trigger Article 50 to leave the EU. We do not expect the EU-27 to offer better terms to the UK than those which UK voters rejected on 23 June.

How will the Bank of England (BoE) respond?

- The current ultra-dovish Monetary Policy Committee (MPC) will probably ease monetary policy in the coming months to support domestic demand. In the near-term, the BoE's main focus will be on calming markets. Last week Governor Carney announced £250 billion of additional funding to existing liquidity facilities. Beyond fixing the near-term panic, the BoE will look to support the real economy.
- We expect a rate cut in Q3 (25 bps) followed by more quantitative easing in Q4 if necessary – probably £100bn over 12 months. But monetary policy will be largely ineffective until the political fallout and level of uncertainty about the economic outlook falls. The Brexit shock has created a set of protracted risks that will reduce the willingness of lenders to issue loans and borrowers to demand them. Monetary policy is not an antidote to political uncertainty. Until the sky clears, any monetary easing will have a limited impact on boosting nominal domestic demand.



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