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BREXIT IMPACT ON EU: CONTAGION OR SALUTARY LESSON?

Berenberg Macro Flash

From an EU-27 perspective, the big British question is largely settled. Sadly, the UK has voted to leave. Unless the UK relents, which I consider as unlikely but not impossible, the UK will be out. For the sake of its own cohesion, the EU-27 cannot offer better terms than before to keep the UK in. The precise terms of divorce to be negotiated in coming years will matter a lot for the UK but much less so for the EU-27 whose economy is five times the size of the UK economy. Instead the EU-27 will focus on its own future.

Eight months ago, we identified a potential Brexit as the most serious risk in 2016 to the economic outlook and the political cohesion of Europe as a whole. While the UK has now descended into political confusion and probably economic stagnation or worse, the risk of domino effects across the EU-27 and the Eurozone looms larger than before. The referendum result encourages anti-EU or anti-euro political movements elsewhere. Having underestimated the Brexit risk, financial markets are likely to now pay particular attention to any potential risk that other countries may follow.

The next big risk to watch is the October constitutional reform referendum in Italy where four of the eight opinions polls published in June show a majority against Renzi's reform. If Renzi were to resign after losing the referendum, his government would likely try to soldier on until the end of the parliamentary term in spring 2018. But we could not rule out an early election instead. In such a hypothetical election, the left-wing "Five Stars" (30% in recent opinion polls), the right-wing "Lega Nord" (13%) and possibly some smaller parties would campaign with a demand for a euro referendum. At the Dutch general election in March 2017, the right-wing populists will also demand to hold a referendum on the euro. Recent polls suggest that they could win 35 out of 150 seats. For more, see our in-depth report [on the domino risks](#).

POPULISTS CAN WIN A VOTE – BUT CAN THEY DELIVER?

As these two examples show, we have to take these contagion risks serious. However, the story does not end there. Life is full of unexpected turns and twists. Populists can win a vote. But can they deliver? The promises of the Brexiteers always looked impossible to meet. If they are now exposed as wrong, people may notice. If the result of the Brexit vote is wrenching uncertainty rather than a fictional paradise with more money for the UK's national health service and fewer immigrants, voters may feel deceived.

From an EU-27 perspective, the UK debate about when to file for divorce from the EU, that is when to trigger the relevant Article 50 of the EU treaties, looks bewildering. To shorten the period of uncertainty and thus contain the economic damage that arises from such uncertainty, the EU-27 would like the UK to go ahead soon so that negotiations could start right thereafter. However, the Brexiteers seem to prevaricate. The EU-27 cannot force the next UK prime minister to hand in the divorce notice soon, or the UK parliament to authorise the prime minister to do so. Conversely, the UK cannot force the EU-27 to start negotiating the divorce terms before the UK has actually asked for a divorce. Any lengthy standoff could add to the economic damage, for the UK more so than for the EU-27. But the apparent reluctance of the Brexiteers to go ahead also creates an impression that they had little idea of what they were up to. If the UK really shies away from filing for divorce once it has a new prime minister, the Brexiteers may month by month look more like an embarrassment rather than an inspiration for would-be copycats on the continent.



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MACRO NEWS

For populists, a rendezvous with reality can be tough. Just think of Greece in 2015 where populists took the reins early that year. The damage they did to the Greek economy and the Greek banking system in their first months in power in 2015 helped to blunt the appeal of other left-wing populists in Europe somewhat.

Of course, the UK case is very different. Nonetheless, a general point holds: winning a vote can be the undoing of those who have campaigned on impossible promises. For now, the UK vote for Brexit adds grist to the mill of the anti-EU and anti-euro political movements on the continent. But the reality shock which is now hitting the Brexiteers can, over time, also turn into a powerful argument for those on the continent who warn against the risks of voting for such populists.

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