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04/07/2016

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UK AND EU: UPDATE ON BREXIT FALLOUT

Berenberg Macro Flash

KEY ISSUES FOR THE UK

- **Frontrunners for Conservative party leader vary on timing of Brexit talks with EU:** Reuters report that Home Secretary Theresa May will not be 'rushed' into starting the formal exit process this year. May is the bookmakers' favourite to win the Conservative leadership race with a 77% implied probability. Junior Energy Minister and prominent 'leave' campaigner Andrea Leadsom has indicated that she would like to trigger the exit process as quickly as possible. Leadsom is the bookmakers' second favourite with a 26% implied probability. Despite pressure from some EU leaders, the UK can decide on when to trigger Article 50 of the Lisbon Treaty to begin the two year period of withdrawal negotiations. Before doing so, the new UK Prime Minister will probably want to select a new cabinet, bulk up the foreign office and set up a new trade department. On a separate note, FT report that a group of UK businesses are preparing a legal challenge to prevent the government from triggering Article 50 without an act of parliament i.e. a vote in the House of Commons – potentially creating further delays.
- **UK Government debt still not a serious risk to the UK economy following change to fiscal plans:** Chancellor Osborne has scrapped plans to balance the budget by 2019/20 because of a likely negative impact of the Brexit vote on the UK economy. Although the fiscal deficit is high at around 4% of GDP (total debt of around 90% of GDP), government debt does not pose a serious risk to the UK economy. Demand for UK government debt remains high. UK gilt yields have fallen to record lows since the June 23 referendum despite credit rating agencies Fitch and S & P cutting the UK's credit rating to AA. Osborne has announced plans to cut UK corporation tax to 15% by 2020. The Chancellor will present an updated fiscal outlook along with the OBR's downgraded forecasts at the Autumn Statement in November 2016. We expect the Chancellor to announce a modest fiscal stimulus, probably in the form of a tax cut for households or additional government capital spending to support demand amid the Brexit-related surge in uncertainty.

KEY ISSUES FOR THE EU-27

- **The future of the EU.** Unsurprisingly, the UK vote to leave the EU has triggered a lively debate about the future of the club. Many contributors use it as an opportunity to advance ideas they had promoted before. For example, prominent German Social Democrats (party boss Gabriel, EU parliamentary president Schulz) argue for more integration and a looser fiscal policy. Other contributors such as German finance minister Schaeuble emphasise the need to uphold rules and to make Europe work better, for instance by strengthening co-operation on some issues such as foreign and security policy without an overall push for more integration. Near-term, the likely result is a "period of reflection" until the EU's Bratislava summit in September, followed by negotiations about some modest changes that will make the EU more flexible while strengthening co-operation on a few selected fields such foreign and security policy for those countries ready to do so. See these [Notes on the future of Europe](#) for our view about the direction that the EU could be heading on trend.
- **French politics.** In the mainstream centre-right Republican party, the top candidates are gearing up for the November primary vote ahead of the presidential election in April/May 2017. Former president Nicolas Sarkozy will reportedly step down as party chairman shortly to launch his bid for the nomination. His key rival, the more reform-oriented Alain Juppé, has meanwhile offered a post-Brexit olive-branch to Britain, calling for a "pragmatic" approach to the negotiations about



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a deal with post-Brexit Britain. Even restrictions on the free movement of people should be up for negotiation according to Juncker in an interview with the FT. While calling on the EU to not “punish” the UK, he urged the UK to trigger Article 50 (the official divorce notice) fast. As explained before, our best guess remains that a post-Brexit settlement with the UK will have little impact on trade in goods but will restrict the UK’s access to the EU market for services while the UK will likely limit the free movement of labour. In French opinion polls, Juppé has long held a lead over Sarkozy, with a strong likelihood to beat the Front National’s Marine Le Pen in 2017. Among Republican party members, however, Sarkozy has recently regained ground, even moving ahead of Juncker in a TNS Sofres poll last Thursday.

- **Bellwether Austria?** The repeat elections to the largely ceremonial post of president in Austria on 25 September or 2 October will mostly be shaped by Austrian peculiarities. At the margin, they may also offer a first insight as to the political impact of Brexit in other EU members. Will the example of the UK vote to leave the EU sway voters elsewhere to back EU-sceptic or euro-sceptic parties more than before? Or will the political and economic uncertainty that has befallen the UK make some voters think twice about the possible consequences of such a protest vote? Last Friday, Austria’s supreme court had ruled that the second round of the Austrian presidential election needs to be repeated because up to 78,000 postal votes had been opened too early. In the election, a Euro-phile candidate backed by the Green party had narrowly prevailed against the candidate from the far-right FPÖ.

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