

UK election outcome alters path to Brexit

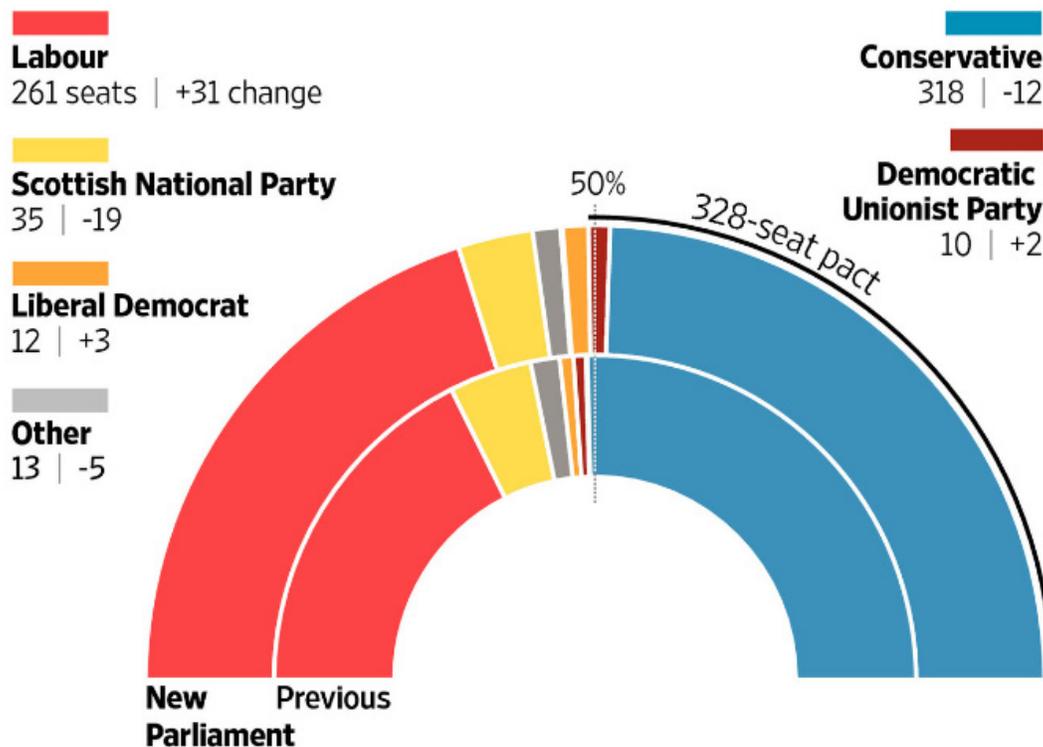
This report analyzes the fallout from the election of a minority government in the UK, with a focus on the following:

- The sharp divisions within UK society
- While the election did not stop Brexit, it reshapes the kind of exit deal that can be delivered politically by the UK government
- Why the EU is taking a hardline approach to negotiations
- The risks of failing to negotiate an exit deal for both the UK and the EU
- The factors that ultimately could lead to a compromise deal between the two sides

The stakes for the UK are very high. Withdrawing from the EU is a massive undertaking, particularly since the EU accounts for about 45%-50% of UK's trade flows and stock of foreign direct investment.

Election Results

Prime Minister Theresa May took a huge gamble calling an election three years early in the hopes of securing a stronger mandate to negotiate Brexit and lost big time. The Conservatives won only 318 seats, down from the 330 they held at the start of the campaign and short of the 326 needed for a bare majority. This is way off from projections made at the start of the election that they would gain 75 to 100 seats.



Note: With 649 of 650 seats declared
Source: Press Association

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This has forced the Conservatives into an alliance with the Democratic Unionist Party (DUP) of Northern Ireland. But even with the DUP’s 10 members of parliament, the Conservatives will have the slimmest of majorities, just three more than the halfway mark of 326 seats needed to govern. Historically, minority governments in the UK have tended to be fragile and short-lived.

While the DUP supported Brexit in last year’s referendum, it wants to maintain a tariff-free border with neighbouring Ireland (an EU member). They also support a comprehensive free-trade deal with the EU.

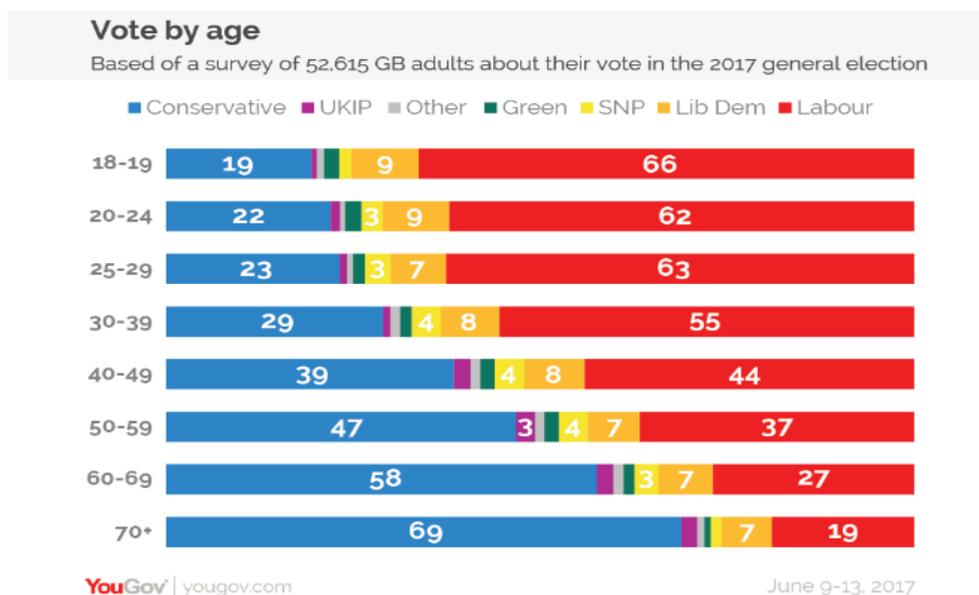
What is saving Theresa May from being ousted from the party leadership for the time being is that the Tories do not want to fight an internal battle in the midst of formal Brexit negotiations and/or enter into another election while they are in such a weakened state. Another reason is that many potential leadership candidates simply do not want to inherit the mess she has created. This includes running a minority government while Brexit negotiations are underway. In addition to ensuring the continued support of the DUP, the PM will have to balance the demands of various factions within the Conservative Party. Indeed, some Tories want a no-compromise Brexit while others are either for a soft Brexit or no Brexit at all.

The Labour Party’s surprisingly strong showing

Jeremy Corbyn’s Labour Party increased its seat total by 32 and its vote share by 9.6 points to 40% (highest percentage since 2001) compared to the last election in 2015. The Conservatives lost 13 seats but nevertheless increased their share of the vote by 5.5 points to 42.3%. **Ironically, the Conservative’s share of the vote is at its highest since 1983 and would have been sufficient to form a majority government in almost any other past election. But this time around it was not enough to overcome the surge in support for Labour.**

Corbyn’s success is more surprising in light of his very far-left policies. He supports nationalizing utilities, railway companies and the postal service. He also wants university education to be free and corporate taxes to be substantially higher. He has historically been a strong opponent of NATO, once referring to it as a “very dangerous Frankenstein of an organization.” Even more worrisome, he tweeted the following in 2013: “Thanks Hugo Chavez for showing that the poor matter and wealth can be shared.”¹

Like the Brexit vote, this election revealed a deep split in the country. About 40% voted for a far-left socialist agenda and a softer Brexit, while over 42% voted for a Conservative agenda and a harder Brexit. This divide is particularly strong along demographic lines. Younger people strongly supported Corbyn’s message of increased social benefits because they have been particularly hard hit by stagnant wages and higher costs for education and housing. Whereas older voters threw their support behind the Conservatives. It is important to note, however, that young people voted at much lower rates than their older counterparts. YouGov, a polling firm, estimates that 59% of people between the ages of 20 and 24 years olds voted in the last election, versus 84% for those over the age of 70.



¹ “Why the Rise of Corbyn’s Labour Party Should Worry the West,” Atlantic Monthly, June 13, 2017

What does this election outcome mean for Brexit negotiations?

Unfortunately, the UK government is entering these negotiations in a much weaker political position than before the election. It will have to negotiate on two fronts simultaneously: with the EU and members of its own governing coalition. It would take just only a handful of defections for the governing coalition to collapse.

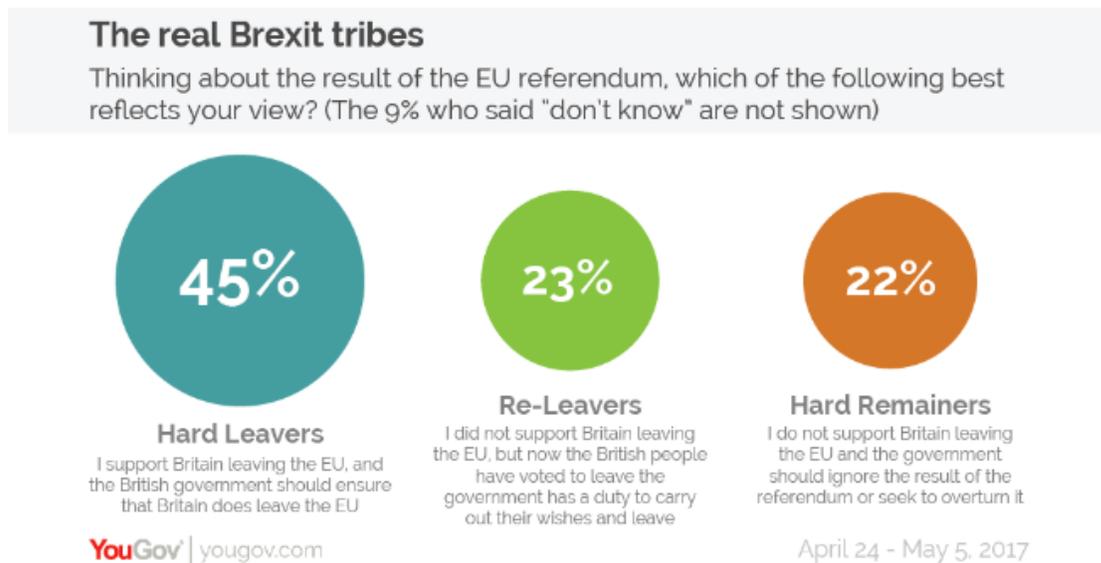
Complicating matters even further, Prime Minister May triggered Article 50 on March 29, which set the clock ticking on a two-year timeframe within which to negotiate the UK's exit from the EU. Doing this and then gambling on a snap election has proved to be an error of epic proportions.

In theory, negotiations could extend beyond the March 2019 deadline, but that would require the unanimous consent of all 27 remaining members of the European Union. For the time being, the EU Commission is not favour of extending this deadline. In fact, the EU Commission's chief Brexit negotiator, Michel Barnier, wants negotiations completed by as early as October 2018 to ensure each member has enough time to ratify the agreement before the two year period is over.

The chances of Brexit being reversed are very slim

Many people opposed to Brexit have expressed the hope it could be reversed. This is wishful thinking. For this to happen, there would have to be another election won by a party promising to hold a second referendum. This referendum would then have to be won by those in favour of scrapping Brexit. In this last election, about 84% of the vote went to parties (Labour and Conservatives) that support Brexit. Although the Labour Party had been in the "remain" camp nominally during the referendum (Corbyn is a long-time critic of the EU), it has since pledged to respect the results of the Brexit vote.

The Liberal Democratic Party (LDP) was the only major party that ran on the promise of holding a second referendum. Although the LDP gained three additional seats (15), it captured only 7.5% of the vote, half a point less than in the 2015 election.



While the election has not stopped Brexit, it will shape the type of exit deal that can be delivered politically by the UK government.

A softer version of Brexit could be in order

Going into the election, the Conservative Party was in favour of a comprehensive free-trade agreement with the EU that did not include free movement of people or being under the jurisdiction of the European Court of Justice. If this was not attainable, the government's mantra was "no deal is better than a bad deal."

However, the Conservative government's new minority status changes matters. The support of its junior coalition partner and possibly other parties (should certain MPs withhold their support) is now required to win parliamentary approval for any exit deal. All of the other major parties, including its junior coalition partner, support a softer version of Brexit that entails maintaining more ties with the EU than previously anticipated.

One option being increasingly discussed is for the UK join the European Economic Area (EEA), a trading bloc which comprises Iceland, Norway and Liechtenstein. EEA members have access to the EU market for goods and services. This includes financial services, which is crucial to the UK economy. EEA members are not subject to EU policy pertaining to agriculture, fisheries, justice and foreign affairs. They are also free to negotiate their own separate trade deals, which is a long-standing UK demand. However, the UK would still have to contribute to the EU budget, follow certain regulations and largely accept the free movement of EU labour.

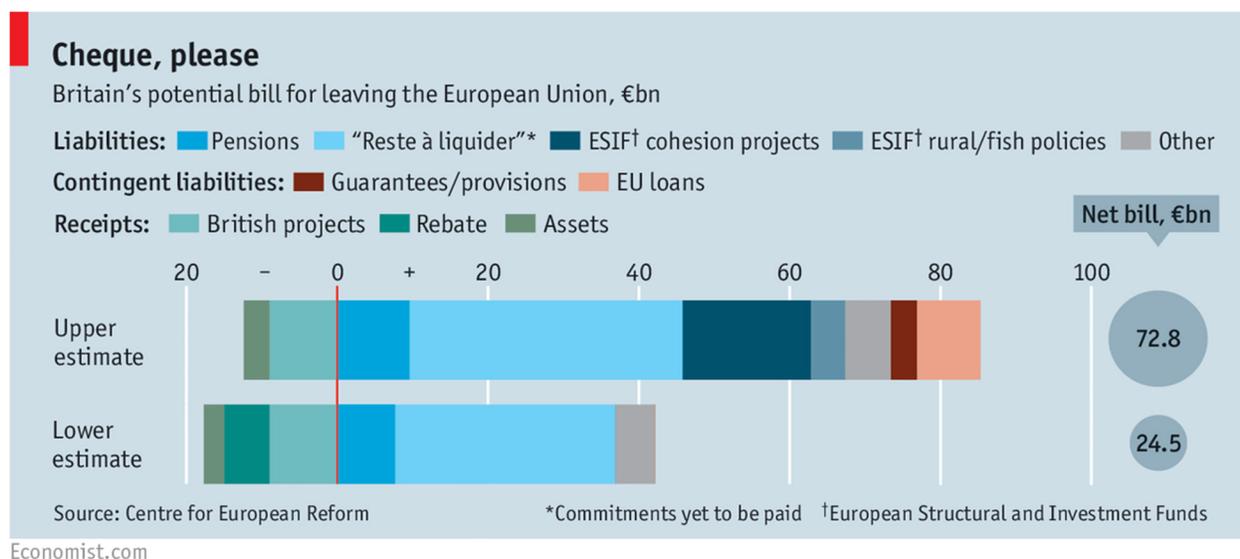
It is important to note also that while simple trade deals can be approved by majority of the member countries, the EU insists that Brexit requires unanimous consent because it covers services, regulatory standards and non-tariff barriers.²

Finally, as if negotiating Brexit was not enough, it is estimated that upon exiting the EU the UK would have to renegotiate 759 treaties with 168 countries. These include agreements covering trade, customs, fisheries, transportation, and regulatory co-operation. This is the number of agreements the EU has signed on behalf of the UK since it joined the EU in 1973.³

First the money, then we can talk

An early test for the UK’s minority government will be how it reacts to demands that it pay an exit bill for 60 to 100 billion euros (minus any assets the UK may have within the EU to offset the amount) before negotiations on a future trade deal can even begin. The EU says the amount covers the cost of pension payments to EU officials, guarantees on bailout loans made during the debt crisis, spending on infrastructure, transfer payments previously agreed upon to poorer countries and the cost of relocating EU agencies from the UK. Many people in the UK government have questioned the legality of such a divorce payment. **No government, whether Conservative or Labour, could ever accept such a high figure for fear of a public backlash. This raises the risk that negotiations could collapse over this issue before they even get off the ground.**

A potential compromise could be for the UK to pay a smaller amount spread over many years. This would make the payment easier for the UK to accept from both a political and an economic perspective.



Source: "The multi-billion-euro exit charge that could sink Brexit talks," The Economist, February 11, 2017

There are two main reasons for the EU’s hardline position regarding the exit bill:

1. The UK’s departure from the EU will leave an annual shortfall of about 7 to 10 billion euros in the EU budget. Countries that are net recipients of EU funds do not want to see their financial aid cut, while net contributors—particularly those with Eurosceptic populations—do not want to provide further financial assistance to other EU states.⁴
2. Some people feel that, similar to Greece, efforts are being made to punish the UK in order to dissuade other countries from leaving and/or defying the EU. (more on this later)

² "After the election, the real test: Brexit," The Economist, June 8, 2017

³ "After Brexit: the UK will need to renegotiate at least 759 treaties," The Financial Times, May 31, 2017

⁴ "Brexit negotiation: Five things Europe fears most," The Telegraph, May 23, 2017

UK financial sector has target on its back

Many global financial institutions established their regional headquarters in London on the understanding that they would be able to serve clients across the EU. In fact, about one-third of the UK financial sector's business involves handling transactions for clients in continental Europe. Brexit jeopardizes this arrangement. Also at risk is the UK's control of the market for clearing euro-denominated derivative transactions. Despite being outside the Eurozone, the UK processes about 75% of these operations, versus only 13% for France and 2% for Germany.⁵ **The European Commission recently announced that it wants the power to decide whether part of UK's euro-clearing business should relocate to the EU after Brexit in order to safeguard financial stability. The risk is that France and certain other countries may push to restrict UK's access to EU financial markets in order to take as much financial-sector business away from the UK as possible.**

However, the Head of the U.S. Commodity Futures Trading Commission warned recently that moves to require euro-dominated trades to be processed within the EU bloc would run counter to international norms and could provoke U.S. countermeasures.

What to do with EU citizens living in UK

According to EU estimates, there are 3.16 million EU citizens living in the UK, and 1.22 million UK citizens living in other EU countries. While the UK is in favour of protecting the rights of expats, the EU's opening demands that their citizens be fully protected by the European Court of Justice are a non-starter for the UK. If the UK agreed to this demand, EU nationals would have more rights than their UK counterparts.⁶

Brexit poses many challenges to EU also

The EU is entering Brexit negotiations from a position of strength. The Eurozone's economy is in recovery mode and political uncertainty has fallen due to recent electoral victories by mainstream political parties over anti-establishment adversaries in both France and the Netherlands. The EU economy is also much more important to the UK than vice-versa. Meanwhile, the UK is struggling to adjust to the reality of a minority government.

However, by openly expressing *schadenfreude*, EU politicians risk overplaying their hand. For starters, it could boost anti-EU sentiment in the UK and revive support for a hard Brexit. Second, despite its favourable position, the EU still faces many challenges that could weigh upon its ability to maintain a hardline negotiating stance:

- Despite a recovering economy, the Eurozone's GDP is still only 3% above its 2008Q1 level. If one excludes Germany from the mix, the figure drops to only 1%. Worse still, the GDPs of Italy, Spain, Portugal, Cyprus, and Slovenia are all still below their 2008 levels. Indeed, in the case of Italy, its economy has barely grown since it joined the Eurozone in 1999. This stands in stark contrast with the situation in the U.S. and Canada, where GDP has risen 13% and 15%, respectively, over the same period. This leaves several EU countries vulnerable to outside shocks.
- Adopting a hardline position with UK that share certain similarities with how it handled Greece is fraught with risk. For starters, the Greek economy is smaller than that of the city of Boston, whereas the UK economy is the fifth largest in the world. **Punishing such a large country with which it has extensive economic ties could have unintended economic consequences for the EU.** Second, Greece was forced to back down from its confrontation with the EU after the ECB cut off liquidity to its financial sector. The UK is not vulnerable to such coercion because it has its own currency.
- Some experts argue that Greece and the UK must be treated harshly in order to dissuade other countries from following suit. However, over the longer term, loyalty to the EU/Eurozone cannot be maintained via the threat of punishment.
- The EU has many geopolitical tensions points that have the potential to spark into a major political crisis during the course of Brexit negotiations. These include disputes over how refugees should be distributed among member countries and how the finances of heavily indebted countries should be managed.
- Anti-EU parties have demonstrated that one does not have to win an election to greatly influence the political landscape. The success of anti-establishment parties has forced many mainstream parties to take a much harder line towards the EU and immigration. **This in turn has made it much more difficult to push for further integration of the EU/Eurozone without sparking a political backlash.** A case in point is the push by some in the EU for jointly financed Eurozone budget and/or Eurobond bonds to provide financial assistance to struggling member states. Convincing the likes of Germany, the Netherlands, Finland and Austria that they should be made even further liable for the spending decisions of other countries will be a near impossible task.

⁵ "Why Brexit could hurt UK clearing," Money Week, June 4, 2017

⁶ "After the election, the real test: Brexit," The Economist, June 8, 2017

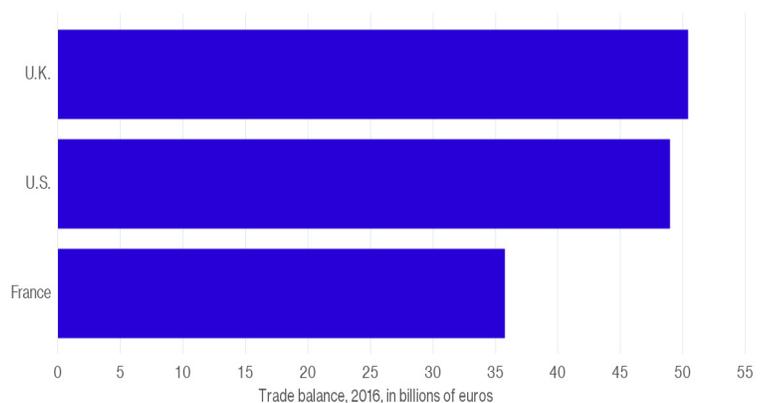
Will countries with closer trade ties ultimately push for a more lenient approach to the UK?

Germany is an example of a country highly dependent on international trade. Exports account for 47% of its GDP and the country has a massive trade surplus of \$300 billion (8.5% of GDP). **Will it ultimately want to risk its large trade surplus with the UK in an increasingly protectionist world, especially since its trade surplus with the U.S. has been heavily criticized by President Trump?** Germany's trade practices have also been the target of frequent criticism by southern European countries. They feel German exports have benefitted immensely from the fact that the euro has been kept undervalued by their economic hardships caused in part by the austerity policies forced upon them by Germany. If Germany had not been in the Eurozone, currency appreciation would have reduced its trade surplus significantly.



Germany AG's Biggest Customers

Country's largest surpluses are with U.K., U.S.



Sources: "A nasty spat erupts between Britain and the EU," *The Economist*, May 4, 2017;
"Cars, Machinery Drive the German Trade Surplus Trump Hates," *Bloomberg*, May 30, 2017

A recent report commissioned by the Dutch parliament concluded that the Netherlands should push for the European Union to maintain strong trade ties with the UK after Brexit. The UK is the Netherlands' second-largest trading partner (9% of exports). As negotiations advance, look for other countries to increasingly voice worries that overly punishing the UK could have a negative impact on their economies.

What would a hard Brexit look like?

If the UK and the EU were unable to negotiate an exit deal, the most likely scenario is that both sides would revert to trading under WTO rules. While the UK trades with many countries under WTO rules, the terms are far less favourable than when trading within a single market.

For manufacturers, WTO tariffs would average about 5%, while farmers would face duties of about 40%.⁷ The imposition of WTO rules would also likely mean more burdensome customs checks.

Moreover, WTO focuses mainly on trade in goods. However, services—especially financial services—make up a large part of the UK economy. Financial firms based in the UK currently can sell their services across the EU without having to obtain a license in each individual country. This access would likely be curtailed significantly under a no-deal scenario.

In the event of no deal, the UK government is considering lowering the corporate tax rate—which at 19% is already far lower than in France or Germany—in order to enhance the country's competitiveness and thus partially compensate for the loss of market access. If the UK followed through with this idea, it would likely be accused of social dumping by countries such as France.⁸

⁷ "A Bad Brexit Deal May Be Better Than No Deal After All," *Bloomberg*, March 29, 2017

⁸ "London's Brexit Apocalypse Is Nowhere in Sight," *Bloomberg*, June 1, 2018

Conclusion

Below are two scenarios of how Brexit negotiations could play out.

Positive scenario: As negotiations advance, the realization among EU members will gradually set in that denying the UK -- a large country with which it has strong trade ties - a decent free-trade agreement would be extraordinarily harmful to both sides. Many EU member states are still struggling with sluggish growth and high debt levels, which renders them particularly vulnerable to outside shocks. As a result, countries will begin exerting growing pressure on the EU to take a more lenient approach. **This gesture will be reciprocated by the UK minority government that now realizes (based on recent election results) that most of the population is in favour of a softer Brexit that entails maintaining significant ties with the EU.** The UK's proposal to join the European Economic Area will then be approved by both sides.

Negative scenario: The UK's inability to obtain sufficient support for a coherent negotiating position among the various factions in the minority government and/or the distraction of another election combined with the EU's refusal to budge from its hardline positions will lead to Brexit without a deal. The EU's tough stance will be taken to dissuade other countries from following in UK's footsteps and to redirect investment from UK to its member countries. Anti-EU sentiment in the UK will then spike, as the public blames the EU for trying to take advantage of the country's fragile political situation in order to strong-arm concessions and steal business. The economies of both the UK and EU will be negatively impacted in the process.

While we feel the most likely outcome is the positive scenario, the risk of failure remains significant.

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