Game On: A Political Outlook for Brexit and Europe

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Key takeaways

- Most voters, politicians, and business leaders in the UK do not want to see a hard Brexit, and there are many vocal supporters of a soft variant in the EU as well. Yet Prime Minister Theresa May's firm commitment to gain control of immigration policy goes against the diplomatic and economic tide and locks in a hard Brexit scenario politically.
- Brexit politics on the continent are becoming more contentious and the EU itself is hurtling toward an unknown future as it faces existential challenges. Disagreements among the 27 remaining EU member countries are significant, and domestic politics within each will muddy the outcome.
- The politics of divorce are likely to derail diplomatic efforts to finesse a soft variant. Expect a drawn-out, contentious process, with costly outcomes for all parties involved. For instance, Belgium's rejection of the EU-Canada free trade agreement signals trouble ahead.
- The UK's future relationship with the EU may not be fully codified when Brexit is expected to occur in early 2019. The rewriting of the UK's trade, investment, and business relationships with the rest of the world likely will take another 10 years after that. As all of this unfolds, businesses will have to deal with a transitional and uncertain regulatory environment.

UK political drivers augur a hard Brexit outcome

- While May has deftly sought to broaden the post-referendum policy agenda to include more inclusive growth, the top political driver in UK politics remains control of the borders. In late summer, 70% of British voters polled felt that immigration levels were too high. (The other priority issue is slashing UK contributions to the EU budget.)
- In her October 5 Conservative Party conference speech, May acknowledged the "quiet revolution" that had taken place at the polls on June 23, and then she essentially took a hard Brexit stance, arguing that elites have ignored the concerns of the voters for too long and advocating for the UK to gain control over immigration policy. She also put pressure on businesses to hire and train locally.

> **"There's no second referendum, no attempts to sort of stay in the EU by the back door. We're actually going to deliver on this."**
>
> —*Theresa May, August 31, 2016*

- The falling value of the British currency since the prime minister's speech has been a wake-up call for many (see box 1). Nevertheless, many British elites believe negotiators can still bargain their way to a softening of the terms, even if it occurs sector by sector. This perspective is exemplified by the Brexiteers' continuing claims that Britain can have its cake and eat it too. ▶

- The migration issue has already proven to be quite contentious. Proposals aired about how the UK should manage future flows as well as the fate of EU nationals already living and working in the UK have elicited bursts of outrage and claims of racism. Many stakeholders are likely to be deeply disappointed by whatever approach ultimately is taken.

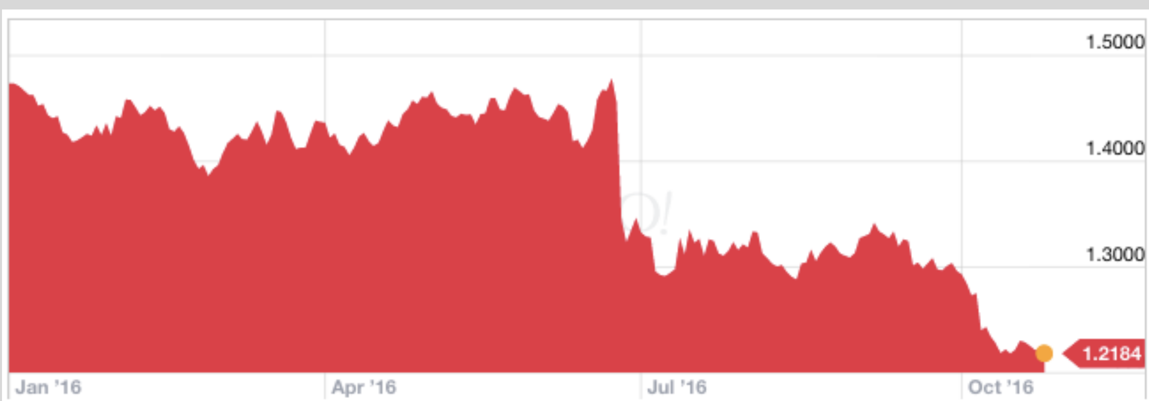
- The Kingdom is not united. Challenging May's bargaining stance, Scotland First Minister Nicola Sturgeon on October 24 reiterated her goal to keep Scotland in the European free trade area and called for a "flexible Brexit." (May has rejected this position.) Sturgeon has threatened to hold a second referendum on independence in the event of a hard Brexit.

- Regardless of Brexit, massive job cuts are already underway in the financial services sector, owing to regulation, downsizing, automation, and off-shoring from business process outsourcing. Yet this structural trend has been overshadowed by Brexit politics.

Box 1: Near-term economic impacts of Brexit

According to the latest IMF outlook, the UK will avoid a recession in 2016, but growth is expected to be just 1.1% in 2017. This is down from a forecast of 2.2% growth made in early June. Euro area growth is expected to come in at 1.7% in 2016, but dip to 1.5% next year.

The value of sterling dropped sharply after the referendum and then stabilized—an apparent calm before the storm. Following May's announcements of her plan to invoke Article 50 by the end of March 2017 and her vision of the Brexit process, the markets responded negatively. In the month to October 25, the currency was down more than 6% against the dollar. It is down over 17% year to date. Investment in the London real estate market, once rated as the most attractive in Europe, has dipped. On the other hand the FTSE100 index of large multinationals has surged to record highs on expectations or stronger forex earnings.



Source: Yahoo Finance, October 25, 2016.

Political volatility on the EU side is growing

- The common wisdom is that the European leaders will deal harshly with London to set an example, especially as key countries head toward important elections. In the face of foot dragging in London and assertive statements by government officials about immigration controls and eating cake, EU leaders continue to harden their stance that free movement of people is tantamount to free market access. This was evident in European leaders' comments at the EU summit last week. French president François Hollande warned, "If Mrs. May wants a hard Brexit, she will get a hard negotiation." ▶

- German Chancellor Angela Merkel is inclined to be pragmatic. The UK is Germany's third-most important export destination, and Germany enjoys a large trade surplus with the UK. Large German companies, such as Opel and SAP, are pushing for a rapid settlement and continued membership of the UK in the EU single market. But the tide of German politics is going against pragmatism. Merkel has faced considerable losses in local elections over the past two months. In both Berlin and her home state of Mecklenburg-Vorpommern, her conservative Christian Democrats gave up considerable ground to the insurgent far right, Alternative für Deutschland, largely because of the immigration issue. As Merkel faces a tougher reelection campaign in fall of 2017, she will have less attention and latitude on the Brexit.

- Important votes are also pending in Italy, the Netherlands, and France in the coming year. Because of rising nationalism and euroskepticism, political leaders are increasingly disinclined to promote a strong pro-European agenda. The next major signpost of voter sentiment is Italy's referendum on the constitutional reform championed by Prime Minister Matteo Renzi. The failed referendum in Colombia, while far away and on a much different issue, showed that like in the UK, elites can not take voter sentiment for granted. "Just say no" seems to be in vogue.

- Proposals that Brexit be used as an opportunity to structurally reform the EU are far-fetched. The union already is facing huge challenges and divisions over the banking system, fiscal policy and austerity, taxes, refugees, border controls, the fight against extremism and terrorism, and the authority of Brussels. Holding steady and putting on a show of unity is the priority for the foreseeable future.

> **"There are all these problems to have a simple trade agreement with Canada. Imagine an agreement with the UK."**
>
> *—Joseph Muscat, Prime Minister of Malta, October 21, 2016*

- That said, European politicians could use any number of Brexit-related votes to blow holes in pan-European policy. The incendiary, anti-European leaders of Hungary and Poland could use the negotiations to reign in Berlin and Brussels. One could imagine the Greeks holding out on a major vote until the British agree to repatriate the Elgin Marbles. To illustrate the potential for protest votes, the Belgian province of Wallonia on October 14 rejected the EU-Canada free trade agreement which took seven years to negotiate and had been approved by the EU's other 27 member states.

A prolonged and messy transition timetable

- May announced that her government will trigger Article 50 by the end of March 2017, setting in motion a two-year interval for negotiation of the UK's separation from the EU. During this two-year interval, negotiators will have to pour over 80,000 pages of EU rules and regulations, deciding which ones will continue to apply to the UK—and from this, decide what the UK's future relationship with the EU will be (see box 2).

- Given the May government's both/and approach, the increasingly fractured European politics, and the EU's typically last-minute approach to deal making, the broad terms of the exit agreement may not be clear until the very end. And, the UK could find itself out of the EU in early 2019 without its new relationship fully codified. ▶

- Expect hedging and interim agreements, given the number and the complexity of issues to be agreed upon. For example, the UK may seek to adopt the "Norwegian model" to preserve market access for an extended transition period. The UK will likely continue to contribute to the EU budget until 2020 rather than reopen the current agreement for renegotiation. If needed, the UK's exit date or any aspect of the current relationship can be extended with unanimous consent of EU member states.

- As an EU member, the UK is a party to over 50 treaties and trade, tax, and investment agreements (e.g., with the US, Canada, China, and Japan). Most of these will need to be renegotiated by the UK government. For the past 40 years, officials in Brussels have negotiated on behalf of the UK; now the newly created Department for International Trade is being forced to build a cadre of negotiators. Meanwhile, these counterparts likely will not open treaty negotiations with the UK until its terms are settled with the EU. Expect the UK's relationship with the rest of the world to take another 10 years past 2019 to sort out.

- As all of this unfolds, businesses will have to deal with a transitional and uncertain regulatory environment. Many will implement exit strategies in the meantime. Given this uncertainty and the rapid pace of change in the global economy, it's impossible to predict what the UK economy will look like circa 2030. ■

Box 2: Key UK-EU issues and costs to be sorted out

Licensing: The foremost political issue at hand is passports for UK-based financial services firms to operate in the EU, but the issue of licensing extends to other industries and professions as well.

Rules of origin and tariff schedules: These are huge issues for today's complex supply chains that cross the English Channel. To this point, the Japanese government has expressed grave concerns about the demise of the UK's existing treaty arrangements with the EU.

Standards and regulation: To make the UK attractive to businesses, the British government likely will seek to relax or modify EU standards in areas such as data and privacy, labor, and the environment. This will create greater regulatory complexity for multinationals, which will want greater harmonization, not less.

Finances: The UK's ongoing contributions to the EU budget (in a soft Brexit scenario) and pensions are major expense items to resolve. Experts expect the UK's divorce costs to reach GBP 20 billion. By contrast, the UK's current net annual contribution to the EU budget is GBP 7 billion.

People: The future status of EU nationals already living and working in the UK is unclear because they are not required to register with the government. Their number is estimated at over 3 million, with more than 1 million living in London alone. The number and status of UK nationals living and working in the EU are unknown as well.