

# Economic Insight

27 June 2016

## Brexit: Reading the runes

**Although it is now more than three days since the result of the UK's EU referendum became known, many of the crucial questions about how to proceed remain unresolved. The political landscape remains in turmoil, as politicians plan how to move forward, and there is extreme reluctance to invoke the Article 50 procedure. But it is hard to see how this can be avoided and the balance of probabilities still favours a Brexit – even if the decision is less clear cut than many people appear to believe.**

Now that the British electorate has voted in favour of leaving of the EU, the government now has to work out how to implement the exit process. This requires a number of issues to be resolved: (i) the UK will have to select a new prime minister; (ii) the new PM will have to decide whether and how to trigger the exit process; (iii) they will have to decide on what basis the negotiations will proceed and (iv) the UK will have to come to an agreement with the EU on how to implement those plans.

### Domestic politics: Short-term considerations

Neither the governing Conservative party nor the opposition Labour party are in any position to take effective decisions. Prime minister Cameron announced in the wake of the Brexit vote that he will be gone by October and the party will have to elect a new leader. This matters because Mr Cameron has announced that he will not trigger the Article 50 process required to formally begin the exit process, believing that it is the responsibility of the new prime minister. Currently, Boris Johnson is the favourite to assume the mantle but he has numerous political enemies, particularly amongst those who viewed his support for the Brexit campaign as a cynical ploy to ensure that he will accede to the premiership. Home Secretary Theresa May is the second favourite, but her support for the Remain camp might count against her.

As far as the Cameron succession process works, Conservative MPs will whittle the number of candidates down to two, from which all party members will ultimately choose the winner. Mr Johnson's problem will be to ensure that he can get enough support from MPs to make it onto the final ballot. If he does so, he will almost certainly be elected as leader (and the de facto new prime minister) due to his popularity amongst grassroots Conservative members. Non-UK readers might be surprised that the removal of the prime minister will not trigger a general election. But there are numerous precedents: The resignations of Margaret Thatcher in 1990 and Tony Blair in 2007 are the most recent examples where the change of premiership did not require a new popular ballot. The simple reason for this is that UK voters do not elect the prime minister: They elect their local MP and it is up to the party with the most seats in parliament to determine who will lead it.

A new election is not out of the question, however. The Fixed Term Parliament Act of 2011 specifies that an election before the mandated date of 2020 can only happen if either (i) the House of Commons passes a no confidence vote in the government with a simple majority vote, and no alternative government is confirmed by the Commons within 14 days, or (ii) two-thirds of MPs vote for an early election. With the Conservatives holding 330 out of 650 seats, it will only require six of them to vote against their own party (assuming that all other MPs vote against the government) to produce a new election. In practice, the number of rebels would have to be higher, given the fact that parties such as Sinn Fein (4 seats) do not take their seats in the UK parliament. In any event, this issue is deemed to be of such national importance, that with more than 70% of MPs believed to be opposed to Brexit, it may not be difficult to ensure a majority of two-thirds in favour of an election.

### Domestic politics: Medium-term issues

What would be the point of holding a new election? The simple fact is that no politician really wants to invoke the Article 50 process and may be tempted to seek a new popular mandate

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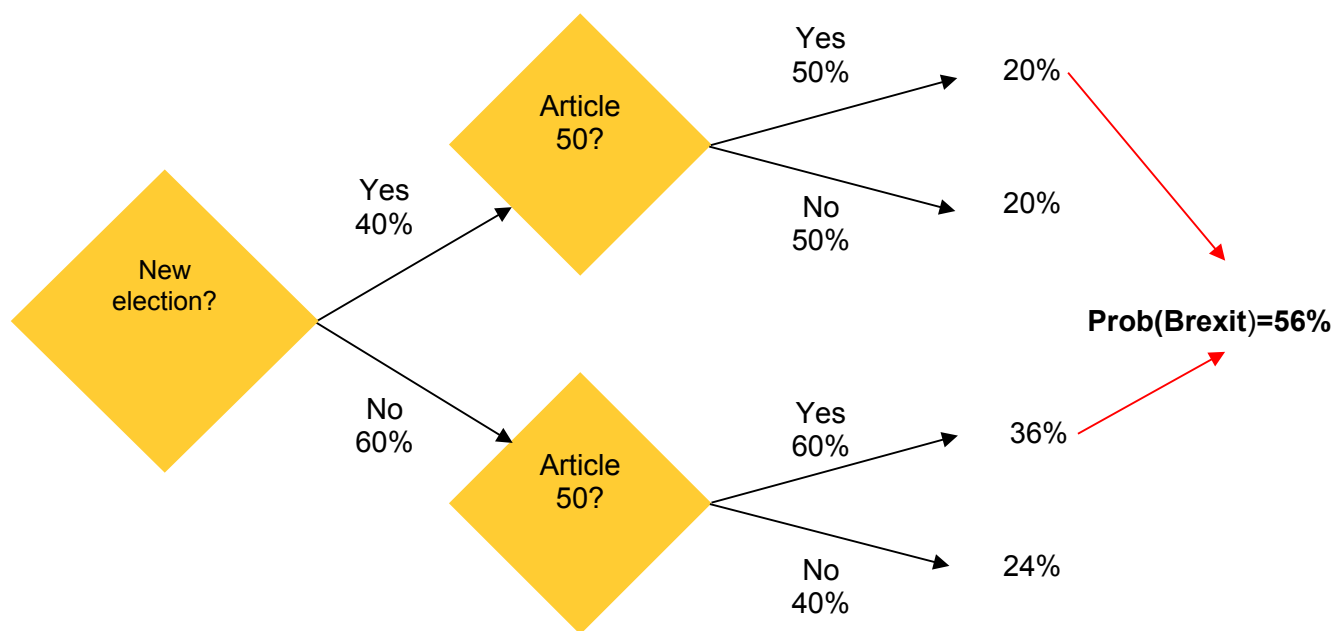
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CHART 1: The various political permutations – a probabilistic representation



Source: Commerzbank Research

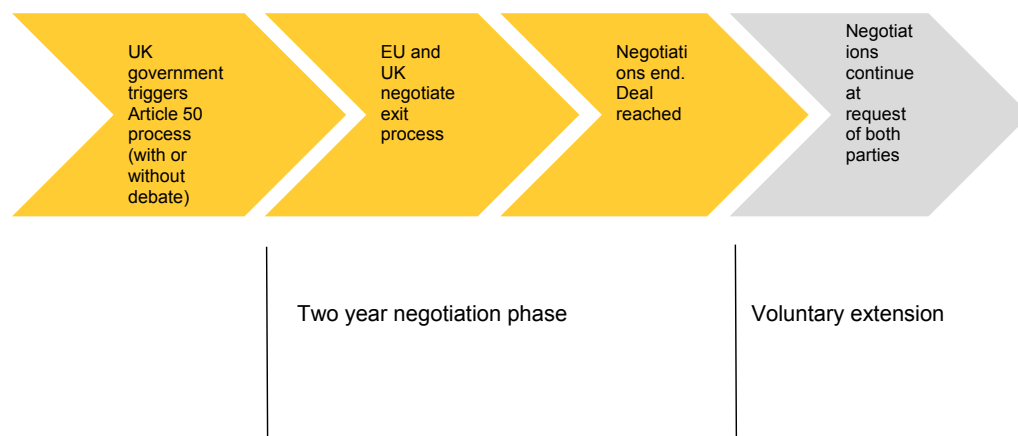
before proceeding. The Brexit debate would then have to be fought along party lines making it much more difficult to achieve consensus. It would also unleash a considerable amount of popular dissatisfaction with the political process, since the clear presumption throughout the referendum campaign was that Article 50 would be invoked. Moreover, since one of the reasons why the result went the way it did on Thursday is that the electorate feels it is not being heard, it would be a very dangerous political tactic to ignore the will of the people.

Since there are numerous permutations to work through, perhaps the best way to think about whether Article 50 will be invoked is to look at it in the context of a probability tree (chart 1). We recognise that different people will assign different subjective probabilities to these events, so investors can work through this using their own judgement. Our first assumption is that there is no new election, based on the notion that the Brexit referendum was supposed to force the current government to take the necessary steps without recourse to a new mandate (probability 60%). If there is no election, we believe the government will continue to drag its feet on invoking Article 50. It will only do so if it believes it can be confident that the outcome will be favourable. If European Commission President Juncker's hard-line position is believed to represent the view of the EU, the UK government will continue to postpone the decision. If, however, the more emollient position of Angela Merkel holds sway, as is our baseline<sup>1</sup>, there is a good chance that the British government will begin Article 50 proceedings, perhaps before year-end. Note that if there is no new election, it is difficult to see how the government can avoid triggering Article 50 (hence the probability that it is triggered is higher in the case where there is no election).

If, however, parliament opts for a new election life becomes more complicated. First of all, it will be an abrogation of the government's responsibility to implement the referendum result, even if it is a non-binding decision, which will have significant political fallout. In effect an election would be viewed as a de facto second referendum, which raises the question of what line the parties will adopt? Even though Conservative voters may be generally eurosceptic, their parliamentary representatives are less so. But on the assumption that Boris Johnson is installed as PM and takes the party into an election, the Conservatives will campaign for a Leave vote and if they win it will require the government to invoke Article 50. But this will make negotiations with the EU very difficult (on the assumption that it is likely to be more lenient with a government led by a closet Remainer or a reluctant leaver). On the other hand a rejuvenated political opposition, which campaigns and wins on the basis of Remain might mean that the UK government does not begin the process at all.

<sup>1</sup> 'Brexit: Merkel or Juncker – who will prevail?' *Economic Insight*, 27 June, 2016

CHART 2: Timeline of the Article 50 process



Source: Commerzbank Research

It is for this reason that we see a 50-50 shot that Article 50 will be triggered after a new election. Of course, if the government does not open exit negotiations before an election, the electorate may become so disenchanted with the main political parties that we see a much stronger showing by the fringe parties which further complicates the picture.

There are, of course, many other permutations, and we will not run through them all. But this serves only to highlight that there are numerous issues at stake here, and we cannot assume that the government will invoke Article 50 as easily as might appear on paper.

### What is the Article 50 process and how will it be implemented?

Article 50 of the Lisbon Treaty states that “Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements”. In terms of how the process works, it is incumbent upon the British government to go to the European Council to inform it of its intentions. This cannot be imposed upon the UK, especially since the referendum result is not binding on the UK government in the first place.

The prime minister has the power to invoke Article 50 (presumably after discussing with their cabinet). Parliament has no formal say over whether or when it is invoked, as this lies within the royal prerogative powers that are exercised by government. But it is highly likely that parliament will pass a motion which requires a debate on the issue, and it is unlikely that the prime minister will stand in the way. Even in this apparently simple matter, there is no obvious clarity on how events will proceed. Once the process does begin, it in effect sets in train a negotiating period of up to a maximum of two years (or longer if by mutual consent) during which existing EU regulations will continue to apply (chart 2). If no agreement is reached after two years, without provision for extension, the UK’s EU membership will automatically expire and the UK will then have to take the terms which the EU offers at the end of the period. Since this may result in terms which are not favourable to the UK, it is no surprise that the government does not wish to pull the trigger because it does not know what the outcome is likely to be.

### In short: We are not really much the wiser

There are more questions than answers in this debate and because we are operating in unknown territory, attempts to answer them run the risk of straying into speculation rather than offering any clear insight. It is hard to avoid coming to the conclusion that the Brexit camp did not expect to win the referendum and as a consequence, there is no plan in place of how to proceed. But in the final analysis, the political calculus appears to boil down to the following question: Can the government (whoever is in charge) really ignore the will of the people and ignore the implementation of Article 50? In a political system in which parliament is representative of the people, the answer is surely not. This whole process may have gone way beyond which many in the Brexit camp expected, but it is effectively now down to them to find a solution.

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