

The Consequences of the EU Referendum

20 June 2016 | Authors: Gregor Irwin

Summary

Whatever the result on 23 June Britain faces political risk. If Britain votes to leave there will be political instability in the UK, the process of withdrawal will be messy, and investors will give their verdict on the structural implications for the UK economy. If the UK votes to stay David Cameron will have to work hard to keep his job, his Europe problem will not go away, and the government's remaining time in office will be marked by weakness.

Britain's referendum on EU membership will have profound consequences whatever the result on 23 June. This note identifies some of the most important for British politics, policy and the economy, and for the rest of the EU.

If the UK votes to leave

There will be political instability in the UK

David Cameron would almost certainly resign. If he tried to hold on, he would be pushed out by his MPs. He would have lost the confidence of the Conservative Party and could not credibly lead the negotiations with Brussels over withdrawal. His departure would trigger a leadership contest overseen by the chairman of the 1922 committee, Graham Brady. Conservative MPs would whittle down the field of candidates to a short-list which would then be put to a postal ballot of the full party membership. The process could take between two to five months, but might naturally aim for a conclusion by the party conference which begins in Birmingham on 2 October.

The key issue in the campaign would be the vision for Britain's relationship with the EU following Brexit. There are as many different visions for that relationship as there are credible candidates. Boris Johnson and George Osborne would be likely to stand but would be divisive candidates. Osborne would also be tarnished by referendum failure. Theresa May would present herself as a unifying

figure. Other Brexiteers would be likely to emerge. Michael Gove has carefully ruled himself out - but may feel obliged to reconsider as the party seeks a big-hitting conciliator with impeccable Eurosceptic credentials to lead the negotiation with Brussels. The final decision lies with party members, so be ready for a surprise.

There could also be a general election. A new party leader's first priority would be to build bridges and unify the party, aided by a fresh party mandate. The working majority of the government is small - just seventeen. A new leader would want to avoid being forced into a general election; but may well choose to engineer one if he or she thought the Conservatives would gain seats, particularly as this would also provide a mandate from the country. The lesson from Gordon Brown's short premiership is that this matters. A weak and disunited opposition, combined with political momentum, could be enough to seal the decision. Timing could also be a factor, however, as Britain is not used to going to the polls in the autumn or winter.

Another source of instability could come from calls in Scotland for a second independence referendum. Scottish National Party leader Nicola Sturgeon would only want this if she was confident of victory. Much depends on the polls in the aftermath of a vote to leave and how the likely political and economic uncertainty across the UK impacts on attitudes in Scotland. She may, however, struggle to contain demands within her own party for a fresh vote.

A second referendum on the same terms as the first could only happen with the consent of the British government and parliament, which is not guaranteed. But a failure to provide this could create the political conditions under which Scottish independence becomes inevitable.

The withdrawal process will be messy, deliberately so

A vote for Brexit would be a political shock for the whole of Europe, with uncertain consequences at national level and for the EU. It would also be an economic shock just when the rest of Europe could do without it. The EU and other member states would have a strong economic interest in ensuring a British withdrawal was orderly and in avoiding unnecessary disruption to trade and investment. The political imperatives would be very different. If the EU is to avoid encouraging euroscepticism in other member states - and the risk of further fragmentation - it must ensure Brexit is costly for the UK. France and Germany have elections next year and the incumbent governments are threatened by eurosceptic populists, albeit in different ways. They would agree that Brexit must not be easy, although the Germans would be more measured than the French. This would mean no special favours and in particular no participation in the single market without the usual conditions - adopt EU regulation, accept free movement, and make a financial contribution. Each would be very difficult for the UK.

The Leave campaign clearly dislikes the legal process for EU withdrawal, as set out in Article 50 of the Treaty on European Union. The UK would be disadvantaged, as the negotiation would be time limited and the UK must first leave the EU before a bilateral treaty setting out the terms of a new economic relationship could be ratified. The UK government would, however, be stuck with Article 50, unless the British parliament was willing to take the unprecedented step of ignoring its international treaty obligations. There would be little appetite elsewhere in Europe to deviate from Article 50, both because of the precedent this would set and because it would require the treaties to be amended.

In practice the UK government may be able to soften the edges, but only a bit. The government would be unlikely to trigger Article 50 immediately, even though David Cameron says he would. Instead, there would be a pause until the political dust settles and a new government is formed. The government might then seek, from the start, to extend the Article 50 process by a year or two in order to reduce the risk

that the negotiations run out of time. It is possible the EU would agree, although this requires the unanimous support of all member states. The UK and the EU could also begin informal talks on a new bilateral treaty before the UK leaves the EU, even if it could not be ratified by then. Finally, in the negotiation itself, while the EU would stick to its principles for fear of the political consequences if it did otherwise, there could be some flexibility in how these are applied. For example, free movement could be applied less strictly to a country that is not an EU member, with a little more leeway for an emergency brake or benefits curbs. This could create face-saving room to manoeuvre for both sides to reach an economically sensible deal. So we should not rule out the UK continuing to participate in the single market, either in part or in full.

Investment decisions will be the cleanest gauge of the long-term economic impact

The combination of political instability in the UK, political uncertainty across Europe, and a messy withdrawal process would exacerbate the impact of a vote to leave on financial markets. The signals are already there with sterling under pressure and gilt yields and equity prices falling as the opinion polls have narrowed. Assessing the immediate macroeconomic impact is more complicated, as it depends on both expectations about an uncertain future and how households and firms react to uncertainty now. While there might be a consensus among experts on the sign of the impact, the scale is another matter.

Looking beyond the macro data the most immediate and tangible signs that Brexit would have structural implications for the UK economy would be from direct investment decisions. These would tell us whether and how large international companies, in particular, see Brexit impacting on the UK's position in their business models. For some companies it may be largely business as usual. We do not expect any to make hard-to-reverse decisions precipitously. But Brexit would inevitably impact on some high-profile investment decisions. This may prove to be the cleanest signal of the structural impact on the UK economy to come.

If the UK votes to remain

David Cameron will have to work hard to keep his job

The referendum was supposed to put an end to divisions in the Conservative Party over Europe, by giving sceptics the opportunity to make their case and letting the public decide. After a good,

clean fight (and a clear vote to stay in the EU) the Conservative Party would then be able to focus on the job of government. That is not how it has turned out. The prime minister's vaunted renegotiation has been dismissed as a sham and damaged his credibility with many Conservative voters. The campaign has been marred by deeply personal blue-on-blue attacks and turned into a surrogate leadership contest. Government policies on tax, immigration, trade deals and the NHS have all been undermined, while the impartiality of the civil service has been traduced and the Bank of England's independence threatened. The damage will be long lasting.

The immediate challenge for the prime minister would be to shore up his position. Number 10 and the whips would start by seeking public backing for David Cameron from friends and foes in the campaign, with the aim of taking the steam out of any potential leadership challenge. Who says what in the days immediately after 23 June would be critical. Cameron must then announce the most difficult and important cabinet reshuffle of his premiership. He must bring in enough Leave campaigners to unite the party, while also rewarding loyalty. He would not want to be rushed, as reshuffles always leave many people disappointed. Better to dangle the prospect of career advancement. Respected Leave campaigners like Michael Gove would be rewarded, while lukewarm Remain supporters such as Sajid Javid could be demoted. Where to put Boris Johnson would create the biggest dilemma.

Cameron's position would not be secure. The slimmer the margin, and the lower the turnout, the more threatened he would be. But barring any miscalculations he should have enough room to manoeuvre to keep his job. Whether he would have enough to protect his ally George Osborne and give him the opportunity to recover the ground he has lost in the race to succeed him as prime minister - when the time comes - is another matter.

Cameron will still have a Europe problem

Brussels, Berlin and other European capitals would be greatly relieved by a vote to remain in the EU. But anyone expecting this outcome will result in a warmer and more constructive relationship between the UK and the EU is likely to be (mostly) disappointed. David Cameron's Europe problem would not go away. At a bare minimum he would need to demonstrate to sceptics within his own party that he is strictly enforcing the deal he reached with other leaders at the February European Council and more likely he would need

to be seen to be testing and pushing its limits. This means more confrontation. Cameron would also have to reassess his position on migration and look for new ways to chip away at some of the financial underpinnings in the benefits system for free movement, while working within the legal constraints of the EU treaties.

David Cameron would likely try to temper this by being seen to be more engaged and constructive as the EU seeks to address its problems. At the top of the list would likely be external affairs, the refugee crisis and trade policy. Cameron would want to take a higher profile in the difficult relationships with Russia and Turkey. He would attempt to show a more constructive side in dealing with external border security and refugee flows, while avoiding any concessions on UK policy that risk inflaming domestic passions on the issues aroused by the referendum. He would also want to kill the myth that the EU is bad at doing trade deals, so we should expect him to put his weight behind a fresh push on negotiations with the US and Japan.

The government's remaining time in office will be marked by weakness

If the government lasts a full term it will have a little under four years remaining. Cameron has said he will not stand at the next election. He would need to give his successor enough time to establish him or herself before a May 2020 election, which means the process must start no later than May 2019 in time to reach a conclusion by the Conservative Party conference in the autumn of that year.

Anyone looking for decisive leadership and ambition on policy until then would likely be disappointed. With a small working majority the government has already established a track record of policy miss-steps and reversals in its first 12 months. The Chancellor's problems did not begin with the referendum, but with his March budget, which quickly came undone when he was forced to drop welfare cuts. The government's hands-off approach to industrial policy has since been overwhelmed by the political fall-out from threatened steel plant closures. Other recent U-turns include academisation of schools, Sunday trading, VAT changes and trade union reform. This suggests that a government that emerges from the referendum even weaker than before would need to curtail its ambitions and focus where party interests are most likely to converge.

A policy 're-launch' would be inevitable. Some elements would be familiar, such as a renewed push to create a 'seven-day NHS', particularly

now that the Health Secretary has untied the knot on contracts for junior doctors. Initiatives to address the strains on public services and housing from immigration would be likely, in order to respond to one of the key pressure points in the referendum campaign. Ensuring money flows to where the problems are greatest would be one possible approach, particularly if the Chancellor could tie this to his devolution agenda. Optimists in government might say that with the referendum over they could afford to be bolder and take more risks by confronting dissent in the party; in practice, the damage to the ties of loyalty would likely be so great as to require the government be more managerial than reforming.

Conclusion

The referendum was a gamble by David Cameron that has not paid off. If he loses he resigns. If he wins, he most likely survives, but weakened and with a damaged party and a damaged political system. The consequence for the UK in particular - but also for the rest of Europe - can be summed up either way in just two words: political risk.

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