



MIND THE GAP: UNCERTAINTY POST-BREXIT

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TWO INTRODUCTORY NOTES

We were wrong. On June 22 we predicted that Remain would pull out a narrow victory. Until approximately 11pm UK time on June 23 that appeared to be a reasonable bet. The unexpected margin of Leave's victory among traditional Labour voters turned the vote. We had focused on divisions among Tory voters (who ended up supporting Remain at 57%); a key to understanding UK politics and positions going forward will be to look at challenges for Labour.

Can Brexit be reversed? Despite calls for a second referendum, the 70% turnout on Thursday, coupled with the direct challenge to Labour in its base, strongly suggests no change. Still, a narrow referendum margin is a poor basis for redefining sovereign powers and leaders will look to keep their options open. A reversal would almost certainly require (i) a general election; (ii) a new referendum; and (iii) a new agreement with the EU especially on the movement of labor. It is hard to see all three happening in 2016.

EXECUTIVE SUMMARY

Carry on...The Brexit vote by itself changes no laws or regulations. Formal decisions about the UK's relationship to the European Union (EU) will result from two negotiations that will take years: one on the UK's departure from the EU and a longer process on the new relationship.

...But start getting nervous. The UK and the EU will disagree while negotiating. More immediately, policy-making will diverge on issues such as tax, the digital single market, and the movement of people. This will precede the divorce decree. ***This is the immediate risk to business.*** In Brussels, the UK will be a faint and fading voice. Lord Jonathan Hill has resigned (decently), and UK officials in the Commission will lack political heft beyond their personal networks. Companies that count on the UK to support policies favorable to them will need to find new friends.

European consequences. The quickest path to disaster would be for multiple EU member states to demand quick renegotiations of their own relationships to the EU. The victory of mainstream parties in Spain on June 26 may avoid immediate contagion. German Chancellor Angela Merkel will nonetheless urge continuity of policy and try to tamp down calls for further re-negotiation of EU rules from other member states. Her meeting on June 27 with other EU leaders will signal the tone for this campaign.

What happens next? With regard to Brexit, officials will try to create order: who is authorized to speak, when, and about what topics. There are no apparent answers and still too many voices. What follows is our best estimate. We will be meeting with EU leaders in Brussels this week to gather further insights.

HOW DO THE SIDES PROCEED?

Who Speaks?

For the European Union: Formally, Council President Donald Tusk will lead negotiations on Article 50. Tusk will be supported by a newly formed EU Brexit task force led by Belgian diplomat Didier Seeuws.

In practice, Angela Merkel will set the tone. She will want a stern line with the UK but (as always) a deliberate pace. She will want to understand the centrifugal pressures elsewhere in Europe; ultimately we believe that she will find a clear direction with the UK by mid-2017, which will help her focus on building alliances for a new EU. France will take a greater leadership role, stoking reservations in Berlin.

Voices from other countries are mainly noise with regard to UK issues. Still, the political forces they represent are important for the future of the EU, and populist voices may point the way to compromises if they focus on specific issues, such as immigration.

For businesses, the European Commission will have an inter-services working group to examine specific issues. This will provide a destination for questions and concerns but will develop answers slowly, because the two-year clock to complete negotiations will not start until the UK Government sends an official notice.

For the UK: There is no authorized voice. British Prime Minister David Cameron shows few signs of wanting to start the process to leave, and the Brexit campaigners – remarkably silent these few days – know only that they want to leave. Labour is facing a full war between its members of parliament (who received nine million votes in the previous election) and its leadership (who received a majority of votes from the 400,000 voting Party members). The UK Independence Party (UKIP) will seek to gain ex-Labour voters.

When?

European leaders are expected met on June 28-29 for a European Council meeting to set guidelines for the EU moving forward.

About What?

In Brussels, the immediate focus will be on how to deal with Cameron's refusal to trigger Article 50. In London, the initial focus will be on what process will be followed for the UK's exit, but some issues will not wait for new political leadership in the UK, including:

- EU budget issues (UK contribution, rebates, and unspent EU grants);
- immigration;
- tax fairness; and
- the digital single market, including copyright rules.



We anticipate UK members of European Parliament (MEP) to remain in Brussels for now, but they will likely give up positions of leadership and rapporteurs. Because the UK will not have an influential role in policy debates on EU tax and digital policy, we expect divergence in policies between the UK and the Continent to grow over the next two years. Technically the UK could veto some decisions; though its threats to do so would be fascinating, they would likely be counter-productive.

This is where businesses should be concerned. The Brexit campaigners knew that they favored one thing – leave – but not how to do it or what else to do. Now the new Tory, and possibly UK, leadership will be asked to form policies on core economic issues, while UK-based businesses will find themselves under intense scrutiny from EU regulators.

THE BROADER AGENDA

For the EU

1. Demonstrating continuity, control, and flexibility. Federica Mogherini, the EU's foreign policy chief, released the "EU Global Strategy" on Monday in an effort to boost defense and foreign policy coordination within the EU. Mogherini's strategy will be followed by additional policy papers on immigration and growth in the coming weeks in an effort to demonstrate that the EU continues to function. Establishing a process for negotiating the UK's departure will help calm nerves. EU leaders will also face pressure from certain members to devolve some powers back to states. The foreign ministers of the EU's six founding members released a statement on Saturday declaring their "joint commitment" to the EU while acknowledging the need to build in additional flexibility for member state participation. How to strike this balance will be the main challenge for EU leaders looking to contain the fallout of Brexit.

2. Managing business as usual. EU officials will also need to decide how to proceed with a number of key legislative proposals, including on tax, capital markets, and digital services. The absence of British influence will likely change the spirit of these regulations and give favor to the preferences of the French and Southern European countries.

3. Deterring further departures. The results from Thursday are likely to provide additional fuel to nationalists and far-left and right wing parties in upcoming elections in France, Germany, Italy, and the Netherlands. A recent Ipsos-Mori survey reveals that more than half of Italians and French want to hold their own EU votes, while a Pew Research Center poll shows that only a quarter of Germans support additional EU integration.

For the UK

1. Preserving political parties. The leadership of each major party faces large challenges. The Tories will try to assume the role of spokesperson for UKIP's voters, especially the former Labour supporters, but will struggle on issues other than Brexit, especially as 57% of Conservative Party voters preferred Remain. Labour has much to lose, given the pro-Brexit vote.

- **The Conservative Party will select its new leader this fall. The party conference is scheduled for October 2, which would be the logical time to appoint a leader, but some want only to start the process then.** Former Mayor of London and leader of the Brexit campaign, Boris Johnson, is the



front-runner. Other contenders include Home Secretary and Remain supporter Theresa May, and MP and former Secretary of Education Michael Gove, who has said he will support Mayor Johnson. The process favors candidates with strong base among MPs; the final election will be by 150,000 Tory party members, a group that will skew more toward Brexit than the majority of Tory voters in the June 23 referendum.

- **The state of the opposition.** Labour leader Jeremy Corbyn – a weak performer in the referendum campaign – faces a full rebellion from Labour MPs, and many expect a leadership vote.

2. Maintaining the political integrity of the UK. Scotland and Northern Ireland were for Remain. Scottish leader Nicola Sturgeon called on her cabinet to prepare for a second independence referendum, predicting that a vote is “highly likely.” A number of options for EU accession may exist for an independent Scotland, including simply taking the UK’s membership, applying as a member through a fast-track process, or applying through regular channels like other EU aspirants, including Albania and Turkey. Meanwhile, Northern Ireland’s Deputy First Minister Martin McGuinness has called for a referendum to join Ireland. Oil prices, popular support, and EU attitudes will shape discussions over potential political changes in both regions.

3. Deliberating calls for early elections. The relative strength of Labour and UKIP in the coming weeks will help determine whether the Tories decide to hold early elections. Pressure to gain a popular mandate for Brexit may also trigger a new election (see below).

4. Deciding whether and when to trigger Article 50 negotiations. Once initiated, the UK will have two years to conclude exit arrangements and leave the EU. Cameron has refused to do this as PM. This both buys time for Brexit campaigners to organize and forces on his successor an overt, difficult act. The results of Thursday’s referendum were not legally binding, and as discussed above, a reversal of the UK’s decision is possible, albeit improbable.

While a full reversal would be difficult, Cameron’s delay has allowed UK leaders to explore options. One scenario being discussed is the possibility of Westminster intervening and calling on early general elections in the fall to ultimately decide whether the Brexit campaign has a popular mandate to lead a departure from the EU. The other option being discussed is the idea of simply not triggering Article 50. In this option the UK would seek to defeat EU policies it opposes while retaining access to the single market; it’s unclear how it would manage this balancing act especially with regard to the European Court of Justice, but the approach could allow for discussions to develop.

5. Deciding how to fashion the UK’s future relationship with the EU. Brexit leaders agree on leaving but on little else (see below).

6. Securing free trade agreements (FTAs) with dozens of non-EU countries that can substitute EU agreements for which the UK currently relies on to trade. Current arrangements could continue until replaced or terminated by one or both sides.

THE UK’S NEW RELATIONSHIP WITH THE EU



Perhaps the most consequential and immediate political development in the aftermath of the vote is Cameron's decision to not trigger Article 50. Cameron will instead leave this to his successor, which will likely push the start of formal negotiations to exit the EU to October at the earliest. In the meantime, the UK will want to begin negotiating its future status in Brussels, something EU leaders – including in Germany – have said they will not consider until the UK formally exits the EU.

Brexit campaigners have yet to clarify their preferred status within the EU. Five options have been widely discussed:

- **The Norwegian model – entering the European Economic Area (EEA).** In this scenario, the UK becomes a member of the European Economic Area with full access to the EU single market. In return, the UK must implement existing EU legislation, adopt future EU rules (without a vote), and abide by the EU principle of “four freedoms”: free movement of people, goods, services, and capital. The UK would lose access to the EU's trade deals with non-EU countries.
- **The Swiss model – striking bilateral accords.** In this scenario, the UK negotiates bilateral agreements with the EU on specific policy areas in order to retain access to the EU single market in those areas (e.g. financial services). Switzerland is also required to contribute to the EU budget and abide by EU regulations in the sectors in which they strike agreements with the EU. Switzerland has negotiated over 100 separate bilateral agreements on goods, but has failed to secure access to the EU single market for financial services.
- **The Canadian model – securing a free trade agreement.** This involves the negotiation of a single, comprehensive FTA with the EU. Terms would be less favorable than the Norwegian or Swiss models, and it is uncertain that the UK would even succeed in finalizing an agreement in today's political environment. Passport rights for financial services would have to be negotiated.
- **The Turkish model – entering a customs union.** Turkey enjoys tariff and quota free access to the EU market for goods. The customs union does not apply to services, and would require the UK to adopt the EU's common external tariff on non-EU countries.
- **The WTO model – pursuing most-favored nation status.** The UK may also forgo negotiating a trade deal with the EU and instead begin trading with the EU under World Trade Organization (WTO) rules. In this scenario, the UK would not be required to accept any EU conditions on free trade, including free movement of labor, but it would face significant barriers to trade for services.

The initial stages of negotiations over the exit and status of the UK are likely to be marred by political brinksmanship, particularly given impending elections in Europe. We expect cooler heads to prevail over time, however, especially as negotiations move from the public eye. U.S. Secretary John Kerry traveled to Brussels and London in late June to urge cooperation and offer the U.S. as a mediator during the upcoming negotiations.



The outcome of the UK's status negotiations will be some mixture of these options outlined above, with some strong protections for the UK with regards to the free movement of people.

ABOUT ASG

Albright Stonebridge Group (ASG) is a leading global business strategy firm. We help clients understand and successfully navigate the economic, political, and social landscape in international markets. ASG's worldwide team of commercial diplomats has served clients in more than 110 countries.

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