
Could Brexit be a marker of things to come?

Mushtaq Khan¹, January 25, 2019

Despite the uncertainty about Brexit, there is one certainty as stated by global media: a no-deal Brexit would be a disaster that would do unprecedented damage to both Britain and the European Union (EU). Yet Britain's politicians appear increasingly incapable of avoiding this outcome.

In a paper we published nine days before the Brexit referendum (*Brexit: Why the 23rd June Referendum is just the beginning*, 14 June 2016), we argued that Britain is likely to choose to leave the EU, but the exit would not be easy, in order to discourage others from opting out. Nevertheless, we argued that a *leave* vote was more likely as people do not vote on the basis of economic arguments, but based on emotions that are shaped by their specific communities.²

We will structure this paper in three parts: (1) why there is such uncertainty about Brexit; (2) how the Brexit process could play out; and (3) what a hard (no-deal) Brexit could look like. We conclude that while Britain is hopelessly divided on Brexit, the likely no-deal exit from the EU is not as scary as its portrayal in global media

1. The political confusion

After the historic defeat of Theresa May's Brexit deal on 16 January, British politics has been up-ended. With almost everyone convinced that a no-deal Brexit would harm the country, how could a vast majority of British MPs reject May's offer of a soft Brexit? Given the utter confusion about what lies ahead, it is useful to make a few clarifying comments:

- Theresa May's deal had been vetted by the EU. Hence, the misgivings by European leaders after May's parliamentary defeat. One must understand that the EU would like Brexit to go away and things to return to the way they were;
- May is pro-trade, but anti-immigration and anti-regulation;
- The Labour Party is deeply divided on Brexit. Jeremy Corbyn is a known Euro-skeptic, but is using Brexit to weaken May's government instead of suggesting a better path forward; &
- While the EU and European leaders are behaving as if this is Britain's problem to solve, the disaster, damage and dislocation that is used to characterize a no-deal Brexit, will also have serious consequences for continental Europe. For all the pain that Britain is expected to experience, the EU will have to deal with the exact equivalent in terms of economic dislocation.³

We would suggest several factors that have created this peculiar environment: (1) Theresa May's four red lines; (2) Britain is losing faith in the EU, which goes beyond traditional Euro-skepticism; (3) the Irish *backstop*; (4) Scottish independence; and (5) Britain's Brexit conundrum and May's lack of empathy.

¹ The author would like to thank Yavar Moini and Danish Hyder (Advisory Board, **doctored papers**) for many helpful discussions to better understand Brexit, and its likely repercussions.

² In the 2016 paper, we showed that Britain's economy has changed quite significantly since 1990, with a shift to financial services, high-skilled jobs, tech companies, media/communication and real estate. On the losing end, we have industry, agriculture and construction. This change was ushered in by globalization, which may have created a degree of resentment amongst those left behind, as the growing presence of wealthy foreigners and Eastern Europeans working to renovate London properties is often blamed for the weakening of British culture and identity.

³ For every failed economic/financial transaction in Britain, the counterpart is somewhere in the EU.

May's red lines:

Theresa May has stated that she is willing to talk to anyone as long as they agree on her “principles”. These are:

- i. A smooth and orderly Brexit;
- ii. A solution that protects the union between England, Wales, Scotland and Northern Ireland;
- iii. Britain has controls of its borders, laws and money; and
- iv. A trade policy that Britain can negotiate on its own.

The first red line implies a soft Brexit. The second condition has already been undermined by the Irish *backstop* clause, which her negotiators have already agreed to with the EU (more later). Furthermore, this issue has lost her support from the Democratic Unionist Party (DUP) in Northern Ireland and also prominent Euro-skeptic MPs in her party. Her third principle means that Britain wants to end the free movement of people from the EU, it wants to end the jurisdiction of the European Court of Justice, and Britain wants to stop making membership payments to the EU. And finally, the fourth red line is that Britain will not join the customs union.

In effect, what Theresa May wants is to have all the advantages of a large single market, but none of the restrictions that come with it. She basically wants to have her cake, and to eat it too. If interim results counted, May has already failed in her first two red lines. Her other two red lines would only be accommodated, if Britain were not part of a common market. The Labour leader (Jeremy Corbyn) has said that if May is willing to agree to stay in the customs union, he would be willing to negotiate a softer Brexit, but his offer has been rejected as it goes against May's fourth red line.

So the question is: why is Theresa May being so stubborn?

Beyond Euro-skepticism:

There has always been a mindset in British politics that wants to maintain some distance from the community of European countries. But events in the past couple of years have given more reason to be cautious.

The 2016 Brexit referendum shocked the world. Since then, Europe has witnessed a public reaction against liberal politics and policies: the Merkel era is at an end, Macron's reform program has been scuttled by the Yellow Vests; and Italy has an anti-establishment government that has clashed with Brussels. The economic troubles in Greece remain, while many EU countries have taken unilateral steps to stop the inflow of illegal immigrants from the Middle East and Africa. Then you have rightwing authoritarian governments in Poland and Hungary.

With this momentum of events, the principal anchors of the EU – Germany and France – may no longer be willing, or able, to steady the ship. This means the liberal politics and collective concerns that had defined the EU in the past two decades, are now being challenged from within. The anger in many EU countries against misguided economic austerity⁴ is now being channeled towards easy scapegoats: immigrants and moneyed interests. In this atmosphere of xenophobia and jingoism, the EU's mission to maintain borderless free trade, seems out of place.

Irish backstop:

⁴ The fundamental problem in the EU is the vast difference in the economic habits of the various citizens of the union. Trying to change such behavior to a European norm, has shown that the EU is a flawed economic experiment. In simple terms, can Germany, operating through Brussels, force Italians to become more Germanic?

The Irish *backstop* is being blamed May's historic defeated in parliament. This refers to the understanding that if the British parliament ratifies May's deal, both sides will finalize the comprehensive deal by the end of 2020. In the event that the two sides cannot come to an agreement, then for a soft border to remain in place in Ireland, Northern Ireland will operate under EU's trade rules and regulations for a period of time at the EU's discretion.⁵

What has incensed many British MPs, is the fact that in May's deal, Britain cannot refuse this *backstop*. So in a sense, despite the 2016 referendum vote, if the *backstop* is triggered by the EU (see **Figure 1**), it would automatically drag Britain back into the EU against her will.

We are unsure about the genesis of the *backstop* clause, but would assume that it was spearheaded by the EU (on behalf of the Republic of Ireland) with some support from Britain. The goal is to ensure the soft border in Ireland remains in place, which is critically important for the Good Friday Agreement that was signed in 1998 (this put an end to the bloody conflict between Protestants and Catholics during the 1960s and 1970s⁶). In our view, the *backstop* clause was put into the May deal by the EU, which means Europe would not be willing to discuss or compromise on this issue. Some would argue that the *backstop* is Machiavellian, as the soft border would automatically make Northern Ireland part of the EU free trade zone.

Scottish independence:

Scotland had a referendum in September 2014, to determine whether to remain a part of the United Kingdom or become an independent country. The 55:45 vote to remain part of the UK was a sizeable majority, but analysts have said that the deciding factor to remain was to continue using the British Pound (as the currency), while the primary motivation to leave was dissatisfaction with Westminster.⁷ In the 2016 referendum, Scots voted 63% to remain in the EU and are not in favor of Brexit.

The Scottish National Party (SNP) is the third largest coalition partner in the May coalition, and has been told by Westminster that Britain cannot afford another vote on Scottish independence. This has annoyed SNP's leadership, especially as Scotland's preference to stay in the EU is being undermined by Theresa May. Many observers have said that if a no-deal Brexit is the final outcome, SNP will withdraw its support for Theresa May's government and push for Scottish independence.⁸

May's mismanagement and Westminster's indecision:

Global media has panned Theresa May's efforts to manage Brexit. Whether it's her refusal to cross her sacrosanct red lines, reach across the political divide, or keep her party members in line, May's term as PM is already being talked about as one of the worst in modern British history. We would largely agree with this assessment, but need to point out that British politics is in turmoil because the main political parties are not operating as they should.⁹

In our view, the political shift away from traditional ideologies, can be traced to the diverging views of constituents (voters). Both blue and white-collar workers are rightly concerned that a no-deal Brexit

5 Since Northern Ireland is part of Britain, this suggests that the rest of the UK would also be inducted into the EU ambit (just when British negotiators were willing to end negotiations for a trade deal. The backstop also gives the EU a significant advantage: if the EU wins when a deal cannot be struck, it has the incentive to ensure that a deal is not reached.

6 Before Al-Qaeda and ISIS became household names of terrorism, it was the Irish Republican Army (IRA).

7 This creates an interesting parallel with Britain: the dominant argument to leave the EU was dissatisfaction with Brussels.

8 Nicola Sturgeon has stated that the EU is more sensitive to Ireland's needs, than Britain is with Scotland's concerns.

9 Historically, Conservatives are pro-business and free-trade, while Labour is pro-workers and champions the cause of the less fortunate. Yet prominent Conservatives pushed for Brexit, while a majority of Labour leaders want Britain to stay within the EU.

could threaten their jobs. Global auto makers, multinational banks, insurance companies, agri businesses, logistics and a host of service providers, have expressed fears that a hard Brexit would severely impact their operations and result in massive job losses. This pressure is being championed by global media groups.

Nevertheless, many pro-Brexit voters in Labour are concerned about immigration, especially about unskilled Europeans they fear are taking their jobs. Furthermore, hardcore Brexiteers argue that the fear campaign of job losses only masks corporate concerns about their own financial interests. This plays to the larger story of the fruits of globalization being denied to the working class, as the country's economic policies have been hijacked by elites and moneyed interests. This makes it very difficult for Jeremy Corbyn to take an anti-Brexit stance, as the argument against financial elites has been driving his political thinking for decades.

Traditional Conservatives are also split. While many have thrived by trading and servicing Europe, they feel their business interests are being hampered by rigid EU regulations and the European Court of Justice. Their ability to use their influence, has been undermined by Brussels.

2. How could this play out?

While Britons brace for 10 weeks of political turmoil, one must realize that EU's parliamentary elections are scheduled for May 2019. Member countries will vote in candidates who will determine the effectiveness of the EU as a unified bloc. If Europe's public sentiments turn sour towards the EU (perhaps inspired by the outcome of Brexit), the next EU parliament may seek to achieve its own demise.

To simplify, we propose the sequence of events shown in **Figure 1**.

It starts with Theresa May's Plan B that is scheduled for 29 January. Most analysts claim that Plan B is almost identical to her failed Plan A. This makes one wonder what will change in two weeks. We show two possible outcomes:

- i. If Plan B is accepted by the House of Commons, this will trigger the final negotiations between the UK and EU (see **B1**) – this could extend till December 2020. So till then, it's pretty much business as usual, which suits the EU. At the end of this period, if the two sides agree on a deal, we have a soft Brexit (a Norway Plus option, see **B5**). If there is no agreement, the EU will trigger the *backstop*, which technically means things revert to the way they were. However, this forceful induction into the EU is likely to provoke a public outcry, which will create political uncertainty and result in snap elections (**B6**); and
- ii. If Plan B is rejected (which is more likely), then the British government has two choices (see **B2**):
 - Accept the parliament's vote and tell the British public that the EU-vetted May deal has *again* been rejected, which means that Britain must leave the EU without a deal (see **B4**);
 - If public pressure mounts (which is very likely), May's government will have to table a second referendum, which is likely to get support from a majority of MPs.

*Second referendum*¹⁰

A leave vote (which most analysts predict is unlikely) will settle the Brexit issue once and for all, and push the country towards a hard exit from the EU (see **B4**). This would create difficult political choices for Westminster: (1) either create a hard border in Ireland or lose Northern Ireland to the EU; and (2) how

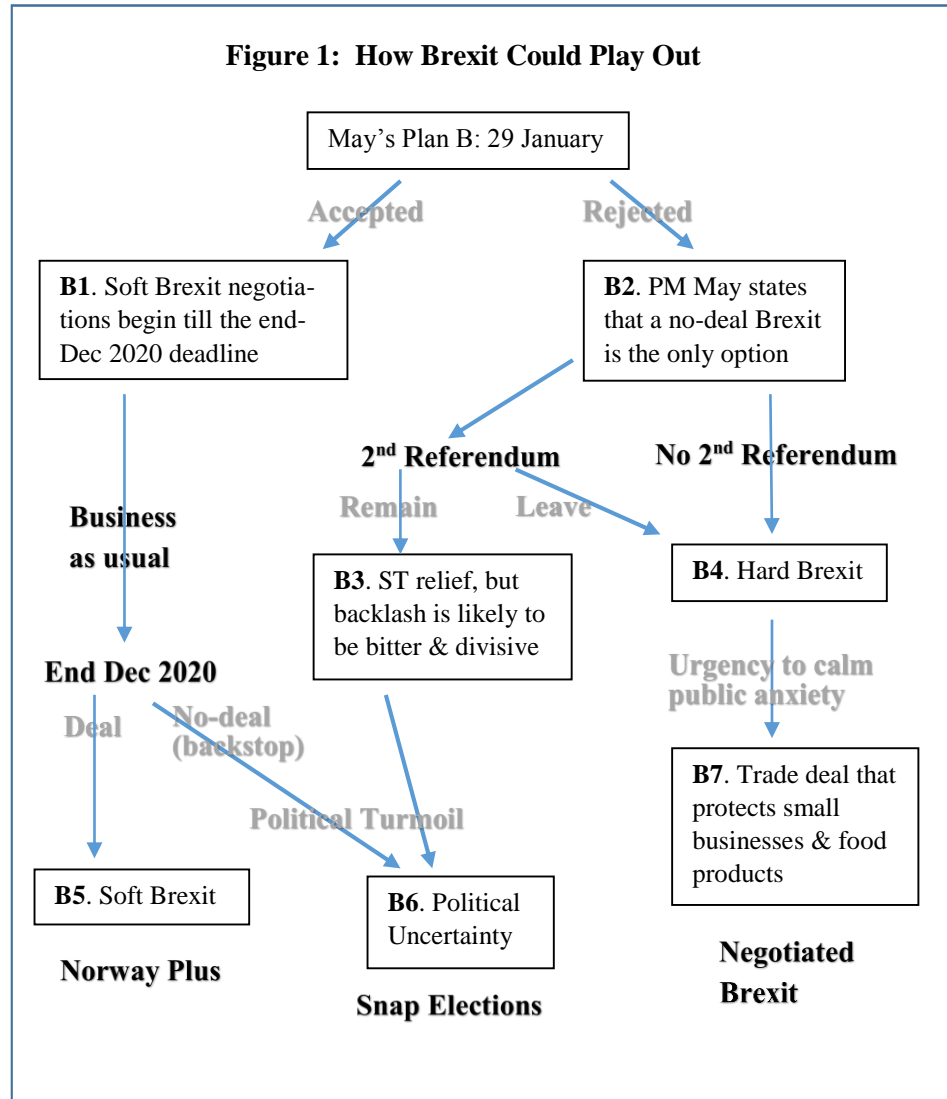
¹⁰ As discussed in **Appendix 1**, what exactly the referendum will seek to resolve is not clear yet, and whatever is decided will be contentious. However, for the sake of this paper, we will assume the original 2016 choice between Leave or Remain.

to manage Scotland's desire for independence, and the possibility that it may opt to join the EU. In effect, a splintering of the United Kingdom is a very real possibility.

A remain vote, on the other hand, will be greeted with a sigh of relief within Britain and the EU (see **B3**). However, for hardcore Brexiteers, this reversal in the people's vote would have to be avenged. Unlike the 2016 vote which was relatively cordial, a second referendum is likely to unleash an ugly public debate about immigrants, wealthy foreigners, the loss of policy autonomy to Brussels, how the average Briton has been excluded from the gains of the single market, how large corporations have influenced the popular vote, and whether Britain is losing its unique identity and becoming a slave to global interests.¹¹

Jeremy Corbyn will use the ensuing political turmoil to demand snap elections (see **B6**). With the Conservative and Labour parties both split in terms of Brexit, Corbyn's demand is likely to gain traction in the House of Commons. However, it would be very difficult to predict the outcome of the snap elections, which means this possible outcome would be the most confusing for the British Isles.

In our model, we made some assumptions to predict what the final outcome could be. Our outlook is as follows: Norway Plus (24%); snap elections (35%); and hard Brexit (41%).¹² Since this scenario suggests that either Britain will crash out of the EU or end up in serious political turmoil, we will look harder at



¹¹ One must also realize that the outcome of Brexit will impact external stakeholders: we have Trump and Steve Bannon in the US, and a bunch of rightwing politicians in Europe who will look at Brexit to forge their own political agendas.

¹² Assumptions: (1) there is a 30% chance that Plan B will be accepted; (2) after Plan B has been rejected, there is a 70% chance that the British parliament will opt for a second referendum; (3) in the 2nd referendum, there is a 60% chance that Britons will choose to remain with the EU; and (4) in the event that Plan B is accepted, there is a 80% chance that the EU and UK will agree on a deal that gives us a soft Brexit.

what a no-deal Brexit would look like. In our view, delaying the divorce deadline without a plan to resolve the irreconcilable differences, is a non-starter and therefore unlikely.¹³

Since a no-deal Brexit will be disruptive for both Britain and the EU, calmer heads will prevail. This should result in meaningful negotiations, and an extension of the separation date. This is shown in **Figure 1** (the *Negotiated Brexit*), where policymakers on both sides will have to respond to the public anxiety of a no-deal Brexit by trying to minimize the economic dislocation, especially for the most vulnerable citizens (see **B7**). Financial and capital flows will also be negotiated, but this could take a different track to ensure that hardcore Brexiters are not angered.

3. What would a no-deal Brexit look like?

Given the build-up to a no-deal Brexit, if the path ahead appears to be moving in this direction, we expect serious efforts to achieve what we call a last minute *Negotiated Brexit*. This is more likely with the fear campaigns launched by large multinational corporations, which had sought to scare enough Britons to vote remain in the second referendum. But as we have argued, a *remain* vote (in the second referendum) may not give Britain much stability.

If Britons realize that a political solution is not possible before the impending deadline, they will create grass-root movement to force MPs to do something to address their economic anxiety. We also think MPs would be accommodative as their political futures would be on the line. Since the focus would be on providing relief to the largest number of people (voters), MPs would look to focus on small businesses and ensure the smooth flows of food products. In effect, we do not think businesses will blindly walk into the deadline, risking their shipments being stuck in a gridlock of trucks on either side of the English Channel.

Despite efforts to ease the pain, a painless break is simply not possible. As cross-border businesses pull away from each other, we expect a wave of nationalism to take hold on both sides. A certain pride in becoming self-sufficient and in promoting local businesses, could take the sting out of the trade disruption. But there will be losers, and they will be bitter. However, if governments are sensitive and proactive, the economic pain could be managed.

In our view, the disruption will be more acute for specialized service providers and those related to the physical transit of goods. For example, the withdrawal of pass-porting rights for the city of London would disrupt the global banks that serve Europe out of London. While disruptive, one must realize that the financial crisis in 2008 that decimated many banking careers, did little to generate sympathy from the general public.

One could even argue that the disruption in banking, insurance, logistics, and high-end retailers, may actually be welcomed by Britons as the necessary rebalancing of the British economy. Opportunistic politicians could use the distinction between *haves* and *have-nots* to attack lop-sided globalization. With EU parliamentary elections scheduled for May 2019, this line of argument could find support in France, Germany and Italy – the dominant economies in the EU. For EU member countries that are struggling with Brussels-driven austerity, this could shake the very foundations of the EU and the common currency.

¹³ At a time of growing anxiety, delaying the deadline may provide some breathing space. Britain would have to make this request, and the EU is likely to accept as long as the British government is able to put forward a credible story about how the extra time will help Britain arrive at a less contentious decision. However, for hardcore Brexiters and even those who are more neutral, seeking an extension would be a sign of indecision and incompetence. Hence, instead of looking for an extension, MPs may seek to salvage some pride and opt to leave without a deal.

Why embark on Brexit?

David Cameron raised the option of a referendum for self-serving purposes and to reassert Britain's influence in the EU. As we have argued, this has set the country on an irreversible path where all the possible options will entail an economic cost. What is surprising, is that despite knowing how this could play out, senior Tories are still insisting on leaving the EU. As we have shown in **Figure 1**, all end options are varying shades of bad.

In our view, Tories are trying to tap into changing public sentiments, while seeking to assert their influence on Brussels. Although many would argue that being part of the EU is net positive for Britain, the loss of policymaking independence has bothered Westminster for quite some time. This – after all – is Great Britain, which was once considered the world's greatest military and economic power. Having stood up to Nazi Germany, and taking the lead in its eventual defeat, many in Britain feel they saved Europe in WW2. Hence, looking for Brussels' approval on its economic policies and being subjected to the whims of European courts, must have ruffled some important feathers.

Furthermore, one must also realize that people like Nigel Farage and Boris Johnson have stated their admiration for President Trump's populist politics. On the day of the 2016 referendum results, Farage even claimed that this date should be viewed as Britain's Independence Day. Such rhetoric has died down, but with the EU struggling with nationalist fervor that is anti-EU (and emanates from both the extreme left and right), these politicians may bet that if they maintain their independence chant and the EU continues to weaken, a new political movement in Britain could be forged. This may find grass-root support given the nationalism that is seen in the US and the European continent.

Conclusion

If there is a certain momentum to events – or to history *itself* – that force currently lies with anti-immigration, nationalism and a growing skepticism of the economic establishment. One could argue that global media is aware of this undercurrent, which could explain why it is so categorical that a no-deal Brexit would be an unmitigated disaster. While we agree that the economic cost for Britain could be steep, we feel the picture is being exaggerated; the more likely scenario is a *negotiated* Brexit that will arise from a no-deal exit.

Before the June 2016 referendum, there was a pervasive sense that a vote to leave the EU was almost impossible. Similarly, the prevailing view is that a second referendum in Britain will deliver a vote to remain in the EU. However, if the average Briton does not feel that he/she is a stakeholder in the current system, then arguing that he/she may be further marginalized by exiting the EU, may not swing the vote to remain. Furthermore, hardcore Brexiteers will not silently accept a vote to remain in the EU.

While the average Briton is now better informed about the cost of a no-deal Brexit, he/she can also see and understand the shifting political tide in the EU. Many in Britain could argue that in view of the growing tensions within the EU, it is perhaps best to separate from an unstable (and possibly unsustainable) economic union. A nostalgic return to British pride and a *be-British: buy-British* attitude, could become a rallying cry as the country moves to divorce the EU. However, the breakup will not be as painful as many expect. Necessity is the mother of invention, and if a no-deal Brexit is the only option, both sides have a strong incentive for last minute negotiations.

Appendix 1: What exactly will the 2nd referendum seek to resolve?

There is a general consensus that the second referendum will again have a binary choice: Leave or Remain. But since Brexit is a divisive issue that has splintered each of the two political parties, MPs face a critical question beyond whether or not to call for a second referendum: what exactly will the choices in this second referendum be?

Two things have happened since June 2016: one, the vote to leave; and two, May's Brexit deal. If MPs cannot accept the May deal, and the EU is waiting and watching, MPs may push this choice back to the people. But there are several options for the specific choices offered in the referendum:

1. Leave or Accept May's Brexit Deal. This would limit the choice to two versions of Brexit: Leave would be a no-deal Brexit, and May's deal would be the EU-vetted soft Brexit;
2. Leave or Accept May's Deal or Remain. This is not a binary choice and could complicate the results of the referendum. It also brings back the Remain option, which many Brexiteers may say is unlawful as it disregards the June 2016 referendum.
3. Leave or Remain. This was the 2016 referendum, but again Brexiteers would argue that since May's Deal is now a reality, the public must have a say on the deal and not revisit the original choice.
4. Remain or Accept May's Deal. This excludes the no-deal option (which is perhaps what Jeremy Corbyn wants), but this will be opposed by the Brexiteers.

We can dismiss Option 2 because a referendum cannot have more than two choices. And the results could be confusing and unproductive: if the votes are Leave (30%), May's Deal (30%) and Remain (40%), does this mean that Britain should remain even though 60% of Britons voted for some version of Brexit?

Option 1 would respect the 2016 referendum but this could anger voters who have since realized that they made a mistake and now want to stay firmly within the EU.

Option 3 is also problematic, as it disregards May's Deal, which is currently the point of contention.

Option 4 is perhaps the safest – the child-proof option. By taking out the most disruptive option, this would seek to get Britons to choose between two safe options. However, for many who have issues with May's Deal and feel that the EU is playing a behind-the-scenes role to keep Britain within the EU, this could trigger a significant anti-EU backlash.

So, even if Britain heads towards a second referendum, the specific path forward remains far from clear while accompanying controversy is guaranteed.