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Brexit Update—The Path(s) Ahead as Deadlines Loom

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Nearly two and a half years after the initial vote, the Brexit process—as well as the country's deep political divisions—remain as inscrutable and intractable as ever. As the March 29th deadline approaches, the UK's time for managing the divorce terms and its future relationship with Europe (and the rest of the world for that matter) is quickly running out. This brief note addresses the recent wrinkles in the process, where the situation currently stands, and the hurdles that lie ahead.

On January 15th, the UK parliament defeated the Brexit deal that had been painstakingly negotiated with the European Union over the last two years. Following the defeat, the opposition Labour Party tabled a motion of no-confidence in the UK government. **Although Prime Minister May prevailed as expected in the no-confidence vote on January 16th, her backing should not be construed as a vote of confidence in her ability to continue leading the Brexit process.** Instead, support from the Tories and the North Irish Democratic Unionist Party (DUP) was likely based on a calculation that a May ouster would lead to general elections and a potential Labour win. An ensuing Labour-led government could have either pushed for a second referendum (with “remain” as an option), or simply revoked the Article 50 process (a distinct possibility after the recent European Court of Justice decision), thus reversing the result of the June 2016 referendum altogether.

The deal's devastating defeat came amid a failure to address the concerns and meet the goals of a deeply divided UK government. Such divisions largely dictated the nature of the UK negotiation strategy: the attempt to stick to “red lines” that proved difficult to adhere to; the commitment to goals that were often irreconcilable, continuously shifting, and at times in contrast to the EU's transparent negotiating guidelines; the over-emphasis on the need to maintain Tory unity even though internal gaps were too wide to bridge; and the stubborn refusal to engage the opposition in the negotiation process. **Predictably, the deal was unsatisfying to all.** EU-sceptic Tories saw it as a betrayal of Brexit and a “trap” that would permanently keep the UK in the EU via the Northern Ireland border backstop. The DUP regarded it as a threat to Northern Ireland's future in the UK, while the Labour Party viewed the deal's implicit loose ties with the EU as unacceptable.

With the current Brexit deal voted down and the no-confidence vote won, PM May's next step is to set out her government's preferred way forward within three sitting days (by January 21st as obliged under the Grieve amendment approved last week). Another parliamentary vote is scheduled for January 29 in the event a cross-party deal with majority support, the so-called “Plan B,” is reached in the interim.

The defeat of May's deal by 230 votes—the largest margin of defeat in the last century—suggests she faces a formidable task to produce a deal that can win a majority in the House of Commons without causing an irreparable split in the Conservative party. The heavy loss also highlights two important points: first, British MP's opposition to the deal runs deeper than initially thought—May's deal is almost universally perceived as suboptimal relative to remaining in the EU (due to potential impacts on economic growth, trade, investment, financial sector, currency, etc.). Second, there's growing cross-party unease about a “no-deal” Brexit. As a result, the strong rejection of the Brexit deal perceptibly lowered the risk of a “hard Brexit” and boosted the probability of a “softer Brexit.” **Of all the options currently being discussed, the only ones that could achieve cross-party majority support—i.e. a permanent customs union, a Norway-style agreement, and/or a second referendum as a last resort—imply a softer Brexit. Hence, markets have taken the deal's defeat as a positive development.**

Another implication from this week's vote on the Brexit deal is the likelihood that potential EU assurances or “tweaks” to the non-binding Political Declaration that accompanies the Withdrawal Treaty¹ and defines the future relationship between the UK and the EU will not sway enough MPs to secure approval of a revised deal. This implies that for a revised deal to gain majority support, substantial changes would be required—changes that EU negotiators are unlikely to grant, especially as it relates to the NI border backstop, which is currently enshrined in the Withdrawal Treaty. The EU's argument will likely remain that the Withdrawal Treaty is a result of “hard-won” compromises

¹ The Withdrawal Treaty is the legally binding agreement that contains the terms of the ‘divorce’ between the UK and the EU.

among member states and renegotiating it would be a non-starter. **This subsequently suggests that success for any modified deal would primarily require concessions from the UK.**

Even if the EU decides to make further concessions, it would likely wait for clarity about a deal that could muster majority support in the UK parliament. And herein lies the difficulty as divisions among and within the UK parties make common ground hard to find. EU-sceptic Tories prefer a clean and/or “managed” Brexit, pro-European Tories want to remain closer to Europe, the DUP wants to avoid different regulatory treatment of Northern Ireland, most Labour Party members favor a customs union with the EU (but some would nonetheless likely vote for Brexit), and yet many others in the Labour Party would likely accept a second referendum. May’s cabinet itself is deeply divided with many members preferring to keep the “no-Brexit” deal on the table, others seeking a deal to smooth the Brexit process, and others open to considering a second referendum.

However, a cross-party majority seems to have coalesced around the idea that a “no-deal Brexit” must be avoided as the worst of all possible outcomes. Hence, faced with the prospect of crashing out of the EU, the parliament would likely step in and try to re-design a deal that would gain majority support. **But this likely would require more time, and, therefore, extending the Article 50 process would become necessary.** In such a case, the UK government would request an Article 50 deadline extension, and the EU would have to agree to do so unanimously. Whether an extension is agreed to at all, or for how long, depends on how the EU assesses the chances of a successful deal with the UK. **If the UK demands a significant overhaul of the Withdrawal Treaty—especially on the issue of the NI border backstop or requests iron-clad legal commitments via changes to the Political Declaration—then chances are that an extension will be denied. However, a more positive assessment by the EU could prompt its members to demonstrate its political will and grant the UK an extension to the Article 50 deadline.**

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of January 18, 2019

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