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# AERIAL VIEW

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**BREXIT: THE END OF  
THE BEGINNING**

BY PETER MADIGAN



## LONG DIVISION

The defining moments that led up to the current deadlock over Brexit

- 
- JANUARY 1, 1973**  
The United Kingdom accedes to the European Economic Community, a free trade and customs union
  - JUNE 5, 1975**  
In a referendum on continued EEC membership, the UK votes 67.2% in favor of remaining part of the bloc
  - SEPTEMBER 16, 1992**  
Black Wednesday—GBP is forced to leave the ERM
  - NOVEMBER 1, 1993**  
The EEC becomes the European Union, evolving from an economic union into a political union
  - JANUARY 1, 1999**  
Launch of the euro, the EU's official currency
  - MAY 1, 2004**  
Ten new Eastern European and Mediterranean nations accede to EU membership
  - OCTOBER 4, 2009**  
New Greek government elected, revealing scale of Greece's public sector deficit. European sovereign debt crisis begins
  - JUNE 23, 2016**  
UK referendum on whether to withdraw from the EU. Nation votes 51.9% in favor of leaving the bloc
  - OCTOBER 17, 2019**  
UK Prime Minister Boris Johnson negotiates amended departure agreement with EU leaders
  - DECEMBER 12, 2019**  
UK general election. Johnson seeks Conservative majority to push his deal through UK Parliament
  - JANUARY 31, 2020**  
Current deadline for the UK to leave the EU

# WHATEVER THE EVENTUAL FATE OF THE UK'S STORIED RELATIONSHIP WITH THE EUROPEAN UNION, THE SEEDS OF THE TORTURED BREXIT SAGA WERE SOWN MORE THAN THREE DECADES AGO. YET, FAR FROM HERALDING A NEW ERA FOR UK-EU RELATIONS, THE REFERENDUM HAS ONLY SERVED TO DEEPEN PREEXISTING DIVISIONS WHILE DESTABILIZING BRITISH POLITICS.

BY PETER MADIGAN

**T**he final departure from 10 Downing Street is the defining visual that accompanies the end of every British premiership.

Whether it's the last wave in front of the famous black door, an emotional resignation from the podium, or the tear-stained face as the car pulls away for the final time, it is the image that exemplifies the old adage that: "All political lives end in failure."

The issue that terminated the premierships of all four of the most recent Conservative prime ministers was the same: Europe, or more specifically, the UK's relationship with the European Union (EU).

Divisions over European integration have vexed UK politics for well over 30 years, but they have coursed through the veins of the Conservative Party in particularly corrosive fashion. The episodic and—on occasion—career-ending flare-ups those disputes have ignited are the stuff of Westminster legend.

Margaret Thatcher spent the 1980s opposing all efforts to draw the UK

into closer union with the European Economic Community (EEC), railing against the notion of a single European currency and the eventual emergence of a "European super-state." In what would prove to be her last Prime Minister's Questions in October 1990, she famously proclaimed "No, No, No" to ceding further powers to European bodies. Thatcher's staunch opposition to European integration was a major factor in her downfall as party members would force her from power within the month.

Thatcher's successor, John Major, was pro-Europe but in 1993 he found himself grappling with eurosceptics within his cabinet undermining efforts to ratify the Maastricht Treaty, which established the EU and laid the foundation for the euro.

After Major was ousted in 1997, when the Conservatives regained power under David Cameron in 2010 many of the factional divisions over Europe that had remained largely hidden during 13 years in the political wilderness came bursting back to the fore.

Cameron's decision to hold a binding referendum on continued EU membership in June 2016, and his subsequent failure to convince the electorate to back remaining in the union, prematurely terminated a political career that was at its peak.

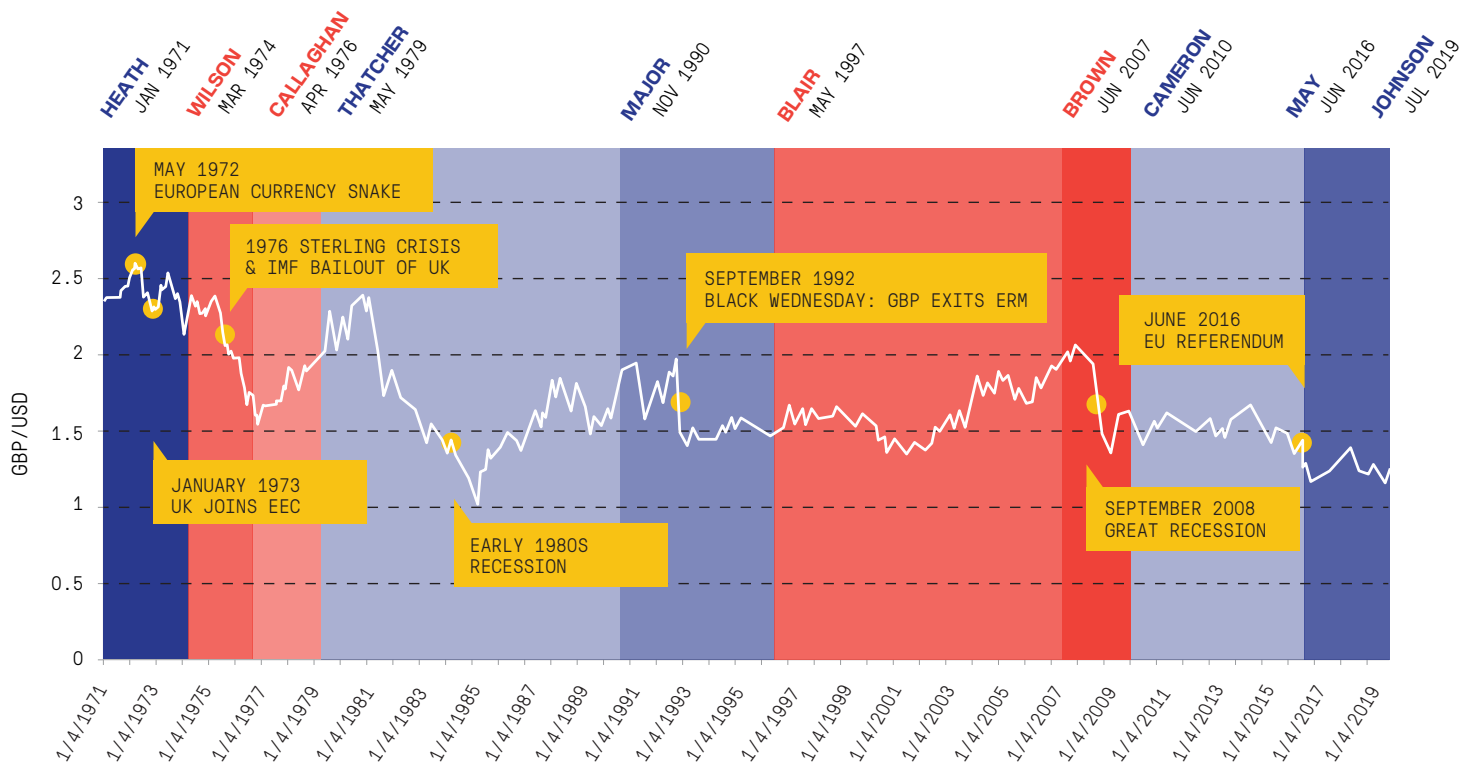
His successor, Theresa May, fared even worse. Although she was successful in negotiating an exit deal with EU leaders, the House of Commons rejected that agreement three times. Appearing to have lost the confidence of a majority of the parliamentary party, she resigned from office in July 2019.

At the time of writing, the political fate of current Prime Minister Boris Johnson is balanced on the outcome of the upcoming general election on December 12—the UK's third in just four years.

Justifying his decision to hold the referendum, Cameron said in 2017: "The lack of a referendum was poisoning British politics, and so I put that right." The fate of every Tory premiership in the past 30 years certainly suggests that

# UNSTABLE CABLE

Economic and political shocks in the past 50 years have yielded periods of volatility in GBP/USD



SOURCE: BNY MELLON

the question of the UK's role within the EU is indeed toxic—for Conservative prime ministers, at least.

Less charitably, it can be argued that the decision to hold a referendum took a poison—which had been largely confined to the Conservative Party—and transfused it into the mainstream of UK politics.

At three and a half years removed from that vote, a compelling narrative can be made that the signs of an eventual breach emerging between the UK and EU were there almost from the very beginning of their association.

The UK was forced to leave both of the major European monetary harmonization initiatives in which it participated in the 1970s and the 1990s, on both occasions due to sterling's inability to remain within the currency bands set by the mechanism.

Then there was the litany of special accommodations that Britain secured

from Europe—from rebates on its contributions to the EU budget, to its ability to maintain a UK border while being a member of the border-free EU, to its opt out from joining the euro. These exemptions reiterated time and again that while the UK was an EU member, the nation clearly held substantial reservations about becoming further intertwined with the Continent.

The clues were there for all to see. While FX markets have become increasingly granular in their daily analysis, investors who had pulled the lens back and heeded those signs could have positioned themselves to benefit from the events that have roiled GBP and UK fixed income and equity markets since mid-2016.

Yet, as we approach the December 12 election, an essential fact seems to have gotten lost in the discussion: the passage of legislation setting out how the UK withdraws from the EU is only

the conclusion of the first part of the overall departure process.

From here, the UK will enter a transition period, during which time a similarly labored negotiation on the future relationship between Britain and the EU will begin.

To borrow a phrase from another Conservative former prime minister, Winston Churchill: "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

## AN INAUSPICIOUS START

The UK's relationship with Europe through the 1960s and 1970s was a fraught one. Britain had joined the EEC—the precursor to today's EU—in January 1973 under the Conservative Edward Heath, but only after two previous attempts at entry in 1961 and 1967 had failed.

Even after its admission, the

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# “The lack of a referendum was poisoning British politics, and so I put that right.”

DAVID CAMERON,  
FORMER UK PRIME MINISTER

nation’s relationship with the EEC—then mainly a free trade and customs union—remained contentious. Heath’s successor, the Labour Party’s Harold Wilson, put the question of continued membership to the people in a 1975 referendum, with the British public voting 67% in favor of remaining.

While that vote would essentially settle the matter electorally for the next 41 years, sterling’s relationship with other European currencies proved more volatile.

The first attempt at monetary cooperation among the European nations was the European Currency Snake, established in 1972 as an attempt to narrow the fluctuation of exchange rates between currencies. Even though it would not be admitted to the EEC until the following year, the UK still elected to place sterling into the mechanism. The Snake proved a failure, however, with the pound forced out within weeks of joining, after being unable to adhere to the rates set by the currency band.

Despite that early lesson in the pitfalls of European monetary coordination, by early 1987 the UK Chancellor of the Exchequer Nigel Lawson was pursuing an informal policy of

having sterling shadow the German deutschmark.

Although an inflationary spiral brought that policy to a close in March 1988, the issue of potential UK entry into the European Exchange Rate Mechanism (ERM)—the monetary convergence system on which a single European currency would be built—was sowing discord within Thatcher’s Conservative Party.

The debate over whether or not to join the ERM provoked a particularly acrimonious split among the Tories, with Lawson (in favor of membership) resigning over the issue in 1989. The battle was ultimately won by the pro-European camp, with the UK joining the ERM in October 1990, just weeks before Thatcher was forced from office.

The timing of the ERM entry could not have proved worse. The UK housing boom of the late 1980s was beginning to collapse while in Europe, post-reunification Germany was suffering from inflationary pressures. By the summer of 1992, the widespread belief had taken hold that sterling had entered the ERM at far too high a rate. With no way for the UK to cut interest rates, the stage was set for a battle over

the UK’s continued membership of the system.

Despite a robust defense of sterling by the Bank of England (which led to a significant drain on the UK’s currency reserves) there was little that could ultimately be done to keep the UK in the ERM in the face of the market forces that had emerged. September 16, 1992—Black Wednesday—saw the UK forced to withdraw sterling from the ERM, mortally wounding the premiership of John Major. Although his administration would limp on for another four years, Europe had claimed a second prime minister.

## DEEPENING DIVISIONS

The political fallout for the Conservatives proved toxic and long lasting. With the party’s reputation for prudent economic management tarnished, it lost the 1997 election and spent much of the next 13 years fruitlessly seeking new policies to sway voters away from the governing Labour Party.

During this period the already festering split between Tory europhiles and eurosceptics was further riven by a trio of new forces.

The first was the enlargement of the EU in 2004, bringing 10 eastern

European nations into the bloc and raising concerns in that significant numbers of economic migrants from these states would seek to relocate to the economies in the north and west of the continent.

The second was the eruption of the eurozone debt crisis in 2009, which tabloids depicted as a bailout of profligate Mediterranean EU nations by their frugal northern neighbors.

Across northern Europe, populist parties sought to capitalize on the debt crisis and the issue of internal European migration. Britain was no exception, with the UK Independence Party advocating for the wholesale withdrawal of the nation from the EU, and peeling off voters from the right wing of the Conservative Party.

With these broiling forces at work as the Tories returned to power in 2010, they proved hugely influential in propelling David Cameron's decision to promise the electorate a binding referendum on the UK's membership of the EU if the Conservatives won the 2015 general election.

When the Tories enjoyed an unexpectedly decisive victory in that year's poll, Cameron found himself bound to give the people the referendum he had promised. It was a pledge that would ultimately lead to his resignation, yet another casualty of the Conservative Party's split personality over Europe.

### **BREAKING THE IMPASSE**

If, to use Cameron's words, the lack of a referendum had indeed been poisoning British politics, the June 23, 2016 ballot did not serve up an antidote. In fact, it had quite the opposite effect.

As an immediate outcome, the referendum placed some members of parliament in the unenviable position of having to respect the decision of the voters in their constituency even if that outcome did not accord with their own opinions.

As withdrawal negotiations with the EU progressed in 2018, pro-remain Members of Parliament bitterly complained that the emerging deal represented such a departure from

the existing UK-EU relationship that it could seriously harm the UK economy. Pro-leave MPs were similarly enraged—but due to their belief that the deal left Britain too intertwined with the EU and did not represent a clean enough break.

The compromise deal that Theresa May was able to agree with EU leaders ultimately placated neither the euro-sceptic nor the pro-Europe factions, leaving both sides further entrenched in their positions.

The withdrawal agreement was ultimately rejected by the House of Commons in the largest legislative defeat in British parliamentary history. May put the bill before the House twice more, only to see it again defeated on both occasions. Shortly thereafter, she stepped down, bringing the EU's prime ministerial toll to four.

The amended deal secured in October by her successor Boris Johnson is in substance the same agreement May obtained.

Like May's deal, Johnson's withdrawal agreement would see the UK consent to honor all of its outstanding financial obligations to the EU (there is no official figure, but it is estimated in the region of GBP38 billion) while the residency rights of EU citizens in the UK, and vice versa, would be preserved post-Brexit.

The major difference between the May and Johnson agreements is in the removal of a controversial "backstop" mechanism, which would have kept the UK in the EU customs union should future negotiations fail to prevent a hard border being erected between Northern Ireland and the Republic of Ireland.

Johnson's deal replaces that provision with a proposal to conduct customs checks at Northern Irish ports instead of at a hard border, with taxes paid on any goods destined for the Republic of Ireland. All the while, Northern Ireland would remain in the UK customs union.

This was the EU withdrawal agreement before Parliament when it was dissolved on November 6 to begin the general election campaign ahead of the vote on December 12, at which Johnson

hopes to win an outright Conservative majority that will enable him to pass his deal.

Opinion polls are delivering an uncertain picture of whether the Tories will indeed achieve that majority. A YouGov poll undertaken on November 12 concluded that the Conservatives can expect to receive 42% of the nationwide vote, a result that would hand the party a working majority.

A Survation poll on November 8, however, gave the Tories just 35% of the vote, an outcome that would imply a hung parliament and the need for Johnson to once again seek out a coalition partner to attain a workable majority.

Given his current coalition ally, Northern Ireland's Democratic Unionist Party, has refused to support the Johnson withdrawal agreement, serious questions remain as to whether there are any other potential partners the Tories could form a government with.

The November 11 announcement by the Brexit Party that it will not stand candidates in the 317 seats won by the Conservatives in 2017 (to minimize the possibility of a second referendum) will likely alter the political calculus, providing a boost to the Tories in those constituencies.

Nonetheless, since the Brexit Party still intends to put candidates forward in swing seats, this strategy may still scupper the Conservatives' attempts to move marginal constituencies into their column.

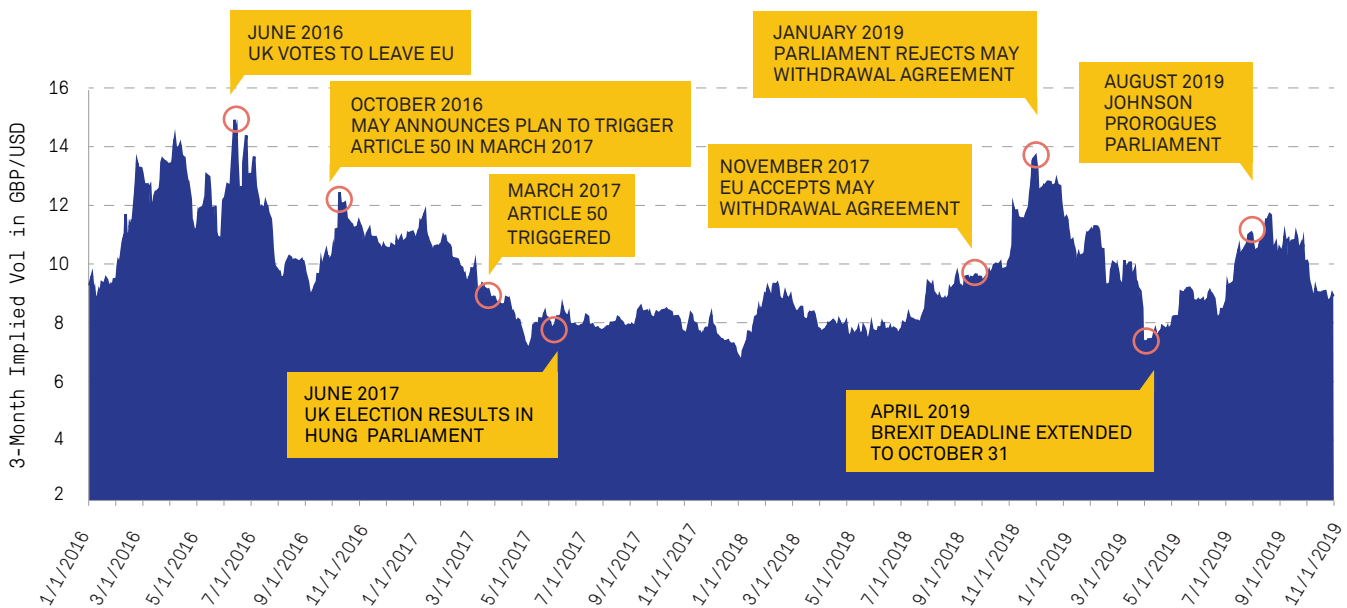
A failure by the Conservatives to win a working majority will lay the groundwork for three possible alternative outcomes.

The first: Johnson could agree to make sweeping alterations to his withdrawal agreement in order to coax another party into coalition with his Tories. This could be a moonshot given that most of the smaller political parties lean in favor of remaining in the EU, and it ignores the likely challenges involved in getting EU leaders to accept a withdrawal deal that is only revised to win coalition approval.

A second, equally outlandish

## DIMINISHING IMPACT

A decline in cable's implied volatility with each Brexit setback suggests markets are becoming inured



outcome, would be the creation of a grand coalition of several opposition parties in order to cobble together the necessary 320 seat majority to form a government.

Thirdly, if no party can find a way to reach that threshold, Johnson would have little choice other than to once again seek a Brexit extension from the EU authorities and hold another general election in the hopes of a more decisive outcome from the British electorate.

What can be said with a higher degree of certainty is that FX markets seem to be growing increasingly nonchalant about the possibility that Brexit will indeed happen at some stage. The chart above clearly demonstrates how implied volatility in cable reacted to each successive Brexit shock in a more muted fashion than the previous one.

While GBP/USD implied vol rocketed after the shock result of the 2016 referendum, the reaction when May's deal was rejected by an unprecedented margin in January 2019—a curveball that threw the entire Brexit process into chaos—was markedly less violent.

Then, when Johnson prorogued Parliament in August—a decision widely interpreted as a move that increased the chances of a disorderly no-deal departure on October 31—vol jumped once again, but less severely than before.

As the legislative wrangling grinds to a halt and the UK awaits an election that may break—or merely prolong—the Brexit impasse, the pause provides time to reflect on the fact that the deep fissures between euromphiles and eurosceptics, especially within the Conservative Party, could be more than a short-term phenomenon.

Today, it becomes increasingly hard to argue with Cameron's oft-stated view that a vote on whether to remain in or leave the EU was "inevitable" at some stage.

As a result, it's unlikely that even after the signing of a withdrawal agreement these divisions will disappear—particularly given that the fraught business of negotiating a new trading relationship between the UK and EU has yet to commence.

Financial markets will also have to contend with the possibility that

general elections in the UK—perhaps beginning with the current one—may no longer provide clearly defined winners and losers, but that future governments will emerge as coalitions.

This not only suggests the possibility of greater instability within Parliament but also that it will be harder to make assumptions about the direction of the UK and GBP in the aftermath of an election.

The passage of a withdrawal deal from the EU through the UK Parliament should prove a positive for sterling, but it is unlikely that this will prove the end of the current volatility for the currency. Instead, the next year could see the pound continue to endure a bumpy ride as long-term political patterns continue to play themselves out. ●

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*Questions or Comments?*

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