

Boris Johnson forcing a hard Brexit

News from the financial markets

Fears of a hard Brexit are on the rise. The new British Prime Minister Boris Johnson is uncompromising towards Brussels and threatens to withdraw Britain from the EU without an agreement. But the British parliament has voted against such a drastic course of action, thereby making the situation just as difficult for the fledgling PM as it was for his predecessor Theresa May. So there is still the prospect of a soft Brexit, which would have the effect of a strengthening Pound Sterling.

Boris Johnson's assumption of office has sent the British pound tumbling. The fear of a hard Brexit, i.e. a cold-turkey withdrawal from the EU, is also rattling the financial markets. Johnson, the new head of government and party leader of the Conservatives (Tories), wants to take Britain out of its contentious marriage with the EU with or without a postnuptial agreement once the already prolonged negotiation period expires on 31 October. But things are not that simple. Under Johnson's predecessor, the British House of Commons resisted an abrupt break in relations with mainland Europe.

Thus the point of departure for the new PM is just as knotty as it was for Theresa May. The following scenarios and consequences for Great Britain are conceivable:

1. Hard Brexit

Even the supposedly "simple" hard Brexit would not be easy for Johnson pull off. Just last March, Parliament voted against withdrawing without a formal agreement. Although this vote has no binding effect, Parliament holds major sway in the matter and could, as it did last spring, force a further extension of the deadline. This is because Johnson, too, heads only a minority government at the indulgence of Northern Ireland's Democratic Unionist Party (DUP). Moreover, his own party is split on a hard Brexit. Thus Parliament holds the baton in its hand on essential issues.

In order to avoid these annoying votes, the government head could force adjournment of the House of Commons from the end of October to the beginning of November. However, the MPs made such a step more difficult with an amendment of the relevant bill. Johnson would also need the Queen's signature, but this would mean that Elizabeth II would have to take at least indirectly a political stand. The question is whether the Prime Minister really wants to bring her into this awkward situation. In addition, an adjournment ordered by the PM could also be viewed as an affront to British democracy. As soon as Parliament is in session again, Johnson would probably find himself confronted with a no confidence vote, which he most probably would lose.

2. Adjustment of the withdrawal agreement and/or extension of the withdrawal period

Prime Minister Johnson is currently opposed to any talks with the EU as Brussels has already signalled that there will be no fundamental changes to the negotiated withdrawal agreement. And Johnson is biting on granite with his demands for a new treaty with the EU member states. But as intransigent as both sides appear to be, the relentlessly approaching deadline will start to fray nerves and negotiations could be resumed. The so-called "backstop" is still the sticking point for ratification by Parliament. Under this stratagem, Britain would remain subject to the internal market and customs rules of the EU as long as no agreement on future relations between the disputing parties is found. The intent here is to avoid a hard external border with the EU being "erected" between Ireland and Northern Ireland. The EU could, however, agree with Great Britain to a so-called "smart border" if no treaty were concluded. Modern technical means would act as an interim substitute for a hard border on the Emerald Isle – obviously, the most amenable solution. If there were signs that talks were set to resume, a further extension of the withdrawal period could be agreed due to the shortage of time. This route is of course wholly dependent on whether or not further negotiations will actually be held.

3. New elections

In recent months, the Tories have lost votes to Nigel Farage's Brexit Party, which was only founded in 2019. According to voter polls, this anti-EU party was even favoured the most for a short time. But Boris Johnson's sharp rhetoric about Brussels appears to be bringing back those lost votes – as the latest trend in opinion polls reveals. Thus the Tories, with an approval rating of approximately 30%, are again the strongest political force in the UK. Johnson could now use this boost in sentiment for early new elections and receive an official mandate from the electorate for a hard Brexit. However, a coalition would be necessary to form a viable governing majority. The other relevant parties are largely pro-European, so Johnson is essentially alone with his hard stance against the European mainland. But if Labour, the second largest party, were to win the election, it could form coalitions with EU-friendly parties and achieve a clear majority. Recent polls show that if Labour Party leader Jeremy Corbyn were to resign, the balance of power could shift again significantly. Accordingly, Labour would become the strongest force. Several first-movers amongst the Labour MPs are therefore flirting with overthrowing their party head. So in a nutshell, the new elections could also backfire, as Johnson's predecessor had to learn the hard way. The new-elections route is therefore unlikely be one of his preferred options. But if no solution is foreseeable in the Brexit process, there is practically no way around an early election vote.

4. Withdrawal with a transition phase solution

If Great Britain withdraws cold-turkey from the EU, Article 24, paragraph 5 of the General Agreement on Tariffs and Trade of the World Trade Organization (WTO) could be used as an interim solution. This passage stipulates that countries negotiating free trade agreements may provisionally apply "trade facilitation" measures for up to ten years before the final agreement is concluded. Since Boris Johnson is banking on a new trade agreement with the EU also in the event of a hard Brexit, Article 24 would be one way of maintaining the status quo. However, a basic agreement is needed to benefit from tariff relief. In the case of a No-Deal departure that lacks any agreement whatsoever in this regard, Article 24 would not apply. As a precautionary measure, the WTO has therefore stressed the need for a prior agreement. In addition, the other WTO members must be convinced that the negotiations are being pursued seriously - otherwise they can demand changes. For this reason, no country has made use of the Interim Facility since 1995. A stopgap solution can therefore hardly be expected, even though Boris Johnson likes to refer to this possibility.

5. New Brexit referendum

The new British government adamantly rejects a second referendum, hence a renewed public vote on the issue is not one of the immediate possibilities. But the more the situation becomes deadlocked, the more likely it is that the people will be asked again - even under Boris Johnson.

And now?

Even though Boris Johnson likes to trumpet the threat of a hard Brexit, analysis shows that even with this option there are some daunting hurdles to overcome. As long as the majority of the House of Commons is against an unregulated withdrawal from the EU, Johnson will grind his teeth out just like his predecessor. In principle, the options remain the same. Of those discussed above, the most likely scenarios in our opinion appear to be a change of the withdrawal agreement, new elections or a new referendum.

Pound Sterling getting pounded

Since May, the British currency has shed more than 8% of its value against the US dollar. The pound's losses against the Euro are of the same order of magnitude. The reasons for this swoon are easy to ascertain: initially, the prospect of having Boris Johnson as Britain's new British Prime Minister weighed on the currency, followed later by his actual confirmation, and finally by the sharp rhetoric coming from Downing Street. With the weaker pound, the forex markets are reflecting the increased probability of a hard Brexit and the associated risk of a severe recession. However, VP Bank

continues to regard a soft Brexit as the most likely scenario. Were that ultimately to be the case, the pound would appreciate significantly against all major currencies. Nonetheless, given the potential for unforeseen turnabouts, the exit process unfortunately remains unpredictable.

Summary

Our analysis comes to the conclusion that the hard Brexit threatened by Boris Johnson will be very difficult to implement. The Prime Minister simply lacks the necessary parliamentary majority. The House of Commons has already successfully fought several times against a hard break with the EU. Thus the new head of government will presumably face the same fruitless fate as his predecessor. It follows that a soft Brexit is still a realistic scenario, in which event the British pound would have considerable upside potential. However, as the situation remains in flux, pound investors should review their degree of loss tolerance if a hard Brexit were indeed to transpire.

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