



Conference Call – May-in-the-Middle: A precarious place for the UK prime minister

This was meant to be a feel-good week for UK prime minister Theresa May: Cabinet agreement on a Brexit position done and dusted, then standing shoulder to shoulder with other European leaders at the NATO summit, hosting the US president afterwards, a projection of Great Britain looking great post-Brexit. And Mrs May, dare one say it, looking strong and stable at last.

However, rather like May's snap election in 2017, it has all gone a bit pear-shaped. Two senior ministers – Foreign Secretary Boris Johnson and Brexit Secretary David Davis – resigned, saying the prime minister had gone too soft on Brexit. Then two vice-Presidents of her Conservative Party followed suit. There was a backbench rebellion of Conservative hard-line Brexiteers angered at last Friday's Cabinet compromise on the government's proposed Brexit negotiating position with Brussels. A revolt repelled, for now, but far from quelled; there is talk of a leadership challenge if May does not toughen up her line on Brexit.

There has always been two Brexits. The one being negotiated in Brussels by the EU – a technical, second-tier negotiation about the United Kingdom settling up its membership account as it goes out the door. And the other one – an existential battle for the soul of the governing UK Conservative party, which has long been divided over Europe.

This week has brutally laid bare that division – and the fact that no faction has sufficient strength to vanquish the others, but all are strong enough to survive. With just nine months to go until the Brexit deadline of March next year, business and investors, too, are staring down a ticking clock and becoming vocal about the cost of the uncertainty. Just yesterday (July 10), JP Morgan chief executive Jamie Dimon said the economic damage of Brexit could be sufficiently severe to dent global growth. His bank, like many other businesses, is relocating staff, operations and investment away from the United Kingdom.

Has the momentum for Brexit changed this week?

In the past few days, we have seen a firming of the view that Theresa May is headed for a softer version of Brexit that most of her colleagues can stomach. What we know so far comes from a three-page Chequers statement. The 120-page White Paper (due for publication July 12) will have a lot more detail and, as we know, the devil is in the detail. What we have so far is a partial picture that gives a good of the direction of travel. Let's not forget that this is a proposal from what was clearly a divided British government rather than a deal, and it may well not survive even first contact with the EU.

The most notable thing from the Chequers statement is that the United Kingdom is proposing that it would maintain a common rulebook for all goods, including agriculturally-based food, with the EU. The phrase 'common rule book' sounds very collaborative but what it means, in effect, is that the United Kingdom would agree to take on the rules agreed by the EU. The difference would be that in theory, parliament would have the right to reject them, but as the Chequers statement makes clear that rejection would have consequences.

Those consequences are fairly obvious: if you do not follow all the rules and regulation of membership of the single market for goods, then immediately your idea of frictionless trade takes on some friction. There are potentially some checks to be done on borders and that is when it spells big problems for business and big problems for the idea of no hard border in Ireland. Parliament under the British plan would have the right to reject specific rules or regulations. Take the example of Norway, which is a member of the single market through membership of the European Economic Area (EEA). Its parliament has the right to reject specific rules and regulations, but it has never chosen to do that because of the implications of what it would mean for Norwegian access to that market. Other things we learnt from the Chequers statement that are going to raise eyebrows and knot brows across other parts of Europe in terms of the legal underpinning of any agreement, is that the United Kingdom is proposing what it calls a joint institutional framework which would be done by British courts in the United Kingdom and by EU courts in the EU. There is a certain nod to the overall powers of the

European Court of Justice (ECJ) but the specific role of the ECJ will continue to be - as it has been since the referendum - something that provides many problems in the different ways that the United Kingdom and the EU understand the relationship that they are trying to forge.

Then there are the proposals on the customs union. We know that there were previously two UK proposals, neither of which the EU particularly liked. One was for a customs partnership and another one known as the maximum facilitation option essentially using technology to remove border checks and to remove physical infrastructure as much as possible. The new proposal or 'third way' is a combined customs territory for the United Kingdom and the EU, which the UK government calls a facilitated customs arrangement. The United Kingdom would charge EU tariffs on goods entering its territory if it thinks those goods are moving on to a EU member state. A lot of businesses feel that it would not work, and a lot of people in the EU are sceptical about how it would work. There will be a lot of argument ahead as to whether that is a realistic option.

Looking at Boris Johnson's resignation letter is interesting. One thing he does not like is the idea of the common rulebook on goods. He says that it seems to him that the opening bid of our negotiations is accepting that we are not going to be able to make our own laws. Sadly for Mr Johnson, this has been clear to many people for two years and more. However, it is not what he promised people in the referendum campaign when he headed the Leave vote. His argument was that it was going to be simple: his political problem now is that his slogans are running up against a complicated reality. He also does not like the idea of this new customs arrangement which he said would be "impractical and undeliverable" something which people on the European side of the argument might agree with.

He also talks about his concern about further concessions on immigration. He has always been clear that he is a pro-immigration politician. The Chequers statement says very clearly that the free movement of people will come to an end. People like Mr Johnson and his supporters fear that things like the free movement of people will be up for bargaining in the negotiations. If the United Kingdom wants as much freedom of movement for services as possible -- and we know that services account for up to 75% of the UK economy -- then in return, the EU will be seeking as much freedom of movement of people as possible. Once again this does not feel like the taking back control of sovereignty that Mr Johnson and other prominent members of the Leave campaign promised their supporters. There is certainly scepticism within the cabinet still, but those who were most sceptical have already resigned. There is going to be scepticism on the EU side, and the public debate in the United Kingdom is becoming increasingly fractious.

It is interesting to note that the Daily Telegraph, the bastion of the Tory shires, said that its post box has been filled up in the past few days like almost never before by people furious with what they see as a betrayal of what they were promised in the referendum campaign. We are back to this deep division with the Conservative Party about Europe and whether you can possibly deliver a Brexit that means anything at all.

How does the EU see the Chequers statement?

From the EU's perspective, the Chequers statement is a step in the right direction but not quite far enough. Several leaders have cautiously welcomed the greater clarity. German Chancellor Angela Merkel said that the proposal was a "solid step forward" and Irish Prime Minister Leo Varadkar said the EU "could be flexible too" if the UK government softened some of its red lines.

However, from the EU's perspective, there are two main problems with the proposals. First, for the EU it looks like cherry picking. The EU has maintained since before the negotiations even started that its four freedoms -- freedom of movement of goods, services, capital and people -- are inseparable. What the United Kingdom wants to do is essentially to stay in the single market for goods but not services and also restrict the free movement of people. For the EU, maintaining the unity of the single market is one of its top priorities in the negotiations. Even for large member states such as France and Germany, preserving this unity is much more important than close trade relationships with the United Kingdom.

Second, the proposed facilitated customs agreement would be a bureaucratic nightmare and allow traders to undermine the tariff systems of both the EU and the United Kingdom. If, for example, the EU charged higher tariffs than the United Kingdom, traders could send their goods first to the United Kingdom and then cross the border into the EU. The only way to prevent this would be to track the movement of every single import.

Another problem is that it would impose costs on the remaining EU member states, as they would have to apply UK tariffs to goods entering, for example, in Rotterdam that are destined for the UK market.

The idea that technology can avoid the need for border infrastructure is an illusion. There is no border in the world between two countries that are not in a customs union that does not have any infrastructure. Even the border between Switzerland and its EU neighbours is not 'frictionless'. This means that contrary to what the UK government said in the Chequers statement, its proposal would not solve the Irish border issue. It is also worth noting that remaining in the customs union but not in the single market would not avoid the need for border infrastructure. If the United Kingdom left the single market, its product standards could diverge from those of the EU. That means that there would have to be some checks.

The next question is how the EU will react. There are a few concessions in the Chequers statement that the EU will find encouraging. For example, the government accepted that there would be a backstop arrangement for Northern Ireland. This is quite an important concession. However, for the EU, the fundamental situation has not changed. It is still a question of whether the United Kingdom is going to remain in the single market and customs union (i.e., the Norway option); and if not, where the border infrastructure is going to be -- either at the Irish border, which is unacceptable for the EU, or in the Irish Sea. The latter would create problems for May, but the EU considers that a domestic UK problem that it would be up to her to solve. The UK government has tried to fudge the issue, but it comes down to this fairly simple choice. The United Kingdom will have to recognise that at some point.

At the same time, the EU is not interested in a weak or unstable UK prime minister who is not able to push through at home what has been negotiated in Brussels. The Chequers agreement has come at a high political cost for May. The EU will probably be reluctant to criticise it publicly before all the details are known with the publication of the white paper. In the negotiations they will definitely ask for more concessions: the main areas will be the unity of the single market; the freedom of movement for people; and, of course, the Irish border issue.

From the EU's perspective it increases the likelihood of both a soft Brexit and a no-deal Brexit. The soft Brexit, or the Norway-style model where the United Kingdom would remain part of the single market, would be the easier solution to the Irish border problem. The EU may try to incentivise a move of the United Kingdom towards that option by repeating that it would agree to revisit its red lines if the United Kingdom revisits its red lines. We could see a bit of rhetoric trying to nudge the United Kingdom towards that model. At the same time, if May cannot get her party to support any further concessions then that makes a no-deal Brexit much more likely.

What the implications for domestic politics in the United Kingdom?

There are three scenarios: First, May is deposed as leader and a pro-Brexit leader is installed before the European Council Summit in October; second, May's Chequers plan is fundamentally re-written and the direction of travel changed towards a harder Brexit; third, May carries her agreement through EU negotiations and to the European Council in October. The third scenario is the most likely. May will probably get through to October.

Scenario One: A key question is whether Theresa May's leadership is safe enough to withstand a continuing drip feed of resignations that are likely to continue. The majority of Conservative MPs voted to Remain in the referendum. MPs are split: 185 voted Remain and 138 voted Leave. There are 141 Conservative MPs on the government payroll which includes a lot of junior ministers. The Leavers are a minority sport in the Conservative parliamentary party but a significant minority. One way to analyse this is to look at the membership of the European Research Group (ERG), headed by Jacob Rees-Mogg, which has consistently petitioned for a hard Brexit. In March, there were 62 active members of the ERG, there are now over 80 Conservative MPs. There is certainly a case for believing the number of those that support hard Brexit has increased since Chequers.

The rules of the Conservative Party require 15% of the Conservative parliamentary party to petition for the leader's resignation – which would be 48 Conservative MPs in May's case – before a confidence vote is called. May's critics have the numbers to force such a vote. But to oust her, 50% (158 Conservative MPs) would need to vote that they had no confidence in their leader. What we can say with 90% certainty is that the number of those in favour of removing Theresa May immediately is somewhere between the 48 needed to force a no-confidence vote and the 158 needed to win such a vote.

Scenario Two: Davis and Johnson's resignations were largely seen to damage the internal power of Theresa May. The steady drip of resignations from the government is designed to do the same. However, these resignations are also an acceptance of intrinsic weakness: the MPs have the numbers to make May uncomfortable but not – at least before summer – to change course.

Next Monday and Tuesday the government is introducing a Trade Bill: necessary legislation to provide for legislative continuity after March 2019. This will be an opportunity for Eurosceptic MPs to table amendments that express their discontent – there is likely to be around 80 MPs expressing discontent on May's proposals to pursue regulatory alignment on areas such as goods and agriculture, which the government is hoping will ameliorate some of the economic risks. For now, this holding pattern (with potential further resignations) is likely to persist but no definite push in a different direction.

Scenario Three: May carries through until October. This is made more likely by the fact that Europhile MPs in the Conservative Party had tabled a series of amendments calling for membership of a customs union with the European Union and they are going to stand away from those amendments now. They are going to wait to see how the direction that May is going in plays out now she has the support of the pro-European members of her party. What the Chequers agreement did do is to secure collective cabinet responsibility and enshrined that within the Brexit process, so it is hard to see internal dissent within the cabinet coming to much. The Brexit White Paper setting out the government's strategy is due to be released on Thursday and will bake in May's new strategy. The unviability of the agreement as it has been set out makes no deal more likely but the conservatives MPs do not want no deal, nor do MPs in the House of Commons as a whole. When we polled MPs, we found that 70% of them did not believe that no deal is better than a bad deal.

One way this could play out is by May trying to forge cross-party links with pro-EU members of the Labour Party by asking them to vote for the final deal when it comes back. That would only be possible if there were a significant softening in membership of the EEA and the customs union. The other option is a move towards extending the process of Article 50 or extending the transition both of which are contentious within the EU.

The United Kingdom has a fixed parliament so if May was ousted as a leader of the Conservative Party, the United Kingdom would not automatically go to a general election; it would just get a new prime minister (though there are parliamentary mechanisms for a new prime minister to call an immediate election should they so choose).

It is likely that May will get through to March 2019. But 2020 is a different question: Eurosceptics in the Conservative Party think that they can change the direction of Brexit after March 2019 and that would mean changing the leader then.

The clock is ticking for investors. What advice is there for business?

On the most immediate front since Chequers and the resignations, sterling has been reasonably stable as markets wait to see. The business case for Brexit clarity has been amply made in the last months. There has been enormous pressure on the government around the consequences of a no-deal Brexit for the UK economy and investment prospects. Business is making it clear how it would work as we know from the economic data that has been served up in the last couple of years. May is not a strong economist but she is strong enough to understand that scenario. The whole process of how May called the Chequers meeting somewhat coordinated with that pressure and it is likely that important people in the Conservative Party engineered it. Possibly the resignations were provoked. The people who have come in have set the tone towards a soft Brexit. We should not be in any doubt that the May cabinet is inclined that way. Before she shifted position a lot, and it was not clear. We now have the pressure from business and the signs of investment failing if it is not made clear what is happening and if we do not get the soft Brexit, there would be more damage.

We have also seen the latest economic numbers. Weather severely damaged the first quarter so a bounce was expected. There has been a bit of a bounce through to the month of May because of the weather and the Royal wedding, but it is a mediocre pickup and not enough to claim that the economy is moving ahead. It seems more likely that we are going to see a very weak year for the economy, maybe struggling to achieve 1% growth for the year as a whole. These lackluster prospects must be part of the cabinet discussion. Philip Hammond has been quiet, but there must be discussions going on as rising inflation increases the pressure to raise rates and, on the other side, there are concerns about falling investment. We are not out of the woods on the economic numbers, and there will be more pressure that will contribute to the view that hard Brexit will be bad for the economy. Ultimately, it will affect job prospects. We have a way to run, but you can see the pressure building. The direction of the cabinet will be pushed further by the pressure that has built in recent weeks. The timing of the slowdown of the economy has been debated by both sides but it is

undeniable that the pressure on the economy has got worse as there is not any clear agreement. May is not in denial that there are problems. These factors will come to bear even more in the next six months, especially if she does not get any agreement in the autumn.

How strong is the voice of Philip Hammond in the cabinet?

His in-private weight has improved quite a lot if only because there is more backing for economic problems and the weight of business wading in. He has been quite careful not to show his head above the parapet but in private his credibility has moved upwards. He needs to find the money for the National Health Service as they know in the treasury that there is not the money to fund the increase in the health service unless there are tax increases. May is not so disinclined to look at economic evidence. In the melee of how you handle Brexiteers, the Party and Brexit negotiations it may not be something that you want to slam on the table but there are signs that there are more pressures within cabinet and the way that May is steering this process, the pressures have grown. Hammond has more sway than he had a couple of years ago.

Is the EU maintaining a disciplined unified front or are rifts opening up?

We saw an interesting rift last week in Germany when interior minister Horst Seehofer went against the government line and said that continuing co-operation between the United Kingdom and the EU should be the highest priority. The German representative to the EU stated that it was not the government line and that this comment should be ignored. Overall, Seehofer's comments need to be seen in the context of the German power struggle. This is one rift that we can ignore.

There is remarkable unity in the EU although we do not know what is going on behind closed doors. Publicly they are maintaining unity, but behind closed doors, there may be more pressure exerted on Ireland to accept whatever is on the table as that is the main issue holding up the withdrawal agreement. No deal is in nobody's interest as we get closer to the end of the year and the deadline. In the trade negotiations, we could see more rifts as the different priorities of member states come to the fore: Germany will be more concerned about exports; Eastern European member states will be more concerned over freedom of movement. But at the moment the unity still holds.

Overall the United Kingdom's big gamble is that it can persuade the EU that its commitment to its rule-based systems can somehow become flexible particularly regarding the four freedoms of the single market: goods, capital, labour and people. One of the big problems for the United Kingdom is that it is trying to urge flexibility in the rules-based system just as the EU sees the entire rules-based system under attack both from without by people like US President Donald Trump and from within by people like Italian Deputy Prime Minister Matteo Salvini and Viktor Orban in Hungary. The United Kingdom's timing is particularly bad. The EU is clinging to the four freedoms as it is essentially the most fundamental tenet of what makes the EU what it is. Thus, the unity is remarkable but not surprising in the current international context.

What is the difference between freedom of movement and the mobility framework included in Mrs May's compromise position?

The Chequers agreement talks about this mobility arrangement. In essence, we know that the United Kingdom is not going to pull up a drawbridge. Everyone in government knows that the UK needs people to work, study and sometimes to live here. The big question within the Brexit debate is who decides. The point about free movement is that it is not a decision that is in the hands of the British parliament or the British people because we have signed onto this larger goal. What the United Kingdom is trying to suggest is something which is not the freedom of movement but a fig leaf of sovereignty to cover that it wants some but not absolute freedom of movement of people. It wants to have control about when people can come and under what circumstances they can come. The most far-reaching view is that anyone could come here if they had a job or a place to study. That would be too much for some in the Leave camp. They want a stricter system with more restrictions on exactly who could come. They want to restrict more of the lower-paid workers from coming over. Businesses would argue that they are the people who keep the construction and fruit picking businesses going. There is an irony that if we end up with a more restrictive immigration policy than the rest of Europe, it would be almost certain that we would have to liberalise immigration policies from the rest of the world and reopen programmes like the seasonal agricultural programme that was closed down when we joined the EU.

A general election is unlikely

We do not know with any certainty what people's position on Brexit would be in the context of a general election. As it stands at present if a general election was forced as a result of a no deal you could see a situation where Labour's ambiguity would mean that they would make further gains sufficient to force a hung parliament. You could have a scenario where Labour would need the support of the Scottish National Party and the Liberal Democrats to break the impasse. Labour's reliance on those two parties would make a second referendum more likely. The Labour Party has said that is not calling for a second referendum but it has not ruled it either. It is open to an election in which there might be no overall winner but after which it would be reliant on these two small parties to get into power.

Are the Ulster Unionists expressing any particular views beyond the Irish border questions?

They are flexible on the broader outcomes of Brexit. They cautiously welcomed the Chequers agreement. Their priority is that there should be no hard border between East and West. They do not have many red lines on what type of Brexit the United Kingdom should pursue.

The question of services is crucial. Will the United Kingdom's regulatory regime look very different?

The idea of maintaining harmonised rules for goods but leaving services out is an oddball one. The whole problem of the Chequers approach is that it may be an intermediate step which is why markets have not reacted. This step has forced out a couple of Brexiteers from the cabinet. If May is allowed to continue and follow her form of Brexit, there will likely be compromises ahead like allowing more freedom of movement in exchange for concessions on services. This is the first step in the direction that May would like to take. Financial services have been working through a lot of solutions themselves. Banks are relatively composed about the process in terms of comments and reactions, although Jamie Dimon went further than most. Will the collapse of various industries be the agent provocateur for the economic overspill? The new few months will show us if May can pursue a certain line and what that line will be. What is clear is that the EU is moving forward with certain changes by putting out the welcome mat for financial companies. Some of these changes will go ahead anyway.

In terms of financial services, which cities will be the winners from the move out of the United Kingdom?

They have all been getting part of the pie for some time as there have been pressures on the City of London for some time. We have seen some movement of back-office operations to Dublin and that will continue as it is more cost competitive than London. The move to Frankfurt has been driven by the presence of the ECB there. The case for France is more strained. Dublin and Frankfurt will continue to benefit. Paris is the swing market. Paris stands to gain from a hard Brexit but if May can get a soft Brexit, Paris is less likely to benefit.

Where will we be in March 2019? Will we have a deal? If not what are the prospects for extensions? Are there any alternatives?

It is important to remember that there are several layers of negotiations. The whitepaper coming out on Thursday is named 'The Future relationship between the United Kingdom and the EU.' The future relationship will be negotiated long after we have left the EU. The ambition is to have a broad political declaration on the relationship ideally by October possibly not until December which will not have any legal force; it will then be negotiated in detail and turned into a trade agreement during the transition period and beyond. The pressing issue at the moment which is where we are going to be by March 2019 is the withdrawal agreement which is essentially tying up all the loose ends from the past. That has been pretty much done on the financial settlement; both sides say that it has sort of been done on the rights of citizens in the future although many of the citizens involved have many concerns still. The big problem is still the Irish border and how to ensure that if there is no agreement in place there is some sort of backstop to ensure that, whatever happens, the border continues to be as open as it is now. What the Chequers agreement and the white paper could do is to provide enough space for agreement to be reached on a withdrawal agreement, for there to be enough ambiguity in the wording for that backstop to be agreed. The Chequers statement says that the UK side believes that what it has proposed will ensure that the operation and legal text will agree on the backstop solution but also that it will never need to be brought into effect. That will allow it to be sold to suspicious Brexiteers. The EU will see it rather differently. It will be presented to different audiences in different ways. The white paper that comes out this week may create the political space to move us towards what needs to be done by March next year which is a withdrawal agreement because without a withdrawal agreement there is no transition. Without a transition then next March would be the cliff edge that many people fear. How do we calculate when time has run out? The United Kingdom has started contingency planning. At what point next year do people start pressing buttons. What do we need to do to ensure that planes are

still insured to fly and medicines can be traded between the EU and the United Kingdom? The alternative is an extension of Article 50 period which would need to be approved unanimously by the EU. One would presume that it would need to emerge from a request from the UK government. Given what would be at stake the EU 27 countries would not block an extension if there is a crash-out scenario. There is a legislative debate about whether that is possible.

Would the EU agree to extend Article 50?

This would require unanimity among the EU27, and they could ask the United Kingdom for concessions. Also, Brexit is not a priority for them; it is something that they want to get done so they can focus on future-oriented issues such as EU reform. Another option would be for the United Kingdom to unilaterally revoke Article 50 with the intention of triggering it again shortly afterwards. It is not clear whether this is possible under EU law and legal experts disagree on it so it would probably have to be settled in front of the European Court of Justice. It would avoid a no deal Brexit but for the EU, it would come at a very high cost. If the ECJ ruled that Article 50 was revocable, any member state could use the threat of triggering it as leverage in negotiations.

The domestic politics of an extension?

It is tough to see this happening and politically difficult. The Withdrawal Bill that just went through parliament is sacred to Brexiteers. It would require quite a political reversal to happen: a mea culpa or a change of leadership.

Could the Conservative Party split into new parties over Europe, and might a pro-EU centrist grouping of MPs emerge in Westminster?

It is very difficult to envisage a new permanent centrist party forming over the issue of Europe. It remains unlikely any more than a couple of pro-EU Conservative MPs will vote against the government's final deal. The strategy of pro-EU Conservative MPs is to shape the agreement before the vote, in the hope of avoiding the sort of rupture that voting against the agreement would cause.

There is also huge reluctance for practical reasons, and a belief the rules of British politics make the barriers to entry too high: new parties do not have access to the resources (including money, and constituency data on voters and party infrastructure) that would be needed to make a new party work electorally.

It is far easier to foresee a splinter on the right of the Conservative Party: Eurosceptic MPs are more likely to vote against any deal that the government makes with the EU, and the UK Independence Party (UKIP) could overcome many of those practical hurdles described above.

How different an approach to Brexit would a Labour government take?

A Labour-led government would have a different approach to Brexit, though the differences are more subtle than the Labour leadership often imply. A Labour government would pursue a customs union with the EU, which would be tangibly different to the customs arrangements than Theresa May is proposing and would create a great deal more certainty on customs.

The internal pressures on a Labour government would also be different. Instead of attempting to placate Eurosceptics, the instincts of a Labour government would push the party towards greater flexibility and concessions to the wing of their party that favour single market access and a second referendum. It is, therefore, likely it would put greater priority on services access to the single market than it would on controls to freedom of movement.