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Speeding Toward Brexit, Some Off-Ramps Emerge: A Dialogue with Lord Kerr

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admin

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The Brexit clock is ticking as the United Kingdom's departure from the European Union (EU) is set to take place in March 2019. But is the UK ready to leave? And is there still a chance it won't? In our latest "Talking Markets" podcast, we hear from Sandy Nairn, Templeton Global Equity Group chairman and Edinburgh Partners CEO, and Lord Kerr, former diplomat and current chairman of Scottish Power and crossbench member of the House of Lords. Kerr also happens to be an author of Article 50 of the Lisbon Treaty, which outlines steps a country must take to leave the bloc. They discuss the implications of Brexit from a political and market standpoint.

Tune in to hear more in our latest "Talking Markets" podcast.

TALKING MARKETS WITH FRANKLIN TEMPLETON INVESTMENTS

Here are some highlights of the views of speakers represented in the podcast:

- **Sandy Nairn:** There doesn't seem to be a clear political majority that suggests Brexit is what the UK wants. It seems to be the product of elements of factionalism within each party and the obvious frictions between the two parties, where the UK could exit without a satisfactory set of arrangements.
- **Lord Kerr:** Public opinion on Brexit still sharply divided, and the opinion polls show now that if the referendum happened today, those who didn't want to leave would win. The argument for a second referendum is that the kind of deal which is emerging is not what the country was told in 2016—shouldn't the country be consulted again?
- **Sandy Nairn:** When you look at Brexit and if you look at why the US would say Brexit is a good thing, to an extent, Brexit weakens our competitive trading bloc. But all economic theory, all history tells you that the more free trade you can have, the more you can grow the global economy, and the better it is for everybody.
- **Lord Kerr**: I think it is quite likely that the 27 continental countries in the EU will be saying to us in October-November, 'don't you guys need more time?' It might be just time to negotiate, or it might be time for an election.

The full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton.

I’m your host, Richard Banks.

Ahead on this episode, potential implications on financial markets from the ongoing Brexit debate. Lord Kerr, a former diplomat who drafted legislation that he never imagined would be used by his own country, takes us through five different scenarios, including the chances of the UK not leaving at all. Plus, Sandy Nairn, Chairman of Templeton Global Equity Group and Edinburgh Partners chief executive, looks at how Brexit fits into a number of global factors for investors right now.

Richard Banks: Gentlemen, welcome to “Talking Markets.” Thank you for joining us. Lord Kerr, you are a former ambassador to Washington, you are the UK’s permanent representative to the EU. Significantly for our conversation today, you were also one of the authors of Article 50, which sets out the rules for leaving the European Union, and you are of course a member of the House of Lords. Plus, you serve on the investment advisory board for Edinburgh Partners. We will get into some of the detail in a minute. But first, for the benefit of some listeners who may not be completely up to speed, can you just explain what Brexit is?

Lord Kerr: Well, we have a rather odd situation in Britain in that we stumbled into a referendum on whether we wanted to be in the European Union by accident. Our then-prime minister promised one, in the firm view that he would never have to fulfill the promise, and then, what a surprise, returned to Downing Street and found he had to. He was still quite confident that he could win it. I was on his side, and we fought a very bad campaign and we lost it 52-48 in summer of 2016. There was no plan for leaving the European Union. There was nothing to take off the shelf because the government had been confident that it would win the referendum. David Cameron left and his successor, Mrs. [Theresa] May, who had believed that we should remain in the European Union— as did 80% of conservative members of Parliament—has the luckless task of carrying out the will of the people as expressed in June 2016.

It has taken the government a very long time to work out what relationship it wants between a Britain outside the European Union and the European Union that would be left. Public opinion is still sharply divided, and the opinion polls show now that if the referendum happened today, those that didn’t want to leave would win by about 8 or 9 points, 54-46 or thereabouts. But that’s an academic question because the government doesn’t intend another referendum. So, what you have is an interesting conflict between direct democracy—a referendum, which we don’t do very often in this country— and parliamentary democracy.

The House of Commons (that is taking the two parties together) about 70-75% are in favor of remaining, so it feels bound to carry out Brexit. The government has produced a plan rather late in the day, and it has been rejected by the hard right in the Conservative party who think it’s too soft. It’s been rejected by Brussels as not negotiable, and of course my side, the House of Lords, doesn’t matter very much, but there is a strong majority of Remainers in the House of Lords. We think the whole thing is a bad idea, and it would be better to stay inside. So, there is a very serious political muddle and bit of a crisis coming up this October or November.

Richard Banks: Sandy, could you tell us little bit about why the Brexit is significant for financial markets?

Sandy Nairn: I guess there are two or three obvious observations and it goes in part to the heart of the debate. There is the economic argument about the benefits of being within a union of frictionless trade or close to frictionless trade. The economics that underlie that are effectively unarguable unless you take the stance that you could create the equivalent without being in that union, which is a geopolitical question. It seems rather fanciful to suggest that one can, if you look at the trade negotiations going on in the world at the moment. So, the first financial market implication is that for a whole range of businesses who have setup themselves in terms of their supply chains, in terms of their distribution, on the basis of a frictionless market, if friction gets introduced, then it puts up costs and will reduce profitability. So, that's the first piece. The second piece is that, as Lord Kerr mentioned, the political will that lies behind this. It doesn't seem to be a clear political majority that suggests this is what we want. It seems to be the product of elements of factionalism within each party and the obvious frictions between the two parties where you could end up exiting without a satisfactory set of arrangements. But, as important, those frictions could easily cause a general election, which in itself has raised the probability from a very slight possibility to a meaningful possibility that you could have a Labor government elected. And if you take, at face value, the Labor government's economic manifesto, it's effectively a return to the manifestos of the 1970s in terms of public ownership, controls, regulation, taxation. None of them are positive for financial markets, for employment and for economic growth.

And that's just specifically for the UK. There are obviously wider implications because this is a manifestation of some of the things that are going on globally because the other argument where we started was a lot of this, it seems to me, is about some of the scare stories on migration and the long-term issue we have had on wage growth, but I'll leave those to the side. But, profound implications for the UK economy if this were to happen, in terms of frictionless trade, and even more profound in terms of a change from a more capitalist market to one with much more regulation, control, higher marginal rates, tax and all that goes with that.

Richard Banks: The process for leaving an institution like the EU is complicated. We can't just stop being a member. Could you talk us quickly through the protocols and explain some of the challenges for both sides in the process for leaving?

Lord Kerr: There is a procedure in Article 50 of the Treaty, which as it happens, I drafted. So, I'm reasonably familiar with it. I didn't think we would be using it. The passages of procedure for divorce, it's a procedure for settling a debt, it deals with the past, it doesn't deal with the future. There is no possibility that we shall have negotiated a future arrangement between the UK and the EU if we leave in March of next year as is the government's current intention. It is possible that we won't even have a divorce agreement because, of course, if we leave the European Union, if we stop paying our subscription, if we don't turn up at meetings, we could do that anyway; we don't have to go through the treaty procedure. It would be a great mistake not to but there are those, mainly supporters of the Conservative party, who think we should just walk out, we shouldn't pay our debts. These are people who tend to believe that Europe needs us more than we need Europe, and that our hand is very strong because they have a positive trade balance, at least in goods, with us, and they will need to maintain access to our market. This would actually be a very bad course. This is the hardest of hard Brexit, which is supported by a minority in the Conservative party and by the extreme right, anti-immigration party, the UK Independence Party.

I don't think this is what will happen, but it might. If it did happen, then because we were not honoring our debts, the commitments we entered into while we were members, there would be no agreements of any kind between us and the European Union, and all sorts of dramatic things would start to happen. The planes would stop flying, there would be queues at the frontier, food shortages and so on. Therefore, I think it probably won't happen, but that's conceivable.

There is a possibility in Article 50 of the Treaty to extend the negotiating period beyond two years. I think it is quite likely that our European Union partners who don't particularly want us to go—in fact, they don't want us to go—and are now alarmed that the negotiations have gone so badly, and alarmed at the risk of Britain crashing out with no due, which I argue would be very bad for us, worse for us, but it would actually be bad for everybody. And there is that positive trade balance that continental Europe has with us. Nobody wants a crash-out scenario. It could happen by accident, but I think it is quite likely that the 27 continental countries in the EU will be saying to us in October-November, 'don't you guys need more time?' That's possibly Number 1. It might be just time to negotiate, or it might be time for an election.

I think for Mrs. May it would be quite difficult if she comes back with a deal which the House of Commons rejects, or she comes back with no deal and the House of Commons rejects, leaving with no deal. In that situation, I think either she resigns, or more likely, she seeks a more compliant parliament, so she takes her case to the country. So, first possibility: an extension. Second possibility: election. Third possibility: this may seem very fanciful, but the chances of it are rising, that we have a rerun of the referendum. That would require an extension because we would need to pass a referendum law, have a campaign. We can't have a second referendum before next summer, but the argument for the second referendum is that the kind of deal which is emerging is not what the country was told in 2016—shouldn't the country be consulted again? That's the argument of people like me—I admit—who think the second referendum is not a bad idea.

I have no idea whether the second referendum produces a different result from the first one—it might simply confirm the first result—but, I think the chances of a second referendum have now risen to about 20%, maybe 30%, and they are clearly rising all the time because it is clear that the failure to define what "leave" would mean is now resulting in difficulties in securing a negotiating position. Also, a disappointment in the country, disappointment for "hard Brexiters" or disappointment for soft, somebody's going to be disappointed.

There are two more possibilities which I rather alluded to. One is that she brings back a deal that is better than I have described, and the House of Commons votes for it, and we leave in March next year. Or, there is a bust-up, she brings back no deal, and I would be surprised, but she might recommend we leave with no deal. The hard Brexiters get what they want. I think that's a little unlikely, but I think there is your menu. Five possibilities could happen. The odds on political turmoil in this country in October-November when she brings back or doesn't bring back a deal are now quite high. And, I think the odds on that turmoil continuing and the continuing period of doubt because of extended negotiations—bad for the economy because doubt always is, I think the odds on that are rising.

Richard Banks: Tell me a bit more about the odds of the UK staying in the EU. You put it there at 20%. That seems pretty high given where we are, can you perhaps delve in to that a little bit more detail for me?

Lord Kerr: Well, start by thinking about the interests of the 27; they would like us to stay. They know that we can withdraw our notification of the intention to leave at anytime, and they know they can't extract any price from us for staying. If, before the end of the negotiating period or any agreed extension of it, we change our mind, then we would never have left, so the terms of our membership couldn't be changed except with our consent.

The top subjects on the European political agenda don't include Brexit. The top subject is immigration, second top subject is President Trump and trade-war threats, third subject is President Putin at different times of war threats, a very serious concern if you're at least European, in say, the Baltic States, the Czech Republic. Then there is a battle about values between rather right-winged totalitarian governments in Poland, Hungary, Slovenia and a new force in Italian politics—the Northern League, Salvini. The crisis is a British political crisis, it's not really an EU crisis. By the way, nobody else is going to follow the British out of the European Union. That's one very good thing we have done for the European Union. They've watched how problematic this position of the British is as they discussed the European Union.

Richard Banks: Sandy, a number of those scenarios that Lord Kerr outlined there, I guess, raise even more uncertainty, and as we have alluded to earlier, uncertainties are bad for financial markets. How are the financial world viewing these scenarios, and what's the way to address that?

Sandy Nairn: So, I think there's probably the general and the specific. I think Brexit sits in a fairly long line of areas where markets are exceptionally sanguine about the potential consequences. I think there's been so many threats, so many debates over trade, tariffs, globally let alone Brexit, so whether you take NAFTA or Asia, and what markets often do is they look at what's happening in the economy now and equate it with news now as opposed to what the news now does is generates events in the future. So, because earnings have been going up, the cost of money, although it has risen a little bit is still close to zero. Inflation, although rising, is still relatively suppressed. It feels like a very benign environment, and they are treating all of the stuff as noise, but it's not noise, it's profound. It's not helped when you look across the Atlantic, and the leader of the free world generates threats almost on a daily basis and people think this doesn't mean anything, but there is a danger that one of them does get carried through.

When you look at Brexit and if you look at why the US would say Brexit is a good thing, to an extent, Brexit weakens our competitive trading bloc. If you are the largest economy and political power in the world, if you can weaken those with whom you trade and pick them off one by one, that seems to make a lot of sense, but the problem with that is it treats the world as a zero-sum game and it isn't. All economic theory, all history tells you that the more free trade you can have, the more you can grow the global economy, and the better it is for everybody. So, my short answer is I think markets are sanguine because current conditions look good—low cost of money, growth—isn't that wonderful? But take the Brexit position aligned with what we discussed before about potential change in administration and suddenly your fiscal position is going to worsen, your fiscal position worsens against the backdrop with the real yield in government bonds is still close to zero. That's not an attractive proposition, and then all the instruments that are priced off—the so-called risk-free instruments—you have to look at the credit spreads against them. So, I think markets are sanguine and the dangers are sanguine in some cases in a number of asset classes from a, best you can say is not a cheap position. And then within the equity market, if you look it, you pick the UK equities, the UK equity market doesn't really mean anything as a concept. The majority of earnings come from abroad. You really need to get very specific on which bit of it that you are actually talking about, which company you are talking about and how does that specifically get affected. But it is very hard to see a segment that will necessarily be positively affected.

Richard Banks: There's a fixed deadline for Brexit—the 29th of March 2019. What can we expect to happen on that day given all the scenarios that you have outlined, all the negotiations that are still to happen or the considerations, Lord Kerr, what do you think will happen on the 29th of March 2019?

Lord Kerr: Well, it rather depends on which of my scenarios we're in. If it's a very "hard Brexit," an absolutely no-deal Brexit, the British not paying their debts, then I do think that there will be a serious disruption. I think that the effect on finance in the UK would be quite sharp, but I'm not predicting that one because it seems to me to be unthinkable that any British government would actually allow that to happen. And I also argue that the 27 don't want it to happen either. So, if it happens, it will be because of an accident. A lot of things in history do happen by accident—more things happen by accident than by plan—but I think we can't properly avoid that one. I think nothing may happen on the 29th because I am beginning to think the sensible cause is to extend.

Richard Banks: If you were in charge of the negotiations, if you were leading the negotiations, what would your approach be at this stage?

Lord Kerr: It's a great tragedy in our national life that I left government! I think we need a bit of honesty. I think we need to have very strong communication, I think Mrs. May finds that very difficult, she is a very reserved person. She is a very serious person, and I feel very sorry for her because she didn't create this mess, she's inherited this mess, but I think she is finding difficulty in communicating to the country who hear about dirty deals of Westminster, and close battles of narrow majorities over various clauses of Brexit bills in parliament. The country is not interested in that really. The government is too caught up in the parliament thinking, and nobody is standing on the mountain top and explaining clearly in simple terms what it means. If the country is told that there is going to be an economic cost to leave, but, we, your government believe that sovereignty, full sovereignty is more important, justifies paying an economic price, well, then maybe the country would rally then, but presently the country is still being told we can take back control without paying any economic price and, a lot of the country is beginning to realize that just isn't true. So we are in a situation which the political system, for the moment, has failed. Neither of the great parties is telling the truth.

Sandy Nairn: I think from my perspective, if we go back to where we started, a lot of this is about income growth and migration. If you want to finish on a note of optimism, the note of optimism would be there is an extension, and by the time we work our way into extension, the fears of a migration have dropped because Europe has a more consistent migration policy with its external borders and the UK is able to actually say we can do the things we want to do to restrict the flow of people within the current regime. So, why would we take all these risks and leave? That needs time, but it's possible.

Richard Banks: Gentlemen, I could think of no better way than to end on a note of optimism. Thank you very much indeed for joining us on Talking Markets. And we will look forward to talking to you again soon.

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