

## A Surprise British Election Result



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The British election on June 8 produced another surprising result. We spoke with Luc de la Durantaye for his views on the implications of the result and the overall outlook for Europe.

Another election in the U.K. and another surprising result! While the Conservative Party held a strong majority the day it announced a surprise election, the June 8 results came out far from original expectations. The Conservative party won 318 seats to Labor's 261, with one district still to be declared—implying that the 326 seats needed for a majority can't be reached. The British pound lost significant ground on the news, depreciating by more than one percent. Given the pound's undervaluation, should having a hung parliament be treated as a buying opportunity, currency-wise? We do not think so.

At first glance, one could be tempted to conclude that, with the lack of a full endorsement of the Conservative Party's political agenda by the British population, these results point to the possibility that the U.K. will now aim for a soft Brexit. The lack of a full majority will likely require the Conservative government to make compromises to gain support from opposition parties. This is likely to lead them to seek the softest possible version of Brexit—something similar to Norway's membership in the European Economic Area.

However, this is easier said than done. Keep in mind that the negotiations start in just a few days and begin in the context of historically-wide trade imbalances between the U.K. and eurozone. The latest trade numbers show that the U.K.'s trade deficit with the eurozone just keeps widening, recently hitting record proportions (-5.2% of GDP)<sup>1</sup>. This is despite the pound's undervaluation against the euro.

British authorities will only agree to a deal that allows for some rebalancing on the trade front in the U.K.'s favour. Why would the EU accept? The eurozone will clearly be holding the upper hand in these negotiations.

Second, even if most EU members prove to be receptive to the U.K.'s demands, any long-term deal signed between the U.K. and EU would require parliamentary ratification in all member states. This, of course, means not only national but sometimes regional parliaments, a total of 38 votes. This increases the odds of a disorderly Brexit. Last but not least, Britain needs some sort of deal that combines market membership with an ability to respond to popular discontent. Precedent does not offer many grounds for optimism. To date, market membership for non-EU states can be secured only through membership in the European Economic Area (EEA). While enjoying membership in the single market, non-EU EEA states also accept the constituent four freedoms, including freedom of movement. Non-EU states in the EEA also contribute financially towards EU support for less developed EU states and regions. What chance, then, of making an exception for Britain?

The bottom line—it is way too early to rule out a hard Brexit and the election result sharply increases political uncertainty. The Conservatives are likely to be dependent on some form of alliance with the DUP in order to get a majority. Under such conditions, the British pound is likely to remain under pressure.

<sup>1</sup> Source: Thomson Reuters, CIBC Asset Management, June 2017

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