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Meetings are held under Chatham House rules, so that opinions expressed may be reported but not attributed. These seminar-style events typically open with short presentations from two experts, one of which is usually a member of the LSE faculty, followed by open discussion among the group.

In these write-ups, issues raised in the discussions are collected into an essay including references to relevant research and exploring some questions in more depth. The authors are encouraged to elaborate and reflect, so they should not be read as an unvarnished record of the discussion.



German and British perspectives on the political economy of Brexit

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Written up by Marcel Hadeed

Where do we stand six months ahead of the British withdrawal from the EU? How do perspectives in Berlin and London differ? And what implications do we expect for three areas that have sparked controversy in the negotiations: economic governance, the financial sector and free movement? This essay summarizes the results and contextualizes them within the ongoing debate around Brexit.

1. The British Perspective

1.1 From red lines to Chequers

As Brexit is approaching, the British political weather is moving towards a softer Brexit. Throughout the negotiations, proposals from Prime Minister Theresa May have become successively more Euro-friendly as the UK has moved away from red lines it had established early in the process. These involve its regulatory autonomy, future

¹ (On this occasion breakfast means lunch not breakfast)

contributions to the EU budget, accepting ECJ jurisdiction and unfettered autonomy in agreeing trade deals. Such limitations hinted at a Canada- or South Korea-type free trade agreement.

However, having had no success in cracking the unity of the European Union at the negotiating table – as most recently demonstrated at the informal Brexit Summit in [Salzburg on September 30²](#) – the Prime Minister’s room for manoeuvre today is severely limited. Nonetheless the Conservative government has remained steadfast in its ambition to reach a bespoke deal with the European Union. In July 2018, it published the so-called Chequers Agreement outlining its desired future relationship with the EU. The proposal is contested both in the UK and in Brussels, warranting the question what alternative arrangements are possible and how likely they are to materialize. The next section provides an overview of the domestic UK challengers and the courses of action their intervention could lead to.

1.2 Domestic Challenges to the Chequers Plan

With the Labour and Conservative party conferences just passed, party functionaries had the chance to clarify their position on Brexit and Chequers. Theresa May has long been deemed to be in weak position as the general election of June 2017 had resulted in a hung parliament. On Brexit, there is currently no parliamentary majority for any proposal. The Conservative party has 315 MPs, forming a government depending on 10 Democratic Unionist (DUP) MPs. 176 Conservative MPs backed ‘Remain’ in the referendum, but hard-line “Brexiters” constitute the most vocal opposition to Chequers. Former foreign minister Boris Johnson most recently called the plan “entirely preposterous” and “deranged”³. Conservative hopeful Jacob Rees-Mogg and his European Research Group have also been outspoken in favouring a ‘clean Brexit’, including the set back of trade relations with the EU to WTO standards.⁴

² Donald Tusk, “Remarks by President Donald Tusk after the Salzburg Informal Summit” (Salzburg: European Council, 2018), <http://www.consilium.europa.eu/en/press/press-releases/2018/09/20/remarks-by-president-donald-tusk-after-the-salzburg-informal-summit/>.

³ Saim Saeed, “Boris Johnson: Chequers Plan Is ‘Deranged,’” *Politico.Eu*, September 9, 2018, <https://www.politico.eu/article/boris-johnson-uk-chequers-brexit-plan-is-deranged/>.

⁴ “Rees-Mogg Joins Forces with Top Economists to Back World Trade Deal” (Economists for Free Trade, 2018), <https://www.economistsforfreetrade.com/News/rees-mogg-joins-forces-with-top-economists-to-back-world-trade-deal/>.

Brexit hardliners clearly favour a ‘Canada Plus’ arrangement based on cleanly exiting the single market and the customs union. This option would leave the question over the Irish border unanswered and thereby jeopardize the implementation of the Good Friday Agreement. Theresa May [has rejected this proposal](#)⁵ – its success would likely spell the end of her Premiership. However, it is the least likely to achieve a parliamentary majority. It would require 320 votes. Labour has already proclaimed its opposition to any deal that would take the UK out of the Customs Union and the Conservative party still features many more moderate voices that would prefer as close a future relationship as possible with the EU.

Labour has also rejected the Chequers proposal, threatening to push for a snap election should Theresa May not present a better deal. Such an early election seems unlikely as it would require a [two-thirds majority in the House of Commons or a vote of no-confidence](#) and the subsequent failure to form a new government within 14 days.⁶ Embroiled in in-fighting and with much popular discontent, the Conservative party would have nothing to gain from a snap election.

What is less unlikely is the possibility of a second referendum or “People’s vote”. A debate that had been dead in the water just a few months back now features prominent supporters such as London’s Mayor Sadiq Khan and is back on the agenda. Even three government ministers are [reported](#) to privately endorse the idea.⁷ A [YouGov poll](#) from July showed that for the first time, more people supported a second referendum than opposed it.⁸ Should Labour decide to back this popular sentiment, it would require 17 Tory rebel MPs to achieve the required 320 votes in parliament. A second referendum would certainly raise numerous political and legal questions. It would require several months of preparation, therefore requiring an extension of

⁵ Peter Walker, “No-Deal Brexit Better than Canada-Style Deal, Says Theresa May,” *The Guardian*, September 25, 2018, <https://www.theguardian.com/politics/2018/sep/25/no-deal-brexit-better-than-canada-style-deal-theresa-may>.

⁶ Institute for Government, “Early Election,” Explainers, 2017, <https://www.instituteforgovernment.org.uk/explainers/early-election>.

⁷ Kylie MacLellan, “Three of UK PM May’s Ministers Privately ‘see Argument for’ Second Brexit Vote: Lawmaker,” *Reuters World News*, 2018, <https://www.reuters.com/article/us-britain-eu-vote/three-of-uk-pm-mays-ministers-privately-see-argument-for-second-brexit-vote-lawmaker-idUSKCN1MB3BV>.

⁸ Matthew Smith, “For the First Time, More People Support a Second Referendum,” YouGov UK, 2018, <https://yougov.co.uk/news/2018/07/27/first-time-more-people-support-second-referendum/>.

Article 50. The legality of such a request is still an open question. Ironically, one could imagine Nigel Farage bringing the case in front of the ECJ. (A Scottish court has recently [asked the ECJ](#) to rule on the related matter of whether Article 50 can be unilaterally revoked by the UK.) More practical questions arise: what would be the question asked on the ballot? Would there be a “remain”-option? How would the European Union react to such a delay, particularly given the complicating factor of European elections in May? It is even unclear which option would win out in such a referendum.

In the midst of such political volatility and the apparent absence of a parliamentary majority for anything except against a “no deal”, what is the most likely path forward for Theresa May’s government? Should Conservative MPs shift towards a more hard-line approach, then a Canada-type free trade agreement could result. Should they split on the issue, neither the Canada- nor the Chequers-option would achieve a parliamentary majority. Under this scenario, parliament might be inclined to vote for a soft Brexit. This would keep the UK inside the customs union and alleviate the need for a hard border on the island of Ireland or in the Irish Sea. Parliament has a natural majority for a soft Brexit and is filled with “Remainers”. Labour has announced that it could support such a deal under certain conditions. Lastly, the fear of a “no deal” Brexit is a powerful motivator to establish a parliamentary majority for whichever deal is presented to the House of Commons. Faith in political rationality dictates the conclusion that faced with the prospect of a cliff-edge Brexit, the House of Commons would vote for the least disruptive path forward, that of a BRINO (“Brexit in Name Only”).

2. The European Perspective

Throughout the course of the negotiations, the European Union has displayed a great amount of unity. Seeking the closest possible future relationship with the UK, it has also remained steadfast on its principles, defined in the [negotiation guidelines of March 2018](#).⁹ Thus, while displaying good faith in the negotiations – German

⁹ European Council, “European Council (Art. 50) Guidelines” (Brussels: European Council, 2018), <http://www.consilium.europa.eu/media/33458/23-euco-art50-guidelines.pdf>.

Chancellor Angela Merkel promised to use “[all our force and creativity](#)”¹⁰ in finding a solution – the Chequers proposal found little sympathy at the recent informal summit in Salzburg and was [explicitly rejected](#) by the Union’s chief negotiator Michel Barnier.¹¹ While some elements of the proposal are deemed workable, some fundamental conceptual problems are still perceived by EU-leaders. First and foremost, selective access to the single market – free exchange of goods but not of services, and without accepting free movement of people – is perceived as exactly the type of “cherry-picking” that is to be avoided at all costs. This is problematic politically, as it would allow for the interpretation of better deals being possible outside the European Union. Economically, it would raise questions of competitive advantages if a country was allowed to trade freely in the common market without having to adhere to the same regulations and under the same state-aid framework. Lastly, it would give the UK parliament the possibility to veto agreements struck between the EU and the UK. This would raise fundamental questions of legal certainty. The question of how to adjust agreements to new developments in EU legislation, how to supervise implementation and how to settle disputes is [currently complicating negotiations between the EU and Switzerland](#).

Guiding EU negotiators is thus the question of what best option can be presented while maintaining the single market ecosystem. A free trade agreement appears to be the best option for those parameters. While details of such a deal need political deliberations to be fleshed out, one remaining obstacle remains in the Northern Irish border. The agreed backstop that has recently been [called back into question](#)¹² by Theresa May was designed to protect the single market and the peace in Ireland. No other workable solution – says the EU – has been presented to date. Selling the backstop to the British public might be a matter of narrative, as the issue

¹⁰ Tom Sims, “Merkel to Commit All Creativity to Brexit Deal, but Cannot Promise Success,” *Reuters*, September 4, 2018, <https://www.reuters.com/article/uk-britain-eu-germany/merkel-to-commit-all-creativity-to-brexit-deal-but-cannot-promise-success-idUSKCN1LK23P>.

¹¹ Daniel Boffey, “Michel Barnier Says He Strongly Opposes May’s Brexit Trade Proposals,” *The Guardian*, September 2, 2018, <https://www.theguardian.com/politics/2018/sep/02/michel-barnier-strongly-opposes-may-brexit-trade-proposals>.

¹² George Parker, Alex Barker, and Michael Peel, “Theresa May Rejects ‘Not Credible’ EU Plan on Northern Ireland,” *Financial Times*, September 19, 2018, <https://www.ft.com/content/4fcea392-bb83-11e8-94b2-17176fbf93f5>.

can be treated as a technicality or a question of core sovereignty. In the current debate, however, it appears to be a major roadblock.

Game theorists might suggest that the current negotiations that have to be concluded by March 29, 2019 resemble a game of chicken with both parties racing towards each other. They would predict that negotiators would swerve at the last possible moment, and five to midnight is commonly known as the hour deals are struck in Brussels.

However, agreeing on Brexit is not an easy matter. The exiting agreement needs to be ratified both by the House of Commons and the European Parliament. Entire groups of society, from bankers to farmers are relying on certainty in order for their livelihoods to continue uninterrupted – or to prepare for disruption should the negotiations lead to that. There is thus a strong impetus to conclude an agreement well before the deadline. The October Summit was long envisioned to be the concluding act of the negotiations but it is [well known](#) that an emergency summit in November is already in the making. A summit of last chance could conceivably be scheduled for January or February as both parties are determined to reach an agreement. A question looming over the conclusion of any agreement is at what point a majority in the House of Commons can be found to agree to anything.

Apart from the process of Brexit negotiations, the departure of the UK will have lasting effects on the European Union, which will be felt for years to come. The next section highlights three policy areas that will be particularly affected.

3. Implications of Brexit – three critical cases

3.1 How might Brexit change EU economic governance?

The overall influence of the UK on the EU's economic governance is hard to assess. It helped shape forms and norms of regulation, including the social realm. It introduced a pro-market approach into the single market and argued for a "lighter touch" on regulation – emphasizing the need for efficient resource allocation and cutting red tape.

Brexit will shift the balance of power in the EU. Not only for the Franco-German engine, whose intentions were set out in the [Meseberg declaration](#),¹³ and which loses a powerful opponent to its integrationist tendencies but also for the balance between the EU's North and South. Without the UK, the fiscally conservative camp loses its blocking minority on legislation, which will facilitate the establishment of new fiscal resources. France and Spain have already [announced](#) their common support for new fiscal resources dedicated to Eurozone stability.¹⁴ It could equally facilitate the creation of a "southern bloc" pushing for more investment and/or redistribution. It is conceivable that this acts as a catalyst to address the outstanding issue of divergence.

An open question will be how the process of accession to the Euro will develop. The exit will reduce the size of the non-euro bloc by 50 percent in GDP terms. Without the UK, 85% of EU GDP is produced within the euro area. Furthermore, the non-euro countries are left without a blocking minority in the Council as the UK, which constitute 12.85 percent of the EU's population, leaves. Legislation that is more closely aligned to the needs of the Euro might accelerate accession, especially should shared fiscal resources be realized.

Brexit will also provide a window of opportunity to do away with "corrections" in the EU budget, better known as rebates. Defending them will become harder in the future and the Commission's proposal for the upcoming Multiannual Financial Framework already includes the phasing out of remaining corrections for [Germany, the Netherlands, Austria and Sweden](#).¹⁵

Brexit will also have an impact on labour migration, as Germany will become the biggest beneficiary of skilled labour migration from the CEE members, as well as trade

¹³ French Republic and German Federal Republic, "Meseberg Declaration" (Meseberg: The press and information office of the federal government, 2018), <https://www.bundesregierung.de/Content/EN/Pressemitteilungen/BPA/2018/2018-06-19-meseberg-declaration.html>.

¹⁴ French Republic and Kingdom of Spain, "Madrid Declaration on Euro Area Reform" (Madrid: Presidencia del Gobierno Secretaría de estado de communication, 2018), [http://www.lamoncloa.gob.es/presidente/actividades/Documents/2018/Madrid Declaration on Euro Area Reform.pdf](http://www.lamoncloa.gob.es/presidente/actividades/Documents/2018/Madrid%20Declaration%20on%20Euro%20Area%20Reform.pdf).

¹⁵ Matthew Parry and Magdalena Sapala, "2021-2027 Multiannual Financial Framework and New Own Resources" (Brussels, 2018), [www.europarl.europa.eu/RegData/etudes/IDAN/2018/625148/EPRS_IDA\(2018\)625148_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2018/625148/EPRS_IDA(2018)625148_EN.pdf).

and investment, although it might prove a sideshow to the effect of the US-reorientation on trade.

3.2 *What is the impact on EU financial markets of the City of London leaving the EU?*

Brexit will lead to a [partial migration](#) of banking business from the City of London to the EU27 with Frankfurt, Paris, Dublin and Amsterdam being the biggest projected recipients.¹⁶ London will also lose some of its attractiveness for US-banks as an entrance into the single market. Paris is [reportedly](#) a preferred replacement destination for the future.¹⁷ Financial regulations will also be more fitting to the needs of continental Europe, for example by shifting away from capital requirements as a metric for stability.

A question yet to be decided is how open or closed the EU's financial markets are going to be for UK firms and banks. Having hoped to attain a principle of equivalence when dealing with the single market, the UK is now focusing on attaining "reciprocal recognition". This will mean reduced market access.

One of the biggest risks of Brexit for the EU and the UK banking sectors is reduced risk-sharing. Risk-sharing is achieved by diversification of risk portfolios. Simplified, the more countries banks have in their debt portfolio, the more resilient they are to economic downturns in particular countries, as only a fraction of their debt fails to be serviced. British banks formed an integral part of European banking activity and were highly exposed in Ireland, and Spain¹⁸. Not only did the British government participate in the Irish bailout – thus contributing directly to financial stability – but EU member states also benefitted from the bank bailouts in the UK.

¹⁶ Uuriintuya Batsaikhan, Robert Kalcik, and Dirk Schoenmaker, "Brexit and the European Financial System: Mapping Markets, Players and Jobs," Policy Contribution (Brussels, 2017), <http://bruegel.org/wp-content/uploads/2017/02/PC-04-2017-finance-090217-final.pdf>.

¹⁷ Stephan Kahl, "Frankfurt Losing Edge in Brexit Race as Paris Gains Ground," *Bloomberg Business*, 2018, <https://www.bloomberg.com/news/articles/2018-07-17/frankfurt-losing-edge-in-brexit-race-after-paris-gains-ground>.

¹⁸ Waltraud Schelkle, *What Impact Will Brexit Have on the Euro Area?*, ed. B. Martill and U. Staiger (London: UCL Press, 2018).

Another way of risk sharing is via [swap arrangements](#) between the two central banks. Swap arrangements allow central banks to freely exchange currencies. When funding markets in one currency area deteriorate, outside access to that currency can become limited. Swap arrangements let Central Banks acquire this currency to lend it to its domestic banks. This ensures stable funding and investment. Currently, the Bank of England and the ECB have a [standing swap arrangement](#), but depending on the ongoing negotiations, this might change. Limited access to Euro liquidity in the UK or Pound liquidity in the euro area can present a serious risk to financial stability.

A source of friction in the negotiations concerns the financial stability mandate of central banks in the aftermath of the financial crisis. It dictates the clearing of derivative contracts that had accumulated before and during the financial crisis in order to reduce over-the-counter (OTC) business. [OTC transactions](#) are non-standardized and can create undetected risks – assets chiefly implicated in the financial crisis of 2008 were all traded in OTC markets. Clearing by so-called Central Counterparties has become a lucrative, yet risky business that [both the ECB and the Bank of England](#) want to supervise because they may be called upon as lenders of last resort.¹⁹ Currently, a lot of euro clearing is done in the City of London, but the ECB, which had lost a court case on that matter in 2015, has already [proposed legislative amendments](#) to establish its competence over clearing in euros, which it views as of “systemic importance”.²⁰ Cooperation between the two central banks may become more fraught.

3.3 *What is the impact of Brexit on free movement?*

Although not necessarily from the start, migration soon became a central issue of the referendum campaign with a consensus emerging, despite much evidence, that free movement of people was a crucial and disruptive issue.

Free movement therefore became part of David Cameron’s renegotiated deal with the EU. Interestingly, after the lost referendum made the deal obsolete, the

¹⁹ Claire Jones and Katie Martin, “ECB in Drive to Control Post-Brexit Euro Clearing,” *Financial Times*, 2017, <https://www.ft.com/content/8888e560-57e5-11e7-9fed-c19e2700005f>.

²⁰ European Central Bank, “Financial Integration in Europe” (Frankfurt am Main, 2018), 60, <https://www.ecb.europa.eu/pub/pdf/fie/ecb.financialintegrationineurope201805.en.pdf>.

proposed changes were dropped and no longer discussed. A debate on intra-European migration that was so pronounced in the UK was not taken up in other EU capitals. Being left alone by politics, the only changes to the principle of freedom of movement of people were induced by the ECJ. [In its rulings](#) in the *Dano* and *Alimanovic* cases,²¹ it upheld restrictions in access to social benefits to intra-European migrations.

This lack of political debate was likely due to the refugee crisis shifting away the focus from intra-European migration. It occupied much attention also from those parties that are critical of EU migration, thereby taking the issue off the political agenda. However, given the persistent socio-economic divergence within the EU, intra-European migration is likely to persist and with it the political forces opposing it. The issue is thus likely to reappear on the political agenda.

4. Conclusion

In conclusion, the path towards Brexit is still unknown. Theresa May's Chequers proposal faces hurdles at home and in Brussels as core issues, such as access to the single market, and the Irish border question remain unresolved. Although political rationality suggests a soft Brexit to be the most likely option, it remains to be seen what final agreement will be able to satisfy the wide range of political and economic demands in both Westminster and Brussels.

Beyond the immediate impact of the Brexit negotiations, the UK's departure will markedly change the European Union. It will shift the balance between Euro- and non-Euro members and likely facilitate a paradigmatic shift away from fiscal conservatism. In finance, the EU will lose its prime trading hub – and the US its preferred entrance into the single market. Some financial migration is to be expected but not all of it towards the EU. And reduced risk-sharing between London and Frankfurt constitutes a serious threat to financial stability – especially in an environment of ballooning central bank balance sheets. Less clear is the impact of Brexit on the debate around free movement. Although amendments had been proposed to David Cameron in attempting to avert Brexit, the debate has not been

²¹ Dion Kramer, "Had They Only Worked One Month Longer! An Analysis of the Alimanovic Case [2015] C-67/14," European Law Blog, 2015, <https://europeanlawblog.eu/2015/09/29/had-they-only-worked-one-month-longer-an-analysis-of-the-alimanovic-case-2015-c-6714/>.

continued in European capitals afterwards. It might be, however, that if the issue of external migration into the EU subsides, free movement will reappear as a contentious issue also in continental Europe.

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