A Brexit Perspective

BY PAUL J.J. WELFENS

The United Kingdom will face slow growth with America's positioning within Europe weakened.

The results of the snap election in the United Kingdom on June 8, 2017, have been sobering for Prime Minister Theresa May's government as the landslide victory expected was not achieved. Rather, the absolute majority of the Conservative government was lost, and May will now continue as prime minister heading a minority government. She will need the support of the Democratic Unionist Party of Northern Ireland where, just as was the case in Scotland, the June 2016 EU referendum brought a majority for Remain. The DUP will not want a hard Brexit, which would imply a hard border between Northern Ireland and the Republic of Ireland, replacing the current soft border across which people can easily move.

Switching to a minority government thus will mean an end to the hard Brexit approach for which May was originally seeking a strong mandate with the snap election. The May government wants full control of immigration and has refused to continue participation in the EU single market. It also does not want a customs union with the European Union. Rather, a special free trade agreement between the United Kingdom and the EU27 is May's goal. She now faces difficult negotiations with the European Union—with a looming deadline in March 2019.

European Parliament elections will be held in mid-2019, and it is inconceivable to extend the negotiation time beyond the standard limit of two years (read March 29, 2019), since electing British members for a new European Parliament would be quite strange in a situation where the United Kingdom wants to leave the European Union.

The 51.9 percent majority of the 2016 Brexit referendum thus brings considerable problems for the United Kingdom where Prime Minister David Cameron resigned after losing the EU referendum which he

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basically had called in order to neutralize anti-EU forces within his own Conservative Party. When May succeeded Cameron in July 2016, the legitimacy of the new government was in question. This resulted in May calling a snap election in June 2017 to reinforce her position. This election brought a weaker minority government, yet still May argues that Brexit has strong legitimacy and that she will make a success of it. Both conjectures are not really convincing for three reasons.

First, while the June 2016 referendum produced a 51.9 percent majority in favor of Brexit, had the information brochure mailed by the Cameron government to households contained the key finding of a 10 percent income reduction from Brexit, as shown in the UK Treasury report on British advantages from EU membership, the use of standard UK popularity functions implies the result would have been a 52.1 percent majority in favor of Remain. Strangely enough, the Treasury report was published April 18, 2016, while the mailing of the Cameron info brochure took place in England just days before (April 11–13).

Second, the Global Britain policy announced by May in February 2017 suggests that a series of free trade agreements with other countries will generate considerable growth impulses that could offset the dampening effects of reduced access to the EU single market. While a transatlantic free trade agreement should be possible in 2019 and a similar treaty with Japan is also probable, an agreement with China and India is quite unlikely. These countries are the truly important potential trade partners, not the many small countries of limited economic weight mentioned in the communications of Brexit Secretary David Davis. A free trade agreement with China would wipe out large parts of British industry, and the United States in turn might object to such an agreement for strategic reasons. Regarding India, a standard question raised by Indian governments concerns easier visa access for Indian citizens interested in working in the United Kingdom. With the anti-immigration mood in the United Kingdom nurtured by both Cameron and May over many years, a high number of Indian immigrants does not look like an acceptable price for the British government to pay for a free trade agreement with India. Both Cameron and May argued that the burden of EU immigrants was impossible to bear as part of the EU single market dynamics, while the OECD showed that immigrants had a net positive effect on the UK budget.

Third, EU-UK negotiations are fronted by a weakened UK government that has to deal with the twin topics of EU immigration and UK exit costs that could reach about €60 billion (about 2 percent of UK GDP), as well as concerns about future access to the EU single market.

In a post-Brexit European Union, internal reform options might be expanded. With the United Kingdom no longer blocking EU-level cooperation in defense, and with Emmanuel Macron as the new president of France, there are new options for supranational policy. The EU27 has reinforced cooperation in the post-referendum environment, not least since Brexit means that smaller western EU countries, which used to rely on strong cooperation with the United Kingdom to counter-balance potential Franco-German dominance, will seek reinforced cooperation with Germany and France. The non-eurozone Eastern European EU countries, no longer able to rely on strong cooperation with the United Kingdom in key fields, face the problem of prospective political isolation after Brexit and thus will come under pressure to join the eurozone. As EU immigrants in the United Kingdom are largely from Eastern Europe, these countries are likely interested in supporting a compromise in the EU-UK negotiations. This is the main reason behind the European Union's determination to clarify immigration issues up front. With the weakened new May government unable to define a clear position for negotiations on the EU single market, the European Union surprisingly obtained this sequence in the negotiations.

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EU-UK NEGOTIATIONS

The European Union will negotiate with the United Kingdom mainly over future UK access to the EU27 single market of 450 million people. British exports to the EU27 currently amount to 12 percent of UK GDP. As the May government has emphasized, hard Brexit and full immigration control, respectively, mean that membership in the EU single market—with free trade, free capital flows, and free migration—is not an option, nor is a customs union that would not allow the United Kingdom to pursue its own trade policy. The United Kingdom could be seeking a kind of free trade agreement similar to the Canada-EU agreement, although the European Union is likely to impose import taxes in some sectors and the United Kingdom then would do the same. If no deal is reached by March 2019—not unlikely given the narrow majority of the Tory-DUP coalition in Parliament—the United Kingdom would face the "World Trade Organization default" as the residual option. In such a setting, access to the EU single market would be no better than that of the United States, and British cars would face, for example, a 10 percent import tariff. The United Kingdom would be at a serious disadvantage, since the new EU-Japan free trade agreement will phase out import tariffs in the automotive sector.

If the WTO default should become reality, the United Kingdom will become much less attractive for foreign investors seeking access to EU markets. The British pound would further depreciate and the total devaluation from June 23, 2016, to mid-2019 could reach about 20 percent. This means not only a strong increase in inflation, but also implies that the United Kingdom's share in the global economy would be reduced by one-fifth and that UK political leverage in international negotiations would be weakened.

If the United Kingdom can negotiate a better deal, it would probably include some agreement on equivalence rules for London banks seeking long-term access to the EU financial market. This could at least help minimize the relocation of international banks' jobs from London to the EU27 countries. A critical point in this area of negotiation is regulatory cooperation. The European Union will not want to consider a broad equivalence framework if the United Kingdom is likely to adopt a new wave of deregulation once the country has left the union. Such deregulation pressure will emerge in the United Kingdom if the growth rate of real income should drop. This, however, is exactly what is anticipated. Since the United States under the Trump Administration has already started banking deregulation, one may anticipate a new banking crisis in Europe in the long run.

The European Union itself needs reform in order to become a more attractive regional integration scheme. While the apparent problems with Brexit in the United Kingdom do not suggest that there are economically sound arguments for leaving the European Union, one should not underestimate anti-EU sentiments in other EU countries. It is still unclear whether any other member countries will consider EU exit to be an attractive option. Political parties in Finland, Denmark, and the Netherlands could push in this direction, not least since the eurozone is not really stabilized as long as Greece has not implemented necessary constitutional reforms.

Will Germany and France as well as other eurozone countries find a way to stabilize the monetary union? This is linked to the issue of a larger EU budget that until now only amounts to 1 percent of GDP. Research from the Forschungsgruppe Wahlen, a German group which analyzes voters' behavior, has shown that German voters understand the relevant political topics for the national and state elections in Germany, but find it impossible to understand the key policy areas of the European Union. Therefore, the EU budget should be raised to about 4–5 percent of GDP (half of the U.S. government's consumption at the national level), namely by bringing a common defense and a joint infrastructure element to the EU budget. A joint unemployment insurance scheme for short-term unemployment could also be useful. However, such a scheme would need to leave out youth unemployment for which national policymakers largely bear responsibility through their minimum wage policies. This would clearly allow reinforcing the effectiveness of fiscal policy.

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An International Monetary Fund report has shown that consumption per capita falls three times as much in the eurozone as in the United States if the same 1 percent adverse shock hits both economies. Moreover, the eurozone—assuming that it works smoothly—could benefit from the status of the euro as a reserve currency, which amounts to free imports of goods and services of about 0.5 percent of GDP every year. Capitalized at an interest rate of 2.5 percent, the present value of the euro as a currency is 20 percent of GDP.

The key question for eurozone stability is whether there can be institutional reform plus economic growth. Regarding the latter, Italy has been a problem case since 1995. If adequate reforms can be adopted, the eurozone will out-perform the United Kingdom in terms of growth. This in turn would stimulate a renewed UK Brexit debate. The year 2019 could see renewed British instability. Failure by Downing Street to get majority support for the EU-UK treaties in the British Parliament could lead to a second EU referendum. If, however, Brexit is implemented, the Scottish Parliament—where 62 percent of the population voted in favor of Remain in 2016—is likely to call for a second Scottish independence referendum. In 2014, in the run-up to the first Scottish referendum, the Cameron government had argued that Scottish independence would entail a considerable income loss and loss of all benefits of British EU membership.

If Brexit should indeed be implemented, the UK economy would face slow growth and the U.S. position in Europe would be weakened. ◆