BRIEF: THE ECONOMIC FUTURE OF THE EU WITHOUT THE UK

INTRODUCTION

The exit of the United Kingdom (UK) from the European Union (EU) will have an important economic impact on both parties. The impact on the UK has been hotly debated. During the UK referendum campaign a number of different forecasting organizations, like the National Institute for Economic and Social Research, the London School of Economics, and the Bank of England, anticipated that a vote to leave the EU would have powerful and negative consequences for the UK economy in terms of trade, consumption, and investment. Those impacts did not materialize immediately; now, however, they are beginning to show their presence.

The economic consequences for the EU, however, were less hotly debated. It goes without saying that the EU is significantly larger than the UK; that access to EU markets is more important for UK industry than access to the UK is for EU firms; and that Britain's decision to leave the EU creates more uncertainty for British industry in terms of both market access and regulatory continuity than for firms operating elsewhere in Europe.

Nevertheless, the process of Britain's exit constitutes an important shock for the European economy, both symbolically and in real terms. Symbolically, the EU and its precursors were created to form an economic trading bloc, and a free trade area. Thus, the backbone of the EU is economics and trade. Although we have seen the EU moving through a very difficult decade of economic crisis since 2007, the direction of travel has always been toward more integration. In many ways, the pace of institution-building has been staggering as the EU has introduced a host of new regulatory agencies (like the European Banking Authority and its counterparts in other financial services), supervisory responsibilities (again, most prominently, related to finance), and instruments for cross-country solidarity (like the European Stability Mechanism). These accomplishments are not perfect and yet they nevertheless constitute an improvement on the status quo ante.[1] Britain's departure goes against that general pattern of movement and so raised important questions about whether Europe faces a future of disintegration rather than integration.

The importance of such symbolism is difficult to assess this early in the process. A lot will depend upon the outcome of the negotiations and the tenor of the relationship between the UK and the EU once Britain's departure is completed. The real implications, however, are becoming apparent more quickly. This note focuses on four dimensions of change: market perceptions; the future of London finance; the pattern of trade between the EU and Britain; and the future of economic relations between both parties and the outside world. The argument is that the short-term implications are all negative. The loss of Britain will be a shock to Europe both in terms of market perceptions and because of the inevitable adjustment costs. The medium-term implications are more finely balanced. The EU could emerge from this process as a more coherent organization; it could also emerge as more market interventionist and more protectionist. How those implications will develop over a longer-term horizon will depend upon more than just what happens in Europe, with or without the United Kingdom. The role of the US is critical in that longer-term perspective. How Donald Trump's administration responds to both the UK and the European Union during the process of Britain's exit could have lasting implications for Europe's economic future and for the transatlantic economy.

MARKET PERCEPTIONS

The reaction of market participants to Britain's exit from the European Union is in many ways ambivalent. For example, the Brexit vote in June 2016 resulted in wide currency fluctuations in Sterling, starting with a dramatic loss of value relative to the dollar and to the euro in the immediate aftermath of the referendum vote. This volatility was unambiguously damaging to the UK economy. Not only did the currency fluctuations reduce the real value of household income without having a noticeable impact on UK export performance but they also impacted labor movements in high-value industries into the UK. Finance, industry, and the higher education sector all experienced recruitment and retention challenges as a consequence. By contrast, similar firms in other parts of Europe found it easier to attract and retain talent and investment.

On another level, however, Britain's withdrawal made European financial markets more alert and vigilant about the economic resilience of the core nineteen Member State Eurozone.[2] For short periods, we could observe some worrying echoes of the crisis that began in 2007 repeating themselves today – for example, the government bond yields of Germany and the southern European Members widened again, demonstrating that markets were willing to price in what they see as the risks inherent in the Italian, Spanish, Portuguese and Greek economies. Such pressures have been effectively contained by the European Central Bank's large-scale asset purchasing program and yet they are likely to re-emerge in the coming months as that program moves closer to its end.

Market perceptions of the EU area are also likely to suffer if the negotiations over Britain's exit go badly and result in deepening divisions among EU member states between those who trade more extensively with the UK (and so seek a more accommodating future arrangement) and those who worry more about the precedent being set by Britain's departure or whatever new burden-sharing arrangement will have to emerge once Britain's contributions are withdrawn from European finances. Such divisions are important because the structure of European macroeconomic policy coordination and Europe's banking union remains incomplete. Any divisions resulting from negotiations with Britain make it more likely that the EU will fail to reach agreement on these other essential projects.

THE FUTURE OF LONDON

Any assessment of market perceptions is complicated by uncertainty over where that market will exist. The UK's position as a center of finance and international corporate banking has come under pressure since the referendum result to leave the EU in June 2016. The result is unlikely to be a wholesale movement from one European financial capital to another. Whilst there are some real threats to the City of London regarding the 'passporting' that allows banking, other financial services and insurance underwriters to operate across the whole European market, the City of London will remain a significant financial force. Nevertheless, key elements of what used to be the core of UK finance will dissipate to other parts of the EU, include almost all euro-denominated clearing and settlement, trade finance, and a large slice of asset management. So, by dint of geography and economic interconnectedness (if nothing else) the EU will need to come to an arrangement with the UK about how financial services will be treated post-Brexit. And whilst some EU Members, like France, have taken early action to attract UK-registered financial houses to move, it is likely to remain in the EU's collective interest to retain links with London as a financial hub to the rest of the world.

The pattern of European financial regulation will also be affected. In the past, the UK played a predominant role in influencing the structure of financial regulation as the headquarters of many large European financial services industries, the home of the European Banking Authority, and a major constraint on the more interventionist ambitions of Germany and France. That role diminished somewhat as the euro area countries moved forward with the creation of a banking union with a single supervisory mechanism and yet the UK retained a high level of authority. Now British financial regulators will have to exercise their influence at arm's length.

The EU may emerge from this process as a more coherent financial regulatory area. That is the positive scenario embraced both at the European Commission in Brussels and at the European Central Bank in Frankfurt. Nevertheless, that outcome is not inevitable. The common rule book for financial regulation is already creating divisions between Northern and Southern European countries. The UK has typically played a balancing role in those conversations. Now that mediating influence will diminish. Many politicians and financial regulators in Southern Europe worry that Germany will take advantage of its increasing predominance to push for ever more ambitious projects to reduce the risks of financial instability by increasing the requirements for burden-sharing and lowering the ability of banks to hold their own country's sovereign debt instruments as assets.

There is also the possibility that British banks will try to cut special deals with EU member state governments to ensure continuous market access. As the EU already has 'special relations' via the European Economic Area (EEA) and European Free Trade Area (EFTA) with Switzerland and Norway, it is not beyond comprehension that this could be used for the UK to enable some form of continuity. Moreover, the EU's collective inability to maintain cohesion over dealing with Russia, for example, is a sign that relations with the UK might be uneven across the Union, offering interesting opportunities for UK businesses.[3] Here again, it is possible that an EU without Britain could be less coherent as a financial actor rather than more so.

TRADE BETWEEN THE UK AND EU

The UK and the EU are heavily invested in each other when it comes to trading activities, and on that basis neither of them have an interest in damaging each other in the withdrawal negotiations nor for the post-Brexit relationship. The UK runs a trade deficit of between £20bn ($25.7bn) and £66bn ($84.8bn) with the EU, which would imply – as many 'leave' campaigners do, that the EU needs the UK more than the UK needs the EU. It is, however, the case that half the UK's good and services exports are with EU nations, and the UK comprises nearly 15% of the EU's GDP, and 20% of the EU's exports.

The EU's collective position on a trade deal with the UK will – in part – depend upon factors such as the timing of those negotiations. The EU's general position is that trade negotiations with the UK can only occur once 'sufficient progress' has been made on negotiating issues around the outstanding financial liabilities held by the UK to the EU and on issues such as the future of EU citizens in the UK and other related border issues.[4] So, whilst multinational enterprises (and many small and medium-sized firms) require greater levels of certainty about what the trading conditions will be like between the EU and UK to make investment and other business decisions, at the time of writing this particular issue has been sequenced as one of the final items for discussion between the two negotiating parties.

The British government (and many of its Eurosceptic Members of Parliament) are convinced that the EU will have to show flexibility on the timing of the bilateral trade talks due to the asymmetry in the number of jobs in continental Europe that are dependent on trade with the UK: the figure is often cited as a ratio of 3:1 in favor of continental European jobs. For those states with free market instincts, concluding a free-trade agreement with the UK would represent a sensible conclusion, albeit whilst ensuring that the terms of such an agreement are not so favorable to represent an incentive to other EU members to leave.

TRADE WITH THE OUTSIDE WORLD

The removal of the UK from internal EU trade policy discussions will shift the balance in the EU around trade and protectionism. Many Northern European countries have tended towards more economically liberal positions, of wanting to seek out new trade deals and supporting broadly neoliberal economic positions. In contrast, France and many of the Southern European states have tended towards instinctive protectionism, be it around agriculture, manufacturing or consumer products, with the hook being that further protectionism would allow for a sensible pacing of the transformation of globally uncompetitive industries.[5] Without the UK in these internal trade discussions, the arguments in favor of further protectionism are likely to be simpler for those states to win. Britain's exit from the EU may – therefore – have the unfortunate unintended consequence for the UK of removing a free-trade voice and influence from the EU precisely at a time when the UK will want to conclude a free-trade agreement with the EU itself.

The future of European trade with the outside world in not only in the hands of Europeans. How other countries respond to Britain's exit from the EU will matter as well. There are some dangers for the post-Brexit EU-27 in having a UK able to forge free trade agreements around the globe without needing to consult with the EU. If this was done well by the UK this would put pressure on an EU that is likely to be more inwardly focused after Brexit is completed. If, however, the EU managed to find post-Brexit cohesion (particularly between France and Germany), it could attempt to shape a uniquely European form of capitalism away from the influence of the UK, which tends towards a US model of capitalism.

Those free-trade-oriented EU member states know that the UK is likely to be able to quickly conclude basic free trade agreements with third party states like India, China and even the United States (even if it is likely that those deals will not be wholly favorable). This contrasts with the EU which labors its trade negotiations and which – through the vagaries of individual Member State rules, can be held up by regional assemblies as was the case with the Comprehensive Economic and Trade Agreement (CETA) with Canada.[6] Hence it is possible that the post-Brexit environment might also be a spur to the EU to try and rapidly conclude the ongoing trade negotiations with, amongst others, the US (although currently politically stalled), with China (also stalled), Canada (which is signed but has yet to come into force) and Japan (which is pending further negotiations).

Trade relations with the United States will be affected as well – and here the influence of the Trump administration could have lasting implications. The EU-US negotiations on the Transatlantic Trade and Investment Partnership (TTIP) collapsed implicitly when the Trump administration withdrew from the Trans-Pacific Partnership. That does not mean, however, that trade negotiations across the Atlantic are impossible. On the contrary, the Trump Administration is looking for opportunities to show its 'transactional' effectiveness by securing a good deal both with the United Kingdom and with the rest of Europe. Indeed, Donald Trump as candidate was an early and vocal supporter of Britain's exit from the EU during the referendum campaign. As President, Trump has promised British Prime Minister Theresa May that he will support her in negotiating a speedy and mutually beneficial relationship. The worry both for trade negotiators and for market regulators in Europe is what the terms of that Anglo-American bargain will be. There are many scenarios, for example, within which the new pattern of trade between the United States and the United Kingdom work to isolate Britain even further from the European marketplace. The agricultural trade is a particular concern given the differences in US attitudes to genetically modified organisms, animal nutrition, and sanitary and phytosanitary standards. However, it also relates to a host of other industrial standards, testing and certification requirements. The more the Trump Administration succeeds in opening the UK to business from the United States, the more it will inadvertently reinforce the distance between Great Britain and Europe.

Transatlantic competition for access to the British marketplace would run directly against the grain of what the Transatlantic Trade and Investment Partnership was meant to accomplish. Rather than promoting transatlantic standards at the global level, competition for access to British markets would further polarize the division between the United States and Europe. In the long run, this would have negative consequences for ability of either side of the Atlantic to play a leading role at the global level.

CONCLUSION: A DELICATE PROCESS WITH SIGNIFICANT IMPLICATIONS

The economic consequences of Britain's exit from the European Union are unambiguously bad for the United Kingdom in both the short and the medium term. They are also likely to be bad for the European economy. Europe will suffer from an adverse change in market perceptions, from the loss of concentration in the provision of financial services, from increasing friction over regulation and trade, and from the potential that Britain's departure could lead to further divisions both within Europe and across the Atlantic. These are all potential outcomes and they are significantly negative.

There is a potential, however, that the European economy will emerge strengthened as well. Although the symbolism of Britain's departure is negative, the EU can take the opportunity to show how much it has learned from the experience both in terms of promoting greater harmony across EU member states and in terms of tightening the links between regulatory authorities at the European level and diverse national publics. The EU can look for ways to bring more coherence to its regulatory policies as they relate to finance and to market access. And it can look to restart trade negotiations with the UK and the US on terms that are mutually beneficial. Economic integration across the European Union and the transatlantic economy could deepen under the right circumstances. It will be a delicate process to manage and yet it will be worth the effort.

WRITTEN AUGUST 2017

[1] Erik Jones, R. Daniel Kelemen, and Sophie Meunier (2016), 'Failing Forward? The Euro Crisis and the Incomplete Nature of European Integration', Comparative Political Studies 48(7): 1010-1034.
[2] Jon Danielsson, Robert Macrae, and Jean-Pierre Zigrand (June 2016), On the financial market consequences of Brexit, Centre for European Policy Studies: London, URL: http://voxeu.org/article/financial-market-consequences-brexit
[3] One example of this is the Estonian e-passport offer to UK entrepreneurs and academics to allow them access to the advantages of EU citizenship (see: Richard Milne (18 April 2017), Estonia aims to lure UK academics as 'e-residents', Financial Times: London).
[4] Ashley Cowburn (27 July 2017), EU 'set to suspend Brexit trade talks' over lack of progress on divorce bill and citizens' rights, The Independent: London.
[5] For a discussion of the recent French Presidential and Parliamentary elections and the role of protectionism see, Pierre Lemieux (Summer 2017) 'Populism and Protectionism', Regulation; Washington, 40(2): 6-7.
[6] Jennifer Rankin (27 October 2016), 'Belgian politicians drop opposition to EU-Canada trade deal', The Guardian: London.