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Economic Strategy

Will Britain leave the European Union?

- "The nearest run thing you ever saw in your life" Arthur Wellesley, first Duke of Wellington 18 June 1815.

The Politics of Brexit

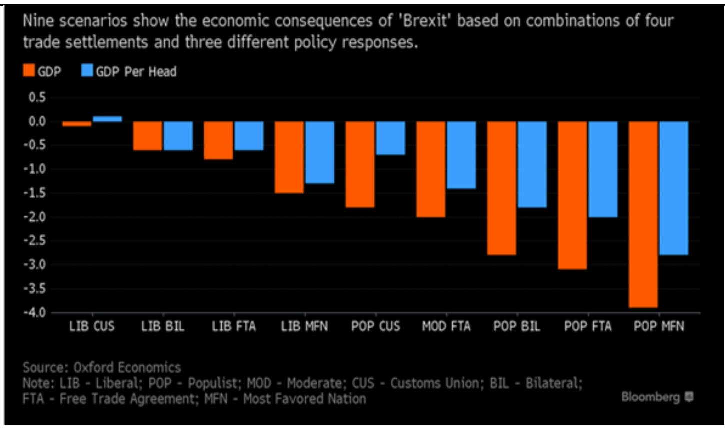
There have been only four Australian-style referendums in British history. Three of them have been during the leadership of David Cameron. The first referendum that Cameron introduced was on 5 May 2011. This was a referendum on the "alternative vote". As part of his Coalition agreement with the Liberal Democrats, Cameron had agreed to hold a referendum of the introduction of a preferential voting system. In the UK this is referred to as the 'alternative vote' (AV). This referendum was defeated with only 32.1% in favour and 67.9% against. Importantly, this referendum was only defeated through the cooperation of the governing Conservative Party and the Labour Party.

The second referendum that Cameron introduced was on 15 September 2014. This was a referendum on Scottish Independence. This followed an agreement between the Scottish and United Kingdom governments enacted in the Scottish Independence Referendum Act 2013. This referendum was defeated with 44.7% in favour and 55.3% against. Importantly, this referendum was only defeated through the co-operation of the governing Conservative Party and the Labour Party.

The third referendum that Cameron has introduced is to be held on 23 June 2016. This is a referendum on whether Great Britain should leave the European Union. Britain leaving the European Union is called 'Brexit'. The problem at the moment is that the governing Conservative Party is divided over the issue of leaving the European Union. Perhaps the most popular politician in the whole of Great Britain is Boris Johnson, the conservative Mayor of London. Boris Johnson has declared himself in favour of leaving the European Union. The leader of the British Labour Party following the 2015 election is Jeremy Corbyn. Jeremy Corbyn is known as a 'personal Euro sceptic'.

Polls show that the issue is extremely close. Polls published on 1 April 2016 (see footnote [1]) suggest that some 45% of the electorate favour staying in the European Union. Some 42% want to leave the European Union. Some 13% are currently undecided. As time goes by, the undecided seem to be drifting towards wanting to leave. Even if a strategy for cooperation between the Conservative Party and the Labour Party can soon be found, defeating the proposition of leaving the European Union could be 'the nearest run thing you ever saw in your life'.

Chart 1: The Impact of Brexit on Real GDP and GDP Per Capital in 2030



SOURCE: BLOOMBERG

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[1] Financial Times Poll of Polls 1 April 2016.

Britain in the European Union

As the British economy emerged from the destruction of World War II, it became apparent that the fastest growth in its international trade was no longer within the old British Empire. Instead, Britain's most rapidly growing market was Germany and other European countries rebuilding themselves from World War II.

In 1957, in the Treaty of Rome, six countries including West Germany, France, Italy, The Netherlands, Luxemburg and Belgium formed the initial group of what was to become known as the European Economic Community (EEC). This was referred to in Britain as 'The Common Market'.

Britain was late to the party. It hesitated because of its existing trade agreements with countries in the British Commonwealth. There was another problem. France saw the EEC as a way that it could exert power over Germany in the post war world. It did not want Britain getting in its way.

The British attempted to quite literally 'get around the problem'. They formed an association which included themselves and many of the other countries which had been excluded from the original Treaty of Rome. This was called the European Free Trade Association (EFTA). This was established on 3 June 1960. It was composed of seven countries. These included Austria, Denmark, Norway, Portugal, Switzerland, Sweden and the United Kingdom. Iceland joined the group in 1970 and Finland in 1986. This group was a very successful free trade area. This group was also very successful in generating access for its members to join the EEC.

Both the United Kingdom and Denmark left EFTA in 1973 to become part of the EEC. Portugal joined the EEC in 1986. Finland and Sweden joined the EEC in 1995 as did Austria. Currently only Norway, Switzerland, Iceland and Liechtenstein (a small principality which is bordered by Switzerland) remain members of EFTA.

The case of Norway and Switzerland is especially relevant. In both cases their governments wanted to join the EEC. In both cases this move was defeated by national referendums. The EEC is now the EU (European Union). Should Britain vote to leave the European Union, it may then return to membership of EFTA with Switzerland and Norway.

The Economics of Brexit

It is apparent from our discussion above that Great Britain put an enormous amount of effort over a period from 1960 to 1973 in getting in to the European Union. We now examine the potential economic results of turning their back on all that effort and leaving the European Union.

Put simply, Britain is 'a banking system with a country attached'. What is another country in Europe that is 'a banking system with a country attached?' The country which most comes to mind is Switzerland. Lord Christopher Patten, the last British Governor of Hong Kong and now the Chancellor of the University of Oxford, once remarked that if Britain left the European Union, it would be 'like Switzerland with the bomb'.

Perhaps the best analysis of the economic effects of Britain leaving the European Union has been prepared by the consulting group Oxford Economics. A chart from the report on the economic consequences of leaving the EU can be seen in Chart 1. This chart was published by Bloomberg on 22 March 2016.

Oxford Economics examined nine different scenarios for Britain leaving the European Union. They then calculated the impact of those scenarios for the British economy by 2030.

What happens next?

It is not so important that Britain leaves the EU. It is very important what happens next. The impact of British exit upon the British economy is essentially determined by the mix of policies that Britain enacts after it leaves the EU. The drive to leave the EU is essentially populist. Populists both in Britain and in the United States share two essential motivations. They attempt to restrict free trade and they attempt to restrict immigration.

What Oxford economics shows is that the damage to the British economy after leaving the EU is directly proportional to the success that populists then have in restricting trade and immigration. The more open the trade regime and the more open the immigration regime after leaving the EU, the less the damage. The more restrictive the trade regime and the more restrictive the immigration regime, the greater the damage will be after leaving the EU.

Chart 1 shows us nine different combinations of openness to trade and openness to immigration. The most open to immigration is shown as LIB or Liberal. The least open to immigration is shown as POP or Populist. Moderate or MOD is half way in between.

The most open to trade is shown as CUS or Customs Union. This means that the UK, like Turkey now, would move to a customs union with the European Union. The next most open to trade is BIL or Bilateral Agreements. This means that the UK, like Switzerland now, would move to bilateral agreements with each individual member of the European Union. The least open to trade would be MFN. This means that the UK would remain outside the European Economic Area and the European Free Trade Association. This would give the UK what is called 'Most Favoured Nation' status. This is the position least open to trade.

Oxford economics calculate that the result of the UK being part of a Customs Union, together with a Liberal immigration policy, would see a negligible loss of GDP of 0.1% between now and 2030. Investment would actually be very slightly higher and GDP per capita would be very slightly higher. This position is shown on Chart 1 as LIB CUS.

At the other end of the scale, we have the populist policies of restricted immigration and restricted free trade. The result of this position would be to reduce GDP by 3.9% between now and 2030. This position is shown on the chart as POP MFN.

Migration or Trade

One intriguing issue emerges from the Oxford economic analysis. What is actually more important to EU GDP: open migration or open trade?

My examination of the comparisons in Chart 1 suggests that around 62% of the beneficial effect to GDP within the EU is caused by open migration. This means that the fact that a skilled labour force can move rapidly within the EU tends to increase the potential GDP of the EU economies. This beneficial effect of open migration is much larger than the beneficial effect of open trade.

My examination suggests that only around 38% of the beneficial effect to GDP within the EU is caused by open trade. Populists are more offended by migration than they are offended by trade. This means that populists are most likely to shut down the most beneficial effect of being within the EU.

Would or could?

Let us dispose of one objection to Brexit. This is that it would place the UK in a poor bargaining position. The UK is the second largest economy in Europe. Right now Turkey has a customs union with the EU. If Turkey can negotiate a customs union, it is absurd not to believe that the UK could do so.

Right now Switzerland has bilateral agreements with the EU. These bilateral agreements support an extremely high level of GDP per capita in Switzerland. If Switzerland can negotiate these bilateral agreements, it is absurd not to believe that the UK could do so.

Switzerland negotiated these bilateral agreements to protect its banking sector. Switzerland, like the UK, is 'a banking system with a country attached'. The UK, like Switzerland, might wish to negotiate these bilateral agreements in order to protect its banking system. Should it do so, it would indeed become, as suggested by Lord Christopher Patten 'like Switzerland with the bomb'.

The question is whether the UK would wish to enter into these agreements such as Switzerland has. Should the referendum on leaving the EU succeed, then it is likely that British Prime Minister David Cameron would be replaced by a more populist prime minister like Boris Johnson. A populist prime minister would tend to have a more restrictive trade policy and certainly a more restrictive immigration policy. It is this more restrictive policy of a populist regime which actually does the economic damage to the British economy.

Conclusion

The vote on whether Britain will leave the European Union appears finely balanced. The economic damage done by Brexit would be determined not by Brexit itself, but by the kind of deal that Britain does with the European Union after it leaves. Britain is the second largest economy in Europe. It is strong enough to get almost any kind of deal that it wants.

The more restrictive on trade and immigration the deal is, the greater the damage would be. The real problem is that the populists who might rule the British economy after it leaves the European Union might negotiate restrictive deals on both trade and immigration. They might manage to shoot themselves in both feet.

Reference:

`Brexit' Would Cause Significant Damage, Oxford Economics Says: Emma Charlton; Bloomberg; March 22, 2016

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