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Brexit: Implications for Europe †

Christopher Pissarides*

Regius Professor of Economics, London School of Economics and Professor of European Studies, University of Cyprus

Abstract

This paper discusses the exit of the United Kingdom from the EU and the potential implications this will have for both the UK, as well as for Europe. After presenting a brief review of the history of the UK-EU relations, we discuss the economic implications of different Brexit arrangements for both Britain and Europe. Finally, we address what reforms Europe needs to undertake in order to function properly and avoid the risk of dissolution.

Keywords: Brexit, European Union, United Kingdom.

1. Introduction

On Thursday 23rd of June 2016, British voters took to the polls to decide in a referendum whether the United Kingdom should remain in or leave the European Union (EU). The Leave camp won by a slim margin (51.9% to 48.1%). In this paper, we briefly review the history of the UK-EU relations and discuss the potential economic implications of such exit, both for the UK as well as for the EU. We analyse the different possible scenarios for separation of the UK from Europe, and discuss some of the reforms necessary at the European level in order to have a well-functioning Union that will discourage other member States from leaving the EU.

In Section 2 of this paper we present a broad overview of the relationship between the UK and the EU. In Section 3 we analyse the economic implications of Brexit, including a discussion of the possible exit scenarios. In section 4, we discuss what reforms are necessary in the EU, while Section 5 concludes.

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* Address: Department of Economics, London School of Economics (LSE), Houghton Street, London WC2A 2AE and Department of Economics, University of Cyprus, P.O.Box 20537. E-mail: c.pissarides@lse.ac.uk.

2. A Brief History of the UK-EU relations

The EU was conceived after World War II with the idea of bringing lasting peace to the continent after two destructive wars. In the mind of its creators, establishing strong commercial ties between European nations would reduce the risk of future armed conflicts.[1]

Starting with the establishment of the European Community of Steel and Coal in the Treaty of Paris of 1951, and then with the establishment of the European Economic Community (EEC) in the Treaty of Rome of 1957, six European nations went through a process of economic integration that would continue for decades. The signatory nations of these treaties were France, (West) Germany, Italy, and the Benelux countries, namely, Belgium, Luxembourg, and the Netherlands. The EEC created a customs union between the member countries. Namely, it established an agreement whereby member countries would not impose tariffs on each other, and would have a common tariff on imports coming from third countries. In addition, it created a set of supra-national institutions with weak executive powers: the Council of the European Communities (which would later become the Council of the EU), the Commission of the European Communities, the European Parliament, and the Court of Justice of the European Communities.

While initially Britain refused to participate in this union, it eventually decided to apply for membership after witnessing the economic success of the EEC and the decline of its own empire. French President Charles de Gaulle vetoed two applications in 1961 and 1967. Eventually, the UK became a member of the EEC in 1973, after De Gaulle's death.[2] The accession, which took place under a Conservative government, was soon under threat, after Labour PM Harold Wilson called for a referendum on membership in 1974. The voting took place in 1975 and the electorate's verdict was for the UK to remain in the EEC. Nonetheless, this would mark the beginning of a Eurosceptic movement within the country.

After Margaret Thatcher's accession to power in 1979, the UK embarked in a lengthy negotiation process with the EU on the terms of its contribution to the budget of the Union. These negotiations resulted in 1984 in a rebate,

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[1] In a famous speech that calls for the foundation of the European Community of Steel and Coal (ECSC), which would eventually evolve into the EU, French Foreign Minister Robert Schuman declared that the "solidarity in production thus established will make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible" (Declaration of 9th May 1950).

[2] Ireland and Denmark accessed the EEC together with the UK. Norway had originally applied for membership, yet its accession was later cancelled after Norwegians rejected it through a referendum vote.

which reduced the UK's contribution. At the same time, the EEC members started a process to strengthen their economic integration by creating the European Single Market. This arrangement provided a framework for freedom of movement for people, goods, capital, and services among member countries. Out of these so-called "Four Freedoms", only the free movement of services remains incomplete to date.

While Thatcher's government was supportive of the Single Market, it opposed further European economic and political integration, including rejection of an eventual monetary union.[3] In 1979, the EEC established the European Exchange Rate Mechanism (ERM) to stabilize the exchange rate within the Union, and prepare for the introduction of a single currency. Although the UK joined the ERM in October 1990, it would only be for a brief period.

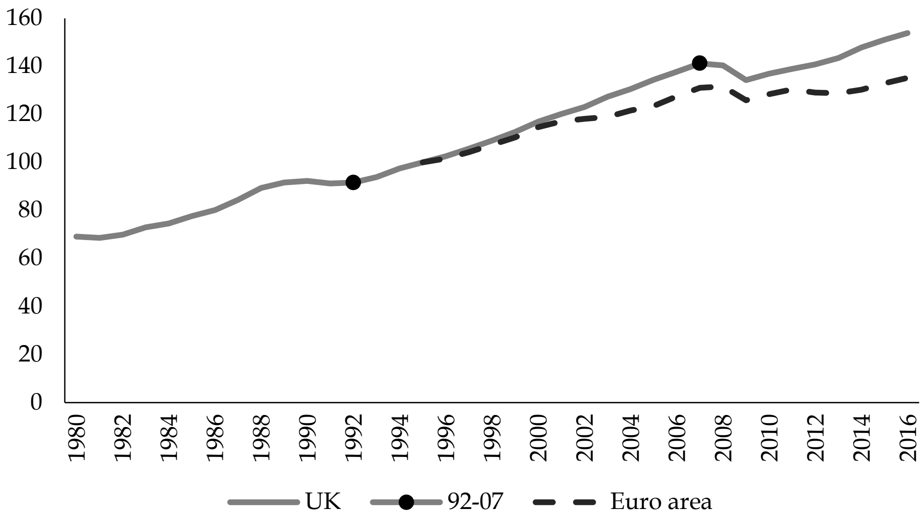
Continued speculative attacks on the British pound led to the infamous Black Wednesday on 16th September 1992. During these speculative attacks, the Bank of England spent up to 3.3 billion pounds to support the UK currency, only to eventually withdraw from the ERM. Underlying these events was the tension created by pegging the British pound to the German Mark and the significant gap that persisted in inflation rates between Germany and the UK.

After 1992 the British economy experienced a steady expansion with low inflation, low unemployment, and high productivity growth. This expansion would continue until the Great Recession of 2008. During this period, the growth of the British economy outperformed that of the Eurozone countries by a considerable margin (see Figure 1). A consequence of this remarkable growth performance was the increase of migrant inflows, while emigration of Britons remained somewhat stable over the years. As seen in Figure 2, the net migration inflows in the UK increased from close to zero in 1992 to about 300,000 in 2015.

[3] Thatcher's refusal to participate in a monetary union lead to disagreements with her Chancellor Nigel Lawson and her Foreign Secretary Geoffrey Howe. These disagreements weakened Thatcher's government and eventually contributed to her ousting from power.

FIGURE 1

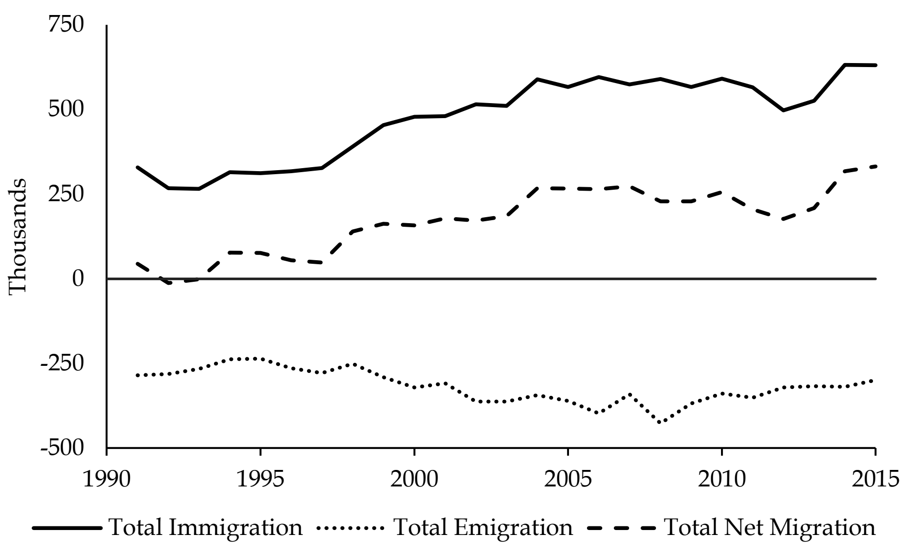
GDP Growth, 1995=100



Source: Author's calculations with data from Eurostat. The Euro area series includes the 11 original Eurozone members plus Greece.

FIGURE 2

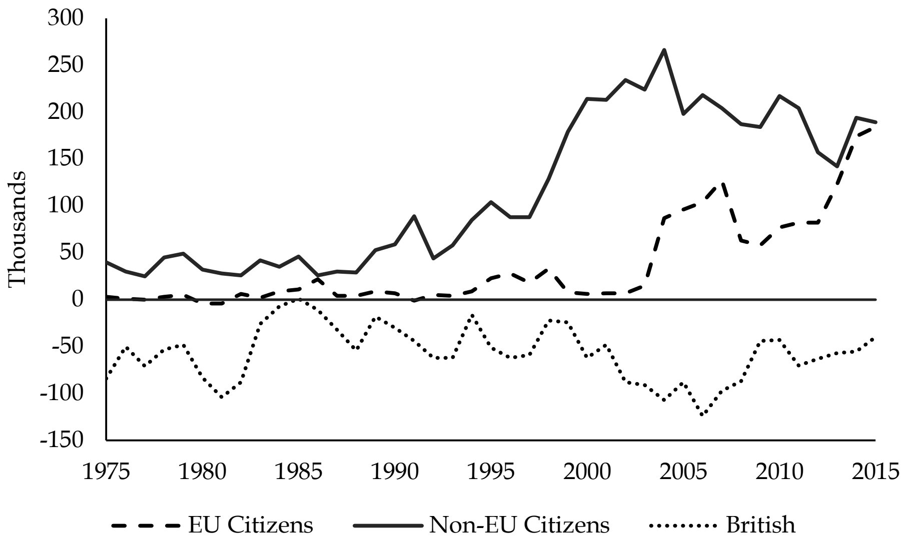
Migration Flows, post-1991



Source: Migration Watch UK with data from the Office for National Statistics (ONS).

FIGURE 3

Net Long-Term Migration Flows by Country of Citizenship



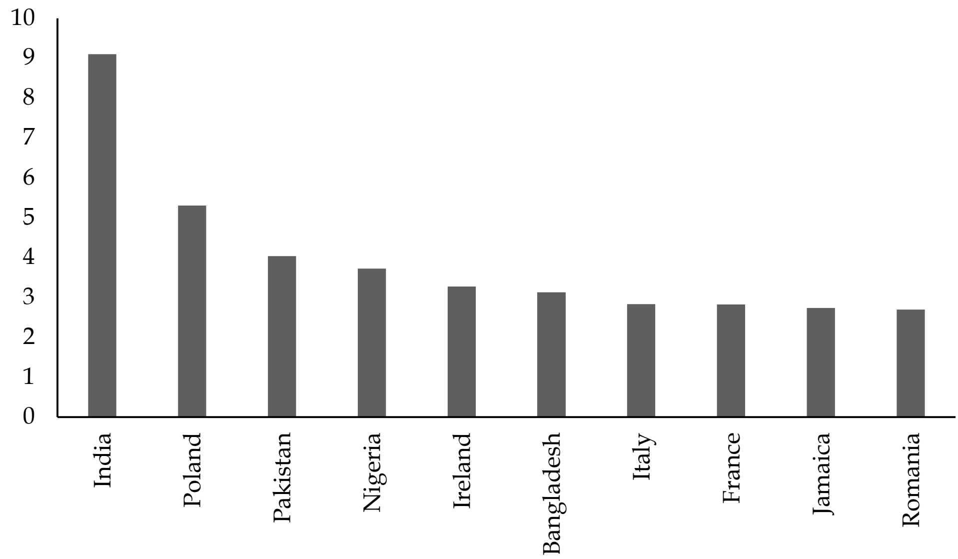
Source: ONS, Migration Statistics Quarterly Report: February, 2017.

A closer look at the migration statistics reveal that the early rise in immigration flows originated in countries outside the EU. However, after the 2004 enlargement of the EU, there was a steep rise in immigration from new member countries, whose citizens could benefit from the freedom of movement within the Single Market (see Figure 3). Some of these countries, like Poland, Romania, and Bulgaria, had a substantially lower per capita income, and thus their citizens had strong incentives to migrate to other EU countries, including the UK.

By 2014 the top sources of immigrants in London were largely a mixture of countries that were former British colonies, and new EU members (see Figure 4). The fact that new EU members, like Poland and Romania, were among the top contributors to UK immigration, along with countries having long historical ties with Britain (e.g. India and Pakistan), is a testimony of how fast the increase of migration from these new EU member states was. This rapid rise in immigration would eventually become one of the crucial drivers of the Brexit campaign.

FIGURE 4

Share of foreign-born by country of birth, London 2015



Source: *Migration Observatory, Oxford*

Another source of opposition to the EU was its complex institutional setting and decision-making procedures. In particular, in recent years it has become increasingly difficult to approve new treaties on substantive matters, due to the large number of members and the requirement that any major reform has to be approved by each and every Parliament.

Initially, Britain was a supporter of enlargement of the EU, because it would help westernize Eastern European countries. However, it did not endorse a closer political cooperation, common EU regulations, single currency and freedom of movement of labour among member countries. In other words, Britain was in favour of a bigger Europe through economic integration only; but was not necessarily, also, in favour of "more Europe".

The change of government in the UK in 2010 brought renewed pressure for revising Britain's relationship with the EU. In particular, Eurosceptic politicians raised, again, their concerns regarding immigration policies and the reduced influence of Britain in the EU.[4] The government's response to this pressure was to promise a renegotiation of the Britain-EU relationship and a referendum on membership.

[4] It is no coincidence that the defining motto of the Leave campaign would be "Take Back Control".

The outcome of the latter is well known. The support of the electorate for exiting the EU shocked the political establishment, and it was against the advice of all political parties except for the UK Independence Party (UKIP). While there might have been economic reasons underlying the Exit vote, it is hard to explain this vote on economic grounds only. Instead, it seems that a nationalistic rhetoric and an anti-immigration sentiment were crucial drivers of this electoral outcome.

The British government had little choice but to accept the outcome of the referendum. Within hours of the announcement of the results, David Cameron presented his resignation as Prime Minister. He was replaced by Theresa May, a Conservative politician supporter of remaining in the EU, who however declared from the outset her determination to negotiate an exit under the best possible terms.[5]

3. The Economic Implications of Brexit

With Brexit underway, a difficult transition period starts for the UK. For more than forty years the British economy has been adapting to the requirements of EU membership; and, currently, about half of Britain's international trade is with European countries. It is reasonable to assume that both the British and EU economies will be weaker as a result of this separation.

According to EU rules, an exit from the EU requires triggering Article 50 of the Lisbon Treaty. Doing so establishes a term of two years within which both parties have to agree on an exit plan and a new status for the UK. On March 29th 2017 Theresa May triggered Article 50 of the Lisbon Treaty, meaning that the UK is due to leave the Union by March 29th 2019. In practice, intense negotiations will likely take more than two years, and it might take another five to ten years for the economies to adapt to the new set of established rules.[6] Given the strict timelines for an exit, it is likely that several interim agreements will be made. Some of these agreements will probably not be well thought out, yet they might become entrenched in the long-run.

All things considered, the years to come will be marked by economic and legal uncertainty. This will hurt the UK economy because, during the transition, both domestic and foreign investment will suffer, technology

[5] It is interesting to note that it was a Conservative government that brought Britain into the EU. However, the relations with the EU have been the reason for ending the political career of every Conservative Prime Minister and Chancellor ever since.

[6] Negotiations can be extended beyond the two year term, provided all 27 EU member countries agree on the extension.

adoption will fall, the British pound and stock markets will become more volatile, and public finances will worsen. After the referendum, the Office for Budget Responsibility (OBR) predicted that by the end of 2021 an extra £58.7bn would have to be borrowed by the government as a result of Brexit (Office for Budget Responsibility, 2016). As with any Brexit forecast, this estimate comes with a great deal of uncertainty, especially because it hinges crucially on how the Brexit negotiations develop. The negative impact of Brexit will also be felt across Europe, as Britain is a large market for European goods and the financial centre of the EU.

The type of exit negotiated in the years to come will be crucial to the economic impact of Brexit on both Europe and the UK. On the European side, the European Commission favours a tough negotiation stance, in order to discourage other members from following Britain's footsteps. However, European businesses prefer a more conciliatory approach to negotiations, as they have a lot to lose from a radical separation.

At the outset of the referendum, Britain had available several models after which it could shape its future relationship with the EU. For instance, negotiations could have followed the models adopted by either Norway or Switzerland, which have nearly full access to the Single Market.

In the case of Norway, trade deals cover most goods, with the exception of agricultural and fishery products. More importantly, Norway is not part of the European customs union. In the case of Switzerland, many separate agreements cover trade in manufacturing goods and in some services. In exchange for this partial access to the Single Market, Norway and Switzerland contribute a reduced amount to the EU budget. This approach however, seems unpalatable for Britain, as it would imply preserving the free movement of labour across borders, and complying with more EU regulations than desired.[7]

In a crucial speech in mid-January, Theresa May delineated the key elements of the deal Britain would seek to strike with the EU. Among the main stated goals were the refusal to remain in the Single Market, and the decision for the UK to follow comprehensive trade deals with other countries, something that would require a drastic departure from the customs union model. These positions amount to an adoption of what informally has been labelled as a "Hard Brexit". Given these goals, a model that could be in principle more acceptable to the UK is the one followed by Canada. In this case, Canada has a free trade agreement (FTA) with the

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[7] Another model that could be followed is that of Turkey, which has a customs union with the EU, but only for goods, and there is no freedom of movement for labour. However, Turkey must accept several EU regulations without having a vote in exchange, and it has no full control over its external tariffs.

EU, yet it can make its own trade agreements with third countries and keep control over its own migratory policy. However, it bears mentioning that such an agreement took seven years to be negotiated.

The reason an FTA is difficult to negotiate is that the abolition of tariffs is not the main policy that needs to be negotiated, as tariffs are not an important barrier to trade nowadays. In contrast, non-tariff barriers are far more important. In particular, in the case of the EU-UK relationship, the "rules of origin" of products are crucial. Barriers through rules of origin establish that only goods with a large percentage of origin in the UK or the EU are allowed free access to the markets. However, setting rules of origin is a complicated administrative process, given today's global interconnections in production. In addition, establishing rules of origin through a free trade agreement would, as a consequence, discourage the purchase of intermediate goods from low-cost economies like China.

Alternatively, the UK could opt for a "favoured status" with the EU, under the framework provided by the World Trade Organization (WTO). Currently, there are fifty-three WTO members outside the EU with such status, through partial bilateral agreements. Incidentally, by leaving the EU, Britain will have to renegotiate special trade deals with these countries as well, or lose the favoured access to their markets. This option is the most harmful for the UK's economy, and according to a Treasury estimate (HM Government, 2016) after fifteen years outside the EU it could lead to a GDP that is 7.5% lower relative to the one that would have been achieved had the UK remained in the EU. In contrast, the same report estimates that after 15 years the annual output cost of a negotiated bilateral FTA similar to the one between Canada and the EU is 6.2%, whereas with a Norwegian-style agreement the output loss is 3.8%.

Under the WTO and FTA scenarios, we would expect a gradual shift of international businesses from the UK to Europe, as locating in Britain would be more costly for those firms seeking to export their goods into European markets.[8] One example of this would occur in the car industry, since half of Britain's car production is by Japanese companies and is exported to the Continent. It is no coincidence that the Japan Foreign Ministry recently urged Britain to retain access to the Single Market, avoid custom controls on exports, let employers hire freely EU citizens, as well as retain the "passport" that allows banks based in London to trade across Europe.

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[8] In the case of an FTA, foreign firms would rather directly set base within the EU and avoid having to establish the origin of their products.

It bears mentioning that the consequences of Brexit for the financial sector will probably be different from those for other sectors. This is because financial institutions may have strong incentives to remain in the UK in order to avoid the excessive regulations faced by banks within the EU. In other words, it is likely that London will retain its primacy in the financial sector even after Brexit.

4. Reforms in Europe

Irrespective of the agreement reached between the two parties, Europe in general, and the Eurozone in particular, will go through a prolonged period of uncertainty. The challenges created by Brexit should be used as an opportunity to reform the European Union for the benefit of its members. The current institutional arrangements within the Eurozone have led to poor outcomes for some member countries and arguably for the countries outside the single currency as well.

One aspect that needs reform is the lack of a true banking union. As of now, the banking union of member countries is incomplete; and, thus, it is not certain how the European Central Bank (ECB) will react in case a bank is in difficulties. So far, the ECB's response to this deficiency has been to increase regulation and supervision, in order to avoid the need to intervene later. However, this has led to an overregulation of the sector, imposing too many costs on banks, and leading to a virtual destruction of the traditional banking model of lending under risk. Until a change is made to banking regulation within the Eurozone, it seems unlikely that the EU banking sector will be able to compete with the British one.

Another aspect in need of reform is lack of voluntary fiscal coordination. Under the current institutional setting, policies are heavily influenced by Germany, their views having primacy over the Eurogroup and the European Stability Mechanism (ESM). Furthermore, the European Parliament remains an institution with very limited power. As a result of these institutional arrangements many decisions in the EU are reached in undemocratic ways. At the same time, as previously mentioned, key agreements require parliamentary approval in each member country. This combination has rendered decision-making within the EU both an unequal and inefficient process. It is no wonder that one of the motives behind Brexit was a rebellion against this flawed institutional design. The institutional arrangements that worked for six member countries back in 1960 do not work for the current twenty-eight member States.

One last issue that will require careful examination is the current immigration policies within the EU. With hindsight, the decision to allow unlimited freedom of mobility of labour between member countries seems misguided. While this arrangement might have worked for the original member countries, it has become more problematic due to the large differences in the standards of living between member nations. Until a more acceptable system is reached, the EU will be under the risk of dissolution due to the threats from extreme-right nationalistic parties that will make immigration their "cause-celebre".

5. Final Remarks

The relationship between the UK and the EU has been delicate since the beginning. For this reason, it is probably not surprising that Britain is the first country seeking to exit the EU. While the outcome of the referendum was probably not the result of a fully reasoned economic analysis, the EU should not entirely pass the blame to the British side.

In contrast, the EU needs to take this opportunity to tackle substantive reforms on issues like political decision-making, fiscal and banking integration, and immigration policy. Failing to do so will lead to other member states quitting, or being forced to quit, and Europe will run the risk of becoming the sick man of the world economy.

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