The economics of Brexit

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Why the UK economy has not crashed

- The UK is still benefitting from its continuing membership of the EU
- Monetary policy is still accomodating and employment is strong
- The weak sterling story may be helping activity and employment but through inflation will progressively hit purchasing power
- But uncertainty is beginning to have a serious effect: this is hitting investment, which will be a contributory factor in the continuing poor productivity story
- Many employers with considerable invested capital are waiting to see what the outcome of the Brexit negotiations is likely to be. But they cannot wait for much longer.
- UK economy now weakest growth rate in G7

Routes from Brexit to the economy

- Trade
- Confidence and Inward investment
- Migration, skills and the workforce
- Exchange rate
- EU budget

Trade and single market

- 44% of UK exports in 2016 went to the EU
- If you increase the cost of trade with your main trade partner, you will normally be worse off
- Access to single market versus membership of single market
  - Every (normal) country in the world has access
  - Membership, which requires regulatory alignment, gives a producer the right to sell its products anywhere in the EU without hindrance or controls
  - It is the lack of regulatory alignment problems (non-tariff barriers) which makes trade inside the single market so efficient
  - Exiting the single market will increase costs for UK exporters

Complexity of modern trade flows

- Non-agricultural trade (goods and services) is made up of complex and international value trains
  - a Nissan car assembled in Sunderland has parts imported in just in time from the EU and from all over the world and we know that Bombardier assembles planes in Canada with wings built in Northern Ireland
- This complexity of trade especially developed within the single market because of the lack of frontiers and the alignment of regulation permitting just in time assembly
  - When the UK quits the single market will a German company still want to use parts produced in the UK which may be held up at frontiers and be subject to regulatory delays and even contingent protection or will it switch to a competitor in another EU country?

Trade with the rest of the world

- Easy to agree trade deals if you put no conditions on imports and accept the conditions on exports imposed by the trade partner – but we want the goods we import to meet certain safety, health, environmental and other conditions? Brexiteers obviously don't.
- Negotiating trade deals if you don't want to reduce your standards is a long process and the UK has no trade negotiators
- The EU has not been preventing the UK exporting to third countries – German exports to China have grown vastly more than UK exports. It is not obvious that if the UK had a trade agreement with China that it would export much more
- Being in the customs union allows the UK to benefit from all the EU trade deals. Outside the customs union, even with a trade deal, there will be rules of origin in trade with the EU.

Trade in services

- Government policy in 1980s killed off much of the rather inefficient UK industry and financial liberalisation led to the UK developing a very strong financial sector
- Exiting the EU is now hitting UK services exports. Outside the single market – without passporting - it will be difficult for UK financial services to maintain its dominance in some areas. Jobs and output will move to the EU (Frankfurt) and to New York. [Lloyd Blankfein Goldman Sachs]
- But financial services provide a large chunk of Government tax revenue – 11% according to a House of Lords report
- Beyond financial services other sectors like legal services may be affected as well as activity moves out of the City

Brexit will hit inward investment

- Inward investment (FDI) raises output, leads to technological advances and provides jobs – Nissan, Siemens, BMW, ALDI, etc
- Britain had always attracted more FDI than other EU states and much of it from the EU
- Many foreign companies moved to the UK to serve the EU market
- Uncertainty about the future trading relationship with the EU is already leading to lower inward investment which will slow economic growth and limit growth of productivity
- There is also a risk of some disinvestment

Migration

- There is no reliable evidence that migration from the EU has caused unemployment or affected wages of UK employees; unemployment is low and labour shortages exist in many sectors
- Migration is often blamed for stagnant wages and poorly paid and uncertain jobs. But this is more to do with the gig economy, the growth of zero hours and similar contracts and the speed of technological progress
- Migration has allowed several sectors to prosper – food processing, horticulture, hospitality which are already finding staffing difficult
- Migration vital for some high value added sectors like finance but also for NHS

Exchange rate

- The pound sterling has fallen sharply against the dollar and the Euro since the referendum. This has pushed up inflation and will continue to do so as the effects come through.
- However use this argument carefully as the pound was probably overvalued at the time of the referendum
- Unfortunately the trade performance has not improved as one would expect pointing to weakness in the export demand for UK products and services

EU budget and the government account

- It is true that after Brexit and after having paid the contributions for which we agreed in the medium term financial plan, the UK will not contribute further to the EU budget if it leaves the single market. However:
  - it will probably need to develop an agricultural policy and a regional development policy.
  - It will need a much enlarged civil service to deal with trade, competition and other areas dealt with by the EU
- The overall negative impact on economic growth will leave a large hole in government finances in spite of the ‚savings' on EU payments
- The argument that resources previously paid to the EU can be spent on increasing resources to the NHS is pure economic ignorance/an attempt to deceive

Summary

- Leaving the EU without a deal will lead certainly to a fall in economic growth, leading to a decline in Government revenues/public services or a rise in taxation.
- If the British want to maintain high standards in food, the environment and health and safety, the idea of negotiating new trade deals with the rest of the world quickly is impossible.
- The increased uncertainty and difficulties of trading with the EU will reduce inward investment leading to less dynamic growth and reduced economic dynamism. Investment as a whole will decline leading to lower productivity and future growth.
- Britain will not disappear into an economic black hole immediately but it will certainly experience a considerable reduction in available resources, leading to poorer public services.

…but what about the economists for Brexit?

- Almost all economists agree on the overall negative impact on the economy through Brexit, although they differ in their judgement on the magnitude of the shock
- But there is a small group of ‘economists for Brexit’ around Patrick Minford at Cardiff using the ‘Liverpool model’ who claim Brexit will bring economic gains to the UK
- They want to adopt WTO rules and tariffs and otherwise totally liberalise trade unilaterally. They admit this would kill off UK manufacturing and increase wage inequality.
- But the Liverpool model is totally discredited
  - it ignores ‘gravity’; Fiji and France are considered the same even though France is far closer than Fiji
  - there is no product differentiation; a car is the same wherever it is produced
  - it assumes price differences between the UK in the EU and the rest of the world are the result of EU trade barriers whereas they represent differences in quality