

**RIETI-CEPR Symposium**

**Brexit:**

**On the future of the UK and the global economy**

**Handout**



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<http://www.rieti.go.jp/en/index.html>

# Brexit: Trade & International Production Network Issues

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# Outline: British + EU exit = Brexit

- Introduction
- Background facts & economic logic
- The Divorce
- The Re-Marriage
- Conjectures about the future
- Some guesses
- Terminology:
  - “Leave” = vote to leave EU; “Remain” = vote to stay in EU.

# Introduction

Making the EU was hard & messy



**1955**



**Customs Union**

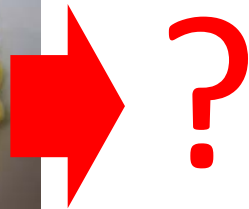
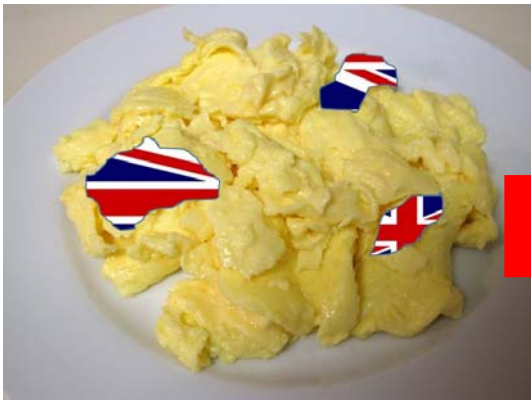


**Common Market**



**Single Market**

Extracting British egg from EU omelette will be messier



# Introduction: It's messy

- Brexit would be easy if it meant just leaving the EU.
- Messy part is “what comes next”.
- Basic problem:
  - The “Leave” campaign was deeply divided over post-Brexit plans, and so did not present a clear vision for post-Brexit plans
  - Thus we know what voters were against, but not what they were for.
  - Hard choices are inevitable, but there is no clear mandate from the referendum to guide those choices.
- The current government is deeply divided over post-Brexit plans.
- RESULT: We still don't know what comes after UK leaves EU.

# Example: The famous “Leave” campaign bus

## Two promises

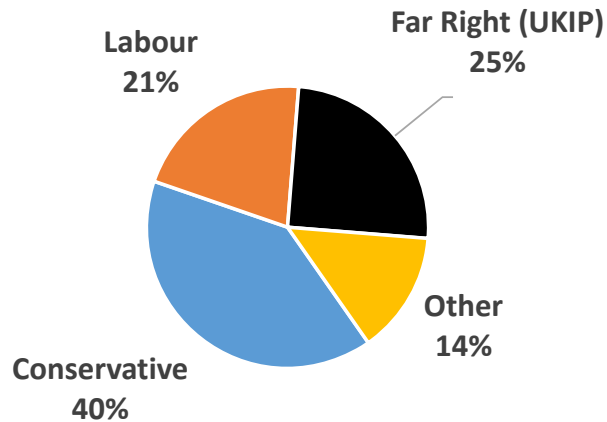


# The Vote (overall: 52% Leave; 48% Remain)

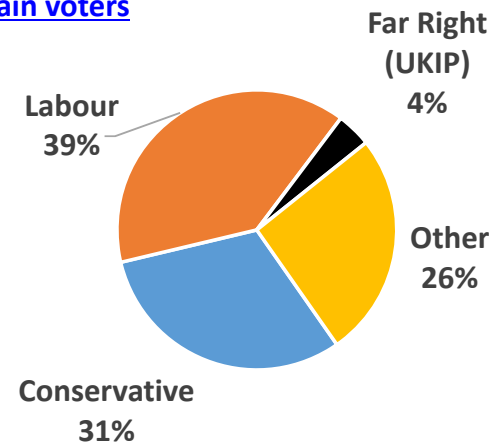
Who voted "Leave"?	Who voted "Remain"?
Majority of old people (over 45 years old)	Majority of young people (18 to 44 years old)
Majority of retired people	Majority of working people
Majority of people without jobs	Majority of university graduates

**The vote was NOT primarily by political party (except far-right):**

Leave voters



Remain voters

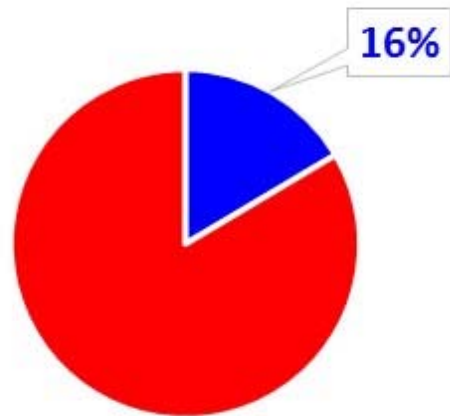


# Background facts & economic logic

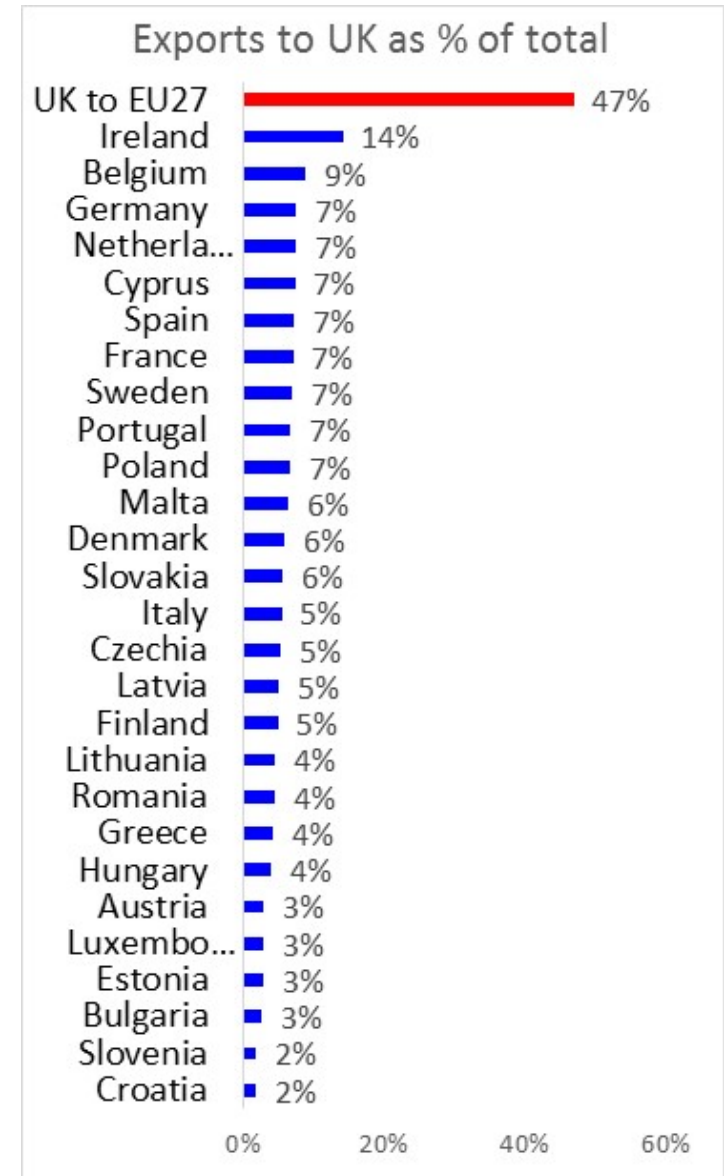
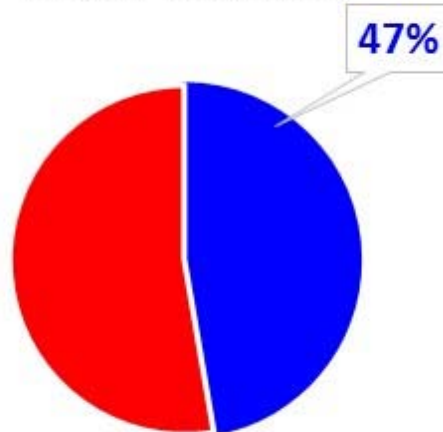


# Trade asymmetry

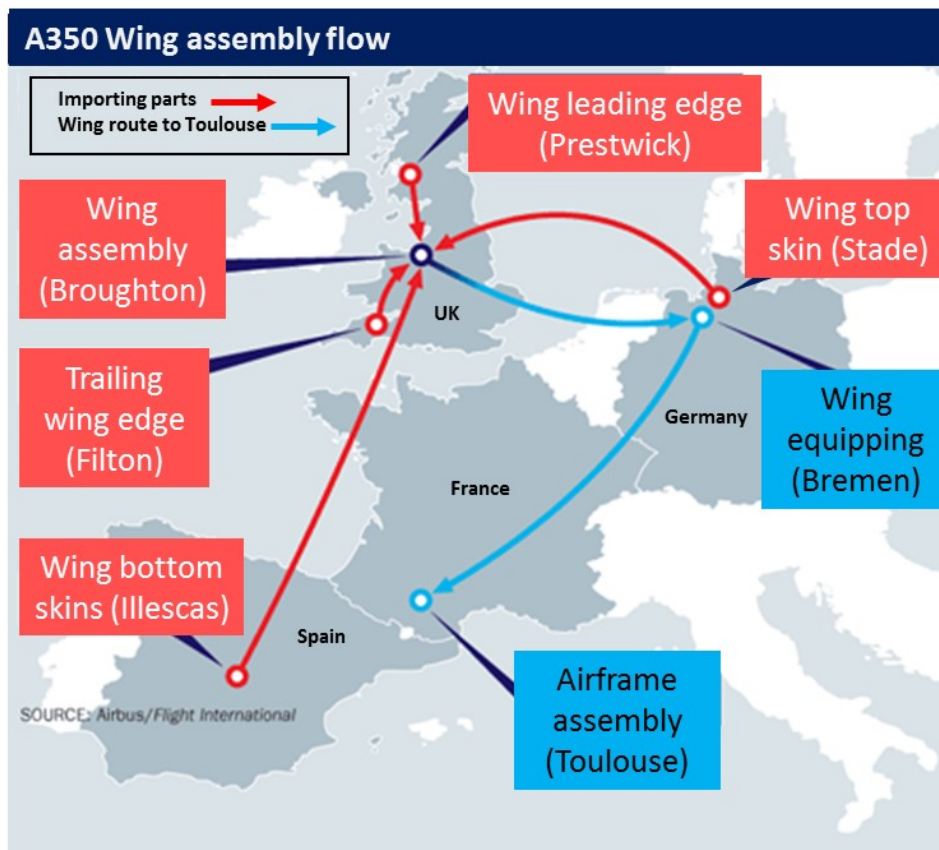
EU27 reliance on  
UK market



UK reliance on  
EU27 market



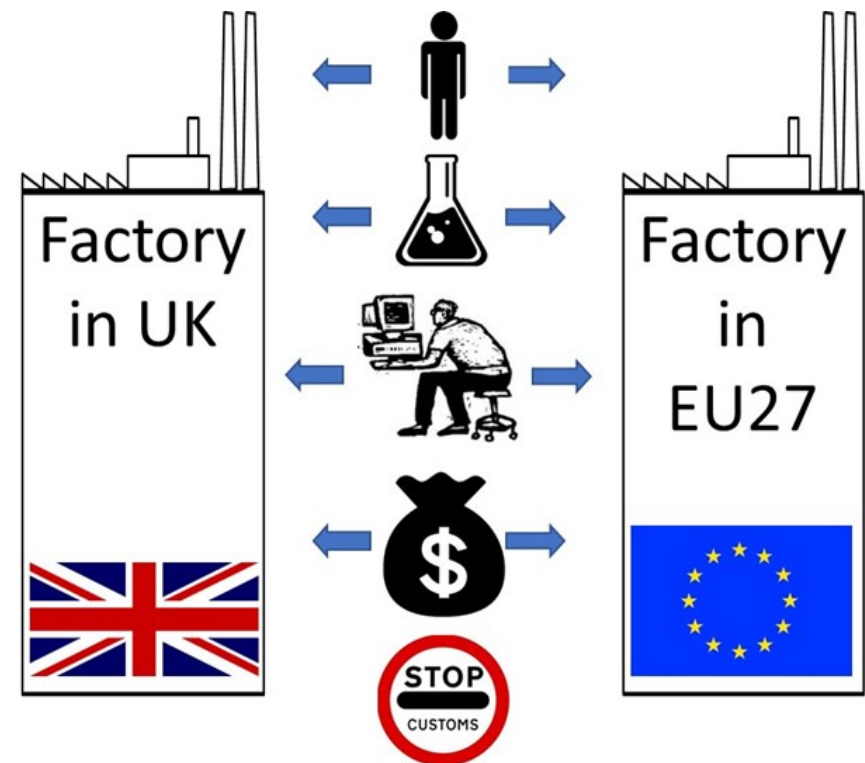
# But Brexit affects more than just trade: UK is part of “Factory Europe”



- Airbus A350 wings are assembled in UK from local parts and parts imported from Germany, Spain.
- Wing is sent to Germany for further processing.
- Then sent to France for final assembly.

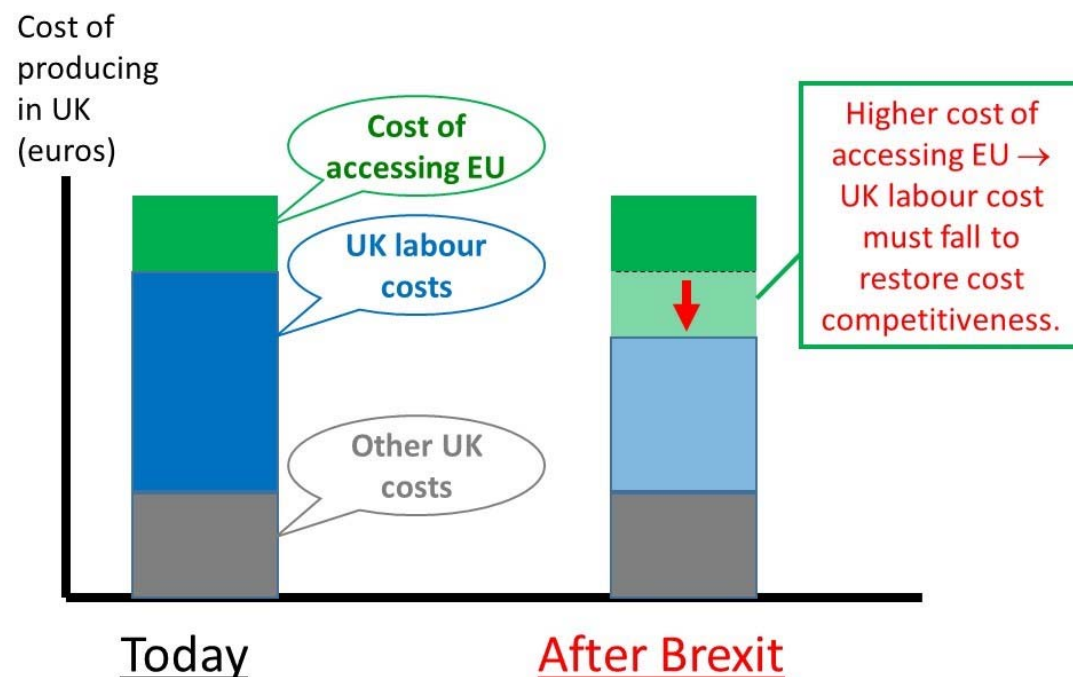
# Factory Europe involves much more than trade in goods

- Two-way flows of:
  - Goods
  - Services
  - Knowledge
  - Skilled technicians & managers
  - Investment
  - Training
- To operate effectively, Factory Europe relies on Single Market rules (more on this later).



# Brexit & economic adjustment

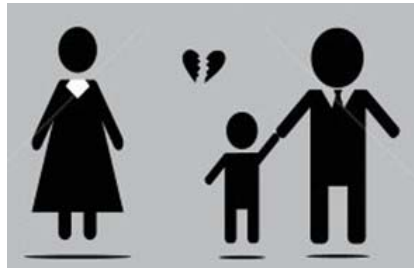
- Brexit → UK-based firms will find it:
  - More expensive/harder to export to EU;
  - More expensive/harder to integrate into EU production networks.
- This → wage & production adjustments to restore competitiveness:
  - Some production leaves UK for EU;
  - UK wages fall somewhat relative to EU wages.
    - The 20% fall in £ has already done this.
- UK's adjustment will be much larger than EU27's adjustment.



# Legal aspects of Brexit

- Two parts of Brexit process

- “Divorce”



- “Re-marriage”



# Timeline

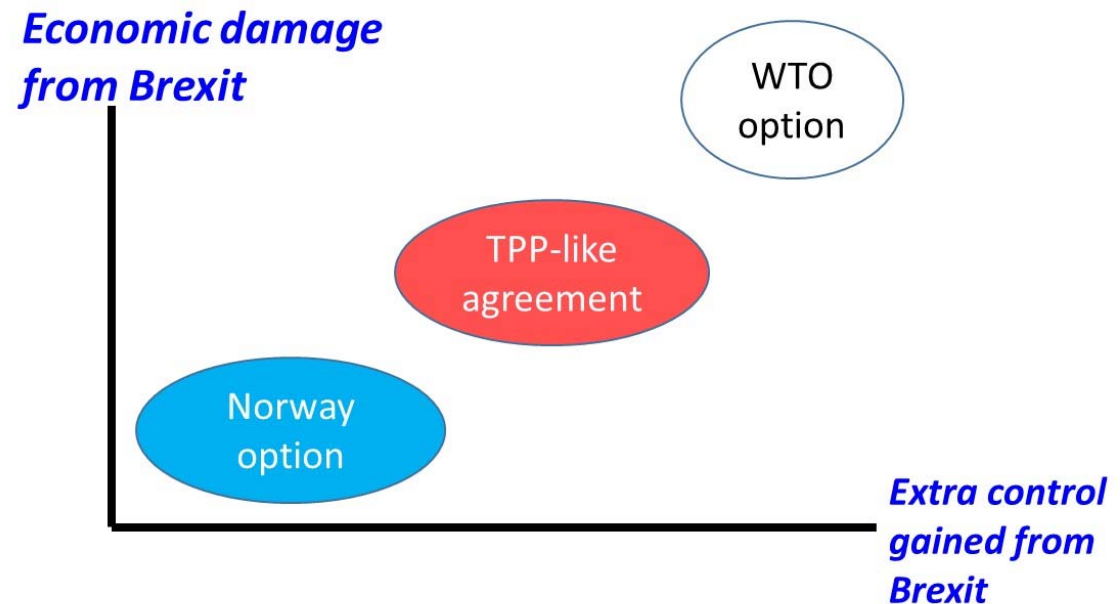
- UK is likely to trigger process in March 2017;
- Maximum of 2 years, unless all agree to extend.
- The “Divorce” part will probably be completed.
- The “Re-marriage” will take much longer, probably 5 years or more.

# Divorce issues (relatively easy)

- Money
  - Amount UK must pay for continuing programmes it committed to in past.
    - e.g. Pensions of retired UK European Commission officials, unpaid bills for infrastructure projects in poor regions, etc
    - Current EU medium-term spending plan goes till end of 2020.
- People
  - Status of EU nationals in UK & British nationals in the EU
- Administrative disengagement
  - For example, European Medicines Agency (now in London).
- Special situations
  - For example, Northern Ireland & Gibraltar.

# “Re-marriage” options (difficult)

1. Norway option:
  - “Stay in Single Market”
2. TPP-like agreement:
  - “No Single Market access”
3. WTO option:
  - “Crash out of EU”



# What is the EU's Single Market?

- Short Answer: Rules that support Factory Europe today
- Specifically: Free movement of goods, services, capital and people.
  - “Four Freedoms”.
- Customs Union:
  - all EU members have same external tariffs.
- Regulatory harmonisation to ensure Four Freedoms:
  - “Approximation of laws”.
- Democratic process to produce new EU laws on Single Market:
  - Complex process involving EU Members & EU Parliament.
- Adjudication of disputes:
  - EU Court is ultimate judge
  - European Court of Justice can over-rule national courts on Single Market matters.
- Cohesion payments:
  - Contribution to EU budget to pay for policies to help lagging regions.
- Dynamic arrangement:
  - All agree in advance to accept all new EU law on the Single Market.

# Option 1: 'UK stays in Single Market': Issues

- Norway has this relationship with the EU.
- Note Norway is:
  - Not in EU Customs Union (can set different tariffs on imports from third nations)
  - Not in Single Market for agriculture & fishery (only for manufactured goods and all services).
  - Has no formal input into new EU laws, but is obliged to accept them regardless (= 'regulation without representation').
  - Does pay into EU budget.
  - Does accept EU Court as ultimate recourse for Single Market disputes that involve an EU member, or company.
    - There is also an EFTA Court for intra-EFTA issues.
- Norway participates via the "European Economic Area (EEA)" agreement.
- UK would have to re-join EFTA if it wanted EEA treatment.

# Option 1: 'UK stays in Single Market': Impact

- This Brexit option would cause minimal disruption to trade & European production networks.
- Would allow UK financial sector to continue selling to EU27 as now.
- BUT would also reduce amount of control that UK wins back from Brexit.
- Would almost surely require unanimous approval of all 27 EU members and EU Parliament.

## Option 2: “Deep” trade arrangement (Comprehensive trade & production sharing deal)

- This would be trade agreement like NAFTA, or TPP, or Japanese “Economic Partnership Agreements” with big ASEAN nations.
  - Would include: duty-free trade in manufactured goods, some liberalisation of services trade, and rules to protect investors and intellectual property owners.
  - Unlikely to include: Customs Union, automatic Four Freedoms, automatic approximation of laws, Supremacy of EU Court, budget contribution.
    - EU-Canada agreement is often viewed as a model.

## Option 2: “Deep” trade arrangement (Comprehensive trade & production sharing deal)

- Would probably not allow UK financial sector to continue selling to EU27 as now.
  - So-called ‘passporting’ rights that mean UK regulation of banks has to be accepted as equivalent to national regulation in all EU27 nations.
  - Is important part of City of London’s attraction as a hub for EU financial sector.
- This is much less economic integration than Single Market, and thus much more disruptive to Factory Europe, especially for the UK.
- BUT it would give UK much more control over its own policy.
- Factory North America, and Factory Asia work on the basis of such agreements.

## Option 3: WTO (no special deal with EU): “Crashing out of EU”

- If no UK-EU trade agreement, WTO rules require EU to charge usual tariffs.
  - MFN tariffs, rules of origin, no special cumulation of origin.
- This happens if UK leaves EU without a new trade deal
  - But, ongoing talks would probably be sufficient.
- This is the default option: UK treated as any other WTO member, like Japan.

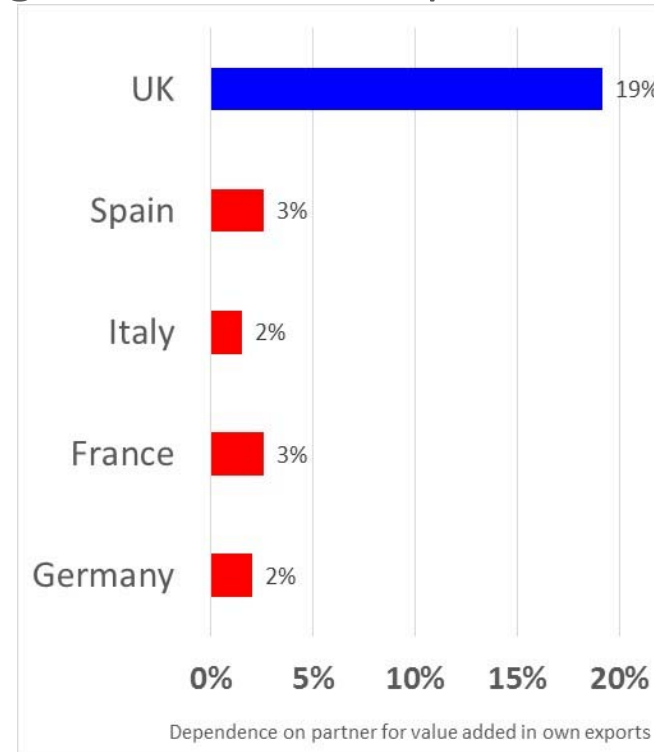
# Option 3: WTO (no special deal with EU):

## Impact

- This would be an economic train wreck.
- EU tariffs can be high, e.g. 4% on auto parts & 10% on autos.
- This would be very disruptive for Factory Europe, especially for UK.
- UK is attractive place to produce, but France, Italy, Germany, Poland are good substitutes and very nearby.
- Would hurt EU27 and UK, but UK much more.

### Asymmetric dependence:

Value added in UK exports depends far more on parts & components from EU27 than the big EU carmakers depend on UK value added.



# Transitional issues

- Only WTO option would be “quick, easy and clean”.
- Norway option & “Deep” trade agreement would take years to negotiate.
  - Complex trade agreements take 5 to 10 years to negotiate.
  - UK already in, so technically easier, but politics more complex due to need for EU27 to avoid a precedent.
  - Regardless, they can take another 2 years to implement (27 national parliaments and the EU Parliament).
    - Example of EU-Canada agreement (CETA)
- To avoid disruption, a transitional arrangement will be needed.
- But the transitional arrangement may turn into the permanent arrangement, so it will not be easy to agree.
  - Most natural would be to continue status quo, but that would require free movement of people.

# Non-EU trade issues facing UK

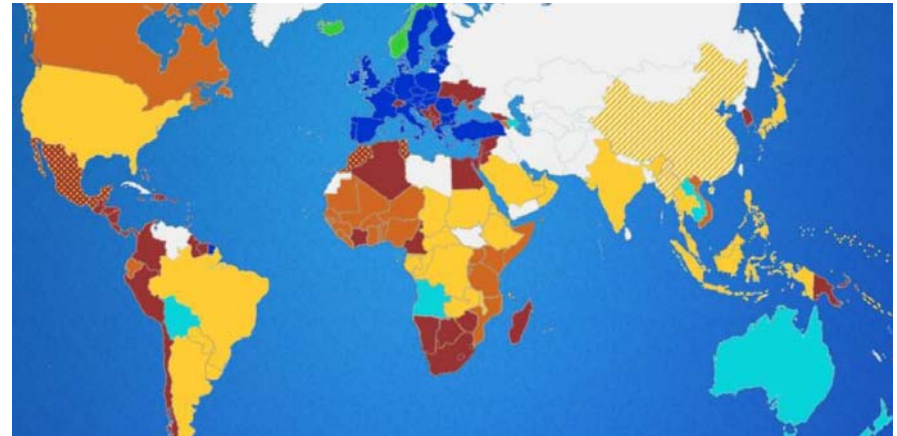
1. UK trade arrangements with non-EU nations.
2. Extracting UK from EU28 commitments in WTO.
3. Extracting UK from EU28 free trade agreements with third nations.

# Trade deals with non-EU nations:

## Background

- EU28 is largest importer & exporter in world.
- Achieved strong position by acting together (not 28 separate trade strategies).
- EU28 has trade deals with most nations in the world.
- Brexit means UK would have to replicate these bilaterally.

Map of EU trade relations



- EU has trade agreements or is negotiating them with almost every nation in the world.
- Two-way agreements with about 70 nations.
- Unilateral tariff preferences granted to almost all the rest.

# Trade deals with non-EU nations:

## Problems

### 1. Market power:

- UK is 5<sup>th</sup> largest economy in world, but much smaller than EU28.
- Other nations may demand more from UK than EU28 (leverage);
- They could also demand compensation from EU27 (smaller market).

### 2. Sequencing:

- Until UK-EU trade deal is clear, other nations “cannot have a serious conversation about what an agreement with UK would look like” (USTR Mike Forman October 2016).
  - UK trade ties with 3<sup>rd</sup> nations, thus unlikely to start until transitional arrangement is agreed (in best of cases, this would be in 2018).

### 3. Transitional issues:

- Even simple trade deals can take years to negotiate.
- Once UK leaves EU, EU28 deals cease to apply to UK.
- UK needs to make transitional arrangements to avoid sudden rupture of status quo trade arrangements.
- UK could probably agree a ‘standstill’ with most 3<sup>rd</sup> nations.

# Extracting UK from EU28 commitments in WTO:

## Background

- EU has negotiated as a block in GATT/WTO for over 40 years.
  - UK has been an important part of the EU block.
- Three sets of problems:
  - Changes to agreements that EU28 made.
  - New agreements that UK will have to make.
    - Probably have to be done simultaneously with EU28 renegotiation.
  - UK has to establish its own tariff schedule in the WTO.
- In principle, each WTO members has a veto on these changes.
- VERY lengthy process:
  - Took 15 years to agree similar issues arising from EU's 1995 enlargement from 12 to 15 members.
  - Talks on adjustments from 2004 are still underway.

# Extracting UK from EU28 commitments in WTO: Issues

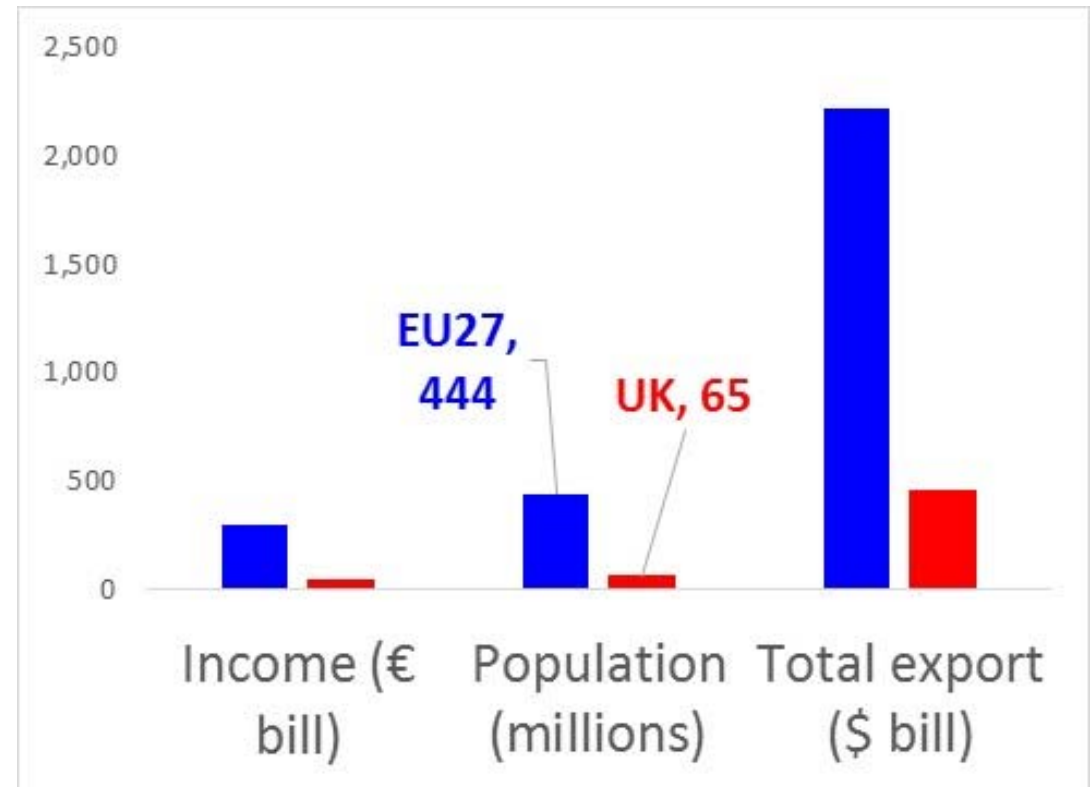
- When UK leaves EU, the deals made by EU28 have a different commercial value to non-EU nations.
- This will force a renegotiation of EU28 commitments among UK, EU27 and other 162 WTO members.
- For example, in the 1994 Uruguay Round deal, EU28 agreed to import 37,800 tonnes of high-quality beef.
- Dividing the 37,800 tonnes between UK and EU will involve difficult negotiations between UK & EU, and exporting nations.
  - Aggressive WTO members could, in principle, use the talks to renegotiate with EU27.
- Overall, probably a headache, but not a source of important disruptions (as long as everyone 'plays nice')

# Conjectures about the future



# Conditioning facts

- EU27 is MUCH larger than the UK.
- EU27 national economies are deeply woven together by Single Market.
  - Politically & economically.
  - This was the plan from 1958; it worked.
  - Any threat to cohesion of the Single Market is threat to each EU27 economy.
- Asymmetric dependence:
  - EU27 market takes about 50% of UK exports;
  - UK takes only about 20% of EU27 exports.
- UK government (& voters) are deeply divided on correct UK-EU post-Brexit option.
- The 2 year deadline & cost to UK of WTO option gives EU27 strong hand in negotiations.



# High politics in EU

- Each EU27 members would like to pick & choose among Single Market measures.
  - They don't since the Single Market only works as a package deal, complex set of compromises agreed over decades.
- Allowing UK to pick & choose, would lead most EU27 members to ask for the same.
  - This would destroy cohesion of Single Market.
- Allowing Brexit to create an attractive alternative to EU membership would:
  - Encourage far-left & far-right anti-EU parties in many EU27 nations.
  - Encourage regional separatism in some EU27 nations (e.g. Catalonia in Spain).
- Germany & French elections:
  - Sitting governments will not want to be discussing clever, creative limits on migration with UK during campaigns.
  - Doing so would encourage demands by far-left and far-right parties.

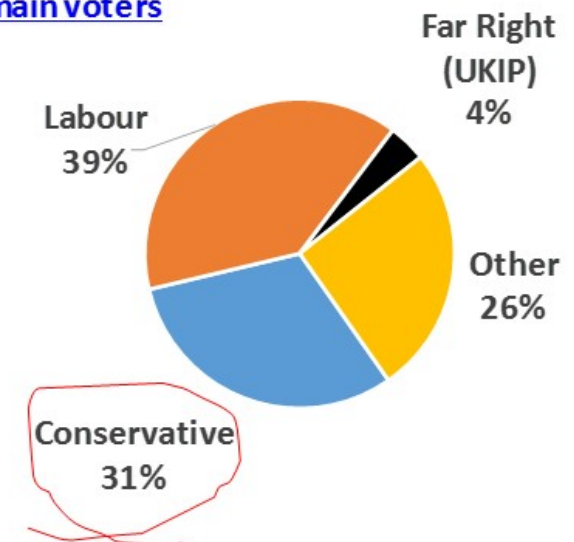
# Low politics in EU

- Labour mobility is biggest issue in Brexit; also big issue in many EU27 nations, BUT
  - some EU27 are net 'exporters' of migrants; others net 'importers'.
  - Some welcome migrants, other not.
  - Some have a big problem with non-EU migrants, others not.
- Since new UK-EU deal will surely be a 'mixed agreement' (like EU-Canada), every EU nation and EU Parliament will have a veto.
- Unanimously agreeing a 'creative' deal with the UK is thus likely to be impossible.
  - Last reform effort (lead to 2009 Lisbon Treaty) took 10 years.
- **CONCLUSION:** Only solution EU27 can agree between now and March 2017 is status quo, i.e. the
  - Single Market: Take it or leave it (Norway Option).
  - OR
  - WTO option.
  - Deep agreement is possible, but will take many years.

# UK political situation: Brexit referendum issues

- Ruling Party (Conservatives) are deeply divided on Brexit (see charts).
  - Idealists concerned mostly with 19<sup>th</sup> century-style sovereignty; '**Hard Brexit**'.
  - Pragmatists worried about protecting UK economy; '**Soft Brexit**'.
- The referendum was a political ploy by Conservative Party, not a grassroots movement.
  - PM Cameron called referendum in January 2013 to keep idealists & pragmatists united during last general election.
  - UK has not had such a referendum since 1970s.
- Referendum result provided no clear mandate on post-Brexit options.
  - We know what Brits voted against, but not what they voted for.
- Opposition party (Labour) is also divided over Brexit.
  - Leader (Corbyn is broadly anti free markets and thus broadly anti-EU), but many Labour voters like EU membership.

Remain voters

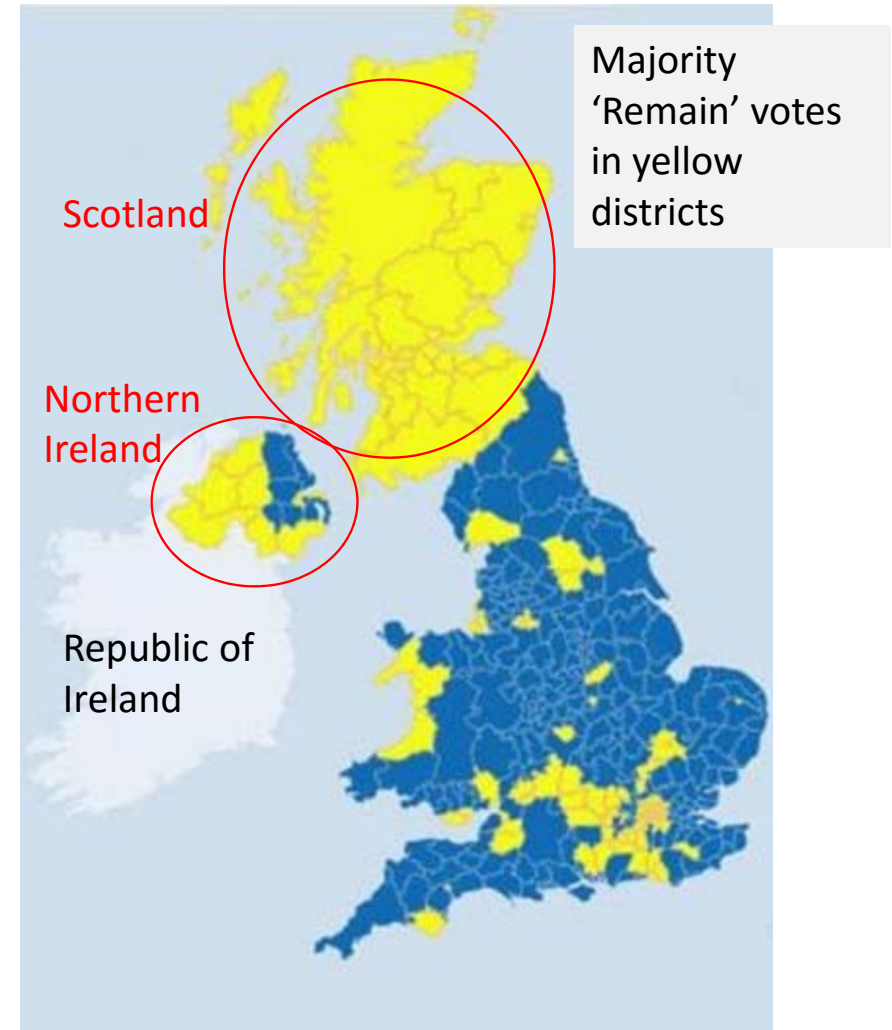


# UK political situation:

## Regional issues

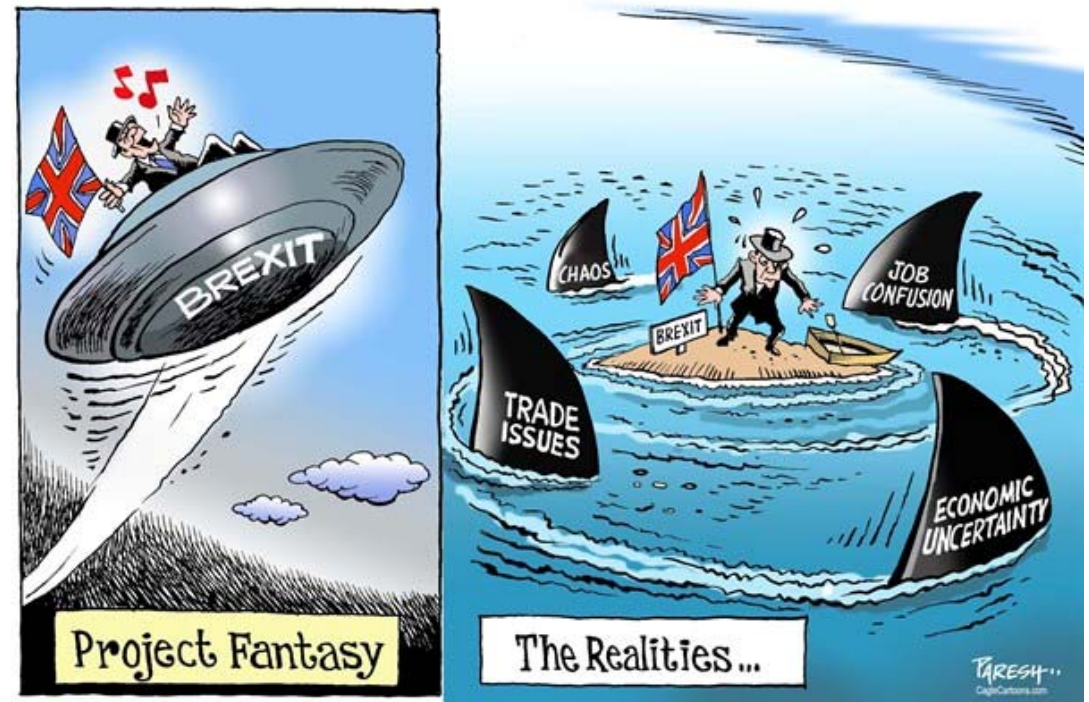
- Scots voted heavily to stay in EU.
- Scotland held referendum on leaving UK in 2014 (before Brexit)
  - Only 55% of Scots voted to stay part of UK.
  - Scotland might break away if 'Hard Brexit'
- Northern Ireland settled 'Irish unification' question by eliminating land borders with Republic of Ireland.
  - Brexit may reintroduce land border and thus spoil the political settlement.

## Scotland & Northern Ireland voted to stay in EU



# Current UK government's stance

- Current government is pretending that UK can have both 19<sup>th</sup> century-style sovereignty & protect economy.
  - PM May is trying to keep Idealists and Pragmatists together.
- Once talks start with EU27, the pretending will end;
  - Hard choices will have to be made.
  - Conservative Party will be split.
- General election in May 2020 could end up as a vote on Brexit options.
  - PM May might be ousted by own party in 2017 or 2018 if Brexit talks start to look like leading to WTO crashing out.



# High Court ruling (last week)

- Legal challenge to Prime Minister's right to start Brexit (trigger Art.50) announced 3 November 2016; Prime Minister will appeal.
- If PM wins appeal, all continues as before. Brexit process likely to start in March 2017.
- If PM loses appeal,
  - Parliament likely to approve Brexit eventually but be involved in developing UK's negotiating priorities & studying consequences, so economic interests better represented.
  - Start of Brexit talks possibly delayed by weeks or months.
  - Hard Brexit much less likely.
- Supreme Court likely to decide in mid-December.

# Guess about likely outcomes

- Three scenarios with reasonably high probability of happening.
1. UK crashes out of EU without an new agreement with EU, and without a transitional arrangement.
    - Likely if UK takes a hard-line position on labour mobility. Idealist win; Pragmatists lose.
  2. Long negotiations but no disruption during transition.
    - Happens if UK accepts to Single Market conditions temporarily. Idealist lose; Pragmatists win.
  3. Long negotiations with disruptions during transition.
    - Happens if UK unilaterally imposes controls on EU workers; Pragmatist win at first, but Idealists win later.



# Two possible scenario

**Brexit talks start; EU27 insist that “Single Market means Single Market”.**

- UK government divides; pragmatist win.
  - Recent Nissan deal suggests this is not impossible.
- Talks are formally extended beyond two years, or a transitional arrangement agreed.
  - UK stays in Single Market
- UK government divides; idealists win.
- EU27 sticks to its position (since impossible to get 27 nations to agree changes).
- UK imposes migration controls unilaterally March 2019.
  - UK crashes out of EU without a transitional arrangement.

**May 2020 General election becomes a vote on post-Brexit options.**

# End

Thanks for listening