



Paul JJ Welfens, Jean Monnet Chair for European Integration and Chair in Macroeconomics; and EIIW president
European Institute for International Economic Relations (EIIW) at the University of Wuppertal

BREXIT: Elements of a Politico-Economic Shock for the UK, the EU and the World Economy

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welfens@eiiw.uni-wuppertal.de

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preliminary, do not circulate



UK' BREXIT Referendum June 2016

- * **Immediate reaction: strong fall of the pound** (raises import prices, stimulates exports of goods); UK in an international net debt position =+foreign indebtedness
- * **fall of stock market prices** (very strong for banks, Ryanair – the latter would lose easy access to EU27), but also in Madrid; in the UK demand-side effects will be negative through declining wealth
- * Rising demand for \$, Yen, Renmimbi; and safe haven effects = rising demand for German bonds AND GOLD, declining for government bonds of **Portugal, Greece, Italy = euro crisis is back**
- * ***expectations matter in financial markets (e.g. future FDI inflows, capital outflows, political instability, ...growth),***

Long Run Perspective (e)

(1) $e = P/P^*$ (purchasing power parity);

(2) $M/P = m(Y, i)$; (3) $M^*/P^* = m^*(Y^*, i^*)$

(2') $P = M/m(Y, i)$; (3') $P^* = M^*/m^*(Y^*, i^*)$

(4) $e = (M/M^*)m^*(Y^*, i^*)/m(Y, i)$; **if Y falls in the UK: due to trade diversion effects/disintegration**, then real demand for money (m) will fall and e will rise

Short-term BRANSON model is better for short-term reaction

This model shows that e and i have to be determined

simultaneously; consider an augmented model in **which e, i**

and stock market price index P' are determined

simultaneously; changes of P'/P , i and r will have an effect on the real economy in the medium term; demand side effect

Supply side effects $Y(K, A, L)$...is long term



June 23, 2016: UK Referendum on BREXIT

51.9 percent for Leaving the EU, 48.1 percent for Remaining

Scotland and Northern Ireland against BREXIT

young voters againsts BREXIT, older voters for BREXIT

Premier Cameron had promised the referendum on the EU membership in 2013 to fend off populist factions in the

Conservative Party and to fight UKIP; **UKIP has achieved**

victory in the 2014 (28 percent of votes) in the European Elections for the EU Parliament, but UKIP obtained only 13% in the national elections in the UK in 2015.

WHY 28 percent EU elections vs. 13% in national elections? looking

at German voting research the explanation is that voters do not

understand what the EU stands for/its tasks (too small: 1% GDP) =

willingness to vote at European Parliament elections more

radical/small parties; UKIP invests EU election money..



RED is leave



- * **UK: Populist political forces** (UKIP; or Boris Johnson) promising many benefits that are unrealistic: e.g. Boris Johnson argued that British EU contributions 350 mill. Pounds per week could be used to reinforce National Health System, only $\frac{1}{2}$ is net contribution – Boris Johnson's promise is a lie
- * Boris Johnson has suggested that **UK access to single market in the future will not be a problem**
- * **Google UK:** 2nd most word searched after the elections was What is the EU?



UK in economic terms is

18% of EU GDP

13% of EU population (grand total is 510 million)

12% of EU exports

1.4 million British citizens living in EU27 countries,

3.6 million EU citizens living in UK (65 mill. Inhabitants)

UK in turn could lose 5.5 million people in Scotland if breaks away after new Independence Referendum

Problems with Ireland/Northern Ireland – *easy border traffic in the EU* - as soon as the UK is out of the EU: 2 years after mid-2016 = 2018

Statistics (EU28 vs. Post-BREXIT) **see attachment**)

GDP: EU28= 18.5 bill. \$; **EU 27= 15.5 bill. \$ (2014)**

POP: EU28 507 mill.; **EU 27= 443 mill.**

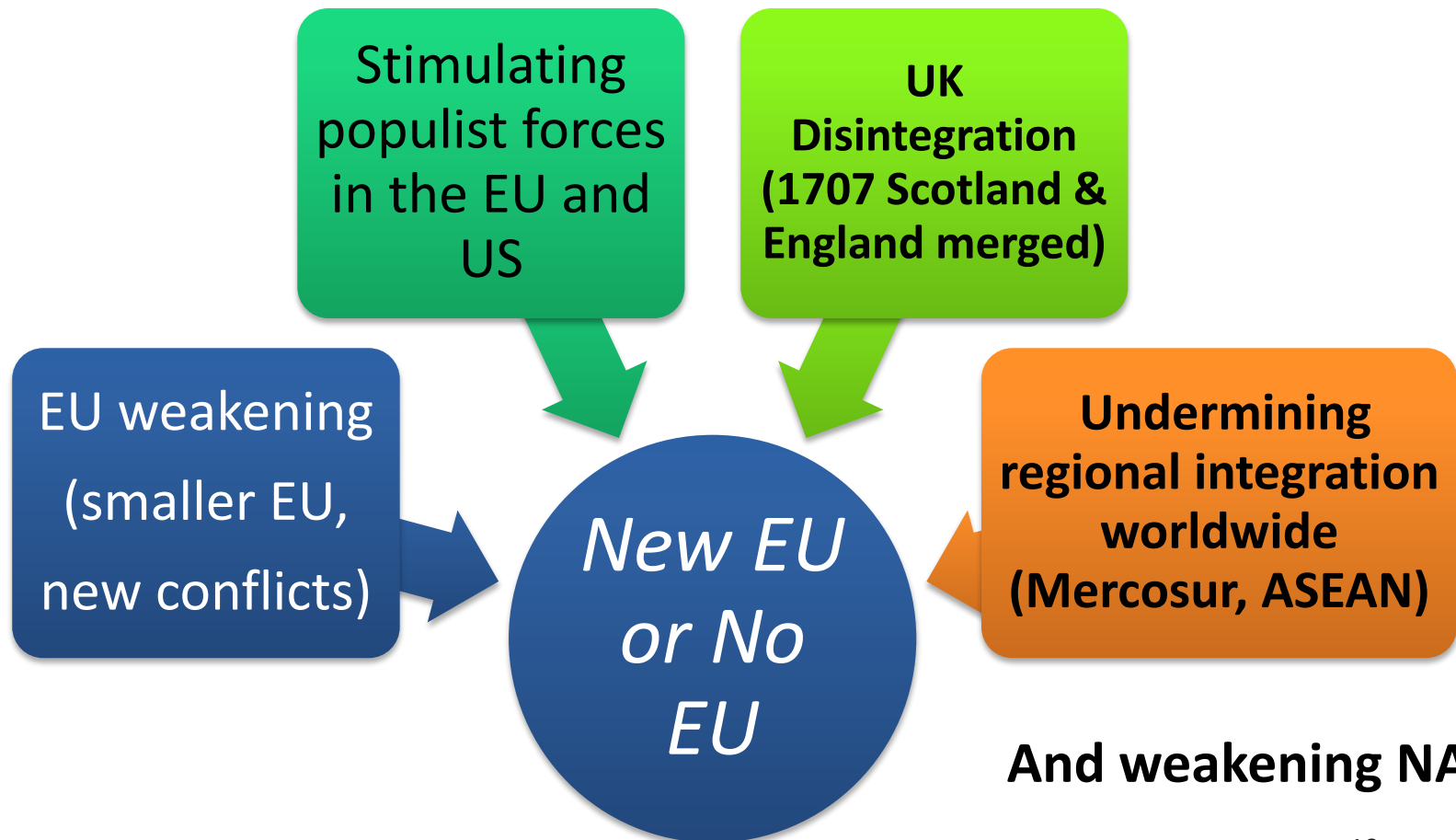
Germany's share in real (PPP) EU28 GDP= 20%; **EU27 GDP = 23%**



Major BREXIT effects related to

- * **Trade** (e.g. UK-EU27; about 45% of EU exports go to EU, high surplus in financial services so far; in the future the EU will not allow Euro clearing in the UK, so London City is a loser); Paris and Frankfurt likely winners; EU exports to UK less than 6% of total; UK has an overall current account deficit, this will worsen, so that UK foreign indebtedness will rise
- * **International capital flows**: a considerable share of FDI will switch from UK to EU27: flows and stocks – appreciation of the euro to the extent that the euro area is attracting higher capital inflows
- * **Migration**: emigrants from EU eastern countries likely to move more to Germany, France, Italy, Spain, Benelux; British citizens might move to EU27 countries

Some likely results from BREXIT referendum





EU is a Customs Union+ (common external tariff; only other CU in world economy - with Parliament - is MERCOSUR)

* **EU single market: free trade, free capital flows, free labor mobility since 1993; all three also important for monetary union** (eurozone that has started in 1999) for which the UK and Denmark have option out clause

* „Ever closer union“ is the slogan in Brussels – does this make sense?

* In a period of rising economic inequality supranational tax policy will be needed; national income redistribution/tax policy is inefficient; in eurozone also joint fiscal policy needed: **Boris Johnson (2016; Washington Post, A12) said: „But there is simply no need in the 21st century to be part of a federal government in Brussels that is nowhere imitated in the world.“ This apparently is nonsense (Merc., Asean? other)**



Some EU critical points:

- * **Commission is hybrid (not clear division of power): Executive power plus legislator; not ok**
- * **Some fields require unanimous (e.g. tax)**
- * **Supranational expenditures is 1% of GDP (40% agric.)**
- * **Often the Council of Ministers from 28 countries will decide (19 in eurozone at the same time); weighted votes for majority – critical fields require 55% of countries, 65% of population (510 mill. In 2015)**

Lisbon Treaty as Constitution of EU; the previous intergovernmental conference failed since France, NL had negative referendum results

Lack of automatic adjustment in the number of members of European Parliament (would be better to have, say, 1 MP for every 1 million inhabitants; Greece -1, UK would have obtained +3), **compare to USA which has fixed 475 and...**

Effects on UK

- * Much trade diversion = negative real income effect.
One critical aspect is future access to EU single market: will be restricted (see e.g. the case of Norway: access in many EU sectors, not financial services; Norway contributes to EU budget, has to implement many EU regulations – without a say in Brussels)
- * **Slowdown of growth** as few immigrants from EU countries in the future $Y(K,A,L)$ and **less innovation...**
- * Less FDI inflows from US, Japan, Korea to UK = lower innovation dynamics and hence reduced economic growth; and short term recession due to uncertainty, lower investment; central bank could reduce the interest rate slightly (already close to zero)

If the UK gets access to EU single market on the basis of Norway-EU or Switzerland-EU the UK would have to accept all four freedoms of the EU single market, **including free labor mobility; but the BREXIT campaign was much focused on reducing immigration.**



Cameron's political speculation failed: BREXIT results reflects

*** disappointment about EU/Euro crisis** (EU GDP gap 2008-2015

compared to US is 10% output growth)

*** immigration issue self-created desaster of Cameron: in the EU single market UK has not control over immigration from other EU countries: Cameron's promise to limit EU**

immigration to 100 was illusory (300 000 total in 2015, ½ from EU)

*** Western confidence declines vis-à-vis government/political elites – much in the context of the banking crisis 2008-2010; and top 1% income pyramid gaining such a high rise in the UK**

(and the US: doubling 1995-2015: 19% instead of 9%; CEA Report 2016...) if the British referendum had been about abolishing zebra crossings – with premier Cameraon supporting zebra crossings – there still could have been a majority against zebra

crossings even if this is self-hurting and dangerous

The Economic Cost of Britain

- * about -5% output over a decade;
- * UK will „gain“ about 0.4% of GDP as net Eucontribution
- * -1% of GDP for the EU27 over five years; more if TTIP is cancelled due to BREXIT= **additional -2% of GDP**
- * US also a loser if TTIP should be dead: about 2% of US GDP
- * potential destabilization of other integration clubs = lower regional growth (e.g. ASEAN, MERCOSUR)
- * **Grand total is 1-2% of world GDP in the long run**
- * the UK's political clout in the world economy will be rather weak – e.g. when negotiating with other countries (EU international free trade treaties no longer applying to the UK once it leaves the EU/Article 50; getting back into the EU possible under Article 49, but then without opting out Euro



Theory of Economic Interdependency (UK is foreign country, EU 27 is home country)

$$(1) Y = G + I + (c-j)Y + c'M/P + bY^*;$$

$$(2) Y^* = G^* + I^* + (c^*-j^*)Y^* + c'^*M^*/P^* + jY/q^*$$

$$(1') Y(1-c'') = G + I + c'M/P + b(G^* + I^* + c'^*M^*/P^*)/(1-c''^*)$$

$$(1'') \text{ medium term equilibrium: } Y'' = (G + I + c'M/P)/(1-c'') + b(G^* + I^* + c'^*M^*/P^*)/((1-c''^*)(1-c''))$$

In the UK G^* , I^* will fall (recession abroad), M^*/P^* will fall as P^* is rising (due to devaluation of the pound; c'' rising and c'' rising and j and j' falling (later) due to disintegration; I also will fall also; M/P up (appreciation, $dP > 0$) medium term impact is fall of Y'' ; * more long term: Y'' rising as c''^* is getting smaller and c'' as well due to disintegration effects

What one should expect in the UK short term/medium term

- * no merger of stock markets London and Frankfurt (I think)
- * massive depreciation of the Pound = inflation of 2-4% by 2017; international remittances will fall slightly
- * recession in the UK and rising unemployment, mainly due to lower investment-GDP ratio
- * higher deficit-GDP ratio
- * a fall of the stock market price index

BREXIT and the US

- * BREXIT is destabilization of Nato as BREXIT brings conflicts
- * BREXIT is economic and political destabilization of the EU – *not in the interest of the US*

In this situation successful TTIP¹ negotiations would be very desirable: requires much more flexible stance on the side of the US in TTIP negotiations than so far

EU/Eurozone should be encouraged to sort out key problems

US loses indirect influence in the EU (via UK); weaker West

G20 promise from Brisbane 2014 to increase GDP by an extra 2% by 2018 is in danger – risk of recession in the UK and

EU27; here there is another negative side-effect of BREXIT

If there is a second Scottish referendum on independence this could destabilize the UK, but also Spain etc.

Consequences from BREXIT/Lessons

- * Globalization in the present form not sustainable; should be slowed down, long transition periods
- * the enormous increase of income inequality/gains for top 1% of income pyramid in 1985-2015 is a problem – e.g. in the US +10 percentage points so that lower 99% face struggle for income/decline of real median income (in the UK similar problems) = **dissatisfaction of many pol.**
- * higher tax rates on top income is necessary if one follows the arguments of Piketty et al. that argue that reduction of top income tax rates have raised^{*} the negotiation power of top managers in the US, UK and elsewhere (US not likely to consider higher tax rates?)

Lessons from BREXIT

Political and economic elite faces decline of influence in the US and Europe = more uncertainty in democratic countries and rise of populism

* The internet makes political fight more ugly

* Indirectly, autocratic regimes are winners of BREXIT:

Russia, China; Turkey might be a loser since **Turkish**

membership perspective now is zero – politicians in all EU countries in post-BREXIT environment much more hisitant to adopt elite projects without popular support, could bring new problems for refugee crisis of the EU

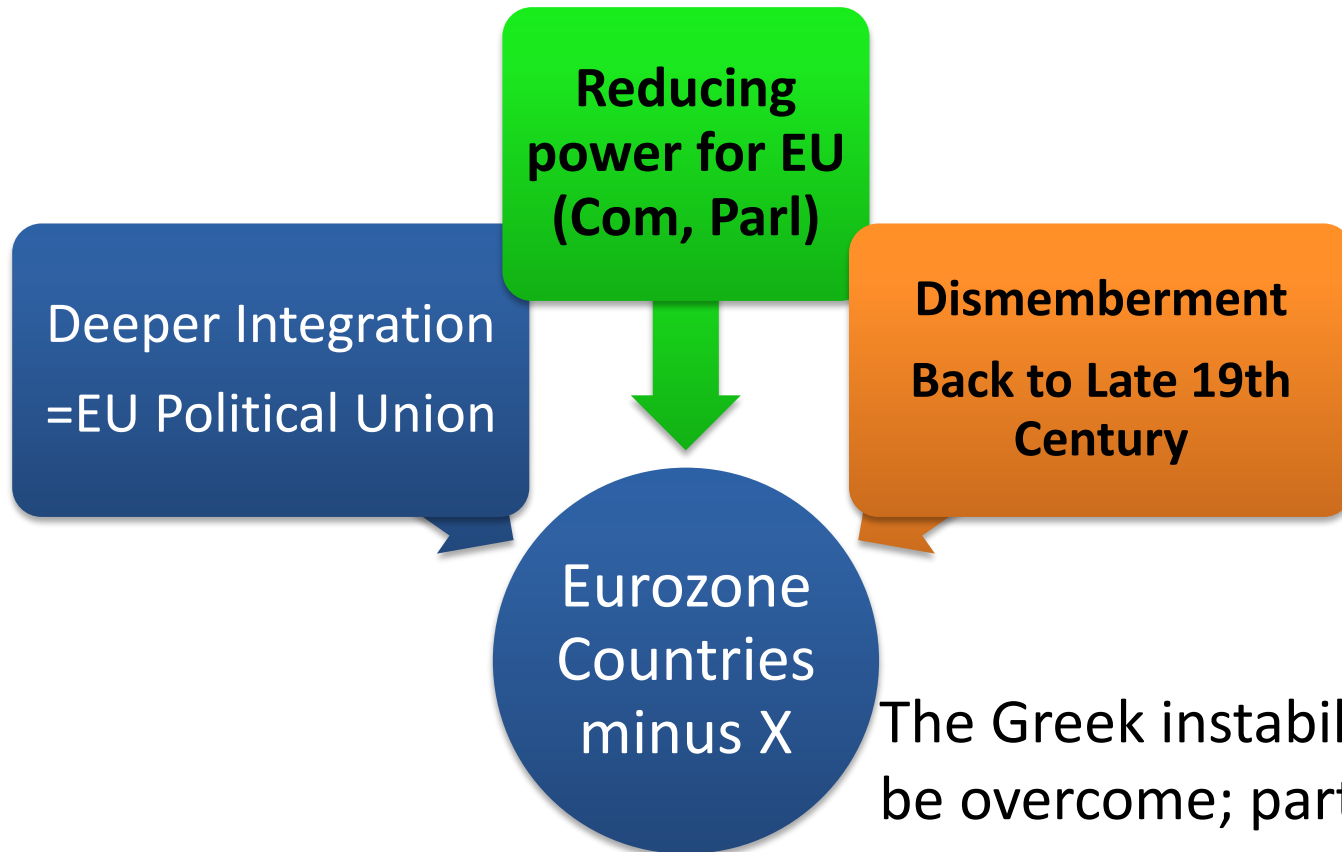
* More European protectionism as consequence of rising right-wing popular parties in many EU countries



Germany's role will be growing

- * Its share in total GDP of the EU is rising**
- * US will focus in the EU more often on Germany – other EU member countries will not find this increasing German power wellcome**

Options for the EU



The Greek instability has to be overcome; partly ; problem partly due to Germany's stubbornness: Debt reduction needed



The EU Member Countries and the EU should get a more professional policy

- * better analysis needed (see bad example of TTIP where Commission only had asked about trade effects; and some FDI aspects – no innovation aspects included in the tender)
 - * European Commission's political weakness has led to many DGs (Directorates) **to buy the political support of major NGOs** (e.g. Friends of the Earth which is not really an NGO since more than 50% of budget comes from Commission); such NGOs have their own life, e.g. green NGOs sponsored by EU fight against TTIP – **inconsistent**
- EU governance is poor and EU will not survive without major reforms: making the EU more visible, more consistent and better known for its activities (clean water in the North South in southern England – not a known directive of the Commission/pensioners in that region pro

What to do with the UK (facing itself a political crisis as the majority of Parliament No-BREXIT)?

Negotiate Divorce
Terms

Define a Common
Project (?)

Establish EU-UK
Foreign Policy Coop

What to Change in the EU?

Looking more carefully at the example of the US (Usgov= 9% of GDP in Washington+11%); EU 1%

**Avoid dominance of
Germany (will not work)**

**Establish UK-type report on
the EU benefits (did not
help in the UK) for all**

countries

**Institutional Reforms and
EU-wide parties = coordin.**

**Find out which governments
willing to shift part of power
to the EU/Euro Political Union**



If there is ongoing disintegration in the EU there are prospects for Europe to return to 19th century (4% military expenditure-GDP ratios) of big powers

Growth of autocratic governments and new conflicts

Global disintegration (old question: integration clubs = building blocs/(stumbling blocs)) would become irrelevant in the long run; everything would depend on the WTO which has outdated decision mode (unanimous)

*** all International Organizations should get democratic accountability and majority rules**



Short Welfens piece: March 30, 2016 (AICGS/Johns Hopkins University) largely has anticipated many critical points of the BREXIT referendum

<http://www.aicgs.org/issue/british-referendum-pains-and-the-eu-implications-of-brexit/>

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