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rexit & Its Consequences

By Jacques Mistral



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How Historic Is the Brexit Vote?

The United Kingdom's vote on June 23, 2016 to achieve greater control over European immigration, to roll back European jurisdiction and to "exit" the European Union by a 52-48% margin has frequently been qualified as "historic", many asserting that this was a terrible threat to the EU. For the British financial press, this instinctive comment was a sort of *post factum* reinsurance but it was clearly a premature conclusion. The first and undisputed fact is that Brexit is a British political drama. Brexit certainly reverberates around the rest of Europe but it is one among many issues (fiscal and monetary policies, immigration, terrorism and security to mention only a few) that will exercise a powerful drive on the future of the EU and the eurozone. The EU and the UK are anyway entering uncharted seas while preparing to launch in March 2017 a negotiation that will last two years. Brexit being but another step in a complex and sensitive relationship between the UK and the continent, let us start by a short historical piece. This is more than justified because 2017 marks a double anniversary, the 60th year of the Rome treaty and the 25th year of the Maastricht treaty.

The Rome treaty created the Common Market between six European countries in 1957; this was an ambitious free trade agreement that would allow European economies to capture the economies of scale that modern industrial production allowed, as previously demonstrated in the United States. But it was much more than that: it was an ambitious political project to bring peace through increased cooperation on a war-ravaged continent. Britain disliked the idea of shared sovereignty that came with the creation of European institutions (at the time the European Commission). The Maastricht treaty in 1992 created the single currency, the euro; it resulted from two converging forces: first, there was a widespread feeling that the success of the single continental market was hampered by monetary disturbances and frequent devaluations and revaluations of national currencies; second, the enlargement of western Europe to eastern and central European countries after the fall of the Berlin Wall made a political imperative of the reinforcement of the EU. Britain disliked the idea of shared monetary sovereignty and did not join in but was shortly thereafter humiliated by the ejection of the British pound out of the then existing European monetary agreement. This is sufficient to remember that the history of Britain *vis-à-vis* the European construction has constantly been ambivalent and even frictional; the country never shared with the

continent any political vision of Europe, its rejection took full force under Margaret Thatcher's mandate, and since then Britain has always kept one foot inside, one foot outside.

How & Why Did the UK Choose to "Exit"?

The explicit motive of the exit vote is frequently said to be anger against EU bureaucracy and its interference with British choices; this is a received but shortsighted a vision. A referendum is an extremely rare and ineffective procedure in the UK where the popular vote surprisingly has no direct effect, all powers being concentrated in the hands of parliament (note that Britain at the moment formally remains a full member of the EU). The referendum was a purely tactical initiative with a view to overcome contradictions within the conservative camp. Two oppositions were facing the then Prime Minister David Cameron, one, mostly from the Labour Party forged against his highly conservative policies, the other against Europe and claiming "independence" for Britain; this offensive had been successfully launched by the United Kingdom Independence Party (UKIP) and was dangerously threatening the cohesion of the conservatives. The referendum on Europe was considered a brilliant tactical weapon to neutralize this opposition and it first seemed to work. But this would finally prove a strategic error.

Cameron and his aides did not forestall the traditional mid-term syndrome that favors the regrouping of all oppositions; they wrongly aligned the interests of the country with those of the City, and they presupposed that the Labour battalions would adopt a pro-European stance. Cameron finally did not anticipate the role of his personal rival Boris Johnson as a talented incarnation of the exit temptations. Looking backwards, there is nothing more surprising than the myopia of the government, of the financial people, of the pollsters, media and markets that constantly predicted, even the day before the vote, a large *Remain* majority. Now, the *Leave* result was met with a shock to those people having believed in media predictions. The electoral map sadly gave the dispiriting image of a fragmented country: in England people massively voted *Leave* except in London and a few other urbanized areas which favored *Remain*; in Scotland people voted heavily to *Remain* (by 62%-38%) and Brexit has rekindled talk of another referendum on independence by the Scottish First Minister Nicola Sturgeon; Northern Ireland again appeared fractured between its Protestant community choosing to *Leave* and preserve its historical links with Britain and the Catholics

who voted *Remain* so that Brexit threatens the fragile peace between the two communities in this part of Ireland. The whole thing reveals a deeply “Disunited Kingdom”.

The referendum in England reflects a reaction of people who previously enjoyed relatively well-paid and secure jobs and who have seen their factories moving to Asia. But the vote was more specifically directed against two aspects of British policies: accelerated immigration from central European countries (there was a widespread reaction against the massive presence of Polish workers) and austere fiscal policies continuously reducing social services and benefits. Significantly, these were definitely no European *diktats* but purely British choices. As a matter of fact, free movement of workers within the EU had been agreed in principle by the conclusion of the Treaty of Amsterdam in 1997 adopting the contents of the Schengen Agreement but subject to strict conditions and long delays; only in the UK was the principle applied without transition or restrictions; on the other argument, the UK not being part of the eurozone is not subject to its fiscal surveillance and austerity was a purely domestic decision of the conservative government. After a campaign in which both sides accused each other of telling lies, the British electorate confirmed that the UK should leave the EU bloc, a consequence brought about, in my view, by the public being misinformed and sparking a major political crisis in which Cameron resigned. It then became clear that there was no particular plan as to how to proceed after the Brexit vote. Theresa May, a conservative who had favored *Remain*, acceded to 10 Downing Street to design a plan with the highest political and economic interests at stake.

Designing an Exit Plan in Case of Conflicting Goals

Predictions of catastrophic consequences from Brexit had been frequent before the vote, dull forecasts in particular emanating from the British Treasury. They didn’t until now materialize but make no mistake – the relief will be temporary. The referendum having until now had no effect except the depreciation of the currency, trade and financial flows unsurprisingly continue to reflect the existing close links between the British economy and the European market. Hoping that this could last is disingenuous, the facts being unambiguous: exports to the EU are a huge share of British total exports, more than 50%; any obstacle restricting future access to the continental market will prove devastating for British industry. By contrast, exports to the UK are a minor proportion of European exports, 6.6% on average, less than 5% for France, Poland or Spain. And this naturally doesn’t play in favor of the UK in the coming negotiations. In the medium term, there is a concern that companies could face strong incentives

to move their production to the continent and the damage could even be stronger; this may be true for American and Asian as well as European companies (the most important single sector being the car industry with General Motors, Honda, Nissan and Toyota factories) that until now chose the UK as a European basis precisely for its participation to the continental market. The UK, a relatively small outlet (65 million people) separated from the huge continental market (450 million inhabitants), could also be a less attractive commercial partner and could face less favorable terms when negotiating trade deals on its own.

Even more serious are the issues concerning the financial industry, which is presently the financial hub of the continent. Despite not being located within the eurozone, the City is authorized to operate in euros and to serve its European clients from London thanks to a “financial passport”, the word summarizing the rules governing the common financial market. Banks with large operations in London directed towards European clients have stepped up their lobbying to convince the British government that the City needed continuous access to the single market or would be forced to move its lucrative operations within the eurozone. Currency would not be a good indicator of the impact of the referendum, since it is affected by many other factors, but it is true that after the referendum we saw a general depreciation of sterling from \$1.50 before the referendum to around \$1.25 early in February 2017. Brexit, in short, could place the fundamental economic interests of the UK at risk.

Entering EU-UK Negotiations

The British government hoped to achieve greater control over European immigration while maintaining access to the single market. Not so answered the 27 which proved united and rapidly made four decisions: the so-called “four liberties” (freedom of circulation for goods, services, capital and people) were an inseparable cornerstone of the Treaty and the UK had to choose between its two major conflicting goals on immigration and access to the single market; nothing would happen before the UK formally triggered the divorce under Article 50, thus opening a two-year period for concluding a deal; no other negotiations about future agreements would take place before agreeing on a “clean” divorce (including closure of the existing financial engagements between London and Brussels); and a task force to negotiate the agreement was created under the authority of Michel Barnier, a former commissioner. The latter quickly clarified that the EU having no responsibility in the divorce, the UK had first to make its demands explicit and that this would be the starting point of the negotiations.

After months of confusion, May announced her plan on Jan. 17.

The speech was positively received because everyone at last got a clear impression of what the UK wanted. The speech was also considered strong and well articulated. The general tone was cleverly chosen: it combined supportive words for the UK's European neighbors and partners with defiant ones declaring the UK is ready to fight any "punitive" deal. *Leavers* were enthusiastic; some of them even said that part of the speech could have been heard at a UKIP meeting. The business community found relief in the end of uncertainty and approved the eloquent description of an open UK continuing to endorse globalization. The most important points are the following: the number of EU citizens entering the UK will be controlled; the UK will not seek continued participation in the single market (which means the end of the financial passport); the UK wants to exit the common external tariff and reach a new unspecified "customs agreement"; the UK will accept paying an "appropriate financial contribution"; the government will seek a "phased process of implementation"; a common travel area with Ireland would be maintained; the UK parliament will vote at the end of the negotiations to endorse the deal; the UK would leave with no deal rather than accept a bad one. In that case, the economic relationship between the UK and the EU would simply be governed by the World Trade Organization's and other UN agencies' rules.

The most important aspect of the speech, and the more problematic for the future, is probably its bravado style, its promise to reconcile visibly contradictory objectives, its confidence to impose a British drive at the negotiations. In short, the prime minister wants to exit while requesting other EU members to concede the benefits of a special relationship with the EU, promoting in some sense an exit at no cost. This will not happen: various European voices quickly observed that no one was obliged to stay in the EU; but the EU should be based on the idea that member countries would be better off inside, and therefore choosing to leave would not be in their best interest. There is no question of friendship or punishment, this is a matter of political arithmetic. In less diplomatic terms, this means that no European government will accept any deal that would please voters supporting an antagonistic view against the EU. "Thinking otherwise simply indicates a detachment from reality," said Maltese Prime Minister Joseph Muscat. Let us see how this works on two major issues.

Coming Tensions on Trade & Finance

Consider first the customs union that the UK government wants to negotiate with the EU. The present European customs union allows goods to circulate within the bloc's 28 members without obstacles. This is an extremely complex construction that requires a strictly

identical policy towards the rest of the world; it is implemented through a common external tariff and similar norms and controls apply from Greece to Ireland. Once the goods, for example Chinese solar panels, have paid the duties and have been subject to appropriate checks in the Greek port of Piraeus, the goods can circulate freely in the EU and be sold without additional duties or controls in Rome or Paris. May wants to exit this common external policy in order to freely negotiate future trade agreements between the UK and the rest of the world, which is fine. But she also requests "frictionless and tariff-free" trade with the EU. This is a great phrase in a textbook and the British public can understand that their government is only willing to recover sovereignty *and* preserve the best of the relationship with the EU. But this doesn't work because such a demand raises huge technical and political obstacles; it simply imperils the very existence of a "common market". This is exactly the cherry-picking that the EU said in advance it will not accept. Naturally, the EU has already demonstrated that its common external trade policy can accommodate lots of sector-specific arrangements. But these trade negotiations take much more time than the two years allowed for the divorce deal.

As a consequence of May's speech, there is a concern that the financial passport for British banks could be dead in two years from now. The fight about the localization of the European financial industry now promises to be violent. Competition to attract this profitable business on the continent is not new and Frankfurt and Paris but Amsterdam, Dublin or Luxembourg as well found new reasons for hope after May's speech: though not many banks have done so, there are some like HSBC and UBS that have already confirmed plans to move 1,000 jobs to the continent. Recognizing its early defeat, the City has already changed his position; it is now lobbying to preserve access to its continental clients through other means while regularly reiterating its threat to outsource thousands of jobs. As a solution, the City is promoting the idea of "equivalence" between EU and UK rules; this may not work because we would need a long time to achieve consensus on harmonization of rules between the two. The most cherished example for the City would be an agreement between the European Central Bank and the UK that would give more powers to the ECB to oversee the City's euro clearing business through a sort of shared supervision with British authorities. This will not fly. The fundamental reason is that even before the Brexit vote the position of the City was precarious precisely because it is outside the eurozone. As a matter of fact, the ECB already tried, for understandable prudential reasons, to oblige the euro-clearing houses to operate from inside the eurozone so that the ECB could eventually have a direct control of these institutions. The rule was adopted by the ECB but contested by the UK

government and finally rejected in the spring 2015 by the European Court of Justice in the name of the freedom of capital movements. The irony is that the court in that case protected vital British interests. Now that the City will be outside the EU, the game is probably over.

These are and will remain polemical issues during the negotiations. Other potentially divisive and painful issues will include the future of expatriate EU and UK nationals. The financial aspects of the divorce will also reveal a high destructive potential. Brussels rightly considers that the UK, being part of previous financial decisions that have consequences for the future, must respect the same obligations as other members and pay its already agreed contribution to budget appropriations, pensions and other commitments while, on the credit side, common property has to be disentangled. Initial estimates for the net final bill vary between 20 billion and 70 billion euro! This is quasi impossible to sell to British citizens because the definitive interruption of further payments to Brussels was a significant factor in the *Leave* vote. May spoke of an “appropriate” payment, which in her mind is certainly much less. This particularly unglamorous issue could finally decide what in British eyes would be a “bad” deal.

Europe & the World after Brexit

The Brexit decision is in short a British domestic problem whose negative economic effects will, in my view, mostly affect the UK. The future of the country as a “Singapore with steroids” is a possibility for the next generation but the divorce with its intractable trade-offs is a much more pressing challenge. Europe will also suffer negative consequences that have been extensively exposed by the British press; some of its arguments are serious. It is undeniable that the UK exercises leadership in terms of openness, globalization and democracy; being a member of the United Nations Security Council and equipped with nuclear weapons, it plays together with France a special geopolitical role among EU members.

Let us scrutinize this argument that May surprisingly introduced in her speech, using it as one of the “three major reasons that play in favor of a good agreement”. As a warning that the Europeans need British protection, it could prove badly inspired: the EU has no competence in the area of defense so that one will have listened to the argument as another attempt to divide the 27 by seducing eastern European countries exposed to Russian threats, a message that simply lacks credibility and will not be welcome in France and Germany. As a matter of fact, the problem is that the UK in the past has always acted independently (except a bilateral technical military agreement with France) and was fully opposed to any common

foreign and defense policies; the government of Tony Blair sided with President George W. Bush against the views of France and Germany in the Iraq War and the UK never contributed (except through the Libyan adventure of Cameron and Nicolas Sarkozy) to security policies, be they in Africa (where France is acting practically alone), in the EU-Ukraine-Russia debate about East Ukraine (the European response was a Franco-German initiative), or more importantly in the management of the major immigration crisis following the Syrian war. It is too late and ineffective for the UK to call for European cooperation at the moment of divorce.

In the months preceding the referendum, there was a debate inside European countries to decide whether a British exit could make European political life (Commission, Council, eurozone, Parliament) easier due to the absence of a reluctant member. What have we learned since the referendum? First, remember that the management of the euro crisis (2010-12) already exemplified a decisive willingness by the EU to stay together and continue the work of Rome and Maastricht. The reaction to the Brexit vote is simply in line with this precedent: the EU has not suddenly disintegrated, and the governments of the 27 other members have been impressively united. Any overt threat to this European unification will only reinforce the perception of their common interests and their common will.

On top of that, there is the other threat to the open world emanating from America. President-elect Donald Trump before his inauguration denounced the transatlantic organization, NATO, as “obsolete” and threatened to reverse US support for an integrated Europe. The world we have known since World War II is changing in a dramatic way and the most important question raised by the UK and US votes in 2016 is: will the movements that have brought about these changes in these countries also prevail in Continental Europe? Given the general failure to anticipate these past votes, it would be presumptuous to give any prediction regarding the upcoming elections in France in May 2017, in Germany in September and in Italy next year. Facing huge international challenges and confronted by Trump’s US and Vladimir Putin’s Russia, Europe has renewed reasons to be collective and negotiations with the UK will be an opportunity to prove this. Expect a more united EU than you thought: it could be the involuntary geopolitical consequence of May and Trump. **JS**

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