Regional Economic Development
Local Economy Briefing 11

DAMNED IF YOU DO AND DAMNED IF YOU DON"T

Economics & the UK Referendum to remain in or to leave the EU – 23 June 2016

The forthcoming referendum on UK membership of the EU will strongly influence local economic 'capacity, competitiveness and aspiration' for years to come.

Future economic performance is heavily influenced by the psychology of value and relationships. Anything that affects confidence, communications and networking, especially if it increases uncertainty, affects behaviour and changes individual and business assessments of investment priorities, as based on prospective returns, costs and benefits.

This is why the whole EU debate before the event is inherently inconclusive. Nevertheless, as I keep being asked, here is some discussion of the key arguments 'for and against' based on economic principles and experience.

Barriers reduce economic activity

Essentially, economists know - from theory and evidence - that borders, boundaries and/or barriers to trade tend to increase costs and decrease investment. In turn, this means lower output and employment than otherwise would occur. **Therefore, most commentators** – including recent analysis from the IMF, the OECD, the Bank of England and HM Treasury – **believe there is likely to be a negative economic impact from a vote to 'leave' compared with a vote to 'remain'**.[1]

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[1] If you are a 'leaver', this may be a short-term cost worth paying for increased domestic 'ownership' of economic decision-making. If you are a 'stayer', you will be keen to avoid the resulting disruption with its long-term as well as short-term impacts. The range of recently published figures suggesting a permanent cost of £2,500-4,500 per UK household per annum from 'leaving' reflect reasonable but not indisputable assumptions about these "barrier cost" impacts. The scale of the eventual outcome is unknown because it involves unpredictable human decision-making. But, the direction of travel to a 'smaller' economy than it might have been is broadly supported by economic theory, historical precedent and applied modelling.

What is not clear is whether the adverse economic effects of leaving the EU (termed BREXIT – short for British exit) would have lasting impact or whether these effects might be mitigated - indeed eventually overcome - by future UK measures to support domestic development.

Importantly, a 'remain' vote is not a vote for the status quo. There will be changes affecting UK economic prospects within the EU/Euro-Zone whatever the outcome of the referendum – (others may leave the EU even as, within it, the euro-zone gets tighter).

Whether the UK 'leaves' or 'remains', the economic development question is still how to improve UK competitiveness over time. This largely means investments in infrastructure, skills and innovation that raise long-term productivity potential and performance.

In or out, the key UK economic problems of low productivity and a lack of competitiveness - as exposed by the UK's huge current account deficits - remain to be addressed. Whether it is 'stay' or 'go', the real economic debate is about what is done about the fundamental development weaknesses. If 'we' go, there will be costs to consider but the fundamental question is the same: what sort of Dorset do we want for 2030 and beyond and what/how are we prepared to invest to make it happen?

Meanwhile, the EU debate has already affected sterling, increasing its volatility (in both directions – so far, down when BREXIT seems more likely and up when it seems less likely) and impairing financial market sentiment towards the United Kingdom generally. At the margin, this may affect trading values and volumes, at least in the short term. It will also impact relative inflation and interest rates to come. The question, then, is whether UK and local business have the will and the scale to exploit any opportunities for (short-lived) competitive advantage that emerge.

BREXIT will probably not save money

A key analytical conclusion is that **BREXIT would not come cheap**. Most of the UK tax-payers' money allocated to the EU will still be spent: the UK government will have to decide what to do at home for the farmers, the Cornish, for supported businesses and others who now receive significant flows "from Brussels".

Then, there will be the costs of bilateral negotiation with the EU and all other trading partners around the world. Lawyers and accountants are going to do well from re-writing a vast array of contracts for government and business and plenty of civil servants (returners from Brussels?) and other administrators will be needed to advise on, and to make, all the changes. The UK will not fill up its fiscal hole by leaving the EU.

Trade negotiations always take longer than expected & tend to produce sub-optimal solutions based on compromise

Judging by other recent trade negotiations, it could easily take 5-10 years to extract the UK from current contracts and processes and to replace them with new ones, especially as many existing commitments to the EU run until 2020 anyway. The uncertainty in the mean time is bad for trade growth.

Moreover, **we cannot assume that all partners (in and out of EU) will be willing and able to negotiate straightaway**. Will the United Kingdom be given the kind of priority it might like and will it be offered the most favourable terms (as might be expected as part of the EU trading block)? For example, as President Obama iterated when in the United Kingdom recently, US trade representatives will be much more interested in settling (or not) the proposed cross Pacific and US-EU trade deals than they will be in starting any talks with the UK alone[2]. The same arguments imply even more to other trading blocs and emerging markets, including the BRICs.

Meanwhile, the insidious side effects of continental trade preferences and prejudices will be free to work against UK companies and workers. (Why would EU representatives consider UK business needs unless they happen to coincide with those of their own constituents? Why would continental businesses and politicians not try to push negotiations towards outcomes that favour their own competitiveness over ours?)

Indeed, exclusion of UK representatives from EU panels on trade, products and services to do with rules and regulations, specifications and technologies, at the very least, might move things away from preferred UK standards. UK

[2] There will be inevitable delays whilst President Trump or Clinton or anyone else who takes the Oval Office puts their team in place and, with the new Congress, decides priorities

trade competitiveness, already inadequate, is unlikely to benefit from BREXIT for the foreseeable future even if positive outcomes are achieved eventually.

Investment will tend to be lower than the baseline

Investment is likely to fall with BREXIT. At present, major academic, scientific, technical, and industrial research budgets are often allocated and used across Europe. In this world, UK institutions (including Universities) often punch above their weight. This will be harder to do after an exit poll.

Then, if you are a foreign-owned, UK-based multinational, faced with the uncertainty as to the eventual effects of a 'leave' vote and what it might mean for your business, at the very least, you will:

- Wait and see - delay or cancel current investment plans - and/or

- Re-direct investment to facilities still likely to be in the EU or in low-cost centres elsewhere - and/or, at worst, eventually

- Close UK operations and supply EU/UK markets from elsewhere.
  As foreign direct investment softens, all this is bad for UK investment, exports, productivity and jobs.

Equally important is the wider effect on **foreign direct investment**. Fewer firms will see the UK as the place from which to serve European markets and some of those who have, or would have, moved here from Europe because of the English language, more flexible labour markets, lower taxes and overall business friendly environment, will re-direct towards key markets, viz Germany et al.

These reactions mean less spending in the economy, lower output and fewer jobs, lower productivity and worse competitiveness. Living standards will be lower than they might otherwise have been.

Even purely domestically orientated firms and consumers, facing uncertainties about the future prospects generally, may delay expenditure plans, weakening growth. Moreover, UK borrowing costs (interest rates) and sterling volatility will rise, especially if expectations about future UK inflation increase above the continental norm, as they did in the 1970s. Also, fiscal management and public borrowing could be disrupted, at least for a while.

Uncertainty and the creation of barriers to exchange damage the wealth creation process by reducing investment from trend and over the cycle, at least until all the new policy/trade arrangements are resolved and activated.

Labour markets will be softer and migration uncertain

If the UK leaves the EU, some workers will face a **potentially more restricted labour market** and adverse skills environment. Job creation will be muted by the overall relative reduction in output and investment.

It is more debateable as to how net migration flows will be affected – that depends on what an 'out UK' chooses to do on border controls and working/residence visas, as well as how the EU 'retaliates'. The message here is that the more we restrict access, the less likely we will get favourable trading relationships from our neighbours. The extent to which that is a 'trade-off worth making' is a political as much as an economic decision.

Generally, however, the continental/global opportunities for UK talent and domestic business access to external talent may be more constrained, at least as long as the period of adjustment to the new reality persists.

The long run is a 'known unknown' for the voters

In the long run, **it is quite feasible for a positive relationship to arise between an "outside UK" and an "ever closer EU" (or at least more integrated Eurozone) and other parts of the global trading world.** By 2030, no economist, let alone politician, can say whether we will be better or worse off 'in' or 'out' of the EU.

All we can say is that the economy will be different and there will be winners and losers: some workers/households and some businesses/sectors will face worse prospects and some might get better ones. Inventors, innovators and entrepreneurs will still exist. They will adjust to the new realities and emerging incentives and act. There is no reason to be pessimistic about the inherent creativity of human beings in the economy.

Local concern

Nevertheless, there has to be **some concern for Dorset's key export industries**, such as aerospace (what happens to Airbus' productive structure and supply chains over time – will French and German bosses in Toulouse change patterns of productive location and buying?), marine (what happens to foreign owners' decision-making with regard to the spatial placement of future investment?) and other engineering.

Moreover, how will financial and other high value services (who can site many activities almost anywhere in a global, digital world) respond to changes in market access driven by the prospect of different requirements and rules, for example, between Frankfurt-Paris and London?

As European attitudes and confidences shift, there will be unpredictable effects on the local 'visitor' economy, retailers and, indeed, the student population, particularly if sterling moves adversely. Will Dutch holidaymakers still want to visit SW England and will Dorset holidaymakers still want to visit the Continent? Will BREXIT affect Far Eastern demand for an English-based education in England or is it irrelevant?

Conclusions

Some of the main economic effects of BREXIT will occur through short-term decisions about trade and investment, but there will also be long-term effects as demand patterns and productive and trading structures adjust.

In the years after a 'leave' vote – possibly over a decade or more, increased uncertainty will cause the Dorset economy to have less, than it might otherwise have seen, output, jobs and incomes.

This is not to judge that BREXIT is right or wrong, per se, as a political or social choice. It is just to acknowledge that the economics is clear - it is not a cost or risk free option.

But, then, neither is 'remain'. Even after a vote to stay, there are bound to be 'unforeseen' consequences, as the EU, and the EZ within it, changes. If the UK votes to 'remain', it still has to deal with the German/EZ desire to forge an integrated core based on tight policy rules and regulations – arguably distinct from the wider EU. Moreover, there are some ‘dodgy’ candidates for EU membership knocking at the gates. The risk is that we stay in a ‘club’ that develops a two-tier membership and that our sensible aversion to the euro means we are just in a group with the ‘dross’ rather than the elite.

“Remain’ is not a ‘failsafe’ option because it could mean we are still a ‘decision taker’ rather than a ‘decision maker’. Furthermore, it does not absolve us from decisions about how our economic future will evolve, including how we address longstanding economic efficiencies at home and how we cope with a change of power relationships abroad.

Damned if you do and damned if you don’t. The key is that, either way, the development priorities remain to be addressed: the only security for future economic health and wealth is that the UK economic team plays at the top of the productivity premiership. Bournemouth appears to have survived its first season in the top flight. The trick is now to consolidate and develop further to stay there and ‘win’ over the long term – as with football so with the economy.

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