

The Economics of Brexit: It's not about the Internal Market

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The United Kingdom's vote to 'Brexit' the European Union is on course to become the year's biggest non-event. Beyond a weaker pound and lower UK interest rates, the referendum has not had much of a lasting impact. Financial markets wobbled for a few weeks after the referendum, but have since recovered. Consumer spending remains unmoved. More surprisingly, investment has remained consistent, despite uncertainty about Britain's future trade relations with the EU. Have the costs of Brexit been overblown?

Not exactly. In fact, the UK may well end up losing the predicted 2-3% of GDP from Brexit. But it is the exit from the single market, not the initial vote to leave, that will bring those losses, and that may happen over a long period. If the exit turns out to be a ten-year process, the losses would be borne gradually over that period, costing the UK about 0.2-0.3% of GDP per year, on average.

This could be very good news for the UK. With a weaker currency, the country will benefit from an increase in export competitiveness that could offset those incremental losses and the transient investment weakness that is likely to occur.

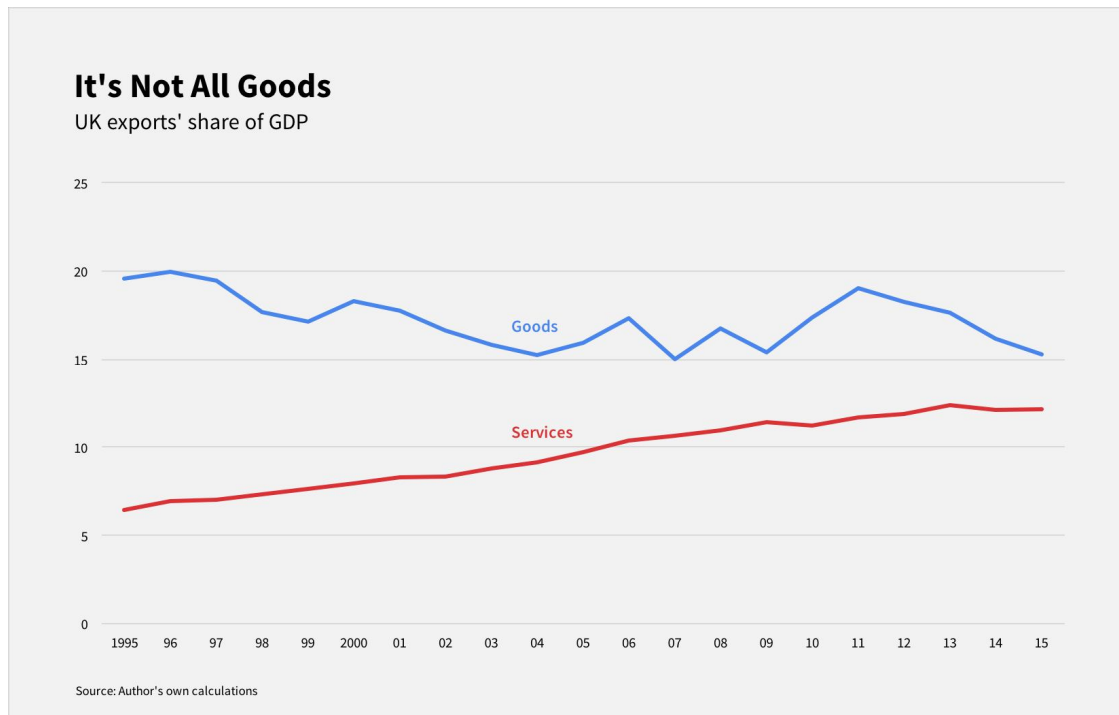
Other factors will also cushion the blow of Brexit. Over the last two decades, the UK has transformed its economy to foster an unprecedented specialisation in services. In the mid-1990s, goods exports were three-times greater than services exports, and the majority of British exports went to the EU. Nowadays, the UK mostly exports services – and mostly to non-EU markets.

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As a result, the internal market for goods is far less significant for the UK today than it is for other EU countries. The value-added contained in British goods exports to the EU accounts for only about 5% of GDP – several times less than for, say, Germany. Meanwhile, Britain's non-EU exports account for about 7% of GDP.

The shift in UK goods exports away from the EU reflects a change in the sources of economic growth, with Asia, in particular, gaining primacy. To some extent, other EU member states have also shifted their goods exports away from Europe, but the effect has been most pronounced in the UK.

The fact that the UK now relies more heavily on access to world markets than on access to the EU's internal market surely contributed to the Brexit vote, as it lessened the sacrifice that the UK would have to make to regain control over 'hot-button' issues like immigration. The belief that the UK could secure privileged access to world markets on its own rather than as part of the EU also helped.

This is where the Brexit bet becomes riskier. To be sure, approving trade deals will be much easier for the UK than it is for the EU, which requires the agreement of 30 parliaments (including some regional ones). The political challenges that have impeded the approval of a relatively low profile free trade agreement with Canada exemplify this challenge. But the UK will also have less leverage in negotiations than the EU does, especially in dealing with large emerging economies.

Similarly, the UK does not have to fear huge changes in its ability to export services to the EU, which currently accounts for about 40% of the UK total, because the EU's internal services market already is far from open. But there is one exception: financial services. And this is a big one.

As it stands, financial services account for about one-third of Britain's total services exports and two-thirds of the overall services surplus that the UK needs to pay for its deficit on goods. The industry's success is a result, at least partly, of the UK's EU membership.

The specialisation of the UK economy and its external accounts toward financial services (and services in general) began when capital movements were liberalised under the internal market programme of the 1990s. It was accelerated with the introduction of the common currency, which, combined with the elimination of obstacles to cross-border capital flows and a global credit boom, fostered the concentration of many types of wholesale financial services in the City of London.

The financial sector has a natural tendency to form clusters, and London – where English is spoken, the legal system is efficient, labour markets are flexible, and the regulatory regime is relatively streamlined – offered substantial advantages. Add to that the EU's 'passporting' system, which enables London-based banks to sell their services directly throughout the EU, and the growth of the city's financial services sector makes perfect sense – as does the fact that citizens of London voted overwhelmingly against Brexit.

Yet the reality is that most of the advantages that have made London a financial services hub will remain even after Brexit. And the loss of passporting might be offset by the creation of subsidiaries or bridgeheads within the EU, such as Dublin, Frankfurt, or Paris. London's financial services industry could therefore survive Brexit, but it is unlikely that it will maintain its previous vigour.

Indeed, no matter what terms the UK negotiates with the EU, it will probably have to change its growth model, probably through a modest revival of manufacturing, among other things. Given decades of decline in British manufacturing, this is easier said than done. But, if the country doesn't manage such a rebalancing, the long-term cost of Brexit might turn out to be substantially higher than current estimates.

The expansion of the financial services industry – which creates few, but very highly paid jobs – has contributed to rising income inequality, has been more pronounced in the UK than elsewhere in the EU. And inequality helped fuel the widespread frustration with globalisation and the so-called 'establishment elites' that helped carry the Brexit campaign to victory.

In this sense, one of the major economic benefits of the UK's EU membership led the British to reject the project. The question is whether the economic changes that Brexit demands will produce the benefits for British workers that the 'Leave' campaign promised. The answer to this question is far from clear.