Meeting Summary

7th Chairman's Business Briefing

Theme: Economics of Brexit

***5 October 2017* - Citigroup, Canary Wharf, London**

On 5 October 2017, the International Business and Diplomatic Exchange (IBDE) hosted its 7th Chairman's Business Briefing. The meeting was held in line with IBDE's post-referendum policy strategy and as a follow-up of its 17 seminars on debating the implications of Brexit for the UK, EU and the wider global markets. Held under the Chatham House rule, these briefings bring together senior diplomats and corporate executives. The purpose of these discussion groups is to facilitate the post-referendum policy dialogue and identify the ways in which IBDE can continue to play a constructive role and support the UK Government, the City and our Embassy and business partners.

The event was kindly hosted by Citigroup and sponsored by Shearman & Sterling.

Given IBDE is the only organisation that covers international commercial and trade diplomacy, the meeting provided some 40 high-level guests with an opportunity to learn more about IBDE's expertise and experience as it continues to play an invaluable role in the post-EU referendum policy dialogue.

The meeting was opened with welcoming remarks from Alan Houmann, the IBDE Chairman of Policy and Citi Head of Government Affairs, who extended his warm welcome to all participants, and members of the IBDE Board and Advisory Board. Following the opening remarks, Barnabas Reynolds, Partner at Shearman and Sterling provided a brief introduction on the Brexit conundrum. The introductory remarks of keynote speakers Patrick Minford, Professor of Economics, Cardiff University and Willem Buiter, Global Chief Economist, Citigroup, were delivered on the record. The remainder of the meeting was held off the record, under the Chatham House Rule.

Patrick Minford's opening remarks

Minford's opening remarks aimed to counteract some of the doom-and-gloom predictions which surround the economics of Brexit, reminding the audience that back in the 1980s he was pro-EU; like Mrs Thatcher, who helped Jacques Delors, the President of the European Commission, to bring in the Single Market, thinking that this would lead to competition, free trade and an open set of policies. Delors used the single market, which provided for widespread Qualified Majority Voting, to introduce the social market and to harmonise regulations in place of mutual recognition; later he pushed for the introduction of the euro, to build European unification "par la monnaie". This made the British realise that this was not the project they had wanted to pursue when they joined.

Minford put forward his presentation on the present situation in three sections. First - the research on the topic. Second – the quantitative effects of the models from the research. Finally, the scenario of no deal between the UK and the EU which he attributed to EU being locked in a "*visitez nous dans quelques jours"* mode or "*we won't give you an answer, and this is not going anywhere"*. The last point, he thought, was becoming an acute question: What if there is no deal?

The research constructed a world trade model in the Ricardian tradition of comparative advantage, based on the supply side with demand allocating supplies to markets and any excess supply to third markets. Minford stated that this model has faced criticism from other contemporary economists who back the gravity model, based on the primacy of geographically-based demand. The latter does not fit the UK economy as it is not landlocked, has a vigorous maritime history and is a major exporter of services, such as those of the City. As a result, the classical model fits the UK trade facts better, and this is fundamental to the policy assessment.

Another area of research focused on the extent of EU protectionism, a feature of the EU not widely understood. The work is based on detailed consumer price studies produced by national and international statistical agencies for Purchasing Power Parity purposes. These studies show that EU manufacturers have a 20% protection margin, of which most is thanks to nontariff barriers (discriminatory standards, anti-dumping duties, quotas and so forth). Similarly, this level of protectionism is also found in food. These estimates are both based on comparisons with other OECD producers. The level of protection margin moves up to 60% against Chinese producers, but the data for this has not been used in the estimates due to its unreliability. The reversal of this protectionism can be achieved through the intended trade deals with US, Japan, South Korea, Switzerland, Canada and so on or by unilateral free trade agreements. Allowing food from such countries at the same standards but at world prices and doing the same for manufacturing would lower their domestic UK prices with an effect on the consumer price index of around 8%. This would drive up competition and productivity, increase consumer welfare and translate into a 4% increase in GDP.

Minford then moved on to the supply side effects of regulation. Much of the UK's 1980s supply side agenda was aimed at deregulating the economy; research on this at the time led to the formulation of the Liverpool model and this is also used in the EU policy assessment. Regulation from the EU touches everything from the labour markets, to finance, to energy, to industry standards which tend to be dominated by big firms, protecting them from smaller competitors. The cost of all this regulation is up to 6% of the GDP. Not all this is reversible in the short to medium run but about a third of it should be. More recent research has also shown that such deregulation stimulates innovation and so also drives up growth.

Another strand of research was on joining the Euro, important because were the UK to rejoin the EU, it would have to join the Euro. The studies showed that having one's own currency is very important to economic stability, particularly compared with Euro membership.

The last piece of research was on immigration and particularly on low skilled immigration. EU policy on free movement mandates that EU immigrant workers get the same access to the welfare state as local workers. This amounts to a 20% wage subsidy at the bottom of the wage scale to unskilled EU immigrants which both imposes a cost on taxpayers and has a depressing effect on wages in the communities where these unskilled migrants settle, as found by Professor Stephen Nickell of Nuffield College, Oxford. Unskilled EU immigrants with jobs cost the UK taxpayer £3500 per annum or 0.2% of GDP. This figure does not rely on any big models. The poorer households have their living standards negatively affected by EU membership to the tune of 15%. This is made up of the consumer price effect, the taxpayer cost and the depressing effect on wages. As a result, poorer people are hit harder than the average.

Putting all of these estimates together, Minford finds that leaving the EU produces a 6.7% (£137 bn) increase in GDP. This is the aggregate of 4% coming from trade, 2% from regulation, +0.2% from reduced immigration in low skilled workers +0.5% from the current net payments. In addition, there is faster growth and removal of the threat of Euro entry. Brexit uncertainty consists of the concern that instead of this 'clean' Brexit there is a 'soft Brexit' which would keep a lot of current arrangements in place; this uncertainty is not damaging provided firm decisions are taken soon.

The question arises: what if there is no deal?

Minford argued that while there may not be a trade agreement or deal, the EU, by international law of the WTO, must recognise UK standards as satisfying its requirements on the same grounds that it does with other countries; similarly, it must provide the same customs service as it does to others. What is not realised by many people is that many customs inspections are entirely virtual (i.e. computerised with no cargo inspection) except when cargo is subject to investigation for fraud or such like.

If the UK leaves with no deal in place, then there will not be free trade with the EU but FTAs with the rest of the world will go ahead. In the manufacturing sector EU tariffs average 3.5% which has a minor effect on profits; and given current compliance with product standards there is no basis for non-tariff barriers. The Brexit devaluation of 15% has provided the manufacturing and farming sectors with a big profit boost - think of it as a transition package providing compensation, one of the biggest in British history.

Minford then considered the City under no deal. The City has developed into a massive entity and stands to gain hugely from Brexit since the EU has never protected the City. There are no protection barriers in the City. It has always traded at world prices, and it has got to where it is through sheer competitive prowess. In the trade model Minford uses, the traded service sectors will be the main beneficiary of the reduction of protection of food and manufacturing since there will be lower input prices, particularly, for land. This will lead to a big cost gain for the City and lead to its expansion. The City will also stand to gain by getting its own regulation since the EU has no finance industry, and from the viewpoint of political economy, rule-makers in Brussels know nothing and care little about the City. It is understandable for the City to be concerned about how difficult the EU will be on issues such as passporting and equivalence and losing business. Research shows that about 9% of City business is at risk from loss of passporting but mostly this loss is expected to be replaced by equivalence. The EU has a strong self-interest in not damaging itself by adopting a protectionist stance towards the City. Minford further argued that should the EU do anything stupid and adopt some protectionist measures, this will not matter to the City for long as it already trades at world prices and the business with the EU that is lost can be replaced by new business elsewhere. This is how competitive industries work in reality as well as in Minford's trade model with its fit to UK trade facts.

Willem Buiter's opening remarks

Buiter started his remarks by saying that having become a British citizen he voted to remain but in vain and watched the most unwise act of electoral collective self-harm he had ever witnessed on 23rd June 2016. Since then and with growing amazement he has witnessed how the UK authorities have effectively wasted 16 months and still have no clear negotiating position on an exit bill, citizens' rights and Northern Ireland. The UK side's incompetence is almost matched by the EU. Juncker follows an approach to the exit bill that can be summarized as: "think of a number and then double it", while Barnier plays the usual Gallic games and the European Parliament, which has to approve any deal - and do not underestimate the difficulty of that - is firing warning shots over the bows of both ships. The main damage will be political. The EU like its predecessor the EEC is a political wolf dressed in economic lambs clothing. A fact not realised by the now elderly citizens of the UK when they voted to join. Post-Brexit, the UK will be politically irrelevant geopolitically, and the EU will be much diminished in the international fora and negotiations, diplomatically, economically and militarily. This is regrettable as the EU has a lot to contribute to global affairs.

Regarding the adoption of unilateral duty-free trade as part of a "match it or lose market access to the UK" all-or-nothing offer to the UK's global trading partners, it is a wonderful idea but not politically feasible. Internally, the UK does not have the distributive tools to compensate the domestic losers (as is clear from Minford's statement that the cost of low-skilled immigration into the UK was borne mainly by low-income UK residents). The UK can only obtain decent terms for its exports if it has negotiating power in trade matters; in Buiter's view, the UK has very little of it.

The UK economy may appear large when it can be shown to be the fifth or sixth largest global economy (comparing GDPs at market exchange rates). It looks small and rather insignificant when we note that it only has 3.5% of global GDP at market exchange rates. On the other hand, the EU 27 is more than five times larger in terms of GDP and the EU27 population is seven times that of UK.

The binary option given to the EU27 and other future potential trading partners: take it or leave it, emulate or lose the UK market, is simply not credible. Instead there will be long drawn-out bilateral, multilateral and regional trade negotiations in which the UK will end up with worse market access terms for its exports to the EU27 and to the rest of the world than it has today. As regards UK exports to the rest of the world, this follows from the fact that the UK's current terms of market access were negotiated by the (large) EU. The post-Brexit terms of market access for its exports will be negotiated by a largely powerless little UK. Third countries will demand additional concession from the UK.

What of the special relationship with the USA? Can it lead to a swift and successful deal for mutual free trade? We are talking about the USA of Donald Trump: America First, protectionist and highly unpredictable. The 219% Bombardier tariff example illustrates this perfectly. The US is negotiating NAFTA and KORUS. It has even threatened to leave WTO, and that, even if does not happen, could weaken it materially. The example of Australia is not relevant either: Australia had 72 years to negotiate its trading arrangement. The UK does not have that luxury. The unilateral free trade deals mentioned will not happen.

The Brexit movement has two wings: the outward-looking, pro-globalization pro-market, pro-deregulation, low taxation, and outward-looking Atlanticist wing as opposed to the inward-looking, anti-globalisation, nativist, anti-market, populist little England wing. The latter is associated with the current Prime Minister as the one in control. Should Jeremy Corbyn become prime minister, these matters will not improve.

Buiter further argued that even when the WTO standards are adopted - free trade: no tariffs or quotas for physical goods (but not for services!) - it can still mean no trade taking place at all. The obstacles to trade which will hurt the UK will not be tariffs or quotas but regulatory, legal, administrative and bureaucratic obstacles to trade. Customs inspections, often onerous, can be made more onerous, destroying supply chains. One only has to look at Turkish trucks queueing at the point of entry into EU. Rules of origin and anti-dumping duties can be consistent with WTO rules. Should a country disagree with these, it will end up in the dispute settlement procedures, and in 3 years time, you may have an answer, if you are lucky. As regards public sector procurement practices, only a few WTO members have these opened-up and non-discriminatory. Protectionism - masquerading as labour standards, environmental standards, health and safety and phytosanitary standards, intellectual property rights protection, national security arguments, and strategic industry arguments - can be used to set limits on imports and FDI.

The end to the infinitely elastic supply of labour to the UK, which will follow the end of free movement, will hurt potential output immediately and in the medium and long-term. The City of London will also be hit. Euro derivatives clearing will go the day UK leaves the EU. Without passporting equivalence, significant existing jobs will be lost. Many city-based companies are already putting into action plans for moving out of London by leasing office space in places like Frankfurt to accommodate staff.

Deregulatory haven status may be possible for the City since financial deregulation, as long as it does not impact retail banking, would not be the politically sensitive domain where deregulation is anathema (labour markets, retail banking, non-financial product markets including health care etc.) As a deregulation haven, the City may be able to poach business from elsewhere. Sunderland cannot do this.

Buiter argued that the City will be hit less hard than manufacturing.

The gains from Brexit calculations by Minford also included a move from current regulatory practices (EU –based) to zero regulation! What EU-derived regulation should be compared with instead is Theresa May regulation or Jeremy Corbyn regulation.

What is the likely outcome? (1) An agreement on the divorce trinity, which is not guaranteed as the exit bill, is the problem here. (2) A transition period of two or three years – effectively EU membership without a vote for the UK. (3) A rather hard Brexit. Towards the latter stages of the transition it will become clear that a hard Brexit is unavoidable and a capital-expenditure driven recession will occur around 2021-22. The hardish Brexit will include no membership of the customs union and the single market and stricter immigration controls, with perhaps some limited form of passporting rights or equivalence for the cross-border financial sector. The growth rate of potential output could be permanently lower by 0.3% - 0.4%. The competitive exchange rate shock that Minford mentioned is actually an adverse trade shock for consumers, which will make the country worse off. The argument that the depreciation of the real exchange rate will boost output does not stand up as the supply side of exporting and import competing industries are likely to be the binding constraint on production – not export and import demand. This means lower output. The adverse supply shock in the labour market caused by the end of free movement (and by the anticipation of the end of free movement) together with lower capx could lead to a stagflationary outcome, and force tightening from the bank of England in a shrinking economy. Between five and ten years after the transition period, the UK will reapply for EU membership on worse terms that it enjoys now and will have to join the Euro. If it is more than five years after Brexit when the UK reapplies, the UK will break up starting with Northern Ireland, followed by Scotland. Brexit will be a political disaster and a serious but manageable blow economically for the UK.

Discussion

Following Buiter's introductory remarks, the remainder of the meeting was held under the Chatham House Rule. Discussion was opened with a number of questions - the first being on the length of time it would take for new equilibria to be reached, fearing a painful transition. The answer to this was that the uncertainty was created by people who would like an endless period of transition rather than a quick implementation of Brexit. The confusion and games being played by the European Union are not helping the situation either.

One participant argued that it would be absurd for all the EU27 to behave illegally towards the UK and have complete disregard for an international law such as Article 50. Should the EU actually go ahead with this kind of threat then the future of the EU is very worrying and more backward-looking than it already is. The EU must also understand that the UK is a sovereign nation which can decide its own future. There was agreement that an early decision on agreements by the political leadership of the two sides will be better for everyone. Of the EU it was said that it was behaving like grown teenagers who throw their weight around in a ridiculous manner.

The conversation moved on to regulation. It was stated that the UK benefiting from deregulation was not likely to happen as neither Theresa May nor Jeremy Corbyn were light touches on regulation - quite the opposite. The reply to this was that this is a major supply-side reform much like the Big Bang experienced in the City 30 years ago. Back then many thought that would bring the end of City, but in fact, quite the opposite happened. The City adopted and fought tooth and nail, survived and has become the leader in the world. The sooner supply-side reform is enacted, the better: other risks can come from the package formulation which compensates the losers in the transition period. Consumers will be harmed in the short run, but it is time-limited. However, another speaker put forward the point that all these desirable supply-side reforms can be done while remaining in the EU as Brussels does not stand in the way of domestic reforms. It is the chaotic and deeply dysfunctional British political system that stands in the way.

Other speakers reminded the attendees that since the UK has a small share of global GDP, it has no bargaining power which renders the notion of concluding unilateral / take it or leave it free trade agreements void. Another participant stated the very reason why international trade deals can be done is often a desire for domestic reform. The Japanese example of the TPP was mentioned, which helped the Japanese get rid of some of their own trade barriers. Politically the elimination of trade barriers in the UK is currently impossible. The conservative party would not accept the removal of trade barriers in the farming sector or indeed most other sectors. Nor would Jeremy Corbyn since he does want to retain intervention in all markets. So, neither of the leading parties show the slightest interest in deregulation or domestic liberalisation. The reply to this was that free trade agreement was possible as the UK is relatively small and not threatening to the negotiating parties, unlike the EU. This also explains why the trade deals made by the EU are messy and protracted over a long period.

One participant stated that where politics is dominating, it is producing bad economics, as seen in the EU itself, notably in the badly constructed Eurozone which has no reverse gear. There are bad political dynamics in the EU as is evident from the rise of extreme parties that have elected representatives in some national parliaments. The response from Brussels is to carry on, as usual, i.e. burying their head in the sand. The reply to this was that the chances for reform in the EU were now higher since there is a greater co-operation between the German and the French governments and also since the UK will not be there to stop it.

There are two ways, it was suggested, to mitigate the rise in the disenfranchisement of people and resentment towards established political institutions. One is to educate and re-educate continuously and two, through more aggressive redistribution of wealth created through the new economy and globalization, where most of the income earned is not conventional labour or capital income but pure economic rents – i.e. the returns to luck, genius and monopoly power found in the shape of Google, Amazon, Apple and so on. These rents are extremely unequally distributed.

Another speaker raised the question of how the City can mitigate any loss in services, particularly in the legal services sector, should it not have access to the EU market. The response to this was that the City is a highly competitive place and renowned throughout the world and can replace any loss in business with new ones. Also, it is in the interest of the EU to tap into the wealth of expertise that the City possesses. Politics may throw a spanner in the works, as when people in nasty divorces cut off their noses to spite their faces. The question for the EU is how much of their nose will they cut off. There is the possibility of the City losing business due to EU protectionism; but the City can find business elsewhere in the global markets. Another speaker interjected that analysis showed that only about 8% of the City's revenues would be affected by the potential loss of passporting. Virtually no revenue in insurance and asset management sectors would be affected. There is no single market in services.

Conclusion

The discussion was a clear reminder that the Brexit debate is not over. Brexit was not a product of events during the last few years events, but in fact, has its roots in the findings of the Delors Commission recommendations concerning the social market, something much of the UK was not in agreement on about the social market. Advances in technology, growing trade openness and freedom of movement led to stagnant real wages in the UK, especially for the low earners. This led to an increase in resentment and decrease in wellbeing for the poorer families, it was claimed. As such Brexit has served as a pressure release valve for anti-globalisation sentiment which is prevalent and being experienced throughout Europe and the USA. In the short term, consumers are expected to be worse off, and uncertainty is at the mercy of political will which so far has not been forthcoming, with each side claiming the other side being uncooperative. Farming and manufacturing are expected to bear the brunt of this regime change, with the City and services affected to a lesser extent. The prospect of the UK leaving the EU without a deal is very real and for many a growing likelihood. Politics are not serving business and the economy well. There are those that seek a swift resolution to this impasse by looking to secure the future, but positions seem only to have become more entrenched which does not make for hopeful reading.

On behalf of IBDE, the meeting's chairman once again thanked Citi and Shearman Sterling for their kind hospitality and sponsorship. He also thanked the speakers, members of the IBDE Board and Advisory Board and all other attendees for providing a stimulating discussion. Following the closing remarks by the chair, the participants had the opportunity to continue their conversation informally during the networking coffee.

IBDE is proud to have played an important and constructive role in the UK's EU Referendum debate. IBDE has been hosting monthly seminars debating the consequences of Brexit since June 2015. Seminars have been inclusive, in that they have attracted leading representatives from various institutions and the fields of politics, policymakers and opinion shapers (including businesspeople, politicians, diplomats, academics, civil society representatives and the media). In addition, these seminars have been thematically comprehensive in their content, having offered speakers and the audience an opportunity to explore the various viewpoints of the In/Out EU referendum debate.

IBDE hopes that the pooling of experience and intellectual resources through these meetings has been useful to participants. Given IBDE is the only organisation that covers international commercial and trade diplomacy, the meeting was a great opportunity for IBDE to showcase its expertise and experience as it continues to play an invaluable role in the post-EU referendum policy dialogue.

If you would like any further information on any of our work or events, or to become an IBDE Member please visit our website or contact us at events@ibde.org

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