CENTRE FOR EUROPEAN REFORM

Why the EU's market matters to Britain

by John Springford

Brexit would free Britain to sign bilateral free trade agreements with the 'BRICS' emerging economies, the Anglosphere and Japan without having to reach a consensus with 27 other EU member-states. The rest of the world is growing faster than the EU, and it offers opportunities that would make up for any forgone trade with Europe. This means that Brexit would boost the economy in the long term, especially if you throw in some deregulation to boot.

This commonplace view is wrong. There are three reasons why. The first is distance. If Britain were to start its trade negotiations from scratch, its first priority should be to reduce the cost of trade with big, nearby economies. Trade diminishes quite rapidly with distance. Half of Britain's exports go to the EU, which makes up a fifth of the world economy. Meanwhile, the non-European members of the OECD – although they comprise a third of the global economy – only buy a quarter of Britain's exports, because on average, they are seven times further away.

The second reason is that trade with the BRICS is not the unalloyed good that many disciples of free trade imagine. After he came to power in 1978, Deng Xiaoping's pro-market reforms allowed China to make use of its comparative advantage in low-value added manufacturing. Other developing economies followed. This process enriched Britain's consumers: electronic goods, toys, clothes and steel became much cheaper in real terms. And over time, labour and capital were redeployed to more productive sectors of the British economy, raising incomes further. Together, these two effects made Britain richer on average.

However, those last two words matter. Trade with poorer countries is not without cost. The scars of deindustrialisation are still visible in Britain's unbalanced economy, with higher unemployment rates and lower productivity continuing to blight the UK's northern cities. As manufacturing and industrial work dried up, many low-skilled people moved into poorly paid services jobs. Productivity growth in low value-added services sectors has been slower than in manufacturing. These trends have contributed to the 'hollowing out' of the British labour market, with more low- and high-paid jobs being created than those which provide middling earnings. That does not mean that an 'independent' Britain should avoid a trade agreement with China – but it does suggest that agreements with richer countries should be its priority.

After the 2008 crash, Britain's productivity plunged and then stagnated. It had been catching up with US levels over the preceding decades, but after six years of weak growth, the UK's output per worker is now a quarter lower than the US. Thus Britain's trade strategy should make productivity growth its ultimate aim. This points us to the third reason why Britain needs untrammelled trade with the EU: imports, especially from rich countries, are more valuable than exports, because they help to boost productivity. In the long run, economic growth is determined by productivity growth – wringing more output from workers and machinery.

Imports boost competition in the domestic economy, which raises the incentive for domestic firms to make productivity-enhancing investments and to invent new technology. This process is known as the 'dynamic' gains from trade. The constant pressure of competition from more productive overseas companies raises productivity growth.

Outside the EU, Britain could unilaterally and fully open its markets to the US, Japan, Australia and the EU in order to take advantage of those dynamic gains. But without unimpeded access to the EU market, foreign direct investment to the UK would be lower. Such investment is a big source of dynamic gains. The UK has been the largest recipient of FDI in the EU because it offers a bridgehead to European markets, with a labour force that speaks English and low taxes and regulatory costs. And, since the UK cannot control what tariff and other barriers the rest of the EU would impose on the country after withdrawal, foreign investment would be at risk: Nissan, whose Sunderland factory now produces more cars per year than Italy, has plants elsewhere in the EU, and higher trade costs would prompt it to expand production inside the single market.

These rules of trade economics give trade negotiators a clear order of priorities. First, seek to open markets with more productive, rich countries. Second, seek to open markets with countries that are nearby. Measures to boost exports with distant emerging economies come third. If Britain votes to leave the EU, it might be possible to negotiate continued market access – with a ban on any behind-the-scenes discrimination against British companies in EU member-states. But this would be difficult politically. The EU would demand that Britain sign up to all single market legislation – so Westminster would not be allowed to repeal unwanted EU regulation. And the UK would have less sovereignty, not more, because we would lose our vote on new EU rules. The UK would also have to continue paying budget contributions and accept unrestricted immigration from the EU. Since those divorce terms would be hard for the UK to accept, Brexit would be likely to raise trade barriers with the EU. We would be poorer for it.

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CER in the press

The New York Times
17th March 2016
But as [John Springford] said in a study last year, "The regions that have most to lose tend to be the most eurosceptic." In the northeast, he said, exports to Continental Europe "are far higher than other regions – yet its residents consistently favour withdrawal."

The Economist
12th March 2016
Many are shocked that the EU has made such a lavish offer when Mr Erdoğan has nothing but contempt for Europe's values... Some EU members, particularly those with strong right-wing parties, regard visa-free travel as "very sensitive and problematic", said Camino Mortera-Martinez of the **CER**.

Bloomberg Business
8th March 2016
Christian Odendahl , chief economist at the **CER** said, "what markets need to know is that the ECB is willing to let inflation overshoot for a while until the recovery is completed before it starts normalising rates. More of the same in terms of forward guidance is not going to achieve that."

Vogue
29th February 2015
The role she played in that historic deal, which has resulted in Iran dismantling large parts of its nuclear program, is widely considered Federica Mogherini's biggest achievement, [says] foreign-policy expert Rem Korteweg of the **CER.**

The Washington Post
20th February 2016
The **CER** concluded that Cameron's "package of reforms will sway few voters, so he must now make the case for the EU itself." "Cameron's best chance of success, is to shift the debate onto more lofty terrain, away from arguments about banking safeguards and migrants' benefits towards a contest over how to secure Britain's interests in Europe and the rest of the world."

Die Welt
15th February 2016
"Contrary to others we have never seen integration as an aim in itself but as a means to an end – the furtherance of our own interests", said Simon Tilford of the **CER**. Precisely because it doggedly questioned the belief in the merits of ever closer integration, the UK was a valuable partner, he said.

The Economist
12th February 2016
"He [Cameron] got diplomacy pretty late in the day, but better late than never," agrees Charles Grant of the **CER**.

The Financial Times
2nd February 2016
Agata Gostyńska-Jakubowska of the **CER**, said Poland had to show resistance as being seen as too accommodating risked backfiring with domestic opinion. "For the moment it seems there is enough flexibility in the text for both to claim some victories. But the devil is in the details, and what Cameron and Szydlo will be discussing."