STRATEGY
ECONOMICS

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A BRIXIT NEEDN'T BE BAD FOR THE BRITISH ECONOMY

SUMMARY

- **The UK will hold a referendum on EU membership at some point in the next five years.**
- **If the UK leaves the EU, the City will suffer, and so will some exports.**
- **But sterling would benefit and there would be a significant boost to competitiveness.**

Forget the Grexit, the Spexit of any of the other possible departures from the euro. There is another possible exit that the markets should be focussing on right now. The Brixit – a British departure from the European Union.

For the first time in a generation that is a realistic possibility. The British started arguing about whether we made the right decision in joining the EU as soon as the then Prime Minister Edward Heath signed the treaty taking us in way back in 1972. We have been arguing about it continuously ever since, without much sign of it actually happening.

Yet an exit is now decisively on the agenda.

Would that help or hurt the UK economy? The question is usually framed in terms of exports and market access. But the relative decline of the EU as a percentage of the global economy makes those two issues less and less relevant.

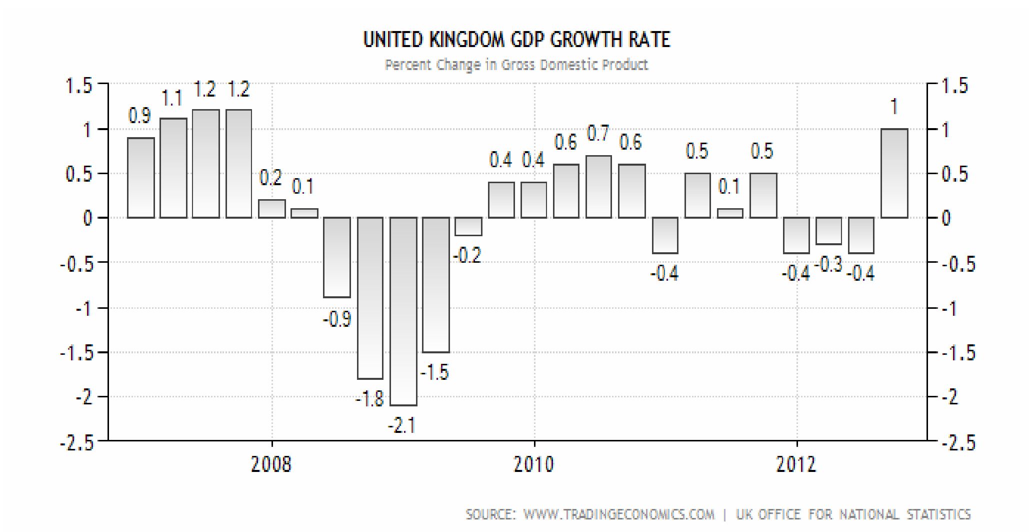
In fact, if the UK did pull out of the EU, Britain would better off. Whilst there would be some costs, sterling would benefit from becoming a quasi reserve currency. And UK businesses would get a one-off competitiveness boost.

One: A Brixit Is Now On The Agenda

For the UK, the European question is changing very rapidly. A decade ago it was just a few cranks who argued incessantly for Britain to quit the EU. But two things have changed.

First, if the euro is to survive, there will have to be a full-blown fiscal union – and it will have to be created very fast. Tax and spending decisions will be made by a Treasury Minister based in Brussels. Members will have to give up control over their national economies – indeed, in the peripheral countries they already have. The UK certainly won't want to be part of that. So the UK may soon have effectively have left anyway – in the sense that it is no longer involved in the EU's most important decisions.

Second, the world has moved on. The global economy is now dominated by the rising powers of China and India and the rest of the emerging economies. The slow-growth, crisis-wracked EU doesn't look like a partner anyone would want to stay married to anymore. No one is going to be very frightened of breaking away from an EU that seems stuck in permanent recession.



It is possible the EU Budget summit later this month may provoke a showdown. The UK wants to cut the EU's spending – a proposal that is likely to go down about as well as a Shostakovich string quartet on the X-Factor. It could lead to an instant referendum on UK membership of the EU. Even if it doesn't, a referendum seems certain in the next five years. The Labour Party is committed to one, and the Conservatives won't want to be trumped in euro-scepticism by the Labour leader Ed Milliband. When it happens, as it certainly will, the vote may well be to leave. Bear in mind that by this stage, the core euro-zone may well be stuck in a deep recession, from which no escape seems possible. That can only tip the popular mood further towards leaving the EU.

Two: Costs...But Benefits As Well

If Britain leaving the EU becomes a realistic possibility, the markets will take fright. Sterling will tank. The FTSE would dive.

Most mainstream business opinion for thirty years has been that Britain needs to be in the EU. It needs access to that market – lose it, and much of our trade would collapse.

But on a medium-term view, it will boost the UK economy.

Here's why.

True, there would be some losers. The City would suffer. It has been the key financial market for the EU, but it is unlikely France and Germany would tolerate that if the UK was no longer part of the club. Global banks would have to move a lot of their operations to Frankfurt or Paris. The wealth they generate would be lost – although, as the mass redundancies at the London office of the Swiss bank UBS demonstrate, that is less of a worry than it would have been a decade ago.

Also, while the UK could almost certainly negotiate the same kind of free access to EU markets that the Swiss enjoy, a lot of hidden barriers to our exports might suddenly be put in place. And while the importance of exports to the EU is often exaggerated – in fact only about 13% of the economy consists of selling stuff to EU markets - some businesses would undoubtedly suffer from that.

But, against that, there would be two big advantages.

First, sterling would strengthen. The pound is already emerging as a partial reserve currency – a status it hasn't held for fifty years. The Swiss for example have increased their holdings of sterling dramatically – the Swiss National Bank this month revealed it had doubled its holdings of sterling while cutting back on euros. The Russian central bank recently revealed that 9% of its reserves were held in sterling. It is not hard to figure out why. Despite all the UK's problems, it is still a stable nation, and it is not caught up in the euro-zone mess. If it was even further detached from the EU, and the euro crisis, its attractiveness would only increase. The pound would be stronger – and borrowing in this country would get cheaper as foreign money poured in.

Second, Britain could expect a one-off competitiveness boost from exiting the EU. Whilst it may have started as a free-trade zone, the EU has increasingly turned into a spending and regulating machine. Its agricultural policies keep food prices crazily high. Its employment regulations make it hard to fire people – and companies reluctant to hire. Health and safety laws put barriers in the way of innovation. Rip all of those away, and businesses would be freed of a massive burden of red-tape in a stroke. There are few better ways of stimulating growth than tearing up regulations – and although it would only happen once, it would give the economy that kind of jump-start it so badly needs. That would help the UK grow again – and that would help the equity markets.

There are not many reasons to be optimistic about the UK economy right now. State spending is too high, taxes keep going up to pay for it, and growth has been flat-lining for four years with little sign of a sustained upturn on the horizon. But an exit from the EU might be the kind of 'growth shock' the UK needs – and could be the one thing to get the economy moving again.

- Matthew Lynn
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FORECASTS

THE UK ECONOMY

	2012	2013	2014
GROWTH:	-0.2%	0.9%	1.5%
INFLATION:	3.1%	2.9%	2.7%
UNEMPLOYMENT:	9.2%	10.2%	9.5%

THE EUROZONE ECONOMY

	2012	2013	2014
GROWTH:	-0.7%	0.2%	1.2%
INFLATION:	2.0%	1.8%	1.8%
UNEMPLOYMENT:	9.4%	9.2%	9.4%

The German Economy:

	2012	2013	2014
Growth:	-0.5%	1.0%	1.4%
Inflation:	2.0%	2.2%	2.4%
Unemployment:	6.6%	6.8%	6.9%

The French Economy:

	2012	2013	2014
Growth:	-0.7%	1.0%	1.0%
Inflation:	1.9%	2.3%	2.6%
Unemployment:	8.9%	8.7%	8.8%

The Italian Economy:

	2012	2013	2014
Growth:	-2.5%	-1.7%	0.1%
Inflation:	2.1%	2.0%	2.1%
Unemployment:	8.9%	10.1%	10.7%

The Spanish Economy

	2012	2013	2014
Growth:	-2.0%	-0.5%	0.6%
Inflation:	1.9%	2.1%	2.3%
Unemployment:	22.3%	24.8%	25.6%

Exchange Rates

	2012	2013	2014
Euro/$1:	1.15	1.10	1.21
Pound/$1	1.60	1.71	1.78

Commodities:	2012	2013	2014
Gold:	1,900	2,500	2,600
Brent Crude:	125	140	150

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