After Brexit*

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Britain has voted to leave the European Union (EU). And the managers of global capitalism have their hands full addressing the fall-out of 'Brexit', even as their efforts to manage the after-shocks of the crisis of 2008 remain unsuccessful. It does not help that Brexit immediately affects the EU where the legacy of the earlier crisis has been the worst. In fact, the churning within the EU is partly the result of the persisting crisis in parts of the region. And it is there that the next crisis is likely to first unfold.

But as recent history has repeatedly made clear, in a globally integrated world no crisis remains confined to one region. So if the partial break-up of the EU worsens the crisis in Europe, it would to different degrees affect the rest of the world, including so-called "emerging markets" such as India. That could worsen the depressed conditions confronting the current world economy. So preventing Brexit from precipitating another crisis that could convert the Great Recession into a Great Depression is the task before these managers. The problem is, they neither know what Brexit would do, nor what needs to be done whatever adverse effect it may have. Moreover, governments across the globe are weighed down by 'stimulus fatigue', or the burden of stimulating a recovery while remaining committed to a neoliberal fiscal and monetary policy framework. They are ill-prepared to deal with one more potential obstacle to that recover.

There are, of course, reasons to hope that Brexit vote, if not reversed as even many 'Leave' campaigners hope it will be, would not be as harmful as the initial collapse of global markets and the pound suggested. According to some, since the UK accounts for just 3.9 per cent of global GDP the exit of this small island economy from the EU Club of 28 could do little to damage the rest of the integrated world economy. The problem is what happens after exit to the remaining 27 and their neighbours. The erstwhile 28 EU members plus Iceland, Norway and Switzerland account for around a quarter of world output,

There is adequate reason to believe that the real economy effects in the UK of Brexit would be significant. A recent paper by Nicholas Crafts of the University of Warwick (The Growth Effects of EU Membership for the UK: a Review of the Evidence, Department of Economics Working Paper Series No 280, March 2016) estimates that the effects of enhanced trade that flowed from EU membership resulted in an annual gain (relative to being a part of the European Free Trade Agreement) of 10 per cent of GDP, which was much higher than the "membership cost" of 1.5 per cent, in the form of a net budgetary contribution and the net costs of common regulation.

Estimates of these kinds are controversial. But as Crafts notes, growth in real GDP per person in the UK has been quite creditable since 1973 when it joined the EU. Thus, during the period 1973 to 1995, real GDP per person rose as fast in the UK as it did in Germany (West), almost as fast as in the US and faster than in France. Moreover, during 1995 to 2007 real GDP per head grew in the UK at a pace faster than it did in France, Germany and the US. Over 2007-2014, which coincides with the post crisis years, growth stagnated in the UK, was negative in France, less than 1 percentage point in Germany and half a percentage point in the US. EU membership has not harmed the UK and possibly benefited it substantially so that a flagging economy began to show a degree of dynamism. Exit would directly harm the UK.

A part of whatever loss is suffered could possibly be recouped after new arrangements are put in place. But that would take time as an agreement would have to be struck with the 27 remaining members of the EU, with the many countries with whom EU had special trade deals that applied to UK as a member as well, and to the remaining members of the WTO,

since the UK as a separate country has not made essential commitments with respect to its trade in goods and services. New benefits if any would be slow in coming and are uncertain, especially with respect to trade with the EU, since it was the UK that chose to leave. But even the US government is not happy with the referendum decision and Brexit, and outgoing President Obama has won many enemies in the UK with his statement that Britain would be “at the back of the queue” among those seeking a trade deal with the US.

The problem is that UK’s decision would badly damage a crisis-ridden Europe as well. To start with, the best performing nation within the “Remaining 27” (R 27, for short), Germany, would possibly find an important market in the UK shrinking as well as less easy to access. In fact, faced with its own problems flowing from its “new nationalism”, the UK may seek to turn protectionist. On the other hand, as banks and firms from the UK are forced to close some or all of their operations in R 27, business could be disrupted in these countries with as yet unforeseen consequences. Those adversely affected would look to greater policy space to address their own problems. Pressure from Germany and a few others to remain open to trade with the rest of the world would meet with opposition from those not benefiting from such trade or even from trade within the EU. The result could be a desire for “independence” that the the Right in Europe would definitely exploit. And the German Chancellor’s softer and accommodative position on the refugee issue may not help. Brexit could prove infectious.

Finally, if all is not well in terms of growth in Europe and the UK, which together constitute a quarter of the world market, the real economy in the US, and the better performing economies in Asia, Latin America and Africa, would be adversely affected as well. Any slowdown in world trade would affect all economies. The dollar is likely to strengthen as investors in Europe flee to safer dollar denominated assets, reducing the competitiveness of American exports. Similar effects, even if on a smaller scale, would bedevil a Japan fighting a long recession. And emerging markets, including China and India, which had earlier shown some signs of being “decoupled” from the world system, have already been hit by the persisting crisis in Europe and the absence of recovery elsewhere. The fall-out of Brexit can only damage them further.

These consequences of Brexit raise the important question: why did 52 per cent of those voters who turned up to vote in the UK referendum (72 per cent of those eligible) say “leave”? From the points of view of finance and industry, the UK seemed to have the best deal within the EU. For example, while it did have to open its borders to workers choosing to move from other members of the union, it was protected by exception from having to meet common labour standards most members had accepted. Membership also gave firms located in the City of London, which has been the growth pole in the UK, access to a “passport” to undertake business in the rest of the common market. Industrial firms located in the UK had full access to the single common market. Some other sections benefited too. For example, British universities starved of public funding could attract a large number of fee paying students and their faculty had access to much needed research funding from the common EU budget for that purpose.

The problem clearly was that much of the middle class and almost all of labour did not really benefit from the arrangement. The inflation-adjusted earnings of many of them have stagnated and jobs, for the young in particular, are more difficult to come by. Thus, official figures on the average weekly earnings of employees show that real earnings fell after the financial crisis until mid-2014. While earnings have risen since, they have not yet regained pre-crisis levels. In other words, workers were severely hit by the 2008-09 crisis precipitated by the speculative activities of Finance, but were not bailed-out while the banks and financial firms were. Since the activities of the banks have increased hugely under globalisation, the anger of workers at their worsened status was directed at corporate driven globalisation and the common European “market”. This made them fodder for cynical right wing propaganda that the jobs and resources that migrants “stole” explains their

condition. So while migration and even the refugee inflow was not a major problem for the UK, it was a useful instrument for many of the politicians involved. Those campaigning for Brexit used it to the hilt, and after he lost his vote, former UK Prime Minister Cameron told EU leaders that the Remain-backers would not have lost the vote and Brexit could have been avoided if EU leaders had given him a freer hand to control migration.

This blame game and the associated debate is unlikely to go away, but would wane as the effects of Brexit on the UK, EU and the world unravel and demand the attention of world leaders. The immediate effect is, of course, deep uncertainty. Would Brexit actually occur and if so what would be the nature of the UK's relationship with the EU? Would Scotland and Northern Ireland that voted to remain in the EU stay in the UK? Would industry in the UK, whether British or foreign owned remain competitive after Brexit? Would the City of London lose its preeminent position as a global financial centre, once financial firms located there have lost their passports to trade in EU market and settle those trades? How far would the effects in the EU impact the rest of the global economy including the US and the more successful emerging markets such as China and India? How would this change the correlation of economic power in the world economy?

It was uncertainty of this kind that was responsible for the collapse of the pound and of equity markets worldwide in the immediate aftermath of the Brexit vote. Declines in stock prices as investors shifted out of equity to safer assets wiped out $2 trillion in stock value across markets on Friday the 24th of June. While the collapse of equity markets was attributed in part to algorithmic trading, human intervention to redress machine overreaction did not make much of a difference. At the end of the next trading day (Monday the 27th) the loss in stock value was placed at $3 trillion. According to the Financial Times, the S&P Global Broad Market index (the BMI), had fallen by close to 6.9 per cent, which was the worst two-day decline since the financial crisis in 2008 and 12th worst on record.

Obviously this collapse was not confined to the UK and Europe, but affected the US, other developed countries and the emerging markets as well. The benchmark index for US stocks the S&P 500 experience its third worst two-day fall on record losing 5.4 per cent or close to $1 trillion. Developed country equity markets as a group lost $2.8 trillion in value, and emerging markets had lost $179 billion over those two days. The much lower figure for equity markets partly reflects their much smaller market capitalisation.

It is indeed true that stock markets tend to be much more volatile when shocks like the Brexit vote generate extreme uncertainty. But the extreme volatility they are experiencing does point to the fact that financial markets would be an important focus of the Brexit fall-out and act as important transmission mechanisms in the spread of the crisis to markets and countries outside of the UK and the EU. Not surprisingly bank stocks took severe and much stronger hits during the post-Brexit collapse.

This financial uncertainty would be strengthened by the fact that London shares with New York the distinction of being one of the two leading financial centres of the world. In fact, a set of rankings compiled by the Z/Yen group in September 2015, suggested that London had overtaken New York as the most competitive financial centre in the world. Rankings aside, London's attraction lies in the access that firms located there have to the European Economic Area (EEA), under the "passporting" option that allowed firms established in one EEA state to undertaken business in another. This could be done either by setting up a branch in another state, by exercising the 'branch passport' option, or by offering cross-border advisory and other services, by exercising the 'services passport' option.

The strength that passporting and light-touch regulation gave the City made it an important hub for financial transactions within the EU. According to Reuters, more than three-quarters of the business conducted in capital markets across the EU is conducted in Britain. As a result, about 417,000 people are employed by banks in Britain, and there are an estimated 1.8 million others offering related financial and professional services. Leveraging those

strengths and exploiting other factors (for example, working hours in London overlap with those in Hong Kong, Singapore and Tokyo), the City has been offering financial services to clients across a highly globalised world. So Brexit not only puts under threat thousands of jobs in the City, with direct implications for economic activity, but would also disrupt a leading hub of global finance. What that disruption would mean is another source of uncertainty.

For “emerging markets” that have been drawn into this globalised financial whirl, and are the locations for substantial sums of legacy investments in financial assets, uncertainty could precipitate capital flight. Even before Brexit capital had been flowing out of these economies because of uncertainty over US interest rate policy, for example. Increased outflow after Brexit could precipitate financial, currency and real economy crises, as they have repeatedly done in developing countries since the early 1980s.

This danger is aggravated by the likelihood of a protectionist response in the developed economies to any further deterioration of an already bad economic situation. It must be noted that both the 2008 financial crisis and Brexit have been outcomes of developments within the developed countries, though they have had or will have repercussions elsewhere. One consequence of these developments and the inequalising responses to them is a disillusionment within the developed economies with finance, globalisation and the elite nexus of business and politicians that sustains the framework that precipitates periodic crises. This has given space to politicians like Marine Le Pen in France and Donald Trump in the US who are avowedly protectionist, and whose aim is to win the support of the majority disillusioned with globalisation and its consequences.

It hardly bears stating that these leaders are by no means against the corporate interests that have determined the direction that global integration or even integration within Europe has taken. The fact that globalisation is corporate driven has meant that restructuring the EU and the global order (to make them more inclusive) and negotiating a coordinated effort to pull economies out of recession has proved impossible. So, if the crisis intensifies, protectionism or retreating from excessive integration with the rest of the world may be the only way to go. Whatever the long term implications of this, it could, in the short run, disrupt world trade, and trigger beggar-thy-neighbour responses. Combined with all the other effects that the Brexit vote may have on a world still steeped in recession, that could make difficult the task of preventing the Great Recession from turning into a 21-century version of the Great Depression.

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