Speech to the Bruges Group by Ruth Lea
Britain and Europe: A New Relationship

1 Introduction

I shall approach the issue of Britain and the EU from an economic point-of-view, though that is not to say that I don't appreciate other issues, including all-important sovereignty. But I believe that the key issue we who would like to see this country free to make its own way in the world, rather than being shackled by the EU, have to make the case that Britain outside that EU would benefit economically and be more in tune with economic developments in the 21st century.

We also have to knock down the various arguments that Britain outside the EU would be isolated & economically sink without trace. These are silly quasi-mythical arguments, but we have to deal with them.

2a Britain & the global economy

And let's start with Britain in the global economy.

- Let's remind ourselves that we are not an economic minnow: Britain is one of the largest of the "second tier" economies. According to the World Bank the UK was the 6th largest economy in nominal (market exchange rate) terms in 2010 and 7th in PPP terms. IMF estimates suggest that Britain slipped below Brazil on both bases in 2011 to be the 7th biggest economy in nominal terms and the 8th biggest in PPP terms.
- And Britain is still one of the great trading nations. In 2010 it was the fifth biggest trading nation after the USA, Mainland China, Germany and Japan and the sixth biggest exporter of goods and services. Incidentally, Britain ran a **large current account deficit (over £52bn) with the EU27 in 2010**, but a healthy surplus with non-EU countries (nearly £16bn). More jobs are created in the other EU countries than are created in the UK because of UK-EU trade…
- Britain has excellent trading and other ties with the rest of the world – as evidenced, amongst other things by the great success of the City of London, which I will defend. It has, for example, much better ties than, say, Switzerland, which is a successful economy by any standards.

2b Britain & the global economy: the Commonwealth

Britain is also a member of the Commonwealth, which as an economic bloc is rarely discussed in Britain. Commonwealth countries have at least four interesting features which are relevant to trade:

- Firstly, because of shared history and commonalities of language, law and business practice, it has been estimated that Commonwealth countries trading with one another experience business costs 10-15% lower than similar dealings with non-Commonwealth countries of comparable size and GDP. This has been called the "Commonwealth advantage".
- Secondly, the modern Commonwealth spans five continents and contains developed, emerging and developing economies. Nearly every major economic grouping is represented and in its diversity it captures the character of the 21st century globalised economy. It contains over 2 billion people and accounts for 15% of world GNI in PPP terms (see annex table 11).

- Thirdly, they have favourable demographics and growth prospects (as discussed above). Their working populations are projected to increase to 2050 and, insofar as economic growth is correlated with growth in the working population, they are set to be the growth markets of the future, along with the US and China. Specifically, the Commonwealth's demographics compare very favourably with several major European countries, where working populations will age and shrink.
- The UN estimates that between 2010 and 2050, Australia's **working population** will increase by 23%, Canada's by 9% and India's by 45%. In contrast Germany's working population will fall by 25%, Italy's by 21% and Spain's by 14%; though the UK's is expected to rise by 5% and France's by 2%. Note too that other big fallers include Japan (31%), China (19%) and Russia (27%). The USA's working population will incidentally increase by 16%.
- Fourthly, the Commonwealth also has the advantage of being a group of friendly (non-threatening and non-adversarial) countries which includes many with deep reserves of key natural resources.
- Conclusion: if the UK withdrew from the EU's Customs Union, the UK should consider negotiating a Commonwealth FTA – but I'll come back to this.

2c Britain & the global economy: the relatively shrinking EU

Following on from the demographic point, the EU is inevitably declining as a world "economic power".

- The EU is in relative secular decline, partly driven by demographic factors, whilst the prospects for China, India, Brazil, Russia, Australia, Canada and the USA all look much brighter. The USA is set to be the largest and most prosperous economy for many years yet.

Shares of world GDP (PPP), %, IMF data

	1980	2010	2016f
EU27	31.4	20.4	17.7
US	24.6	19.5	17.6
Japan	8.6	5.8	4.9
China	2.2	13.6	18.0
India	2.5	5.5	6.7

- **Britain needs to realign its trade towards fast-growing economies in order to stimulate economic growth**. Of course, David Cameron is touring the Far East at the moment, but membership of the EU's Customs Union, prevents us from developing FTAs with favoured trading partners – whether they are the Commonwealth, as just discussed, or the US, or whoever.

3a British membership of the EU: the costs & benefits

- There have been several reputable cost-benefit analyses all show net costs to Britain of EU membership. For example, both Patrick Minford & Ian Milne suggested that the basic costs were around 3.5% to 4% of GDP (2004). It is a pity that the British Government doesn't provide a CBA of its own.
- Though the Swiss Government did vis-à-vis contributions. The estimates made by the Swiss Federal authorities (2006) on the costs of joining the EU and their decision to remain with the *status quo* as the best option for Switzerland. If Switzerland were to join the EU, the annual net contributions would increase to

SFr3.4bn annually (six times the current sum), with gross contributions of SFr4.9bn (nine times the current sum).
- But note that the Treasury was sceptical from the start, according to Hugo Young. "The Treasury…remained officially against British entry. That is to say, its judgement of the economic consequences was negative, and it submitted a paper to that effect."

However, let us consider some aspects of the costs & benefits:
- Firstly, Britain's **net contributions** to the EU – the tip of the iceberg. They were £8.1bn in FY2010 compared with £4.4bn in FY2005. They are moreover set to increase in forthcoming years, as the budget will increase & we'll probably lose more of our rebate. If Britain had had a Swiss-style relationship in FY2010 the net contributions could have been 1/6th of what they were. They could have been £1.3bn – a saving of nearly £7bn.
- The costs to Britain of membership of the EU's **Customs Union**, specifically the opportunity costs of being unable to negotiate its own free trade deals, are substantial, though difficult to quantify, and will become more substantial, given the EU's shrinking share of global output. The Commission negotiates on our behalf for the interests of the EU27.

3b British membership of the EU: the costs & benefits, continued
- Membership of the EU's **Single Market** comes with a very heavy regulatory price, even though we are told that it is the "jewel in the crown". For me the Single Market is the problem – not the solution. The UK has just 8 ½ % of the votes in QMV.
- There have undoubtedly been some benefits from the Single Market, but the costs seem to have comprehensively outweighed the benefits. The EU Commission has conceded that the EU's regulations are costly. Günter Verheugen (the Commissioner for Enterprise and Industry, 2004-10) was reported in the *Financial Times* in 2006 saying that the costs to business of complying with European legislation could be up to **€600bn** a year, almost twice the previous estimates. €600bn was equivalent to 5.5% of EU GDP, equivalent to the size of the Dutch economy. Meanwhile the benefits are, apparently, much lower than the costs. The Commission has said that "…over the last 15 years the Single Market has increased the EU's prosperity by 2.15% of GDP. In 2006 alone this meant an overall increase of €240 billion, or €518 for every EU citizen, compared to a situation without the Single Market."
- And note that about half the legislation affecting business is EU-sourced and cannot be amended and/or repealed whilst Britain remains a member of the Single Market. (Lord Triesman.) We have to apply the EU's regulations to 100% of the economy, whilst less than 15% of GDP actually trades with the EU.
- The EU is extending its regulatory control over the **City of London** in the wake of the 2008 financial crisis – not just regulations but also high level supervision. The hostility to the EU in the City grows by the day…Whilst Britain is in the Single Market, there is little the Government can do to resist the regulatory creep. And don't believe them when they say they can…
- **Note the scare story**: if the UK withdrew from the Single Market there would probably be little disruption to UK-EU trade because, quite simply, disruption would not be in the interests of those EU27 countries which run big surpluses with the UK. Similarly, it is unlikely that FDI flows would be severely disrupted.

- **CAP & CFP**: the Common Agricultural Policy (CAP) and the Common Fisheries Policy (CFP) are both costly.
- The UK has adopted the EU's **climate change and energy policies**, including the Emissions Trading System (ETS) and the Renewables Directive, with zeal. If Britain withdrew from the Single Market, but still wished to pursue its GHG emissions reductions targets, it could drop the ETS and the Renewables targets. It could then introduce a straightforward carbon tax to incentivise low carbon technologies and focus on gas-fired and nuclear generated electricity, dropping expensive and unreliable wind-turbines.
- Finally, let us just note that Britain's influence in the EU is remarkably modest, given that it was the 6th biggest economy in the world in 2010 (7th in 2011) and the 5th biggest trading nation in 2010 with a unique set of international links. The EU is "not going Britain's way". It never has done and it never will. We get a bad deal…

4 A new relationship for Britain: reform, repatriation, leave?

The status quo is not satisfactory. I would like to see a relationship based on trade & cooperation with the EU, rather like Switzerland's - not the current relationship of ever-closer union:

- Could it be achieved by working to **reform the EU from within**? Well no, tried that since 1973.
- Could it be achieved by negotiating a **repatriation of powers**? I would not be optimistic. Last Autumn German MOF Wolfgang Schäuble said that Britain should forget any attempts to use the Eurozone crisis to repatriate EU social & employment laws. And I cannot envisage the other 26 EU members would ever agree to renegotiate the treaties unilaterally for us, thus agreeing to concessions for us. We would never get the support. It's inconceivable.
- So the alternative is to make a clean break. Britain, under the WTO umbrella, should move towards the following trading relationships with EU and non-EU countries respectively:
    - **With EU countries**: a Swiss-style relationship, based on free trade and mutually beneficial bilateral agreements – reinstate our membership of EFTA. [Norway is in the Single Market/EEA.]
    - **With non-EU countries**: closer trade links with the Commonwealth, the USA and other favoured nations. These links could include the establishment of a Commonwealth FTA and/or Britain's membership of NAFTA. NAFTA (North American Free Trade Agreement) could then become North Atlantic Free Trade Agreement. By negotiating these closer relationships, Britain would be in a much better position to realign its trade patterns towards fast-growing economies, thus stimulating economic growth, than it is now.
- Building up mutually beneficial free trade links with the EU, Commonwealth and NAFTA would mean that, rather being isolated, Britain would actually be better internationally networked, especially with the world's growing economies, than as a member of the EU.

5a The Eurozone: economics - didn't get this far in the speech

- The Eurozone crisis staggers on. At heart there is a major "**competitiveness gap"** between Germany (& other northern European economies) the peripheral economies. Putting aside the financial crisis for one moment, the "real" economic crisis is the competitiveness gap. The southern European countries need a major

improvement in their relative labour costs to regain to competitiveness, around 30-40%.

- This gap plus the tough austerity packages (to cut the deficits) imposed on the weaker Eurozone countries means that Spain, Italy, Portugal and especially Greece (the economy is tanking) are in recession. (Ireland was in 2011H2, so is the Netherlands). Given the austerity packages it's very hard to see how these economies can recover – and get on top of their deficits as Spain is currently finding out…as the markets are now panicking about. And there is speculation that Spain may need a bailout.
- The Commission is projecting GDP declines for Italy and Spain of 1.3% and 1.0% respectively in 2012, after weak growth in 2011. The situation in Portugal and, especially, Greece is far worse. Portugal's GDP may shrink by over 3% after a 1½% decline in 2011, whilst Greece's economy is tanking. GDP has fallen significantly for the last three years and will probably continue to do so in 2012. It is estimated that in the years 2009-2011 GDP fell a cumulative 13%. If the Greek economy shrinks by the projected 4½% in 2012, then the cumulative decline between 2009 and 2012 would be 17%. And there are no signs that this profoundly troubled country can recover given its current economic policies, with or without bailouts.
- Unemployment (January 2012): Greece (20%), Spain (23%+), Portugal (15%), Ireland (15%), Italy (9%).
- The authorities have bailed out Greece (2x), Ireland & Portugal and have introduced a new bailout fund (end March); the ECB has provided lashings of liquidity to the banks (staunched the panic temporarily) etc. But this is sticking plaster.

5b The Eurozone: solutions

The Eurozone's leaders have really only two basic choices:

- They either establish a **full fiscal union** for the euro area. And this doesn't just mean the tighter fiscal discipline of the new "fiscal compact" treaty. There is quite a lot of confusion about the term "fiscal union." **Full fiscal union (**I give this a 5% probability in the next 5 years.**)**:
    - EU Treasury *de facto* run by Germany & its northern economic allies, with the severe curtailment of the economic sovereignty of the southern countries.
    - The issuance of "Eurobonds" (common sovereign bonds) – banned by the EU treaties. Merkel says at the end of the process of economic integration, not before.
    - Fiscal transfers from the rich north to the uncompetitive south. Otherwise the "poor south" will just struggle. It's unacceptable to Germany & allies because of the costs & unacceptable to the "Club Med" because of the loss of sovereignty.
    - The ECB would have to become the lender of last resort to the governments (as well as the banks) his is also banned by the EU treaties.
- Or they acknowledge that a major **reconfiguration** is in unavoidable.
    - Some people suggest something like an **orderly dual currency regime**: the northern euro (the new DM?) & the southern euro. Unlikely.
    - **Some countries may leave**, for example Greece. If Greece left then the speculation is that others would follow: Portugal, maybe Spain, maybe Italy, maybe Ireland. This would have to carefully managed, but it is not impossible (see precedents, see the Wolfson prize).

    - Maybe the **whole Eurozone would break up**, but the political fallout would be enormous such has been the political capital invested in this project.
- In the short-term **reconfiguration** could, of course, be economically disruptive. But by lancing the boil and restoring certainty, restoring confidence, letting devaluation happen, letting default happen, growth could then be restored. There are precedents: Argentina, for example, in the early 2000s: austerity, default and devaluation. The notion that a break-up of the euro would mean economic perdition forever and therefore "must not be allowed to happen" is absurd. The Treasury already working up contingency plans for a break-up of the Eurozone – and surely the French & German MOF's and Brussels are too.
- And note: "if a thing can't go on forever, it'll stop" (Herb Stein). The Eurozone as it is currently configured & governed can't go on forever.