Shashithanganee Weerawansa

Ms. Shashithanganee Weerawansa is a Lecturer in Economics at the university of Colombo over a decade. In addition to her qualification in Economics she also holds a Master in Business Administration. She has wide experience as a lecturer serving local and foreign degree programs of the University of Wales, University of London, University of Southern Queensland, University of Monash etc.
Shashi has many publications to her credit, on a wide range of Economic and Management related subjects.

BRITAIN Leaving the EU

– Is it a move towards a freer trade?

Backdrop

The idea of Economic Integration originated with the aim of promoting trade between countries which subsequently resulted in forming economic unions and implementing Regional Trade Agreements. NAFTA, CAFTA, ASEAN, SAFTA are few of such Regional Trade Agreements that aimed at promoting the trade integration.

European Union (EU) stand amongst the Economic Unions due to its unique nature of economic integration. EU is an association of states, consisting 28 member states which have relinquished part of their sovereignty to EU institutions, with many decisions made at the European level. The EU has developed an internal single market through a standardized system of laws that apply to all member states. EU policies aim to ensure the free movement of people, goods, services, and capital within the internal market.

The EU has established a single market across the territory of all its members representing 508 million citizens. EU member states as estimated own the largest net wealth in the world, equal to 30% of the $223 trillion global wealth. Nineteen member states have joined a monetary union known as the euro zone, which uses the Euro as a single currency; euro is the second largest reserve currency as well as the second most traded currency in the world after the United States dollar.

Brexit – A surprise?

Despite the positive aspects of the existence of the EU, it seems that freer movement in trade is in force as 52% of the UK people are in favour of ending its 43-year membership in the European Union. According to some economists the UK's decision to leave the EU is a watershed event. It may bring to an end the free movement of labour and limit the free trade of goods and services between the UK and EU. This limits the job options of both parties; the UK people had the freedom to work in any of the 28 member countries or set up companies and have immediate access to trade. In the light of all the strengths the people of the UK decided to take the country out of the biggest single market. However, after the Brexit the UK could have more trade with other countries for economic and political reasons.

According to Andrea Leadsom, the UK is the world's 5th biggest economy, the 8th biggest manufacturer, speak the world's international business language, have the best contract law and one of the most trusted judicial systems in the world and have the most creative and innovative financial services sector anywhere, have three of the top universities in the world and, according to the World Bank, the most powerful capital city on earth.

Thus, the UK will experience a boost from the newfound freedom to set up tariff free trade with the 80 per cent of the world that is not in the Single Market. Hence, Brexit is a clear expansion of globalization where UK will engage in more market friendly policies with the rest of the world. In that backdrop, the article attempts to analyze the future economic effects of freer trade on the UK after the Brexit, on the European Union and Sri Lanka in the short to medium term.

Emergence of Economic Integration

The post second world war period has seen an enormous increase in the interest in problems of economic integration. In Europe the customs union and later the economic union of the Benelux countries, the European coal and steel community, the European Economic community (common market) and the European free trade associations are manifestations of this movement. Plans have also been made for the establishment of a free trade area encompassing the countries of the common market. (Bela Balassa,1961)

Regional economic integration provides an immediate alternative by offering the prospects of economies of scale for local producers and the reestablishment of broken chains of production as well as the creation of new ones so as to enhance export competitiveness. In addition, economic integration among countries enhances the region's ability to attract much needed foreign direct investment.

Question of Free Trade

The mainstream thinking has been that free trade is beneficial to countries in general. However, for the several decades this notion has shifted to free trade within members of a trade block as being more beneficial and more practical; the exit of Britain from the EU poses the question whether the UK experiment of freer open trade would be a superior option to conditional free trade of being a member of the world's largest trading block

Methodology

Impact of Brexit could only be assessed sometime in the future. The analysis is based on predicted information that is derived assuming different scenarios. Hence, the analysis does not involve empirical validation. Hard data and information are reflecting the short term speculative factors. Thus, could not be taken as a representative as the outcome in the mediums and the long term.

Findings

Impact on UK

The UK has chosen to be less economically integrated with the rest of the EU. This is likely to lead to lower levels of migration and trade. As a result the economy is likely to be less specialized and less productive with a lower level of investment. These are all standard supply side effects (A. Armstrong).

Low productivity and the low output of the UK will lead to slow economic growth. There is much evidence that FDI brings benefits in terms of enhanced productivity. For example, Bloom et al (2012) find that multinationals boost productivity in the UK establishments through enhanced technologies and management practices. On top of the direct effect, Haskel et al (2007) find that there are foreign investment 'spillovers' to other, UK-owned firms in the same industry. For instance, the consensus medium term projection is that the output in 2020 will be 3% lower than otherwise. This implies economic growth is 0.76% per year lower than otherwise during the transition. One cannot consider this as a recession.

However, according to a Bloomberg poll almost three-quarters of market economists surveyed expect the UK to have a technical recession that is two consecutive quarters where output falls in the next eighteen months.

Also, UK will face an extended period of elevated policy uncertainty as the UK undergoes a protracted separation from the European Union and finds it necessary to re-negotiate many of its international economic agreements.

As the Pound depreciates immediately after Brexit there is a risk of transfer of a part of the financial capital to lucrative destinations and this may further erode the UK currency.

Move towards FTAs

As per the brexit decision, UK will no longer be a part of the single market, meaning free movement of people is not allowed. Theresa May, commenting on the matter has said, UK "cannot possibly" remain within the European single market, as staying in it would mean "not leaving the EU at all".

The PM promised to push for the "freest possible trade" with European countries and warned the EU that to try to "punish" the UK would be "an act of calamitous self-harm". It is interesting as how these changes are adopted.

Professor David Collins, Professor of International Economic Law, opined that the UK government must work to establish clarity regarding the UK's position in the World Trade Organization (WTO) as quickly as possible.

"Given the length of time associated with the conclusion of FTAs (normally several years), the UK must accept the possibility that it may trade for a time under WTO rules alone. This will involving setting tariff commitments on a range of goods (likely in step with existing ones as a member of the EU) as well as its specific services commitments under the General Agreement on Trade in Services (GATS), especially in financial services. Issues relating to the UK's portion of the EU's tariff free quotas and agricultural subsidies will need to be ironed out as well. Simply cutting and pasting EU commitments in these areas will not work, as many have suggested," Prof. Collins.

Financial services are a major part of the UK economy. Being part of the EU is central to the role of the city of London as a global financial hub. Financial services account for 10% of the UK GDP and 12%of tax receipts employing over 330,000 persons in high skilled and high wage employment. This is one of the few areas where the UK has large and consistent trade surpluses amounting to 47 billion pounds.

Within Europe, the city of London dominates the wholesale banking services and the EU being a single market, the city of London plays a major role as a global hub for wholesale trading. Also, the clustering of the European headquarters of large international banks in the city of London would be under threat.

Britain's biggest high street retailers have signaled that clothing prices could rise next year as the impact of Brexit boosts inflation, amid warnings that food prices could also climb. (Guardian, 2016); a retail analyst at Bernstein Research, states that the cost of food for retailers could rise by up to 3% – as only 15% of the fresh fruit sold in the UK is grown in the country, and 55% of vegetables, with most of the rest coming from the EU. Nearly 40% of pork sold in the UK also comes from overseas. If the sterling remains weak or falls further, prices will inevitably rise, leading to high food prices.

Impact on EU

Currently, in 2015, an estimated 270,000 citizens form other EU countries immigrated to the UK, and, 85,000 migrated abroad. So the EU 'net migration' was around 185,000. This would be a huge blow in terms of economic and social aspects to the EU countries if the UK decides to send them back. Hence, Brexit will result in economic setbacks in Europe.

There are many health and social care professionals currently working in the UK who have come from other EU countries. This includes 55,000 of the NHS's 1.3 million workforce and 80,000 of the 1.3 million workers in the adult social care sector (Health and Social Care Information Centre 2015; Skills for Care 2016).

The NHS is currently struggling to recruit and retain permanent staff – in 2014, there was a shortfall of 5.9 per cent (equating to around 50,000 full-time equivalents) between the number of staff that providers of health care services said they needed and gaps in the post Brexit, particularly in nursing, midwifery and health visitors (National Audit Office 2016).

Similar problems exist in the social care sector, which has an estimated vacancy rate of 5.4 per cent, rising to 7.7 per cent in domiciliary care services. High turnover is also an issue, with an overall turnover rate of 25.4 per cent (equating to around 300,000 workers leaving their role each year (Skills for Care 2015).

London is the largest global center in the Euro foreign exchange markets, with a daily trade of over US$1 trillion. This is nearly 45% of global trade, a figure that far exceeds that of any country belonging to the Euro zone. London is dominant in markets for swaps, especially interest rate swaps and such London based trades in these assets amount to over US$1.3 trillion per day. The extraordinary size of these markets mean that city of London is central to the stability of the Euro.

Europe is losing its biggest military and diplomatic power, the world's fifth largest economy and one of its biggest free-market champions.

Impact on Sri Lanka

UK being the second largest export destination of the country accounting around 10% of its total exports and marinating a trade surplus with the UK and the EU, Sri Lanka may experience many direct and indirect economic consequences.

The immediate effect would be the depreciation of the Pound to 1.33 against a US $ (Before Brexit US$ = 1.50) Hence, the Sri Lankan foreign exchange earnings would drastically diminish. Nearly 40% of exports (28.8% to EU) are sent to the EU and 10% of that to the UK; there will be a reduction of such exports as the depreciation of the pound and the Euro would no doubt erode the demand for exports. Current earnings from exports to the EU are around US$ 3bn while an amount of US$1bn is from the UK. The Sterling Pound depreciated by 8-10% against the $ after 31 years. Also, the Sri Lankan Rupee appreciated against the Pound by 9% from Rs.217.53 to Rs 200.10 on June 24,2016.

The depreciation of the Pound and the Euro means exports to Europe are not as lucrative as before. Since, the EU is the second highest importer of our apparels Sri Lanka will have to suffer due to lower revenue than earlier.

Since, the US$ strengthens mainly against emerging economies , Sri Lanka may be compelled to depreciate the rupee in order to retain its export revenue from the UK ;but definitely the country's import expenditure would escalate since many imports have an inelastic demand. On the other hand, most of Sri Lankan exports to the EU are income elastic.

In case if Sri Lanka get its GSP Plus back this may not be applicable to the UK and may have to negotiate for a different preferential agreement as 83% of our total exports to UK consist of garment and textiles. The amount of revenue from garments and textiles will depend mainly on the future arrangements regarding the preferential trade system between Sri Lanka and the UK.

If risky assets are fleeing from the UK due to the depreciation of the Pound and are converted to US $, there is a tendency of appreciation of the latter. This would lead to further escalation of Sri Lanka's debt burden (Public debt is 77.2% of GDP) and of the Balance-of Payments (BOP) deficits. Hence, Brexit will create balance of trade issues because exports to UK and the Euro-zone will become expensive while imports from those countries will be relatively cheaper.

There would also be an impact on Sri Lanka's tourist industry as currently 30% of the tourists have been Western Europeans. Due to the depreciation of the Pound, the number of tourists visiting the country may considerably fall due to the consequential escalation of costs.

The total resident/worker remittances from the EU to Sri Lanka amount to around $1.2 billion, which is about 18% of total remittances. This will have a negative impact if the Euro and Pound continue to depreciate.

However, there are positive sentiments that Brexit may create a level playing field for Sri Lankan apparel as Sri Lanka will be able to compete on equal grounds with other competitors after they lose their GSP Plus accession to the EU market.

Concerns

Britain's weaknesses outside the EU will be scrutinized more carefully than they were when it was inside, including its continuing high annual budget deficit and growing debt, as well as its persistently high current account deficit. Hence, the UK leaving EU, may apply more pressure to correct the fundamental macroeconomic variables to upkeep the image of a strong economy or may have to adopt structural reforms.

The UK has been critical in driving forward the integration of the European energy market and has been a strong advocate of liberalized energy markets and some climate change mitigation policies. In the field of energy and climate change policy, remaining in the EU would have offered the best balance of policy options for Britain's national interests: the UK would have continued to benefit from the integrated energy market, while maintaining an influence over its direction and minimizing uncertainty for crucial investment.

Sri Lanka has already applied to get the GSP+ scheme and in case if the UK does not accept it, it would be a major loss to the country. On the other hand, if the UK has a common policy not to grant GSP+ this may be applicable to all competitor countries and Sri Lanka all have to compete purely on a productivity and quality basis.

Conclusion

The UK could implement new policies and offer new tax incentives to compete with the EU countries, it will be able to become more competitive in the long run and retain its current investments. Britain's exports to other countries outside the EU have been growing since the year 2000 (growing by 37%) and imports from outside the EU nations, Britain has been involved in importation of goods from the rest of the world on a large scale. It is visible that Britain was not totally dependent on the EU nations and it could develop trading partnerships outside the EU; the more promising free trade partnerships could be with China, India, Brazil, Russia, Australia, the USA and Canada.

The general belief is that if the UK is on its own outside the EU, it will be able to better tackle the available set of tools to manage the financial system and monetary policy to respond successfully to any crisis situation. Also, post Brexit Britain could deal with the market with an open hand policy and attract Foreign Direct Investments to the country without any restrictions if it is no more partnered with the EU, are clear signals of a movement towards a freer trade.