UK risks falling behind Europe

May's weak government may opt for regulation
by Holger Schmieding in Berlin
Mon 26 Jun 2017

On many counts, the British economy is still in pole position in Europe. But the UK faces a dynamic Germany, a mostly reformed Spain, and a France that, after the election of President Emmanuel Macron with his large parliamentary majority, is finally getting its act together. On present trends, the UK will soon be falling behind Europe.

Britain can avoid that fate if it opts for a 'soft' withdrawal from the European Union, resists the urge to turn away from the neoliberal consensus of the post-Margaret Thatcher decades and fixes its budget in a way that does not weigh unduly on productive capacity.

As prime minister in the 1980s, Thatcher crushed rebellious trade unions, modernised the economy, deregulated the City and prodded the EU to liberalise so that London could exploit a vast neighbouring market for financial and other services. Some of those benefits are now at risk.

On the one hand, the 8 June general election marked a return to the common sense missing in the EU referendum debate last year. Voters showed no great support for the hard Brexit line of Prime Minister Theresa May, but they stopped short of handing power to Jeremy Corbyn, leader of the Labour opposition. The electorate dealt a blow to Scottish dreams of a second independence referendum, and abandoned the right-wing UK Independence Party.

On the other hand, the UK is now saddled with a government that is far from 'strong and stable' as May had hoped. An unusually weak and wobbly administration has to make unusually hard choices before the Brexit deadline in March 2019. Although Corbyn failed to become prime minister, the election revealed a domestic tilt to the left. By losing preferential access to the EU market for financial services, and possibly for other services and goods as well in case of a hard Brexit, Britain may undo parts of Thatcher's pro-growth legacy. May's weak government may regulate, not deregulate. Outside the EU, the UK could become a more regulated economy than when it was inside.

In leaving the EU, Britain is forsaking most of its influence on European decisions that will continue to affect the UK. Britain can quit the EU but it cannot beat geography.

Some British observers have proclaimed that Brexit could destroy the EU27. That was always nonsense. The opposite seems to be the case. The electoral appeal of eurosceptics on the continent has fallen because of the travails of Ukip, the electoral humbling of both May and her predecessor David Cameron, and the glaring contrast between the big savings promised by the Brexiteers and the reality of a large Brexit bill.

A European backlash against three major external opponents of a more united Europe – Donald Trump in the US, Russia's Vladimir Putin and Turkey's Recep Tayyip Erdogan – is helping to re-energise the forces of integration. Angela Merkel in Germany is joining forces with Macron, seen in her newfound support for a euro area finance ministry.

Moreover, the Brexit process is contributing to a 'them against us' split across the English Channel. It has strengthened those on the continent who want to turn the EU and the euro area into more coherent and politically relevant entities.

All this means Britain will have to negotiate vital issues for its future with an unusually united EU27. Instead of playing one European neighbour against the next, Britain may have to deal with a more united core Europe. It will not be able to profit from the balance-of-power game that had served Britain so well over the centuries.

By making Britain less attractive for skilled migrants and for inward investment, Brexit will probably reduce Britain's annual trend rate of growth to around 1.8% from 2.1%. A hard Brexit with a loss of preferential access to the EU27 extending beyond the inevitable restrictions on UK-based providers of financial

UK risks falling behind Europe by Holger Schmieding in Berlin - Mon 26 Jun 2017
services could depress trend growth to 1.5%. Any significant surge in domestic regulation would compound the damage. The UK has many options for the years ahead: few look promising.

Holger Schmieding is Chief Economist at Berenberg Bank.