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How to Deal With Brexit*

The vote for Brexit was a resounding slap in the face to the so-called political and economic elites in London, Brussels and across Europe from British voters. It is not easy to react in an appropriate manner in such cases. Like other fits of anger, the Brexit was caused by a mixture of irrationality and rage over real problems. It was irrational because exiting the EU will significantly damage Britain's economy. Although many Brexit voters live outside the affluent centres that benefit most from the EU internal market, they are nevertheless harming themselves with this vote. Falling tax revenues will inevitably lead to cutbacks in nationwide public services like schools and healthcare via the NHS, as well as slower pension increases. This irrationality was fuelled by a Leave campaign that deceived many voters by spreading absurdly false information about the EU in some cases, wildly exaggerating costs of immigration and making unrealistic promises. This was only possible thanks to the poor organisation of the Remain campaign, which featured spectacular failures not only on the part of David Cameron, but also by Labour Party leader Jeremy Corbyn, who refused to make a determined stand for the EU, because it isn't socialist enough for his liking.

The real problems in Europe include the way that European politics have dealt with the refugee and euro crises, and the doggedness with which the EU has for decades squandered its largest budget item on agricultural subsidies. The idea that competences should constantly be shifted to Brussels also goes against the wishes of vast swathes of the population. The real problems in the UK include the failure by British politicians to address the growing alienation between the country's booming south east and stagnating regions in the rest of the country.

Now it is a question of limiting the damages of Brexit. This raises three questions: firstly, what are economic consequences to be expected? Does a recession loom similar to the post-Lehman downturn in 2008, or are things not really all that bad? Secondly, clarification is needed as to how the exit process will be structured and what Europe's future relations with the UK will be. Thirdly, Brexit raises the question of whether what remains of the EU needs to change in order to survive.

As far as the economic consequences are concerned, economists unanimously agreed prior to the referendum that Britain would face significant economic losses if it decided to leave the EU. Smaller, but tangible losses were also forecast for the rest of the EU. The effects of the Brexit can be expected to unfold in two phases: the first phase, which has already begun, will consist of negotiating the terms of an exit. The second phase will begin once those negotiations have been concluded.

In the first phase uncertainty over the future and the reaction of the financial markets will play a central role. For the next two years at least Britain will remain a member of the EU. The framework conditions for cross-border economic activities will not change during this period. There is, however, a great deal of uncertainty surrounding longer-term plans. Many companies will put investment projects on hold until it becomes clear whether it remains profitable to produce goods for the EU internal market in Britain despite new customs borders and vice versa. On top of this, there is general uncertainty regarding stability and the future of both Britain and the EU. Scotland has already announced a new referendum on its independence and anti-EU movements across Europe are sensing a change in the air.

Once the EU and Britain have finally reached a settlement, the second phase of economic effects will begin. In this phase Europe's economy will adjust to the new rules of play. If Britain's economy remains largely integrated in the internal market, the long-term economic damages should remain manageable. However, it is far from clear whether this will be the case. Without Britain EU policy may well become more protectionist and dirigiste. If that happens, Germany will be the loser in view of its dependence on exports.

One indicator that Brexit could have huge costs is the financial markets' reactions to it on the day after the vote. Although these reactions partly reflect sentiment and herd behaviour, a great deal of information and assessments are also bundled up in them. As expected, the British currency significantly lost value, falling by 7.6 percent against the US dollar. The euro rose against the British pound, but also depreciated by 2 percent against the dollar. Many investors abandoned risky investments and bought gold and government bonds instead.

The British share index “only” fell by 3.2 percent, with the depreciation of the pound having a stabilising effect. Measured in US dollar, however, British companies sustained losses of around 11 percent. Losses were even higher in some other EU states: measured in US dollar, Greece sustained the highest losses of 15 percent, followed by Spain and Italy at around 14 percent respectively. In those EU states with the closest links to Britain like Ireland and the Netherlands, losses were lower at 7-10 percent, and were similar to those seen in Germany and France. These figures clearly illustrate that the flexible exchange rate of the British pound has softened the economic shock of Brexit to some extent. They also suggest that Brexit will have a negative impact on the Eurozone.

How should the EU approach exit negotiations and what outcome should it strive to achieve? Many are now demanding that access to Europe’s internal market should be made as difficult as possible for Britain in the future to ensure its economy sustains sufficiently large damages. It is accepted that this will entail costs and destroy jobs in the rest of the EU. The aim is to make an example of Britain that will discourage other member states from leaving.

This strategy would accelerate the disintegration of the EU, not prevent it. There are already signs that the British economy is suffering as a result of the decision to exit. There is no need to demonstrate that leaving the EU gives rise to economic risks. One lesson to be learnt from the British referendum is that the threat of economic disadvantages does not deter voters who are keen to leave. In the British referendum populists like Nigel Farage argued that the EU is an unscrupulous organisation that destroys everything obstructing the expansion of its powers. To punish Britain for its exit would be tantamount to proving Farage right. It would also be grist to the mill of EU opponents in other member states. If the EU were to be so unattractive that it could only retain its members with threats, then it surely and justifiably would have no future. Fortunately, that is not the case.

The aim of the exit negotiations should be to minimise the economic and political damage of Brexit to all concerned. That can be achieved by keeping the British economy as integrated in the internal market as far as possible. This is less a question of whether the exiting country should be allowed to “cherry-pick” and more a matter of establishing which sectors trade constraints should be imposed, whether EU citizens should be allowed to live and work in Britain in the future and vice versa, and the size of London’s future financial contribution to EU programmes. It may also be wise to review the rules of play in the internal market in the light of the British reform proposals that were on the table prior to the referendum. A central objective for Britain is to prevent immigration into national social welfare systems and this is a justified concern. In the interest of all member states, the EU should pass regulations to effectively stem this kind of migration. The path agreed upon with David Cameron not to grant immigrants the same social benefits as the domestic population until they have resided in their new host country several years is a sensible one.

In setting out Britain’s future relationship to the EU, it is crucial to prevent those who would like to punish Britain by cutting its financial sector off from the internal market, for example, from getting their own way in negotiations. The foreign ministers of the EU’s founding states have called upon the British government to declare that the country wishes to leave the EU as quickly as possible. The British will not be as foolish as to do so. Any such declaration would trigger the exit procedure described in article 50 of the Lisbon Treaty. This procedure has hugely adverse effects on the exiting country. Declaration of an exit marks the beginning of two-year period. When this period ends, the membership of the country wishing to leave is terminated automatically. The period can only be extended via a unanimous vote by the European Council. A blocking majority of 35 percent in the European Council is enough to prevent any agreement being reached within this period of time. In this procedure a small group of states seeking to maximise the economic damages of Brexit to Britain could easily prevail. Those seeking to minimise the damages have to be constructive and hammer out an agreement that keeps the

British economy within the internal market. This calls for a qualified majority, or 55 percent of member states' votes representing 65 percent of their population. Angela Merkel has therefore rightly opposed calls by foreign ministers trying to force Britain to swiftly declare its intention to exit. But this will not solve the problem. Britain's government will insist that negotiations take place before the country officially declares its exit. If the other EU states do not agree to such informal talks, there will be stalemate. It will be interesting to see who makes the first move if that happens.

At the moment a growing number of voices within and outside Britain are calling for a stop to Brexit, despite the referendum. How could that work? If the British government refuses to begin the exit procedure for the reasons cited above and calls a general election instead, the Labour Party and the Liberal Democrats could campaign to keep the country in the EU and prevent Scotland from splitting off. This path would, however, reinforce the impression that Europe's political elites ignore democratic decisions when it suits them to do so. Britain's exit from the EU could still be avoided, but it's a long shot.

What are the implications of the Brexit vote for the rest of the EU? Many politicians now see an opportunity to follow through on their visions of how the EU should look. Critics of deeper integration are calling for the EU's powers to be curtailed and for a large-scale re-nationalisation of political competences. Supporters of a federal Europe are using the Brexit as an opportunity to further deepen the EU and see the exit of the recalcitrant Brits as a unique chance to do so. Alexis Tsipras, for instance, is demanding a strengthening of the EU's redistribution policies. As for Commission President Juncker, reports suggest that he seriously wishes to propose extending the euro to all EU member states.

Such hasty responses are highly dangerous. Redistribution creates winners and losers. The losers will turn their backs on the EU. Scepticism over the EU is already growing very fast in those countries that would be burdened by a stronger redistribution policy, especially in The Netherlands and Scandinavian member states. The proposal to extend the Eurozone in its fragile and incomplete state to cover the entire EU is also misguided. In countries like Sweden or Poland it would certainly be met with a weary smile.

What next? It is inevitable that a phase of reflection should follow the shock of the Brexit referendum's outcome; but this phase should not last too long. European politicians need to do two things to rein in centrifugal forces: firstly, the EU needs to direct its resources more strongly into policy areas in which they really can create added value that benefits all member states. Such areas include, for example, foreign and security policy, fighting terrorism and migration policy. The biggest obstacle here is that the EU cannot be successful active in these areas without its member states relinquishing their sovereignty to some degree; and the readiness to do so on the part of individual member states varies. In Germany, for example, it is certainly higher than in several eastern European member states. It is therefore advisable for a subset of states to proceed and agree on a common policy. That leads to the second implication of the referendum. The EU has no alternative but to adopt more flexible integration concepts. That applies to deepening political integration on the one hand, and to cooperation with states that do not wish to be full EU members on the other.

Another key issue is Brexit's implications for the EU's biggest area needing improvement, namely the reform of the Eurozone. Britain's exit merely reinforces existing doubts that the European integration process is sustainable. Many are now demanding that such doubts be countered with a strong signal of willingness to integrate. One example is the demand that a fiscal union finally be set up with collective liability for state debts and centralised control of government debts.

The fact that there are good reasons why such a step towards integration has not yet been taken is overlooked; and these reasons remain valid even after the result of Britain's referendum. Citizens in most member states would simply reject the transfer of power to Brussels required to achieve such integration. The diverging opinions of member states in the Eurozone on the correct fiscal policy to follow would lead to massive conflicts. Experiences to date with attempts to achieve effective political debt controls at a European level have been sobering.

A more promising approach would be trying to make progress with less ambitious, but nevertheless important projects, and specifically with cleaning up the European banking system. Three steps would be important: firstly, the bad loans that many banks (not just Italian banks) still have on their books should be written off and the banks in question should be recapitalized or liquidated. Secondly, the equity levels of banks should be raised significantly. Thirdly, banks should have equity to back the government bonds that they hold. Taking such steps would lead to a far more solid banking system that would be in a position to adequately finance investments. If European politics were to show that it could implement a comparatively manageable reform agenda, it would push forward the economic recovery in Europe and boost confidence in the future of European monetary union and the European integration process. That would be more useful than calling for visionary, but controversial reform projects for the EU that fail due to a lack of political support.

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