

July 2016

Economic Bulletin

BREFTA: BEST OF BRITISH?

A Simple Way to Soothe Markets and Appease
the Majority of Referendum Voters

Henry Cobbe



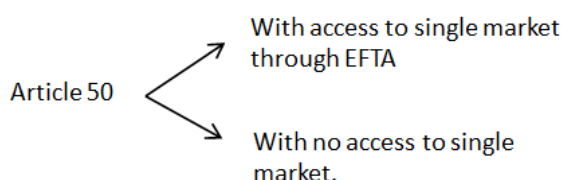
- The absence of a clearly defined plan for Brexit is creating damaging uncertainty for businesses and the markets.
- Leaving the EU, but remaining in the EEA through EFTA would address the concerns of the majority of Referendum voters, whilst also requiring a spirit of compromise from both sides.
- Joining EFTA would immediately provide the UK with continued free trade within the EU/EEA, a more valuable set of external Free Trade Agreements, and the added flexibility to negotiate its own free trade deals bilaterally.
- Setting a timetable for re-joining EFTA provides a straightforward solution that will give the necessary confidence and direction to businesses and the markets whilst respecting the outcome of the EU Referendum.

1. DIVISION AND DISTRACTION

Now that the dust has settled following the conclusion of Britain's EU referendum, Theresa May and her newly formed cabinet must determine a plan for Brexit. But how should this be done? Divisions that emerged during the referendum campaign over reasons for and against Brexit must be considered as a new relationship with the EU is set out.

Despite the abundance of debate during the build up to the referendum, there has been a lack of coherent analysis of potential policy configurations on how Brexit should be implemented, once Article 50 had been triggered. The major decision in this respect: whether or not to remain part of the single market.

Figure 1: The decision that matters



2. HOW CAN THE UK BECOME REUNITED OVER EUROPE?

Given the high turnout for the referendum, and indeed the strong support for both Leave and Remain, the Government would be wise to consider the primary voting motivations of both camps. These can be summarised as follows:

Table 1: UK Voting Motivations

| Leave | |
|--------|--|
| 49% | The principle that decisions about the UK should be taken in the UK. |
| 33% | Voting to leave offered the best chance for the UK to regain control over immigration and its own borders. |
| 13% | Remaining meant little choice about how the EU expanded its membership or powers. |
| 5% | Other reasons to leave. |
| Remain | |
| 43% | The risks of voting to leave the EU looked too great when it came to things like economy, jobs and prices. |
| 31% | Access to the EU single market, while out of the Euro and no-borders area giving the best of both worlds. |
| 17% | A feeling that we would become more isolated by leaving |
| 9% | Other reasons to remain. |

Source: Lord Ashcroft Polls

Table 1 shows that the Leave and Remain voting motivations are not mutually exclusive. In fact, by re-joining the European Free Trade Area (EFTA)¹ but remaining outside the EU could address the concerns of most voters. Indeed this approach would result in a return to the status Britain previously enjoyed in the *Outer Seven*² European countries (which is now just an *Outer Four*, comprising Iceland, Liechtenstein, Norway and Switzerland (as observer)) that are within the EFTA free trade area but outside the EU political club. This approach of Britain re-joining EFTA or “BREFTA” provides the Government with an opportunity to honour the referendum result while providing compromise that takes into consideration the full spectrum of voter’s motivations.

3. BREFTA: THE BEST COMPROMISE

Adopting a BREFTA approach (British exit of the EU, but membership of EFTA and the European Customs Union), close to the so-called *Norway model*, would mean that:

1. **the result of the referendum is respected:** the UK would leave the EU and be able to decide its own future. This would be supported by Leave voters, and some marginal Remain voters whose main concern was the economic consequences.
2. **the economic impact would be mitigated:** the UK would retain access to the Single Market, hence “business as usual”. This would be supported by Leave and Remain voters alike. Leave voters are generally supportive of free trade and the single market, but are passionately against political integration projects
3. **an economic opportunity is created:** the UK would gain access to the broader more valuable markets available to EFTA members, as well as regaining autonomy to make its own trade arrangements. Improved economic prospects would be supported by Leave and Remain voters alike.
4. **migration of EU/EEA citizens:** this would be the direct cost of maintaining access to the Single Market, although there is mounting pressure to re-examine this across Europe. This would be a compromise that Leave voters would have to accept – at least in the short-run, to provide stability to markets before more detailed negotiation can take place.
5. **migration of non EU/EEA citizens:** this would fall back under full UK control. With no requirement to consider European Court of Justice (ECJ) rulings, the UK would regain lost

¹ The EFTA is a free trade area set up for European countries unable or unwilling to join the EU. Countries that are members of the EFTA are not permitted to place tariffs on goods and services traded between them, but can choose their own external tariffs for all other countries with which they trade, that are outside the EFTA.

Upon joining the EFTA, countries can choose whether or not to be part of the European Economic Area (EEA) Agreement which permits them free trade with all EU countries, but still allows them to set their own external tariffs on the goods and services of non-EEA countries, albeit with the condition that they must accept some elements of EU regulation. All countries that join the EU must become members of the EEA as a condition of membership, must submit to the rules of the customs union, and must accept all EU regulation.

² The Outer Seven consisted of Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the UK. The Inner Six consisted of Belgium, France, Italy, Luxembourg, Netherlands and West Germany

powers over asylum policy and deportation of foreign terror suspects and criminals. This would address a key concern of Leave voters on sovereignty of UK courts, illegal non-EU migration and border security.

6. by remaining part of the European Economic Area (EEA) through EFTA, the UK maintains a strong **European identity for Scotland** and other parts of the UK and continued involvement in EU/EEA programmes which could satisfy Scottish votes to “Remain”.
7. by remaining part of the EEA through EFTA, there will be **no trade border in Ireland** between Northern Ireland and the Republic of Ireland, which could satisfy Northern Irish concerns that led to a “Remain” vote.
8. the UK would become even **more outward looking**: by joining EFTA, the UK would remain part of the EEA, but gain the opportunity to adopt a less Euro-centric world view. This would address a key concern of Remain voters.

4. BREFTA ADDRESSES MANY OF VOTERS’ CONCERNS

Combining the voting motivations of both the Leave and the Remain camps, weighted by the Referendum results, helps create a focus list of the key issues that a BREFTA policy could address.

Table 2: Voting motivations of referendum voters, by weight

| Weighting | Motivation | Vote | BREFTA |
|-----------|--|---------------|--|
| 25% | The principle that decisions about the UK should be taken in the UK. | Leave | The UK would no longer be part of the EU integration project. |
| 21% | The risks of voting to leave the EU looked too great when it came to things like economy, jobs and prices. | Remain | These risks are substantially mitigated through membership of EFTA as we would continue to have access to the single marketing and passporting regimes. |
| 17% | Voting to leave offered the best chance for the UK to regain control over immigration and its own borders. | Leave | EU citizens: negotiate greater controls alongside other EFTA members. Non-EU citizens: UK law would no longer have to refer to ECJ rulings on deportation and enforcement. |
| 15% | Access to the EU single market, while out of the Euro and no-borders area giving the best of both worlds. | Remain | By remaining in EFTA UK retains access to single market without. |

| | | | |
|----|--|---------------|--|
| 8% | A feeling that we would become more isolated by leaving. | Remain | By leaving EU and joining EFTA, UK gains access to more markets, and can make its own agreements. UN P5 status and NATO membership ensures international engagement. |
| 7% | Remaining meant little choice about how the EU expanded its membership or powers. | Leave | Through EFTA, the UK would continue to have a consultative role. |
| 4% | Other reasons to remain. | Remain | n/a |
| 3% | Other reasons to leave. | Leave | n/a |

Source: Lord Ashcroft Polls, *How the United Kingdom Voted and Why, 2016*, intentions of leave and remain groups adjusted by overall result (52% Leave, 48% Remain) to rank motivations by significance. BREFTA policy positions summarised from this article.

5. REMAINING STRONGER, WHILE TAKING BACK CONTROL

From a policy perspective, BREFTA could provide the ‘best of both worlds’. Whilst the Belgian Prime Minister has argued that the UK cannot have its cake and eat it too,³ there is a strong case that with BREFTA, it can.

The mapping of EU policy areas under Remain and under BREFTA can be set out as below⁴

Table 3: Comparison of EU policy under Remain and BREFTA scenarios

| REMAIN SCENARIO | BREFTA SCENARIO |
|--|--|
| <p>UK access to EU/EEA for:</p> <ul style="list-style-type: none"> Free movement of goods Free movement of services Free movement of EU/EEA persons Free movement of capital Customs Union | <p>UK retains access to EU/EEA for:</p> <ul style="list-style-type: none"> Free movement of goods Free movement of services Free movement of EU/EEA persons Free movement of capital Customs Union |
| <p>EU control over:</p> <ul style="list-style-type: none"> Agricultural and Fisheries Policies Trade Policy Foreign and Security Policy Justice and Home Affairs | <p>UK regains control over:</p> <ul style="list-style-type: none"> Agricultural and Fisheries Policies Trade Policy Foreign and Security Policy Justice and Home Affairs |

³ <https://www.theparliamentmagazine.eu/articles/news/charles-michel-uk-cant-have-its-cake-and-eat-it-too>

⁴ <http://www.efta.int/eea/eea-agreement>

| | |
|--|--|
| UK control over: Monetary Policy | UK retains control over: Monetary Policy |
|--|--|

Source: EFTA, Proprietary research

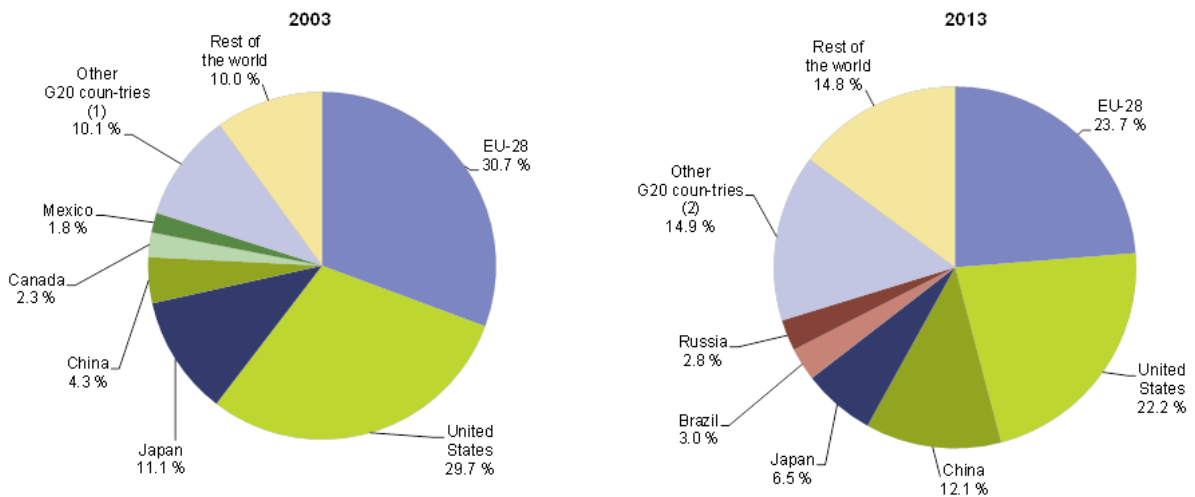
The main policy compromise for Leave voters under a BREFTA model is the issue of EU/EEA migration. However, this will become a negotiating point for all EU countries, and combined with stronger migration controls on non-EU/EEA migration, there is a case to make that the UK is able to partially take back control. Furthermore, in terms of combined voter concerns, despite media depictions, migration is ranked third as a voter concern after sovereignty and the economy.

BREFTA would enable the UK to take back control of key policy areas, whilst retaining access to the Single Market. Indeed, EFTA is more outward looking and offers greater opportunity than the EU.

6. THE EU HAS A SHRINKING SHARE OF GLOBAL GDP

Economic growth has greatly reshaped the international market since Britain joined the EEC, the pre-cursor to the EU, in 1973. Emerging markets have made significant gains, displacing the EU’s share of global GDP. As recently as 2003 the EU-28 represented 30.7% of global GDP, but this figure had fallen to just 23.7% by 2013, according to Eurostat.⁵

Figure 2: Share of global GDP by region

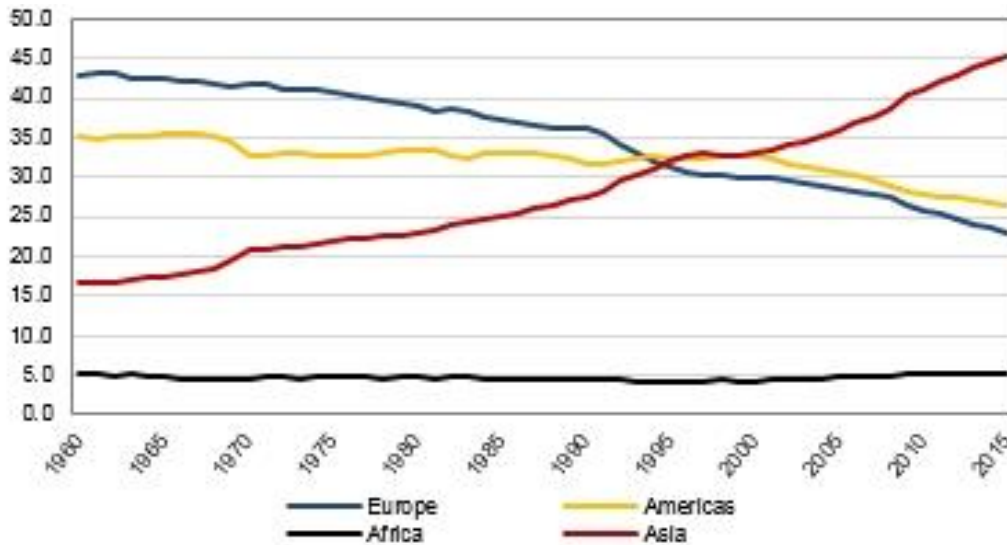


(*) Brazil, India, Australia, South Korea, Indonesia, Russia, Turkey, Saudi Arabia, Argentina and South Africa.
 (†) India, Canada, Australia, Mexico, South Korea, Indonesia, Turkey, Saudi Arabia, Argentina and South Africa.
 Source: Eurostat (online data code: nama_10_gdp) and the United Nations Statistics Division (National Accounts Main Aggregates Database)

⁵ [http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Share_of_world_GDP,_2003_and_2013_\(%25\)_EU_world15.png](http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Share_of_world_GDP,_2003_and_2013_(%25)_EU_world15.png)

Looking back to 1960 shows that this trend is persistent:

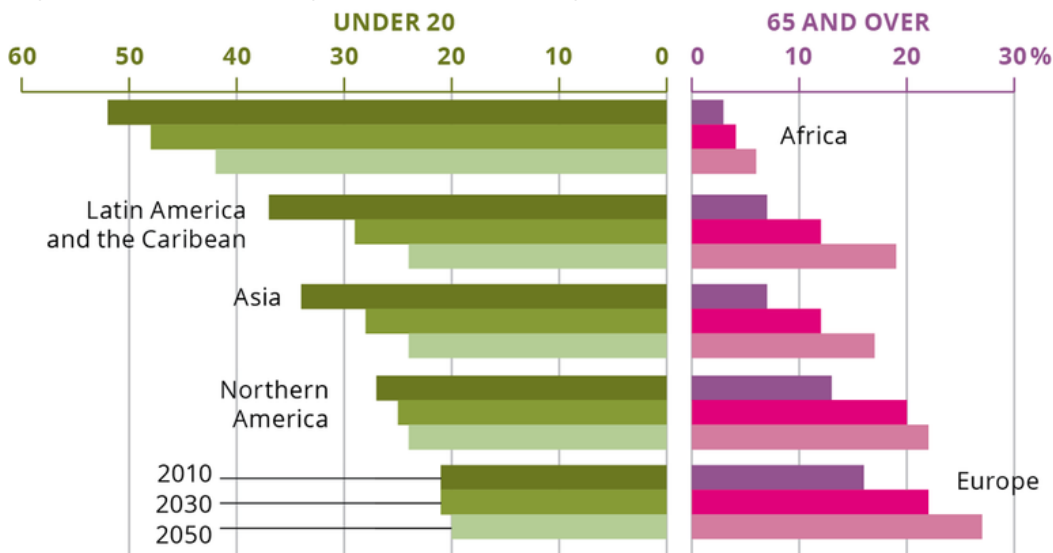
Figure 3: % Share of world real GDP by continent



Source: World Economics⁶

This decline is expected to continue as the demographic trends within the EU are forecast to deteriorate in the long-term – this is due in particular to an ageing population.

Figure 4: Forecast of age class share of regional populations



Source: European Environment Agency⁷

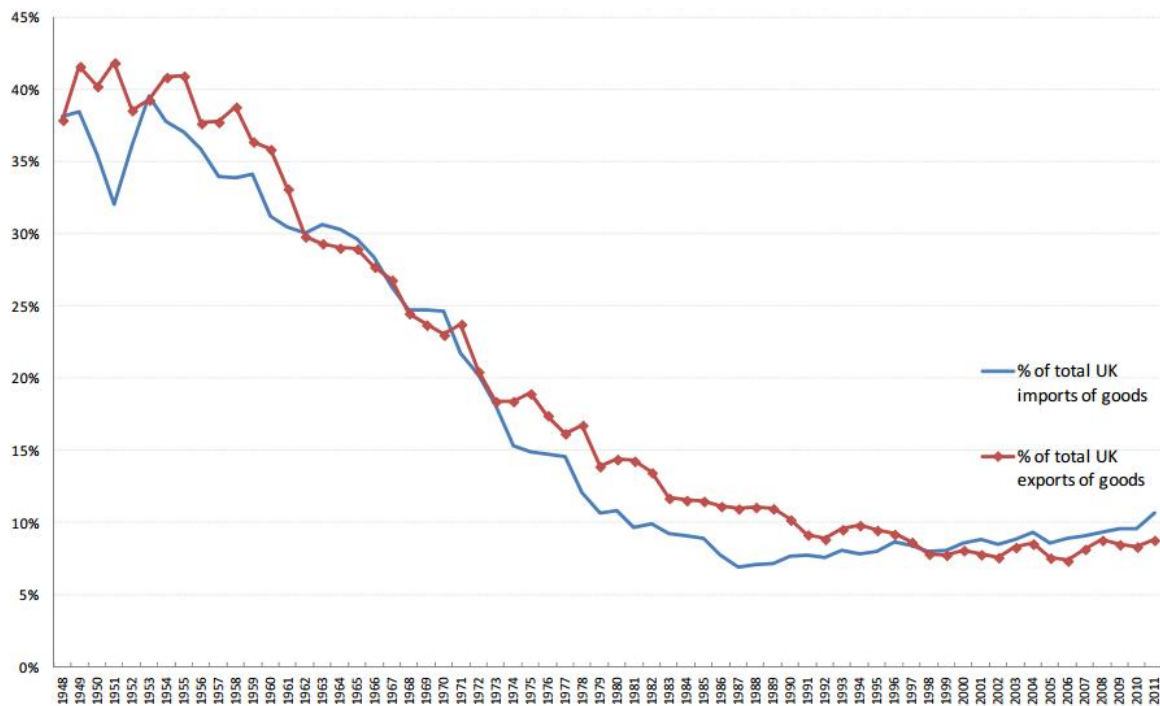
⁶ http://www.worldeconomics.com/papers/Global%20Growth%20Monitor_7c66ffca-ff86-4e4c-979d-7c5d7a22ef21.paper

⁷ <http://www.eea.europa.eu/data-and-maps/figures/percentage-of-total-population-under> & <http://www.eea.europa.eu/soer-2015/global/demography>

7. BRITAIN'S MEMBERSHIP OF THE EU HAS ALTERED ITS TRADE PARTNERSHIPS

Britain's membership of the EU has not ensured full international trade exposure, particularly with emerging economies. For example, declining trade with the Commonwealth resulting from EU membership has meant that the UK did not benefit from exposure to fast-growing economies such as India, Malaysia and Nigeria.

Figure 5: UK trade in goods with the Commonwealth as a % of UK total trade in goods



Source: House of Commons Library, UK Commonwealth Trade Statistics

The UK's major trading partners have changed substantially over the years as the shift away from the Commonwealth became more pronounced.

Table 4: Main goods trading partners with the UK; 1960, 1980, 2011

| UK, main goods trading partners, Imports, 1960 | | | UK, main goods trading partners, Imports, 1980 | | | UK, main goods trading partners, Imports, 2011 | | |
|--|-----------|-----------------|--|-----------|-----------------|--|-----------|-----------------|
| | \$million | % World exports | | \$million | % World exports | | \$million | % World exports |
| 1 United States | 1,605 | 13% | 1 Germany | 11,797 | 11% | 1 Germany | 80,362 | 13% |
| 2 Canada | 1,060 | 8% | 2 United States | 10,593 | 10% | 2 China | 52,329 | 8% |
| 3 Australia | 556 | 4% | 3 Netherlands | 8,937 | 8% | 3 Netherlands | 45,378 | 7% |
| 4 New Zealand | 521 | 4% | 4 France | 8,342 | 8% | 4 United States | 44,741 | 7% |
| 5 Germany | 516 | 4% | 5 Ireland | 6,182 | 6% | 5 France | 36,410 | 6% |
| 6 Netherlands | 509 | 4% | 6 Belgium-Luxembourg | 6,098 | 6% | 6 Belgium | 30,427 | 5% |
| 7 Sweden | 460 | 4% | 7 Italy | 4,414 | 4% | 7 Norway | 30,184 | 5% |
| 8 Kuwait | 449 | 4% | 8 Sweden | 3,773 | 3% | 8 Italy | 22,471 | 4% |
| 9 India | 420 | 3% | 9 Switzerland | 2,906 | 3% | 9 Ireland | 20,823 | 3% |
| 10 Denmark | 408 | 3% | 10 Germany | 2,799 | 3% | 10 Canada | 18,258 | 3% |
| World | 12,559 | | World | 110,078 | | World | 640,157 | |

Source: House of Commons Library, UK Commonwealth Trade Statistics

BREFTA: Best of British?

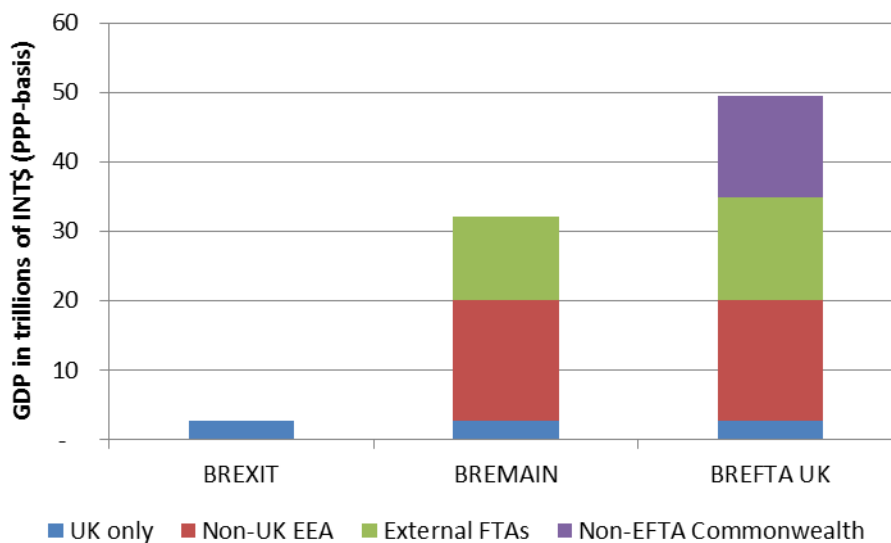
BREFTA would enable the UK to re-engage with free trade with Commonwealth countries without losing access to the EEA.

8. EFTA IS MORE OUTWARD LOOKING THAN THE EU

In terms of opportunity, EFTA has fewer agreements but greater access to markets on a GDP basis.

The EU has external Free Trade Agreements (FTA) in place with 53 markets representing \$12.0tr of GDP on a PPP basis.⁸ The EFTA has external FTAs with markets representing \$14.8tr of GDP on a PPP basis. The ability of the UK, as an EFTA member, to enter into its own trade agreements means it could target Commonwealth markets not already covered by EFTA – markets which represent a further \$14.6tr of GDP on a PPP basis. In this respect, the market opportunity available with BREFTA – external FTAs plus non-EFTA commonwealth countries – is double the size of the EU opportunity set including external FTAs. Withdrawing from EU and not applying to join EFTA would be economically disastrous for the UK economy.

Figure 6: Total GDP value of markets available to the UK in different scenarios



Source: Proprietary research, EFTA, HMG, IMF

9. WHICH MARKETS WOULD THE UK WIN OR LOSE ACCESS TO THROUGH EFTA?

- Through EFTA, the UK would retain access to key markets such as Chile, Israel, Mexico, South Africa South Korea, and Turkey. This would minimise disruption to UK trade.
- Through EFTA, the UK would gain access to markets that the EU does not have agreements with such as Canada, Bahrain, Kuwait, Oman, Qatar, the UAE, Hong Kong, and Singapore. This creates a material opportunity for UK trade.

⁸ Source EFTA for List of EFTA external FTAs, HM Government for list of EU external FTAs, PPP Data from IMF.

BREFTA: Best of British?

- The UK would lose access to, and therefore have to negotiate bilateral arrangements with the following Commonwealth countries: Antigua, Bahamas, Barbados, Barbuda, Belize, Cameroon, Fiji, Grenada, Guyana, Jamaica, Mauritius, Papua New Guinea, Seychelles, St Kitts & Nevis, St Lucia, St Vincent and the Grenadines, and Trinidad and Tobago. Concluding agreements with Commonwealth countries should be relatively straightforward given commonality in legislative and governance structures.

Hence the only non-Commonwealth markets that the UK would lose access to under a BREFTA scenario are: Algeria, Dominican Republic, El Salvador, Haiti, Honduras, Madagascar, Moldova, Nicaragua, Suriname, and Syria. The temporary loss of access to these markets pending renegotiating bilaterally or through EFTA would not pose an economic risk to UK trade.

10. ENGAGEMENT WITH THE COMMONWEALTH

By joining EFTA and remaining within the EEA, the UK would be able to enhance its free trade opportunities. Not only would Britain have access to EEA markets and EFTA external Free Trade Agreements, but it would also be able to re-engage more directly with the Commonwealth, which offers an opportunity set commensurate to that of the EEA, yet with a more favourable demographic.

With BREFTA, UK trade and foreign policy could focus on engaging with the “C10” the largest Commonwealth economies, overleaf.

Table 5: GDP and population size of the C10 Nations

| The "C10" | GDP (USD, millions)* | Population |
|-------------------------|----------------------|----------------------|
| Australia | 1,138,085 | 24,114,915 |
| Canada | 1,631,943 | 36,155,487 |
| India | 8,642,758 | 1,291,627,475 |
| Malaysia | 815,646 | 31,402,164 |
| Nigeria | 1,091,700 | 186,988,000 |
| New Zealand | 168,187 | 4,696,735 |
| Pakistan | 982,380 | 194,097,420 |
| Singapore | 471,877 | 5,535,000 |
| South Africa | 723,518 | 55,653,654 |
| UK | 2,756,748 | 65,110,000 |
| Observer Members | | |
| Republic of Ireland | 257,417 | 4,635,400 |
| Hong Kong SAR | 414,566 | 7,324,300 |
| Total | 19,094,825 | 1,907,340,550 |

* Note: GDP figure is measured in international (Keary-Khamis) dollars "INT\$" on PPP basis (Source: IMF), Population statistics Source: Wikipedia

By joining EFTA and remaining within the EEA, UK businesses would benefit from a business-as-usual continuation of their operations. While the UK government would lose out on votes and veto on policies affecting free trade within the EU, the UK would continue to have a role in decision shaping.

11. WHAT ROLE DO EFTA MEMBERS HAVE IN EU DECISION MAKING?

One of the key arguments against adopting a *Norway model* approach is that the UK would no longer have any say in how EU rules are made.

This misses two key points:

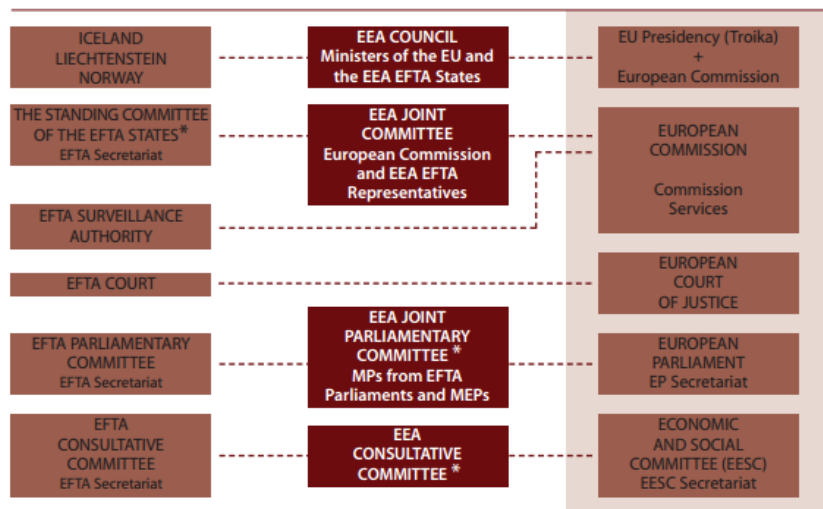
Firstly, as an EU member, EU rules will affect all goods and services in the UK. However, as a member of only the EFTA, EU rules only affect goods and services supplied to the EU, they would not extend to goods and services supplied to other markets where the UK or EFTA can have trade agreements in place.

Secondly, EFTA states are involved throughout the preparatory and drafting phases of those rules, as illustrated in the table below. While the UK would no longer have final say, it would have significant influence in the draft legislation that came to the table.

BREFTA: Best of British?

The EEA has a two-pillar structure that brings together EFTA and the EU through joint EEA bodies. EFTA consists of Iceland, Liechtenstein, Norway with Switzerland as an observer.

Figure 7: The Two-Pillar EEA Structure

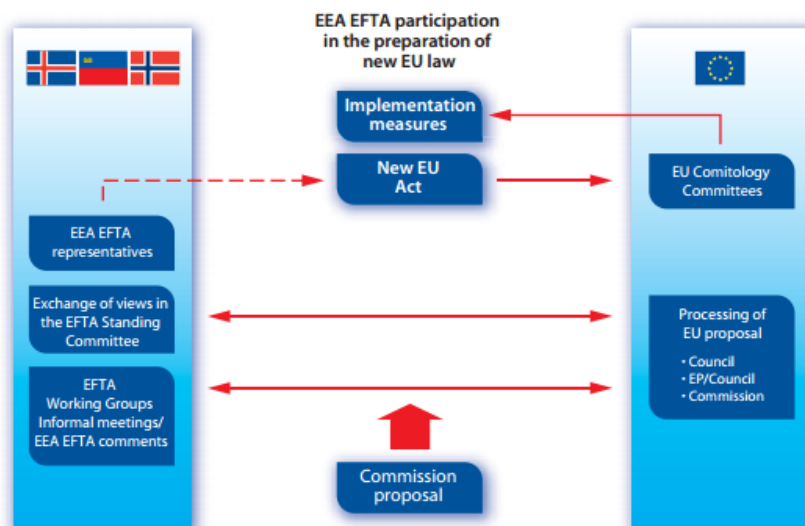


Source: EFTA

* Note: Switzerland is an observer. This figure illustrates the management of the EEA Agreement. The left pillar shows the EFTA States and their institutions, while the right pillar shows the EU side. The joint bodies are in the middle.

Formal structures exist to ensure EFTA views are heard in the preparation of EU law:

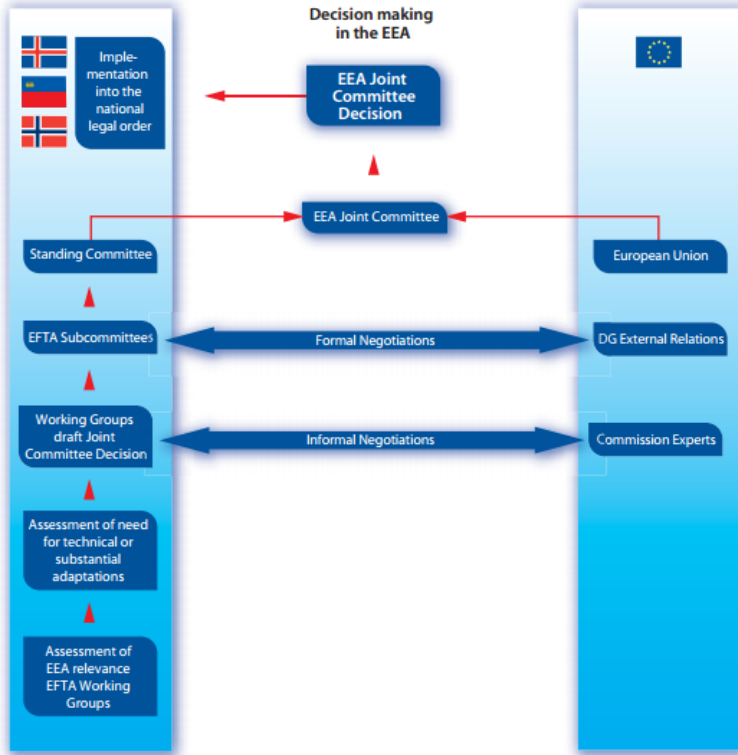
Figure 8: Structure of EFTA contribution to EU legislative process



Source: EFTA

Within the EEA decisions are made jointly before being implemented into national legislation. However, this predominantly affects only goods and services traded within the EU.

Figure 9: Structure of EFTA contribution in decision-making process



Source: EFTA

Membership of EFTA would therefore ensure the UK retains a key role in decision shaping in the European Economic Area (EU + EFTA),⁹ albeit with loss of vote and veto on the final legislation that affects goods and services traded within the EU. EU laws would not apply to UK trade with non-EU markets, and would not affect policy areas that return to the UK after leaving the EU, namely Agricultural and Fisheries Policies, Trade Policy, Foreign and Security Policy, Justice and Home Affairs and of course Monetary Policy.

12. CONCLUSION

BREFTA offers a compromise position. But between the alternatives of an anti-democratic dismissal of voter concerns, and economic isolation and disruption from full BREXIT, it is the least worst option available to policy makers that can ensure repatriation of sovereignty, business continuity, and the opportunity for greater free trade.

Henry Cobbe

July 2016

⁹ <http://www.efta.int/sites/default/files/publications/bulletins/eeadecisionshaping-bulletin.pdf>



THE AUTHOR

Henry Cobbe is Head of Research at Elston Consulting which provides consultancy services to asset managers. The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of Elston Consulting.