PROPONOMICS – MACRO VIEW

JULY 2016

THE UK AND THE EEA

Via membership of the European Economic Area (EEA), Britain can continue to access the single market and financial passporting, but at a price.

Headlines

Access to the single European market is via membership of the EEA, not the EU. **Like Norway, the UK could be a non-EU member of the EEA**

This will guarantee access to the single market and financial passporting, **easing the threats to the economic outlook posed by Brexit**

There will be a price though, **in particular the loss of the UK's vote on EU regulations**

The EEA route could quickly stabilise the economy and the property market, but the political inertia must end

JAMES ROBERTS
Chief Economist

"This model is tried and tested – Norway is already doing it – so the EEA can easily be sold to investors, firms and consumers as 'business as usual'."

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The free movement of goods, services, capital and labour within Europe is not based on European Union (EU) membership. Single market access is based on membership the EEA, of which every EU state is an automatic member. Every member of EFTA (European Free Trade Association) is also entitled to join, but are not compelled to do so. Norway has exercised that right, whereas Switzerland considered doing so but the proposition was voted down at a referendum.

As part of its EEA membership, Norway agrees to implement EU regulations related to the single market (but has no say on their content), but not regulations on other areas covered by EU membership, like agriculture and fisheries. It also contributes to the EU budget, and some argue that by certain measures Norway pays more than EU member states (although you can juggle numbers to prove anything).

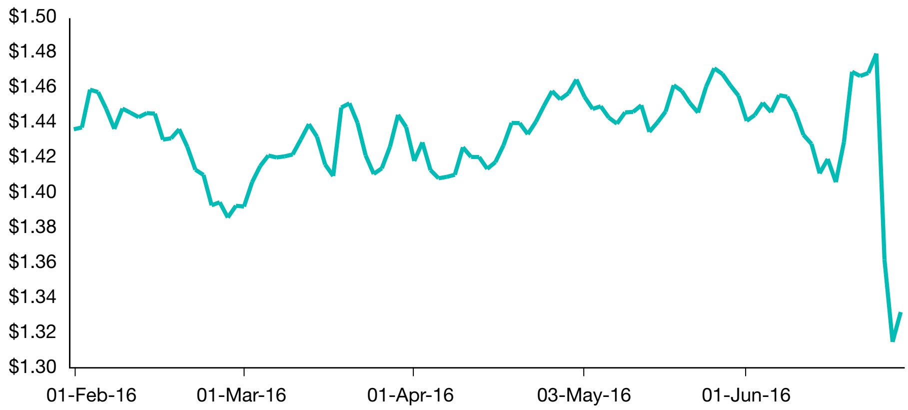
The UK is already a member of the EEA by virtue of its EU membership, and even if legally that has to end as part of the Brexit, Britain could join EFTA and access that way. Moreover, the European nations that trade with the UK the most (such as Germany) have reason to want to keep Britain in the EEA.

The advantages of EEA membership for Britain would be that businesses will still have access to the single market, the City will maintain financial passporting, and it should take the heat out of calls for Scottish independence. Critically, very little in the economy will change, outside of agriculture and fisheries. Also, this model is tried and tested – Norway is already doing it – so the EEA can easily be sold to investors, firms and consumers as 'business as usual'.

The advantages to the EU (and any future plan must have advantages to the EU, or it is unworkable) is that economic stability is maintained at a time when certain Eurozone countries have only recently emerged from deep recessions. Also, it will be easier for French and German politicians to face down their own Euro sceptics if they can show that for Britain little really changed as a result of Brexit.

From a political perspective though, the elephant in the room will be immigration. This was a big issue in the 'Labour heartlands' in the north of England that unexpectedly backed leave. A u-turn on immigration is going to draw an angry reaction.

FIGURE 1
Pound / US Dollar exchange rate



Source: Bank of England

However, the sad truth of life is that politicians do back out of key pledges and perform u-turns, and have done so over far bigger and more explosive issues than this. Richard Nixon was elected US President in 1968 pledging to re-unite a bitterly divided nation by ending the Vietnam war. He then escalated the war, and still got re-elected. Brussels is known as 'the capital of compromise', and a face-saver minor concession on immigration could probably be added to the UK's EEA access.

The reason I believe the next Prime Minister will risk letting down those who voted leave on immigration grounds, is that trying to pull up the drawbridge on Europe is probably the greater political risk. The threats range from a break-up of the UK with Scottish Independence, to a possible General Election later this year fought on leave / remain lines, followed by the next Parliament throwing out the referendum result entirely. The referendum it should be noted is not legally binding, and there is a lot of anecdotal evidence of leave voters changing their minds now they are witnessing the consequences of Brexit.

Moreover, if the UK does not give a clear indication it is embracing reality fairly soon, the financial markets will vent their wrath.

Similarly on the EU side there needs to be pragmatism and realism. Last week, Trade Commissioner, Cecelia Malmstrom said that the UK would need to exit the EU before negotiations on trade could even begin. Inevitably we should expect some negotiating hard-ball during this process, but disrupting trade between the UK and the EU would be mutually damaging. It is in both sides best interest that the UK can transition from one trade deal to the next as seamlessly as possible. Germany ran a £43 bn trade surplus with the UK last year, and probably does not want to see that threatened.

Property investors, given the pound's sharp fall, will need to be ready to respond quickly to events, as if the UK moves in this direction, foreign buyers will probably be re-entering the market soon after. Given markets hate uncertainty, it is important to note that an option offering a lot of certainty could soon be on the table.

In short, if the politicians get their act together, and put the country first, the car could be out of the ditch and on the road. The procrastination not the economy is the problem.

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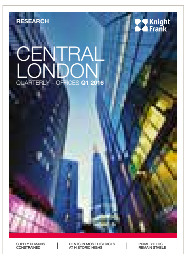

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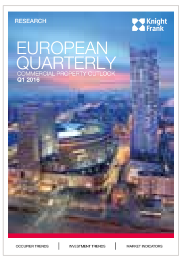

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