### Question 2: Brexit – Breaking out of the European Union

The European Union (EU) is a political and economic union of 28 member states that are located primarily in Europe. While the United Kingdom (UK) is part of the EU, it uses its own currency, the pound sterling, instead of the euro. The UK is made up of England, Scotland, Wales and Northern Ireland. Ireland, on the other hand, is a separate independent country under the EU.

### Table 4: Rates of growth of GDP, annual percentages, 2015-2017

|  |  |  |  |
| --- | --- | --- | --- |
|  | 2015 | 2016 | 2017 |
| EU | 2.32 | 1.96 | 2.44 |
| Germany | 1.74 | 1.94 | 2.22 |
| Ireland | 25.56 | 5.14 | 7.80 |
| UK | 2.35 | 1.94 | 1.79 |

Source: The World Bank Group, 2018

**Extract 4: Why Brexit?**

The UK has voted to break out of the EU, according to official results on Friday (June 24, 2016), allowing ‘Brexit’ to strike a thunderous blow against the bloc and spreading alarm through markets as the pound sterling plummeted to a 31-year low against the dollar as the UK took a lurch into the unknown. Their decision will undoubtedly re-awaken fears of a domino-effect ripple of exit votes in EU-sceptic members that could imperil the integrity of the bloc, already struggling with twin economic and refugee crises.

The UK is also a net contributor to the EU budget, where the money is used across Europe to ensure a level playing field for the EU's poorer countries by being invested in for example, new roads or broadband. However, the bill is rising as the UK’s economy improves, with a net contribution of £11.3 billion in 2013, compared to £2.7 billion in 2008, according to official UK data.

Freedom of movement for labour is one of the key principles of the EU. This ease of movement has been attacked in the UK, which had an unexpectedly high level of migration from several old Soviet bloc states after they joined the EU. Some of the blue-collar workers felt threatened by this new, cheap, source of labour as their income decreases.

Source adapted from The Straits Times, 24 June 2016 and CNBC, 27 May 2015

**Extract 5: EU membership has been good for Ireland**

The creation of a single market in Europe in the 1990s was exploited by Ireland like no other country. Increasingly, companies are choosing Ireland as a jumping off point for their European ambitions. Many of them are also using Ireland as a technology hub by placing vital data centres on Irish soil. Ireland has 8 of out 10 of the largest ICT companies in the world here because the infrastructure is at the levels these companies expect.

While Ireland's "natural" advantages ‒ English-speaking and geographical location between east and west ‒ cannot be discounted, a key advantage of coming here is that incoming companies can avail of leading-edge services. If these services weren't available, the companies wouldn't come, no matter how attractive the tax structure.

Source: IDA Ireland, 12 April 2012 and The Guardian, 17 June 2016

**Extract 6: Brexit one month on – the good, the bad and the ugly**

One month on and the UK is still reeling from the referendum result on the country's place in the European Union. The political and economic landscape of the country has changed radically since. UK now faces a mountain of issues, many of which are tied to Brexit. Inflation is surging, consumer spending is slowing, productivity remains mired in pre-crisis growth levels, and uncertainty reigns supreme. The Bank of England has sought to respond: After the referendum, it cut interest rates to the lowest level in its 322-year history.

Global financial markets have surprised many people by recovering faster than expected in the immediate weeks following the Brexit vote. Yet, confidence in the UK economy is starting to look shaky.

One bright spot was that the weaker pound had boosted exports orders for manufacturing. Given the drop in sterling, UK firms are seen as ripe for takeovers – earlier this week, Japanese firm Softbank agreed to buy semiconductor firm ARM Holdings in a deal worth more than $32 billion.

Source: Various

**Extract 7: Brexit and its impacts on the EU**

The European Union’s chief concerns over UK’s vote to leave the group are political but losing its second-largest economy will have a huge economic impact as well. For one, other members will have to fill in at least some of the shortfall from a lack of its contributions. UK’s total contribution to the EU budget for 2016 has been set at 19.4 billion euros. Germany, the EU’s largest member, would inevitably have to provide the most extra cash, estimated to be about

2.5 billion euros.

Many economists also forecast Brexit would at least temporarily reduce UK growth. A possible reintroduction of import tariffs could lead to a reduction of rest-EU GDP by 0.26 percent. However, the UK is also consistently the largest recipient of foreign direct investment in the EU, with an average of $56 billion per year in the 2010-2014 period. Given that access to the European single market has been cited as important to the UK’s attractiveness to FDI, there is therefore a risk that some FDI would be diverted to other EU countries if UK lost access to the EU single market.

Additionally, one of the main arguments for Brexit campaigners is to limit migration of workers from other EU countries. Hence, if UK did cap immigration, it could have a negative impact on eastern European countries. The impact could be most acute in the countries with the most citizens in UK – Poland (853 000 in 2014), Romania (175 000) and Lithuania (155 000). By contrast, other affluent western European countries, such as Germany, could as a result see higher inflows of EU migrants.

Research determined that impacts could be worse in Ireland than in UK, based on their degree of trade dependence on UK, while the impact on Germany would be very limited given that its auto and other manufacturing sectors have many other markets. There could also be “dynamic effects”, such as a potential loss of productivity because a decreased openness to trade reduces international competition and lowers the incentive to improve competitiveness. With dynamic effects, the long-term impact on German GDP would range between 0.3 and 2 percent below the value if UK remained in the European Union.

Source: Reuters, 24 June 2016

**Questions**

(a) With reference to Table 4, compare the changes in GDP between Germany

and the UK from 2015 to 2017. [2]

(b) (i) Using a diagram, explain why the pound sterling fell in value after UK had voted to break out of the European Union. [2]

(ii) Explain whether the depreciated pound sterling would lead to a higher cost

of living and standard of living in the UK. [6]

(c) Explain a likely advantage to the foreign firms for locating their businesses in Ireland. [2]

(d) In light of the issues faced by the UK as mentioned in Extract 6, evaluate the Bank of England’s decision to cut interest rate. [8]

(e) With reference to the data where appropriate, assess whether on balance, the benefits of Brexit outweigh the costs for UK and the remaining EU member countries. [10]

Suggested Answer

**(a), With reference to Table 4, compare the changes in GDP between Germany and the UK from 2015 to 2017.,**

**[2]**

**Similarity:**

GDP of both Germany and the UK increased from 2015 to 2017.

**Difference:**

However, Germany’s GDP was increasing at an increasing rate, while the UK’s GDP was increasing at a decreasing rate.

**(b), (i), Using a diagram, explain why the pound sterling fell in value after UK had voted to break out of the European Union.,**

**[2]**

As mentioned in Extract 4, breaking out of the European Union was a “lurch into the unknown”, which could give rise to loss in investors’ confidence in the economy.

**Explain impact on SS of pound sterling in forex market:**

This would cause capital outflow from the UK, leading to an increase in supply of pounds in the foreign exchange market, hence reducing the external value of the pound sterling.

**OR**

**Explain impact on DD for pound sterling in forex market:**

This would cause a fall in capital inflow into the UK, leading to a decrease in demand for pounds in the foreign exchange market, hence reducing the external value of the pound sterling.

**(b), (ii), Explain whether the depreciated pound sterling would lead to a higher cost of living and standard of living in the UK.,**

**[6]**

Depreciated pound sterling  fall in price of exports in F.C but increase in price of imports in D.C

Impact on cost of living

If consumers consume a large quantity of imports, the increased price of **final**

imported goods and services will mean that cost of living will increase. OR

If UK firms import significant amount of raw materials from overseas, this will cause imported inflation and hence, increase their unit cost of producing domestic final

goods, hence, causing SRAS to fall, leading to increases in GPL. Hence, cost of living increases.

Impact on material SOL

Assuming marshall-lerner condition holds (PEDx + PEDm>1), net exports will increase as seen from “boosted exports orders for manufacturing”(Ext 6)  assuming there is spare capacity in the economy  increase AD will result in increase in real output  national income increases by a multiplied amount  increase in quantity of goods and services consumed  increase material standard of living

Explain “whether”: Comment on the extent of change

Material SOL may have worsened instead if the rise in general price level is faster than the increase in national income.

**(c), Explain a likely advantage to the foreign firms for locating their businesses in Ireland.,**

**[2]**

**Cost advantages**

Locating businesses in Ireland will enable foreign firms to tap into the large EU market and sell to a larger market as inferred from “jumping off point for their European ambitions” (Ext 5). Such increase in market size in turn enable it to produce larger quantity, reaping economies of scale, hence enjoying lower average cost and higher profit, ceteris paribus.

**Or**

Access to good “technological infrastructure” and “leading services” (ext 5) can enable foreign firms to gain greater productivity if these translate to greater output produced per hour with lesser disruptions to internet connection etc, hence enjoying lower average cost and higher profit, ceteris paribus.

**Revenue advantages**

Being able to sell to a larger market means that foreign firms will be able to gain larger increases in demand for their goods and services, resulting in increases in total revenue and hence profits, ceteris paribus.

**(d), In light of the issues faced by the UK, as mentioned in Extract 3, evaluate the Bank of England’s decision to cut interest rate.,**

**[8]**

**Issues faced by UK:** Extract 3: “Inflation is surging, consumer spending is slowing, productivity remains mired in pre-crisis growth levels, and uncertainty reigns supreme”

**Explain how decrease in interest rate works**

Decreases in interest rate  decrease cost of borrowing more firms will be willing to invest  Investment level increases

The fall in the cost of borrowing would also result in an increase in consumption expenditure on big ticket items as consumers would have the ability to purchase items on credit.

**Decrease i/r: Ability to address the various issues faced by UK**

*(Students should address at least 2 problems mentioned below.)*

1. **“Slowing consumer spending”**

The lowered cost of borrowing will therefore help to address the ‘slowing consumer spending’ and hence help to contribute to economic growth.

The increase in both consumption and investment expenditure would result in an increase in UK’s aggregate demand as AD= Cd + I + G + X  shortage created  firms run down inventories  upward pressure on GPL incentive for firms to

↑output to meet demandreal output in economy has increased, leading to actual growth.

1. **“Inflation is surging”**

The decrease in interest rate may cause hot money outflows, hence, causing pound to depreciate further. This would worsen inflation rates as explained in part bii. However, this maybe a temporary impact as pound may strengthen after the situation on Brexit has stabilised.

1. **“Uncertainty reigns supreme”**

However, given that ‘uncertainty reigns’ the extent of increase in Cd and I will be smaller as consumers are more likely to withhold consumption given uncertainty in their employment and firms are also likely to withhold investment levels given the uncertainty in UK’s economic outlook after Brexit  policy will be ineffective in raising economic growth, if this is the intent of the UK govt.

1. **“Productivity remains mired in pre-crisis levels”**

Also, whether the decrease in interest rates will help to increase productivity in UK depends on the type of investment that the firms will undertake given the cheaper cost of borrowing. Given that it is rather incidental; the effectiveness of the policy is likely to be very low.

**Conclusion**

[evaluate UK’s decision] UK’s decision to cut interest rate is ineffective given that it is less likely to address any of the above problems. With uncertainty as the biggest problem, therefore, increases in AD is likely to be low.

More importantly, weak productivity is likely to be a main concern and area for the UK govt to focus on as UK leaves the EU. It needs to increase its competitiveness in order to prevent greater loss of FDIs out of UK as a result of foreign firms that used to locate in UK to have access to the larger EU market.

[suggest alternative policies] This can also help to reduce the uncertainty on UK’s future economic outlook. Therefore, the UK govt should start looking at implementing ss-side policies instead.

**(e), With reference to the data where appropriate, assess whether on balance, the benefits of Brexit outweigh the costs for UK and the remaining EU member countries.,**

**[10]**

**Introduction:**

The decision to leave the EU will give rise to both benefits and costs to the UK as well as the remaining EU member countries. However, whether the benefits outweigh the costs for the UK and the remaining EU member countries depends on a few factors.

*(Note: Students should at least discuss 1 cost and 1 benefit for UK and EU respectively.)*

**Development 1: Explain the impacts of Brexit on UK Benefit**

1. ***Impact on export revenue of the economies***

One major and immediate impact on the UK after the Brexit vote was a depreciation of the pound sterling against the dollar (Extract 4), which was explained in (b)(i). This will lead to an increase in price of exports for the UK in foreign currency, as well as a decrease in price of imports in pound sterling. Assuming the Marshall-Lerner condition holds, where (PEDx+PEDm)>1, this leads to an increase in (X-M) and hence AD. There is an increase in real output and hence actual growth in the UK. As mentioned in (b)(ii), this may lead to an increase in material SOL.

1. ***Impact on govt’s contribution to the EU budget***

Given that the UK is a net contributor to the EU budget, contributing up to £11.3 billion in 2013 (Extract 4), Brexit would mean that the UK government doesn’t need to contribute to the EU budget in future and could use the funds to stimulate their own economy. For example, the government could now use the funds to build infrastructure in the UK, giving rise to an injection via increased G in the UK economy. This will lead to an increase in AD, and hence actual growth in the UK economy and improvement in material SOL due to rising incomes and greater purchasing power and access to goods and services. Depending on which area the government spends on, for e.g. if they spend on education and healthcare, there could also be improvement in non-material SOL.

**Costs of Brexit to UK**

1. ***Impact on migration and the labour force***

One of the main arguments for those in favour of Brexit was with regard to the migration of labour from other EU countries. Moving forward, if the UK were to cap immigration (Extract 7), there could be some consequences on their economy. Firstly, with these migrants now returning to their own countries, the UK’s labour force shrinks and this could give rise to a fall in productive capacity, illustrated by a fall in the AS curve. This results in a fall in future material SOL as inflationary pressures may persist with any increases in AD given a lower AS curve.

**EV:** However, this cap on immigration could also bring about some benefits to the UK. With lesser migrants in their country, the quality of life of the remaining citizens (and hence non-material SOL) may improve since issues like congestion will be reduced given the smaller population size.

## 2. *Impact on level of FDI*

Given that the EU single market was a major factor in attracting FDI into the UK (Extract 7), now that the UK is preparing to leave the EU, they would no longer have access to the single market as before. As mentioned in Extract 7, FDI may be diverted to other EU countries now, instead of the UK. The UK faces a fall in FDI and this leads to a fall in AD and hence negative growth. The fall in FDI could also lead to a fall in the UK’s AS curve as well, if the rate of increase in FDI does not outweigh the rate of depreciation of capital. This causes a fall in the UK’s productive capacity in the LR.

# Development 2: Impacts of Brexit to EU members Benefits of Brexit to EU members

## 1. *Impact on level of FDI*

Given that the UK is no longer seen as a viable destination for FDI (Extract 7), there could be diversion of FDI to the remaining EU member countries. This will cause an increase in AD in the SR and AS in the LR for these countries, causing actual and potential growth.

# Costs of Brexit to EU members

## *Impact on export revenue of the economies*

As it is predicted that there could be a possible reintroduction of tariffs (Extract 7), where the UK imposes tariffs on goods from the remaining EU countries, the UK will import less from the other EU member countries as compared to before when the UK was still part of the EU and they enjoyed free trade. Given a fall in import expenditure by the UK for these countries goods, they will then experience a fall in export revenue and hence a fall in AD. This causes negative economic growth and rising unemployment  fall in material SOL.

**EV:** However, the extent of fall in X and AD for the remaining EU members depends on how close they were to the UK as trading partners. For instance, Extract 7 suggests that Ireland could be more severely affected compared to Germany, especially because Germany has diversified its trading partners and has “many other markets” for its auto and manufacturing sector. Hence, even with the lack of free trade with the UK, Germany can still generate export revenue through the sale

of exports to other countries. That said, Ireland has actually been able to enjoy higher growth rates than the UK and the EU as a whole from 2015 to 2017 (Table 4), so it could mean that they have been able to generate growth through other means apart from export revenue to the UK.

## *Impact on govt’s contribution to the EU budget*

Since the EU’s biggest contributor to its budget (i.e. the UK) has voted to leave the EU, the remaining EU member countries would now have to “fill in some of the shortfall from a lack of its contributions” (Extract 7). This is estimated to be up to

19.4 billion euros in total, with a large amount contributed by Germany of about 2.5 billion euros. This would mean that the governments of those countries would incur an opportunity cost in terms of the loss in benefits from not spending that sum of money on areas such as healthcare or education in their own economies. The larger their contribution is to the EU budget (e.g. for countries like Germany), the larger the opportunity cost incurred.

## *Impact on migration and the labour force*

If the UK were to cap migration, migrants from other EU countries who used to be in the UK will now have to return back to their countries. As mentioned in Extract 7, countries in eastern Europe (e.g. Poland, Romania) will suffer the most as they have the most number of citizens in the UK. With the large numbers of migrants returning home, assuming if they are low-skilled workers, this will cause the supply of low- skilled labour in those countries will increase, driving down wages in their labour market. There could also be large scale unemployment which could bring about increased social problems and increased burden on government budget should these governments have to provide unemployment benefits for these returned unemployed migrants.

EV: However, migrant workers maybe also be of higher skillsets. If so, they can contribute to a more productive workforce and hence increase productive capacity (rightward shift of AS)  potential growth.

# Conclusion:

**[Answer the question] Evaluate whether benefits outweigh the costs:**

For the UK, whether or not the benefits outweigh the costs would depend on whether the government is able to put in place appropriate policies to deal with the potential loss in FDI as well as the fall in productive capacity. For instance, if the UK is able to develop the right infrastructure to attract FDI (e.g. like Ireland, in Extract 5), the fall in FDI may not be so significant despite them not being a part of a large EU single market. In addition, should the government be able to adopt appropriate supply-side policies to increase productivity in the economy, in spite of the cap on immigration which would lead to a fall in the quantity of labour, the quality of both labour and capital can more than make up for it and hence still allow for an increase in the productive capacity of the UK’s economy in the LR. This is especially possible since the UK govt’s contribution to the EU budget can now be reallocated for such a purpose.

For the remaining EU members, whether or not the benefits outweigh the costs depend on the closeness they are to the UK as trading partners and whether they are able to diversify their trade to depend on other economies now that free trade with the UK is no longer possible after their departure. Also, while the UK has now left the EU, making the remaining member countries more attractive to FDI since they are still part of the single market offered by the EU, the extent to which they can benefit from increased FDI also depends very much on their own attractiveness as a destination for FDI. For e.g., Ireland is an attractive destination for FDI and would probably be able to attract much of the existing FDI in the UK over given their “natural advantages” (Extract 5).