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Europe 2.0?

Four Scenarios for Europe Post-Brexit

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Executive Summary

On June 23, 2016, after a rancorous campaign and with a relatively high turnout (72 percent), a majority of voters in the United Kingdom (52 percent vs. 48 percent) cast their ballot in favor of leaving the European Union after more than four decades of membership. So far, the British economy has not yet been much affected by this slow-motion shock. Despite a rise in uncertainty, consumer spending has stayed relatively strong although investment seems to have slowed. However, in the end, it is the negotiation terms of the actual departure from the EU that will change the rules of the game for every economic agent and therefore have an impact on output.

Following the referendum, the economy of the rest of Europe has also held up relatively well. But in the short term, the threat from Brexit for Europe is more existential. Critical elections over the coming year will reveal the extent to which Europe is under pressure to reform one way or the other. In this context, the negotiations between the UK and the EU can lead to a "soft" or "hard" Brexit, and a win-win, a win-lose, or even a lose-lose outcome. Global economic growth can provide a "tailwind" or, if growth remains weak, create a significant "headwind." Over the next few years, the contours of the new European policy environment and the governance of European institutions will become much clearer. In the meantime, however, the private sector is struggling with the question: will the new environment affect business?

Given the complexity of the situation and the high level of uncertainty, The Conference Board has approached the question through scenario analysis—plausible future environments that firms may face by 2020.

- We sketch four possible European business environments, in the form of scenarios.
- We underpin each scenario with economic growth ranges.
- We extend the scenarios to "unthinkable" versions beyond 2020.
- We address the business implications for each of these environments and across them.
- We point to the critical role companies will and should play.

Our overall conclusions are that Brexit has the potential for real economic implications beyond the short term and has highly symbolic political implications more immediately. Rather than characterizing Brexit merely as a shock, we reframe Brexit as a slow-burning fuse for Europe. Rising anti-globalization and anti-system sentiment is a goad to political and institutional EU reform, although it is unclear what form this reform will take. Finally, global economic growth can significantly help or hinder reform. Given these key uncertainties, scenarios are in order.

While companies may face very different business environments in 2020 and beyond, they do not have to be passive bystanders, waiting for the turmoil in a highly polarized atmosphere to subside. They have a role to play in Europe by investing and reshoring, taking advantage of the low interest rates and the new technologies available. Business can also respond to sensitive taxation issues and speak up for reducing some of the largest income gaps. Ultimately, a proactive business response will contribute to addressing the discontent that led to Brexit and feeds much of the dissatisfaction among citizens in other European countries.

Four Scenarios

Adequate institutional reform (or not) and robust global growth (or not) can lead to four very different business environments, or scenarios (described in detail in Part III):

1. Without both EU reform and robust global growth, the business environment is best characterized by "**Continued Stagnation**," with timid EU consumer demand as the main driver of low EU growth—which is a continuation of the last five years.

2. The combination of EU reform and robust global growth leads to a "**Reset**" environment of higher growth rate based on multiple, diverse, and reinforcing sources of growth—consumer demand, private sector investment, public investment and spending, and export.

3. Reform of the European governance without robust global growth leads to a "**Tightrope**": the main initial source of EU growth is government investment and spending, which addresses increasing anti-EU sentiment. But without the external demand pull, results materialize slowly in the European economies and societies.

4. If robust global growth occurs without EU reform, countries will pay "**Lip Service**" to the EU while going their own ways, with modest export as the main driver of mildly increased EU growth.

Each of these scenarios can have an "unthinkable" follow-up beyond 2020, the planning horizon for the Brexit scenarios; they are "unthinkable" only in the sense that a complete disintegration of the EU is neither expected nor likely. Nevertheless, even the unthinkable is conceivable and possible, with major ramifications beyond 2020.

Sources of economic growth differ across scenarios

What turn European integration takes in response to Brexit will not only affect its growth rate, but will also determine what its growth sources will be. From the economic point of view, sources of growth will be different depending on the scenario: internal consumer demand vs. export, private vs. public consumption and investment, inside vs. outside Europe. Hence, different environments will favor different types of industries and business. Companies will eventually be required to look at different markets in different scenarios, forcing them to make strategic choices.

- In Scenario 1 (**Continued Stagnation**), most of the low economic growth comes from consumer spending, and firms focusing on consumer demand will profit most.
- In Scenario 2 (**Reset**), sources of growth are more diversified—concerted government spending, reduced income inequalities that lift consumer spending, public sector (education, science, early stages of technological development, infrastructure) inducements to additional private sector spending already primed by global economic growth and export possibilities, as well as foreign direct investment.
- In Scenario 3 (**Tightrope**), concerted EU government spending on infrastructure as well as education and care services, combined with institutional reform at the EU level, provide growth. But the effects of reforms come in later.
- In Scenario 4 (**Lip Service**), growth is driven by consumer spending with some additional export-enhancing government investment in specific countries, supporting private investment that is focused on economic growth outside the EU. Export businesses, their employees, suppliers, and stakeholders will do relatively well, accentuating income differences within and among countries.

Hard or Soft Brexit?

A "hard" Brexit, as the media have dubbed it, refers to a separation in which neither party gives up on anything in the negotiation. In its most extreme form, the relationship between the UK and the EU-27 will be defined by the rules of the World Trade Organization. As with any other country, the UK will have no preferential agreement with Europe. In such case, companies would encounter tariff and nontariff barriers. The average tariff applied by the EU is 1 percent.[a]

In the case of a "soft" Brexit, the UK and the EU aim to retain part of their privileged access to each other's markets and maintain their future relation as close as possible to the existing one. The relationship will be framed around an agreement along the lines of the EU-Canada Comprehensive Economic and Trade Agreement (CETA) or the EU's Association Agreements with Ukraine, Moldova, and Georgia.

(Text continues on next page)

Without a reform in EU decision making, however, a soft Brexit is unlikely because all major decisions would have to be made by the European Council, an institution comprising heads of state and government and therefore subject to the political dynamics of its own election cycles.[b] A hard Brexit is therefore most likely, especially in the case of Continued Stagnation or Lip Service.

The soft Brexit in its most extreme form will be a separation of the UK and the EU along the lines of the Norwegian or Turkish model. This option is becoming increasingly unlikely. UK Prime Minister Theresa May has made clear that limiting migration and not being subject to the European Court of Justice are non-negotiable for her government. Both conditions are incompatible with the quasi-membership of the Norwegian model. As part of a Custom Union like Turkey, the UK would not be able to negotiate its own trade agreements, which the UK government considered a top priority for the post-Brexit era.

a The latest available data, from the World Bank, refer to the year 2012.

b Marco Buti and Muriel Lacoue-Labarthe, "Europe's Incompatible Political Trinities," VoxEU, September 7, 2016. The authors frame the issue in terms of "incompatible political trinities": the intergovernmental method that has dominated EU decision making since the economic crisis, the habit of blaming all evils on "Brussels," and the lack of a unified external representation for the Eurozone in global economic governance.

What does this all mean for business?

In view of Brexit, different companies will face different problems, depending on their home base and the amount and type of activity conducted in the UK.

European companies with manufacturing facilities in the UK will likely refrain from investing in the UK whenever new product lines have to be launched, and Brexit will affect the choice of where to manufacture in the future. In the case of services, where less physical capital is required, relocation can happen faster, and those companies have therefore greater flexibility. Brexit will also have a substantial impact on logistics: whenever an office or an establishment in the UK is part of a value chain, new arrangements will have to be made to ensure that intermediate and final goods can get from the UK to the continent and vice versa.

For European companies based in the EU-27 that serve the UK market, tariff barriers to trade would be limited, even in case of a hard Brexit. However, in the medium to long term, standards and regulations might start to diverge between the EU and the UK. It took years of discussions in Brussels to agree on a common definition of chocolate, for example. In some cases, separate product lines might be necessary to serve the UK market, possibly based in the UK to more easily satisfy the local demand. Not all companies will be able to cope with the smaller market size. Of course, the depreciation of the pound might, to some extent, compensate for this.

Non-EU companies with their European headquarters in the UK have the highest incentive to move and set up branches in another EU country. It is unlikely that a single country will substitute for the UK or a single city for the financial hub of London.

As a consequence, many EU countries and cities will receive a piece: Luxembourg, Paris, Dublin, Frankfurt for the financial sector, each based on its specialization; and Eastern Europe (especially Slovakia and the Czech Republic) for the manufacturing activities, taking advantage of the already established wider-German value chain and the labor cost that will still be lower than in Western Europe for a while to come. Moving to the continent will undoubtedly create staffing issues: companies have already been reporting in the last couple of years severe talent shortages in central and eastern European countries, including Germany, Austria, Poland, Hungary, and the Czech Republic.

Companies cannot entirely rely on such adjustments and on the ability of member states and the EU to manage the transition. Too often in recent times, the EU has relied on crisis-driven management, such as with the Eurozone and the refugee crises, disappointing many. Therefore, in times of rising anti-globalization sentiment, companies should consider themselves as co-authors of change. Global companies should promote initiatives to support a Europe-wide tax reform that is sustainable in the medium term, consider opportunities for reshoring, and take advantage of the low interest rates to capitalize on new technologies, including digital transformation and best environmental practices.

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