City of London beware: the perils of leaving the single market

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Exiting the Single European Market would involve a profound adjustment to the UK's economic relations with the EU and the rest of the world. This will likely prompt major, long-term changes to the structure of the UK economy. What might be the result? Steve Coulter predicts the City of London will initially suffer most, despite our competitive advantage in services. Later, foreign direct investment will probably be hit.

Over the last few decades the UK economy has been transformed by three big trends: inward investment; the emergence of the City of London as a global financial services hub; and, latterly, growth in high technology industries. The UK's economic 'model' revolves around these activities to a large degree and in many ways the country has found itself in a 'sweet spot' with regard to the burdens and benefits of its membership of the EU.

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First, the UK is Europe's number one destination for foreign direct investment largely because unfettered access to the Single European Market (SEM) gives UK-based manufacturers, including foreign-owned volume car producers like Nissan, the opportunity to sell tariff-free to a developed market of 500m people. The flipside of the SEM is, of course, the EU's 'social dimension', which imposes rules on rights at work. This animated the Brexit campaign as some firms find these regulations irksome. But there were plenty of opt-outs available and they were never remotely a deal-breaker when set against the enormous gains from being in the SEM.

Second, 'passporting' rights available to UK-based banks allowing them to do business in other EU countries have made the City of London an extremely attractive base for global investment firms. Yet, outside the Eurozone, and pledging to remain aloof from EU plans for a Banking Union, the UK also stood apart from grand schemes seen as contrary to its interests.

Third, the UK is well positioned in a number of promising-looking high technology fields, such as green fuels, biotech and digital manufacturing. However, these sectors depend on good links with the UK's formidable scientific research base. Universities get a significant proportion of their research funding from the EU, which will now need to be replaced. They also recruit heavily among EU scientists and technicians, although Brexiters argue that they could draw from a global talent pool instead.

The Brexit camp insists that these sectors could thrive outside the EU, and this is indeed possible. But there are serious risks of the opposite happening and, either way, it would have been nice to have had a plan. Brexit means the UK may need to find a new economic model to go with its changed position in the world. Unfortunately, it's not yet clear what this is, although there are some clues for the short-term.

The key issue to clear up is whether the UK stays in the SEM. Business groups such as the CBI and IoD will certainly push for an exit deal with the EU that involves continued access to the SEM in some form. As economic growth is sure to suffer in the coming years any future government will want to help industry by reaching an accommodation over trade that preserves easy market access. This may also be the minimum necessary to keep Scotland in the UK.

Senior Conservatives have strongly hinted they want Norway's arrangement for the UK, which preserves market access in return for a contribution to the EU budget and obeying SEM rules. Crucially, however, these rules include accepting free movement of labour and there seems little prospect of the UK being 'rewarded' for Brexit by relaxing this condition. However, reneging on promises to end mass immigration from the EU will be unacceptable to the millions of people who voted for Brexit on exactly this basis. Staying in the SEM may therefore be impossible to reconcile with political reality, and policymakers may have to come to terms with this.

Life outside the Single Market

The impact of quitting the SEM would be felt most quickly in the City of London as financial services industries have limited sunk costs and are globally mobile. HSBC has already indicated it is relocating 1,000 jobs to Paris, and others may follow if banks judge the advantages of operating inside the EU outweigh London's other attractions. Up to 100,000 highly paid jobs could go.

Some commentators actually welcome the prospect of an exodus of bankers as it gives the UK a chance to 'rebalance' the economy towards manufacturing; an outsize financial sector artificially boosts sterling, making other exports uncompetitive, and sucks scientific and technical talent into the Square Mile.

But the UK's manufacturing sector is only around 10% of GDP – much less than Germany's. Of course, sterling's 10% decline offers an immediate boost to competitiveness that could kick-start the revival of manufacturing. Over time, this could go some way to replacing the hit to GDP from finance.

There are reasons for caution, however. The UK is particularly well suited to service industries owing to its flexible labour markets and corporate governance structure, as well as an education system biased towards producing workers with general skills. Altering this would not be easy. The government may have recently rediscovered industrial policy, but this works best in enhancing existing strengths rather than promoting entirely new industries.

Perhaps the biggest question mark is over foreign direct investment (FDI). Most companies in goods markets depend on a complex global value chain. So what matters is how the UK is integrated in the European economic area. If the EU is not the area on which economic decisions depend then a Brexit might not be a disaster for FDI; however, if the EU is very important in the supply chain of British firms then Brexit could be a major factor in location with negative consequences.

The LSE estimates that FDI could decline by 22% over a decade as investors opt to hedge their bets by looking for destinations with the right cost profile and mix of institutions inside the EU. Foreign-owned firms, in the automotive sector for example, are unlikely to pull out immediately, or even at all. But we may find that future product lines get directed to other countries with better connections to the vast EU market.

So there is a lot still to play for. Staying in the SEM will minimise disruption to the economy and offers the best prospects for riding out the economic storm. The alternatives are risky and uncertain and could go badly.

This post represents the views of the author and not those of the BrexitVote blog, nor the LSE.

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