Why Brexit won't happen

Anatole Kaletsky | GaveKal | 23 February 2016

Among the multiple existential challenges facing the European Union this year - refugees, populist politics, German-inspired austerity, government bankruptcy in Greece and perhaps Portugal - one crisis is well on its way to resolution. Britain will not vote to leave the EU.

This confident prediction may seem to be contradicted by polls showing roughly 50% support for Brexit in the 23 June referendum. And, British public opinion may move even further in the "Out" direction for a while longer, as Euroskeptics ridicule the "new deal" for Britain agreed at the EU summit on 19 February.

Another apparent indicator of looming Brexit is the behavior of currency markets. The Pound is now as cheap against the US Dollar as in the darkest days of the Global Financial Crisis, when almost every bank in Britain was believed to be on the verge of collapse. City financial analysts are starting to vie for attention with ever more extreme downside "targets" for sterling in the months of uncertainty ahead of the vote.

Peak Brexit

Despite this financial anxiety - or rather, because of it - the world should probably stop worrying about Britain's willingness to stay in Europe. It looks like "Peak Brexit" has now arrived.

This is because the interaction between politics and economics behind the In-Out question virtually guarantees that British voters will ultimately back EU membership. The main risk for investors is not that Britain will actually vote for Brexit, but rather that the almost certain victory of David Cameron's pro-EU campaign will not become apparent in public opinion polls until a few weeks, or even days, before 23 June.

To understand the dynamics that strongly favor an In vote, start with the politics. Until this month's deal, Britain's leaders could not seriously make the case against Brexit. After all, Prime Minister David Cameron and his government had to pretend that they would contemplate a breakup if the EU rejected their demands.

Political imbalance

Under these circumstances, it was impossible for either Labour Party politicians or business leaders to advocate an EU deal that Cameron himself was not yet ready to promote. The Out lobby therefore enjoyed a virtual monopoly of public attention. This situation may briefly persist, even though the EU deal has now been agreed, because Cameron has no wish to antagonise his party's implacable Euroskeptics until it is absolutely necessary. But, as the referendum approaches, this political imbalance will reverse abruptly.

One reason is Cameron's decision to release his ministers from party discipline during the referendum campaign. Initially viewed as a sign of weakness, Cameron's move has turned out to be a masterstroke. Having been offered the freedom to "vote your conscience" on the EU deal, most significant Conservative politicians – with the notable exceptions of Boris Johnson and Michael Gove – have come around to supporting Cameron.

As a result, the Out campaign has been left effectively leaderless and has already split into two rival factions – one driven mainly by anti-immigrant and protectionist sentiment, the other determined to concentrate on neoliberal economics and free trade. Even in the unlikely event that the charismatic Johnson manages to unite the squabbling political eccentrics and widely divergent ideologies backing Brexit, the London Mayor's buffoonish image and his many contradictory comments in the past about Europe will only add to the air of chaos and frivolity surrounding the Brexit campaign.

Financial interests

It can be confidently predicted that as the political tide turns, the British media and business opinion will follow, mainly because of direct financial interests. For example, Rupert Murdoch, whose outlets dominate the media landscape, needs membership in the EU single market to consolidate his satellite TV businesses in Britain, Germany, and Italy. Another powerful motivator for Murdoch, as well as for other media proprietors and business leaders, is to be on the winning side and to maintain good relations with Cameron, unless they see overwhelming evidence that he will lose.

That brings us to the main reason for ignoring current opinion polls: only when Britain starts seriously debating the costs and benefits of leaving the EU – this may not happen until a few weeks before the referendum – will voters realise that Brexit would mean huge economic costs for Britain and no political benefits whatsoever.

Overwhelming challenges

The economic challenges of Brexit would be overwhelming. The Out campaign's main economic argument – that Britain's huge trade deficit is a secret weapon, because the EU would have more to lose than Britain from a breakdown in trade relations – is flatly wrong. Britain would need to negotiate access to the European single market for its service industries, whereas EU manufacturers would automatically enjoy virtually unlimited rights to sell whatever they wanted in Britain under global World Trade Organisation rules.

Margaret Thatcher was the first to realise that Britain's specialisation in services – not only finance, but also law, accountancy, media, architecture, pharmaceutical research and so on –

makes membership in the EU single market critical. It makes little economic difference to Germany, France, or Italy whether Britain is an EU member or simply in the WTO.

Britain would therefore need an EU association agreement, similar to those negotiated with Switzerland or Norway, the only two significant European economies outside the EU. From the EU's perspective, the terms of any British deal would have to be at least as stringent as those in the existing association agreements. To grant easier terms would immediately force matching concessions to Switzerland and Norway. Worse still, any special favors for Britain would set a precedent and tempt other lukewarm EU members to make exit threats and demand renegotiation.

Among the conditions accepted by Norway and Switzerland that the EU would surely regard as non-negotiable are four that completely negate the political objectives of Brexit. Norway and Switzerland must abide by all EU single market standards and regulations, without any say in their formulation. They agree to translate all relevant EU laws into their domestic legislation without consulting domestic voters. They contribute substantially to the EU budget. And they must accept unlimited EU immigration, resulting in a higher share of EU immigrants in the Swiss and Norwegian populations than in the UK.

Infringements on sovereignty

If Britain rejected these infringements on national sovereignty, its service industries would be locked out of the single market. The French, German, and Irish governments would be particularly delighted to see UK-based banks and hedge funds shackled by EU regulations, and UK-based businesses involved in asset management, insurance, accountancy, law, and media forced to transfer their jobs, head offices, and tax payments to Paris, Frankfurt, or Dublin.

When confronted with this exodus of high-value service jobs and businesses, Britain would surely balk and accept the intrusive regulations entailed by Swiss- and Norwegian-style EU association agreements. Ultimately, Brexit would not only force a disruptive renegotiation of economic relations, it would also actively erode Britain's ability to control its own affairs.

Inevitably, many among the Out camp will seek to portray the debate not as a question of economics, but as one of principal, of defending British democracy against an encroaching European super-state. However, I am convinced that most people in Britain do not give a damn about abstractions such as "sovereignty" and "ever closer union". And most of the polling confirms that the referendum will be decided mainly by prospects for jobs, property prices and financial conditions, not by "patriotism". The EU side has not even begun to warn of the catastrophic economic consequences of exclusion from the single market. Once Britain's political, business, and media leaders start drawing attention to the hard facts of life after Brexit, fear of the unknown will prevail over romantic idealism – as we saw in the 2014 Scottish independence referendum – and we can be confident that voters will decide to stay in the EU. As a result, sterling at US$1.42 is a terrific bargain.

Anatole Kaletsky is co-founder of GaveKal Research, GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.