Featured Article

Beyond Brexit: An Initial Analysis and Questions for the AIB Community

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Introduction

The United Kingdom voted to leave the European Union the week before the 2016 AIB Annual Meeting. It occurred to me that it would be a shame if the meetings afforded no opportunity to discuss one of the most shocking international policy developments of the last few years—or decades. (Ian Bremmer of the Eurasia Group promptly tweeted a characterization of Brexit as "the most significant political risk the world has experienced since the Cuban Missile Crisis.") I suggested as much to the Program Chair, Charles Dhanaraj, who helpfully organized a townhall session with Peter Buckley, Jeremy Clegg, and Yves Doz as speakers and me moderating. Since it was still in the early days of the Brexit vote, much of the session was devoted to decrying the outcome of the vote and discussing why it had come about. There was less discussion of the consequences of Brexit but some sense that many of them would remain unknown for some time given multi-year lags in defining the terms of (any) separation and then enacting them.

Although I limited my role at the townhall to directing the flow of the conversation, I had been thinking about Brexit as well, but more in the context of a panel earlier the same day that I had organized with my coauthors, Steven Altman, Geoffrey Jones, and Sebastian Reiche, around my forthcoming book, The Laws of Globalization and Business Applications. A friend teased me after that first panel: had British voters just broken my two laws of globalization?

The "Legality" of Brexit

Instead of being controverted by Brexit, the laws of globalization—the law of semiglobalization, which deals with the depth of globalization, and the law of distance, which deals with the breadth of globalization—help clarify some of Brexit's implications.

The Law of Semiglobalization

The law of semiglobalization asserts that international interactions, while non-negligible, are significantly less intense than domestic interactions. The UK is an illustration: flows across its borders (particularly of inbound migrants but also of trade and capital) were large enough to provoke a backlash, yet still fall far short of what one would expect if borders had ceased to matter. Thus, the UK's (gross) exports account for about one-third of its GDP, about the same as the world as a whole and far below a zero-border effect benchmark of 96% (100% minus the UK's share of world GDP). And first-generation immigrants comprise 13% of the UK's population, although Britons think—as reported across three different surveys—that 24–31% of the country's population was born abroad.[1] In this and other respects, the UK illustrates not only the law of semiglobalization but also what I refer to as globaloney—a strong tendency to exaggerate actual levels of globalization.

Specificity about magnitudes also sheds light on fears that Brexit might significantly hurt global trade. Since the UK's exports account for approximately 1% of global GDP, under the assumption that they will be no worse than decimated, the implied drop in global exports is 0.1% of global GDP. So Brexit seems unlikely to sink global trade unless it has knock-on effects. Which is why the blog I posted on Harvard Business Review just before the townhall stressed the criticality of keeping the rest of the EU together.[2]

I would even add that the law of semiglobalization seems essential to the possibility of Brexit being consequential. If globalization were so weak that cross-border interactions didn't matter much, neither would Brexit nor any other international realignment. And if globalization were so strong that the world was close to completely integrated, the adverse consequences of leaving the EU (and snapping back to WTO arrangements as a worst case scenario) would be limited as well.

The Law of Distance

Turning to the second of my two laws, the law of distance asserts that international interactions are dampened by distance along cultural, administrative, and geographic dimensions and are often affected by economic distance as well. On this score, my book assembles evidence that the same handful of variables related to distance versus proximity—a common official language, a colony-colonizer link (in the past), a trade agreement or common membership in a regional bloc, physical distance, a common land border, and per capita income disparity—do a good job of explaining variations in intensity of interactions along a slew of dimensions—not just trade and FDI but also other kinds of capital flows, information flows and people flows. The variables are the standard ones that are employed in gravity modeling of merchandise

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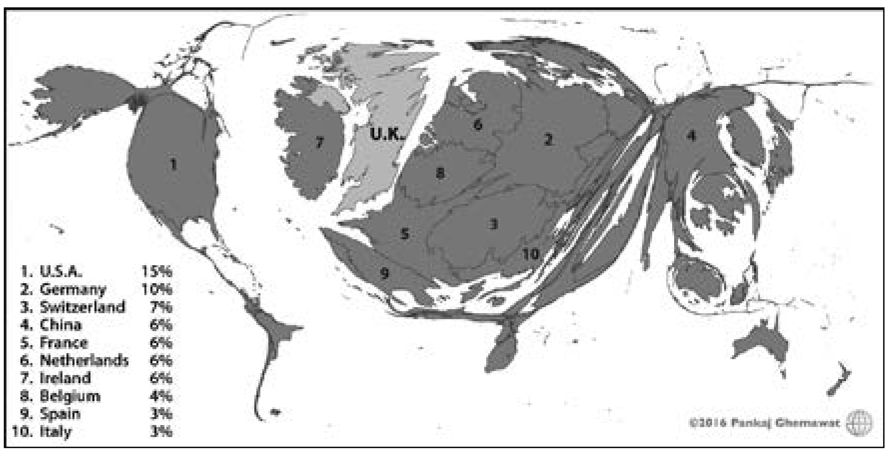
trade (Head & Mayer, 2014), except that I have swapped in (for reasons discussed in the book) per capita income disparity versus similarity for common currency. What is remarkable is that without any further adjustment, the variables emphasized in analyses of merchandise trade work as well as they do for other international interactions as well.

Running UK-focused gravity models suggests that the UK does conform to the law of distance. The biggest difference—in both the equations for merchandise exports and outbound FDI—is that sensitivity to physical distance is considerably lower for the UK-focused regressions than that for the world as a whole. This conclusion is backstopped by the observation in the 2014 edition of the DHL Global Connectedness Index (Ghemawat & Altman, 2014),[3] that the UK ranks second among 140 countries in the breadth of its trade interactions and first overall when other kinds of interactions are accounted for as well. The UK's international interactions mirror the global distributions of those interactions more closely than do those of any other country.

The UK's lead on breadth, however, does not mean that it could separate itself from the EU without severe consequences. In 2014, 43% of the UK's total exports and 53% of its total imports—and 39% of outbound FDI stocks and 49% of inbound FDI stocks—involved the EU. And the more recent data that are available do not change that picture: see the cartogram (Figure 1) below in which countries other than the UK are sized in proportion to its merchandise exports to them in 2015. The UK is still far more connected to Europe than to any other part of the world.

Figure 1. The UK's Merchandise Exports, in 2015



Source: IMF Direction of Trade Statistics (2016)

Consistent with these numbers, when the IMF cut its global growth forecast due to Brexit, it predicted that the worst of the effects would be concentrated in the UK (where the 2017 growth forecasts was slashed from 2.2% to 1.3%) and in the rest of the EU (the Eurozone's growth forecast was reduced from 1.6% to 1.4%) (IMF News, 2016). Growth projections for 2017 remained unchanged for the US and for Asian emerging markets.

Business Applications

That Brexit does not falsify the laws of globalization is helpful, but it would be even better if the laws could be applied to reduce the penumbra of uncertainty around it. Two such applications are proposed here, one at the country level and the other at the company level.

A Country-level Application

At the country level, to the extent that the Brexiteers see anything good in globalization, they want to unshackle their country from a slow-growth EU and connect it more intensively to its former empire and to faster growing emerging economies. Do these hopes stand up to scrutiny? While gravity models affirm that the cultural and administrative/institutional commonalities that the UK shares with the Commonwealth do ease trade and FDI, so do the geographic proximity and economic similarity that link the UK to the EU. So, one needs to actually run the numbers to estimate whether it is a wise choice to pursue seemingly greener pastures in more distant parts of the world.

The rest of the EU is 1.8 times as large in GDP terms as is the rest of the Commonwealth, and is also less than one-eighth as physically distant from the UK on a GDP-weighted basis: 1,072 km versus 9,026 km.[4] Given the estimated distance exponent for merchandise exports (-1.51),[5] geographic and economic considerations imply that the market opportunity in the rest of the EU is 45 times as large as in the rest of the Commonwealth! Correcting for the estimated effects of a common official language (estimated to boost trade to 2.15 times what it otherwise would be) and of a colony-colonizer link (boosting trade another 2.05 times), both of which Commonwealth countries are much more likely to share with the UK, makes the Commonwealth opportunity look comparatively larger, but it is still only a fraction as large as that in the rest of the EU.

As a check, even if one works with the lower sensitivity to physical distance estimated from the UK-specific regressions—along with the lower estimated sensitivity to a common official language and colony-colonizer links—the opportunity in the rest of the Commonwealth remains smaller than the opportunity in the EU. And the notion that the UK's EU membership is getting in the way of its pursuit of other opportunities is rendered less rather than more plausible by the lower physical distance-sensitivity and world-topping breadth calculated for the UK.

A Company-level Application

For a more micro application, consider—more briefly—the implications of Brexit for companies considering what to do about their operations in the UK. As noted during the AIB townhall session, the commercial implications of Brexit are very uncertain because it is still unclear whether it will happen and, if so, on what terms. In addition, there is the fact that the only previous vote to leave the EU (or actually, its predecessor, the European Economic Community), by Greenland in 1985, is not much of a guide because Greenland has less than 60,000 inhabitants, mostly just exports fish and continues to be associated with the EU by virtue of its relationship with Denmark (Ghemawat, June 2016b).[6]

Given these multiple sources of uncertainty, academics have generally refrained from making predictions about the company-level implications of Brexit. Consultants, however, have rushed into the breach by, for instance, suggesting elaborate scenario-based approaches for dealing with the current situation (Reeves & Carlsson-Szlezak, June 2016). This makes some sense, but surely there are some first-order implications at both the industry and firm-level that stand out above the weeds of proliferating scenarios.

If Brexit happens, what is likely to change the most, in terms of underlying structural parameters, is the administrative distance between the UK and its former partners in the EU. This suggests that industries with a high degree of a sensitivity to administrative distance—industries that are heavily regulated or subject to state ownership or involve selling to governments, to cite some examples—are likely to be affected more than others.[7] Unless, of course, the provisions under which UK-based operations can access EU markets happen to be eased the most for such industries—which, at least from an EU perspective, looks implausible. No wonder some financial services firms are thinking of reconfiguring their operations in the UK if the rest of the EU is important to them—whether they are headquartered in the UK or not.

And at the company level, the pressures to reconfigure operations are more likely to be felt by companies whose operations do involve significant cross-border mandates that are likely to be stretched by post-Brexit increases in administrative distance between the UK and the EU. Auto companies with plants in the UK are a prime example. But it is important, once again, to avoid globaloney in this regard. The median affiliate of a US multinational ships nothing to the rest of the corporation (Ramondo, Rappoport, & Ruhl, 2016).

Concluding Questions for the AIB Community

Brexit by itself does not look as if it is going to break the world, but nobody who spoke up at the AIB townhall session thought that it was good news. The analyses presented in this short essay help buttress this sense. But what should give us pause is that quite a bit of analysis along these lines was available before the Brexit vote. Thus, the UK Treasury's 200-page April 2016 report, blandly titled "The Long-Term Economic Impact of EU Membership and the Alternatives," predicted that Brexit would significantly reduce the UK's GDP largely on the basis of gravity modeling of the sort discussed above.

As one (UK-based) participant in the AIB townhall plaintively put it, "We have so many studies that help answer the question of whether or not Britain should leave the EU—but they just don't seem to have affected what happens." The importance of this plaint is magnified by the fact that we are seeing a wave of sentiment in advanced Western economies for undoing some of the cross-border integration of the post-war period. At the EU level, Brexit has encouraged similar rumblings in other member states. At an intranational level, Catalonia, where I live part of the year and can testify about from personal experience, is desperately seeking a divorce from Spain, and similar movements can be identified within at least a dozen other EU members. And splittism is not confined to Europe: the US is in the midst of a political campaign in which one of the major party candidates is threatening to rip NAFTA apart and the other has repositioned to an anti-trade stance as far as the two major pending items of business, the transoceanic TTP and TTIP, are concerned.

The AIB should, as an intellectual community, be at the heart of these issues—but I daresay it is not. What is to be done? Both our Executive of the Year, Indra Nooyi, and our Educator of the Year, Joseph Aoun, seemed to suggest that AIB members needed to step out more as "public intellectuals." I naturally found myself in sympathy with their message since that is how I spend some of my own time, but more specifics about how to influence the public discourse, beyond simply being involved in it, would be helpful. And important questions loom regarding our traditional constituencies as well.

As far as research is concerned, Brexit and the like raise multidisciplinary, messy issues that are clearly hard to publish in refereed journals. Thus, when I was interested in exploring multidimensional concerns about globalization in the wake of the financial crisis, I eschewed journal publication and instead wrote a book, World 3.0: Global Prosperity and How to Achieve It. But is this the only option to be pursued—especially given that book publishing is subject to its own limitations?

And on the educational side, another globalization-related challenge relates to the fact that business schools and the business community in general are much more pro-globalization than society at large. Consider some casual evidence from two important groups that I polled in 2009, shortly after the onset of the global financial crisis: 400 business school deans during a plenary presentation at the AACSB Dean's Conference and 600 strategic management academics during the opening keynote at the Strategic Management Society Annual Meeting. Asked whether the effects of globalization had been basically good, bad or mixed, less than 1% of each group, by my count, characterized globalization as basically bad or mixed! While I am—with caveats suggested by the writing of World 3.0—a pro-globalizer as well, I do worry that we do not do a very good job of equipping our students to deal with the issues that globalization raises "out there," where it is much more contested. What can we do to improve on this front?

Of course, if you also think that nothing new or different needs to or can be done by the AIB or its members, it would be good to hear your reasoning as well!

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Endnotes

1 See the 2014 and 2015 editions of the Ipsos MORI "Perils of Perception" surveys as well as the 2013 edition of the German Marshall Fund of the United States "Transatlantic Trends" survey.

2 Refer to my Harvard Business Review blog post, *The EU Needs to Make Sure Continental Countries Don't Exit* (Ghemawat, 2016a).

3 The 2016 edition of the GCI will be released in November 2016.

4 Calculated using population-weighted distances between major cities from CEPII and IMF World Economic Outlook, April 2016.

5 This estimate as well as those that follow are drawn from the baseline model reported in Chapter 5 of my book, *The Laws of Globalization and Business Applications*.

6 For more discussion of why previous instances of dissolution of administrative relationships offer limited guidance, see my Fortune blog post, *What the World Will Learn from Brexit's Market Mess* (Ghemawat, 2016b).

7 Chapter 2 of my 2007 book, *Redefining Global Strategy*, contains more discussion of the determinants of sensitivity to administrative distance, and Chapter 6 of *The Laws of Globalization* presents new results on such distance-sensitivity at the industry and company level.

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