Perspectives

Fresh economic thinking for business

The possible impact of Brexit on UK trade

In June 2016, the United Kingdom voted in a historical referendum to leave the European Union. Earlier this year, PM Theresa May triggered the Article 50 exit clause, giving the country until the end of March 2019 to reach an exit agreement. In this article, SRM Economics' Niki Etebari seeks to briefly explore and analyse the possible impact of Brexit on UK trade through long-term scenario modelling of possible future UK-EU trade arrangements.

Introduction

The clock is ticking at the Brexit negotiating table with a mere 17 months left until the UK is set to formally exit from the European Union.

At one side of the table, the UK government is fixated on coming out of the negotiations with a deep and comprehensive Free Trade Agreement with the EU. At the other end, the EU-27 is rather explicitly unwilling to even discuss a future trade deal until 'divorce negotiations' regarding the rights of EU citizens in the UK (and vice versa), previous UK financial pledges to the EU, and the border in Ireland are finalised.

Whatever the outcome, economic modelling and analysis have overwhelmingly concluded the economic costs of Brexit far outweigh those of EU membership.

Since the post-war period, the UK has experienced a period of sustained growth in trade. In the past decade, trade as a share of GDP has increased to over 60%, compared to under 30% in the years preceding its joining the EU.[1] In contrast to pro-Brexit arguments, membership of the EU has not caused trade diversion, but has rather allowed both UK-EU and UK-ROW trade to flourish. With a market of 500 million citizens and "an economic weight five times the size of the UK", the EU has been able to negotiate advantageous access to global markets on behalf of the UK.[2]

Today, the UK stands as the world's fifth largest economy and Europe's leading financial centre- accounting for 78% of EU Forex trading.[3] It is also one of the world's most competitive markets and has "the second least restrictive regulatory regime among all advanced economies after the Netherlands, a fellow EU member".[4]

As exit negotiations continue, the UK government has a difficult choice between choosing political sovereignty ('taking back control') or economic prosperity. The following article seeks to analyse the impact of Brexit on UK trade under different future UK-EU trade models.

[1] *HM Treasury analysis: The long-term economic impact of EU membership and the alternatives* (2016 report); pg. 9.

[2] HM Treasury report (2016), pg. 9.

[3] Bank for International Settlements, 2013 data; HM Treasury report (2016), pg. 16.

[4] HM Treasury report (2016), pg. 10; derived from *Evidence from the Organization for Economic Co-operation and Development on product market regulation.*

Love thy neighbour?

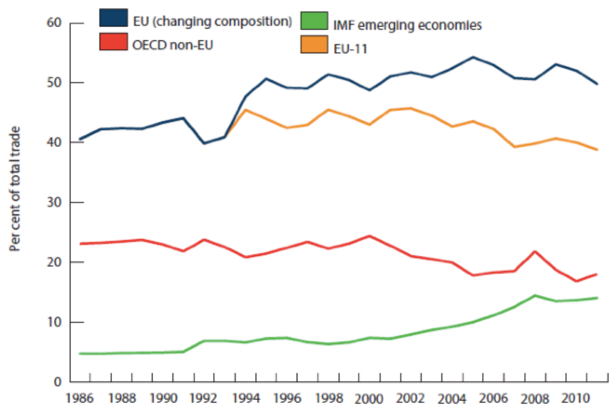
Trade analysis has long showed that geography has a significant impact on trade patterns. Distance matters and the European Union is unsurprisingly the UK's largest trading partner, with EU countries accounting for seven of the UK's top ten trade partners.[5]

In 2015, the EU comprised 44% of UK exports and 53% of UK imports.[6] Despite the overall trade deficit with the EU, the UK does run a trade surplus in services – driven by its booming financial and business services sector. In terms of growth, between 1999 and 2015, UK exports to the EU rose by 68% while imports rose by 101%.[7] This same balance of trade relationship is true for the UK-ROW, highlighting the UK's relative manufacturing weakness and service strength *vis-à-vis* its trading partners.

Over the past sixty years, the UK has witnessed massive de-industrialization with the service sector gradually replacing manufacturing to account for almost 80% of GDP. The UK has however has retained some manufacturing strength in areas such as motor vehicles and pharmaceuticals, and is part of a complex, cross-border EU supply-chain.

Trade with emerging markets, particularly China and India, has been on a steady rise since the turn of the 21st century as these economies play catch-up to the developed world.

Graph 1: Trend in UK trade with the EU and ROW



Source: CER 2016 Report; International Monetary Fund, Direction of Trade Statistics.

At first sight, this sustained growth in trade with emerging markets can be interpreted as sign that UK trade will prosper post-Brexit – as the UK will be free to negotiate new advantageous trade arrangements, unhindered by Brussels. It is not that simple; however, as the proportion of UK exports going to the EU paints an incomplete picture of the importance of Europe for the British economy.

Among other factors, these figures do not take into account the indirect EU demand on UK supply chains. Amongst OECD countries, UK business tend to be heavily concentrated "in the production of intermediate upstream goods and services."[8] Brexit has put this UK-EU supply-chain integration at risk with the possibility of large "ripple effects across the rest of the economy" should exports to the EU fall.[9] The stakes are high, and not always obvious, for the UK in negotiating its exit and future relationship with the EU.

Britain vs. 'Brussels' at the Negotiating Table

With Brexit negotiations in full swing, where does the UK stand at the negotiating table?

It has been argued, on the pro-Brexit side, that the UK has the stronger negotiating position because of its sizable trade deficit with the EU. This argument fails to recognize that while "44%

[5] ONS (2016): UK Perspectives 2016: Trade with the EU and beyond.
[6] Ibid.
[7] Nominal growth rates; Ibid.

[8] CER report (2016), pg.32.
[9] Ibid. pg.32.

of UK exports go to the EU,…less than 8% of EU exports come to the UK."[10] In relative terms, this relationship indicates that "the impact of EU demand on UK GDP is six times larger than the impact of UK demand on EU GDP."[11] The UK would be naive to "assume that it could dictate terms…by virtue of the fact that it is running a trade deficit with other member states."[12] It is Brussels that has the stronger negotiating position. Nevertheless, both parties should be well aware that reaching some form of trade agreement is beneficial to no deal.

Where do we go from here?

This begs the question - what kind of UK-EU agreement can be negotiated? Essentially, there are four long-term arrangements for the future relationship between the UK and its neighbours across the channel:

1. European Economic Area (EEA)/ Norway Model
2. Swiss Model (bilateral agreements)
3. European Free Trade Association (EFTA)
4. World Trade Organization (WTO)

The least disruptive arrangement would be to adopt a relationship similar to that of Norway - such that the UK becomes a member of the EEA. This would give the UK control over her external trade policy while still retaining membership in the single market.[13] In effect, trade would become largely tariff free and the economic cost of Brexit would be minimized. The UK would, however, still be expected to make financial contributions to the EU and there would be some new costs associated with reinstalling border controls to enforce rules of origin. While such an arrangement may appease those voters who were in favour of EU membership, it is not politically realistic for a government wishing to respect the outcome of the referendum. The UK would still have to honour the free movement of labour, make a financial contribution to the EU (albeit a bit less than it currently does), and essentially be under the jurisprudence of the European Court of Justice.[14] Rather than taking back the control that so-dominated the Brexiteer's campaign rhetoric, the UK would, in effect, keep EU rules and regulations "without having a seat at the table where the rules are" made.[15] While it is possible to have a single market without free movement of labour (i.e. Bruegel's continental partnership), this type of arrangement would, it seems, be unacceptable to the EU-27.[16]

The UK could instead seek an arrangement like that of Switzerland – negotiating bilateral agreements with the EU. While the Swiss model maintains free trade in non-agricultural goods, Switzerland still "pays about 40% as much as the UK to be part of the single market in goods" despite it being considerably smaller than the UK.[17] Furthermore, the Swiss have no arrangement on free trade in services, with Swiss financial institutions "often [serving] the EU market through subsidiaries based in London"[18] Considering the UK's service dominated economy, such an arrangement would prove costly.

Essentially under the Swiss model arrangement, the UK would again face *regulation without representation*. This trade-off is much more consequential for the UK than say for Norway or Switzerland whose economic weight implies that "they would have a much less significant influence even if they were members of the EU."[19] Without participation in EU-decision making, the UK will inevitably face future rules that favour full-EU members at the expense of the UK.[20] Furthermore, EU-27 have made it clear that if the UK wants to stay in the Single Market, it must accept the free movement of people. While Switzerland has tried to impose restrictions on

[10] HM Treasury report (2016), pg. 11.
[11] CER report (2016), pg.39.
[12] Ibid. pg.39.
[13] As an EEA member, the UK would not be part of the Common Agriculture Policy (CAP) or Common Fisheries Policy and thus would still face tariffs for such goods.

[14] Smith, Alasdair. Brexit: hard truths and hard choices. 2016.
[15] CEP report (2016): Life after Brexit – What are the UK's options outside the European Union?, pg.1.
[16] Bruegel report (2016): Europe after Brexit: A proposal for a continental partnership.
[17] CEP report (2016), pg.1.
[18] Ibid. pg.6.
[19] HM Treasury report (2016), pg. 11.
[20] Ibid. pg.11.

immigration, it seems unlikely that the EU-27 will tolerate any such cherry-picking by the UK.

With the previous two arrangements likely out of the running, this leaves the scenario in which the UK re-joins EFTA. The UK would no longer be a member of the single market, but would instead trade with the EU based on tariff-free trade in domestic (non-agricultural) goods. Under such an arrangement, the UK takes back control over its regulatory, external trade, and immigration policy; however, EFTA is neither designed to guarantee right of access for trade in services nor address non-tariff barriers, which can add “2 or 3 times as much to the cost of traded goods as tariffs.”[21]

Regarding an independent EU-UK FTA, such an arrangement is not logistically possible in the immediate timeframe. Furthermore, there is significant uncertainty about how and the extent to which such a mutual arrangement can be agreed upon even in the long-term. This is to say nothing of the long and arduous process the UK has ahead of itself in renegotiating the more than 50 FTAs it had with the ROW via the EU. The most comprehensive FTA the EU has negotiated to-date is its agreement with Canada which took seven years and provides little access to service markets.[22] The crucial fact of the matter is that EU-27 has no incentive to offer the UK a better deal than what it had previously and the longer such negotiations take, the higher the degree of uncertainty and thus the economic costs.

Analysis – Hard Truths

Given the near impossibility of negotiating a comprehensive FTA within the Article 50 timetable, Britain is left with the harsh reality of possibly reverting back to trade based on WTO terms if it continues to be unwilling to budge from its ‘red lines’. While such an arrangement would give the UK the control it so desires, the economic cost of this new found sovereignty will be high and far-reaching.

Under WTO terms, trade with the EU would be subject to the most favoured nation (MFN) tariffs and there would be significant non-tariff barriers to trade. Under MFN, the UK would have to unilaterally lower tariffs with all other WTO member countries if it wanted to keep trade with the EU tariff-free. In a classic catch-22 case, the UK would have to either chose between unilaterally lower tariffs (and thus lose its “critical negotiating leverage in trade agreements with the ROW”) or the alternative of unilaterally higher tariffs and thus higher cost implications on exports. The UK services sector would be heavily impacted as would its the most vulnerable manufacturing sectors: motor vehicles, pharmaceuticals, and agricultural products.

While it is difficult to quantify the exact impact Brexit will have on UK trade, the HM Treasury’s gravity model has estimated (in line with the broad consensus) that the impact on UK trade will be most devastating under the WTO arrangement. As the table below shows, membership of the EEA option would have the smallest impact on trade (at around 9%).

Table 1: Effect of leaving the EU on total trade volumes (% difference from level in EU after 15 years)

	EEA	Negotiated bilateral agreement	WTO
Lower end of the range	-9	-14	-17
Upper end of the range	-9	-19	-24

Source: Adapted from *HM Treasury analysis: the long-term economic impact of EU membership and the alternatives; 2016*

Conclusions

What might seem like a long road ahead in the Brexit negotiations is fast-approaching with 2019 not far off. The UK government must decide whether it is willing to stay firm to its ‘red lines’ and sacrifice economic performance for sovereignty. It cannot have both.

Economic modelling and analysis have broadly concluded that the impact of Brexit on UK trade follows an inverse relationship between integration and economic cost. If the UK government wants to fully-honour the Brexiteers and the outcome of the referendum, it will likely

[21] HM Treasury report (2016), pg. 9.
[22] CER report (2016), pg.43.

have to chose to return to trade on WTO terms, at least in the interim period before an FTA could be negotiated. While this is far from ideal in an economic sense, it is the only scenario in our time frame in which the UK can fully honour the referendum.