Brexit and Trade

Is it true that UK will still trade with EU and can increase trade with non-EU countries?

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Abstract

The main focus of this paper is to analyse the effect of Brexit on the UK-EU trade and discuss the benefits and costs of the available options. According to the literature, none of the future alternatives are as profitable for the UK as the EU membership and Brexit will cause a decline in the UK's GDP, living standards and average households' income. It cannot be predicted whether the UK will be able to strike new attractive trade deals with the rest of the world. However, due to its small bargaining power and market size compared to the EU, it is not probable it will.

1. Introduction

In June 2016, 51.9% of the British citizens voted against the EU membership in the Brexit referendum. Even though the referendum was legally non-binding, the government decided to implement this decision and leave the EU. The public opinion of what they were voting against was clear, however the British citizens did not know what they were actually voting for. The voters' view was substantially influenced by the media promoting a better future without contributing to the EU budget and the UK having a full control over their regulations and trade policy without having to make compromises with the EU. Moreover, Brexit seemed like a solid solution against the rising issue of immigration in the eyes of voters.

This main focus of this paper is to analyse what Brexit means in terms of trade policy and the benefits and costs of each available option to the UK after leaving the EU. Will becoming independent result in a better position for the UK to strike more attractive trade deals with other countries outside the EU or will the UK's economy experience a decline in living standards? At this time, it is too early to be able to address these questions with certainty as current research can only forecast the possible consequences that could occur as a result of Brexit.

The paper is organised as follows; Section 2 defines what Brexit means for the UK in terms of trade policy. Section 3 focuses on the available options for the UK after leaving the EU and compares their costs and benefits. Section 4 discusses the position of the UK to negotiate future trade deals with non-EU countries. Section 5 concludes.

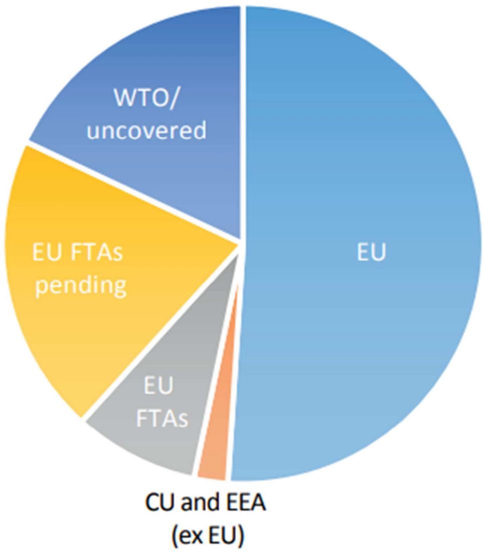
2. Trade policy

Being a member of the EU has had a positive effect on the UK's economy and living standards. Since the admission in 1973 the trade volumes in the UK substantially increased mostly due to the reduced cost of trading and high level of economic integration. According to Crafts (2016) joining the EU increased the trade volumes of the UK by 21.1% by 1988. Similarly, Campos et al. (2014) claim that the EU membership raised the UK's GDP by 8.6% in ten years. Hence, economic integration and the EU membership increase productivity through creating competition and engaging in trade which positively affect economic growth.

Exiting the EU and taking over the trade policy implies that the UK is free to negotiate its own trade deals without compromising with the EU and seek new trade partners. However, this freedom also results in numerous complications. The UK's major task is to renegotiate its trade agreements with the EU, as the EU accounts for more than a half of the UK's trade (Dhingra et al., 2016). Furthermore, the UK has to be removed from the EU's World Trade Organisation (WTO) membership and arrange new trade agreements with the nations as an independent member to replace old ones that were previously set up by the EU. This is going to be a very complex task for the UK as there are 148 negotiations with the WTO members the UK has to undergo (Holmes et al., 2016). Finally, trade deals with the third nations, which already have an agreement with the EU or are currently negotiating one need to be discussed. This also implies, that UK is no longer going to be a part of the attractive Transatlantic Trade and Investment Partnership (TTIP) with the U.S. focusing on reducing the non-tariff barriers (Booth et al., 2015). It could potentially negotiate its own trade deal with the U.S. however it is unlikely to include as many benefits due to the lower bargaining power of the UK after Brexit.

Figure 1 highlights the importance of the future negotiations for the UK as adding together the trade with the EU, European Economic Area (EEA), Customs Union, countries that currently have a preferential trade agreement (PTA) or are currently negotiating one covers 82% of the UK's trade (Armstrong, 2016).

Figure 1: Share of total UK trade covered by trade agreements



Source: Armstrong (2016)

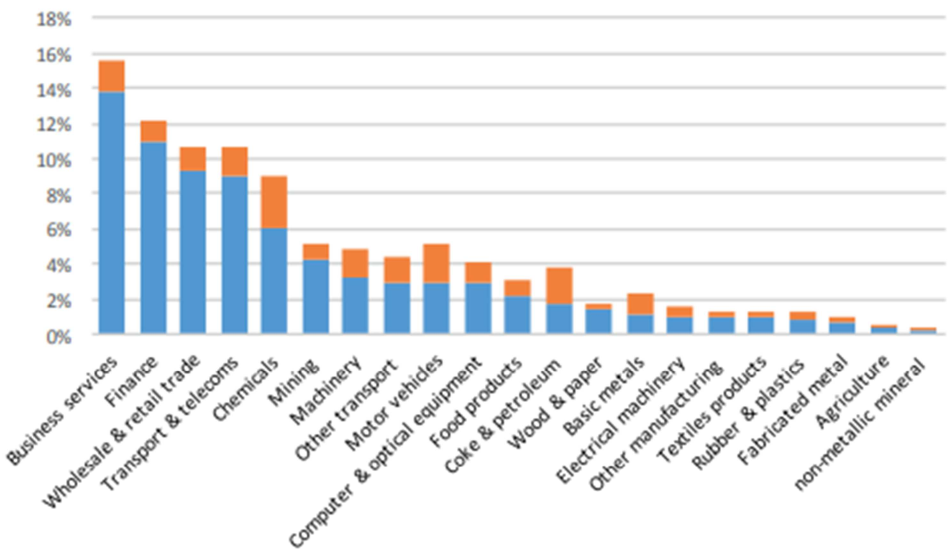
3. Hard or soft? The options for the UK after Brexit

Brexit was announced in 2017 and the UK is expected to officially leave the EU in 2019 as according to Article 50 it is given a two-year period to negotiate a new settlement. However, due to the limited time available to close all the necessary deals, it was granted a two-year transitional period and will completely leave the EU in 2021 (Blitz, 2018). Afterwards, the UK has essentially three options.

The first option is potentially the 'Norway option', which would imply a 'soft' Brexit. Under this option the UK would remain a part of the EEA and, hence, a part of the Single Market. It would, however, be excluded from the Customs Union. This means that the UK would have to accept some non-tariffs barriers to trade such as rules of origins and anti-dumping duties. Any alternative to the EU membership results in imposing non-tariff barriers on the UK-EU trade but this one would be the least disruptive to the UK's economy (Dhingra and Sampson, 2016). In the case that the UK would remain a part of the Single Market, there would be no tariffs in the UK-EU trade as this implies free movement of goods, services, capital and people. On the other hand, in this case, the condition of free movement of people which was one of the main causes of the referendum is not negotiable. Furthermore, the UK would have to comply with the EU regulations and accept the contribution to the EU budget which would be reduced by only 17% (Haas and Rubio, 2017). The reduction of the contribution is however offset by the fact that the UK farmers would no longer receive subsidies from the EU and would potentially have to be compensated by the UK's government. The UK's gain would be the freedom to close its own trade agreements with countries outside the EU. Choosing this alternative and remaining in the Single Market would keep the UK as integrated as possible after Brexit and would result in a substantial gain for the UK as "the EU market encompasses about 500 million consumers and almost a fifth of world income" (Baldwin, 2016). On the contrary, the Brexit vote to leave stated to 'take back the control' of its immigration policy, laws and regulations (Menon and Fowler, 2016). Hence, at that time it did not seem the UK wanted to remain a part of the Single Market.

The second available option is the ‘Swiss alternative’ which would allow the UK to partially access the Single Market through bilateral agreements with the EU. The agreement is very similar to the one with Norway and it would require the UK to adopt all the EU regulations in the parts of the Single Market that it participates and allow free movement of labour. On the contrary, this agreement does not include services which could economically harm the UK as it is a country with a substantial financial sector accounting for more than 44% of UK’s export and covering above 52% of the value added (Armstrong, 2016).

Figure 2: Domestic and foreign value added in exports by industry (as percent of total gross exports, 2011)



Source: Armstrong (2016)

Another available option is to negotiate the 'Canada deal', which includes free trade in industrialized goods and some liberalization in services, however does not include 'passporting rights'. The working-age population in the UK now has a larger proportion of EU citizens, rising from 2% to 6% in the last two decades (Petrongolo,2016). Therefore, this option is appealing for many voters as that would potentially solve the immigration issue due to the fact that the EU citizens would not automatically have the right to work in the UK anymore. However, similarly to the 'Swiss alternative', the UK would lose as services are not fully included in this deal. Beyond this, the loss of 'passporting rights' could result in a decline in financial services exports by half (Kierzenkowski et al., 2016) and relocation of the operations of some London-based international banks into the EU territory (Galbraith, 2017).

If the UK will not be successful in negotiating a new trade agreement with the EU, it will have to follow the WTO rules. This is a form of a 'hard' Brexit. The 'WTO option' would considerably disrupt the UK's economy as it would mean trading on the Most Favoured Nation basis and facing in some cases high tariffs such as 17% with Korea and 30% with Egypt (Rollo and Winters, 2016). This was one of the reasons why the European Free Trade Association (EFTA) governments in 1990s decided to negotiate the Single Market (Baldwin and Flam, 1994). In the positive scenario of this alternative UK could simply follow the EU's agreed commitments in the WTO and inherit its rules and obligations. This would however depend on the outcome of the negotiations with the 160+ WTO members which could use this as an opportunity to strike a better deal for themselves (Baldwin, 2016). The HM Treasury (2016) estimates a decline in GDP between 5.4% and 9.5% if the UK will be forced to adopt the rules of WTO.

It is not clear at this point whether these are the only available options and only the future negotiations will reveal the type of deal the UK will get from the EU. The UK was hoping to get an agreement with all the privileges of the Single Market but without accepting the free movement of labour (Giles, 2017). However, it is not probable that the EU will allow this kind of “cherry picking” as agreeing on a deal is of higher importance to the UK than to the EU. According to Holmes et al. (2016) the UK would experience a disruption in 45% of its exports while the EU’s exports would be affected by merely 6.7% on average. Thus, the UK would potentially lose more than the EU in the absence of a free trade agreement. Furthermore, Ebell et al. (2016) claim that the UK will experience a decline in its GDP in each case as reducing openness to trade might result in a lower productivity.

4. Will the UK be in a better position to negotiate trade deals with non-EU countries after Brexit?

One of the key objectives of Brexit’s campaign was the freedom of the UK to negotiate its own trade agreements with countries such as China, India and the U.S. The UK claimed that it could negotiate more profitable deals without having to compromise with other EU countries. However, the last time the UK negotiated trade rules on its own behalf was in 1967 in the Kennedy’s Round of The General Agreement on Tariffs and Trade (Trommer, 2017). In that time the UK was one of the four largest economies in the world with its bargaining power incomparably higher than at this point. Moreover, the UK does not even have its own trade negotiators anymore (Bishop, 2017). Hence, it is questionable whether the UK can achieve more profitable deals than the EU offering access to over 500 million consumers. It is also necessary to mention that the U.S. stated that it is not interested in negotiating a trade deal with the UK alone (Holehouse, 2015). Beyond this, as Holmes et al. (2016) suggest, to compensate a reduction in exports with the EU by 1% due to the reduced market access, the exports with the U.S. for instance would have to increase by 4%. Even though the UK often claims that they do not substantially benefit from the EU's trade agreements, its consumers' benefits are twice as large as the ones of the other twelve members that joined the EU before 1995 (Dhingra et al., 2016). Moreover, negotiating PTAs is mostly based on country-by-country basis, which is heavy on financial and human resources and requires a substantial amount of time to close the deals one-by-one. Table 1 provides examples of current FTAs and the length of the negotiation processes. As can be seen, the shortest one lasted three years until it was implemented.

Table 1: Length of Free Trade Agreement negotiations, examples

Negotiation	Time (years)
Switzerland – China	4
EU – Korea	4
EU – Mexico	4
US – Australia	3
EU – Canada	5 (not yet in force)
EU – Switzerland	10

Source: Kierzenkowski (2016)

According to Dhingra et al. (2016) each possible future scenario is going to result in a fall in the living standards of British citizens and a decrease of their income as portrayed in Table 2 below. Furthermore, HM Treasury (2016) predicts a decrease in

GDP in each of Norway, Switzerland, Canada or the WTO alternative and fall in households' income. The aforementioned arguments suggest that the costs of Brexit exceed its benefits in terms of trade. However, it is not clear whether the economic perspective is the only one considered when negotiating future agreements for the UK.

Table 2: The effects of Brexit on UK living standards

	Optimistic	**Pessimistic**
Trade effects	-1.37%	-2.92%
Fiscal benefit	0.09%	0.31%
Total change in income per capita	**-1.28%**	**-2.61%**
Income change per household	-£850	-£1,700

Source: Dhingra et al. (2016)

5. Conclusion

According to the economic predictions, Brexit will be substantially harmful for the UK's economy and living standards and will negatively affect trade. As more than half of the UK's trade is with the EU, its future exclusion from the Customs Union and potentially the Single Market will result in decline of its GDP. The extent will depend on the agreement the UK will reach with the EU. Nevertheless, none of the available options offer as many advantages as the EU membership. This is true especially for a country with a substantial service sector as none of the current FTAs include free trade in services. If the UK wants to solve the rising immigration issue and stop contributing to the EU budget it will have to give up free trade in services and accept facing at least some non-tariff barriers. In other words, 'taking control' over its own regulations and trade policies comes with great costs. It is not clear whether the UK will be able to achieve attractive trade deals with the rest of the world that would offset the loss from leaving the EU. Due to the UK's smaller bargaining power and market size compared to the EU, it is not probable that it will. Moreover, negotiating new trade deals will be very costly and time consuming.

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