Through a glass, darkly?

CLUES FOR UK TRADE POLICY AFTER BREXIT

Recent developments at the Conservative party's conference have done little to reduce uncertainty over the UK Government's aims for trade policy post-Brexit, adding to the frustration expressed by some business groups. Meanwhile the EU's chief negotiator, Michel Barnier, continues to maintain that too little progress has been made on the EU's priority issues – the exit bill, the status of EU citizens in the UK and the UK-Irish border – for trade even to be allowed on to the agenda yet. And in an overwhelming (if non-binding) vote that it shouldn't, the European Parliament has shown how difficult it could be to get a deal. Through this fog, some of the Government's aspirations are now beginning to emerge. But as this bulletin explains, there are significant difficulties in putting these aspirations into practice.

In February, the UK Government's Brexit White Paper called for a bespoke free trade agreement between the UK and the EU. Its contents were rejected, as not only vague but self-contradictory, by the rest of Europe. While the UK's position on the free movement of people and the European Court of Justice seemed to rule out continued participation in the single market, it also aspired to a much deeper free trade agreement with the EU than any that the EU has concluded with its trade partners that are neither members and nor part of the European Economic Area.

This position was reiterated, more or less, by the Prime Minister in Florence on 22 September, although she did at least try to set the negotiating ball rolling on the "priority issues", in a speech acknowledged as "conciliatory" by other European leaders. And realising the need for a transition period after March 2019, she put in a bid for a two-year arrangement.

During this time, EU rules would continue to apply, implying continued participation in both the single market and customs union over that period. This, in turn, would mean accepting the judgments of the European Court and allowing free movement. And while her offers on EU citizens' rights and the exit bill were immediately rejected in Europe as too little (and attacked by some back home as too much), they were also acknowledged to be a starting-point.

Signs of division within the UK Government, combined with the firm rhetoric of EU negotiators, mean that the risk that talks will collapse and the UK simply fall out of the EU – in the hardest of "hard Brexits" – remains real. But there is still a possibility that, politics permitting, the Government will find its way to a compromise. And empirical analysis carried out by Frontier Economics and others continues to underscore the economic importance, and the challenges involved, of achieving this.

Damage limitation?

The most important acknowledgement of this economic necessity by the UK came in a "position paper" produced in August 2017, on future customs arrangements. This stipulated a key objective: to minimise the level of disruption to merchandise trade between the UK and the EU. Whether this is achievable depends, of course, on the attitude taken by EU partners, and also on political dynamics within the UK.

So what does that mean in practice? Overall, the main elements that seem to emerge from the positions the UK Government has taken are:

- Recognition of the importance of single market access for goods and services, but uncertainty as to how far this is achievable given political difficulties created by one of the four pillars of the single market, namely the free movement of people.
- An implicit, if not explicit, intention to prioritise frictionless access to the EU's market for goods, even if this comes at the expense of being free to strike free trade agreements on goods with the rest of the world;
- The possibility of pursuing the liberalisation of trade in services through negotiations with the rest of the world. Even if the UK were to be bound to the EU's customs union through a transition agreement and then by mirroring its customs regime, it would not, at least in theory, be prevented from negotiating services agreements with non-EU countries, assuming it had formally left the EU.

One of the implications of this approach, not yet openly avowed, is that the UK would accept greater restrictions on its scope for developing an autonomous trade policy on goods, in order to provide stability of access to cross-border supply chains. This would still allow the UK to have greater autonomy in the area of services, which is in line with the fact that, historically, trade regimes across the EU have evolved in a much less uniform manner in services than they have in goods, and the UK relies less on the EU for trade in services than it does for trade in goods.

In the light of this objective, we have revisited our previous empirical work on the impact of Brexit on trade in goods. In this bulletin, we also present further modelling on trade in services, to examine the options available to the Government, and the factors that it needs to consider if it is to pursue such a differentiated strategy.

Delivering the goods

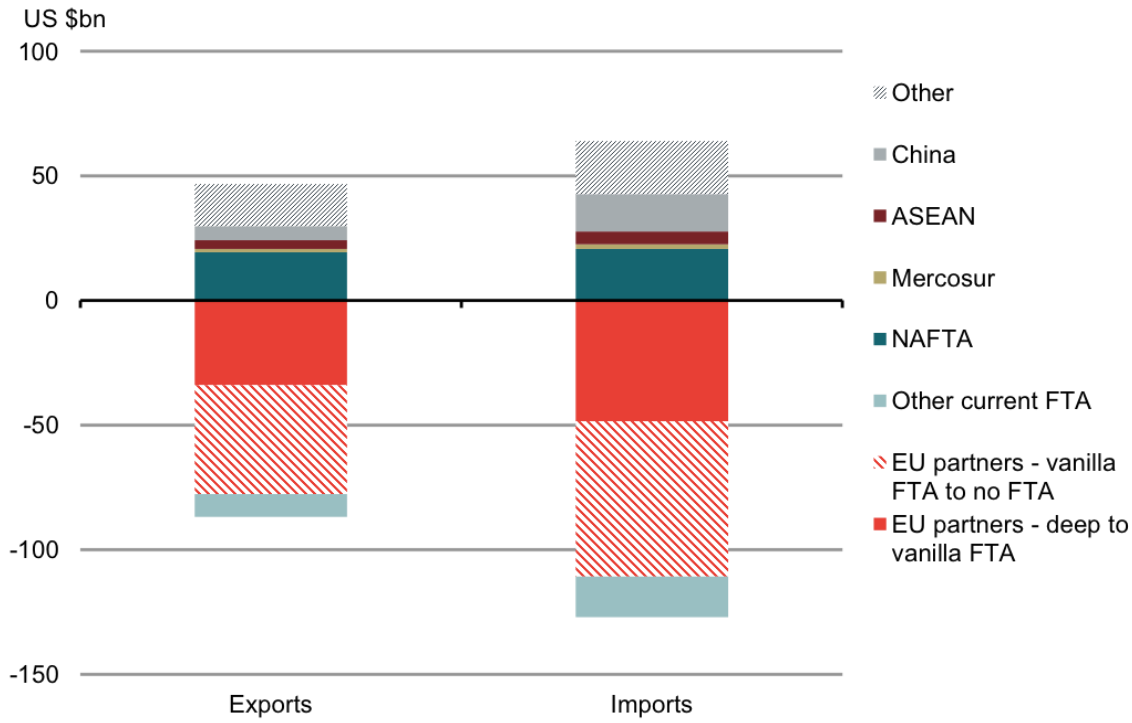
Our analysis of trade in goods supports two key conclusions arrived at in a number of other pieces of empirical work as well.[1] First, that a "hard Brexit" - that is to say, one in which the UK and the EU reverted to trade on the "most-favoured-nation" (MFN) terms currently applied within the World Trade Organisation (WTO) rules - would have the greatest negative impact on the economy of all possible outcomes. And second, that the fullest possible sheaf of new Free Trade Agreements (FTAs) on goods with the UK's other non-EU trading partners would not be sufficient to compensate for its effects. And that is on the assumption that these agreements would not only be negotiated, but that they would also enter into force and be implemented in full, at the time at which the UK's exit from the EU took effect, an extremely unlikely scenario even assuming a transition period of several years.

Policymakers in the UK Government should also take note of another conclusion from this work: that a shift in the UK-EU relationship from present arrangements to the kind of FTA that commonly exists outside the EU or the European Economic Area would generate significant losses.

These points are illustrated in Figure 1 below. The possible benefits from achieving new FTAs with respect to goods with the UK's main non-EU trading partners are shown above the zero line. The negative impact of possible different arrangements for trade in goods between the UK and the EU are shown below the zero line. The gains from new FTAs are assumed to be achieved at the same time as the losses from Brexit (an obviously unrealistic assumption, since many would take years to negotiate).

[1] See in particular Frontier Economics (2017), Changing the terms of trade, available at http://www.frontier-economics.com/publication/changing-terms-trade/

Figure 1 Effects of different forms of FTA with the EU, and effects of FTAs with other trading partners



The red part of the bars indicates the losses that we could expect to suffer in EU trade, both exports and imports, if the UK were unable to agree a deep FTA that essentially replicated current levels of integration under the single market, and had therefore to settle for a more standard form of FTA.

Such an outcome could be expected to lead to a loss in exports of about $34 billion, to which should be added about $9 billion lost as a result of withdrawing from FTAs to which the UK is party via membership of the EU, giving a total of $43 billion. The corresponding figure for a loss of imports is $64 billion.

The red and white hatched area depicts a more drastic outcome. It shows the difference between the achievement of a “vanilla” FTA and and the effect of achieving no FTA at all - i.e., the effect of a “hard Brexit” following from a breakdown of negotiations, leaving the UK and EU trading on current applied MFN terms.

The economic impact of such an outcome, well understood within business and parts of government at least, is what has led to calls for the UK to work “creatively” towards a solution that helps secure an FTA in goods, and to demands for a transition period. But the depth that could be achieved through negotiation of any such agreement remains heavily in doubt.

Back through the origin

The overall effects presented in Figure 1 do not, however tell the whole story, and indeed understate some of the challenges faced by the Government. In particular, they gloss over a deep-seated tension between two objectives, namely to minimise losses on trade with the EU, on one hand, and to maximise trade with other countries to compensate, on the other. This tension has to do with the question of rules of origin.

If the UK leaves the customs union, but agrees some sort of FTA with the EU, it will need to agree rules of origin with the EU. These will be required, for example, to avoid goods leaking into the EU from third countries that have signed a FTA with UK but do not have one with the EU.

Such rules will impose an entirely new set of costs on UK and EU firms that depend on cross-border supply chains that span the UK and EU. The UK’s supply chains are deeply integrated with the rest of the EU. OECD data suggest that at present, most (80-90%) of foreign value-added in UK final demand and exports comes from the EU Preserving “friction-free” access to the EU’s single market is essential to the protection of the competitive position of many UK (and EU) businesses.

The proposals contained in the August position paper on Customs Arrangements tries to resolve this tension by pushing for arrangements on origin that mirror the EU’s arrangements with third parties, with the intention of eliminating additional compliance costs on UK-EU supply chains. The mechanics are not spelled out. But it would seem that this approach constrains the benefits the UK would get from FTAs with non-EU jurisdictions. Firms looking for cheaper raw material sources, for example, would not benefit if their main market for final sales was still the EU. Compliance costs for firms would increase: How would one demonstrate that, say, fruit from Brazil was intended for consumption in the UK, rather than for processing and exporting to the EU, without driving food manufacturers into an administrative labyrinth?

Moreover, if the UK commits from the outset to mirroring the EU’s customs arrangements with non-EU partners, this could reduce the attractiveness to these partners of seeking trade agreements with the UK in the first place. The UK’s commitment to mirroring EU arrangements vis a vis non-EU partners is likely to constrain the amount of preferential liberalisation the UK could offer these partners through a FTA. Put simply, reducing the area “below the line” in Figure 1 is likely to become more difficult the more gains above the line are pursued.

This fundamental tension explains why the UK Government might wish to minimise disruption to existing arrangements for trade in goods, even if this comes at a cost to its arrangements on goods with the rest of the world.

Service games

But could the UK strike out on a more ambitious course for services? After all, services account for nearly 80% of the UK’s GDP, and are the fastest growing component of trade. Cross-border supply chains do not have to deal with rules of origin issues. And there is no legal obstacle that precludes the UK from negotiating primarily on services with non-EU trade partners, once it is no longer an EU member.

To estimate the effects of liberalisation of trade in services with such partners is harder than estimating the effect of the lowering of tariffs on trade in goods. For our baseline, we have drawn on the OECD’s services trade restrictiveness index. This is used as a variable in a gravity model of services trade to estimate how far a percentage point of liberalisation increases trade. [2]

The OECD also estimates the effects of services FTAs on trade. It finds that:

- A services FTA increases services trade by 36%
- Services liberalisation undertaken within the European Economic Area, which is deeper than undertaken under the auspices of other FTAs, increases trade by 4% over and above the FTA effect described above

These numbers should be interpreted with caution. The OECD itself observes that when estimating the general FTA effect, the inclusion of the EU in its sample of FTAs is likely to mean that within-EU liberalisation influences the overall result. Because intra- EU services liberalisation is much deeper than liberalisation in other FTAs, this means that applying the estimated FTA effect to FTAs outside the EU may overstate their effect. Indeed, other estimates, notably a recent paper by the National Institute for Economic and Social Research (NIESR) has found that the effect of standard FTAs (i.e. outside the EU) was zero[3]. This result is consistent with research in other jurisdictions that finds, at best, modest effects from free trade agreements in services.[4]

With these caveats in mind, we proceed based on the estimates provided by the OECD. The results are depicted below. The area in red depicts the value at risk from rolling back UK services’ access to

[2] Nordås, H. K. and Rouzet, D. (2017), The Impact of Services Trade Restrictiveness on Trade Flows. World Econ, 40

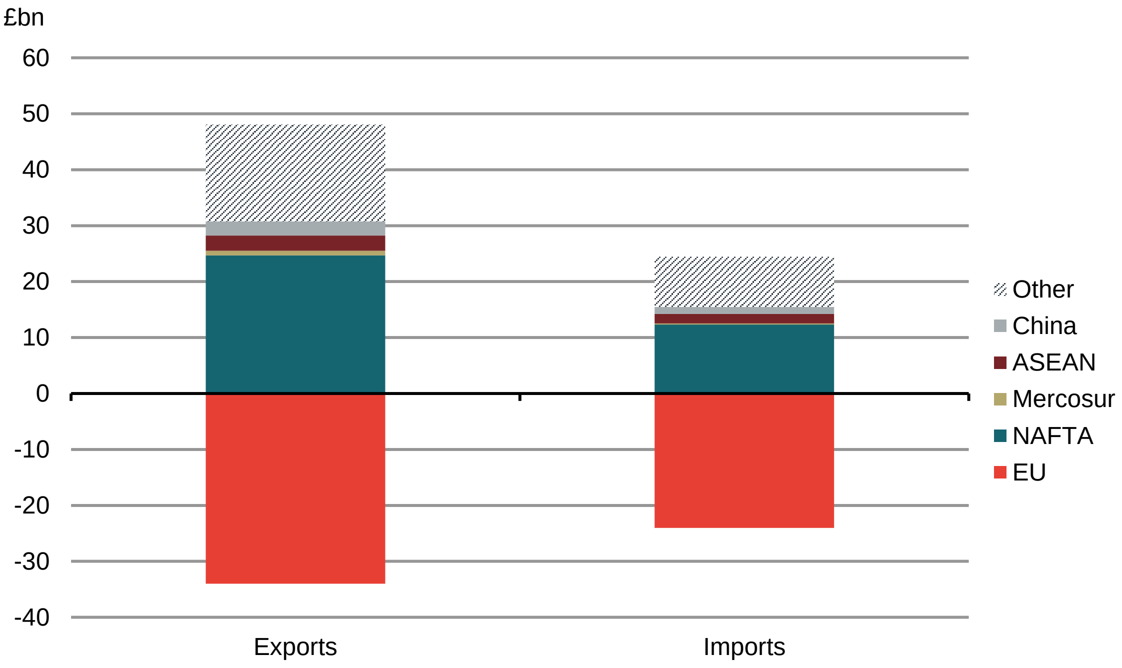
[3] [3] Ebell, M. (2016). Assessing the Impact of Trade Agreements on Trade. National Institute Economic Review, 238

[4] See notably Productivity Commission (2010), Bilateral and Regional Trade Agreements, Productivity Commission Research Report, p 161; and Malcolm Bosworth and Ray Trewin (2011), “Australian PTA’s in service: Much ado about nothing”, NCCR Trade Regulation Working Paper, No 2011/52

the EU single market and reverting to trade on MFN terms. Exports would fall by around £34 billion per annum and imports by around £24 billion.

Could these losses be offset by FTAs with the rest of the world? On paper, if the UK were to sign services FTAs with the rest of the world it could more than compensate for losses on its EU-facing services trade. An agreement with NAFTA economies would, for example, increase services exports by around £24 billion per year. If the UK could retain some level of preferential free trade with the EU so that it reduces its losses (i.e. shrinks the red area), then it could conceivably break-even. For example, it might be able to negotiate an equivalence agreement with the EU on financial services, allowing UK based institutions continued access to an EU passport, and thus the ability to trade seamlessly across EU-borders.

Figure 2 Effects of services FTA with the EU, and with other trading partners



However, these estimates are precarious for a variety of reasons. First, as already observed, FTAs outside the EEA have generated only modest impacts on services trade. The magnitudes described above for UK FTAs with the rest of the world are likely only if they involve a level of reciprocal liberalisation that is unprecedented outside the EEA. The upper bound shown on the results for a putative services FTA with NAFTA, for example, depends on the unlikely assumption that it would be possible to replicate many elements of the EU's single market for services (including deep commitments of free movement and regulatory cooperation). It is highly unlikely that such a result could be achieved within the time-frame under consideration for Brexit, if it ever could.

Specifically on the issue of regulatory cooperation, a key supporting element of liberalisation in trade in services lies in regulatory convergence. But for many services sectors, there are significant differences in regulatory philosophy and practice between the US and the EU, and a decision to align with one may compromise the extent to which the UK could align with the other.[5]

This is the case, for example, in key services sectors such as financial services. While the US accounts for a greater share of UK financial services trade than the EU, much of that has to do with the presence of affiliate offices of US banks in London. Their presence in London is influenced by the ability to use London as a hub for seamless cross-border trade with the EU. If there were to be a growing divergence between the UK and the EU on regulatory matters, UK based institutions would

[5] Discussions on regulatory cooperation in financial services was one of the key sticking points in the now-stalled negotiations between the EU and the United States on the proposed Transatlantic Trade and Investment Partnership

face greater friction in accessing the EU, which would in turn reduce the attractiveness of the UK for US (and other) based institutions seeking to access the EU.

In some respects, the question of regulatory convergence, and the hard questions this raises about deals with potential trade partners on services, is analogous to the problem rules of origin with respect to trade in goods. They show the danger in the assumption the assumption sometimes tacitly made by Brexiteers, often on the basis of economic models that simply assume away such frictions, that post UK trade policy options are simply about rearranging the furniture.

Finally, there may be tensions between conflicting ambitions for goods and services. Liberalisation of trade in services, while likely to benefit the UK, may be unattractive to trading partners if the scope for increasing market access for their goods exports is limited. Moreover, because the UK has been an early mover in the liberalisation of services, most of the remaining restrictions on entry to its market that it could in theory "put on the negotiating table" are sensitive matters (labour market regulation, movement of people) or relate to sensitive sectors (such as professional services, education and health).

Still knowing only in part

The UK Government began trying to implement the results of the Brexit referendum last year by attempting to drum up a set of outside options on trade. Its aim was to increase its bargaining power with the EU, with which it clearly needed to maintain a deep trading relationship, while trying to make headway on other politically sensitive issues such as the repatriation of powers and control over immigration. But this approach has been beset by problems.

One of these is that the tension between developing outside options and maintaining friction-free trade ties with the EU has become steadily more apparent. With respect to trade in goods, the difficulties associated with the complexity of supply chains, and the challenge presented by rules of origin with respect to third countries, are a vivid illustration of the difficulty of maintaining European markets while pursuing an independent trade policy.

In services, the potential gains from liberalisation with non-EU members are predicated on rapidly negotiating agreements of unprecedented depth, something that is unlikely within the time-frame for Brexit, even with added transition arrangements. And that is of course assuming that EU trade partners would assent to a transition period, which they are unlikely to do without extracting a concession on, say, the Brexit bill to be paid by the UK – a fraught issue as it stands.

Both the economics and the politics of Brexit, therefore, are proving extremely complex, and the risk of complete breakdown in the negotiations remains high. The options may have become a little clearer, but they have not become any easier, and significant "unknowns" remain. Small wonder that some of Mrs May's Ministers told their party conference that the Brexit negotiating task is Britain's most difficult peacetime challenge ever.

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