Three *Trade*

With Brexit meaning Brexit and the Government preparing to invoke Article 50, *Ruth Lea* CBE Economic Adviser to the Arbuthnot Banking Group, looks at three potential models for post-Brexit UK trade.

Somewhat unexpectedly, 51.9% of the British electorate voted to leave the European Union on 23 June 2016, whilst 48.1% opted to remain. Though there are legal challenges to the referendum outcome, it is all but certain that Britain will leave the EU. As Prime Minister Theresa May has said: "Brexit means Brexit".

There are, of course, substantial political uncertainties surrounding Brexit. Not least of these uncertainties is when the British Government will decide to invoke Article 50 of the Lisbon Treaty, which will trigger the two-year period during which a new arrangement between the UK and EU is to be negotiated. We will have to wait. But it looks likely that Article 50 will be invoked sometime next year and "Brexit Day" will occur sometime in 2019. At the time of writing, moreover, it cannot be clear just how comprehensive the negotiations will prove to be or what specifically can be achieved during this period.

Trading options for the UK on Brexit

Putting aside the issue of what precisely may be negotiated by Brexit Day, it is worth noting that there are three frequently discussed trading options for Britain's new relationship with the EU.

The first option involves staying in the Single Market, with its "four freedoms" of goods, services, capital and people. Whilst the first three are relatively uncontroversial, the fourth is very controversial. In the absence of any major concession on freedom of movement of people by the EU (which should not be totally ruled out) and given the fact that the Leave campaign majored on the need to control immigration, it would be surprising if the UK stayed in the Single Market on Brexit. There are, however, some downsides to leaving the Single Market. Financial institutions located in London would lose the "passport" for example.[1] But it should be remembered that many countries, including the US and China to name but two, trade very successfully in goods and services with the EU and have free capital flows without being in the Single Market.

The second option is a negotiated, bespoke trade agreement for the UK. It would be beneficial if tariff-free goods trade with the EU could continue ("zero tariffs to zero tariffs"). And it would be beneficial if a "regulatory equivalence" regime for financial services, which would act much as "passporting" does now, could be agreed.

[1] *The 'passport' means that financial services firms authorised in the UK can provide their services across the EU/EEA (European Economic Area), without the need for further authorisations. The EU's financial services passport is currently only available to firms authorised in EU/EEA countries.*

It is sometimes claimed that the UK would be obliged to pay into the EU Budget and/or accept freedom of movement of people if there were a trade deal. But neither of these is necessary. Granted Norway and Switzerland contribute to EU programmes, but they do not pay into the EU Budget as they are not EU members. And the UK may or may not contribute to EU programmes after Brexit. Granted, too, Norway and Switzerland have freedom of movement of people (Norway because it is in the EEA and Switzerland has a bilateral agreement), but the EU has around 35 trade agreements with 3rd countries that do not involve freedom of movement. These agreements include those with Turkey, Korea, Mexico and Chile.

Another question that frequently arises is whether this British "bespoke deal" would be feasible if the UK were not prepared to "pay" for "access". But Britain has a huge trade deficit with the EU and, if UK-EU trade were disrupted on Brexit, it could be argued that some EU exporters could be more damaged than UK exporters. In 2015, the UK's visible trade deficit was nearly £90bn with the EU, of which £31.5bn was with Germany alone. And the UK had sizeable goods deficits with the Netherlands, Belgium, France, Italy and Spain. Britain is, therefore, in a good position to negotiate a successful deal, which would be in everyone's interests.

Concerning financial services, European financial institutions benefit from locating key global operations in London, Europe's undisputed premier global financial centre with an unrivalled talent pool and global reach in Europe. European financial institutions would, therefore, be commercially disadvantaged if their trading activities currently located in London were hampered and/ or disrupted after Brexit. It is in the commercial interests of these institutions, as well as the City's, that free trade continues. Significantly, "regulatory equivalence" should be all but automatic given the UK currently complies with EU regulations.

The third option would be trading under the World Trade Organisation (WTO) rules, without a specific trade agreement with the EU, as a default. But the UK would face the EU's Common External Tariff which is, for example, 10% for cars. Whilst the WTO option would be far from disastrous (EU-China trade flourishes under WTO rules) it is not optimal.

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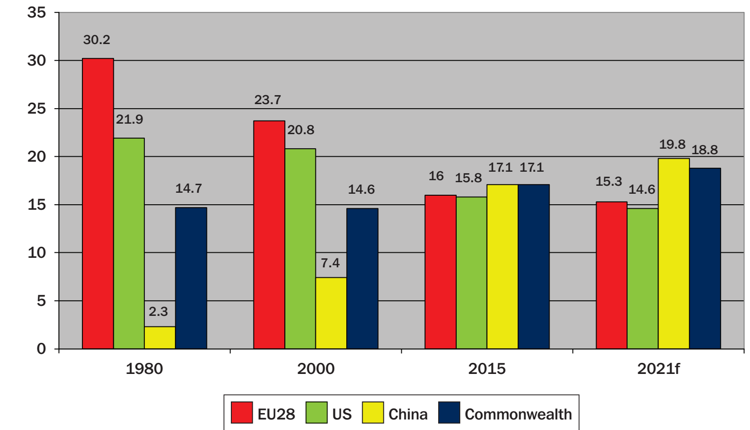
Chart 1a: Shares of world GDP (PPP terms), %



Source: *IMF, World Economic Outlook,* database, April 2016.

Leaving the EU's Customs Union: economic implications

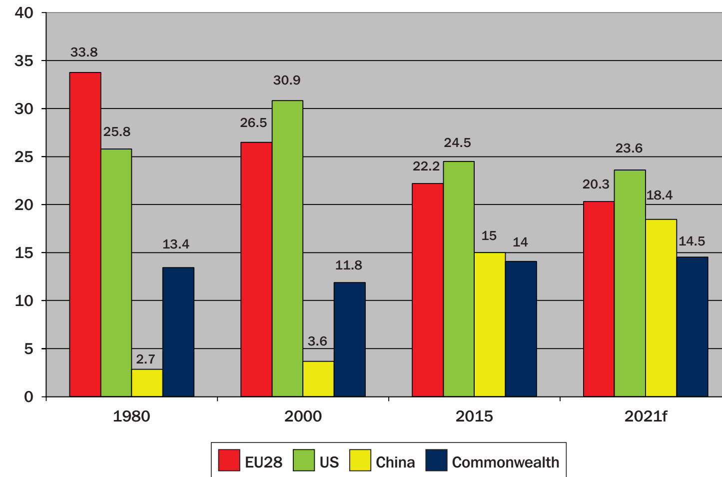
On Brexit, it is assumed that the UK would be leaving the EU's Customs Union. This has two major implications, both of which being potentially economically beneficial.

The first is that the UK will no longer be subject to the EU's Common External Tariff and will, therefore, be able to determine its own tariffs, though note they would have to be non-discriminatory between third countries under WTO rules. The EU has relatively high tariffs on agricultural products and clothing and footwear, as it seeks to protect these industries against low-cost producers. A future UK government could decide to slash the tariffs on these products, giving a boost to consumers, preferring instead to support its domestic producers directly.

The second implication is that the UK will be able to negotiate its own trade agreements with third countries, not least of all with the US, our single largest trading partner, instead of being reliant on the EU. And, more specifically, the UK will gain the freedom to recalibrate its future trading patterns towards the world's growth markets. Crucially, these growth areas include China and Commonwealth countries. The EU, in contrast, is expected to remain a relatively sluggish and declining part of the global economy.

Crystal ball gazing is a risky business. But, insofar as it shows the changing relative economic significance of the EU, the US, China and the Commonwealth, it is a useful exercise. Chart 1a above shows how the world economy has changed since 1980 in Purchasing Power Parities (PPPs) and is expected to change until 2021 (the final year of the IMF's current forecasts). In 1980, the EU28 countries accounted for over 30% of world GDP, whilst the US contributed nearly 22%, China just over 2% and the Commonwealth nearly 15%. By 2015, the EU28's share had dropped to 16%, a smidgen ahead of the US, whilst the Commonwealth had increased its share to 17%, on a par with China, which has shown simply staggering ►

Chart 1b: Shares of world GDP (MER terms), %



Source: *IMF, World Economic Outlook,* database, April 2016.

growth over the past 30 years. According to the IMF, China and the Commonwealth will continue to pull ahead, not least of all because of the expected buoyant growth in India within the Commonwealth.

The PPP data, of course, are just one way of measuring GDP. The other measure is in market exchange rates (MERs, chart 1b above). They both have strengths and weaknesses. PPP data allow for the relative prices of goods and services (particularly non-tradeables) within an economy and are, therefore, the better overall measures of the internal, domestic "purchasing power" in a country. But MER GDP data provide a better measure of a country's international purchasing power, so relevant for international trade, than PPPs. MER data have, of course, the disadvantage of being subject to exchange rate fluctuations. And exchange rates can fluctuate wildly. Currencies can, for example, be "overvalued" or "undervalued" for considerable periods of time. Chart 1b shows that a strong US dollar in 2000 noticeably "boosted" the US's share in MER terms.

Putting aside the caveats, it is clear that the EU28's relative global significance has dropped dramatically in MER terms, as well as in PPP terms. In 1980, the EU28 accounted for over a third of the world's GDP; by 2015 its share was 22% and the IMF forecasts its share to be about a fifth by 2021. China's share in MER terms has risen almost as quickly as in PPP terms. But the improvement in the Commonwealth's position between 2000 and 2021 looks more muted. Nevertheless, it is, crucially, improving.

Trading relationships and Brexit: two final thoughts

Whilst on the subject of trading relationships, there are two other issues to be kept in mind, one a reassurance and one an opportunity. Firstly, the point of reassurance. The EU has a suite of trade agreements with third countries. But these could continue for the UK and the third countries on Brexit, providing there was mutual agreement. The trade deals are, however, not economically important except for Switzerland, Norway, Korea and Turkey. And, secondly, Brexit affords the UK the opportunity of applying to re-join the European Free Trade Association (EFTA), which comprises Switzerland, Norway, Iceland and Liechtenstein. Not merely would this be mutually beneficial in itself, but the UK could also have access to EFTA's set of trade agreements. Interestingly, EFTA's trade agreements are more comprehensive and more in tune with the UK's trading patterns than the EU's.

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