Institute for Fiscal Studies

Free trade agreements and the implications of Brexit for the UK

Ian Mitchell, Research Associate

ian_m@ifs.org.uk

@EconMitch

Presentation to APPG for Social Science and Policy

1 November 2016

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

Outline

I. Economics of Brexit
II. UK trade overview
III. EU trade post-Brexit
IV. Trade beyond the EU (inc EFTA and Emerging markets)
V. 10 conclusions/ take-aways
VI. Background material

Based on the following IFS reports:

1) Brexit and the UK's public finances, June 2016

https://www.ifs.org.uk/uploads/publications/comms/r116.pdf

2) The EU Single Market: Value of Membership vs Access, Aug 2016

https://www.ifs.org.uk/uploads/publications/comms/R119%20-%20The%20EU%20Single%20market%20-%20Final.pdf

Part I

ECONOMICS OF BREXIT

Overview of long-term Brexit macro-impacts

Issue	Uncertainty in estimates	Magnitude of GDP Impact
Budget	Low	<0.5%
Trade	Low	>1%
Trade openness & productivity	High	>1%
Foreign direct investment (FDI)	Low	<0.5%
FDI and productivity	Medium	<1%
Regulation	Medium	<1%
Migration	High	<1%

Source - Authors assessment, see table 5.1 pg30, EU Single Market, Aug 16 report
Note – this refers to an FTA scenario vs EU membership in 2030

Institute for Fiscal Studies

Economics of Brexit

- Budgetary savings of circa £8bn/ year would be wiped out if national income (GDP) is just 0.6% lower
- Trade is the largest and most important impact
- Regulation and Migration are relatively small in comparison
- Depending on the exit scenario, GDP in 2030 to be, roughly, over 2% lower (than it would have been), and plausibly could be something like 7% lower
- Uncertainty plays a role – story so far is of similar or slightly slowed growth vs. pre-Brexit – but means little in terms of longer-term impact

Part II

UK TRADE OVERVIEW

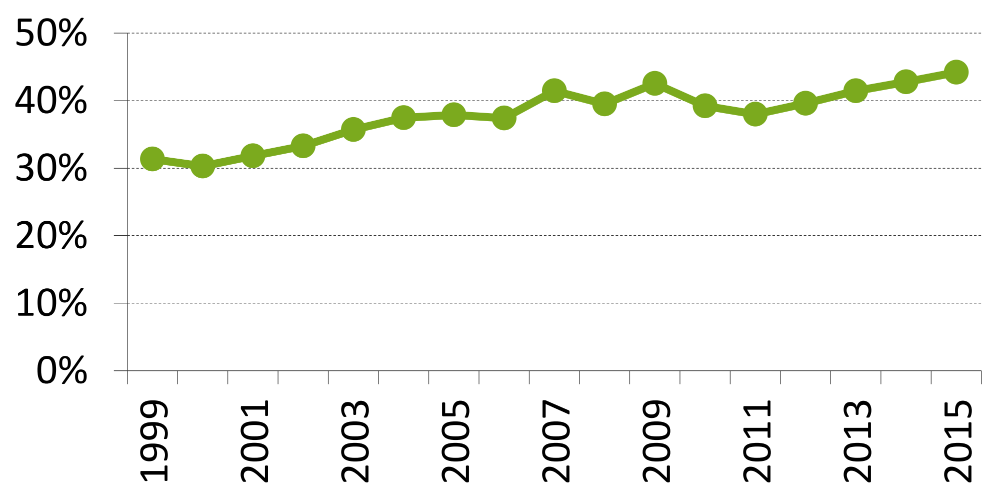
EU's economic size and proximity make it our most important market

UK trade value and EU share, 2015

	Exports		Imports	
	£bn	Share	£bn	Share
EU	223	44%	291	53%
US	95	19%	60	11%
Rest of the world	193	38%	197	36%
Total	511	100%	548	100%

Note: Shares may not sum due to rounding.
Source: Bank of England, 2016.

UK service exports as a percentage of total exports

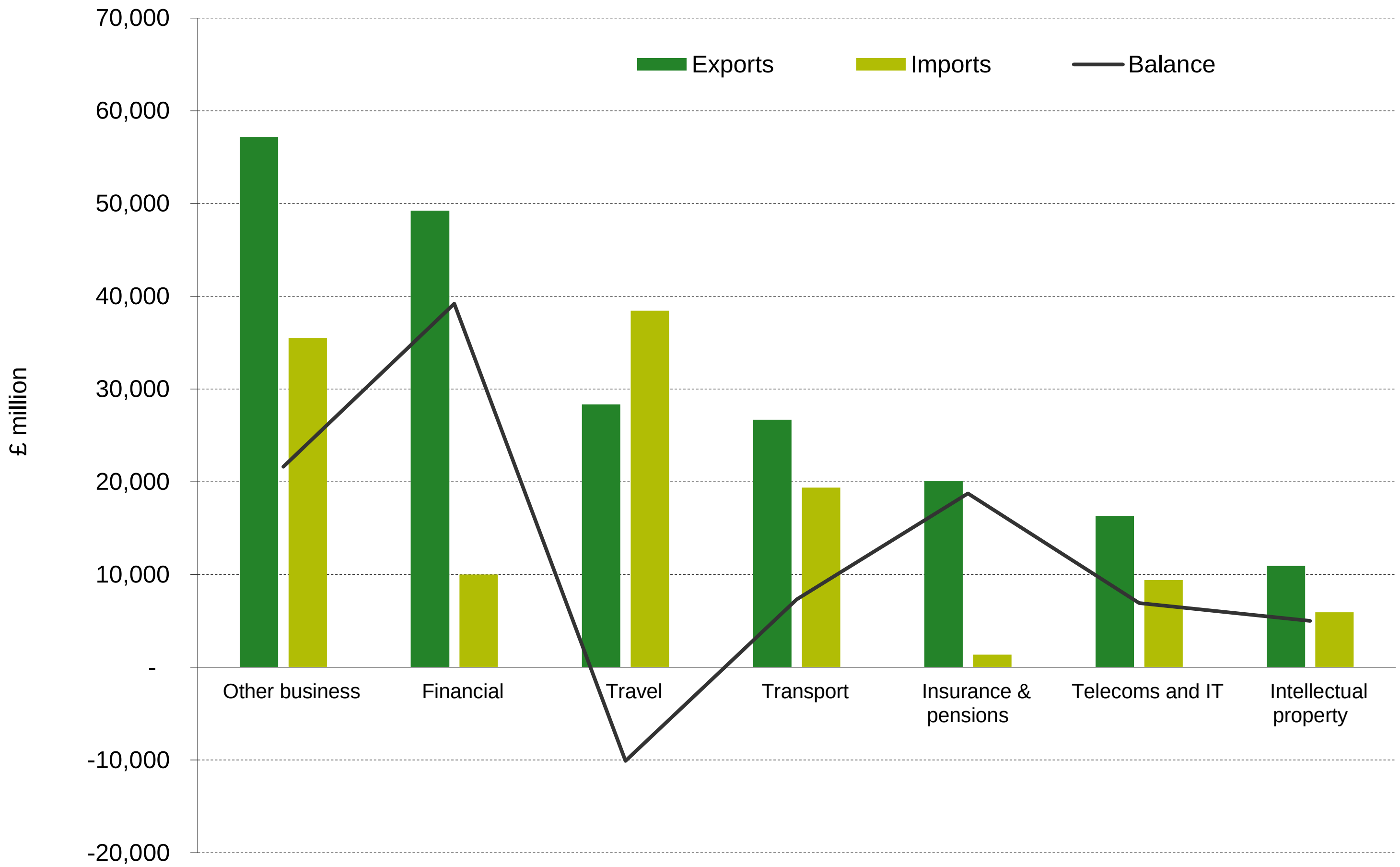


- Service exports of growing importance
- 'Tariffs' largely irrelevant for services
- Non-tariff barriers (licensing, standards, regulation) are key

Institute for Fiscal Studies

Business and financial services generate a substantial trade ‘surplus’

Largest trading service sectors, 2014



Note: Sectors importing or exporting over £5 billion.
Source: Authors’ calculations using ONS Pink Book 2015 data,

Institute for Fiscal Studies

UK Trade Overview

- EU our major trade partner and the starting point for trade impacts
- US by far our next most important market (19% of exports). After that, Switzerland, China and Japan (each under 4% of exports)
- Services account for almost 45% of exports, up from 30% in 2000.
  - Create a significant ‘trade surplus’ ie help balance out goods ‘deficit’
  - UK service exports were third largest in world in 2010 (BIS)
- For services, “non-tariff” barriers are what matter.
  - Non-tariff barriers include licensing, standards, regulations
  - Reducing non-tariff barriers involves mutual recognition of regulations, or agreeing common regulation (ie giving up some sovereignty)
- Brazil, Russia, India and China together account for around 6.2% of all UK exports (less than 5% of service exports)

Part III

EU TRADE POST-BREXIT

EU Single Market: Membership versus Access

- ‘Access’ is virtually meaningless as a concept
  - Any country in the World Trade Organisation (WTO) – from Afghanistan to Zimbabwe – has ‘access’ to the EU
  - Membership by contrast involves elimination of barriers in a way that no existing trade deal, customs union or free trade area achieves
- Financial Services ‘passporting’ is an example within Membership
  - UK-based financial firms can service EU businesses and customers directly (and vice versa).
- The European Economic Area (EEA) would maintain near-full membership but at the potential cost of submitting to future regulations designed in the EU without input from the UK.

Scenarios outside the EU

- Customs Union (like Turkey?)
  - Member of customs union, imports at EU rates but unable to strike separate trade deals
  - Unclear whether this would include single market membership
- European Economic Area (e.g. Norway)
  - Membership of the single market, virtually no tariffs, potential access to EFTA (but not EU) trade agreements
  - Contribution to EU budget, accept regulations and free movement, customs barriers
- Trade deal like Switzerland
  - Limited tariffs, some special access to single market, EFTA (not EU) trade agreements
  - (smaller) contribution, less access to single market, some regulation, free movement
- Trade deal like Canada
  - Reduced tariffs on a wide range of goods, freedom to agree other FTAs, some access on services, no special access to benefits of single market
- WTO rules
  - Face full EU external tariffs, full freedom

Institute for Fiscal Studies

Brexit scenarios and trade costs

✓ Yes

+ Reduced

✗ No

	WTO	FTA	EEA	CU	EU
	Are trade costs avoided?				
Trade tariffs and quotas	✗	+	+	✓	✓
Customs checks and costs	✗	✗	✗	✓	✓
Non-tariff measures (NTMs)	✗	+	✓	?	✓
Cultural and transport costs	✗	✗	✗	✗	✗

Note – see Table 3.2 in full report - EEA's near-full membership of the Single Market effectively eliminates non-tariff measures in the same way as the EU, and reduces tariff measures to zero except in agriculture and fisheries

Modelling the options

- Only a small number of studies looked at these options (HMT, NIESR, LSE). Some differences in assumptions but:
- Cleary hierarchy – EEA strongest and WTO weakest
- Single Market membership in an EEA scenario worth maybe 4% to GDP in 2030 relative to WTO
- ‘FTA’ in between these – and dependent on assumptions about degree to which tariff and non-tariff barriers are lowered

Part IV

TRADE BEYOND THE EU

Institute for Fiscal Studies

Trade options

- All options would enable the UK to strike its own trade deals (except the Customs Union)

- V. limited research on the <u>future</u> potential of non-EU trade (forward looking 'gravity models' needed) so some indicative analysis here:

  - First, value to UK of 'grandfathering' existing EU trade deals, or (re)joining the "European Free Trade Association" (EFTA)

  - Second, what is the potential of deals with emerging markets?

Existing EU and EFTA Trade Deals

<u>All **EU** trade deals</u>

33 deals

57 countries (excluding EU–EFTA)

8.6% of global GDP

12.0% of global population

Over 4.8% of UK exports

<u>All **EFTA** trade deals</u>

28 deals

38 countries (exc EU–EFTA)

13.1% of global GDP

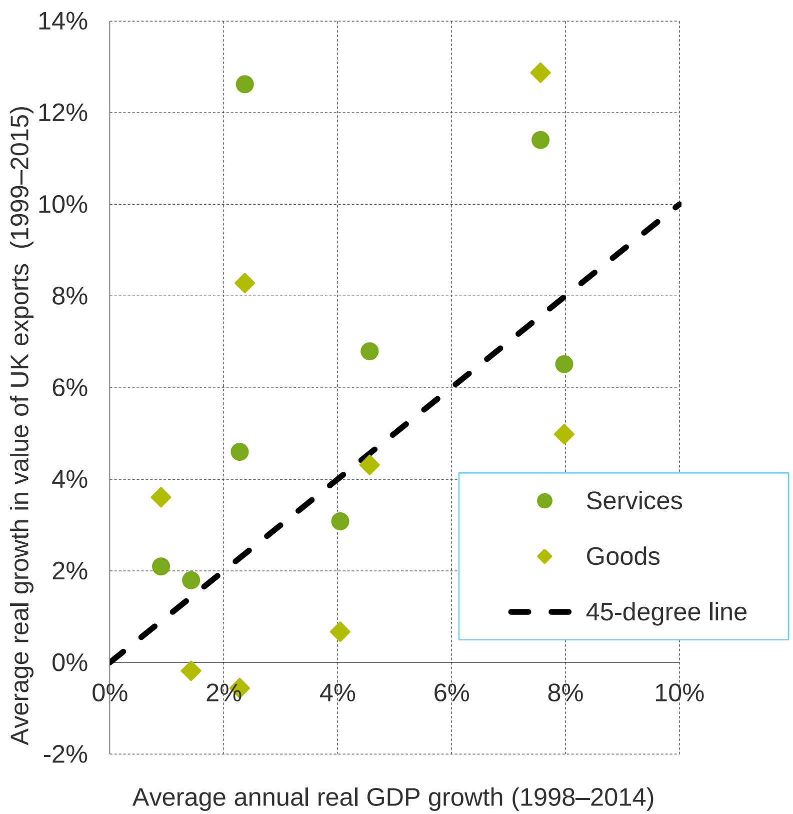
11.8% of global popn

Over 10.0% of UK exports

Note – see Figure 4.1 in Single Market report for full discussion and limitations of this chart. Also see background info (below) for actual country coverage

Emerging markets potential

Growth in UK exports and recipient GDP for the top 10 export destinations since the late 1990s

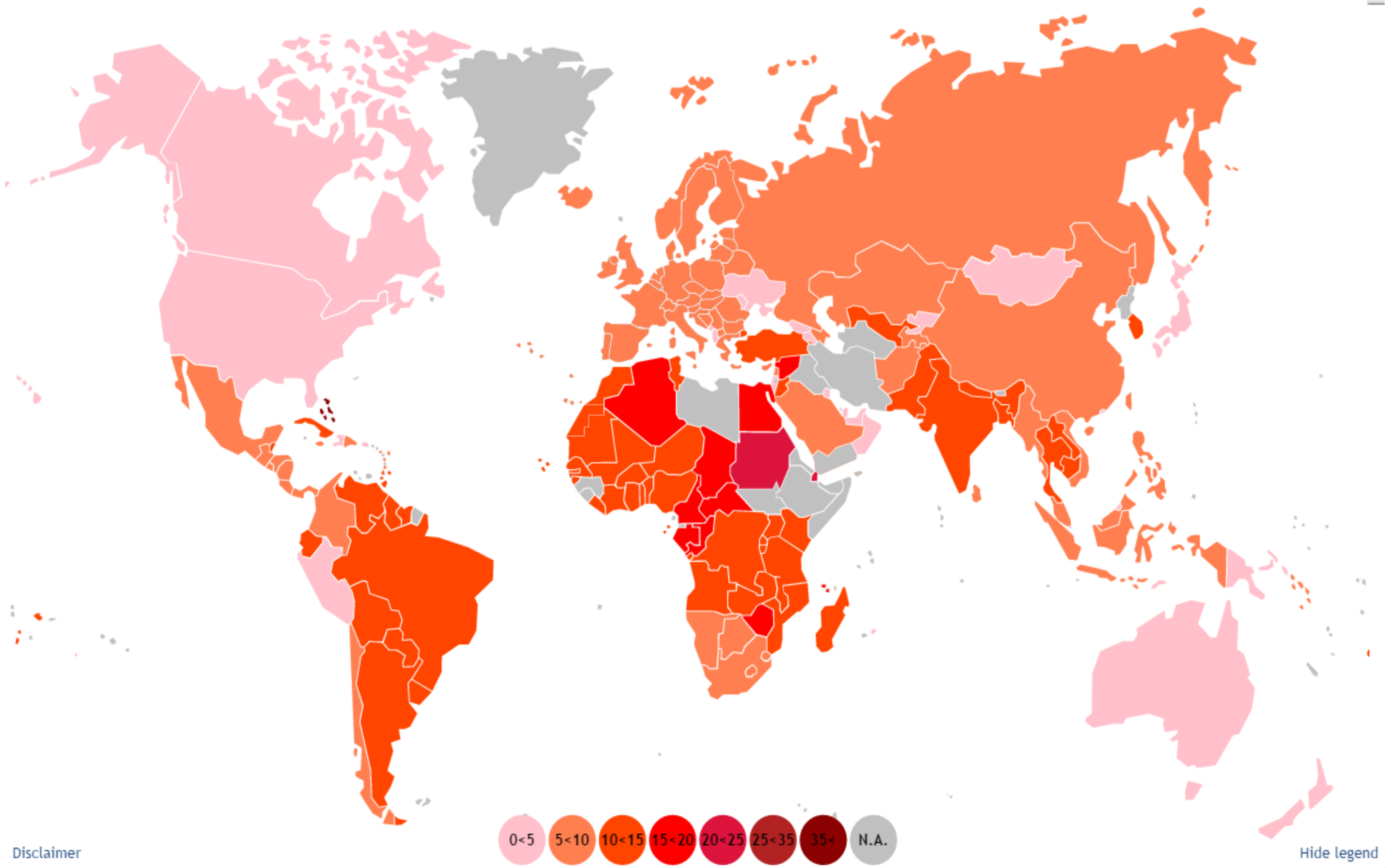


- The UK could strike trade deals with other countries, including emerging economic powers
- Chart suggests that export growth related to destination GDP growth
- Trade with emerging markets starts from a low base, largely reflecting their distance and relatively small economies
- China and India together accounted for 4.6% of all exports, and 2.6% on services

Institute for Fiscal Studies

Trade deals can reduce WTO goods tariffs

Simple average applied (MFN) tariff (all products)



Potential Growth in Trade with China

- Chinese tariffs average 9.6% - trade deals that reduced this could *accelerate* trade growth but perhaps not transformationally.
  - If exports to China grew very rapidly at 10%/ year to 2030, exports would reach around a third of <u>current</u> EU levels (two thirds of current US).
  - Trade deals typically do little for services exports unless they involve mutual regulation or recognition (ie giving up sovereignty in some way)
  - A deal with China would also mean reducing tariffs faced by Chinese imports – political issues given example of Steel and Port Talbot?
- Overall – even small proportionate losses in trade (or lost growth in trade) with the EU would require quite dramatic – and probably implausible – increases in trade with countries like China

V. Overall conclusions and take aways

1. Brexit very likely to have a negative impact on public finances
2. EU will remain our most important trade partner and trade agreement will largely shape the economic impact of Brexit
3. The UK is a world leader in services exports
4. Membership of the Single Market is economically valuable
5. Trade deals can cover services…..
6. …..but then involve mutual agreement on standards and regulations (ie sharing sovereignty/ control)
7. Some policy opportunities: Agriculture; Trade for Development
8. EU or EFTA trade deals with third countries are valuable
9. Research needed on UK's future trade patterns
10. Emerging markets will be important but unlikely to be transformational

Institute for Fiscal Studies

VI. BACKGROUND MATERIAL

Overview of long-term Brexit macro-impacts (FTA scenario, 2030)

Issue	Uncertainty in estimates	Magnitude of GDP Impact	Summary assessment
Budget	Low	Small <0.5%	If the UK does not join the EEA, there would be direct budgetary savings of 0.4% of GDP.
Trade	Low	Large >1%	Robust estimates suggest reduced trade, with NIESR suggesting a central estimate of just greater than –1.8%.
Trade openness & productivity	High	Large >1%	Strong link between trade openness and productivity but little UK-specific evidence. Still, this represents a significant downside risk which HM Treasury not implausibly estimates at around –4.5%.
Foreign direct investment (FDI)	Low	Small <0.5%	Wide agreement on impact on FDI flows with a direct knock-on to GDP which NIESR estimates at just greater than –0.2%.
FDI and productivity	Medium	Med <1%	Evidence that FDI improves productivity – a downside risk which HMT estimates would be –0.7%.
Regulation	Medium	Med <1%	UK lightly regulated but scope for some net benefits, contributing perhaps +0.3% (OECD) to +0.7% (Open Europe).
Migration	High	Med <1%	Significant reductions in migration are a downside risk, which PwC estimates at –0.7%. Also the possibility of improving skills mix of migrants, which could have a smaller but unquantified positive impact.
Overall impact			NIESR's estimates of uncertainty, budget savings, trade and FDI impacts suggest GDP would be 2.1% lower. There is more uncertainty over the other impacts. OECD and Open Europe highlight upside risks of improvements to regulation, and perhaps migration, but these seem unlikely to exceed 1% of GDP. The downside risks are more significant – if trade or investment falls affect UK productivity, then GDP could plausibly fall by a further 5%.

Source - See Table 5.1 pg30, EU Single Market, Aug 16 report

EU only	EU & EFTA	EFTA only
Europe & Central Asia • Kosovo • Faroe Islands • San Marino • Andorra	• **Turkey** • Bosnia & Herzegovina • Serbia • Ukraine • Montenegro • Albania • Macedonia	• Georgia
Americas • Ecuador • Central American States (El Salvador, Honduras & Nicaragua)[a] • CARIFORUM States • (15 Caribbean & the Dominican Republic)	• **Mexico** • Chile • Colombia • Peru • Some Central American States (Costa Rica, Guatemala & Panama)	• **Canada**
Middle East & Mediterranean • Algeria • Syria • Iraq	• Egypt • Lebanon • Jordan • Israel • Morocco • Tunisia • Palestinian Authority	• Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, **Saudi Arabia** & the United Arab Emirates)
South and East Asia	• **South Korea**	• Hong Kong • Singapore • Philippines
Africa & other • Cameroon • Papua New Guinea & Fiji • Madagascar, Mauritius, the Seychelles & Zimbabwe	• South Africa	• Southern African Customs Union (Botswana, Lesotho, Namibia & Swaziland)[b]
<u>EU only</u> 13 deals, 34 countries <u>EU total</u> 33 deals, 57 countries	Both – 23 countries	<u>EFTA only</u> 7 deals, 15 countries <u>EFTA total</u> 28 deals, 38 countries

Country coverage of EU and EFTA trade deals

Bolded countries are 'large' (account >1% of Global GDP)

See appendix B p 41 in Single Market report for full notes