CONTINENTAL BREAKFASTS

The LSE Continental breakfasts are one element of a wider academic programme that aims to understand and inform the process of agreeing Britain's future relationship with the rest of Europe. The breakfasts are private, off-the-record meetings for a select group of distinguished individuals from around the world. They bring together LSE's most renowned academic experts with a diverse group of insightful and influential people to explore key issues shaping the European political landscape.

Meetings are held under Chatham House rules, so that opinions expressed may be reported but not attributed. These seminar-style events typically open with short presentations from two experts, one of which is usually a member of the LSE faculty, followed by open discussion among the group.

In these write-ups, issues raised in the discussions are collected into an essay including references to relevant research and exploring some questions in more depth. The authors are encouraged to elaborate and reflect, so they should not be read as an unvarnished record of the discussion.

Britain's future trade relationships

(London April 5, 2017. written up by Chrysa Papalexatou)

"Above all, UK companies need to know as soon as possible about the UK's future trading relationships."

Josh Hardie, CBI Deputy Director-General

At the start of the BREXIT negotiations, the UK's preferred outcome remains unclear, at least in any depth. The outcome of the 2017 General Election has only added to the confusion, seemingly re-balancing the contending forces behind 'softer' or 'harder' forms of BREXIT. The seminar – held before the election – addressed the issues that loom on what kind of trade deal the UK should seek, its preparedness for doing so, and the issues to be addressed in determining its preferences. What opportunities or threats open up to the UK?

Having not negotiated any trade agreements since joining the EU in 1973, the UK will find itself in the position of having to sign 295 trade deals just to maintain its current trading relationships.[i] If the UK's new relationship with the EU results in a reduction in trade across the Channel, then it will need to find new trading partners to make up the difference. How will the current international trade and investment system and domestic political constraints shape the future of post–Brexit trade?, and how will that in turn shape domestic politics?

International trade today

In the numerous discussions on trade before and since the referendum, much of the focus has been on tariffs, which is to ignore the nature of today's international trade system. As Bishop (2017)[ii] suggests it seems that some politicians believe trade is all about finished goods going back and forth between countries. According to UNCTAD (2013)[iii] 80% of trade takes place in 'value chains' linked to transnational corporations. Most international trade is not shaped by the multilateral agreements on tariffs, but by preferential trade agreements between the biggest markets (EU, US, China and Japan) which aim at reducing costs related to non-tariff barriers (Woolcock, 2015)[iv].

Thus, contemporary trade negotiations have little to do with freeing trade in the classical sense of the word, and the challenging purpose of a trade agreement today is rather to reduce these non-tariff related costs while simultaneously ensuring that legitimate public policy objectives pursued through regulation are safeguarded. In other words the content of trade negotiations and agreements today is as much, if not more, about rules that facilitate trade and investment by reducing regulatory incompatibility and duplication. It is in this sense that the EU Single Market needs to be understood. It is the most advanced form of rules that ensure such a balance between commercial and social, environmental and other legitimate policy objectives. Rather than restricting trade, EU rules facilitate trade and investment.

In leaving the EU, UK policy makers must define what new balance between commercial and social/environmental policy objectives is in the national interest.

In today's trading system, as production and investment undergo further globalisation and e-commerce gives smaller companies access to the international arena, this implies that for companies to be competitive in international markets, trade costs related to non-tariffs are, and will continue to be, of major relevance (Woolcock, 2015)[v]. These costs are often related to meeting the regulatory standards in the export markets. The more different these standards are, both from each other and from the domestic standards, the more expensive it is to comply. Trade agreements therefore include provisions on 'regulatory equivalence' which set certain regulatory parameters that constrain domestic policy. Trade then tends to flow more freely among groups of countries with similar regulatory standards, who may find it easier to reach agreement. Multilateral negotiations generally try to strike a balance between reducing these non-tariff barriers and leaving room for national governments to pursue their own legitimate domestic public policy.

Outside the single market and the customs union, some immediate costs of doing business with the EU will emerge, such as the costs of border controls (i.e. customs clearance, border checks, rules of origin costs). Thus, companies based in the UK will not have guaranteed access to EU (or other) markets and could face high costs related to non-tariff barriers. One of the main reasons that the UK has been attractive to foreign companies is that it acts as an export platform to the rest of the EU, and leaving means that this position is under threat. This matters because foreign multinationals tend to be highly-productive firms and they bring new technologies and management skills with them (Bloom et al, 2012)[vi]. At the same time, globalised networks nowadays allow companies to relocate their activity or investment quite easily, and market access can therefore be the driving factor in where firms choose to locate production.

Moreover, outside the EU, the UK will no longer be part of the group which currently plays a major role in shaping these international rules, and would have to follow rules set by the EU and other major economies in order for UK-based companies to compete in the global economy. More simply, the UK is facing the danger of becoming a "rule taker" rather than a "rule maker" in the international trade arena (Woolcock, 2015)[vii]. Even were the UK to maintain full access to the single market, it would be in a similar position as Switzerland, whose exports have to obey EU regulations, but does not have a seat at the table when those regulations are decided (Dhingra and Sampson, 2015)[viii].

In order for UK exports to continue to meet the standards that are required for access to these foreign markets, the UK will have to either remain within the jurisdiction, or duplicate the work of no fewer than 34 European regulators, covering areas such as agriculture, energy, transport and communications. There are already growing concerns from many industries about how to avoid a "cliff edge" scenario where companies are unsure what or how regulation applies to them (CBI, 2017)[ix]. If the UK signs new trade agreements with trading partners with lighter regulatory standards, then companies may not be able to use components from these countries in goods they export to the EU. Also, if the UK maintains regulatory standards that are more costly than those of their new trading partners, then UK producers may find themselves at a competitive disadvantage.

UK and its trading partners

In 2015 44% of total UK exports of goods and services went to the EU and 53% of total UK imports came from the EU. The 50 countries with which the EU currently has FTAs in 2015 accounted for 13% of the UK's trade. This rises to 25% when including countries with which the EU is currently negotiating (excluding the US). In 2015, 20% of total UK exports of goods and services went to the US and 11% of imports came from the US. 8% of UK exports went to the BRICS and 11% of imports came from the BRICS. 9.5 % of UK exports were destined to Commonwealth countries while 8% came from the Commonwealth. Regarding Foreign Direct Investment (FDI), the EU provides 54%, US 32%, BRICS, excepting Hong Kong, 1.6%. Of the outward FDI 43% goes to the EU, 23% to the US and 5% to the BRICS.

While these ratios are likely to change over time especially given Brexit, they indicate clearly that the EU and US together account for over 60% of UK's export market and constitute the core of the UK'S trading relationships.[x] The UK has more trade outside the EU than other EU countries, and so may be better placed to adjust to leaving the block than would be other member states. However, even in the most optimistic scenarios, it would be a very long time before trading relationships with the Commonwealth or the BRICS could offset a significant reduction in UK trade with the EU. Furthermore, many of these countries – 32 members of the Commonwealth – already have trade agreements with the EU, so unless new agreements are quickly organised, then the UK could find itself with less favourable trading terms with those countries than before it left the EU.

Sampson (2017)[xi] argues that the purpose of trade agreements is to make all parties better off through governments agreeing to refrain from adopting 'beggar-thy-neighbour' policies which benefit their own economy only because they hurt other countries. Trade negotiations are not about countries identifying a common objective and working together to achieve it, they are a bargain between countries with competing objectives. One of the main arguments of the Brexit campaigners was that the UK has the ability to negotiate its own trade agreements more quickly than the EU. It is true that small countries such as the EFTA countries can negotiate agreements more quickly than the EU, however this is usually at the expense of a good agreement since very unequal negotiations tend to be over quickly and have unequal outcomes.[xii] Bargaining power affects the outcome of trade negotiations. The statistics above clearly indicate that the UK starts from a weaker position than the EU since EU-UK trade accounts for a much larger share of the UK's economy. At the same time, from the EU side one of the major priorities would be to preserve the unity of 27, ensuring that the UK does not gain from leaving by freeriding on the benefits of trade without contributing to the costs that make the single market work, or undermining EU regulatory standards.

Given this complexity, it is not yet clear how the Government will approach these trade negotiations. The white paper mentions sectoral agreements and there are obvious sectors that are at the top of the list, such as financial services or automotive exports. However this approach may be problematic, both because the EU may resist it and because of the complex level of interconnectedness among sectors.

How different business sectors are affected will be determined by both the trade settlement and the government's policy response, but certain sectors are more at risk. Among service sectors, the financial services industry is most at risk.[xiii] Concerns, have also been expressed about the construction sector where a future depreciation of sterling that may help exporters in the manufacturing sector, could also increase the cost of inputs for the construction sector making projects more expensive.[xiv]

There are opposing views coming from the Brexit campaigners who suggest that the UK will not face substantially higher trade barriers leaving the single market. The EU is considered to have a relatively liberal trade regime with low external tariffs. Even if the UK faces additional barriers – such as new customs requirements and certificates of origin – the costs could still be relatively small. Gross (2016)[xv] argues that Switzerland – which is even more integrated into EU production chains than the UK – shows that efficient customs administrations on both sides are enough to keep such barriers to a minimum.

<u>Trade with the US</u>

The Office for National Statistics reported that the UK runs an overall trade surplus with the US[xvi], which according to the Financial Times is of about £14bn annually, exporting mainly pharmaceuticals and cars[xvii]. With President Donald Trump considering the reduction of US trade deficits a priority, this would imply that a good deal for the UK would pose a challenge. However according to the US Department of Commerce, the UK in fact has a trade deficit with the US.[xviii]

Secondly, a US-UK deal will only be possible when the UK leaves the EU and has its own external trade policy, which is supposed to be by the end of March 2019. US negotiators would want to know what kind of a trading relationship the UK will have with the EU, making a quick and easy US-UK trade deal unlikely. The UK priority will not be tariff-reduction but improved market access for services and investment, as well as enhanced mutual recognition of standards, qualifications and regulations. However, the question is, given the UK is the smaller market and the weaker party, whether the US will ask a lot (e.g. business opportunities for the US companies in the UK National Health service, access to British food and animal feed market for US farmers who are allowed to use GM crops etc.) and give little.

Another priority that the UK should address is new deals with the countries with which the EU already has an FTA. However, it is not clear whether these countries will be willing to replicate the terms of the EU FTA, because they might expect to get a better deal with the UK than the one they managed to negotiate with the EU. Simon Hix and Hae-Won Jun (2017)[xix] examine exactly this question using the example of South Korea, suggesting that Seoul might feel it could improve on the terms of the EU-South Korea agreement (given that the EU has an economy 10 times larger than South Korea, whereas the UK economy is only twice the size of South Korea). The fact that the UK may be impatient to conclude such deals may also put it at a disadvantage.

One of the main arguments of the "liberal leavers" in the Brexit campaign was that membership of the EU constrains the UK's ability to expand its trade links with the rest of the world, both with the big emerging markets, notably China and India but also with the Commonwealth (Murray- Evans, 2016)[xx]. One of the reasons behind this argument is that in the last few decades the UK has seen its exports to non-EU countries growing faster than those within the EU (Lea, 2016)[xxi]. Nonetheless, new opportunities, even when they do arise, may take a long time. For example, it took Australia ten years to agree an FTA with China and India, and six years to get a deal with ASEAN.

Bringing the politics in

Even if -hypothetically speaking- the UK were able to achieve the "optimal" deals, would this be achievable given the domestic political constraints?

Attitudes towards free trade are changing, not in countries which have been traditionally protectionist, but in countries which have embraced globalisation. Trade liberalisation is no longer the engine of global growth that it was before the financial crisis. The rise of xenophobic sentiment and the reversal of public opinion towards free trade has stimulated academic and political debate. Some social groups or geographic areas are worse off as a result of globalisation, and this is thought to influence their voting behaviour. Colantone and Stanig, (2016)[xxii] suggest that globalisation, and in particular the Chinese import shock, was a key driver of the vote for Brexit.

According to Sacks (2016)[xxiii] Brexit reflects a widespread phenomenon in the advanced world-- rising support for populist parties campaigning for a clampdown on immigration. As he states "*Roughly half the population in Europe and the United States, generally working-class voters, believes that immigration is out of control, posing a threat to public order and cultural norms.*"

As Gross (2016) underlined, many Brexit voters clearly wanted to impose controls on the movement of workers from the rest of the EU without losing access to the single market. Many leaders of the "Leave" campaign were promising this kind of deal prior to the referendum. What appears clear is that access to the single market is linked to free movement of people. There seems to be a contradiction in what many see as the motivations for the vote to leave the EU, which were protests against some of the consequences of an openness to the world, and the claims by many of the "Leave" campaigners and the new government that Brexit will make the UK more open.

The UK has been a rhetorical advocate of free trade, but as a member of the EU, it has not had to make the political decisions on which sectors of the economy to prioritise in its trade policy, and by implication, which geographical regions. It will now have to make these decisions, and national politicians will have to take responsibility for them. Furthermore, without being able to advocate through the EU, will the UK have less influence over the international trading system, which seems to be retreating from the rules-based multilateral agenda on which the UK outside the EU would rely?

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[x] Simon Fraser's (2017) Tacitus lecture: *The world is our Oyster? Britain's Future Trade relationships* http://www.flint-global.com/wp-content/uploads/Tacitus-Lecture-2017.pdf (accessed May 2017)

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UK construction bounces back after Brexit shock OCTOBER 4, 2016 by Gemma Tetlow
https://www.ft.com/content/cb0e61fc-8a0f-11e6-8aa5-f79f5696c731
Construction industry hesitant ahead of Brexit vote APRIL 4, 2016 by: Emily Cadman
https://www.ft.com/content/fb3e6020-fa45-11e5-8f41-df5bda8beb40
UK construction suffers worst quarter in four years after Brexit vote NOVEMBER 11, 2016 by: Mehreen Khan
https://www.ft.com/content/ae60177e-c922-3a68-9e1a-c95364f148e2

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[xvi] *UK Perspectives 2016: Trade with the EU and beyond* 25 May 2016 By ONS Digital
http://visual.ons.gov.uk/uk-perspectives-2016-trade-with-the-eu-and-beyond/ (date accessed May 2017)

[xvii] Financial Times *UK faces struggle to redesign trade relationships, in charts* FEBRUARY 3, 2017 by: Valentina Romei https://www.ft.com/content/37aa67a0-e94e-11e6-893c-082c54a7f539 (date accessed 30 April 2017)

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[xxiii] Sacks J. (2016) The Meaning of Brexit. Project Syndicate JUN 25, 2016 available on line: https://www.project-syndicate.org/commentary/meaning-of-brexit-by-jeffrey-d-sachs-2016-06 (date accessed 26 April 2016)