Brexit and Trade Choices in Europe and Beyond

Session 1: A Framework for Evaluating Policy Directions for the National Benefit

Towards a Framework for Trade and Investment Policy in post-Brexit United Kingdom

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Outline

- The broad trade and investment framework options
- What economic modelling can reveal about the options
  - Adjustment of tariffs
  - Affecting broader costs and benefits
- A new statutory national review institution could have merit
- Summing up

1 Introduction

- UK has enjoyed rapid growth in living standards while a member of the EU
- Growth has been supported partly by preferential access to evolving European markets and partly by domestic reform efforts
  - The period of growth came to an end, at least temporarily, with the GCF
- How UK positions itself in trade policy will be material for future growth
  - Without preferential access to EU markets, UKs future will depend on its capabilities in global markets
  - With preferential access to EU markets, UK prospects would depend more heavily on its capabilities in that market

Trade policy options

- No end in sight to the conclusion of the Doha Round
- There appear to be three policy options
    - (i) Seeking to remain in the EU customs union and/or the Single Market
    - (ii) Withdrawing into a more protectionist environment vis a vis Europe but seeking the exchange of trade preferences with selected partners
    - (iii) Shifting to a more open trading environment in which UK unilaterally opens its external borders, both towards Europe and elsewhere - the unilateral MFN option
- Our bottom line: we suggest option (ii) is problematic – negotiating times substantial, outcomes uncertain, there are rules of origin penalties and regulatory costs, and possible effects on reform efforts and so productivity
    - May be necessary to consider (iii) or reconsider option (i)
    - We recognise that all options will be overlaid with political economy considerations and – in particular – that options (ii) and (iii) will confront the Irish border issue

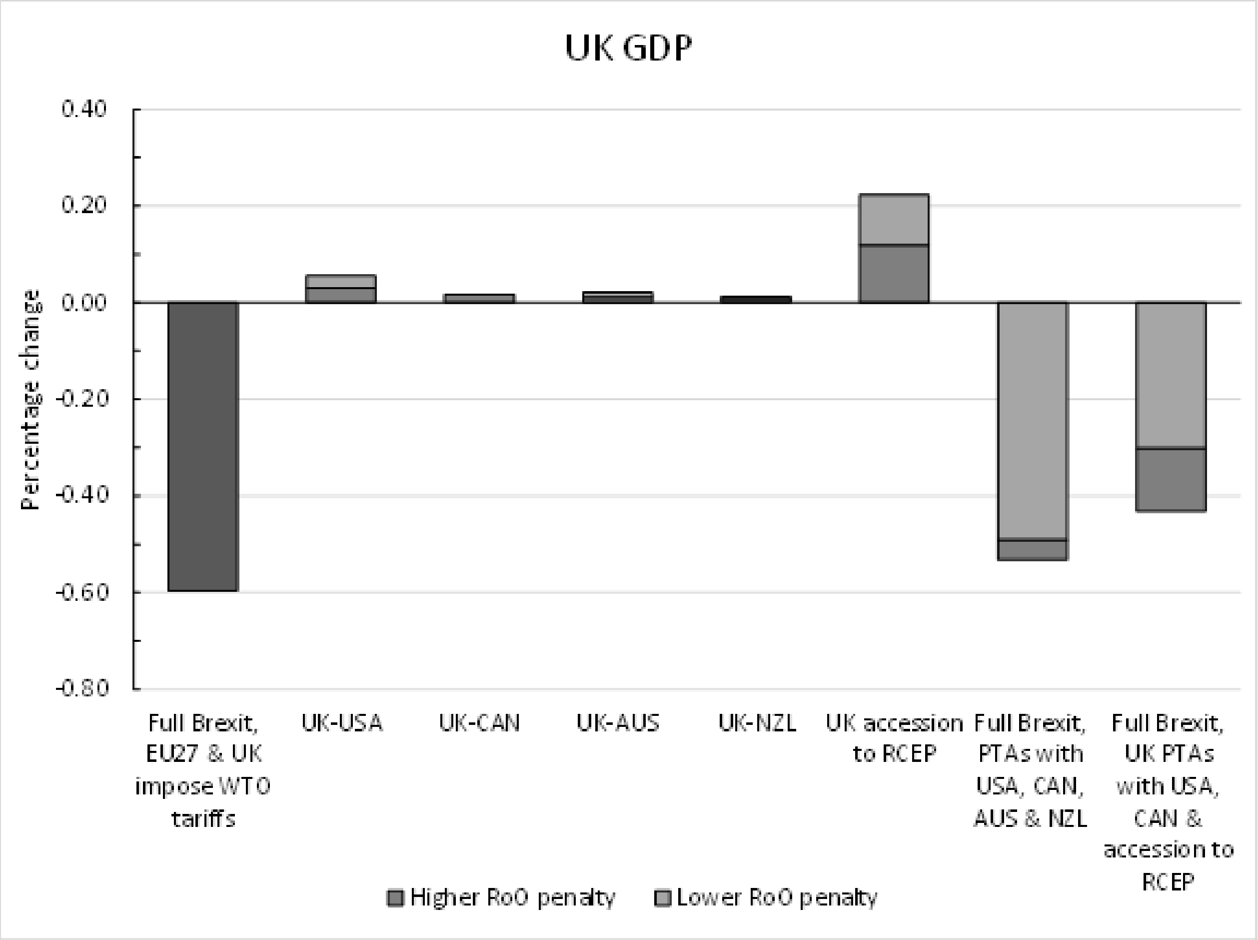
Modelling can help to illustrate the national economic implications of options

- We use a computable general equilibrium framework is used – theoretically based, detailed treatment of 57 sectors to highlight distributional effects. Of course, assumptions are contestable
- We model matters how Brexit will affect the basic terms under which commerce is conducted within the UK and with its trading partners. Two parts of paper
  - Part 1: Choices on tariffs and tariff quotas – cost of imports to industry and consumers
  - Part 2: Choices to do with market access, regulation of goods and financial markets, and institutions – with effects on country risk and productivity
- Take a longer-run perspective – full adjustment of national capital stocks, given the population and labour force
  - Note resources fully employed so that reduction in trading opportunities requires reduction in domestic unit labour costs – *i.e.* real exchange rate depreciation

2 Modelling the Effects of Tariff changes

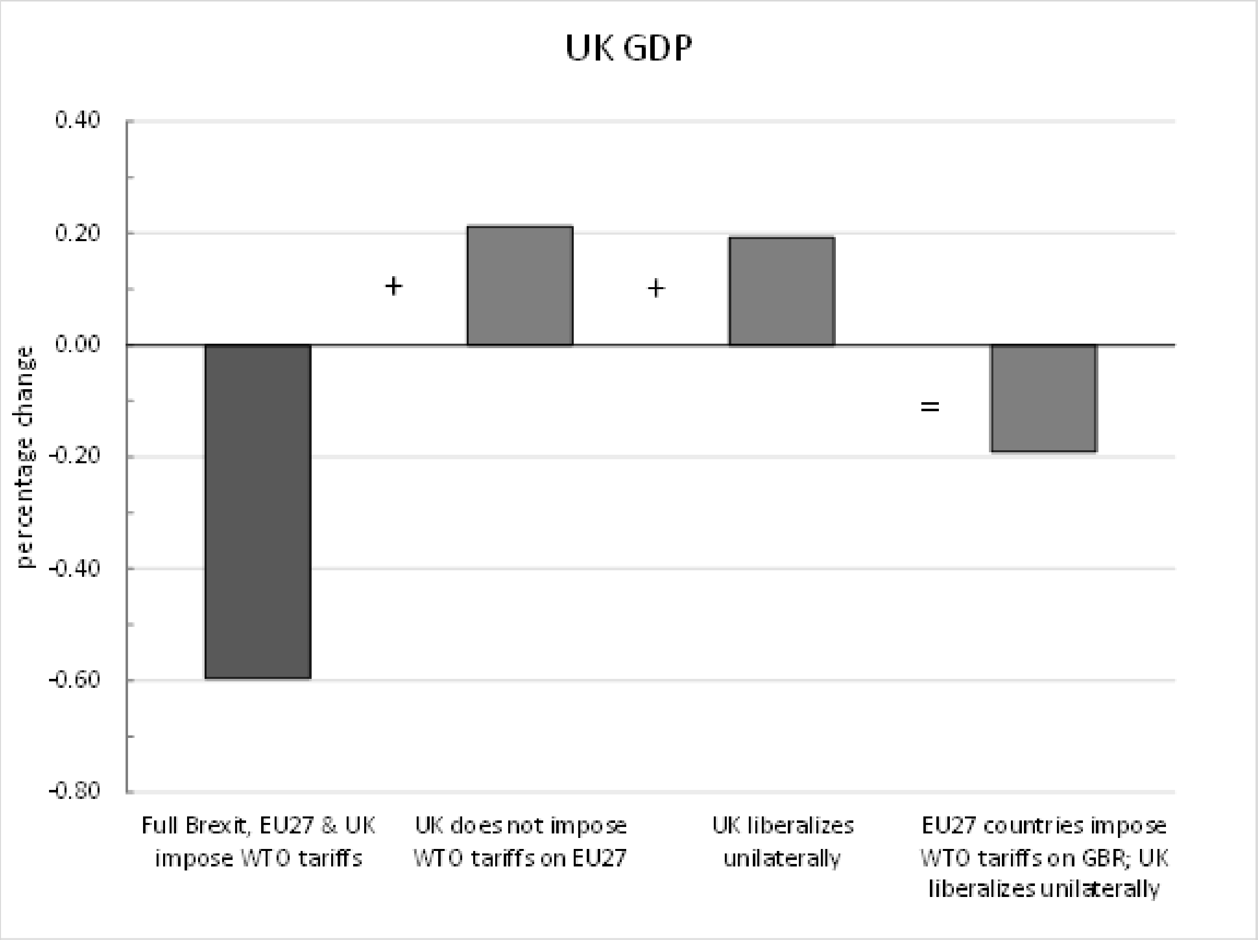
- Effects of exiting Single Market & Customs Union, estimated to cost 0.6% of GDP
    - EU 27 erecting WTO tariffs on imports from UK: 0.4% of GDP
    - UK erecting tariffs EU 27: 0.2 percent of GDP
  - These effects are small: WTO tariffs small for most commodities. See Appendix 3 of paper.
    - Effects are much larger than average in agricultural sector, in textiles and clothing, and in heavy manufacturing which includes motor vehicles
- Effects of joining FTAs likely to be very small – difficulty of negotiating agreement and rules of origin restrictions limiting uptake
    - With Lower Rules-of-Origin Penalty (ie with 75 percent take up), effects of FTAs with US Canada Australia NZ and joining RCEP might reduce losses from 0.6 % to O.3 % of GDP
    - With Higher Rules of Origin Penalty (ie with only 40 percent takeup) the reduction in losses would be less - a reduction in losses from 0.6 % to 0.4 % of GDP
- Unilateral Liberalisation by the UK would reduce these losses by much more than the effects of joining FTAs
    - If UK does not impose tariffs on imports from EU 27, this might raise GDP by 0.2 percent
    - If UK were to remove tariffs on all imports - *ie* on MFN basis – this might raise GDP by another 0.2 %.
    - Industry effects: services would benefit, reductions would fall most heavily on agriculture, textiles and clothing, and manufacturing

Pursuing preferential trade agreements (PTAs) could provide some benefits (option ii)



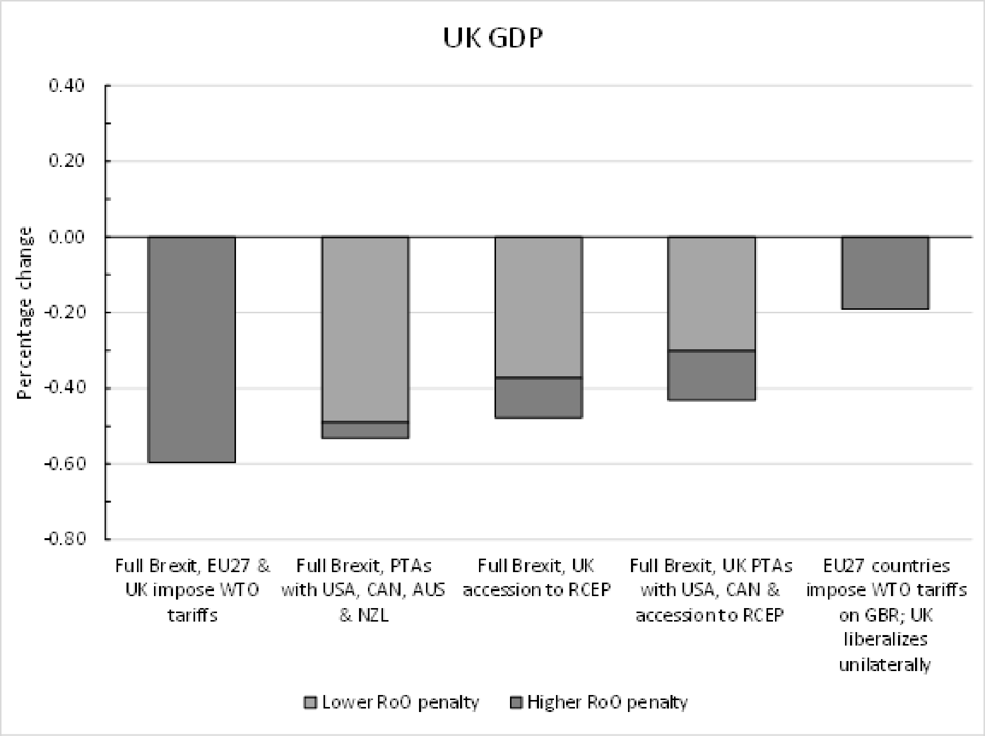
Source: Author projections based on: Gretton 2017; GTAP database version 9a, released 2016.

Unilateral MFN trade strategies would also influence final outcome (option iii)



Source: Author projections based on: Gretton 2017; GTAP database version 9a, released 2016.

Benefits from unilateral liberalisation likely to outweigh any gains from PTAs



- PTAs subject to product-specific Rules of Origin, typically lengthy negotiating periods
- Unilateral liberalisation may need to be achieved gradually

Source: Author projections based on: Gretton 2017; GTAP database version 9a, released 2016.

…additional complication with MFN liberalisation

- One issue, also not discussed at all yet, is the is the extent to which doing this would deprive the UK of negotiating coin in seeking access to the European market – either soon after Brexit or further into the future
- Analysing this issue would require consideration of the economic costs and benefits of retaining barriers to trade in order to retain that negotiating coin

3 Modelling broader costs and benefits

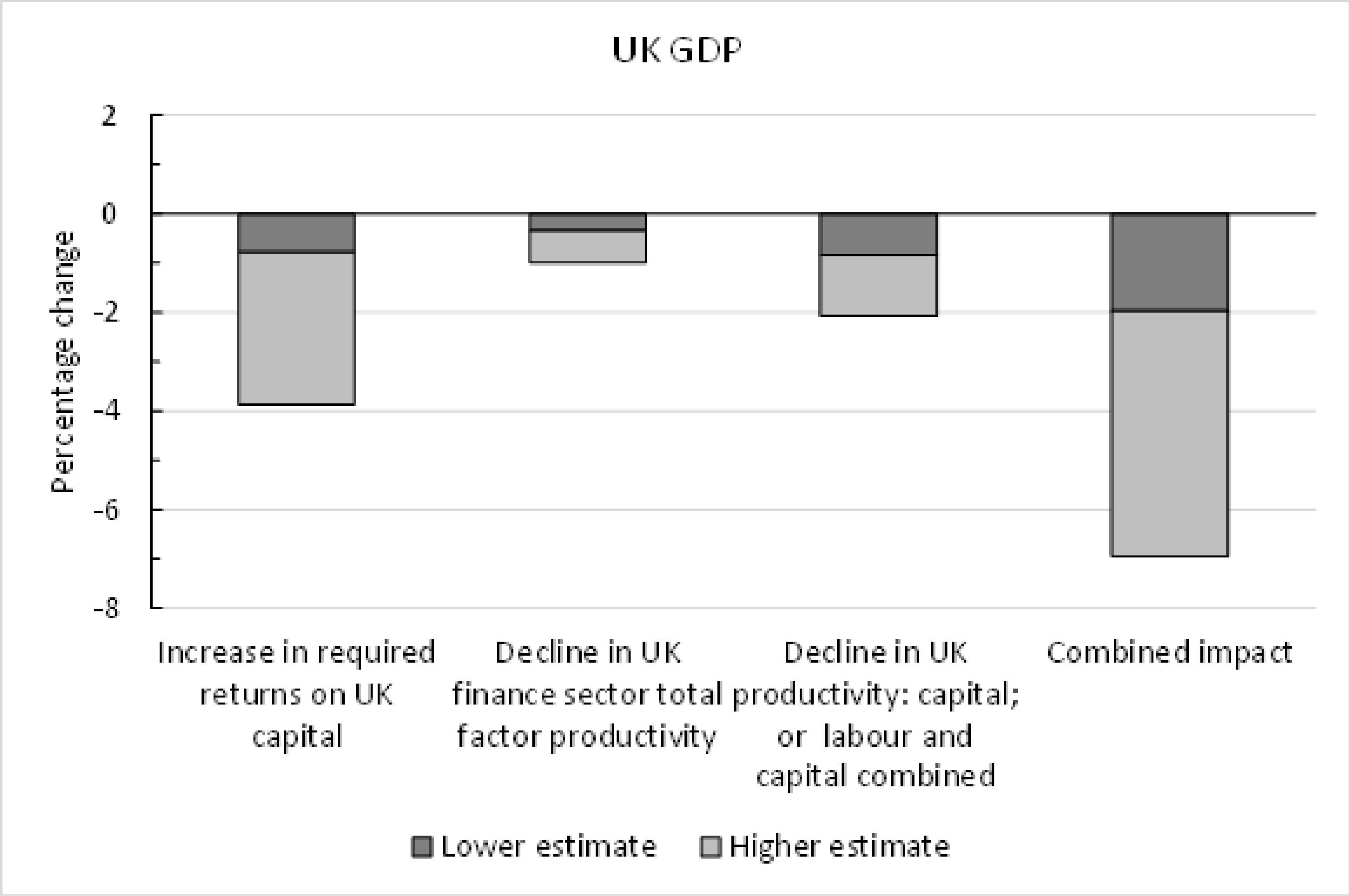
Leaving the EU single market and customs union has wider implications

- Trade between the UK and EU will be limited by regulatory impediments if the UK leaves the single market
- Border administration barriers to cross-channel trade will also occur if the UK does not remain a member of the customs union
- There will be a loss of the economies of scale which the Single European Market has provided to British firms, and
  - a loss of the opportunities which the Single Market has provided for foreign direct investment and portfolio investment
- The erection of barriers to trade with Europe and increased protectionism, there is a possibility that this option will also be associated with a decline in productivity and an increase in the risk premium associated with doing business in the UK
- In addition there will be a loss of financial openness on leaving the single market and a loss of Passporting

These broader costs of exiting Single market and customs union could have a number of effects

Increase in country risk manifesting as an increase in the required rate of return on investments, at given technologies	Lower estimate: 15 basis points	Equivalent to 10% of average wedge between Swiss and UK commercial lending rate 2000-2014
	Higher estimate: 77 basis points	Equivalent to 50% of average wedge
Decrease in productivity in the provision of financial services	Lower estimate: 2.4% decline in TPF	Equivalent to 10% of LP productivity wedge between UK and Euro area financial service providers between productivity peaks of 1999 & 2009
	Higher estimate: 5.5% decline in TFP	Equivalent to 50% of increase cost of investing between US and EU due to NTBs. Contagion assumed to domestic sector
Erosion of technology and organisation of capital	Lower estimate: 1.7% decline in capital productivity	Equivalent to 10% of MFP growth between productivity peaks of 1987 & 2007
	Higher estimate: 1.7% decline in labour & capital productivity	

These broader effects could have large impact

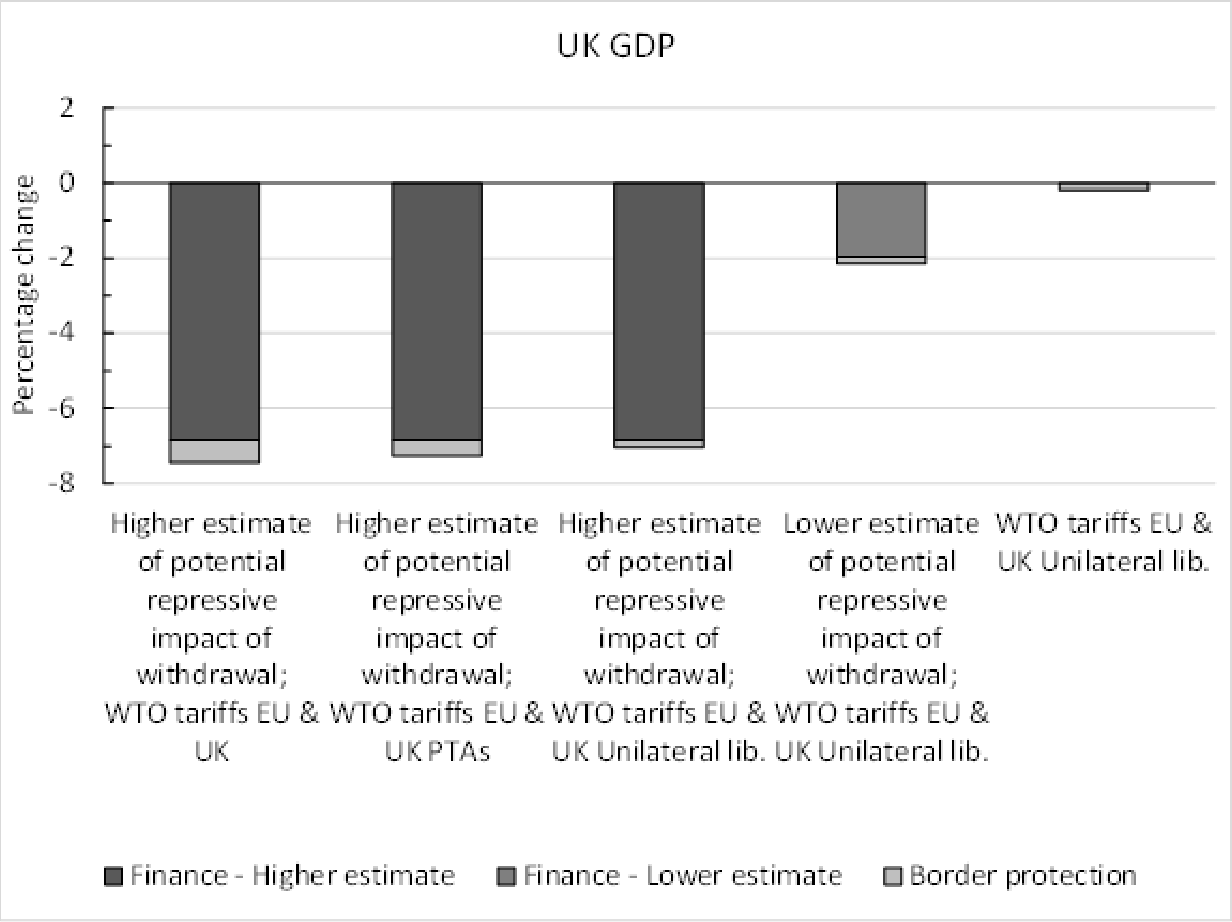


Moderating these costs through domestic reforms associated with MFN liberalisation

We have noted that the decline in productivity and an increase in the risk premium which might be associated with the FTA route

- Unilateral liberalization – *i.e.* tariff reductions - by the UK on merchandise would provide a larger and more assured gain, but alone would not make material inroads into the higher potential economic costs of withdrawing from the single market (See previous figure) .
- UK liberalization of merchandise trade, and exposure in global markets, however, might afford a stronger policy environment in favour of domestic reforms
- Such a policy environment might lead to a lowering of the economic costs of withdrawing from the Single Market and loss of financial market access and Passporting
- If this were so, the potential repressive effects could shift towards the lower-cost bound discussed in the previous figure
- If they were to be fully overcome when the UK gained full regulatory sovereignty, the main negative effects could be accounted for by tariffs on merchandise trade and other non-tariff barriers (not explicitly modelled)
- Further productivity improvements or a reduction in country risk, could actually outweigh these negative effects

Benefits from reforms associated with unilateral liberalisation could make inroads into possible costs of withdrawing from the EU



4 A national policy review institution could have merit for the UK

- Issues are complex – FTA negotiation and MFN liberalisation would have material distributional/adjustment effects
- A new policy review institution could help identify and raise public awareness national rewards from liberalisation
  - Government would determine what is to be reviewed
  - Institution would have: statutory independence; transparent process; community-wide perspective
  - Could initially focus on Brexit issues
  - Could also be tasked with examining broader questions arising from: technology, international trading conditions, wider social concerns
- Policy review procedures would be comprehensive

5 Summing up

- Relinquishing membership of Single market and customs union will leave a significant economic gap for UK
- Unilateral trade reform by UK is likely to outpace potential gains from bilateral & regional deals
- Unilateral domestic reform of non-tariff measures and services is likely to be very important in closing the gap left by UK relinquishing EU membership – particularly through financial market deepening (or avoiding shallowing)
- Brexit and the changing centre of gravity of global economic activity likely to elevate gains from trade openness for UK -- and EU
- New statutory policy review institution adopting comprehensive review procedures worth consideration