



Brexit's impact on trade

Brexit and the election of Trump has injected a major dollop of uncertainty into international commerce. Dan Ciuriak writes about how this could reshape the global trading system

Upwards of €250 billion in two-way trade between the UK and the rest of the EU is at risk from a hard Brexit. This falls to the €70 billion range with a soft EFTA-like agreement ('Brefta') in place. As Europe careens towards its uncertain future, hostage to plot twists in British politics and binding time constraints, which seem to make a hard exit the default, the salient question is how far upward of €250 billion are we really talking – and at what cost to the economy?

The above figures, which are to be read relative to projected 2030 levels of trade and represent respectively 27% and 8% declines compared to the baseline, emerge from simulations of Brexit using a computable general equilibrium (CGE) model (Ciuriak et al. 2017; see summary of results in Table 1).

This method quantifies effects of the UK leaving the single market, around which we can put some numbers: the impact of new tariffs under a hard Brexit; a hard border and the associated higher transactions costs under both the Brexit and Brefta variants; a modest 'drift' of UK regulation away from EU laws under the hard exit; and the introduction of new non-tariff measures on services and investment under both variants. There are, however, many other factors that are not captured.

An alternative approach to evaluating the amount of trade at risk is to estimate the extent to which membership in the EU has worked historically to boost trade amongst its members based on the actual trade patterns that have evolved, reflecting all the influences of the single market. Based on gravity models, which take into account the size and distance of trading partners, as well as various factors that impact on bilateral trade costs, the Centre for European Reform (2016) estimates that UK-EU goods trade is 55% greater than would otherwise be expected.

Meanwhile, Fink (2009) estimates the EU Services Market Directive boosted trade and FDI stocks by one-third. The average for goods and services from these estimates is substantially greater than the 27% trade discount implied by the €250 billion figure cited above – indeed, half again as high.

For both the UK and the EU27, some portion of the lost trade will be made up with new trade with third parties. However, for both, this will be trade with more distant partners and subject to greater border transit costs. Accordingly, it will inevitably be less than the foregone cross-channel trade. This point is illustrated by estimates of the extent to which an FTA for the UK with the United States might offset the impact of Brexit. The negative impact on welfare would be shaved by a little more than one-fifth – but only that much (Ciuriak et al. 2017).

This reflects the heavy toll that distance exacts on trade: although the United States is larger than the EU27, the distance across the Atlantic is sufficiently greater than that across the English Channel that the trade gains under a UK-

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US FTA are a steep discount to those available under the Single Market. This reality of economic geography is compounded by the necessarily shallower degree of liberalization possible with the United States under a conventional FTA – if indeed such an agreement is available any longer with the United States – compared to the Single Market.

There is also the challenge of securing new FTAs. Given the position of US trade policy, viewed through the America First lens, the small gains for the United States under a UK-US FTA imply a low rank for the UK in the US FTA queue. Meanwhile, given the US withdrawal from the Paris climate change accord and other environmental policies, and the EU's commitment to sustainability, it is a stretch to see the EU being able to ratify a Transatlantic Trade and Investment Partnership (TTIP) agreement – regardless of where the EU27 would be in the US queue.

Looking beyond the United States, the major FTA targets for the both the UK and the EU27 would be China and Japan – both tough targets and both smaller and more distant than the United States.

For the UK, a study of potential target markets for a post-Brexit future identified Canada, Israel, and the Indian sub-continent as those in which UK exports under-perform the most compared to the UK's established level of export capability (Open Europe, 2017).

Making up potential ground in these markets would more than offset the trade decline under Brefta, but not under Brexit. Moreover, for the machinery of trade – from customs brokers to shippers – the realignment of trade flows means adjustment and learning costs. Trade ultimately is done one exporter and one client at a time.

Finally, the intensification of UK-EU trade due to EU membership evolved in the benign context of expanding global trade under the rules-based system established by the GATT/WTO agreements and anchored by American hegemonic underwriting of the multilateral system. Trade is no longer expanding faster than GDP and Trump's America is no longer prepared to underwrite the multilateral system.

Table 1. Summary of Real GDP and Welfare 2030 – Alternative Scenarios

	Real GDP (% change) 2030				Welfare (USD billions) 2030			
	Brexit	Brefta	Brexit with Single Market Effect	Brexit with Single Market and UK-US FTA	Brexit	Brefta	Brexit with Single Market Effect	Brexit with Single Market and UK-US FTA
UK	-2.54	-0.97	-2.50	-2.39	-101.6	-41.6	-99.1	-74.9
EU27	-0.30	-0.11	-0.40	-0.40	-71.8	-24.3	-107.8	-110.3
Canada	0.03	0.02	0.05	0.04	1.9	0.9	2.5	1.8
Japan	0.04	0.01	0.05	0.05	4.8	1.6	6.6	6.0
Russia	0.03	0.01	0.06	0.06	3.7	1.6	5.0	4.7
USA	0.02	0.01	0.04	0.06	8.3	3.8	11.4	18.3
China	0.03	0.01	0.04	0.04	15.9	6.8	21.1	19.7
World Total	-0.09	-0.03	-0.09	-0.09	-90.7	-33.2	-96.0	-95.8

Table 2. Impacts of Brexit Scenario in Present Value Terms

	Brexit	Brefta	Brexit with Single Market Effect	Brexit with Single Market Effect + UK-US FTA
EU28	-832	-357	-1,007	-998
UK	-503	-229	-491	-468
EU27	-329	-128	-516	-530
Ireland	-38	-14	-47	-48
Benelux	-38	-14	-61	-63
Netherlands	-29	-9	-44	-45
Baltics	-4	-1	-7	-7
Denmark	-11	-3	-16	-16
Mediterranean	-8	-4	-11	-11
Iberia	-38	-14	-59	-60
Germany	-55	-23	-85	-88
Poland	-13	-5	-24	-25
CEECs	-15	-6	-31	-31
Sweden	-9	-4	-16	-16
France	-45	-19	-71	-73
Italy	-19	-8	-30	-31
Finland	-3	-2	-5	-5
Austria	-3	-1	-8	-8
Adriatic	-1	-1	-2	-2
G8 & China				
Canada	8	4	10	7
Japan	21	7	29	27
Russia	17	8	22	21
USA	38	17	52	87
China	60	25	79	74
World Total	-504	-220	-570	-560

Source: The author is indebted to Jingliang Xiao for the calculations. The figures are based on Ciuriak, Dadkhah and Xiao (2017).

Indeed, strong signals have been sent by the Trump Administration that it intends to extract what it can from trading partners, exercising its full political and economic leverage. The UK will not be sailing from the single market's safe harbour with trade winds in its sails, but tacking into protectionist headwinds and trying to secure new markets in competition with other countries under pressure to reduce their bilateral surpluses with the United States.

The bottom line is that Brexit scenarios reported here put the UK and the EU27 onto lower-output tracks due to economic inefficiencies that persist year-in, year-out.

There are some caveats to this conclusion based on factors that are not explicitly incorporated in the modelling: one set is based on potential economic gains that Brexit might afford; the second is based on dynamic effects that could amplify the losses.

A major premise of support for Brexit is that EU regulation impedes UK growth. This can be neither substantiated nor dismissed out of hand since: (a) EU regulation by definition has a 'one size fits all' character within the Union; and (b) given there are thousands of regulations, it is not possible to parse through these and identify those where the purpose of the regulation is not served by its application in the UK, but the cost of compliance is nonetheless borne by UK firms.

Looking first at regulations that address product quality and are required for market access (eg. documentation of products' chemical content), Brexit is not a solution – the better option to modify regulations is to remain in the Union and influence their making.

Looking next at regulations that address overriding social or environmental (eg. labour market or climate change) or other objectives, de-regulation in these areas by the UK might generate cost savings to the UK economy. An

Open Europe assessment (conducted pre-Brexit) suggested GBP 12.8 billion of savings were possible (about €20 billion at 2017 prices).¹

This, if realizable, would represent a modest offset to the Brexit/Brefta border costs, if it flowed entirely into UK household incomes. If the benefits flowed primarily to multinational firms' bottom lines, UK welfare might be minimally improved, if at all. At the same time, the UK would face constraints from potential anti-dumping/countervailing duty actions if new regulations were construed as generating either social or environmental dumping.

The second set of caveats concerns factors that are difficult to quantify and therefore not explicitly included in conventional trade models. The majority of these represent negative impacts for the UK and the EU27 because of additional transactions costs and heightened uncertainty. In particular:

- First, modern trade economics emphasizes the role of fixed costs of trade in screening in larger, more efficient firms – and screening out smaller firms. The low-cost trade regime created by the single market was thus especially conducive to trade participation by small firms.
- Second, the value proposition of cross-channel value chains will be affected since the sliver of value added by the firm doing outsourced work will bear the full cost of new tariffs or additional border costs – this may be prohibitive as a share of the value addition.
- Third, uncertainty about future market access re-enters UK-EU trade, as flows will become subject to contingent protection (anti-dumping or countervailing duties).

Reduction of trade frictions and uncertainty are drivers of trade expansion in trade liberalization episodes, especially at the 'extensive margin' – new products and new exporters entering new markets (Kehoe et al. 2015). A critical question is whether the impact of Brexit will be symmetrical in a negative direction?

If the effect is symmetrical, thousands of firms on both sides of the channel will abandon export markets. This will exact a hidden cost, as the intangible assets associated with the sunk costs of export market entry will be effectively written off. Further, retreat to the domestic market may leave firms that invested to serve export markets with too much capacity and too little flexibility for the domestic market (Lileeva and Van Biesebroeck, 2010).

In this regard, it is important to distinguish the build-up over time in the equilibrium impact reported in CGE studies and short-term dynamics. The initial impact of Brexit could be much greater in a negative sense than portrayed here because of market reactions that are then dampened over time. Table 2 sets out the present value of the foregone income from Brexit on an equilibrium path.

Presented in this fashion, the estimates are large – as much as US\$1 trillion for the EU27 and the UK combined. If the economy takes a low road – ie. greater short-term disruption than would be felt in the long-run outcome – the present value of the foregone income would be even higher.

The chances of a high road seem to be small since the reaction of business to the announcement of Brexit is already to make adjustments rather than wait for the actual change in trade relations.

The world on which Brexit was premised – a rules-based multilateral system anchored by the United States, which provided ample opportunities for the UK to make up trade foregone with the EU – is now long gone, in part be-

cause of Brexit, but more so because of the election of Donald Trump. Both events have injected a major dollop of uncertainty into international commerce. Both promise to re-shape the trading system. ■

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Endnotes

1. *Scarpetta (18 May 2015)*

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This article draws heavily on Ciuriak, Dadkhah and Xiao (2017).