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BDO FOCUS ON…

BREXIT & INTERNATIONAL TRADE

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THE RISKS AND OPPORTUNITIES FOR INTERNATIONAL TRADE

The UK exports 45 per cent of its goods and services to the rest of the European Union accounting for £223bn of trade in 2015. As a result of the UK's membership of the EU, these exports did not attract any tariffs for access to the EU single market.

Overall, UK trade with the EU represents approximately 12.6% of UK GDP whereas EU trade with the UK represents in aggregate, just over 3.1% of the GDP of the other 27 EU Member States although there are considerable variations within those countries. Meanwhile, the UK currently imports over 53% of its goods and services from the EU giving a net trading deficit of £61bn in 2014. Regardless of the outcome of the various political processes, it is clear that even in a post-Brexit environment, the EU will continue to be the world's largest market and the UK's biggest trading partner.

It is still too early to predict what this future EU-UK trade relationship will look like but most commentators agree that there are a limited set of options, each with their advantages and disadvantages, both politically and economically.

The European Commissioner for Trade, Cecilia Malmström, has already indicated that the UK will not be in a position to begin trade negotiations with the EU before the exit talks are concluded although Article 50 of the Treaty on European Union (TEU), part of the Lisbon Treaty, is not clear on this.

At this juncture, the EU views those negotiations as separate and distinct, although the outcome of one will have a significant bearing on the other.

Pro-Brexit campaigners in the UK referendum maintained that a trade deal would be agreed in parallel with exit negotiations but if the two sets of negotiations are sequential as now seems likely, the UK may well have left the EU before knowing what its subsequent arrangements with the EU will be. Of course in practice, this is unlikely to be wholly the case as it is not in the EU's interest to damage the EU Single Market or one of the world's largest economies and current EU member, i.e. the UK, so undoubtedly a common sense approach will prevail.

It is the view of most experts also that under existing EU law, the UK cannot enter into trade agreements with third countries until it has formally left the EU. This will make it difficult for the UK to replace quickly, the 50+ agreements with those third countries to which it is party as a result of its EU membership but which would no longer apply to the UK once it leaves the EU.

The regulatory and public policy team at the BDO Global Office, in conjunction with external consultants, prepared this short paper to help you begin to understand the impact of Brexit on trade issues in the short, medium and long term.

UK-EU TRADE RELATIONSHIP POST-BREXIT

The possible trade relationship models include:

- European Economic Area (EEA) agreement with the EU (the 'Norway option') or variations of it attracting the terms 'EEA-minus' or 'EEA-plus'
- EFTA membership along with bilateral agreements (the 'Switzerland option')
- Access to the EU Single Market without applying certain free movement principles
- Customs Union (the 'Turkey option')
- EU-UK Free Trade Agreement (FTA) such as the EU–Canada Comprehensive Economic and Trade Agreement (CETA)
- Trade under the World Trade Organisation (WTO) Rules

The Norway and Switzerland options would oblige the UK to *adopt some or all of the body of EU Single Market law with no effective ability to shape it*. It is not clear that this would be palatable to the new UK Government given the circumstances of the UK referendum. Nonetheless, membership of the EEA possibly with amendments, appears to offer the least cumbersome future trade model and reduce if not eliminate the economic damage of 'full Brexit'.

Meantime EU leaders have robustly ruled out the possibility of the UK accessing the Single Market without applying the four fundamental freedoms, including free movement of workers.

These freedoms in fact constitute the EU single market and would therefore seem to be non-negotiable and even if it was minded to do so, it seems unlikely that the EU could reform some or all of the free movement principles to a degree that would satisfy UK concerns without raising concerns among the other 27 Member States. There has been media speculation that an 'emergency brake' on the free movement of workers (for up to 7 years) may offer some hope for a workable compromise with the UK in this area but such a proposal would likely encounter severe political resistance in some EU quarters.

The alternative feasible options therefore include an EU-UK FTA or a complete separation from the EU bloc with no arrangements in place which would see the UK applying WTO rules.

EU-UK FREE TRADE AREA

The negotiation of a comprehensive FTA, along the lines of the EU-Canada (CETA) FTA, would confer advantages on both partners. Modern EU bilateral FTAs include a high degree of trade liberalisation for both goods and services and have made significant inroads into enhancing respective investment interests. Other characteristics include eliminating non-tariff barriers by way of regulatory cooperation and the protection of innovation through the enforcement of Intellectual Property Rights.

However, some commentators argue that an EU-UK FTA would prove expensive for the UK given that it would lose preferential access to the Single Market, at least in the short term. This would be especially the case if FTA negotiations only began after the UK formally left the EU. Furthermore, it may take years to negotiate such an FTA and the UK's financial services sector would lose its prized passporting rights for selling services across the EU.

The loss of regulatory predictability, certainty and continuity would also likely be unacceptable to businesses and have a grave economic impact in the hiatus period.

TRADE UNDER WTO RULES

In this scenario, both the EU and the UK would be members of the WTO in their own right although the UK is currently a member under the aegis of the EU WTO membership. Some see this option as the worst case scenario which would only arise in the event that the EU and the UK had failed to negotiate an FTA or other arrangement. Brexit proponents argue that this would allow the UK to pursue its own trade policy agenda unhindered by EU demands.

UK exports would be subject to the EU's Common Customs Tariff, which the EU currently applies to products from third countries. In turn, EU exports to the UK would be subject to a tariff regime of the UK's choosing, provided that it satisfies WTO Most Favoured Nation (MFN) tariff requirements.

However, the comparative advantage of UK trade in recent times lies in the growth in its services output. As the WTO has made far less progress than the EU in liberalising trade in services, this would likely lead to reduced access to EU markets for UK service providers, notably financial services providers.

This outcome would not offer freedom of movement of workers which could also affect the availability of talent to the UK services sector.

In any event, automatic UK membership of the WTO cannot be assured, especially considering pre-referendum comments by WTO Director General Roberto Azevêdo who suggested that the UK would likely have to renegotiate its entire membership with the 162 other WTO members. This would be extremely difficult and complex and resetting the terms of the UK's membership of WTO could therefore take years if not decades to accomplish.

UK TRADE POLICY POST-BREXIT

The UK's post-Brexit trade policy is likely to remain liberal given the UK's stance in international trade negotiations to date. This will lead to greater efforts to penetrate the UK market from third countries who would seek to challenge the market access currently enjoyed by EU Member States.

The trade tariff regime which might be applied by the UK to imported products is unknown but it is unlikely that restrictive tariffs would be adopted given the UK's need for imported goods, particularly in the agri-food sector.

In relation to trade with non-EU countries, commentators differ on whether the UK would simply 'inherit' current EU FTAs (unlikely based on the territorial scope of the articles) or be forced to renegotiate new FTAs independently with third countries under time constraints and not having had to negotiate any in its own right since acceding to the EEC in 1973. The latter approach could entail loss of market access and suspension of imports from current trade partners in the short term.

Finally, it is unlikely that the UK can retain any share in the EU's Tariff Rate Quotas (TRQs), even where most products currently imported under such TRQs are sold in the UK, e.g. lamb from New Zealand. In the case of WTO-related TRQs (under the GATT Schedule), there will be legal arguments made in favour of renegotiating EU TRQ volumes to reflect the reduced size of its market as well as historical trade flows between the UK and the wider EU.

WHAT CAN WE EXPECT?

It is clear that Brexit is a process and not an event in its own right. The UK referendum to leave was, in a sense, the start of that process domestically but until the UK triggers the Article 50 TEU process, Brexit remains a UK matter. Notwithstanding that the UK remains a full member of the EU, it is clear however that its voice at EU level is already diminished, not least in the area of trade where it is a pro-market, liberal economic powerhouse. Continuing EU negotiations on FTAs with third countries (e.g. USA, India, Japan) will therefore be less influenced by the UK voice than would otherwise have been the case.

The UK will likely seek to negotiate FTAs speedily with key trading partners once it is in a position to do so, particularly with countries such as the US, Canada, India, Australia and New Zealand. It is clear in the aftermath of the referendum, that the new UK Government has made immediate efforts to initiate contacts with their counterparts in these and a number of other key countries around the world.

However, the lack of experienced trade negotiators in the UK civil service has already been flagged as a short-term impediment as a result of the UK having not had to negotiate trade agreements with any country since acceding to the then EEC in 1973.

If the UK does not remain in the Single Market, and even in the event of an EU-UK FTA, UK exports to the EU would face additional costs, including clearing customs, border controls and administrative costs associated with complying with EU requirements such as rules of origin.

The manufacturing and production sectors of the UK economy face a more uncertain outcome than services, particularly if the UK adopts a low import tariff regime.

If the UK becomes subject to the EU Common Customs Tariff, it can expect sectors such as agri-food and automobiles to be hit with higher than average tariffs. In financial services, leaving the Single Market would entail a loss of EU 'passporting' which would have a profound impact on the sales and distribution strategies of financial firms located in London.

For the EU, obvious disadvantages include potential barriers to one of its key export markets and the loss of a strong pro-trade voice around the EU table. The latter may impact the EU's ability to strike significant future trade deals (e.g. TTIP with the US) in the face of growing opposition from protectionist interests on the continent.

Over time, it is reasonable to expect regulatory divergence between the UK and the EU as they chart different courses across most policy areas, and this could also present barriers to trade. However, it will continue to remain in the UK's interest to align its regulations to the greatest extent possible with its largest trading partner (the EU as a bloc) in order to secure continued market access and maximise trade opportunities.

Our view is that whilst the political uncertainty prevails, it is difficult to know where the final Brexit arrangements will land. Economic pragmatism, however, is likely to ensure that the UK will continue to enjoy substantive access to the Single Market for its' goods (and vice versa) and some level of compromise will be found to continue the patchy but important access for UK services to the EU Single Market.

TRADE COSTS SET TO INCREASE

The cost of trade between the EU and the UK is set to increase, but the scale of that cost will ultimately be determined by the nature of the future relationship between the UK and the EU. The further the UK moves away from the EU Single Market, the greater the cost of trade and additional barriers between both parties.

There will be opportunities for the UK to open up trade with third countries and to increase its competitiveness, but this will need to be balanced against disadvantages such as higher tariffs on UK goods entering the EU. For over 300 years, the UK's largest trading partner has been what we might now call the EU. The EU's geographical location, especially given its service-oriented economy, will perpetuate that reality.

In the long term, exiting the EU will exclude the UK from the benefits of current and future EU FTAs such as CETA and TTIP (the potential EU-US FTA).

In an international trade environment which is increasingly moving towards regional trade blocs, questions remain over how attractive the UK market will be for larger trade partners and its ability to leverage advantageous trade deals.

WHAT NEXT?

The political situation is of course very fluid at the time of writing and doubtless there will be further developments and clarity as the months and years go on. Now is the time for clients with exposure to trade issues to consult with their BDO expert advisers to identify opportunities and risks arising from this dynamic situation.

It will also be vital to engage and lobby at UK Government and EU member state level to ensure that as few obstacles as possible are put in the way of liberal and open international trade. Governments will need help to understand the issues and to mitigate the impact of Brexit on trade. It should not be assumed that the UK Government will necessarily see the benefits or weaknesses of the pre-referendum access to the EU Single Market or seek to maintain the position. Nor can it be assumed that EU Member States or the European Union institutions will seek to preserve the current regulatory framework. It will be important therefore that industry in the UK takes every opportunity to ensure that the new government prioritises this policy area in future decisions and in its detailed exit negotiations.