SUERF THE EUROPEAN MONEY AND FINANCE FORUM

SUERF Policy Note
Issue No 72, May 2019

Analysing the Economics of BREXIT and World Trade

By David T. Llewellyn
Loughborough University

JEL-codes: E65, F02, F15.

Keywords: Brexit, European Union, Withdrawal Agreement, World Trade Organisation, Free Trade.

The context

The UK has been engaged in its most momentous and historic set of international negotiations in generations. And yet even after three years since the referendum, no consensus has emerged in Parliament about the type of BREXIT it is willing to support. The negotiations with the EU Commission have been particularly complicated as the governing Conservative party (and even the Cabinet) has been split on key aspects of the BREXIT debate.

Although there is a wider set of complex political and constitutional implications, the focus in this paper is exclusively on: (1) the trade and economic implications, (2) the range of alternative BREXIT models, and (3) the economic and political trade-offs involved. Some advocates of BREXIT accept that, while there will be net economic costs, in a cost benefit calculation, they are worth paying in order to secure the alleged wider benefits of alleged enhanced sovereignty, etc.

There have been three basic strands in the negotiations between the UK and the EU:

(1) the Withdrawal Agreement,

(2) the conditions during the twenty-one month transition period during which detailed trade negotiations will take place, and

(3) the contentious issue of a possible Hard Border and backstop between Northern Ireland and Eire.

Whilst emphasis has been given in public debate to the Withdrawal Agreement, the important long-term implications of BREXIT are focussed on the future long-term economic and trading relationships between the UK and the EU which the EU has insisted can only be negotiated after the Withdrawal Agreement has been settled. It is likely that these trade negotiations will be protracted and last for several years. The Withdrawal Agreement does not deal with this issue in any detail except for a series of vague aspirations. It is in this area that the long-term and enduring implications of BREXIT will emerge and the extent of any net costs or benefits of exiting the EU.

There has been, and remains, much disagreement in the UK, and in the British Parliament, about the type of BREXIT that is envisaged, and precisely what voters envisaged in the referendum. It has been described by a former Prime Minister as a "blind BREXIT." The alternative models lie within a spectrum of what has been termed hard- and soft-BREXIT and include: a European Economic Area model (close alignment with the current EU arrangements but without membership of a customs union); a customs union arrangement with the EU; some form of Free Trade Agreement; what has been termed "Common Market 2.0" (an arrangement similar to that agreed with Norway but including a customs union – this would be the softest form of BREXIT); and the default position of a no-deal and reversion to World Trade Organisation rules – with or without across-the-board tariff reductions on UK imports.

As the implications of each model vary substantially, many of these views and objectives are mutually exclusive which implies that trade-offs need to be made. In general, the closer the final arrangement is to the current relationship between the UK and the EU, the more concessions the UK would be required to make over, for example, immigration rules, payments to the EU budget, ability to negotiate trade deals with non-Member States, etc.

A particular anomaly is that the referendum did not specify any particular model of BREXIT and the majority of MPs in Parliament were initially against BREXIT. There has, therefore, been substantial disagreement in Parliament and government about the precise model of BREXIT to be adopted. This is reflected in the long delay in reaching a final decision.

Key issues: more than economics

There are many different political, economic and social dimensions to the BREXIT debate. While most of the technical debate and expert opinion has focussed on the economic dimension, this has not necessarily been the dominant motive in the debate. By far the majority of economic analyses conducted by the government and other bodies conclude that there are net economic costs associated with BREXIT. However, for many voters and MPs the central issues have focussed on issues such as sovereignty (an ill-defined concept of "taking back control" was a dominant theme of the case made in favour of BREXIT); limiting the free movement of labour; saving annual payments to the EU budget; and being subject to the jurisdiction of the European Court of Justice. The debate has often been based on seeking what was judged to be a simple solution (leaving the EU) to what in truth is a complex set of issues.

In effect, the implicit trade-off implies accepting the alleged economic costs of BREXIT in return for alleged political and constitutional benefits. It has been argued elsewhere (Llewellyn, 2017) that many of these alleged political and constitutional advantageous are more nominal than real. With respect to the issue of sovereignty, for instance, it is not always the case that independent national sovereignty is the optimal approach. In an increasingly interdependent world, where externalities can be powerful, there is advantage in some areas in collaborating in decision-making. In this regard, a distinction can be made between *independent sovereignty*, *effective sovereignty*, and *collective sovereignty* (Llewellyn, 2017).

The alleged BREXIT case with respect to regulation is that there is too much of it, it is disproportionate, it infringes national sovereignty, and it weakens the economy. However, the UK has agreed to most of the EU's regulation and would in any case have chosen to have similar regulations even if it were not a member of the EU. This is also an area where in many cases regulation can be more effective when conducted beyond nation states not the least to limit the extent of regulatory arbitrage between countries. It is also the case that much of EU regulation has been designed to support the Single Market and competitive neutrality both of which are principles that the UK strongly supports. In the event of the UK exiting the EU, there would be significant benefits from having a common set of regulations rather than twenty-eight different sets of national rules. Furthermore, many industrial and manufacturing processes involve complex supply chains with inputs sourced from different EU countries. Such structures would become problematic if the UK were to have a different set of regulations than the EU. In any case, it is likely that any trade deal negotiated with the EU would require the UK to adhere to the bulk of EU regulation.

Historic context

To fully understand the complex and intricate BREXIT debate, a short historical perspective is needed. The Common Market was established in 1957 by its six founding members. The UK joined what had become the European Economic Community only in 1973 and over the years it negotiated a series of "opt-outs". The terminology is significant because, from the outset, there has been a fundamental difference in perception between Continental members and the UK. Britain has always regarded the European project as essentially an economic model with many of the political aspects (such as political union) being viewed negatively. The Maastricht Treaty was something of a turning point for the UK as it outlined the ambition for the EU to become a Political Union.

In contrast the continental perspective has viewed the EU much, if not primarily, as a political project. The UK has focussed on economic integration, the single market and the enhancement of competition in the economy. Continental members, on the other hand, have often focussed on the concept of "ever deepening political integration" which the UK has always resisted. There has, therefore, been something of a disconnect between the UK and continental perspectives. It also explains why the objective of the UK has been to retain most of the economic aspects of its relationship with the EU while exiting the more overtly "political" dimensions even though in practice it is not an easy distinction to make.

A further context is that, possibly for the first time in history for any country, the UK has been considering such a wide range of alternative trading models. The Bank of England has argued that "there is no precedent of an advanced economy withdrawing from a trade agreement as deep and complex as that which the UK has with the EU." This is particularly significant globally given that the UK is a leading trading country: imports plus exports as a proportion of GDP are around 60 percent. Exiting the EU would mean the country leaving the largest Single Market and customs union in the world in favour of some other (yet to be defined) model.

This is the first time a major trading nation has decided to leave an existing trans-national Single Market and Customs Union which accounts for over 40 percent of the country's trade in favour of an ill-defined alternative trading model. This also involves losing the advantages negotiated by the EU with third countries (e.g. Japan).

UK as a trading nation

The UK is a major trading nation, and has been for several centuries. Taking exports and imports of goods and services together, trade is equal to 64 percent of GDP having risen from around 26 percent in 1970. In this sense it is one of the world's largest trading nations.

Trade with the EU accounts for over 40 percent of total trade in goods and services and around 60 percent when trade with those non-Member States with which the EU has trade agreements is included. This emphasises the importance of the UK both maintaining open trading relations with the EU and of negotiating trade deals with those countries with which the EU already has trading agreements from which the UK would be excluded on leaving the EU. The EU is the UK's largest trading partner.

UK exports of services is the highest among G7 countries. The financial services industry represents close on 10 percent of GDP and although the balance of trade in goods is around £82 billion in deficit, there is a £4 billion surplus in services. Exports of services account for 38 per cent of all UK trade with the EU. The importance of the EU as a trading partner in services is indicated by the exports of services to the EU being the same level as to the next eight destinations taken.

An important point of perspective is that the majority of UK exports and imports are inputs into production especially when considering trade with the EU. Taking the EU as a whole, over half of EU imports are from the UK and the majority of those are intermediate goods and services. This means that supply chains have become increasingly international with the import content of UK exports rising from less than 30 percent in 1995 to a little under 40 percent currently. This means that any non-tariff barriers to trade would have a negative impact on UK exports.

The negotiations and red lines

The main objectives of the UK have been to secure the most frictionless trade in goods and services while being outside the Single Market and Customs Union, More specifically, the core objectives have been to end the freedom of movement of people, to secure the ability to negotiate trade deals with third-party countries, to end making financial contributions to the EU budget, to avoid any physical infrastructure between the border of Northern Ireland and Eire, and to end the direct jurisdiction of the ECJ.

The basic objectives of the EU have been to develop a close partnership with the UK and to avoid a hard border on the island of Ireland. Its red lines have included: the preservation of the integrity of the Single Market, maintaining the indivisibility of the "four freedoms", ensuring a level-playing-field with regard to trade, and ensuring that the UK would not achieve a better deal and conditions outside the EU than Member States have inside the EU.

The negotiations have been complex and protracted because difficult trade-offs need to be addressed because some of the objectives and conditions have been incompatible between the two sides in the negotiations. Furthermore, there have been substantial disagreements in the UK Parliament (and in government) as to the precise exit model to aim for and in particular where the decision is to be made within the spectrum of hard-soft BREXIT. Debates in Parliament have indicated clearly what MPs do not want but there has been a failure to agree on what exit model they do want. In a series of indicative votes in Parliament, no majority emerged for any of the eight options discussed. The problem has been compounded by the UK unusually having a minority government which has relied upon a small party in Northern Ireland for its support and which objects strongly to the clauses in the negotiated agreement which relate to the position of the border between Northern Ireland and Eire.

It is also clear that many MPs have been engaged in a Game Theoretic voting strategy: voting for an option that they do not agree with for fear that the outcome might be a worse outcome. Indeed, some MPs with very strong objections to the proposed Withdrawal Agreement, and who strongly advocated exiting the EU, voted for the agreement for fear that the alternative might be a long delay, a second referendum, or even a withdrawal of Article 50 which would effectively maintain the *status quo*. At different times, the Prime Minister has urged the hard-line Brexiteers to vote for the deal as the alternative might be a long delay or not leaving the EU at all, while at the same time urging those MPs who do not support BREXIT to vote for the deal as the alternative could be an exit without any deal which most analysts argue would be the worst of all the options!

Prime Minister Theresa May negotiated a lengthy Withdrawal Agreement with the EU Commission although it was rejected on three occasions by Parliament. Several aspects of the Withdrawal Agreement proved to be very contentious and much disputed by hard-line Brexiteers. Five in particular have been highlighted: the extent of the payments (£39 million) to be paid to the EU budget; the fact that the UK in effect remains within the Customs Union in the interim period; the UK remains a rule-taker in the interim period: it will be subject to EU rules of the Single Market but will have no say in creating any new rules, and the fact that the UK will not be able to unilaterally decide when the temporary backstop for Northern Ireland will end. The last-mentioned is regarded by hard-line Brexiteers to be an infringement of sovereignty.

Although there has to date (May 15th) been no overall majority for the negotiated Withdrawal Agreement or any of the alternatives, there have been two significant measures of agreement in Parliament: a decisive vote against a withdrawal with no agreement, and the need for an extension to Article 50.

On April 15th, the UK Prime Minister formally requested a short delay to Article 50 (to June 30th). The President of the EU offered a one-year extension with the option of an earlier date if Parliament were to agree to the Withdrawal Agreement (on a fourth attempt), or an acceptable alternative. When it was decided to have a longer delay this opened the possibility of a second referendum, UK elections to the European Parliament, a General Election, or conceivably (though highly unlikely) the withdrawal of Article 50.

The negotiated exit agreement

The negotiated Withdrawal Agreement runs to 585 pages. It is focussed exclusively on the divorce settlement and the terms of the twenty-one month transition period during which negotiations are to be conducted about the longer-term relationships between the UK and EU.

The agreement focuses primarily on four areas: issues concerning citizens' rights, UK payments into the EU budget, conditions related to the interim period, and arrangements regarding the Northern Ireland border. There is no agreed view (other than non-legally binding vague commitments) about the long-term relationship between the UK and the EU which is to be negotiated in the twenty-one-month interim period. The long-term implications of BREXIT will be determined by the precise nature of the agreement made about future trading and other relationships with the EU made during the transition period.

During the interim period the UK would remain a member of the Customs Union and stay within the Single Market. The entire EU *equis* will continue to apply as if the UK were a member, and the ECJ would continue to have jurisdiction in the UK in its areas of competence. The four freedoms would continue to apply as would the regulatory requirements of the Single Market and Customs Union. The UK would continue to make EU budget contributions. Special arrangements would be made to address the special problems of the Northern Ireland border. If the EU were to negotiate trade deals with other countries, these would not automatically apply to the UK although the EU will request that they do.

Overall, there would be little change in the interim period from the *status quo* of membership.

Regarding the longer term negotiations (where the real impact applies), the title of the addendum to the Withdrawal Agreement is indicative: "Political Declaration setting out the framework for the future relationship between the UK and the EU". This outlines a series of somewhat vague aspirations only. It contains several statements of ambition:

"[It] Establishes the parameters of an ambitious, broad, deep and flexible partnership across trade and economic cooperation, law enforcement and criminal justice, foreign policy, security and defence, and wider areas of co-operation."

"Develop an ambitious, wide-ranging and balanced economic partnership…. Encompassing a free trade area."

"Comprehensive arrangements that will create a Free Trade Agreement combining deep regulatory and customs cooperation."

As always, the devil would prove to be in the detail during the negotiations.

The BREXIT Matrix

The central problem is that Article 50 was triggered without any clear vision about what type of BREXIT was intended and, therefore, what the UK's negotiating position was to be. As the options have different characteristics, it is not possible to analyse the impact of BREXIT on trade and the macro economy without considering the precise model of BREXIT outlined in the matrix below (Table 1). There is a wide spectrum between what has been termed "soft" and "hard" BREXIT ranging from the *Common Market 2.0* option (at the soft end of the spectrum) and exiting the EU with no agreement and defaulting to the WTO model with unilateral free trade at the other end of the spectrum.

Although there are nuances within each model, and various hybrid versions are possible and probably likely, the trading options fall into eight broad categories:

(1) **Remain a member of the EU**: a reversal of the Brexit decision, perhaps after a second referendum,

(2) The **Norway-European Economic Area model**

(3) **Common Market 2.0 / EEA model** (Norway-Plus option - Single Market and Customs Union)

(4) **Permanent Customs Union** only (without Single Market membership)

(5) **Free Trade Agreement with the EU**

(6) A **Deep and Comprehensive Free Trade Agreement** (Canada Model)

(7) Exit with **No deal**: the default position of WTO rules

(8) Exit with **No deal: Unilateral Free Trade**

Each of these models has been proposed and discussed in Parliament though there has been no agreement either in Parliament or government about the preferred option.

Table 1 below considers the implications of each model. It outlines the basic options that are likely to be available in subsequent discussions in the Interim Period. More important, it illustrates that a key issue focusses on a set of trade-offs where political and economic choices need to be made.

TABLE 1

BREXIT STRATEGY MATRIX

	Full EU Member	Member EEA	Switzerland Model[1]	Costums Union[2]	Free trade Agreement	WTO	DCFTA[8]	Common Mkt 2.0
Member of single market	Yes	No	No	No	No	No	No	Yes
Tariff-free access to single Market	Yes	Yes[5]	Limited[5]	Yes	Yes[6]	No	Yes	Yes
Member of EU Customs Union	Yes	No	Limited	Yes[5]	No	No	No	Yes
Accept free movement of labour, capital etc.	Yes	Yes	Yes	No	No	No	No	Yes[3]
Make payments to EU Budget	Yes	Yes	Yes	No	No	No	No	Yes
Accept EU regulation	Yes	Yes	Limited	No	No	No	Yes	Yes
EU Decision making	Yes	No	No	No	No	No	No	No
Accept jurisdiction of ECJ	Yes	Yes[10]	Yes[4]	No[11]	No	No	No[11]	Yes[10]
Able to negotiate non EU trade agreements	No	No	Yes	No[12]	Yes[9]	Yes[7]	Yes	No
Customs controls and Rules of origin tests	No	Minor	Yes (?)	No	Yes	Yes	Yes	Yes
Subject to non-tariff Barriers	No	Limited	Limited	Limited	Yes	Yes	No	Limited
Northern Ireland border problem solved	Yes	No	No	Yes	No	No	No	Yes

"Limited" means that the dimension applies to only some sectors of the economy.

1) Switzerland is a member of EFTA but not the European Economic Area. It has over 100 bilateral deals with the EU that give privileged access for goods (excluding agriculture) which need to be continuously re-negotiated to reflect changing economic circumstances. These deals effectively mimic much of the Single Market without giving membership.

2) A Customs Union agreement with the EU means that external tariffs are set at the same level as the EU sets them. There are no Rules of Origin, and the country cannot negotiate its own deals with non-EU countries. Turkey has formed a Customs Union with the EU which implies a common external tariff which is set by the EU.

3) With possibility of an emergency break.

4) There is a requirement to accept many of the single market laws.

5) Excluding services, agriculture and fisheries.

6) Does not cover all services and does not cover non-tariff barriers.

7) Excludes services.

8) Ukraine, Korea, and Canada have Deep and Comprehensive Free Trade Area agreements with the EU and some other countries are in the process of negotiating such an arrangement.

9) In an FTA a country is free to set its own external tariff and negotiate other FTAs. If tariffs vary from those of the EU, there need to be rules-of-origin requirements.

10) Members of the EEA are subject to judicial review by the Court of the European Free Trade Area though this court is required to follow the case law of the ECJ.

11) Is subject to an agreed joint court.

12) If the UK were in the customs union but not a full member of the EU it would be subject to the common external tariff and would not be able to negotiate its own trade deals in goods with non- EU countries. If the EU were to negotiate trade deals with other countries, the UK would be required to accept imports from the country on the terms of the agreement. However, there would be no automatic reciprocal arrangement for UK exports to that country. Trade deals would be possible in services.

For illustrative purposes, we focus on the two extreme models: Common Market 2.0 and the No deal WTO model. Overall, the closer will be the ties and trading relationship with the EU after BREXIT, the more the UK will be bound by EU rules of the Single Market and Customs Union and hence the less will be the alleged restoration of national sovereignty.

Common Market 2.0

In essence, this would be "Norway Plus" with the main component of the plus being membership of the EU Customs Union. This would be the softest form of BREXIT and would be close to full membership. However, the UK would have no role in decision-making with respect to regulation. At the end of the transition period the UK would join the EFTA and move into what is termed "the EFTA pillar of the EEA" which binds the economies of the EU with that of the UK. By remaining in the Customs Union (or equivalent arrangement) there would be no need for a hard border on the island of Ireland. The UK leaves the Common Agriculture Policy and the Common Fisheries Policy. Although the UK would be required to maintain free movement of labour, there would be a mechanism to suspend this if "serious economic, societal or environmental difficulties" arise.

No Deal: WTO model

In the event of a no-deal (which some MPs have been strongly in favour of) the UK reverts to the default position of WTO rules and the Most Favoured Nation clause. The UK would have the ability to set its own tariffs subject to ceilings imposed by the WTO. There would be no special access to services into the EU and exports to the EU would face the EU's Common External Tariff (CET) and also a series of non-tariff barriers and customs checks. There would also be some regulatory barriers to free trade: firms exporting to the EU would be required to conform to EU standards. At the same time (and this was also advocated by the Economists for Free Trade Group), the UK would also be able to reduce its own tariffs though in this case the Most Favoured Nation requirement would apply: any preferential tariff to any one country would have to be applied to all countries. The UK would not have access to any trade deals with non-Member States that have been or will be negotiated by the EU.

In practice, there are several important areas that the WTO rules do not cover most notably financial and other services all of which are important for the UK. Other areas include cross-border flows of data, road haulage, aviation and airline safety, energy, and mutual recognition of product testing.

On exiting the EU without a formal Withdrawal Agreement, the UK would be leaving the Common External Tariff and defaulting to WTO rules and the Most Favoured Nation clause. Regarding tariffs on imports from the EU the government would have a clear choice. If it aims at keeping prices of imports from the EU constant in the UK, it would not impose tariffs on imports from the EU. This would imply zero tariffs against EU imports. In this case, the zero tariff regime would need to be applied to similar imports from all countries which would have the effect of lowering the prices in the UK of imports (especially some food products) from the rest of the world. This would be a competitive threat to UK producers.

Conversely, if in order to avoid this potential threat to some UK industries the UK were to impose tariffs on imports from the EU, domestic prices of such imports would rise. In effect, a choice would have to be made between the domestic sterling prices of EU imports (which would rise if the UK were to impose tariffs on imports from the EU), and those from the rest of the world (which would decline if no tariffs were imposed on such imports from the EU and hence also on imports from the rest of the world). Given that world food prices are generally lower than in the EU (because of the CET), this would lead to a sharp rise in food imports which in turn would have a negative impact on British agriculture. The same argument applies to other imported goods (such as motor vehicles) where the CET imposes a significant tariff on imports.

Inevitably in a complex paradigm, there are several limitations. Firstly, when considering the full detail of countries' relationships with the EU, there are detailed exceptions in each model. Secondly, because of the close economic ties between the UK and EU Member States (whether or not the UK is a member) developments and regulation within the EU would have an impact on the UK. Any realistic trade deal with the EU would almost certainly imply the UK being required to adhere to the bulk of existing EU regulation. If the UK were to maintain membership of both the EU's Single Market and the Customs Union (the "soft" Brexit option) the UK would be required to accept much of existing EU legislation and regulation without being able to contribute to the formulation of any new regulation.

Impact of Brexit: Alternative models

The impact of exiting the EU depends crucially upon the particular model adopted (see matrix above). This means that the impact is indeterminate until the model is specified. All alternatives involve a reduced degree of openness of the economy and trading relationships which in turn raise the costs and lower the volume of trade via tariff and non-tariff barriers. The key determinant of the macro economic impact is the nature and extent of any increased trade barriers. Under all BREXIT models, the UK faces increased NTBs on trade with the EU. Any impact on the exchange rate will also affect the outcome.

Several attempts have been made by the government, other agencies, and private sources to model the impact on the UK economy of the various BREXIT models. With one exception, they all point to varying degrees of negative impacts on the level and future rate of growth of GDP and income per capita. The differences between models arise for several reasons: the BREXIT model applied (i.e. the nature of the exit model), the assumptions made about, for instance, the extent of post-BREXIT non-tariff barriers, the time period considered, assumptions about the way trading companies will respond, and the extent to which a distinction is made between *static* and *dynamic* effects: the former relate to the immediate impact *via* trade and the latter is the extent to which there is a longer-term impact on the growth potential of the economy.

In any model the economic operates through several routes:

- The impact on trade of changes in tariff and non-tariff barriers with the EU and other countries.

- The effect of the loss of access to the trade deals the EU has established with non-Member States [just to maintain what the country enjoys through the EU, would mean negotiating new trade arrangements with the EU and over 50 other countries while commencing trade negotiations with a further 67].

- The effect that BREXIT could have on immigration given that the empirical evidence is that past immigration has had a positive effect on output, growth, and the public finances (Llewellyn, 2017).

- Any impact that exit from the EU might have on inward foreign direct investment. The UK Treasury has argued that any reduced access to the Single Market would make the UK a less attractive destination for foreign investment which in the past has been a positive impact on productivity.

- The UK would become a third-country with the EU being legally bound to make border and customs checks.

All the alternative models increase the costs of trading with the EU and none is likely to give full access to the Single Market which, as noted above, is the UK's largest single trading market. This implies that the UK would lose the full impact of the proximity-effect of membership of the Single Market.

Table 2 below gives the estimates on the impact on GDP of a selected number of official agencies for three alternative models: leaving without a deal (the default position of WTO arrangements), a negotiated FTA with the EU, and the EEA model described above. It also gives the average of a wider range of estimates and the average for all selected studies.

TABLE 2

Percent decline in UK GDP

	WTO	FTA	EEA
Banque de France	-2.9	-2.4	
IMF	-4.0	-2.5	
UK Civil Service	-6.5	-4.5	-1.5
OECD	-7.7	-2.7	
Range	0 – 18.0	0 – 12.5	0.6 – 10.0
Average of all studies	- 4.4	-3.0	-2.3

The UK Civil Service has conducted its own analysis of the potential impact on output over a fifteen year horizon, and also reviewed several other published studies. It summarises its findings as follows:

> "In conclusion, the Treasury's analysis shows that none of the alternatives comes close to matching the net economic benefits to the UK of EU membership.....The overall economic benefits of EU membership are significantly higher than in any potential alternative........
>
> The UK would be permanently poorer if it left the EU.. Productivity and GDP per person would be lower than in all the alternative scenarios, as the costs substantially outweigh any potential benefit of leaving the EU."

The Civil Service simulates the impact of four different scenarios: a no-deal BREXIT, an FTA with the EU, an EEA model, and what is termed a "modelled white paper". The results are summarised in Table 3.

TABLE 3

Percent impact over 15 years

	WTO	FTA	EEA	WHITE PAPER
GDP	-7.7	-4.9	-1.4	-0.6
GDP with zero net inflows of EEA workers	-9.3	-6.7	n/a	-2.5

A dissenting view

The strong consensus is that BREXIT would impose net economic costs on the UK economy. However, a free-market group of economists (*Economists for Free Trade*) takes a fundamentally different view. The group favours a no-deal exit, default to WTO arrangements, and the adoption of a unilateral free trade strategy by abolishing or substantially reducing all tariffs on imported goods. The group also argues the benefits to the macro economy of the abolition of much regulation, and the general benefits of free trade and enhanced competition in the economy.

A major component of the strategy would be the ability of the UK to negotiate its own FTAs with fast-growing economies in Asia, USA and elsewhere rather than be tied to the more slow-growing economies of Europe. In particular, the UK would have the benefit of negotiating FTAs in its own interest rather than having to accept the compromises that EU FTAs inevitably entail because of the different interests of twenty-seven Member States.

The Group's analysis emphasises the protectionist features of current EU structures (e.g. the CET) and that their abolition would enhance competition in the British economy and in the process raise efficiency, output and the growth potential of the economy. This would also be facilitated by the freedom to abandon allegedly efficiency-restricting regulation and the absence of a requirement to make annual payments to the EU budget.

Rather than BREXIT imposing net economic costs on the UK, the EFT analysis suggests that output would be around 4 percent higher over a fifteen year period. However, this assumes that the UK adopts a unilateral free trade strategy, that all barriers to trade with the non-EU world are removed, and that the EU will not impose additional barriers.

If the UK were to abandon all tariffs on imports (including from the EU) this would be likely to have a major impact on some industries including agriculture and manufacturing given that, as a member of the EU, UK imports have been subject to the CET which includes, for instance, 10 percent on motor vehicles and 50 percent on dairy products. While this would be beneficial for consumers through lower prices, some producers and employees would be negatively affected by unilateral free trade. The dissenting view, on the other hand, is that there would be a general gain through an erosion of protectionist measures.

Trade-offs

The political economist Thomas Sowell famously wrote that "in politics there are no ideal solutions, only trade-offs". This is most certainly the case with respect to the conditions for the UK exiting the EU. The BREXIT Matrix outlined above indicates several economic trade-offs, between economic and political considerations, and also between different political objectives. The BREXIT Matrix is itself a pattern of trade-offs. In general, the more comprehensive will be the UK's access to the Single Market and membership of the Customs Union, the more the country will be required to maintain free movement of labour, make annual payments to the EU, accept EU regulation and elements of the jurisdiction of the European Court of Justice (ECJ), and be constrained in negotiating its own trade deals with third countries.

It is not possible for a non-member country to have access to the internal market under different conditions as apply to Member States: in particular, the "four freedoms", and common regulation. No compromise is possible on these conditions because the credibility of the single market depends upon them. Only EEA members (such as Norway) have partial or full membership of the single market and Norway accepts the "four freedoms" and the jurisdiction of the EFTA Court which operates in a similar fashion to the ECJ.

Deals with rest of the world

Three types of trade deals will need to be negotiated once the UK has exited the EU: (1) with the EU itself, (2) with those countries with which the EU has negotiated trade deals, and (3) other countries. This will be a formidable task. However, some analysts (notably *Economists for Free Trade*) have argued that the freedom to negotiate FTAs is one of the most important advantages to be derived from BREXIT. A similar view has been taken by those MPs in the UK Parliament who have advocated a "no deal" BREXIT.

However, there are several problems with this strategy not the least being that FTAs have usually taken several years to finalise. Most FTAs exclude services (which are particularly important for the UK) and only limited free trade is allowed for many agricultural products. The UK would also be negotiating alone and its bargaining position would clearly be weaker than that of the EU when negotiating trade deals. There is a global trend towards trade negotiations being conducted by trading blocs. This is partly because of rules-of-origin requirements to prevent trade arbitrage: such requirements are less extensive the larger/bigger the number of countries within the FTA bloc.

Some countries are also likely to delay negotiations until the final deal is made between the UK and the EU over their future trading relationship. It cannot be assumed that the UK would be able to seamlessly maintain the advantages of the EU's deals with third parties once the UK is no longer a member.

Negotiating partners are likely to make sometimes difficult conditions. For instance, the US farm lobby will press strongly for the UK to accept different standards for its imports of US farm products which are strongly resisted in the UK. It is alleged that India, for example, would also press for less stringent immigration laws for their citizens wishing to live and work in the UK in return for an FTA.

The irony is that the UK will be exchanging regulation dictated by the EU for regulation imposed by third countries. As adherence to EU regulations (particularly product regulations) will continue to be a requirement for trade with the EU, the result is likely to be a net rise in regulation dictated by other countries compared with EU membership.

An important non-EU trading partner for the UK is the United States. This is likely to be a complex and contentious issue not the least because any trade deal is likely to depend in part on the nature of the deal the UK strikes with the EU. In particular, the issue of access by financial firms (notably US banks located in the financial centre of London) to EU markets will be a central issue. The US Commerce Secretary has warned that striking a deal with the EU that severely restricted UK access to EU financial markets after BREXIT would weaken the chances of a successful trade agreement with the US. In general, the US is likely to prefer the UK to move away from EU regulation. In addition, the US has indicated that the UK should abandon EU food safety regulation. The US Congress will almost certainly insist on the UK accepting some agricultural products that do not conform to UK standards. The problem of chlorinated chicken has become a symbolic *cause celebre*. The US is also likely to demand access to the UK health market.

Overall, it is impossible to envisage that any trade deal with a third country would be as free as the arrangements within the Single Market not the least because FTAs usually do not involve substantial reductions in non-tariff barriers which are generally excluded from WTO requirements. Furthermore, any advantages to be derived from independent negotiations with third countries are likely to be more than offset by the losses associated with exiting the EU Single Market and Customs Union. It is not clear that BREXIT will actually free the UK from externally-imposed regulations: in many areas it will remain subject to EU regulation (with the difference that it will have no say in the regulatory process) and will have additional externally-imposed regulation through third party trade deals.

Although some analysts and Members of Parliament have emphasised the importance of the UK being able to conduct its own trade negotiations with third parties, most empirical studies indicate that new FTAs add little to output. The government's analysis suggests that such trade deals would add only around 0.5 percent to GDP against its estimate of a substantial loss with regard to the EU.

Assessment

In the final analysis, BREXIT involves important trade-offs between different economic and political objectives, and difficult choices will need to be made in the post-BREXIT negotiations. We have emphasised that the ultimate economic impact of BREXIT will depend critically upon the precise BREXIT model adopted and the positioning along the spectrum of a soft BREXIT (such as Common Market 20) and a hard version (e.g., exiting without a deal).

References

Ricardo, David (1817), *Political Economy and Taxation* (volume 1), page 132.

Llewellyn, D. T. (2017), "Ten Myths in the Brexit Debate", *SUERF Policy Note* No. 7, SUERF – The European Money and Finance Forum, Vienna.

About the author

David T. Llewellyn is Professor of Money and Banking at Loughborough University and an External Member of Kellogg College at the University of Oxford. He is a member of the Council of Management and former President of *SUERF – The European Money and Finance Forum*. Until recently, he was Chair of the European Banking Authority's Banking Stakeholder Group and was formerly a Public Interest Director on the Board of the UK's former retail investment regulatory agency – the Personal Investment Authority. He has also had career posts as economist at Unilever, HM Treasury, and International Monetary Fund and has served as a consultant to financial institutions, international agencies, and regulatory authorities in the UK and abroad. He served as part-time Consultant Economist at ICAP plc for several years. Other positions have included Visiting Professorships at universities in the UK and elsewhere in Europe. He has researched and published extensively in the area of banking strategy, competition in financial systems, and banking and financial regulation. In 2016 he was awarded an honorary doctorate for his contributions to banking regulation.

SUERF Policy Notes (SPNs)

SUERF THE EUROPEAN MONEY AND FINANCE FORUM

SUERF is a network association of central bankers and regulators, academics, and practitioners in the financial sector. The focus of the association is on the analysis, discussion and understanding of financial markets and institutions, the monetary economy, the conduct of regulation, supervision and monetary policy. SUERF's events and publications provide a unique European network for the analysis and discussion of these and related issues.

SUERF Policy Notes focus on current financial, monetary or economic issues, designed for policy makers and financial practitioners, authored by renowned experts.

The views expressed are those of the author(s) and not necessarily those of the institution(s) the author(s) is/are affiliated with.

SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at