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Patrick Minford on why the consensus of economics opposed Brexit and why no deal is the best deal

Can the UK 'take back control' and be better off at the same time? Angus Armstrong asks

Dan Ciuriak writes about how Brexit could reshape the global trading system

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FOREWORD

A soft or hard Brexit?

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Brexit talks have begun. The UK's Brexit secretary, David Davis, and the EU's chief negotiator, Michel Barnier, have sat down together for the first time to formally negotiate terms of the UK's withdrawal. Beforehand, major UK business bodies have come together to call for continued access to the European Single Market until a final Brexit deal is made with the EU. Business wants to know what will be the basis of future trade with the rest of the European Union.

There have been calls saying that the United Kingdom needs to pay large and continuing sums to the European Union. There is no legal requirement to do so. The rest of the world trades with the EU without payment. There are calls for the UK to stay in the Single Market and the Customs Union. The EU have said that the UK cannot stay in the Single Market without accepting freedom of movement and budget contributions.

The so-called Remainers talk about a 'soft' Brexit, and that no deal would be a bad outcome. The Brexit vote was quite clear; the referendum question was unambiguous - *Should the United Kingdom remain a member of the European Union or leave the European Union?* -with the responses equally unambiguous - *Remain a member of the European Union* or *Leave the European Union.*

Some say there is not time to negotiate a free trade agreement with the EU. That would be true if there were lots of barriers to remove and discuss. The UK is offering a continuation of current free trade with no new barriers. It is also saying it will translate into UK law all the present rules and regulations to allow continuity. Others are aiming for a lengthy transition period before a long-term deal is in place. Others even say that the negotiations should be postponed. Whilst there will be more tough talk and posturing from some EU officials, many in the other member states will want easy access to the UK market and will see that has to be reciprocal.

If the EU wants to impose barriers on their trade with the UK, they would have to be complaint with WTO rules, which limits the ability of the EU to do damage to the British economy. The main sector which could end up with high tariffs is agriculture, where they sell twice as much to the UK than the UK sells to them. Being out of the Customs Union means that agricultural products can be sourced outside of Europe at a lower cost.

The UK will leave the single market and the Customs Union when it leaves the EU, as the rest of the EU also intends. With political will, a sensible trade agreement is in reach. It is in both sides' interest to avoid a no-deal scenario and a fallback to WTO rules. After Brexit, economic and political links between the EU and the UK will be weaker. But the UK will still be the EU's closest neighbour and an important ally. It is time to discuss how to soften the damage of Brexit for citizens and business on both sides. Brexit can be a success, but aiming for failure serves no one. Goodwill and a sense of perspective are the way to protect the EU and UK alike. ■

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The economics consensus about Brexit

Patrick Minford examines why the consensus of economics opposed Brexit, why they are wrong and demonstrates that no deal is the best deal

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Why did the consensus of economists oppose Brexit? This is an important question because after this election once the negotiations with the EU begin, that same consensus will be rooting for a 'deal' that is as close as possible to the status quo. The May government has said that 'no deal is better than a bad deal' and committed itself to leaving the single market and the customs union, taking back its laws, and resuming control of its borders. If the EU makes any trade agreement conditional on acceptance of EU Single Market regulation and the 'four freedoms' which include free migration, then there will be no deal and that economics consensus will be in full attack mode again.

So why? I have spilt a lot of ink[1] in detailed examination of several consensus cases: especially that of the Treasury and of the LSE group, which was heavily consulted by the Treasury. But there were many others. A partial list includes PwC for the CBI, Oxford Economics for various business clients, the IMF, the NIESR and the OECD. I also reviewed these cases in less detail. I should mention Open Europe which produced an assessment ranging from a small negative to a small positive according to a variety of policy assumptions: this was the only modelling assessment, apart from ours, which was not uniformly hostile to Brexit and as such was not in the consensus.

The consensus assumptions about Brexit policies

There is one main reason for this consensus hostility to Brexit. These modellers all, without exception, assumed that under a full Brexit where there was no deal with the EU, often called the 'WTO option', the UK government would continue with existing EU trade barriers against the rest of the world and would not alter its regulative approach from that of the EU.

Some modellers went further and assumed that the immigration policy would greatly reduce skilled immigration. Yet they made these assumptions knowing that they represented bad policy: continued protection against the rest

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of the world plus protection against the EU, no regulative improvement from well-known EU failures, and in some cases a bad immigration policy not currently followed on non-EU migrants.

During the referendum, when challenged about making them, the various groups somewhat embarrassedly could not justify them but simply argued that this was 'inevitably' what policy would be for 'political reasons'. Plainly these groups were campaigning against Brexit in the referendum and so had the motivation to paint a grim picture; now

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There are two routes to free trade: a negotiated route via free trade agreements, with the EU and then with significant others - and the route of unilateral elimination of our own protection, such as happened in 1846 when Peel abolished the Corn Laws

however when they like the rest of us must be concerned to make a success of Brexit, this position will not do, especially as the government is setting out policy positions that are quite different - namely free trade with the rest of the world, regulative reform and an immigration policy that will target unskilled immigration with its large costs to the taxpayer and enable skilled immigration needed to supplement our native skills.

Since none of these modelling groups have to date costed such optimal policies we do not know what difference it would make to their assessments. However, we can get an indication from one solitary exercise carried out by the LSE group, in which they assumed the UK unilaterally abolished the EU average tariff on manufactured goods, around 3% on their calculations. They found that this would add 0.3% to UK GDP, against losses from the WTO option of 1-2.5% of GDP. LSE dismissed this as trivial, barely changing their overall assessment.

Yet I have pointed out at various times that this is a massive underestimate of the EU protection we would abolish by moving to free trade with the rest of the world. My research team's estimates of EU protection of manufactures is around 20%, made up of significant non-tariff barriers in addition to those low tariffs; these estimates are based on very detailed estimates of price differentials against world suppliers. They also tally with direct estimates of non-tariff barriers cited by LSE.

But this is only the half of it. LSE also ignored the massive tariffs on agriculture which have the effect together with the rest of Common Agricultural Policy intervention of raising farm prices by 20% also; this is the standard estimate from the OECD of 'Producer Subsidy Equivalent'. Together with the manufacturing total barriers these two pieces of protection raise consumer prices by around 8% according to our modelling. But even in the LSE model they multiply the gain from unilateral free trade by nearly 7 (20/3) which raises it to about 2% and more or less offsets the worst end of their range of losses from Brexit.

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What one gets out of this calculation is rather the conclusion of Open Europe using a model from the same general stable: the gains or losses under the WTO option could be quite small in either direction, depending on the choice of Brexit policy. It is interesting that as we move towards actual policy choices in this Brexit era the rhetoric from the consensus is becoming more muted. In a recent interview with Ambrose Evans-Pritchard of the *Telegraph* the leader of the LSE group, Prof. John van Reenen, candidly admitted that for a largescale regime change like Brexit he could not be too certain of the outcome.

We can also note a variety of detailed ways in which the various groups calculated the losses from the Brexit departure have been criticised, taking their modelling approach as given. For example Ken Coutts and colleagues at the Cambridge Centre for Business Research have noted that the way the EU effect was estimated by the Treasury relies heavily on other countries' experience and is unlikely to be accurate for the UK. In my original critique of the Treasury study I noted a number of similar points about estimation, as did David Blake. Much of this critique carries over to the other studies to a more limited extent.

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The general modelling approach of the consensus and the 'gravity model'

However, this is all to take the general modelling approach of the consensus as correct in principle. We come then to the other major reason for the hostility of the consensus towards Brexit: the way that they think about the origins of trade.

The classical view of trade, going back to Ricardo, John Stuart Mill and later Heckscher and Ohlin, is that it originates with differential supplies due to comparative advantage. Ricardo had wine and cloth in his famous example: Spain produced wine relative cheaply, Britain cloth. The later economists went behind these relative cost facts to argue that they in turn came from the supplies of 'factors' or resources native to each country, whether it was the 'land' (including the weather) or the skilled labour or the capital. These 'resources' would include such things as the climate

for investment and property rights since these would enhance the effectiveness of the factors in production. We can think of this analysis as being a 'supply-side' theory of trade.

Of course demand has a role in just how much is traded; but the broad pattern of what a country supplies and so exports after satisfying domestic demands compared with what it does not supply and so imports to meet home demand is set by supply forces. In these classical models if a country faces a trade barrier in another market it simply diverts any supply that is not sold there to another market, all markets being governed by competition across the world, so producing 'world prices'.

Now of course if you join the EU which is a vast customs union, you find it advantageous to switch your output entirely into that market wherever you can, since its trade barriers against the rest of the world will raise the prices within it above world prices. In the classical literature on customs unions, it was shown that while in general everyone would be better off with completely free trade, a particular country could gain from the customs union if it produced much larger amounts of the protected goods than it bought: this was because the gains to its producers from higher prices exceeded the losses for its consumers.

Unfortunately the UK is in precisely the opposite situation: it buys much more of the protected food and manufactures than it sells! Hence in the last referendum my LSE mentor, Prof. Harry Johnson, vocally opposed the UK's joining of the EU.

Now contrast this with the view that dominates the current consensus - often known for short as the 'gravity' principle. What dominates trade is demand from countries that are large and also close by, because transport costs rise with distance ('gravity' equals size/distance). So the picture is of consumer markets in which a lot of different goods, with differing 'brands', are sold by producers from around the world supplying those brands. The prices of those

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brands are raised by transport costs the more distant the supplier. Consumers choose between them all and buy most from the cheapest sources. Clearly big countries have a lot of demand and as producer your share of those markets will depend on your price and so your transport costs. Tariffs and other trade barriers are simply one element in these 'transport costs'.

Now take a country like the UK: it sells exports to its trade partners according to how expensive its goods are in those markets. So if the EU puts up barriers to UK exports it will sell less. Carrying out FTAs with 'distant' markets is unlikely to replace the loss of sales to the close-by market of the EU. Now consider import trade: the UK buys from other countries according to its GDP and if it leaves the EU, its imports from the EU will go up in price while under FTAs its imports from the rest of the world will go down in price but overall its imports will not be changed much. So because exports will go down overall trade will fall.

This demand-side effect is then compounded in these models by the assumption that foreign investment and also R&D depends on trade and so demand. The resulting fall in FDI and R&D then lowers productivity. So what we have is a model of trade and production that is dominated by demand.

There is an interesting parallel between these current demand models of trade and the Keynesian models that once dominated macroeconomics after the second world war. In those too there was no role for supply. In both cases the suppression of supply came about because of the assumption of rigid prices and generalised lack of competition, 'imperfect competition', which underpinned this price rigidity. In current trade models competition plays very little role as the responses to relative prices are generally low.

It is a curious fact of economic thought that just as Keynesian models were rightly displaced by models based on classical principles where supply is dominant except in the short run, their sister-models in trade came into fashion,

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even though their assumptions plainly contradict those of modern macro thought and appear totally unsuitable for the long run. In trade theory the focus is on the long run because trade regimes work themselves out over this time frame and the regimes last for a very long time: so it is particularly odd to find that demand is dominant over what amounts to a decade or more.

If we revert to the obvious facts of world trade and competition, we can see that there is free entry into globalised world markets and that brands are frequently brutally displaced by competition: note the experience of Nokia and Blackberry, or the way in which Amazon has come to dominate retailing, or Google to dominate internet search.

In whole areas of consumption such as the car market there is upheaval ('disruption') as the entry of electric and driverless, computerised, cars threatens to destroy the main car producer model. Then there is the steady grinding out of weak performers in worldwide supply chains. It has never seemed more appropriate to assume world competition, as in the classical model.

Now think about the UK's trade trends. The UK is now one of the world's major export supplier of services; for example, in foreign currency trading it has the largest share of the world market. Back in the 1970s the City was a small part of the UK economy and of little consequence worldwide. Manufactures were 35% of UK employment, now only 8%. Have these changes had anything to do with demand from the EU or the world?

Plainly not. They are the result of the UK's own policies during the 1980s to transform the economy in the direction of free markets and competition. Workers left inefficient manufacturing industries, and new workers acquired skills whether in education or services and supplied competitive service products to the world economy. Capital flowed in from abroad after the abolition of exchange controls.

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Then consider how UK industries would respond to some EU protection. 60% of our car industry's exports by value already go to world markets, outside the EU's protected market. With the UK only 3% of the world economy it is really not difficult to imagine those exports being somewhat expanded either in existing or in new markets around the world, at world prices just like now.

On this view the demand side is essentially irrelevant: supply will seek out demand where existing demand falls back.

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Which models are consistent with the facts?

One rather amusing claim made by these gravity modellers is that their models must be right because they 'fit the facts' as found in the 'gravity equations'. Yet what these modellers have done is fix ('calibrate') their models precisely so that they mirror these equations! These equations do indeed summarise certain facts about trade, as has been well-known since the 1950s when they were estimated by Jan Tinbergen.

As we have seen demand will affect trade; and where supply has an effect it will be captured in these equations by ad hoc additions such as varying constant terms. The 'gravity models' are little more than a demand structure that produces these gravity relationships at a small remove. The gravity equations in no way 'test' these models by their consistency - since plainly they have been set up precisely to be consistent.

Similar claims were made back in Keynesian times about the models fitting the facts. So indeed they did: modellers simply looked at the macro facts of consumption being associated with income for example and estimated models that gave back these facts. But what we learnt from brutal later macro experience is that these were not causal explanations of the facts; and so when policies or the environment changed so did these 'fact' relationships. We concluded that these Keynesian models were simply not proper causal models.

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In much the same way these gravity models are not at this stage full causal models. Full causal models need a full treatment of supply, competition and pricing for the long run. To test them we also need a much wider range of data than just the trade shares covered in gravity equations: for example the behaviour of a country's production sector shares also has to be accounted for. Whereas we have now acquired the tools to test and reject proper causal macro models, these tools have yet to be applied in trade theory, partly because they have such a long-time perspective that long tracts of data are ideally required. However, such testing is overdue and we academics need to get on with it.

While this academic process is going on, policymakers need a robust and plausible theoretical framework to make policy with. The classical model of trade and comparative advantage provides an approach that does explain the main trade developments of a medium-sized country like the UK and its assumptions of high competition and free entry in global markets are plainly in line with recent experience.

What does such a model say about the best policy for the UK to pursue?

The best trade deal is no deal - echoes of the Corn Laws

The key element is the high rate of EU protectionism on food and manufactures, which erects a peripheral wall around the EU keeping up the prices of imports from the rest of the world and so raising prices to EU consumers for not just imports but all EU-made products competing with them. In both sectors the protective rate (from tariffs and non-tariff barriers) is as we have seen around 20%, raising UK consumer prices by around 8%. This in turn artificially boosts farming, the price of land and the inefficient parts of the manufacturing sector. By removing it with Brexit and going to free trade we reverse this and in the process raise consumer welfare and productivity, with a 4% boost to GDP.

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There are two routes to free trade: a negotiated route via free trade agreements, with the EU and then with significant others - and the route of unilateral elimination of our own protection, such as happened in 1846 when Peel abolished the Corn Laws. He got fed up with foreign recalcitrance over reducing trade barriers and simply struck out with unilateral free trade. We too could well get fed up with similar recalcitrance today as the mercantilist EU insists on special demands for its industries or its migrants and even other countries hold out for demands we cannot meet. The FTA route to free trade depends on others cooperating in genuine free trade.

It might just work and go well. But realism suggests it could get bogged down and derailed. So suppose it falls at the first fence with no EU deal. What is the UK's best option? It is to go unilaterally for free trade, with the gains described above. We simply say to the EU: look we abolish these barriers against you anyway and by implication under WTO rules we will do so against all others too. We so reduce consumer prices, increase competition and productivity and boost GDP.

The EU would no doubt levy their tariffs on our exports; and other countries too would maintain their existing tariffs against us. But in a competitive world market where we are now selling at world prices, this has no effect on our national welfare. The reason is straightforward, as explained above: these world prices reflect world demand and supply and the EU tariffs we are speaking about do not affect the EU's total demands and so do not affect world prices at all. All they do is cause EU demands to move towards home products away from us, but as they do so their home output is now not available in third markets where we will make up the deficit.

The EU tariffs are noted earlier rather low - around 3.5% on manufacturing industry. Edgar Miller and I have estimated[2] that they can easily absorb this cost in the short run when sterling is low and boosting their profits; and in the long run they can raise productivity to offset it.

As for our farmers, they will after Brexit face world prices: protection of the CAP and high EU tariffs will be removed. They will sell on world markets for food instead of on EU markets where prices are artificially raised. So EU tariffs on our farming are simply irrelevant. We will revert to helping struggling farmers whose activities are necessary for the rural environment directly from the public purse. We have many large and efficient UK farmers who will change their practices, and adapt by raising productivity.

So no deal is better than a bad deal. Indeed what the above shows is that no deal is better than any deal! But of course we will try to get a sensible EU deal in good faith, simply to maintain good relations even if it is not so good in pure economic terms. ■

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Endnotes

1. See the relevant publications on www.economistsforfreetrade.com

2. 'What shall we do if the EU will not play ball?' on www.economistsforfreetrade.com

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Brexit fork in the road

Angus Armstrong asks if it really is the case that the UK can 'take back control' and be better off at the same time?

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It is said that history is written by the victors. Since winning the Brexit vote, campaigners for leaving the EU have coalesced on 'take back control' as their 'big idea'. They argued that Britain would benefit economically from taking back control of its borders and trade policy. By creating a trade policy that best suits its needs, Britain would sell more and so be better-off as a result. It could restrict immigration and at the same time save £350 million per week.

The government has chosen to interpret 'take back control' as leaving the jurisdiction of the European Court of Justice (ECJ). Since the ECJ is the final arbiter over the Single Market, this means leaving the biggest market in the world. All options of associate membership have, for now, been set aside as 'failing to deliver'. This includes returning to the European Free Trade Association (EFTA), the UK's status back in 1973. That some of the most high profile Brexit campaigners made clear that the UK would stay part of the Single Market is now ancient history.

But whenever someone offers the best of all worlds, it is usually wise to check the small print. Victors may write history, but they don't re-write economics. One can certainly argue that any economic loss that results from taking back control is a price worth paying. But is it really the case that we can 'take back control' and be better off at the same time?

The UK can strike a tariff free trade deal with the EU almost anytime. The drama of whether we can or not is pure theatre. We have been doing trade deals since 1860 and there are over 400 regional trade deals in force today. We start from a position of free trade with the EU so there has to be no agreement on tariffs or painful adjustment to the new regime. This could be done very quickly. But while all politicians say they want a tariff free trade agreement, the devil really is in the detail. Can we really strike powerful trade deal while 'taking back control'?

First, making a trade agreement, by definition, means sharing some sovereignty. There is simply no way around this. It commits a country to abide by certain rules or face review and sanctions imposed by a foreign body. For example,

if a nation violates World Trade Organization rules then they may be subject to a dispute resolution procedure. Any comprehensive trade agreement between advanced nations will have an independent dispute resolution procedure.

Second, after the UK leaves the Single Market, suppose that the UK were to promise to keep to EU rules and regulations. Being outside of the EU, there would need to be some regulations verification process and enforcement mechanism. The UK is one of the most complex economies in the world. It is central to many global supply chains across industries and many nations. So introducing the smallest verification cost would damage its competitiveness.

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There are challenges to overcome in offsetting trade losses from leaving the EU. Countries always sell more to neighbours than the other side of the world

Third, of course the UK will eventually use its repatriated powers - perhaps get rid of some allegedly overbearing EU laws or subsidise its car or steel industry again. But since the core idea of the Single Market is a single set of rules to create a level playing field, deviating from the single set of rules will inevitably lead to a loss of market access over time. One of the curiosities of the referendum was the lack of specific examples of laws that would change in the event of leaving the EU. Perhaps most of the changes will be to conform to requirements for new trade agreements elsewhere in the world. Whether the devil we don't know is better than the one we do remains to be seen.

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Fourth, not all trade agreements are created equal. Today's trade limitations between advanced economies are mostly 'behind the border' rather than 'at the border' or tariff restrictions. Modern trade agreements are increasingly broad in terms of sector coverage, institutional arrangements, regulatory convergence, competition and even social policies. Economists at the World Bank show that the broader the trade agreement, the bigger the impact on trade and ultimately welfare. European trade agreements are generally by far the broadest in the world. Intrusion is the price to pay for getting the most from a free trade agreement.

Fifth, we trade because we are interested in higher living standards. This means higher domestic wages and profits, or domestic value added. Yet the UK is a particularly services orientated economy. More than eight out of ten jobs in the UK are in the services sector and our services exports have a higher domestic value added than our goods exports.

Selling services is different to selling goods. They are mostly consumed at the point of sales. For example, education, dentistry or enjoying the arts generally require us to consume at the point of sales. Either foreigners must come here (immigration), or we have to set-up establishments overseas to export our services. Both require agreeing and abiding by rules and regulations. Setting up establishments overseas requires rules to protect investments

in foreign countries. The UK is the third largest beneficiary of foreign direct investment in the world (behind the US and China). New dispute settlement systems will be required once out of the EU.

These five points show that the question of whether the UK and EU can agree a free trade agreement is not the point. It is whether the UK is willing to accept sharing sovereignty and control to the extent necessary to have beneficial trade agreements that play to the UK's strengths. At a minimum, this will require rowing back on the rhetoric of 'take back control'.

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Some Brexit advocates accept some loss of market share with the rest of the EU is inevitable. But they see this as a virtue because they believe leaving the EU will allow the UK to strike better trade deals around the world. We hear more and more of the plan to strike new trade deals with New Zealand and even the US. It is worth pointing out that only 18 per cent of the UK's total export markets (including the EU itself) do not have an existing agreement with the EU or are not currently negotiating with the EU for a trade agreement.

There are challenges to overcome in offsetting trade losses from leaving the EU. Countries always sell more to neighbours than the other side of the world. Ireland is the UK's fifth biggest export market despite only having the 124th largest population in the world. New Zealand has a similar population and close cultural connections but they are barely a top 50 trading partner. If the UK lost 1 per cent of its market share in goods exports to Ireland, it would have to increase its market share in New Zealand by 30 per cent just to offset this.

The UK can try to replace the loss of EU market share by striking new deals around the world. But this will require accepting many broad and intrusive trade agreements, just to have a chance of standing still. UK total trade with the US and European Economic Area (EEA) countries is 15 per cent and 53 per cent respectively. This means a 1 per cent loss in market share in the EEA requires a 3.7 per cent increase in market share in the US to compensate. The

same 1 per cent loss to the EEA would require a doubling of trade with the next top ten export destinations outside of the US. This is possible, but it will require sharing a lot of sovereignty.

It may be possible for the UK to offset a small decline in market share with the rest of the EU by reaching trade agreements around the world. But the broader that these trade agreements, the more that the UK will deviate from EU rules. We are unlikely to be dealing with only 1% loss in market share. This means the UK will have to strike even more trade deals around the world. At some point the UK runs out of countries to deal with.

As we look ahead, we are at a fork in the road. The paths offer very different outcomes for the future of the UK. One path, favoured by an influential group of politicians and coterie of unelected advisors, believe that 'no deal' with the EU is a good because it allows the UK to stand alone and unilaterally lower UK import tariffs to zero. They accept that this will lead to the virtual eradication of the manufacturing sector, but they see this as collateral damage. In their view, the UK will lead a new world liberal trade order as like-minded countries follow.

The other path is that UK re-joins EFTA. The UK would have a free trade agreement with the EU, a framework to negotiate bilateral agreements on services and allow the UK to strike its own deals with other nations around the world. Earlier this year I was a Special Adviser to the House of Commons' International Trade Committee. Membership of the Committee was evenly divided with deeply held convictions on both sides. After a trip to the World Trade Organization, the Committee returned and agreed that joining EFTA would be 'clearly beneficial to the UK'. They suggested that the Secretary of State publish a White Paper on EFTA membership before year end. ■

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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

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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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Brexit ...the election of Donald Trump ... have injected a major dollop of uncertainty into international commerce

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.

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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

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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).

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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

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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).

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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-

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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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Post-Brexit trade and development policy

Richard Baldwin, Paul Collier and Anthony Venables suggest that the time is ripe for the UK to embrace a new trade and development agenda to demonstrate a country ready to play a key role on the world stage

Introduction

Regardless of what one may think of the decision, the British people have voted to leave the EU – a result that throws up historic challenges as well as historic opportunities. EU economic policies, after all, consisted of 'the good, the bad and the ugly' and the EU's trade and development policy was among the worst. Brexit, therefore, should be viewed as an important opportunity for fresh thinking.

This short thought-piece suggests that the time is ripe for the UK government to embrace a new trade and development agenda which demonstrates that post-Brexit Britain is an outward-looking country, ready to play a key role on the world stage. Our proposal walks on two legs.

The first leg consists of pro-development trade and investment policies focused, initially, on Africa and the Caribbean. The second consists of domestic policies, aimed at ensuring that the gains and pains of progress are shared, ie. that British trade policy is truly in the service of British society, not just in the service of free trade.

Why the focus on developing nations?

This is easy to answer. Under WTO rules, Britain can offer preferential trade terms to developing nations, without first having to negotiate trade agreements. Offering preferences to, for example, the US or Canada, would require negotiation and ratification of a WTO-consistent Free Trade Agreement – a process that takes years, even in the best of cases. Moreover, most advanced countries will be reluctant to open talks with Britain before the main outlines of its eventual relationships with the EU are clear. Thus, even though such deals will be commercially far more important, they are many years down the road. The same is not true when it comes to developing nations.

Developing nations will be happy to open discussions immediately on the issues that are most pressing to them, namely the level of tariffs that post-Brexit Britain will impose on their exports[1]. This is especially so, given that the

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EU's trade policy with respect to Africa is particularly fraught at the moment. The EU strategy rests on coercing developing nations into providing EU exporters with preferences, in exchange for being granted preferential access to the EU market.

The EU's so-called 'Economic Partnership Agreements' (EPAs) have, in reality, been neither partnerships nor agreements. For example, the EPAs for both East and West Africa remain unsigned, despite nine years of negotiations. Now the EU is threatening to put up tariffs against African exports, if the agreements are not signed soon. The British government can rest assured that it will be welcomed by developing nation leaders, if it proposes a different set of trade and development policies.

This year is the 200th anniversary of free trade's touchstone tome – David Ricardo's On the Principles of Political Economy and Taxation. What better time to launch a new phase of British world trade leadership?

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We should note that we are not alone in these judgements. An excellent eBook edited by Mendez- Parra et al. (2016) presents a wealth of specific ideas and analysis, as does the thought-provoking essay by Lande and Matanda (2016).

Why package trade and social policy?

UK trade policy has been within the purview of Brussels for over four decades, while the main domestic economic policies remained matters for Westminster. Brexit allows Britain a chance to bring the two back together – an outcome that is both natural and important.

Opening any economy to international competition and opportunities creates winners and losers. Maintaining a social consensus for liberal trade policy thus requires the people to embrace a general belief that both the gains and pains of trade will be shared fairly.

Brexit provides an opportunity to systematically rethink the links between the policies that help share the gains and pains of trade and the policies that promote openness. What we have in mind is a mostly political connection between trade policy and a set of policies that fight economic disenfranchisement arising from all sources (be it robots and technology, or trade and immigration).

The key elements of our proposal are: striving for mutual benefits with developing nations, simplification of trade schemes achieved through generosity, and complementary policies that ensure it all works in the interest of British consumers and workers.

Making UK trade policy work better for development

For over four decades, UK trade policy has been decided jointly with all other EU members. This has not always gone well. Trade policy designed to serve 28 different national interests has, to say the least, not always been in the best interests of British people.

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In particular, the EU's trade policy with respect to developing nations has not been particularly pro-development, due to compromises that were made to oblige geostrategic and protectionist interests. For example:

- Continental EU members tend to favour agriculture protectionism – including on tropical goods – since they have significant domestic production to protect.

  This has been bad for farmers in poor countries, and bad for British consumers.

- The same is true when it comes to protectionism regarding clothes and other labour-intensive goods which are still produced in some Southern and Eastern EU nations.

  This reduces opportunities for industrialisation in poor countries, and is bad for British consumers.

- Britain has consistently advocated less protective trade policies, but has been outvoted by other EU members.

A Britain in charge of its own trade policy can do better. The UK now has an opportunity to rethink its trade policy, with respect to developing nations, in such a way that it would demonstrate Britain's global leadership in the trade and development arenas.

Act immediately

Trade negotiations typically take years, which is too long to wait. Jones (2016) notes that some developing countries rely heavily on the UK market, meaning that uncertainty about the sort of tariffs their exporters will face after Brexit hampers their development prospects. Economic development, after all, requires firms, people and govern-

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ment to invest but, in truth, such investments are bets on the future. Uncertainty over what UK policy towards developing nation exports might be tomorrow, hinders development today.

An immediate political commitment by the British government that is bold, clear, simple and generous will help reduce such negative effects (Rollo 2016). The first step is to set out the guiding principles for British trade policy, with respect to developing nations, at the unilateral, regional and global levels.

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Unilateral trade and investment policies

Unilateral trade policy, with respect to developing nations, is the first target of opportunity for the government. Since it is decided unilaterally, this is an area where Britain can immediately demonstrate its vision.

We suggest British preferential trade policy, with respect to developing nations, be guided by a few basic principles. The trade policies should be:

- Simple in design and generous in nature;
- Respectful and based on mutual advantage, rather than power and mercantilism;
- Based on existing 'global best practice', rather than re-inventions of the wheel; and
- More liberal and more pro-development than EU policy.

Given that distance still has an enormous influence on natural trade flows, Africa and the Caribbean should be the first focus of the new policy initiatives.

Perhaps the most pressing matter is to send clear signals of Britain's intention to lead global free trade from the front.

- To give meaning to intentions, Britain should make an immediate political commitment to maintaining or improving current levels of preferential access for developing nations, for the next ten years[2].

At the head of the commitment queue should be maintenance of the 'everything but arms' programme, granting duty-free treatment to exports from the least developed nations. Going further, the UK could commit to broadening the range of preference items, so as to include agricultural goods that the EU has, up till now, restricted in order to protect economic interests of import competitors.

As part of this, one bold move would be for the UK government to make a political commitment to, for example, at least double the tariff-rate- quotas allowed to Sub-Saharan African nations for 'sensitive products' like sugar, tropical fruits, cotton, etc.

Pro-development trade policy, however, is more than a matter of tariffs, as Mendez-Parra et al. (2016) point out in detail. One set of barriers that hinder developing-nations from exporting to Britain are the so-called 'rules of origin'. While these rules are necessary to prevent tariff cheating (eg. Chinese shirts being passed off as having been made in, say, Tanzania), excessively strict rules can be used as subtle protectionist devices. Indeed, under EU rules, which currently bind UK practices, these rules of origin are significantly more restrictive than those offered by the US, Australian and Canadian pro-development trade programmes (Crowther et al. 2016).

Britain should commit to using simple, generous, best-practice rules of origin – for example, following the Australian and Canadian practice of setting 25% of local value-added as the qualification threshold for duty-free treatment.

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America's pro-development policy, known as the African Growth and Opportunity Act (AGOA), should be another source of inspiration, as Britain moves away from the EU's approach. In particular, it does not demand that African nations lower their tariffs to American goods in the way that the EU's current policy does. Further, it applies not only to EBA-eligible low-income countries but also to others such as Kenya, which often have a better prospect of industrialisation.

Britain could extend the same offer of market access to countries such as Kenya as it does to those eligible for EBA. To foster regional production cooperation and intra-African trade, exporters should be able to cumulate value added in any eligible nation in reaching the 25% threshold.

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The question of a WTO waiver

Since the first principle of the global trade system is non-discrimination, granting tariff preferences brings any government straight into the difficult terrain of WTO rules. The way to deal with this is to immediately start discussions with other WTO members on a 'waiver' of the type that the US won for its pro-development, tariff-preference (AGOA). Indeed, were Britain simply to make exactly the same countries eligible for its market access package as are eligible for AGOA, it would be adopting a category of countries already granted a waiver by the WTO for US preferences, and this could minimize the risk that a waiver for its own preferences might be blocked.

Even though Britain cannot change its tariffs until it leaves the EU customs union, it can start waiver talks before Brexit is settled, since the UK is an independent member of the WTO. Moreover, while it is true that the intricacies of WTO law could prove a hurdle, the moral imperative of this British proposal should help to clear the path. With most of the WTO's 164 members – the vast majority of whom are developing countries – good intentions can go a long way towards smoothing out legal wrinkles.

Specifically, Britain should immediately launch a political initiative at the WTO aimed at securing a waiver for its eventual preferential tariff policy.

This can and should happen, even before the UK has managed to extract itself from commitments it made at the WTO as an EU member. Whilst this ordering might not conform to strict legal theory, the difference between theory and practice is different in practice than it is in theory (as the saying goes).

Beyond tariffs

The world has long experience with trade and development policies. The UK should therefore rely on existing best practices. Although the EU's EPAs policies have met with a great deal of criticism, one that does seem to work well is the EPA with the Caribbean Forum (Keane 2016). This could be a model for the UK's own bilateral agreements with developing nations, especially when it comes to beyond-tariffs issues.

It covers services, investment and e-commerce, and is more ambitious on services than the EU's existing commitments in the General Agreement on Trade in Services (GATS). As such, it offers what can be thought of as the equivalent of tariff preferences, but for services instead of goods.

Investment is another important, beyond-tariffs issue that needs to be addressed. In the world of 21st century international commerce, trade and investment are thoroughly intertwined – the government free-trade initiative thus needs an investment component.

Currently Britain has over one hundred so-called Bilateral Investment Treaties (BITs), most of them with developing nations. Moreover, since investment policy was a matter for national prerogative for EU members up until the 2009 Lisbon Treaty, all of Britain's BITs were negotiated by Britain. Nevertheless, the key part of the UK's new leadership in

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the trade arena should include a rethinking of its investment treaties from a pro-development perspective. As Gelb (2016) points out, new issues have come to the fore with the rise of global value chains. One of his specific recommendations is that the UK government work towards a more open and transparent dispute settlement mechanism.

While unilateral trade policy is ripe for rapid progress, fostering development will require new trade agreements. We thus turn to ideas for what the UK's new trade policy should look like in terms of bilateral, or regional agreements with developing nations.

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Regional trade and investment policies

Trade in today's world can be thought of as factories crossing borders, not just goods crossing borders. This makes trade policy about much more than just trade. In other words, it is not enough for Britain to simply lower its tariffs and hope that development will follow. The government should add specific commitments on reinforcing aid/technical-assistance programmes aimed at boosting the export capacities of its developing- nation partners — this is best done in a trade agreement (Evenett 2016). The examples that Evenett (2016) provides include:

Improving Sub-Saharan African transport infrastructure (both within the region and with rest of world),
Helping governments to reduce hindrances arising from local market power and red tape, and
Supporting the development of supply-side capabilities in developing countries, to meet the standards of western buyers.

Whilst not necessarily tied to trade agreements, issues surrounding so-called Aid-for-Trade (A4T) packages almost always arise in discussions on trade and development. Since these have always been under national control (the EU has only a small development aid budget at its disposal), there is much less need for us to comment on this aspect, beyond a call for coherence between the British government's new trade and investment policies, and its A4T policies.

Avoid the bespoke deal 'trap'

When it comes to advancing a pro-development trade policy, 'particularism' is a trap to be avoided. There is a tendency to see each developing nation as a special case, requiring its own set of rules and exceptions. This, however, runs two sets of risks, since, first, it tends to delay initiatives – often by years – and, second, it usually leads the more powerful nation – Britain in this case – to slip into a paternalist mind set.

To avoid 'particularism' and speed implementation, Britain should seek to negotiate simple, generous arrangements that are applied as equally as possible across all developing nations.

Additionally, this even-handed, non-reciprocal approach will reduce the chance that British policy, like the EU's EPA policy, obstructs African efforts to set up their own free-trade zones. One of the heaviest criticisms of the EU's trade and development policy (which is also Britain's policy for now) concerns its disruptive impact on African attempts at within-Africa trade-integration. It is a story of unintended consequences, but it provides important lessons about why the government needs to consider regional factors and eschew particularism.

Both the EU and the US launched new trade and development programmes at the turn of this century. The US offered lower tariffs, without requiring African countries to reciprocate. However, it did ask that any preferences granted to other developed nations also be extended to the US. The EU, by contrast, demanded reciprocity. Now the EU is threatening to put up tariffs against African exports, if the agreements are not signed soon.

Worse still, some of the least developed nations, such as Lesotho, whose exports rely heavily on AGOA preferences, could find their duty-free access to the US reduced or rescinded, since their EPA commitments say they should discriminate in favour of EU exports. The best way to avoid such problems and help African-wide trade integration is to make Britain's tariff preferences truly unilateral.

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The final pillar, that is now wide open for a bold British initiative, concerns the global stage.

A bold, global initiative: updating trade and development policy to match 21st century realities

Today's world trade governance 'space' is a vacuum waiting to be filled. For various domestic reasons, world leaders in North America, on the Continent and in large emerging economies are deeply reluctant to present bold visions for global commerce. Yet the nature of international commerce has changed radically in recent years, in particular with the Global Value Chain (GVC) revolution. A rethink is needed to update trade and development policy to match 21st century realities. The door is wide open for Britain to return to its centuries-old leadership of global free trade. (Next year is the 200th anniversary of Ricardo's famous tome.)

While the opportunity is clear, rapid progress is unlikely in most areas. An important exception concerns the trade and development sphere. The trade and development agenda has stagnated at the WTO, along with the Doha Round. As a result, current thinking and policy is based on a very 20th century view of exports and export barriers. For example, the 'Special and Differential Treatment', which has been part of the DNA of the GATT/WTO since the beginning, is conceptualised almost entirely in terms of tariffs, longer phase-in periods, and technical assistance.

- Britain should lead the push for rethinking trade policy at the global level (specifically at the WTO, G20, World Bank, and regional development banks).

This new initiative could give an impetus to ideas that were caught up in the Doha deadlock. It could also seek to add new dimensions to the discussion relating to the changed nature of international commerce and the GVC revolution.

Recent work at the World Bank on 'making global value chains work for development' have brought to the fore the more complicated nature of international commerce (Taglioni and Winkler 2016). This is not just true for the rap-

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idly industrialising nations in East Asia, it is even the case for least developed nations. Global value chains are now important in many agriculture exports (coffee, tea, nuts, etc.) – not just in the classic manufacturing sectors such as autos and aircraft. Across the world, importing-to-export is a much more dominant fact (with important policy implications for tariff preferences, rules of origin and rules of cumulation). Likewise, investment, firm-specific flows of know-how, and availability of world class infrastructure services, ranging from air cargo and telecoms to trade financing and pre-shipment inspection, play far more important roles than they did just a decade ago.

In the global value chain world, 'special and differential treatment' could (and probably should) mean much more than tariff preferences. Things like local-content restrictions, and other forms of cluster-level industrial policy measures could help developing nations get more good jobs in international production networks. Furthermore, GVCs often involve massive power asymmetries with the multinational companies being able to play off developing nations against each other.

Britain should put its weight behind a WTO-level initiative to develop codes of conduct that enable developing countries to participate in and benefit from GVCs.

Making UK trade policy work better for the British society

Trade liberalisation creates winners and losers – it always has and always will. As Pascal Lamy, ex-Head of the WTO, puts it:

> *"Opening trade creates efficiencies. It works because it is painful. It is painful because it works."*

But globalisation in recent years seems to be affecting societies with a finer degree of resolution; it is not just sunrise and sunset sectors anymore. Because globalisation is now driven more by advances in communications and

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information technology, it is more individual, more sudden, more unpredictable, and more uncontrollable (Baldwin 2016). In short, no matter what job you have and no matter what sector you work in, you cannot really be sure that your job won't be the next to suffer from, or benefit from, openness.

The British government should recognise that globalisation is acting in new ways and that this requires new domestic policy responses. Specifically, since it is much harder to identify who will win and who lose, and since it is basically impossible to determine precise causes (globalisation, demographics, immigration, robots, technology, climate change, etc.), a new social compact needs to accompany Britain's new trade policy.

Education, infrastructure, regional, technological, and industrial policies all need to be more nuanced, nimbler, and more tightly focused on helping losers adjust. The key is to focus on helping workers adapt; to protect workers and communities, not particular jobs and sectors.

Brexit: reconnecting trade policy and domestic policy

British trade policy was largely run by the EU for four decades but UK social policy remained national. The result is today's general approach of dealing with social policy and trade policy separately. Brexit allows Britain a chance to bring the two back together.

This is important and natural. After all, everyone knows that trade policy creates winners and losers and that maintaining a social consensus for liberal trade policy requires some sharing out of the gains and pains of trade. Rethinking UK trade policy as a whole provides an opportunity to systematically rethink the links between policies that help share the gains and pains of trade and the policies that promote openness.

Now the UK has an opportunity to propose a policy package that is pro-openness and anti-exclusion at the same time. The anti-exclusion policies should be viewed very broadly – everything from secondary education in languag-

es to benefits schemes. The idea is not to link each and every trade agreement to a particular package of benefits but, rather, to create a political linkage – above all in the eyes of the electorate – between Britain's leadership of a liberal global trade system and domestic policies that ensure a just sharing of the burdens and benefits. In a phrase, the key is to commit to a trade policy that is in the service of society, not just in the service of free trade. As part of this, the government could commit itself to undertaking studies that look at the distributional impact of trade agreements by region, skill groups, disadvantaged groups etc.

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Concluding remarks

This essay argues that Britain faces a unique window of opportunity for demonstrating that it is a confident, outward-looking country, ready to play a key role on the world stage. Today's world trade governance space is a vacuum waiting to be filled. For various domestic reasons, world leaders in North America, on the Continent and in large, emerging economies are deeply reluctant to present bold visions for global commerce. The door is thus wide open for Britain to return to its centuries-old leadership of global free trade.

To seize this opportunity, the government should embrace a new approach to trade and development, and it should push the issue to the top of the global policy agenda. Simultaneously, it should embrace complementary domestic policies, recognising how important it is that citizens feel there is a fair sharing of the gains and pains of international openness.

The package, we believe, could be thought of as trade policy in the service of society, not just in the service of free trade.

While the British government faces massive complexities in its trade-policy dealings with the EU and other advanced economies, it could, almost instantly, launch bold trade-policy initiatives with respect to developing na-

tions. Moreover, failing to do so will cause actual harm by creating uncertainty over what UK policy towards developing nation exports will be after Brexit.

This year is the 200th anniversary of free trade's touchstone tome – David Ricardo's *On the Principles of Political Economy and Taxation*. What better time to launch a new phase of British world trade leadership? ■

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Endnotes

1. Almost any plausible version of Brexit will involve the UK leaving the EU customs union and thus becoming free to provide unilateral tariff preferences to developing nations.

2. Such an announcement would not presume UK membership of the EU customs union. If the UK stays in the Customs Union, tariffs will not rise. If it leaves the Customs Union (as we believe it should), Britain would be committing to not raise tariffs against developing-nation exports.

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The post-Brexit fandango

To leave the EU cleanly the UK must make sure that this path leads to unilateral free trade and not some half-hearted protectionist substitute, Patrick Minford argues

In the referendum debate Remain claimed that not only would the economy go into recession if voters foolishly chose Brexit but even the second quarter would be hit by the polls showing a good chance of Brexit. This last is now conveniently forgotten by Remainers, now that the second quarter has shown a more than 50% rise in growth on the first quarter.

This second quarter was the only hard data on 'Brexit uncertainty effects' till now. Now we have the third quarter's preliminary GDP estimate, at 0.5% solidly in the 2-3% range we expected without Brexit: there is no observable Brexit effect on the short-term outturn as we expected. Probably the estimates for manufacturing and construction will be revised upwards, as the estimated falls in these are at variance with the latest Purchasing Managers' Indices (PMIs), all above 50%. The surveys we have so far show that actual output and orders remained on their previous track but that 'confidence' took an early hit and subsequently recovered.

Experience with past surveys when the media are full of gloom and doom is that there is a disconnect between 'confidence' about the general economy and what people do in reaction to their own circumstances. Today ordinary households' situation has never been better: real disposable incomes are rising at over 3% and employment levels are at a record. Credit is easily available; and the Bank has just made that easier still. The pound has dropped around 17%, as it usually does when the UK hits a bump in the road, and this represents a far bigger monetary stimulus than the Bank's 0.25% cut in interest rates. There was no need for Philip Hammond to deviate from fiscal prudence in the autumn; and he hardly did.

The UK economy will certainly survive any short-term bumpiness; most forecasts have become more optimistic already. The real focus of debate should be on where Theresa May's government is taking our trade and other economic policies in the long term. She and her ministers have made some good noises about free trade and pro-business regulation, admittedly larded with some talk about less attractive intervention in corporate affairs.

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These noises were turned into explicit forward commitments at the Conservative party conference in October. Current talks with small business highlight the key fact that smaller firms are less able to carry the heavy costs of social regulation so favoured by the EU Single Market; for them a UK-run regulative system that has always understood small business is much to be desired. Large businesses can lobby and have the staff resources to cope with endless 'compliance'. But in the UK over half of our employment is in small businesses; this too is the most dynamic and innovative part of our economy.

Our future trade framework is the heart of the matter; on it depends how far the UK can pursue the road of self-government, the control of laws and borders demanded by the Brexit majority. It is good to see Liam Fox getting off to a strong start negotiating draft free trade agreements, FTAs, with countries around the world. These countries will then lower their tariffs and trade barriers against us, and we ours against them.

... the UK has now reached the cross roads where it has decided to leave the EU cleanly. Now it must make sure that this path leads to unilateral free trade and not to some half-hearted UK protectionist substitute for the EU's damaging protectionism

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But the gain that we get from this does not come from their lowering their barriers against us, contrary to what is generally thought. When they do that there is a negligible effect on the world prices of the things we sell, because even the largest of these countries, such as the US, buys only a small proportion of the world supply of these products; when they buy a bit more from us, and a bit less from some other countries due to some new FTA, their total demand for the product barely changes, so nor does the world price of what we sell. So we gain nothing and sell the same output overall.

No, the gain we get from these FTAs is that we remove our tariffs and other trade barriers on them; this means that our consumers pay less for them and so enjoy a rise in their standard of living. Once these high-visibility trade agreements are signed we should make sure that we trade freely with all the rest of the world, however we can arrange it. Our ultimate aim should be to achieve unilateral free trade with all countries of the world. As this implies we could actually short circuit all these FTAs and simply go at once to unilateral free trade, as has been done by countries such as New Zealand and Singapore; even China has unilaterally brought down its tariffs to aid its development.

It is this that lies at the heart of our EU trade relationship. The EU Single Market is highly protectionist which of course is why there has been so much fuss about being outside it. This protectionism raises the prices of both food and manufactures by around 20% to UK consumers, implying an 8% rise in their overall cost of living. While this is nice for farmers and manufacturing firms who make higher profits, the losses of consumers are far greater. When we leave the EU, protected prices are replaced by world prices. This generates healthy competition which pushes up productivity, forcing firms to go 'up the value chain' towards more hi-tech methods; we can also help them to access the Single Market from the outside as the US and Japan do. The gain in GDP and living standards according to my standard world trade model is about 4%; on top of that there are the gains from replacing EU regulation with our own and from regaining control of mass unskilled immigration which is costly to the economy and politically toxic.

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As for the City, it too will gain greatly from having its regulations made in free market London instead of a Brussels hostile to 'Anglo-Saxon finance'. The City fears EU protectionism but it need not worry. Suppose Brussels withdraws 'passporting' or 'equivalence' and the ECB declares that euro-bonds must be cleared in Frankfurt. Just as with not having an FTA, the City will sell less in the EU and more elsewhere.

The implication of all this is that the main remaining task of Brexit policy is for the Ministry of Brexit under David Davis to withdraw us from the Single Market and take us to unilateral free trade, to reap these huge gains from eliminating EU protectionism and regulation. Mr Davis would like to sign some broader FTA with the EU; I would like to wish him luck but the bald truth is that, as David Cameron found out, the EU has virtually no flexibility when each of 27 countries wields a veto. He should save us all time and policy delays by simply walking away from the EU, lock, stock and barrel. At that point Liam Fox can pursue a free trade policy with the rest of the world.

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The incredible shrinking 'Brexit recession'

Astonishingly the July 2016 consensus forecast growth rate for the UK in 2017 was 0.6%, close to a recession. Forecasters generally followed the UK Treasury's lead in projecting a 'doom and gloom' scenario after Brexit. Of course, now that we have had the strong recent figures for retail sales, the continuing strength of employment and of the latest Purchasing Managers Indices (PMIs), we will no doubt see these forecasts being raised and we expect this raising to continue.

In our own post-Brexit forecast made on May 10th this year, as taken from our Brexit pamphlet of that time (*The Economy after Brexit*), we projected growth at 2.7% for next year. Our forecast today also takes account of the reactive fall in sterling, larger than we assumed then but perfectly consistent with the idea of a downward adjustment necessary to accommodate the needs of faster post-Brexit growth and the reduction of our current account deficit.

How did our forecast come to be so different from that of the Treasury and the rest of the consensus?

First, we made a different assumption about the Brexit policies that would be followed: we argued that the optimal policy would be for unilateral free trade as well as the UK taking over all regulatory functions from the EU and we said that since these policies were optimal they would be chosen. This meant the abolition of the heavy EU protectionism of farming and manufacturing, as well as a programme of liberalisation of industrial regulation: the long-term gains from the trade liberalisation came to 4% of GDP while those from deregulation were put at 2% of GDP.

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By contrast the consensus assumed that both the EU levels of protection and EU regulations would be left intact. Making these last assumptions gave varying long term negative effects to GDP. Yet we argued that no economic case could be made for these last assumptions: plainly they actually reduced the scope of UK free trade by eliminating free trade with the EU and putting nothing in its place! We were told by various consensus economists that 'it was not politically practical' to introduce unilateral free trade; yet plainly when there is a referendum normal political 'practice' (under which this possibly could be true) is suspended.

The second big difference between our forecast and the consensus lay in the treatment of 'Brexit uncertainty'. Consensus economists put into their forecasts large negative assumed effects of this uncertainty, starting in Q2 and continuing for around two years. These effects generally caused risk premia on asset yields and directly reduced investment and consumer spending.

Our treatment of this uncertainty was based on rational expectations (nowadays a default modelling assumption) about post-Brexit policy: we evaluated the two main possible policy scenarios, an EEA-type deal and the free trade/deregulation assumption we made. Essentially the first leaves the status quo intact while the second gives gains as noted above. We also considered that before Brexit there was a more negative assumption possible, that of in-

ward-looking protectionism and controls. Computing uncertainty as the difference between the extremes we found that this was at its height in Q2 and in Q3 fell as the third scenario disappeared under the new May government. We projected it as being steadily reduced as policies were finally chosen in the way we now see that they are being.

How big is the effect of such uncertainty and how negative is it? Our view is that the effects are quite small. This seemed to be borne out by the Q2 growth rate, at 0.7% well up from Q1's 0.4%. By Q3 once the May government was in place we argued it was of little consequence at all. On the sign of the effect, one can argue that while more uncertainty will make people more cautious, this could make them spend more on certain items that enhance security (eg. more investment in innovation to fend of greater competition). In sum we put in nothing for these effects from Q3.

In this we seem to have been right. The PMIs across all sectors dipped immediately after Brexit but have since rebounded. The immediate dip can be put down to the political chaos of that time with the Conservative leadership election in prospect and no viable government in office. It seems that once the May government was installed matters became 'business as usual'. As for the long-term effects of policy these appear to have been treated as on balance positive, which would be consistent with our assumptions about the two scenarios: either the same as now or positive. Given that these effects will take a long time to come through because of lags in policy implementation, this muted response to the long term appears right: in our forecast we assume a five year lag in the full implementation which makes the effects positive but long drawn out.

In our early May Brexit forecast we underestimated the effect on the exchange rate. We projected a 5% fall over about two years; we got this effect from the model's projection that with higher output the exchange rate would need to fall to achieve the necessary higher overseas sales. In fact we have had an immediate fall of around 17%. How is this to be interpreted?

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Here we come into the area of 'signal extraction' where we (and everyone else) try to understand what (the 'signal') may be driving short term events (the 'noise'). We know that in the very short term ideas about what is happening can drive asset prices sharply. Clearly the Brexit vote was a big surprise and reactions to it factored in 'doom and gloom' forecasts that were widely being made as we have seen. When a negative shock hits an economy the market reaction is to sell the currency and this is also an optimal economic stabiliser, boosting demand for exports and home production at the expense of foreign goods. It seems likely that the negative forecasts and the political chaos together drove the pound down.

With the new government moving ahead steadily with its Brexit policies and the economy normalising, it is likely to recover. As we have seen, the growth prospects have remained firm, as supported by recent data. Apart from the strong PMIs for September, we have seen strong growth in retail sales volume, employment, money and credit, and house prices. Furthermore, the exchange rate fall has provided a massive monetary stimulus to the economy.

Given these latest developments we expect growth to continue at current rates of 2-3% per annum, much as we forecast back in early May. We also expect consumer spending to remain strong and private investment to continue growing moderately as in Q2. Net exports will rise on the back of the fall in sterling and inflation will rise quite sharply, with it also wage rises because of the continuing rise in employment and the tight labour market, pushed ahead too by the rising minimum wage and the new controls on unskilled immigration. Public spending will move towards less restraint especially on infrastructure; but in spite of this the public finances will improve with rising tax revenues and the debt-GDP ratio will start to fall within the next year. Rising inflation will soon be seen as a threat to the inflation target by the Bank of England and interest rates will have to be raised.

The latest contribution to this debate has come in the Autumn Statement from the Office of Budget Responsibility which has conceded that 2016 will show growth of 2.1% but is now predicting 1.4% growth for 2017. It says that it

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has based this on some average of other forecasters in view of the 'uncertainty' surrounding the Brexit effect. Yet as we have already explained this is a strange way to assess the effects of Brexit given that these forecasters made variously damaging assumptions about Brexit policies and we now have a government committed to a Brexit of free trade with the rest of the world, UK-controlled regulation, and an immigration policy based on the economic contribution of migrants- all of which are positive for UK growth.

Why did the OBR not base its forecasts on such optimal policies? And given that instead it based them on some ill-defined but worse policies why did the Chancellor not make it clear that as a senior member of this government committed to the best policies he did not agree with their assessment? I fear the answer is rather clear: Whitehall is embarking on its own Project Fear Mark 2 in order to try and reverse the Brexit decision and the Chancellor is leading a faction within the government that supports this reversal objective.

Ending the policy uncertainty over Brexit

Now that we have had Theresa May's speeches to the Conservative Party Conference, it is clear that the government has finally made up its mind to leave the EU straightforwardly: that is, to leave the Single Market, the Customs Union and all other EU budget and legal mechanisms. The repeal of the European Communities 1972 Act will end all UK dependence on EU law and other authority.

There has been much lobbying by manufacturing industry and the City for an 'EU-Lite' whereby the UK would be like Norway in the European Economic Area. But this would have clashed with the referendum vote, since it implies that the UK accepts free migration from the EU, is subject to virtually all the Single Market regulations, and pays a still large budget contribution. Not merely inconsistent with the vote, it would also impose all the same costs of EU protectionism, regulations and budget: this makes it highly suboptimal economically.

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In sum, the UK has now reached the crossroads where it has decided to leave the EU cleanly. Now it must make sure that this path leads to unilateral free trade and not to some half-hearted UK protectionist substitute for the EU's damaging protectionism. ■

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A roadmap for a post-Brexit EU

Brexit is a blow to the European idea, but it also presents an opportunity for Europeans to discuss a realistic future, Petros Fassoulas writes

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An entire summer has passed since the British people made the historic decision to leave the European Union. The outcome itself is a blow to the European idea, yet it also presents an opportunity for Europeans to stand up, take responsibility, and openly discuss a realistic future. In doing so, we must not shy away from offering and proposing bold solutions in order to deliver a better and more prosperous future for the European Union and, more importantly, for its citizens.

Over recent years, a dark cloud of nationalism, isolationism, fear of the other, and euroscepticism has swept the continent. These factors were brandished in the UK referendum and influenced the outcome, signifying the dangerous power that these bitter elements hold. The result was a nightmare-come-to-life for pro-EU European citizens, while it has added fire to the flame of eurosceptics everywhere, who may now eagerly await their nation's turn to follow the path taken by Britain.

Therefore, it is at this time more than ever that we as citizens need to stand together, united in our belief that we can confront these challenges head-on. Whether it is in facing the issue of Britain's exit from the EU, migration, the economy, globalisation, climate change, or security threats both within our Union and on our doorstep, we need a clear political vision. The European Union in this post-Brexit world must be built on solid and meaningful pillars that deliver for its citizens. The European Movement aims to deliver just this type of thought-leadership, which we are developing on several fronts:

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Legitimising politics

Leave-voters in the UK and large swathes of demographics across the EU feel that their voice is unheard and diminished. They no longer feel represented by politicians, both nationally and particularly in Brussels. Rebuilding this trust between European citizens and the role of politics and policy-making at National and European level is critical to building legitimate European policies that tackle real problems. This means establishing greater partic-

ipation in the democratic process for citizens and a clearer role for civil society organisations in keeping a check on the work of the institutions.

Each and every citizen of the EU must feel that their voice is valued and that the path of the Union is influenced by them. Only then can we encourage meaningful participation that will create a brighter post-Brexit EU. The lobbying process should be made more transparent and the presence of the European political parties more obvious. Moreover, the European political system needs to be updated for the Twenty-First Century with more online accessibility, and more emphasis on generating public debate around policy issues.

Fighting economic frustration

Europe is facing a period of economic stagnation and widespread unemployment, particularly youth unemployment in the likes of Spain and Greece. These citizens hardest hit by the global recession, policies of austerity and globalisation feel left behind. This pattern is extensive across the north of England in regions of former traditional

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Bold decisions and courageous acts are needed by all citizens of this Union if we are to deliver a better, safer, and more prosperous European Union in this post-Brexit world

industries and this frustration was evidenced in the UK referendum on its EU membership. To ensure that this is not repeated, we need to create sustainable economic growth with enhanced social rights that will help even our least protected citizens to prosper.

This will mean securing greater investment to build a system that works for everyone, and offering incentives such as minimum wage criteria across the Single Market. Enhanced social convergence must also be at the forefront of a post-Brexit European Union in order to help the least protected citizens of our Union.

The Brexit referendum has thrown Britain's access to the European Single Market into question. Months of negotiations between both sides lie ahead as the UK aims to retain this privilege while gaining greater control over its immigration and stopping the complete freedom of movement of people, something that the EU is vehemently against. However, while these talks take place, we must not be distracted and must ensure we strive to improve the Common Market for the remaining 27 EU states.

There are many important innovations currently being considered to further the effectiveness of the Single Market, and these should provide opportunities for more job creation and progressive citizen-centric policy-making. However, one crucial area for improvement is to ensure businesses, especially SMEs, face fewer barriers to trade and are thus at the forefront of adding skills and jobs to the workforce.

Lastly, much debated trade agreements such as TTIP and CETA can only succeed if the concerns of all stakeholders and citizens are thoroughly recognised and addressed in an open and fair manner. A post-Brexit EU needs the greater prosperity that these trade agreements can deliver, but only if citizens are adequately consulted.

Fundamental freedoms

The four freedoms of movement of the EU are foundational pillars upon which the entire Union has been built.

Without these core freedoms, the EU we have today and all the benefits it brings to its citizens would cease to exist. In addition, the Schengen Agreement has directly benefitted Europe's economic prosperity through the reduction of internal barriers. While Britain may have voted to leave the EU largely in opposition to the principle of free movement across borders, a post-Brexit Union must be steadfast in its commitment to maintaining this principle.

The greater freedoms associated with the free exchange of goods, services, labour and capital has led to the exchange of ideas and best practices across our continent. Greater travel opportunities have also led to increased cultural exchanges and understanding as a result both of targeted programmes such as ERASMUS and increased cross-border interactions. The European Movement will continue in its work to promote all forms of European exchange that aim to offer shared solutions to common problems. The recent refugee crisis has been a point-in-case for many who are keen to highlight both the weaknesses of Europe's external border management and the problems of shared internal borders. However, the large-scale and human nature of this challenge means that we must forge ahead with a Common European Immigration and Asylum System, which should respect EU citizens' and refugees' rights alike.

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One voice on the global stage

Britain's decision to leave the EU impacts on the EU's international position, but not as much as eurosceptics hope. The remaining 27 states will continue to stand as a leading voice and figure in an increasingly competitive global environment. However, we must do so in a united manner, offering one voice on the global stage.

Unfortunately, Brexit has come at a particularly unstable time in global security. The deterioration in relations between the EU and Russia brought about by the annexation of Crimea has deepened fears on our Eastern border. Radical Islamic terrorism has intensified as horrific atrocities are committed across our Union. Future challenges

will include further cross-border assaults, including cybercrime, which necessitates joined-up security thinking that is above any one member states' individual interests.

While Brexit may impact on the stability of the European Union, it will not break it. It is built beyond one member. The enlargement policy of the European Union has undoubtedly been one of its most successful policies, and has spread peace, democracy and security across our continent. The outcome of the UK referendum has thrown open the door to further enlargement prospects, which should be foreseen as an integral part of the EU Global Strategy on Foreign and Security Policy. Indeed, a clear enlargement perspective is the surest way to develop democracy and the rule of law in areas such as the Western Balkans.

Inalienable rights

The European Union is a values-based entity - respect for human dignity, liberty, democracy, equality, the rule of law and human rights are its inalienable features. Whether it is the challenge of the UK leaving the EU or any future obstacle that may present itself, the Union should never and will never stop defending these core European values and rights. As such, these rights should be demonstrably linked to a notion of EU citizenship alongside other EU-level guarantees, including certain social, environmental and employment protections.

A post-Brexit European Union must make it its priority to ensure that no citizen of the Union ever suffers the loss or deterioration of rights. We at the European Movement International will remain committed to building a Union that protects the citizenship of every individual.

A European Union without one of its strongest members will no doubt be severely tested and strained. The challenges may seem potentially overwhelming. However, the Union, which was born out of a period of immeasurable conflict, has overcome difficulties in the past and will do so again. Perhaps the fallout of the UK referendum will act as a reminder to European citizens of the wealth of benefits that the EU brings to every individual. Too often we take

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such rights for granted and politicians are quick to smear the EU as the cause of any setbacks that arise, rather than standing up and taking responsibility.

We should take pride in the fact that we are citizens of such a unique family of nations. That said, we should not be distracted from acknowledging the faults that lay within it. Bold decisions and courageous acts are needed by all citizens of this Union if we are to deliver a better, safer, and more prosperous European Union in this post-Brexit world. ■

Petros Fassoulas is Secretary General of the European Movement International

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The trade issues which must be solved by David Davis' Brexit Department

Robert Oulds says Brexit negotiations must aim to prevent the complexities of trade slowing the free flow of goods after Britain leaves the EU

Brexit negotiations must aim to prevent the complexities of trade slowing the free flow of goods after Britain leaves the EU. Any withdrawal agreement between the EU and the UK, must look at these complexities and find practical solutions to make sure that trade enters the EU as seamlessly as possible.

The biggest challenges to resolve are the practical logistics. Few, if any, so far, have looked at these issues from the perspective of eliminating, or at least mitigating, the real hurdles that would appear after Brexit.

Inside the EU, exporting to Berlin is effectively not any different from sending goods to Birmingham, just that the transportation will, due to the distance involved, set a slightly greater logistical challenge. There is no requirement for burdensome bureaucracy when moving goods between EU member states. When goods from Britain are transported to the EU, just like those destined to our shores from the European Union, they come and go via our ports, be they channel ports like Dover or airports such as Heathrow.

Presently this is with no let or hindrance. No administration is involved. In fact, national borders in terms of trade can be said to no longer exist within the European Union. At least some red-tape, has been eliminated. Yet, without a practical agreement businesses that are involved in either exporting to the EU, or importing from it, will face costly delays.

The enormous mutual dependency, between British and continental firms, rightly cited by many as a reason why an agreement will eventually be reached on issues such as trade tariffs, have, however, not considered that the high volume of trade can be a source of problems. This centres around the fact that all imports to the EU must go through customs posts.

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The UK's trade in goods with third countries outside the EU is often relatively unfettered because it is in bite-sized portions. The trade from Britain through the many customs posts of the numerous states around the globe to which Britain exports is in manageable quantities. However, the sheer scale of goods going through for instance French ports is staggering. Quite simply they do not have adequate facilities in place to deal with the enormity of post-Brexit trade.

Ports in the UK and Europe are not up to managing the high volume of freight, they lack the necessary infrastructure. The UK does not at present have the capacity to dramatically improve the UK's customs facilities to deal with trade coming from the remaining EU states. Planning for what would be a series of major construction projects has not yet begun, and nor have the financial resources been allocated. Serious question marks exist over France's abil-

David Davis' Department for Exiting the European Union must, however, focus on addressing the bureaucratic trade hurdles that can cause delays at customs posts

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ity, let alone willingness, to upgrade their facilities to deal with trade coming from the UK. Furthermore, a special UK-EU agreement on customs clearance must be in place by Spring 2019. Without such an agreement there will be trade gridlock.

Tariffs in themselves are not the issue, time is. The cost of collecting the customs duties, a set percentage of their sale price agreed with the WTO and charged to the importer, makes any financial benefit for the EU almost irrelevant. Any 'benefit' comes from increasing rival's costs to protect EU producers. However, with increasingly interdependent markets, with global value chains where the genesis of a manufacture rests in many nations which have supplied the numerous parts, such a strategy makes little economic sense.

The real advantage of eliminating tariffs for the exporter, and the business importing the product, is not the removal of this tax on trade. The main benefit is that without the need to produce the paperwork and payments to meet these customs duties, the item will be subject to less delays at customs posts.

Before solutions can be found to ease the process of trade the hoops and obstacles need to be explored. All non-EU companies that send good to the EU must either pay tariffs, complete paper work, and clear customs; sending the goods to be approved via what is known as a designated port of entry. Even if a free trade agreement is in place customs officers checking products and making sure the necessary bureaucracy is complete is a common place occurrence.

The trade process

Designated port of entry

When exporting goods to another territory the host nation can stipulate a designated port of entry for the product. At present Britain and the European Union are one trade zone the UK has free access to any and all established plac-

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es where both people and produce can be admitted. The EU has the hypothetical ability in the short term to prescribe a port of entry, and terms, that are inconvenient for British exporters.

However, this will be a serious breach of international trade law. Articles XI:1, XIII:1, V:2, V:6 and I:1 of the 1994 General Agreement on Tariffs and Trade now administered by the World Trade Organization. Under these rules one country cannot be treated less favourably than any other state in the export and transit of goods. What is more, as both businesses and consumers on the continent depend upon British imports there is no reason to believe that such problems will arise.

Regardless of how the UK leaves the EU it should be business as usual via the existing ports of entry. Indeed, Brexit negotiations should seek to expand them to include more destinations accessible via HS1, the Channel Tunnel. So far so good. However, there are other serious issues.

Exporting to the EU from outside is not bureaucracy free

Exporting into the EU requires a convoluted process to be completed. Goods must have assigned to them an identification number, inputted at the port of destination. The larger importers find the process easier. They can make their declarations at the end of the month. Those who export less to the EU will, however, be faced with bureaucratic hurdles.

Clearance for use, allowing the product to go into circulation to be sold in the UK, or an EU country, needs to be obtained. The process for assessing this, even in the EU, will differ from country to country. Mostly, however, this is often just a theoretical problem, rarely do customs officials demand compliance with national standards and rarely do they conduct a strict examination of documentation declaring that an item conforms to national or EU standards.

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It is legally possible to detain goods on the grounds of differing standards, but in practice this only usually applies to items that are deemed to be dangerous, illegal, or subject to anti-dumping duty (a tax on products suspected of being sold substantially below their normal value).

Still, the process of shipping goods to and from the EU is not without other bureaucratic impediments. The freedom of the items is also strictly regulated. From outside the EU, any goods entering the EU, if not cleared at port, which can be a laborious process, must be stored in a bonded warehouse, also known as an Enhanced Remote Transit Shed (ERTS) warehouse. Until they are declared to customs for an approved treatment or use.

Transhipped cargo not in free circulation will also require what is known as a CMR document. The CMR is a consignment note with a standard set of transport and liability conditions, which replaces individual businesses' terms and conditions. It confirms that the carrier (ie. the road haulage company) has received the goods and that a contract of carriage exists between the trader and the carrier. It derives from the Convention on the Contract for the International Carriage of Goods by Road.

The process of clearing customs is increasingly becoming electronic. Systems used by exporters that integrate with the British customs system are the CNS and Destin8 computer systems.

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The VAT hurdle

Value Added Tax (VAT) is often charged on imported goods, that is in addition to any customs duties. The details must be entered onto the Customs Handling of Import and Export Freight (CHIEF) system. This system records the declaration to the customs authorities details of the goods whether they are transported by land, air and sea entering or leaving the UK/EU. It allows importers, exporters and freight forwarders to complete customs information electronically. This is not without charge.

If there is no prior agreement for each consignment, going to a specific destination, to clear customs the importer must produce customs records for each, pay VAT and the customs duty, if any. This will be calculated per the value of the item at its final point of sale. The VAT rate will differ from country to country, and even item to item. In some cases, a product will be exempt, VAT will not apply. In other cases, an item will be zero-rated, requiring the documentation to be completed but with no final payment.

Even where tariffs are eliminated when importing from outside of the EU there is still the requirement to pay Value Added Tax. If the exporter is registered for VAT then this can be claimed back but only if they registered. There is also a requirement for an input VAT certificate to be completed.

Remaining in the EU's customs union, but being in the EU, does not eliminate the requirement for form filling to be completed. The requirement to clear customs and complete documentation, known as an ATA Carnet, to validate the origin of goods and confirm that they are free from tariffs even applies to Turkey. This country is considered part of the EU's customs union and therefore has tariff free access for industrial products; but it is not bureaucracy free access.

The EEA is not the answer on its own

The EU's internal market, open to the EFTA states of Iceland, Liechtenstein and Norway, have sought to resolve some of the problems through the European Economic Area agreement. Beyond granting the theoretical access to the single market in services and the right to bid for public procurement, the EEA seeks to remove all technical barriers to trade. There is regulatory conformity and most importantly the European Economic Area has the mutual recognition of standards. Regulation EC 764/2008 of 9th July 2008 demands that all members allow goods that are legally sold in one country to be sold in another EEA state.

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One of the main benefits of being part of the single market comes through the principle of mutual recognition. This allows businesses to export to the entire European Economic Area, the internal market, without having to seek standards approval. As the Single Market is still not complete some member states still have differing standards. The principle of mutual recognition is that if a product has been approved as safe and saleable in one member state then it can be sold in all. This bypasses potentially costly and time consuming safety and regulatory checks in each country where the good is sold.

The EEA agreement also abolishes customs duties between the states participating in the single market. However, EFTA/EEA members must still go through a customs clearance process and outlay for VAT. These time-consuming procedures apply even to states such as Norway. Britain renouncing its EU membership but retaining, through membership of the European Free Trade Association, its status as a part of the European Economic Area will not on its own answer the practical and bureaucratic trade hurdles.

Tariff free trade

Whilst every possibility exists of there being an agreement(s) on reducing tariffs between the UK and the does not in itself eliminate all the bureaucratic hurdles. If a business is sending produce to the EU from a country that has a free trade agreement it must prove that they were mostly manufactured or re-worked in a country that had a free trade agreement with the EU. If the business cannot confirm the origin of the goods, then the tariffs will apply. This can be sidestepped by making some modifications to the products in the exporting state, yet this may be subject to investigation. This is a rare occurrence, yet the need for paperwork to prove it is not rare.

Rules of origin

If the goods are of UK origin and if Britain has a free trade agreement, namely no tariffs to pay, importing into an EU country may require a Certificate of Origin to show its provenance. If its tariff free origin cannot be proved, a cus-

toms charge will be applied. Certificates of Origin can be obtained from a relevant countries chamber of commerce, they are however, expensive to obtain.

Anything that is already inside the customs union that has originated from a non-member will have been charged at its original port of entry and can therefore circulate freely within the EU. At present, as the UK is an EU customs union member, British exporters to the other 27 do not have to prove that they comply with the EU's rules of origin. As supply chains are becoming increasingly globalised the need to demonstrate an item's origins can be a complex burden.

The Trade Policy Research Centre argue that *'the process of adapting to rules of origin based duty-free trade under a new UK-EU free trade agreement would be tedious, costly and disruptive to trade.'*[1] However, some developments are making this concern less relevant. The reduction in tariffs, where many goods are zero rated, reduces the need to complete the administrative duties. The EU has extended the area in which origin can be accumulated to not only cover more states but also to allow for an item to be obtained and manufactured in a number of countries without the final product losing the benefit of being tariff free when it enters the EU.

This system has been in existence in the EU and European Free Trade Association since 1997 and for Turkey since 1999. Over time the EU does grant greater allowance to other countries to claim exception from rules of origin. And from 2017 under World Customs Union rules the procedure declaring a products origin will be simplified.

These are hurdles, but they can be overcome through effective negotiation. Furthermore, the application of these rules does present opportunities for Britain. If a tariff free trade agreement is in place UK businesses can corner the profitable market for business assembling goods. The now complex supply chains that dominate global production can create jobs in the UK. Gate way Britain.

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Britain obtaining tariff free access to the remainder of the EU, along with measures designed to speed the passage of goods through customs, and developing trade links with the third countries around the world, will benefit Britain. Having a more liberal regulatory regime and tariff free access to the EU's single market will make the UK a base by which third country producers, who have entered preferential trade deals with Britain, can access the EU without being subject to tariffs.

Within Britain value can be added to goods and re-exported from the UK to the EU. This will allow exporters to sidestep the EU's rules of origin regime. Britain will be able to become a regional value added production hub. The British economy will therefore not only benefit from the additional bilateral trade with other territories but will also capture a number of benefits:

1. Increased trade

2. Increased freight and haulage through the UK as a pass through onto final destination

3. Increased assembly and manufacturing within the UK (to meet rules of origin that require a declaration to be made that at least partial reworking has occurred to the produce)

4. Increased economic activity and employment and the resulting fiscal benefits

5. Increased use of a made in Britain mark makes the UK's regulatory regime more internationally relevant

Even in the EU, technical requirements on import processes as well as standards will differ from each country. However, the fear that EU legislation prejudicial to the UK may queer the pitch against British sales to the continent is

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probably unfounded. As Britain conforms to EU standards at present there is little, if any, divergence. Further, as an increasing proportion of technical standards originate from global bodies, agencies of the United Nations, or relate to international agreements on technical barriers to trade, there will not be a sudden deviation from permissive regulations.

These international agreements are designed to encourage cross border trade. It is worth reiterating the fact that rarely do customs officials demand compliance with national standards and rarely do they conduct a strict examination of documentation declaring that an item conforms to national or EU standards.

David Davis' Department for Exiting the European Union must, however, focus on addressing the bureaucratic trade hurdles that can cause delays at customs posts. The alternative will be even worse congestion on the M20 after Brexit than that which exists at present. ■

Robert Oulds is Director of the Bruges Group

Endnotes

1. Ronald Stewart-Brown and Felix Bungay, Rules of Origin in EU Free Trade Agreements, Trade Policy Research Centre, 2012

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What consequences would a post-Brexit China-UK trade deal have for the EU?

Alicia García-Herrero and Jianwei Xu find that a UK-China FTA will be neither easy nor clearly advantageous for the UK

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Brexit means that the United Kingdom could be able to run its own trade policy, which opens the door for the potential negotiation of a free trade agreement between the UK and China. We ask three questions about this important issue for the UK-EU economic relationship. If a China-UK FTA was signed, could Chinese exporters break into the EU market through the UK, making a possible China-EU FTA relatively superfluous? Would a China-EU FTA help UK exporters to gain a competitive advantage in China relative to EU exporters? Will UK producers benefit by importing cheaper Chinese intermediate goods?

Our analysis indicates that a UK-China FTA will be neither easy nor clearly advantageous for the UK. First, it will be difficult for the UK to reach an agreement with China without first establishing a new post-Brexit partnership with the EU. Negotiating tariffs with other WTO members will be a pre-condition if the UK exits the EU customs union, and this process will require time and effort. Second, even if the UK reaches an agreement with China, the UK cannot serve as a back door for Chinese products to enter the EU, because the EU is very likely use rules of origin to close any such loopholes. In addition, entering the EU via the UK will entail an additional transportation cost for Chinese goods that will, at least partly, offset any tariff savings, making use of such a loophole less worthwhile. Third, the UK and the other EU economies differ in most of their exports to China, so there would be very limited substitution between them.

It therefore seems that establishing a new trade relationship with the EU would be a more urgent task for the UK in the post-Brexit world, rather than an FTA with China. Under such circumstances, the UK might need to postpone its trade negotiations with other economies outside of EU, including China. This goes beyond the current discussion of the illegality of the UK starting to negotiate trade deals before it leaves the EU. The issue is whether it makes economic sense for the UK to do so, and the answer is no. In fact, the more the UK reaches an independent favourable trade agreement with China after Brexit, the harder it will be for the UK to strike a good deal with EU. In the meantime, it is also urgent for the UK to negotiate with the main WTO members on tariffs, because outside the EU, the UK

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might not participate in the EU schedule of concessions. The best strategy for the UK would be to negotiate with the other WTO members with the EU-based tariffs as a starting point, to avoid negotiating over terms separately and also to maintain a close relationship with the EU.

Introduction

Brexit means that the UK could be able to run its own trade policy, which opens the door for the potential negotiation of an FTA between the UK and China.

The United Kingdom has for long time flirted with the idea of establishing a free trade agreement (FTA) with China. Already in December 2013, during an official visit to China, the then UK prime minister David Cameron claimed he could act as a catalyser for an EU-China trade deal. Such a statement was not well received in Brussels, given the Commission's sole responsibility for trade policy at the EU level. Furthermore, the mood in Brussels was that the EU-China economic relationship was not yet balanced enough to engage in FTA negotiations[1].

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The more the UK reaches an independent favourable trade agreement with China after Brexit, the harder it will be for the UK to strike a good deal with EU

Brexit has obviously drastically changed this picture. Brexit means that the UK could be able to run its own trade policy, which opens the door for the potential negotiation of an FTA between the UK and China. However, the UK still faces a number of constraints.

First, if Brexit means that the UK would no longer enjoy the EU's schedule of concessions for goods with the World Trade Organization, the UK would be obliged to negotiate a fresh schedule of concessions before any bilateral FTA. This negotiation would not be as simple as it might seem because its outcome would require the consent of all WTO members. In reality, some WTO members might want to gain more favourable terms given that the UK would have less negotiating power, its economy being four times smaller than the rest of the EU[2]. All in all, the process before the UK could conclude FTAs with countries such as China would be full of uncertainties, and most importantly, would be time consuming.

Second, even if the UK were to resolve the WTO-related hurdles and could technically start to negotiate an FTA with China, the type of trade partnership that the UK might eventually want to shape with the EU would be bound to have a bearing on its negotiations with China. The more the UK retains its EU trade ties through its FTA with the EU, the harder it will be to do the same with China. It should be noted in this regard that even those campaigning for the UK to leave the EU favour maintained access to the EU market through an FTA. Their real problem was the labour mobility aspect of the single market[3].

In the baseline scenario that the UK will pursue a trade agreement with the EU[4], the question then is how the UK will pursue an FTA with China in parallel.

We break down this important issue for the UK-EU economic relationship by asking three key questions. First, if an FTA between China and the UK were to be signed, would it be possible for Chinese exporters to break into the EU

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market through the UK, making a possible FTA between the EU and China relatively superfluous? Second, would such an FTA between the UK and China help UK exporters to gain a competitive advantage in China and replace the EU's exports? Third, will UK producers benefit by importing cheaper Chinese intermediate goods and thus gain competitiveness relative to the EU?

By addressing these questions in turn, we conclude that a China-UK FTA would have a very limited impact on the EU's imports. However, it would affect the EU's exports although in a very asymmetric way for different EU member states.

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The UK 'back door': no easy way for Chinese exporters to use the UK to enter the EU market

The irony of a push by the UK to rush into an agreement with China is that it could make it harder for the UK to retain full access to the EU single market.

What would be the consequences for the EU of China signing an FTA with the UK while the UK maintains at least an FTA with the rest of Europe, if not full participation in the single market? This 'status quo' scenario should raise concerns for the EU about whether Chinese exports could use the UK 'back door' to enter the EU market without China signing a bilateral FTA with the EU. The answer really depends on what type of trade agreement the UK and the EU reach following Brexit.

If the UK were to maintain EU single market status, there would be virtually no inspections of products transferred from the UK to other EU countries. In this circumstance, a favourable FTA between China and the UK would become a true back door for Chinese products to enter the EU market. The irony of this push factor for the UK to rush into an agreement with China is that it could actually make it harder for the UK to retain full access to the EU single market, with an outcome that would probably be more costly (surely as far as financial services are concerned) than the gains from an FTA with China.

There is however a halfway option, as illustrated by the Swiss example. Switzerland is not in the EU but has reached a number of FTAs with the EU in the context of the European Free Trade Association (EFTA). At the same time, Switzerland has also established FTAs with 38 partners outside the EU, including China[5]. To prevent non-EU imports from entering the EU market through Switzerland, the EFTA states such as Switzerland must apply rules of origin that show to what extent a certain good is produced and processed within the European Economic Area (EEA) in order to enjoy preferential tariffs, otherwise normal tariffs apply[6].

The same type of rule has also been included in the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada, which is yet to come into force[7]. Following these precedents, it is very likely that the EU would apply rules of origin to the flow of goods between the UK and the EU. These measures will thus make it difficult for Chinese corporates to use the UK back door to enter the EU market.

In addition, international transportation of goods from China through the UK to EU countries will be handicapped by additional transportation costs. Goods sent from China to Europe mainly travel by sea, with maritime transportation accounting for nearly 60 percent of China's international trade[8]. Unlike air or road transportation, long-distance maritime transportation must follow specific routes to minimise time and costs. Table 1 lists the main shipping routes from China to Europe, as provided by the China Ocean Shipping Company (COSCO), a major Chinese global carrier company. Most container ships from China to Europe dock at the ports of Antwerp, Hamburg and Rotterdam, with more limited volumes going through Felixstowe and Southampton in the UK (Table 1).

As Felixstowe and Southampton, two of the UK's major ports for Chinese ships, only rank as the seventh and seventeenth busiest container ports in Europe (Table 2), their cargo-handling capacities is relatively limited. Therefore, detours for goods from China via the UK before they enter other EU countries would be not realistic in the short run.

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Table 1. COSCO European and Trans-Atlantic service routes

Asia-Mediterranean Route	
AMX8	Malta, Rijeka, Koper, Trieste, Venice
BEX	Piraeus, Ambarli, Constanze, Odessa
FEM	Piraeus
AMX1	La Spezia, Genova, Fos, Valencia
MD1	Piraeus, Genoa
MD2	La Spezia, Genova, Fos, Valencia
MD3	Malta, La Spezia, Genova, Valancia
MEX1	Malta, Fos, Barcelona, Valancia
Asia-North Europe Route	
AEX1	Felixstowe, Rotterdam, Hamburg
FAL1	Algeciras, Dunkirk, Southampton, Felixstowe, Rotterdam, Hamburg
FAL3	Le Havre, Antwerp, Rotterdam, Hamburg, Felixstowe
NE2	Piraeus, Antwerp, Rotterdam, Hamburg, Felixstowe
NE3	Antwerp, Rotterdam, Hamburg
NE5	Rotterdam, Hamburg, Felixstowe
NE6	Algeciras, Rotterdam, Hamburg
NE7	Piraeus, Antwerp, Rotterdam, Hamburg, Felixstowe

Source: Bruegel based on China Ocean Shipping Company (COSCO), http://www.coscon.com/, as of 27 September 2016.

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Table 2. Europe's busiest ports

1	Rotterdam	Netherlands	12,298
2	Hamburg	Germany	9,729
3	Antwerp	Belgium	8,978
4	Bremerhaven	Germany	5,796
5	Algeciras	Spain	4,555
6	Valencia	Spain	4,442
7	Felixstowe	United Kingdom	3,700
8	Piraeus	Greece	3,585
9	Ambarli/Istanbul	Turkey	3,600
10	Giola Tauro	Italy	2,970

Source: Report from the Port of Rotterdam. https://www.portofrotterdam.com/en/files/top-20-european-container-ports.

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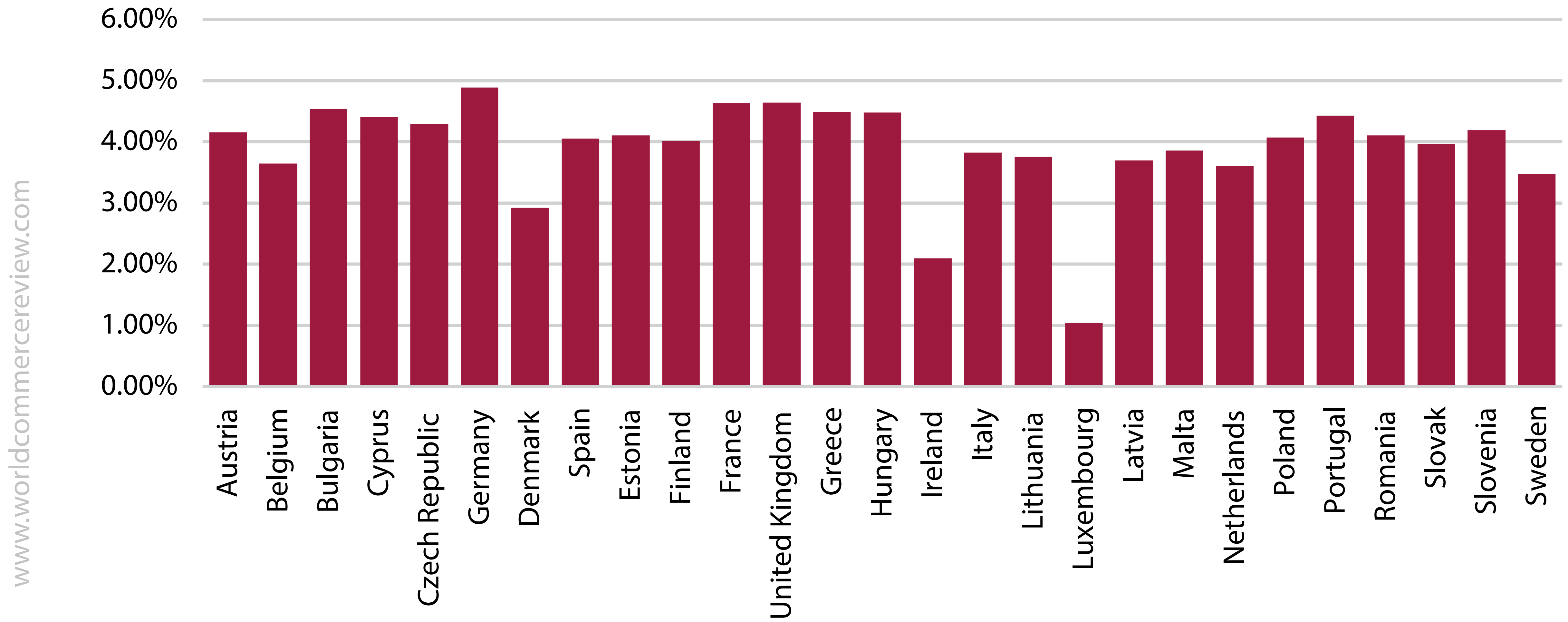
Figure 1. International transport costs, share of total foreign inputs



Source: Bruegel based on WIOD database

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Even if the handling capacity of UK ports is increased in the future, a company using the UK as a back door to the EU would incur a non-negligible transportation cost to their final destination, whether by maritime or other transportation modes. According to our calculation, based on the World Input-Output (WIOD) database, the share of international transport costs in total inputs for both intermediate and final goods is approximately 4 to 5 percent for most EU countries (Figure 1), while the average Most Favoured Nation (MFN) rate for Europe is already as low as 1.5 percent[9]. Therefore, in international trade terms, transportation costs seem to be more important than tariffs. Thus, the additional transportation cost of a detour via the UK for Chinese goods destined for the EU would at least partly offset the intended tariff saving to make the UK back door a less profitable choice.

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An FTA with China would benefit the UK in the Chinese market, particularly for the 'motor cars and vehicles' sector

China is the second largest destination for EU exports, accounting for 9.5 percent of the EU's total exports. If a China-UK FTA was reached, the UK would undoubtedly gain competitive advantage in terms of access to the Chinese market. Would the improved UK-China economic collaboration affect the EU's exports?

To understand the possible implications of a China-UK FTA, it is straightforward to compare the EU's and the UK's export structures. Figure 2 decomposes the UK's exports into capital goods, consumer goods, intermediate goods and raw materials, and compares them to those of the rest of the EU[10]. Consumer goods constitute the largest share of the UK's exports to China (45 percent), followed by intermediate goods (25 percent), whereas the consumer goods share for the rest of the EU is 25 percent and the intermediate goods share is only 17 percent. The EU mainly exports capital goods to China, with a share of 46 percent of total exports, but the capital goods share makes up only 16 percent of the UK's total exports to China. In this sense, the UK's export composition is distinctly different to that of the rest of the EU.

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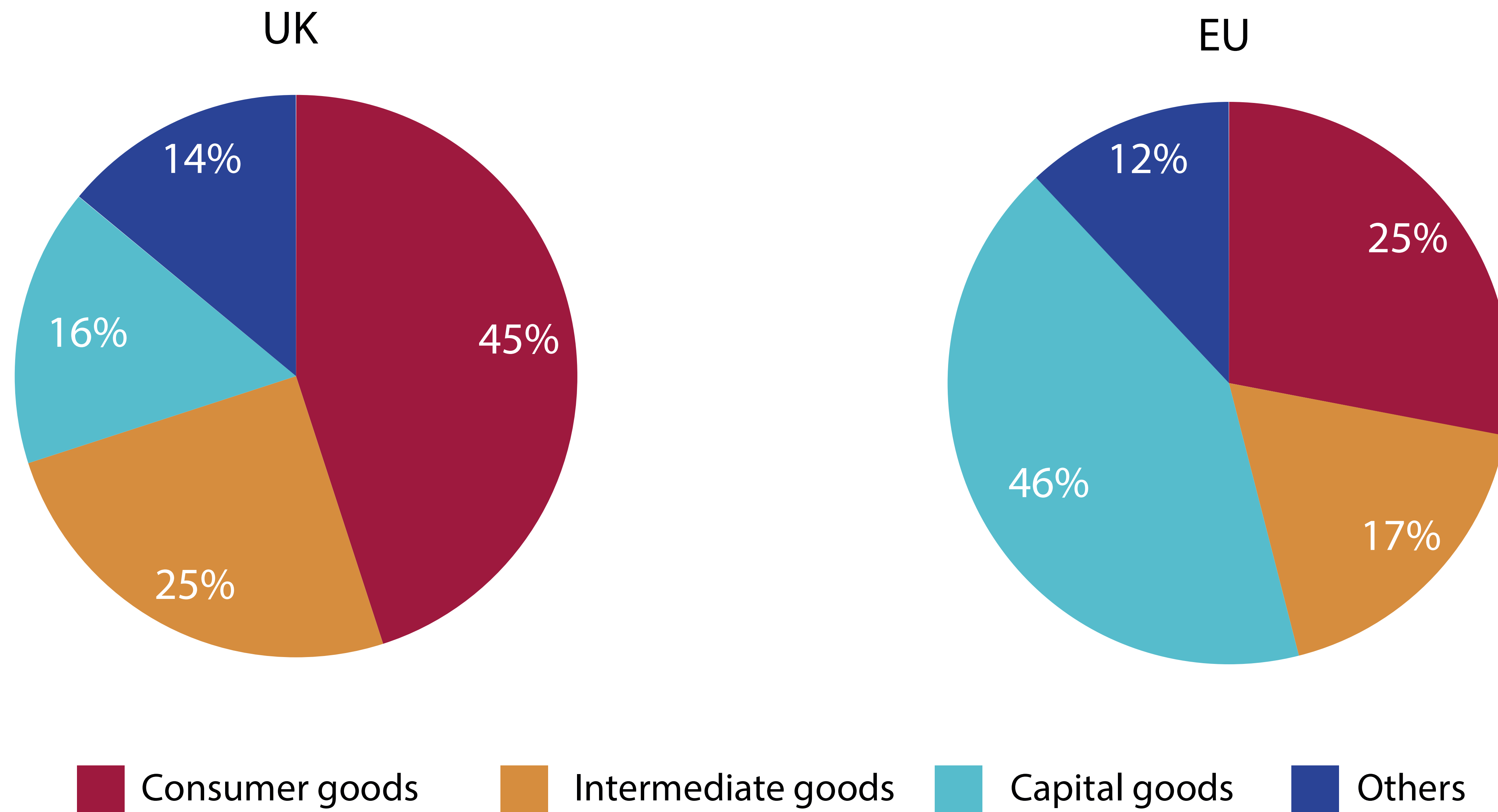
We next move to the product structure of the UK's exports in comparison to those of other EU countries. Figure 3 reports the UK's top ten product categories exported to China. These products constitute 70 percent of the UK's exports to China. In Table 3, we compare these top exports to those of the UK's major competitors in the EU. To see the potential of a China-UK FTA, we also report the current MFN tariffs for these products.

The most important export category from the UK to China is 'motor cars & vehicles'[11], which alone accounts for 35.2 percent of the UK's exports to China. The major competitor to the UK in this category is Germany, whose exports make up more than 50 percent of the EU's total exports in this product category. The auto category is also important for Slovakia. Although its share is only 5.23 percent, it is nonetheless an important industry given that it is the country's largest industry and accounts for 12 percent of its GDP[12]. Because the current importing MFN rate to China is 25 percent, once the UK strikes an FTA with China, UK exporters in this category could expect a big cut to their bilateral tariffs.

However, this trade benefit might be less promising than it seems. Most UK car manufacturing is foreign owned, and its continued presence in the UK could be very dependent on the UK keeping or losing its single market mem-

If a China-UK FTA was reached, the UK would undoubtedly gain competitive advantage in terms of access to the Chinese market

Figure 2. Composition of exports from the UK and the rest of the EU to China



Source: Bruegel

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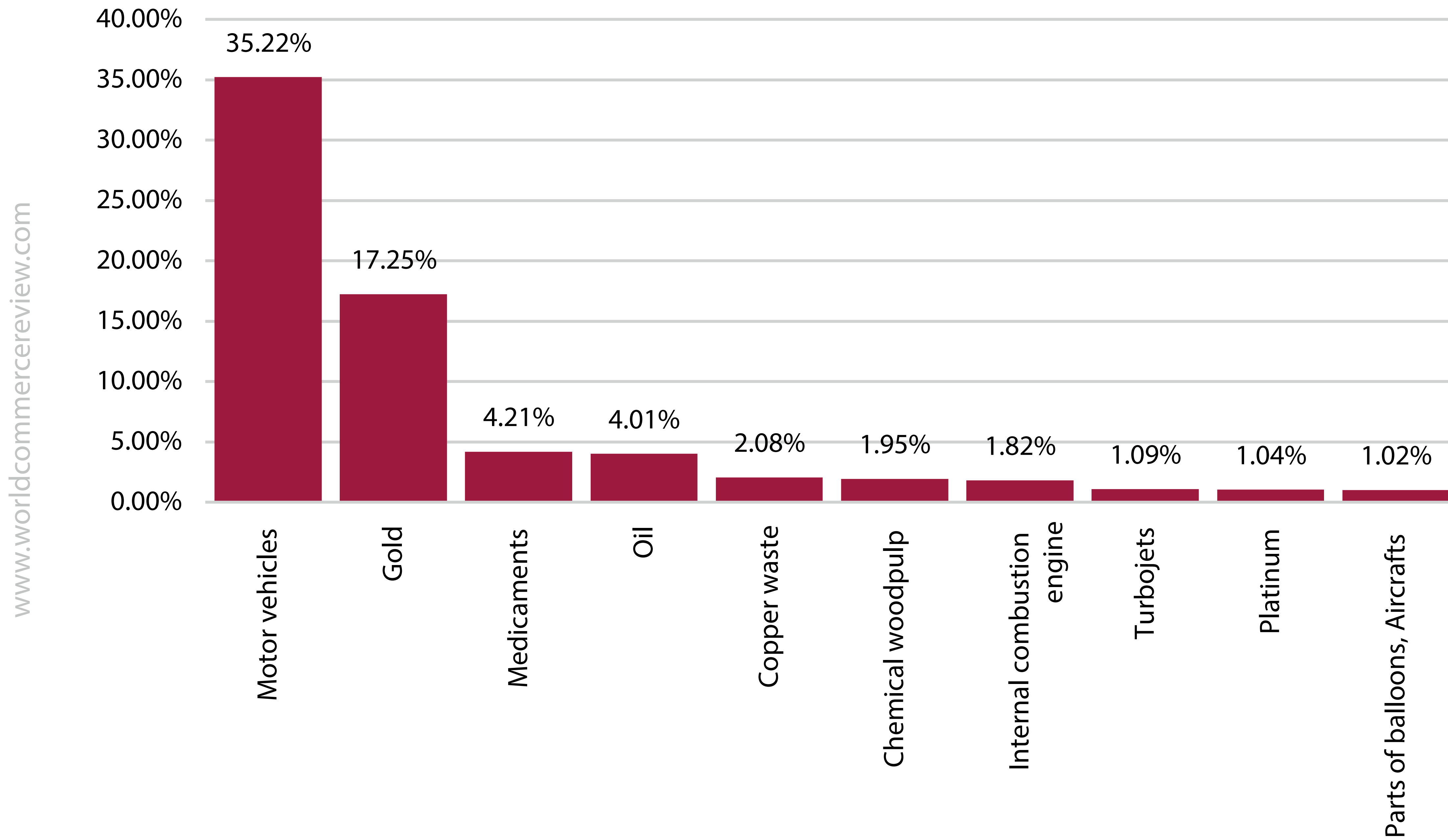
Figure 3. The UK's top ten exports to China as a % of EU exports to China in each category



Source: Bruegel based on the OECD bilateral database

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Table 3. UK share of EU exports to China compared to its main EU competitors, selected categories

	Motor cars & vehicles	Gold	Medicaments	Crude oil	Copper waste and scrap	Chemical wood pulp	Internal combustion engines	Turbojets and turbopropellers	Platinum	Parts of balloons, aircraft, spacecraft
Belgium	4.10%	0.00%	8.47%	0.00%	5.92%	6.76%	0.57%	1.08%	5.57%	0.79%
Germany	51.67%	0.10%	23.41%	0.00%	20.71%	3.07%	40.10%	8.57%	42.22%	54.85%
Spain	0.04%	0.00%	2.71%	0.00%	7.04%	7.62%	0.15%	0.13%	0.00%	0.92%
France	0.57%	0.03%	10.11%	0.00%	5.45%	5.80%	2.25%	61.76%	0.01%	20.69%
United Kingdom	29.21%	99.87%	17.54%	99.98%	22.66%	45.82%	44.80%	14.51%	46.04%	18.74%
Italy	3.11%	0.00%	10.20%	0.00%	6.75%	11.49%	3.60%	6.01%	6.04%	0.92%
Netherlands	0.47%	0.00%	2.92%	0.00%	19.03%	17.05%	0.46%	2.80%	0.02%	0.74%
Slovakia	5.23%	0.00%	0.00%	0.00%	0.10%	0.00%	0.00%	0.00%	0.00%	0.01%
Sweden	0.85%	0.00%	12.75%	0.00%	1.92%	0.03%	4.50%	0.80%	0.07%	0.04%
MFN tariffs	25.00%	0.00%	5.11%	0.00%	0.00%	0.00%	8.26%	2.67%	0.75%	0.75%

Source: Bruegel

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bership. If the UK exits the single market, these foreign investors could divert their investment to other EU countries, minimising the impact of a UK-China trade deal. Instead, if the UK were to continue to have single market access[13], a China-UK FTA could harm other EU countries' competitiveness in the automobile sector, with Germany and Slovakia being especially affected.

Another potentially important product category is 'internal combustion engines', which ranks as the UK's seventh most valuable export category to the Chinese market. The UK and Germany compete strongly in this sector, with each taking more than 40 percent of EU market share in China. Given that the MFN tariff for the product is 8.26 percent, a possible China-UK FTA would also facilitate the UK's competitiveness in China and could have some negative effect on Germany.

The spillover effects for the other products are expected to be small. The UK's second largest export product is 'gold', making up more than 17 percent by value of the UK's exports to China. However, because the MFN tariff for this product in China is zero, there is already no room for further reduction.

The third largest product category is 'medicaments', which makes up 4.51 percent of the UK's exports to China. Although there are several countries competing in this product category, including Belgium (8.47 percent share of EU exports to China in this category), Germany (23.41 percent), France (10.11 percent), Italy (10.20 percent) and Sweden (12.75 percent), the current MFN tariff rate is 5.11 percent and there would be limited room for tariff reduction. As such, a China-UK FTA would only have a moderate effect on this product category.

The UK's next three top export products, 'crude oil', 'copper waste and scrap', and 'chemical wood pulp', make up a significant share of the EU's exports to China. However, the MFN rate is again zero percent, so there would be no

spillover effect arising from the China-UK FTA. For the UK's other top export products, the MFN tariff is also very low, so the possible FTA would offer little gain to the UK's firms on the Chinese market.

All in all, if the UK can maintain some form of single market status with the EU, a China-UK FTA could be expected to produce huge benefits in favour of the UK's 'motor cars & vehicles' sector. This would undoubtedly have a significantly negative influence on German and Slovakian auto exports to China. In addition, German export sales of the product category 'internal combustion engines' would be jeopardised. For the rest of the product categories, the spillover effect would be moderate at most.

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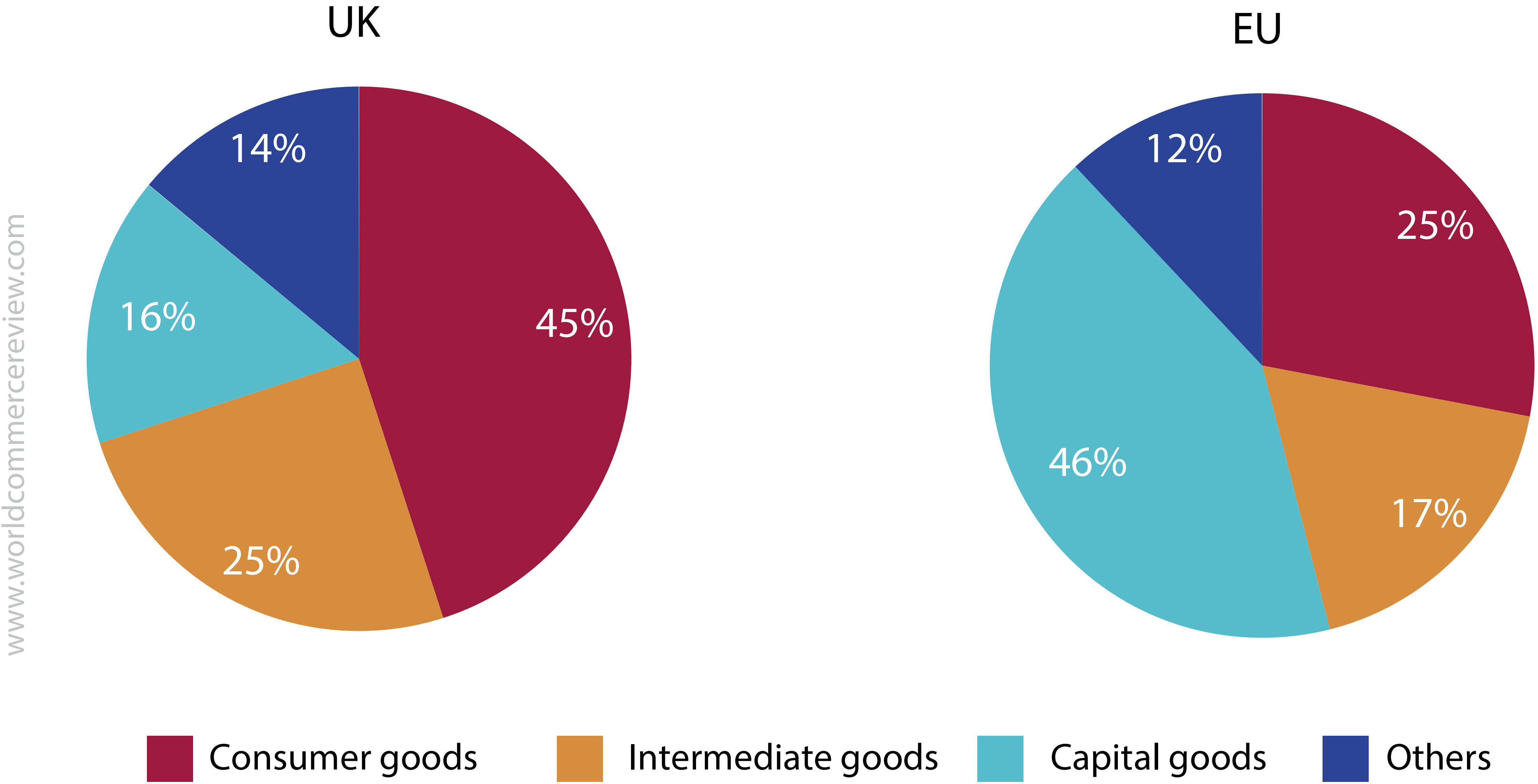
The reduced costs of UK imports, thanks to an FTA with China, would be at most moderate

The UK's imports from China are also mostly concentrated on consumer goods. Within the EU, the UK is after Germany the second largest end importer of consumer goods from China. Consumer goods from China account for more than half of the UK's total imported goods from China by value (53 percent). In comparison, the values of capital and intermediate goods are 22 percent and 16 percent respectively of the UK's imports from China, below the average level for the rest of the EU.

Although the UK relies more on consumer goods in its imports from China, the distribution of these goods is broad based. Even the largest consumer goods category, 'furniture and its parts', makes up only 2.36 percent of China's exports to the UK. Therefore slicing tariffs would have differing impacts across a variety of consumer goods categories, depending on the specific tariffs that currently apply. The second column of Table 4 reports the related MFN tariffs for the UK's top five categories of consumer goods imports from China.

It can be seen that the greatest impact might come from 'sweaters, pullovers and vests', for which the current MFN tariff reaches nearly 12 percent. But for the other sectors, the MFN tariffs are quite limited so the benefit from an FTA

Figure 4. Capital, intermediate and consumer goods imported from China by the UK and the rest of the EU



Source: Bruegel

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Figure 5. The UK's top ten imports from China, as % of total imports from China

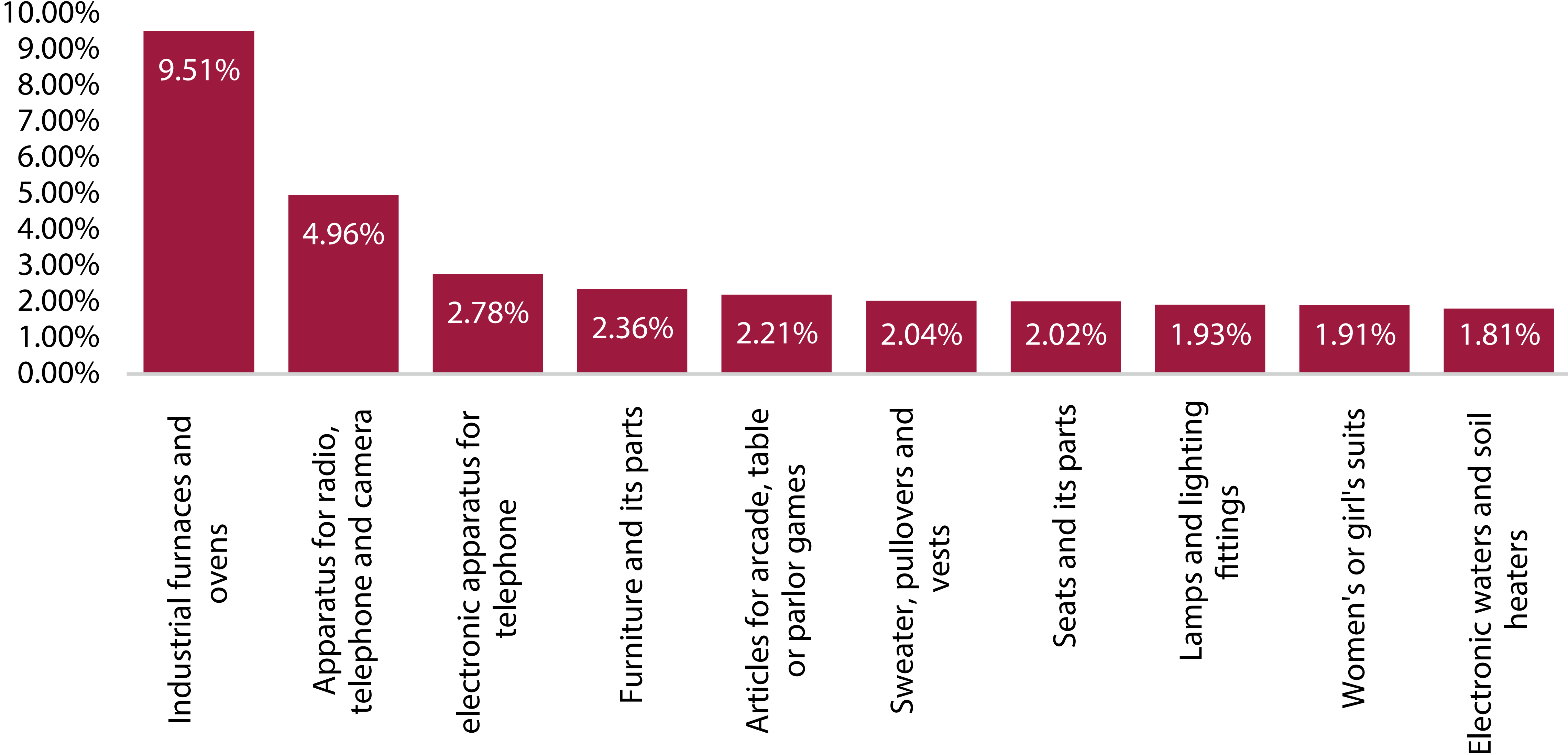

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Table 4. MFN tariffs for UK's top five imported consumer, capital and intermediate goods categories from China

Consumption goods		Capital goods		Intermediate goods	
Product	*MFN tariff rate*	*Product*	*MFN tariff rate*	*Product*	*MFN tarriff rate*
Furniture and its parts	1.66%	Industrial furnaces and ovens, non-electric, parts thereof	0.00%	Festive arts	2.03%
Articles for arcade, table or parlour games	3.70%	Apparatus for radio, telephone and camera	2.90%	Iron and steel parts	0.00%
Sweater, pullovers and vests	11.91%	Electronic apparatus for telephone	0.00%	Flat-roll iron and steel	0.00%
Seats and their parts	2.98%	Semiconductor devices, light-emit diodes etc, parts thereof	0.00%	Knitted or crocheted fabrics	14.50%
Lamps and lighting fittings	0.00%	Parts etc for typewriters & other office machines, computer assessorial	0.33%	Bars and rods	0.00%

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would be small. This is especially so for the 'lamp and lighting fittings' category for which the MFN tariff is already zero percent so there would be no possible effect arising from an FTA. As such, an FTA could be only relevant for specific consumer goods sectors.

The distribution of capital goods is more concentrated. Figure 5 shows that the top three product categories that the UK imports from China, 'industrial furnaces & ovens, non-electronic products' (9.51 percent) , 'apparatus for radio, telephone and camera' (4.96 percent), 'electronic apparatus for telephone' (2.78 percent), are all capital goods. However, for these three product categories, the average MFN tariff rates are 0.00 percent, 2.90 percent and 0.00 percent respectively, implying that there would be nearly no potential for these major capital goods from further reductions in tariffs.

Intermediate goods have received global attention in modern international trade. Undoubtedly the reduction in tariffs can have certain implications for sectors that depend more on imported intermediates. The UK's Brexit minister David Davis has argued that an FTA with China will reduce the intermediate cost of car components and increase the UK car sector's global competitiveness. However, according to our estimates, only eight percent of the UK's imports from China fall into the intermediate goods category, so the final effect is expected to be small. The last column of Table 4 shows the MFN tariffs for the UK's top intermediate goods imports from China. It can be seen that the MFN tariffs for most products in this category are already very low. Though there are very high rates for certain categories, such as 'knitted and crocheted fabrics', the trade volumes for these product categories are low, making up less than one percent of the UK's total imports. In particular, the MFN tariff for the parts and accessories of motor vehicles is as low as 3.81 percent.

Against this backdrop, even if China and the UK succeed in striking a zero-tariff agreement for these intermediate goods, the impact on the price of final goods would be far less than four percent. Therefore, a China-UK FTA would

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have very moderate impact, if any, on the UK's global competitiveness from the intermediate goods perspective.

Policy recommendations

A China-UK free trade agreement has been extensively discussed since the UK's vote for Brexit. Many supporters of Brexit argue that the UK's regained flexibility to strike trade deals with other partners, and in particular with China given its economic size, will be a key advantage. Our analysis indicates that a China-UK FTA will be neither as easy nor as clearly advantageous as portrayed by Brexit supporters.

First, it will be very difficult for the UK to reach an agreement with China without first establishing a new post-Brexit partnership with the EU. Negotiating independent MFN tariffs with other WTO members will be a pre-condition if the UK exits the EU customs union, and this process will require time and effort.

Second, even if the UK reaches an agreement with China, the UK cannot serve as a back door for Chinese products to enter the EU, because the EU is very likely use rules of origin to close any such loopholes. In addition, entering the EU via the UK will entail an additional transportation cost that will, at least partly, offset any tariff savings, making use of such a loophole less worthwhile.

Third, the UK and the other EU economies differ in most of their imports and exports, so there would be very limited substitution between them. Even for the product categories in which the UK and the EU compete on the Chinese market, current MFN tariffs are already too low for there to be further sizable reductions. The only exception is the 'motor cars & vehicles' category, in terms of which the UK, Germany and Slovakia do compete on the Chinese market. It is possible that the UK might gain some advantage were a UK-China trade deal to be signed. However, the cost for the UK might be high, because such a deal could end up creating obstacles for the UK's current most important trade partnership, namely the one it has with the EU.

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It therefore seems to us that establishing a new trade relationship with the EU would be a more urgent task for the UK in the post-Brexit world, than an FTA with China. Under such circumstances, the UK might need to postpone its trade negotiations with other economies outside of EU, including China. This goes beyond the current discussion of the illegality of the UK starting to negotiate trade deals before it leaves the EU. The issue is whether it makes economic sense for the UK to do so, and the answer is no. In fact, the more the UK reaches an independent favourable trade agreement with China after Brexit, the harder it will be for the UK to strike a good deal with EU. In the meantime, it is also urgent for the UK to negotiate with the main WTO members on MFN tariffs, because outside the EU, the UK might not participate in the EU schedule of concessions. The best strategy for the UK would be to negotiate with the other WTO members with the EU-based tariffs as a starting point, to avoid negotiating over terms separately and also to maintain a close relationship with the EU.

In general, the EU should not be too concerned by a potential China-UK FTA. After all, the overall EU-China trade pattern differs from the UK-China trade pattern. Even if the UK can maintain its EU single market status to the EU, as long as the EU includes rules of origin in its trade negotiations with the UK, there would be at most a limited substitution effect in certain sectors, such as motor vehicles, and this would mainly affect Germany and Slovakia. The overall impact would be very moderate. Therefore, when establishing the new trade relation- ship with the UK, the EU does not need to overplay the significance of the China-UK factor, and can focus more on its internal priorities. ■

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Prepare now for Brexit's tax implications

Brexit will have enormous tax implications for companies working in the UK and on the continent. Unless they start preparing now, 2019 will be a major financial and bureaucratic shock, Les Secular writes

Multinational firms should start preparing now for the effects of Brexit in 2019. Unless new agreements are put in place, tax arrangements could get a lot more complex. There are three major areas in the international tax arena where changes may have to be made without even touching on the many VAT changes that will also be necessary.

Interesting information

The first factor that could have an immediate impact following Brexit is the EU's Interest and Royalties Directive. Under this directive, interest and royalties paid between associated entities in different member states can be made free of any withholding taxes.

After 2019, unless a new arrangement is entered into or transitional arrangements apply, withholding taxes will be governed by the provisions of double taxation treaties. Not all double taxation agreements between the UK and EU member states provide for full exemption from withholding taxes on interest and royalty payments. For instance, under the UK's double taxation treaty with Poland, withholding taxes of five percent can apply on certain payments of interest and royalties. Other treaties also contain provisions allowing such payments to be subject to withholding taxes, albeit at reduced rates.

Joining up

The second area is the Mergers Directive (MD). Adopted in 1990, the MD was designed to remove obstacles to cross-border reorganisations involving companies in two or more member states. In the case of mergers and divisions, where the transferring company transfers assets and liabilities to one or more receiving companies, the MD provides for deferral of taxes that could be charged on the difference between the real value of assets and liabilities transferred and their value for tax purposes.

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Where there is a share exchange, the MD provides for deferral of the taxes that could be charged on the income or capital gains derived by the shareholders of the transferring or the acquired company from the exchange of such shares for shares in the receiving or the acquiring company. After 2019 potential capital gains issues could arise.

Conflict resolution

The final area is the EU Arbitration Convention (AC), and double taxation arising from transfer pricing adjustments. Initially in force from January 1 1995 for a period of five years (with extensions), an amending protocol was ratified in 2004 and the AC re-entered into force on November 1, 2004, with retroactive effect from January 1, 2000. The AC applies in all EU member states, and establishes a procedure to resolve disputes where double taxation occurs as a

Although changes are unlikely to have any impact until 2019, MNEs should be preparing now

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result of an upward adjustment of profits of an enterprise of one member state. It specifically refers to arbitration and a three-year timeframe, and imposes a binding obligation on contracting states to eliminate the double taxation.

The AC only applies to member states and, unless a specific deal is brokered or transitional arrangements are made applicable, taxpayers suffering double taxation on their profits, income or gains would have to resort to the pre-1995 system of relying on the provisions of the specific double taxation agreement with each separate EU member state. While some double taxation agreements provide for arbitration and a time limit, the provision is not in all treaties. Consequently, until such treaties are renegotiated, any action may become more time-consuming, with no guarantee a decision will be made between the states to eliminate the double taxation.

Although changes are unlikely to have any impact until 2019, MNEs should be preparing now. This is particularly the case if changes to their systems are needed, and because the potential impacts mentioned above will also have an impact for EU entities investing in the UK.

Brexit will have enormous tax implications for companies working in the UK and on the continent. Unless they start preparing now, 2019 will be a major financial and bureaucratic shock. ■

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Europe after Brexit: a proposal for a continental partnership

Jean Pisani-Ferry, Norbert Röttgen, André Sapir, Paul Tucker, and Guntram B Wolf[1] propose a new form of collaboration, a continental partnership, that will maintain Europe and the UK's influence in an increasingly volatile world

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Introduction

For nearly sixty years, a seemingly irreversible momentum towards integration within the framework of the European Union has, for many, defined the future of the continent. On 23 June 2016, the electorate of the United Kingdom made a sovereign choice to leave the EU. After the British decision to leave, Europe's trajectory, even its destiny, has again become a matter of choice. Brexit marks both a major constitutional change for the UK and a significant rupture for the EU. If only for this reason, the negotiation of the terms of Brexit must take a long-term view, beyond the possibly drawn-out negotiations that will begin in the coming months.

Over the next 15-20 years, the balance of economic and geopolitical power in the world is likely to alter significantly, with a new world Top Table of highly populated countries with massive economies. Our part of the world should want to have a seat at this table, so that our particular version of civilisation continues to be represented in the councils that seek to maintain peace, set rules and generate prosperity globally. Representation cannot be taken for granted. Of the EU's three largest countries, Germany, France and Britain, none can be confident of having a place at the new top table.

More immediately, the constellation of security threats in Eurasia calls for managing the Brexit divorce so that it does not weaken Europe further at a time of major challenges to the security, freedom and wellbeing of its peoples. The current situation is a worrying reminder of the unavoidable interdependencies of geographical neighbours: the UK can leave the EU but it cannot relocate away from Europe.

The same can be said of economic links. Nearly half a century after the first enlargement of the EU in the early 1970s, the economic circumstances of the EU and the UK are now so interwoven that their prospects cannot be independent over any foreseeable horizon. Perhaps the greatest economic uncertainty for the UK is the future course and prosperity of the euro area, by far the largest economy in this region of the world. EU reform matters hugely for the whole continent with or without Brexit.

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EU-UK cooperation will therefore remain profoundly important. Ways must be found to put it on a new and secure footing. Different approaches will no doubt be needed to reflect the substantive differences between, for example, trade and security issues. But any new framework will need to recognise that economics and politics are not neatly segmented. For example, they are interwoven in decisions on economic sanctions designed to help maintain international order. The new arrangements will need to be able to cope with the fuzzy boundaries of different public policy spheres.

It is vital, therefore, that the EU and the UK enter exit negotiations not only with a clear view of their near-term goals but also of their long-run interests and likely interdependencies.

On the British side (and indeed, to policymakers all over the developed world), the referendum result is a signal that urgent efforts are needed to ensure that the benefits of future economic growth can be enjoyed by all. Beyond any costs from the unavoidable medium-term uncertainty surrounding Brexit, other risks need to be navigated, including undoing trade integration with the EU (Sampson et al, 2016)[2].

Brexit is now a reality. It carries risks. It can be turned into an opportunity

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On the EU side, there may be a temptation to apply punitive terms to the UK's exit and the new relationship. Certainly Britain cannot be rewarded and it will not be allowed to pick and choose at will policies that it wants to participate in or abstain from. The EU needs to avoid reaching a series of ad hoc agreements with partner countries that are not based on clear principles. But an exceedingly unfavourable deal would be liable to damage everyone and would not achieve cohesiveness within the EU itself. For the EU, continued support should rest on reforms that can regenerate growth and jobs and, in particular, provide more secure foundations for the euro area.

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An outcome that isolated the UK and blunted the incentives for EU reform would, in short, be in no-one's longer-term interests. The issues of EU/euro-area reform and how to define the relationship between the UK and the EU are therefore interlinked. With or without Brexit, the UK would have had to define its relationship with a reformed euro area (Sapir and Wolff, 2016). Similarly, increasing policy integration within the euro area, for example on banking, was already raising questions before 23 June 2016 about the relationship with the UK (Pisani-Ferry et al, 2012).

This article leaves aside the issue of EU reform and focuses on the desirable EU-UK relationship after Brexit. Our starting point is the proposition that none of the existing models of partnership with the EU would be suitable for the UK. Nor would the off-the-shelf models recognise the importance of the multi-dimensional EU-UK relationship in other fields such as security and defence. The 'Norway' option would not allow limits on freedom of movement for workers, which is likely to be a priority for the UK government. It would also turn the UK into a pure rule-taker, a role that would be inadequate given the size and significance of the UK. Similarly, under the 'Swiss' model, the UK would become a pure follower of EU regulation in the sectors in which it would participate. Moreover, from an EU point of view this approach would be open to the justified criticism of the UK cherry-picking its participation in a shared public good.

There is also the option of a free-trade agreement. This would be technically feasible and could be based on a close agreement that also incorporated bilateral dispute-settlement mechanisms if political agreement could be reached. Such a structure would not, however, provide an adequate basis for the kind of deep economic integration that some kind of continued participation in the single market would constitute.

The UK's comparative advantage is largely in regulated services, which require an agreed regulatory framework in order to be provided across borders. For example in banking, the ability of banks and other intermediaries based in the UK to operate across the EU is based not only on a single set of rules but also on elements of supranational supervision (Schoenmaker, 2016). A trade agreement would not include such 'passporting' rights and so would constrain not only the City of London but also service companies operating outside the capital.

We therefore make a new proposal for the EU-UK relationship that is considerably less deep than EU membership but rather closer than a simple free-trade agreement. Policymakers in the UK and the EU will ultimately face the political choice between either pursuing something along the lines of our proposal or establishing a distant free-trade arrangement.

Our proposal might also have broader significance for Europe over the long-run as a basis for relationships with other neighbours. Beyond the immediate priorities of the UK situation, Brexit challenges the EU to reconsider and reorganise its relationships with other countries in the region, such as the EEA countries[3], Switzerland and, less pressingly, Turkey and Ukraine.

In the long run, our proposal could lead to a Europe of two circles, with the supranational EU and the euro area at its core, and an outer circle of countries involved in a structured intergovernmental partnership[4].

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We believe that departing from the standard templates is essential for the success of the UK exit negotiations. Without a common vision of their shared future over the longer term, the UK and the EU risk being dragged into unprincipled bargaining and, albeit in slow motion, weakening their positions in the wider world.

The future of EU-UK relations

At its core, the EU has been a political project. It is not just a group of states that cooperate, but a group of states which have created supranational institutions that have executive and judicial authority over EU member states and that can pass laws that are directly applicable throughout the EU. This is perhaps most visible in the form of the European Court of Justice, which can overrule national jurisdictions, or the European Parliament, which can, with the Council, pass laws that effectively replace national laws. The supranational authority of the EU is also manifest in the European Commission's regulatory remit in, for example, competition policy and state aid.

A majority of the participating British electorate have in effect rejected this vision of the supranational exercise of voluntarily pooled sovereignty. It was especially significant that the UK electorate rejected one of the constituting elements of the single market: the free movement of workers. As of 2014, there were 5.3 million non-UK nationals resident in the UK, of whom EU nationals accounted for 2.9 million. Of those, 2.2 million currently work in the UK[5]. While there appears to be little conclusive evidence that the number of foreigners in an electoral district was a determining factor in the likelihood of that district voting to leave (Darvas, 2016), there can be no doubt that the Leave campaign tapped into seams of genuine concern about the scale and speed of immigration.

In our proposal, we take those two political constraints as given. The relationship between the UK and the EU that we propose would therefore be based on an intergovernmental form of collaboration, with no legal right to free movement for workers but a regime of some controlled labour mobility and a contribution to the EU budget. The goal of the proposal is to create a framework for continued close cooperation, even integration, on matters of common interest.

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For some, the most controversial question is likely to be whether it is possible to have close economic integration comparable to the single market while partly limiting labour mobility. There are two ways of characterising the deeply integrated market. One is functional, and the other constitutional.

The functional definition of a deeply integrated market consists of its central functional elements: (i) the absence of tariffs; (ii) a single set of rules or minimum standards; (iii) enforcement of those rules and standards under shared, supra- national jurisdiction; (iv) a single competition policy and state-aid control; and (v) the contribution to shared public goods, including through EU budget.

But the EU's market is also often defined in terms of the dimensions of an economic- political constitution. Essentially those dimensions are the so-called 'four freedoms' in goods, services, capital and people of the single market (eg. Balassa, 1961). In that conception, free movement of workers is an essential element of the single market established with the Treaty of Rome.

We endorse the first view of a deeply integrated market. It is inconceivable that firms should operate freely in an economic area without ensuring a single set of rules or minimum standards that provide a level playing field across all the participating countries. State-aid control, competition policy and common rules or minimum standards are therefore indispensable parts of the single market, as is participation in an essential core of social rights, consumer protection and health and safety regulations. Future rules, standards and other policy areas that affect the integrated market may give rise to political controversy, as in any region seeking cooperative agreement.

As a political project the single market consists of all four freedoms. Arguably, freedom of movement of workers, whereby EU citizens are entitled to look for a job in another EU country and to work there without needing a work permit, constitutes the element that makes the single-market part of the EU into a political project[6]. Granting access

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to the domestic labour market to some 510 million citizens is a significant political choice and a powerful symbol of integration amongst EU countries. It is this political project that the UK electorate has effectively rejected.

From a purely economic viewpoint, however, goods, services and capital can be freely exchanged in a deeply integrated market without free movement of workers, though not entirely without some labour mobility. It is also possible for capital to move freely and for banking services to be provided across borders without free movement. Free movement of workers is, thus, not indispensable for the smooth functioning of *economic* integration in goods, services and capital.

On the other hand, some degree of labour mobility is an essential counterpart of the free flow of goods, services and capital. Firms that operate in foreign countries need to be able to transfer workers abroad, at least for temporary periods, in order to produce efficiently. The four freedoms of the European single market are therefore closely economically connected, but not inalienable for deep economic integration[7]. Free movement of workers can be separated from the rest, but some temporary labour mobility is needed. Our proposal is, accordingly, about how to manage the governance of the single market in this functional sense without everyone being a full member of the EU.

The same logic applies to other areas of EU competence. As indicated, some of the chapters of the *acquis communautaire* are essential to the proper functioning of an integrated market for goods, services and capital. They should be retained in a new framework for the EU-UK relationship. Other chapters, such as energy or research, are however not essential and should be regarded as optional.

A proposal for structuring EU-UK relations

Our proposal is about how a less-political definition of economic cooperation-cum- integration can be framed and organised. We propose the creation of a Continental Partnership (CP). The aim of this CP is to sustain deep econom-

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ic integration, fully participating in goods, services, capital mobility and some temporary labour mobility, but excluding freedom of movement of workers and political integration. The CP should involve:

- Participation in a series of selected common policies consistent with access to the Single Market;
- Participation in a new CP system of inter-governmental decision making and enforcement;
- Contribution to the EU budget;
- Close cooperation on foreign policy, security and, possibly, defence matters;

The CP would build a wider circle around the EU without sharing the EU's supranational character, except where common enforcement mechanisms were needed to protect the homogeneity of the single market. Members of the CP would be the EU, all EU-countries, the UK together with any other countries that participated.

The obvious challenge for EU-CP cooperation will be to preserve the processes and structures of the EU as a supranational entity and at the same time to ensure that CP members that are not part of the EU have a say in common matters. Two basic cases must be distinguished. The first concerns matters for which the EU already has an intergovernmental decision-making process. Here, the issue of cooperation can be relatively easily solved as the CP by its very nature is intergovernmental.

Politically, this area of intergovernmental cooperation is important. In particular, the activity of the CP in the fields of foreign, security and defence policy – the areas in which Europe has to face a range of complex, persistent and existential threats – would be included.

The second, and arguably more difficult case, concerns areas in which the EU acts as a supranational body with (partial) sovereignty, including in particular all single market matters. Cooperation in this area means that although a CP member is not a member of the EU, it would get full access to the respective parts of the single market with

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all rights, opportunities and obligations other than freedom of movement for workers. In the following, we discuss how this cooperation could be organised.

One issue concerns the law making itself: We propose that CP countries would meet in a CP council, in which EU institutions would participate. At the level of the CP council, the UK would thus continue to participate in the numerous different formations where the details of single market regulation and other policies in which it would continue participating are discussed and negotiated. Obviously, the CP council could not pass EU legislation but CP partners would be involved in CP council readings of draft EU legislation and they would have a right to propose amendments.

EU law on the single market would, however, continue to be adopted through the normal EU legislative process. In practice, in the areas that concern the CP, the CP council would deliberate the legislative proposals before they are formally passed in the council of the European Union and the European Parliament, so that positions expressed by non-EU members could be taken into account throughout the legislative process and in the final decision.

Formally, it would be a *political* – not legal – commitment by EU member states to take into account the positions and deliberations in the CP council. Our CP council would therefore deal with this major political task. If the EU and its partners disagree within the CP council, the final say would formally remain with the EU. The non-EU CP members would then still have to implement the single market legislation in their national legislation or face restrictions on participation in the single market. The CP partners therefore would not have veto rights over the EU decisions but they would be closely involved in law-making at the intergovernmental level of the CP council[8].

Conversely, CP members would have to accept the enforcement measures and jurisprudence that safeguards the relevant freedoms of the single market. Otherwise the integrity and coherence of the single market would erode.

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The key challenge will be to balance fairness with the necessity of homogeneity in application. In the case of EEA countries, an EFTA court is responsible. It consists of judges from the three EEA countries.

However, rules ensure that the court follows the relevant case law of the ECJ (Allen and Overy, 2016; Wikipedia, 2016). Whether such a mechanism would be sufficiently strong in the case of the CP with a major country as the UK is for political and legal debate. We think that it may be necessary to contemplate instead an extended ECJ court composition involving judges from all CP countries. However this court would still be bound by ECJ case law.

Another important question is competition policy enforcement and state aid control (Petropoulos, 2016). In the case of EEA EFTA countries, the European Commission is largely in charge for any cases that have repercussions beyond borders[9]. Whether this is a feasible model for the CP should be for political debate.

Participation in the EU budget would also be vital. While many spending items of the EU budget might look outdated, the budget still constitutes an essential element of the integrated economic space. It is indispensable in the area of agricultural policy but, with its aim of structural convergence, is also important for opening up economic opportunities for less-developed parts of the EU.

The EU budget also provides support for 'catch-up' countries. While the effectiveness of Structural Funds is a matter for debate, they serve as a quid pro quo for the adoption by cohesion countries of demanding single market legislation that might exceed what would be appropriate at their development level. Participation in the budget is therefore the necessary counterpart to participation in the single market. The UK would need to make a budgetary contribution.

From a political point of view, our proposal would constitute a significant concession by the EU to the UK on the free movement of workers. Politically, there may be a tendency in continental Europe to demand limits in other are-

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as of the single market such as financial services. We would note, however, that under our proposal there is already a political 'price' to be paid by the UK, as CP membership entails significantly less political influence compared to EU membership. Whether that price is appropriate is a matter for political judgement.

Other CP policy areas

We see three areas in which the CP would operate. The first, as we have outlined, consists of accepting the acquis in all single market areas except those relating to the free movement of workers. Here, we would see the emergence of a system under which the UK would impose a quota-system of some kind on the EU as a whole, while the EU would impose a quota on the UK[10].

Second, the CP would deal with shared external economic policies, in particular in trade and financial regulatory matters. The CP should aim for global influence in trade, financial regulation and climate and energy policies. Its creation would ensure that Brexit does not result in a long-term weakening of Europe's voice in global negotiations, bearing in mind the growing dispersion of international power.

Trade policy is an exclusive competence of the EU. We could see an interest of non-EU CP countries participating in EU trade policy through the CP council, thereby choosing to give up their ability to negotiate individually new free trade agreements. Again, ultimate decision making would, however, remain with the EU, which legally would retain formal competence. But there are also substantial obstacles and it will therefore be a matter of intensive political discussions (Sapir, 2016).

Financial regulatory matters are often negotiated and agreed on in global institution such as the Basel committees. In these fora, Europe is represented by a combination of EU institutions and the authorities of some of its member states. In the medium to long term, we would expect an increasing concentration of the external representation of the EU through EU institutions such as the European Central Bank. It would make sense to coordinate the positions

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of the Bank of England, other CP central banks and the ECB. Whether or not CP countries will ever want to cede their representation to common institutions would be a matter for future discussions.

Finally, energy and climate policies are also areas for the CP. This could involve participation in the EU emissions trading system (ETS), coordination of CP positions in international climate negotiations and participation in an energy union if it progressed.

The third area of CP policy should consist of an active role in foreign, security and defence matters. Russia's annexation of Crimea and military incursion into Eastern Ukraine are not bilateral issues, but threaten Europe's peaceful order as a whole. This new status quo is not just a challenge for EU countries. The same holds for the turmoil in the Middle East and North Africa. The spill-over effects from the conflicts in this region to Europe are unprecedented in recent times.

No European nation state will be able to manage these and other future threats single- handedly. The CP should emerge as a forum and even an active participant in foreign security and defence policy[11]. Justice and security affairs are a shared EU competence, which means that it is not a purely intergovernmental set-up and EU institutions have formal roles. This raises difficult, but hopefully surmountable, legal questions of how the CP-EU collaboration should be structured[12].

The UK, one of the two permanent European members of the UN Security Council and one of the current EU members able to project forces overseas, will remain a crucial partner on these matters. The Europeans cannot and must not solely rely on the US as the guarantor of European security. The Cold War is over, the Pacific sphere is of growing significance, new threats in forms of cyber-conflict and terrorism have materialized, and US politics is likely to face its own domestic challenges for some time to come. For this reason we believe that closer cooperation in this area

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is important and will be even indispensable over the medium-term if Europe is to be able to adequately to react to threats.

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Geographical scope

One advantage of the proposed Continental Partnership is the flexibility of its governance model. At its core it consists of participation through the CP Council in the EU law-making process while simultaneously accepting the ultimate authority of the EU and the enforcement of commonly agreed rules or minimum standards. Its nature is thus essentially intergovernmental. The Continental Partnership could thus be open to other European countries that might want to join.

It will be important not to overstretch the flexibility of the CP in the economic area. The central issue here is the move away from free movement of workers. But the CP should be flexible in relation to the security and defence policy area and potentially also external economic relations. Since security and defence policy are at the core of national sovereignty, we could see some CP members participating in the joint security partnership while others would not.

One important question is about the members of the European Economic Area (EEA) that are not part of the EU (Iceland, Liechtenstein and Norway). These three countries fully participate in the single market but do not have any significant say in the law-making process of the single market. We could imagine that these three EEA countries could have the right to join the CP if they wished[13]. We could also see the CP as an attractive model for Switzerland since it wishes to limit free movement – but, as a counterpart to joining CP, it would have to adopt the full set of single market regulation in other areas.

The creation of a Continental Partnership might also provide a basis for coming to honest terms in the negotiations with Turkey[14]. Arguably, one of the reasons why some EU member states would never accept Turkey joining the EU

is free movement and, more broadly, the political nature of the EU. Framing the relationship with Turkey in terms of EU accession was, therefore, always liable to be awkward.

But provided there is a shared will to strengthen the partnership and provided that essential political conditions are met, we see it as possible and perhaps even desirable to move towards including Turkey in the Continental Partnership in the medium- to long-term. Offering Turkey the prospect of a structured partnership with the EU in which it would have a voice could contribute to deterring a drift away from democracy and associated values.

In the longer term, the CP might also provide a framework for a strengthened relationship with EU neighbours in the east (Ukraine). It is an open question whether a similar template might be used for relationships with neighbours to the south (Morocco, Tunisia). Again, the intergovernmental character of the partnership and the exclusion of free movement of workers could contribute towards addressing existing stumbling blocks.

Becoming a member of the CP would require compliance with criteria, assessed via clear procedures. For the UK, the negotiations over its participation in the CP should be held in parallel with the EU exit negotiations to avoid unnecessary and mutually damaging disruption. EEA members could also qualify for CP. Other countries would have to comply with the necessary legislative acquis before being admitted to the CP. There should also be a definition of shared values of the CP, including issues such as the rule of law and democracy.

Conclusions

The British vote to withdraw from the EU marks a major constitutional change for the UK and a significant rupture for the EU. Our proposal is to turn the rupture into an opportunity to reorganise Europe in two circles. The inner circle constitutes the EU with political aims and supranational constitutional structures. The outer circle, of European cooperation, adding countries not in the EU would have more flexibility and be based on an intergovernmental

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structure, the Continental Partnership. Most important, CP countries would not participate in the freedom of movement of workers, would not share the political commitment to ever closer union, and would have less political influence over decisions of common interest.

Our proposal requires the UK and the EU to make tough choices. The UK will have to answer the question of whether it wants to continue to maintain close economic cooperation with the EU and whether it wants to maintain and potentially even strengthen its engagement in security and, conceivably, defence matters. This is ultimately a political choice that must be spelled out unambiguously.

The EU will have to agree among its members to put aside punitive motives and reach an economic settlement that grants control over labour mobility to the UK while allowing continued access to and participation in important parts of the single market. This is a political choice on which clarity is needed. The EU countries will also need to reflect on whether this model would be adequate for other neighbouring countries[15].

Finally, our proposal should be combined with a strengthened EU and a strengthened euro area. As a start, it involves concrete progress using the community method. Rendering the EU's own construction more effective and increasing political legitimacy is not only desirable for its own sake but also essential for the political stability of Europe with different levels of cooperation. We see the deepening of the euro area and the building of a continental partnership, in what would amount to concentric circles, as close complements that are in the interest of both the UK and the EU.

Our proposal is driven by the firm belief that neither the EU and its member states nor the UK have an interest in an escalation of tensions or costly disengagement following Brexit. Neither the UK nor the continuing members of the EU can escape their geographical interdependencies. Both have a stake in economic and political stability in

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Europe. Today's volatile and dangerous world requires its nations to collaborate to confront new and multiple challenges. The longer-run prospect of a future world in which Europe is only one amongst many powerful regions demands the same.

Brexit is now a reality. It carries risks. It can be turned into an opportunity. We hope that our proposal can provide a benchmark, even a vision, for the undoubtedly difficult negotiation that lies ahead. ■

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Endnotes

1. This article is the outcome of a dialogue among the five authors during the summer. It is published simultaneously in several European capitals under the sole responsibility of the authors, who write in their personal capacities. Jean Pisani-Ferry is Professor at Hertie School of Governance; Norbert Röttgen is Chairman of the Foreign Affairs Committee of the German Bundestag; André Sapir is Professor at the Université libre de Bruxelles and Senior Fellow at Bruegel; Paul Tucker is Chair of the Systemic Risk Council and a Fellow at the Harvard Kennedy School of Government; Guntram Wolff is Director of Bruegel.

2. There will be costs in the way of replacing trade with the EU with trade with other, more distant countries due to the gravity law in international trade.

3. Iceland, Liechtenstein, Norway.

4. In 2002, Romano Prodi, when he was president of the European Commission, wanted "to see a 'ring of friends' surrounding the Union and its closest European neighbours, from Morocco to Russia and the Black Sea", who would be "sharing everything with the Union but institutions" (Prodi, 2002).

5. As of Q1 2016 (Office for National Statistics, 2016). That number has increased from 752,000 in 2003 (before EU enlargement). Immigrants to the UK have been shown to be significant net contributors to public finances and to economic growth (Dustman and Frattini, 2013; Wadsworth et al, 2016).

6. Labour mobility is economically desirable because workers can move to the places where their productivity is highest. It is also socially desirable because it constitutes a fundamental personal freedom to go and work where one wishes.
7. We therefore contradict the current view of the European Commission President (Juncker, 2016).
8. Our proposal therefore goes well beyond the participation of EEA countries such as Norway that meet in the EEA Joint Committee at the level of ambassadors some 6 times per year with little influence on the council of the EU.
9. For a detailed discussion, see Allen and Overy, (2016).
10. We assume that the EU will define a joint migration policy. We would reject a quota system by which the UK would impose quotas on individual EU countries.
11. Theresa May (2016) in her speech on April 25 as home secretary said that in the EU the UK would benefit from issues such as the European arrest warrant, which has allowed the UK to bring 675 suspected or convicted criminals to face justice in UK. It has also been used to get terror suspects. Arguably, the CP should find a way to continue that useful cooperation, in line with EU laws.
12. Justice and security affairs are formally a shared competence in the EU: EU member states cannot exercise competence in areas where the Union has done so. It is conceivable that the EU may want to move significantly further in this area in the next 10 years. This would raise political and legal questions for the cooperation via the CP.
13. Specific grandfathering provisions might be needed to allow them to continue to be full member of all elements of the single market thereby continuing to participate in the freedom of workers.
14. For an earlier proposal to include Turkey in the wider circle, see Sapir and Wolff, (2014).
15. In our discussion, we leave aside the already variable geometry within the EU, in particular the differentiation between the euro area and the EU. Arguably, the management of that differentiation will increase in importance after Brexit as non-euro area countries will constitute only 15 percent of EU GDP. Its importance will also grow with further integration in the euro area.

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Brexit: a new industrial strategy and rules on state aid

Nicholas Crafts argues that there is an unheralded downside of a hard Brexit

Depending on the outcome of negotiations, Brexit potentially changes the rules that govern the use of industrial policy. The UK government has in mind risky policy reforms that appear to be incompatible with EU rules on state aid. This column argues that this is an unheralded downside of a hard Brexit.

The UK government has both embarked on Brexit and announced the outline of an 'industrial strategy' (HM Government 2017). The two initiatives are more closely related than is generally recognised because leaving the EU could mean a relaxation of rules controlling state aid, while the new supply-side approach entails a shift towards selective industrial policy.

Should we see this as an exciting new opportunity to build a stronger economy or as an unwelcome threat to the making of well-designed economic policy? In two recent papers, I argue that the latter is nearer the mark than the former (Crafts 2017a, 2017b).

State aid is defined by the EU as interventions – including grants, subsidies, loans, guarantees, and tax credits – that give the recipient an advantage on a selective basis that has distorted or may distort competition and which are likely to affect trade between member states. These are generally prohibited, but there is a broad exemption for horizontal industrial policies deemed to address market failures with relatively slight implications for trade.

State aid has to be notified to and approved by the European Commission, whose decisions are subject to scrutiny by the EU courts. Under this regime, UK expenditure on state aid has been relatively low: in 2014, it was 0.33% of GDP. Table 1 reports the main categories of expenditure and also notes spending on sectoral development; this was only about 0.1% of the total.

If, following Brexit, the UK chooses to stay within the European Economic Area (EEA), rules on state aid would remain much the same. Selective industrial policy would generally remain illegal.

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Table 1. UK expenditure on state aid, 2014 (million euros)

Environmental protection and energy saving	2,714.3
R&D and innovation	1,594.8
SME	1,346.0
Regional development	782.3
Sectoral development	8.2
Other	1,085.0
Total	7,530.6

Note: total excludes agriculture and transport.
Source: European Commission (2016)

Table 2. G20 protectionist measures recorded by GTA (2009-2016)

State aid	1,456
Trade defence	1,141
Tariff	600
Public procurement local content	382
Trade finance	373
Other localisation	352
Other	561
Total	4,865

Source: Evenett and Fritz (2016)

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If, as seems more likely, the eventual outcome of Brexit is a trade agreement between the EU and the UK, the implications are somewhat less clear. Nevertheless, it seems quite likely that the EU would insist on continuation of the equivalent of EEA rules and enforcement mechanisms: a majority of existing EU trade agreements have legally enforceable rules on state aid (Hofmann et al. 2017). On the other hand, a hard Brexit with a default solution of WTO trade rules would allow much more scope for selective industrial policy as is underlined by the recent surge in 'murky protectionism' (see Table 2).

The *Green Paper* (HM Government 2017) aspires to deliver *"a stronger economy and a fairer society"* so that *"more people in all corners of the country share in the UK's success"*. It identifies ten pillars for the new industrial strategy (see Table 3).

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A recent poll of economists finds that a large majority thinks that it is time for a new industrial strategy, but at the same time they doubt that the government could implement one successfully

Table 3. The 10 pillars of UK industrial strategy

1	Investing in science, research and innovation
2	Developing skills
3	Upgrading infrastructure
4	Supporting businesses to start and grow
5	Improving procurement
6	Encouraging trade and inward investment
7	Delivering affordable energy and clean growth
8	Cultivating world-leading sectors
9	Driving growth across the whole country
10	Creating the right institutions to bring together sectors and places

Source: HM Government (2017)

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It is conventional to distinguish between 'horizontal' and 'selective' industrial policy. The former addresses economy-wide issues with a view to correcting market failures and removing policy distortions. Well-designed policies can improve productivity and perhaps have a small positive impact on the rate of economic growth. Many of the ten pillars, especially the first three, are essentially of this horizontal type.

The latter – selective industrial policy – entails interventions that favour particular sectors and/or categories of investment, skills, technologies or places. The fifth, sixth and especially the eighth pillars can be seen as explicitly selective policies.

The most eye-catching new policy initiative relates to the pillar *"cultivating world-leading sectors"* in terms of a proposal for 'sector deals'. The Green Paper indicates that the government is prepared to work with any sector that can organise behind strong leadership to help deliver upgrades in productivity. This could involve addressing regulatory barriers, promoting competition and innovation, working together to increase exports, and working together to commercialise research.

To complement this, it is intended to take a strategic approach to government procurement to support investment in innovation and skills. All major government projects will be structured so that UK-based suppliers are in the best position to compete for contracts.

There will also be a new, more strategic approach to inward investment. This clearly envisages giving more inducements for foreign direct investment in projects that are judged to have a greater impact on economic growth.

Taken together, these three announcements signal an intention to rebalance industrial policy towards a distinctly more selective stance.

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The proposed horizontal policy reforms to innovation, infrastructure, and skills can happen with or without Brexit, whatever the flavour of Brexit. The obstacles to better policy in the past have been located in Westminster, not Brussels. It is difficult, however, to believe that the proposed moves towards selective industrial policy would be allowed under EU rules on state aid.

If a high priority is attached to pursuing a return to state intervention, then that in itself would be a reason to choose a hard Brexit. If, on the other hand, a high priority is attached to controlling the politicisation of industrial policy, then an attractive aspect of a trade agreement with the EU is that it would provide a commitment technology to constrain ministerial discretion.

The problem with selective industrial policy is that government failure is highly likely. It has been widely remarked that, as in the UK in the 1970s where such policies were an expensive failure (Morris and Stout 1985), support is disproportionately given to declining rather than new industries, and this may be an inherent aspect of the political economy of industrial policy that slows down the process of creative destruction (Baldwin and Robert-Nicoud 2007).

Protection against the ravages of industrial decline is probably what many pro-Brexit voters want: it has largely been precluded by EU membership, but it is a likely outcome of a newfound concern to help the 'left-behind'. But the constraint on political discretion arising from EU rules on state aid has been helpful since inhibiting the exit of poorly performing firms and industries is not good for long-run productivity performance.

In any case, it is highly desirable that as the government formulates its industrial strategy, it pays attention to the institutional architecture (LSE Growth Commission 2017). A framework is needed not only to replace EU rules on state aid but also to provide appropriate oversight of the whole gamut of industrial policy. This is highlighted by the

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recent deal with Nissan, which sets an unfortunate precedent, especially since this is surely only the first of many companies that will threaten to move production to locations inside the Single Market.

Policy guidelines for intervention should be made public and transparent, and evidence-based evaluation both ex ante and ex post by an independent body is required (Banks 2015). The chances of this approach being adopted in UK policymaking have always been remote and, no doubt, it is even less likely in the current political climate.

A recent poll of economists finds that a large majority thinks that it is time for a new industrial strategy, but at the same time they doubt that the government could implement one successfully (Den Haan et al. 2017). I share these opinions. And hard Brexit reduces rather than enhances the likelihood of success since it increases the scope for bad policymaking. ■

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Ben Broadbent looks at the possible effects of Brexit on investment and the financial markets

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Introduction and summary

The vote to leave the EU led to a big drop in sterling's exchange rate. One consequence is a rise in import prices and a squeeze on households' real income. We may already be seeing the impact of that squeeze on retail spending, which in real terms fell quite sharply around the turn of the year.

While it's hit the income of households, however, the depreciation has come as a boon for many exporters. In sterling terms goods export prices rose 12% through the course of last year. This will significantly have boosted exporters' profitability and with it the incentive to invest in extra capacity.

In general, it's not really right – not enough at least – to think about the impact of a change in the exchange rate in isolation. Asset prices are volatile in the short run, sometimes inexplicably so. But over time they tend to move for a reason. They're driven by deeper things that can have important effects of their own. To get the full picture you need to take both into account, not just the partial impact of a change in the exchange rate but those of its underlying drivers as well.

Take sterling's fall in 2008 and 2009. One plausible explanation was that the financial sector is more important for the UK – notably its exports and the government's tax receipts – than for other countries. So its economy and public finances were more vulnerable to the global financial crisis. The depreciation helped to cushion these effects but it wasn't enough to outweigh them. The downturn was no less severe here than elsewhere, notwithstanding sterling's fall.

Sterling's more recent decline was clearly prompted by the referendum result. It also seems likely that the foreign exchange market has decided the consequences are negative. The most plausible explanation for the depreciation is that, in the eyes of the market, leaving the EU will make exporting harder and more costly. To help compensate the currency needs to be cheaper.

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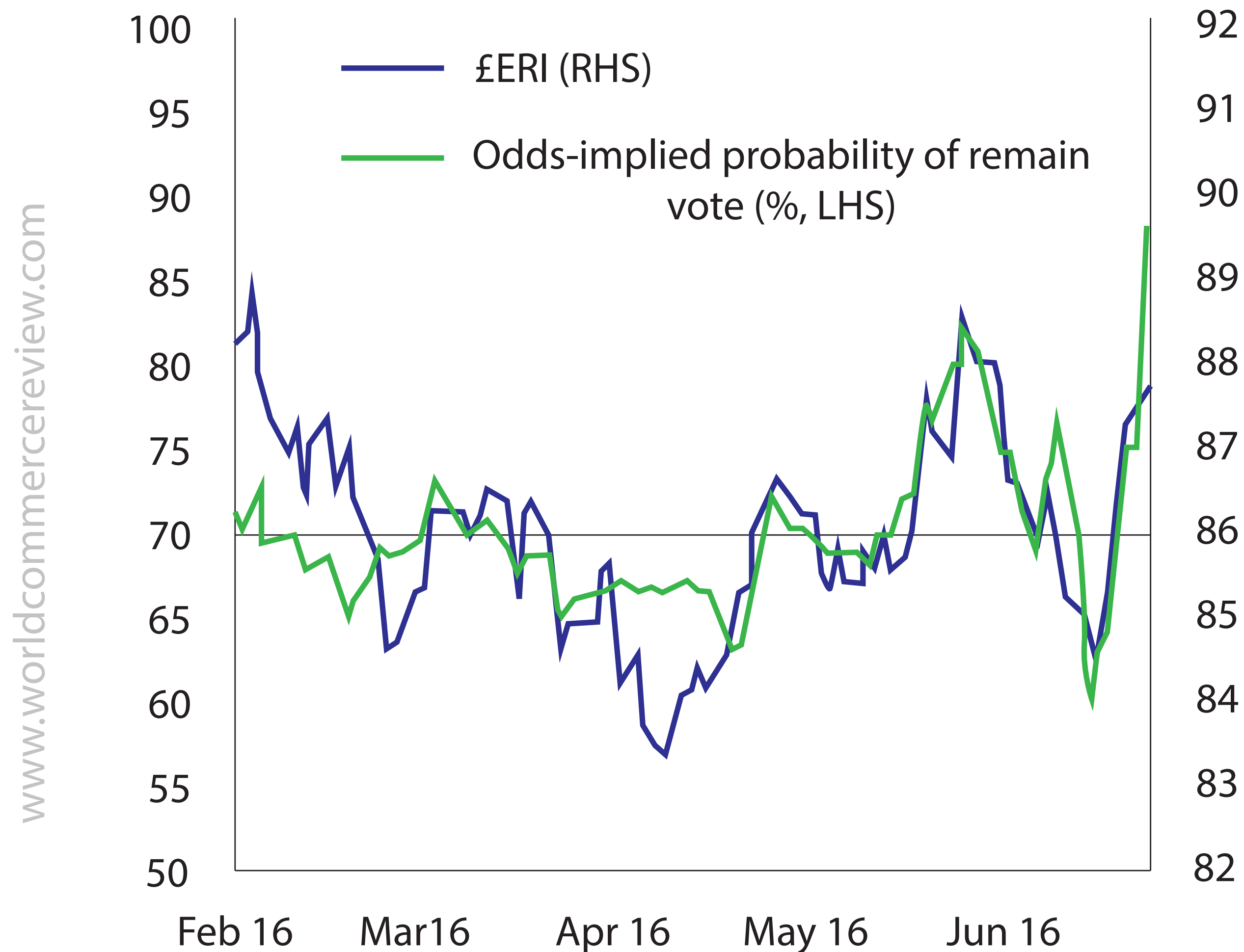
There are many important differences with 2008/09, of course. One is this: Brexit hasn't happened yet. Back then sterling's fall happened alongside its cause. On this occasion the depreciation reflects beliefs about a change in the UK's future trading arrangements, but it's acting on an economy where those arrangements are for the time being unchanged. The result – higher prices and profits but unchanged rules and costs – represents something of a sweet spot for exporters and businesses that compete with imports.

How they respond is one important determination of economic growth this year. Usually, one of the more positive aspects of an exchange-rate depreciation is that, by raising their profitability, it encourages the expansion of firms in the tradable sector. With the world economy in better health than for some time, there is certainty every incentive to do that today. On this occasion that response might be more muted than usual, however, because it's not clear how long the sweet spot will last. If the currency market is right the UK's future trading relationships will be

...the uncertainties involved in longer-term decisions could temper the usually positive response of business spending to depreciations in the exchange rate

Chart 1. Sterling sensitive to expected result well before the referendum itself



Source: Bloomberg, Thomson Reuters Datastream, Betfair

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less favourable; if it's too pessimistic sterling is likely to rebound. Either way, future returns in the tradable sector may not be as healthy as they are right now. This may act as something of a deterrent to longer-term, sunk-cost investments in that sector.

In what follows I'll begin by looking at sterling and what economics has to say about its reaction to the referendum result. I'll then say something about how depreciations work in small open economies, in particular their impact on profitability and investment in the tradable sector. There's a short concluding section.

Sterling's response to the EU referendum: some exchange-rate economics

So let's begin with the depreciation and its proximate cause, the outcome of referendum. The link between the two was clear long before the vote itself. In the months leading up to June 23 there was a tight correlation between the value of the currency and the perceived likelihood of a 'remain' vote (Chart 1).

That's why the MPC, in conditioning its May 2016 forecasts on that outcome, assumed a higher path for the exchange rate. It's also why the Committee suggested there might be a 'sharp correction' in sterling's value in the event of a leave vote. And in the event that's what we got. On June 23 and 24 sterling fell further against the dollar than over any two-day period since the devaluation of 1967.

You didn't need any economics to make this prediction – the relationship in in Chart 1 was enough. But you probably do need some economics if you want to understand why the currency reacted this way. While we don't know precisely what's in the collective mind of the foreign exchange market, in my view there are two broad possibilities: Brexit is expected either to weaken domestic demand or raise the cost of exporting.

To understand these effects remember first what the real exchange rate is: the relative price of consumption here compared with that in our trading partners[1].

Suppose you split consumption into stuff that can only be produced domestically ('non-tradables' like homes or haircuts) and things that can also be imported from abroad ('tradables' such as holidays and cars). This distinction is important because you'd expect prices of traded goods and services to move reasonably closely across countries (I'll return to this point later). If so, it turns out you can re-express the real exchange rate in terms of another relative price, that of non-traded to traded output[2]:

$$\varepsilon \approx P_{NT}/P_T$$

So when things happen that push up this relative price, whether on the demand or the supply side of an economy, the real exchange rate will tend to move in the same direction.

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Take domestic demand first. The material distinction between non-traded and tradable output is that, whereas the first can only be supplied domestically, the second is also produced elsewhere: its overall supply is more 'elastic'. New houses can only be built by domestically located firms; cars are made everywhere.

So even a general increase in domestic demand will put relatively more pressure on the resources used to produce non-tradables as their global supply is more limited. As a result their relative price will tend to rise in domestically led expansions and to fall in contractions. This is illustrated in an extremely stylised way in Chart 2. You can think of the appreciation, in this case, as the economy's way of tempering the effects on relative demand and, at the same time, encouraging resources to move where they're needed. If domestic demand strengthens, the resulting rise in the exchange rate reduces returns in the tradable sector and raises them in the non-traded sector, drawing investment from the first to the second[3].

This isn't just theory. We know, for example, that fiscal expansions tend to be associated with an appreciating exchange rate[4]. More generally real exchange rates tend to be pro-cyclical. Chart 3 plots the relationship for the UK, with both lines – sterling's real exchange rate and domestic demand growth – plotted as four-year moving averages. The graph also illustrates quite how weak the currency is at the moment (the green dot on the right-hand side) given the recent robustness of domestic demand growth (the blue dot).

Among other things this framework has important implications for the link between exchange rates and 'imbalances'. The UK has periodically experienced episodes where the exchange rate is strong, the external balance deteriorates and, on the production side of the economy, the traded sector gets 'crowded out'. One often hears that all this is the 'consequence' of an 'over-valued exchange rate', as if that were some arbitrary, unexplainable thing.

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Chart 2. Stronger domestic demand tends to push up the exchange rate

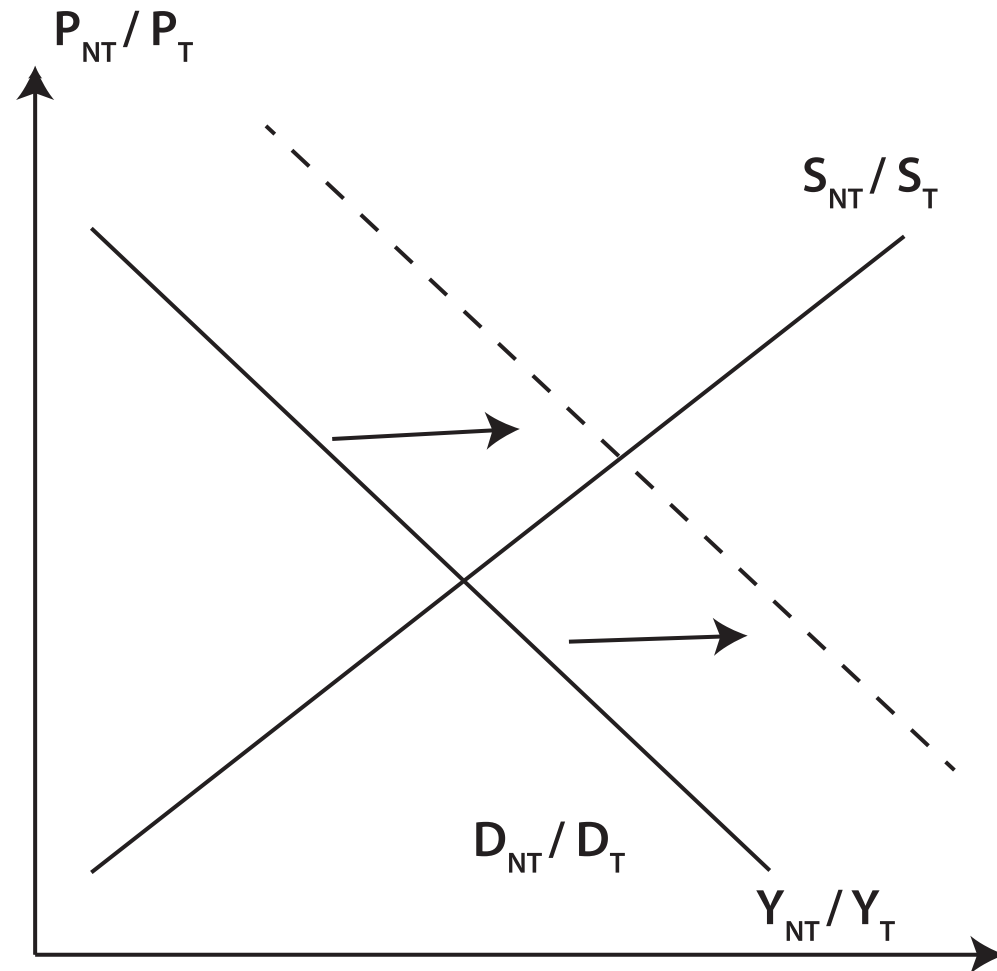
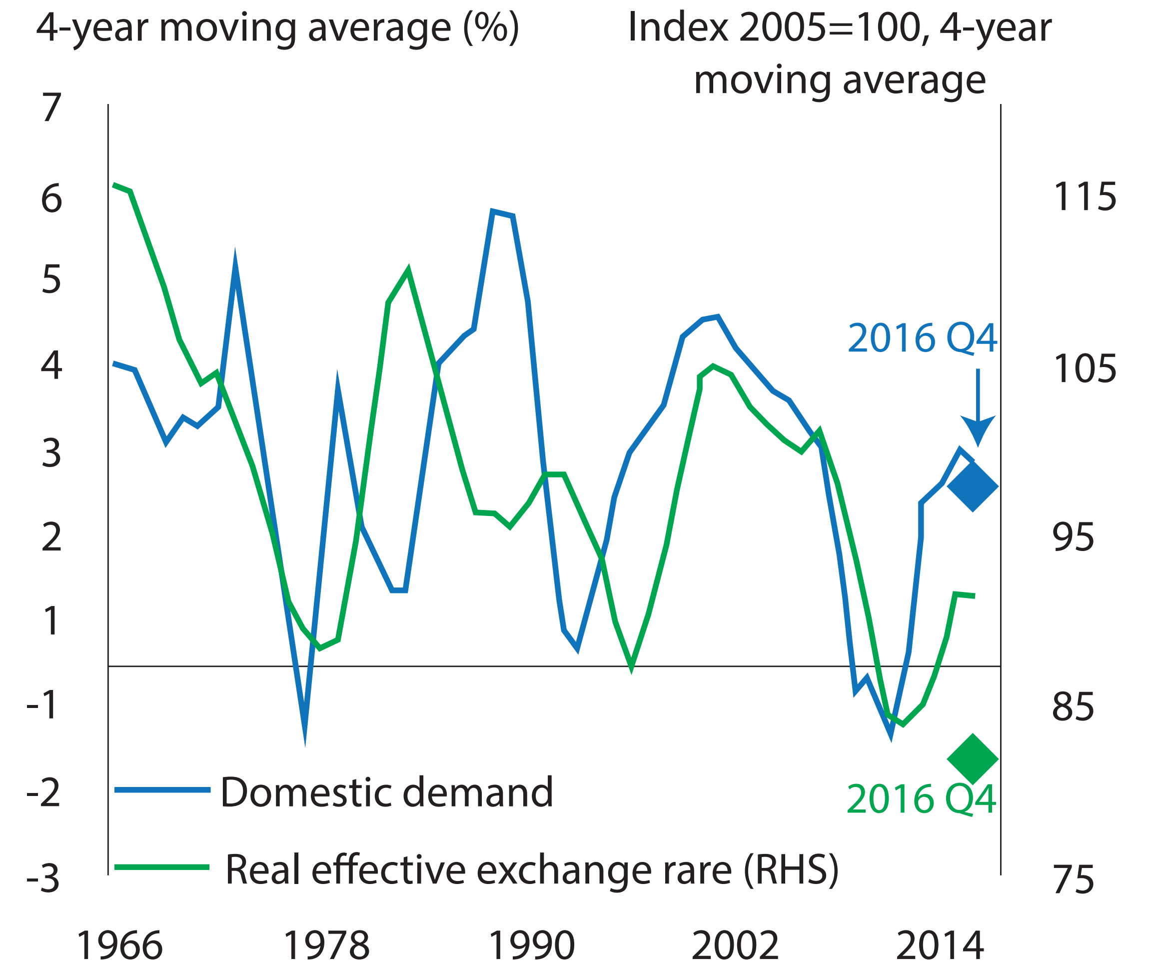


Chart 3. UK data bear this out



Source: ONS and Thomson Reuters Datastream

But in these situations the exchange rate is more symptom than cause: the underlying driver is relatively strong growth in domestic demand[5]. And it's this that jointly pushes up both the value of currency and the trade deficit[6]. Indeed I think this helps explain to explain why sterling appreciated so strongly after 2012 (and until last year): relative to their respective incomes, domestic demand grew much more strongly in the UK than among its main trading partners in continental Europe.

There's a limit to the duration of financial deficits, at an aggregate as well as an individual level. It was always unlikely that the UK could finance a 5%-of-GDP current account deficit indefinitely and the market would presumably have anticipated a closure at some point, partly via weaker growth of domestic demand. But one possibility, regarding sterling's recent behaviour, is that the foreign exchange market believes that leaving the EU will hasten the correction of these imbalances. If, for as long as it lasts, financing the relies on *"the kindness of strangers"* (as the Governor once described it) perhaps the foreign exchange market thinks those strangers will be less generous to a UK outside the EU. International capital markets might require a higher premium for sterling finance. If so, this would slow the growth of domestic demand that much earlier, accelerate a rebalancing of the economy and depress the fair value of the exchange rate[7].

While possible in principle, I'm not convinced this is the main explanation for sterling's reaction to the referendum result. The currency has remained weak even in the face of robust consumption growth since that date. And if the foreign exchange market had anticipated a higher cost of finance for sterling borrowers after Brexit you'd probably have seen the same expectation in other financial markets – a steeper yield curve, perhaps, or higher premia in UK banks' funding markets. That hasn't really happened.

A more likely channel, to my mind, involves expected supply. Go back to that relationship in [1] and imagine now that something happens to push up the cost of producing or selling tradable goods. Perhaps productivity in that

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Chart 4. Weaker productivity in tradable sector depresses the exchange rate

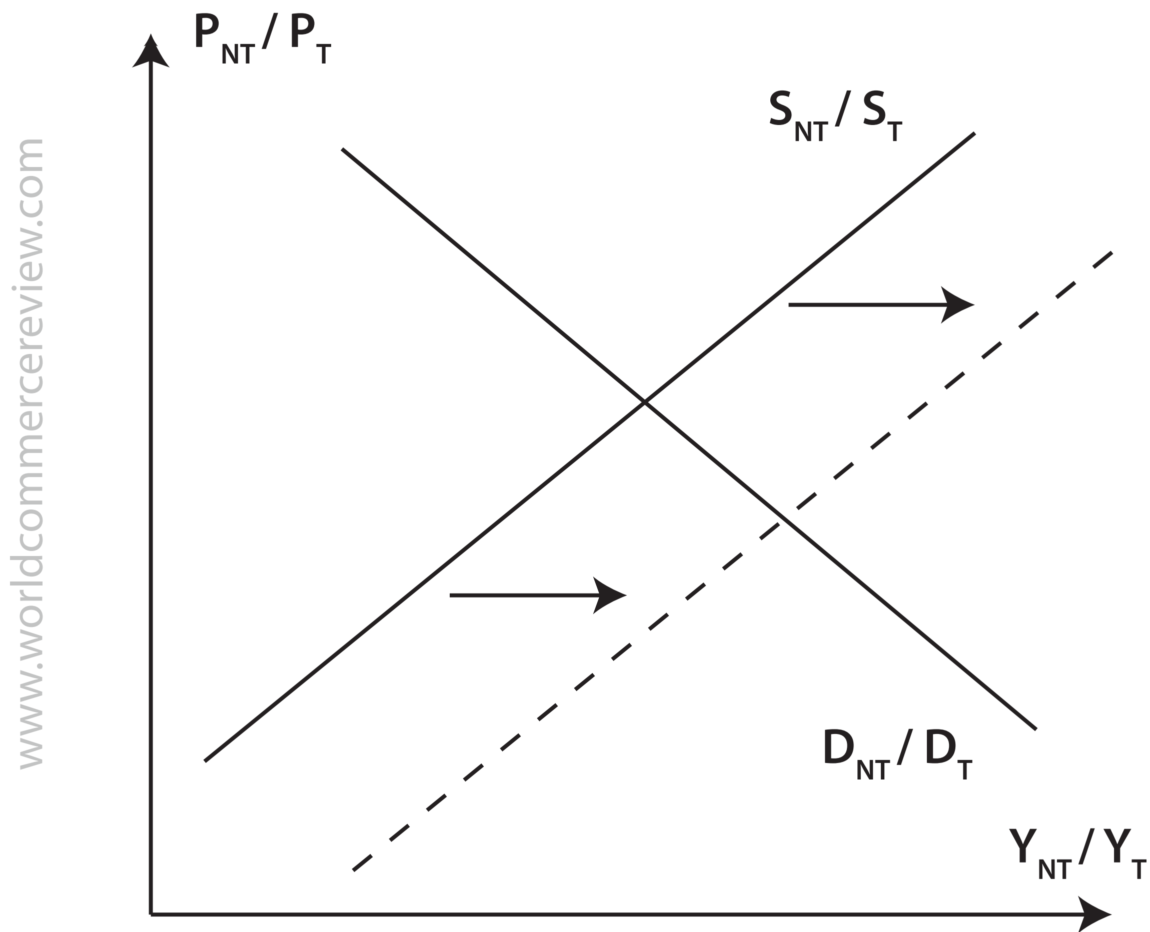
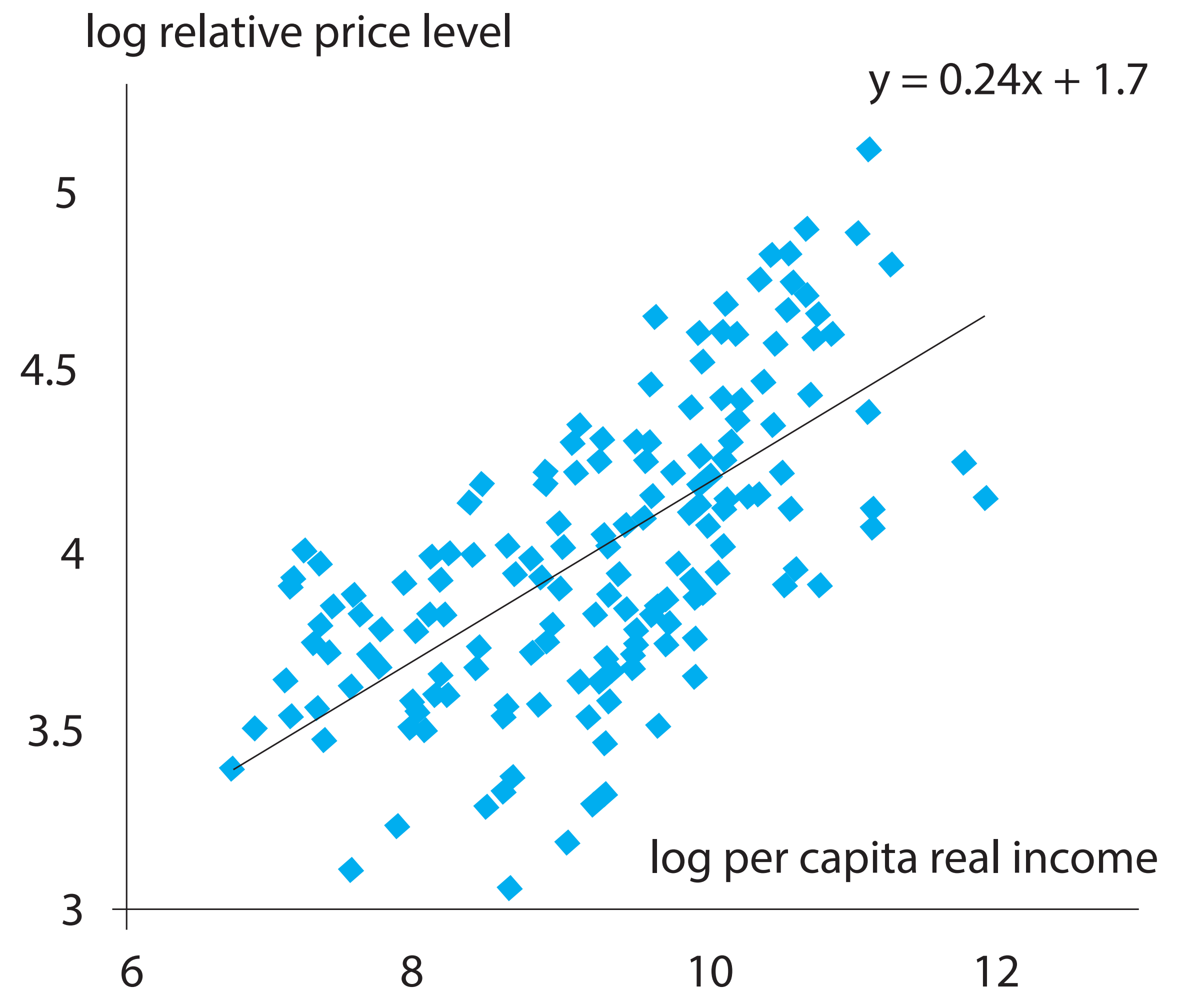


Chart 5. Supported by cross-country evidence



Source: Penn World Table

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sector grows less rapidly (relative to that in our trading partners)[8]. Or perhaps tariff and/or non-tariff barriers are imposed on international trade. Either way, if the relative cost of producing or selling tradable output goes up then so must its relative price (Chart 4[9]). In effect, the currency falls to help absorb these costs. In doing so it spreads them throughout the economy: even those in the non-traded sector have to work longer to buy the same quantum of imports.

There is ample empirical evidence of this channel in the data. Chart 5, for example, is a cross-country plot of relative price levels (the real exchange rate) against per-capita income. The latter is determined by whole-economy productivity. But much of the variation in aggregate productivity, across countries as well as over time, is in the tradable sector specifically. So the correlation is reasonably persuasive evidence of the link between tradables productivity and exchange rates[10]. And it's quite possible that this is what lies behind sterling's reaction to the referendum. Foreign exchange markets may believe that exiting the EU will in some way raise the cost of exporting – either directly, via the erection of barriers of one sort or another, or by depressing inward investment and productivity in the tradable sector (relative to that in other countries).

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What does the weaker currency do in the meantime? Some more exchange-rate economics

I should emphasise at this point that what I'm musing about here are the implicit beliefs of the foreign exchange market. The specific question is why that market thinks the long-term consequences of leaving the EU warrant a lower sterling exchange rate. For its part the MPC has no particular expectation about the forthcoming negotiations. The currency market could turn out to have been too pessimistic.

Two things are clear, however. First, if the market has misjudged the risks – if the UK emerges from this as open an economy as it is today, or more so – one imagines the exchange rate will re-appreciate, all else equal. I'll come back to the significance of this point later on.

Second, the weaker exchange rate is acting on an economy whose trading relationships are for the time being quite unchanged. As yet Brexit has done nothing directly to affect the UK's openness because Brexit hasn't happened.

The MPC is always keen to caution against treating a change in asset prices as some independent, 'exogenous' event, without considering its underlying cause. This case is a bit special, however: in this instance the cause has yet to occur. We've had the reaction in asset prices well ahead of the event. In that sense it's more independent than usual.

And what's striking about this is that economists usually view independent depreciations in the exchange rate as expansionary rather than contractionary. Yes, they dent real household incomes and therefore consumer spending. But the usual view is that this negative effect is compensated, indeed outweighed, by positive effects on other areas of spending, net exports and investment.

With the additional tailwind of a strengthening world economy you might expect most forecasters to have predicted faster economic growth following sterling's decline. Yet the opposite is true: after 2% through 2016 (in the year to Q4), the consensus forecast is that UK GDP growth will slow to 1.2% through this year.

I want to ask why this is. Why do forecasters think the more negative effects of sterling's fall will predominate – what impediment might there be to its more positive effects? To do so it's worth taking a closer look at how depreciations actually work.

The view one often hears is that they make UK output cheaper in foreign currency terms, encouraging extra demand from overseas. I'm not sure that's quite right.

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I said earlier that economists often make the approximation that prices of tradable goods and services are the same in all countries (measured in some common currency). This makes intuitive sense when you think of an area like commodities. For example, you would not expect sterling's fall to reduce the dollar price of North Sea oil or the euro price of UK-produced wheat. Those are determined largely in global markets. What happens instead is that their prices go up in sterling terms. And if there is a response of net export volumes it comes about largely because the rise in prices directly boosts the profitability of UK-based production. Whether we're talking about firms that export or those that compete with imports, it encourages such businesses to expand. In other words it's a matter of supply not demand.

Chart 6 gives a stylised description. In a competitive market the demand curve facing an individual firm (and those in a relatively small country) is essentially flat. Domestic events don't have much effect on the global price. When the currency falls, pushing up prices and profits of outward-facing firms, the response of export volumes depends on the slope of the supply curve: to what extent do firms in the tradable sector have the capacity to raise output and, where that is insufficient, the willingness to invest in more?

Now commodities may be an extreme case. They're essentially homogenous – one country's output is much like another's. But even in non-commodity goods markets you find a similar pattern. The UK is relatively small, accounting for only 3% of international goods trade (even including oil). Many UK firms are to a significant extent 'price takers' in international markets.

And you can see from Chart 7 the close correlation between the sterling price of the UK's (non-oil) goods exports and the exchange rate. The reaction is a bit less than one-for-one but in general no less marked than that of import prices. That's true of the most recent period as well: prices of non-oil goods exports rose 12% through the course of last year, in line with those of imports.

Chart 6. For a small open economy tradable demand is highly elastic

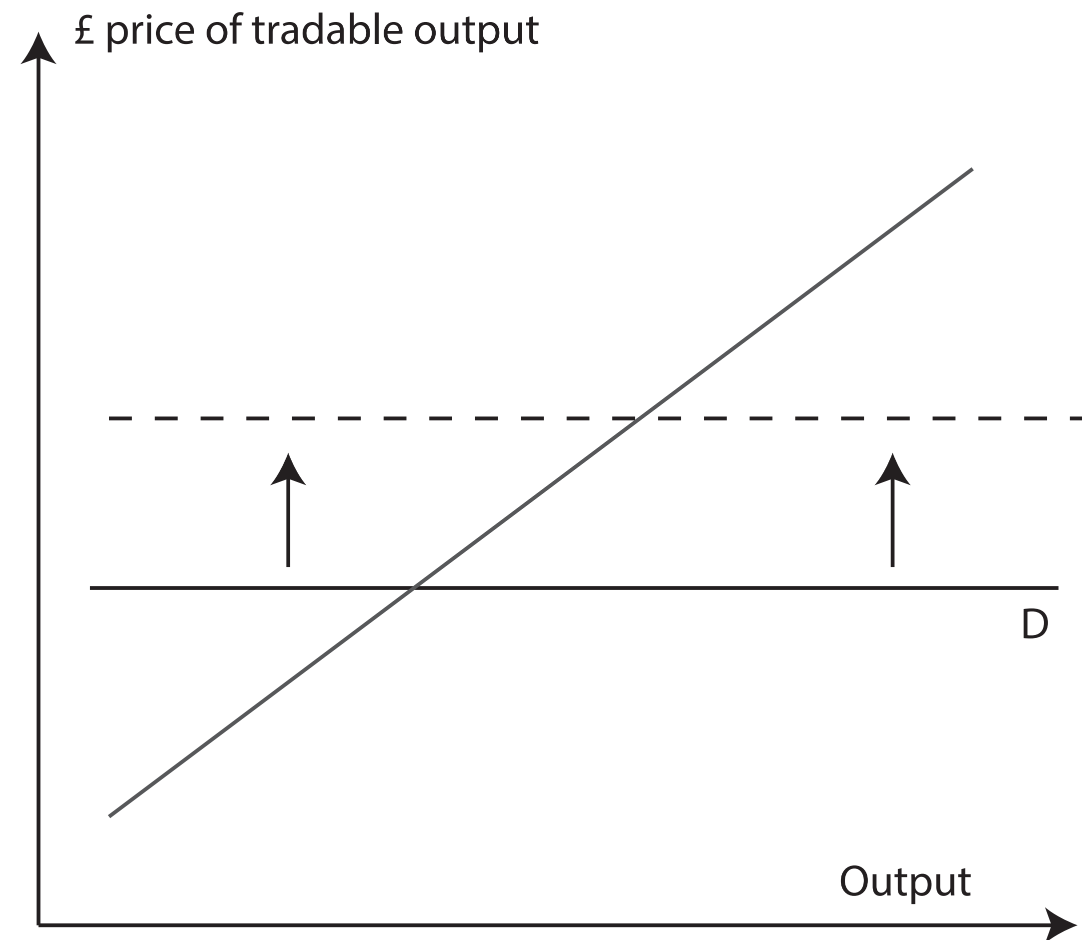
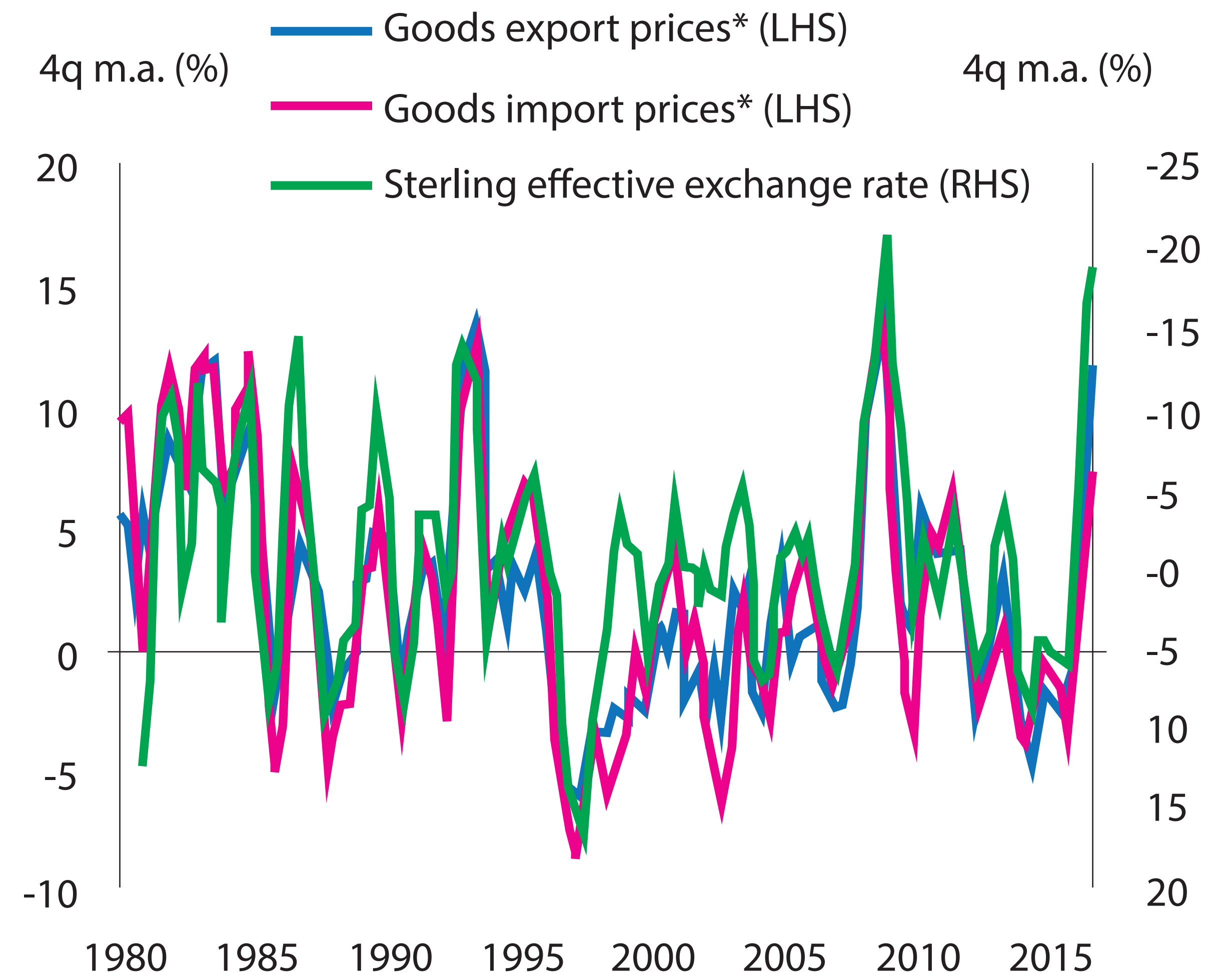
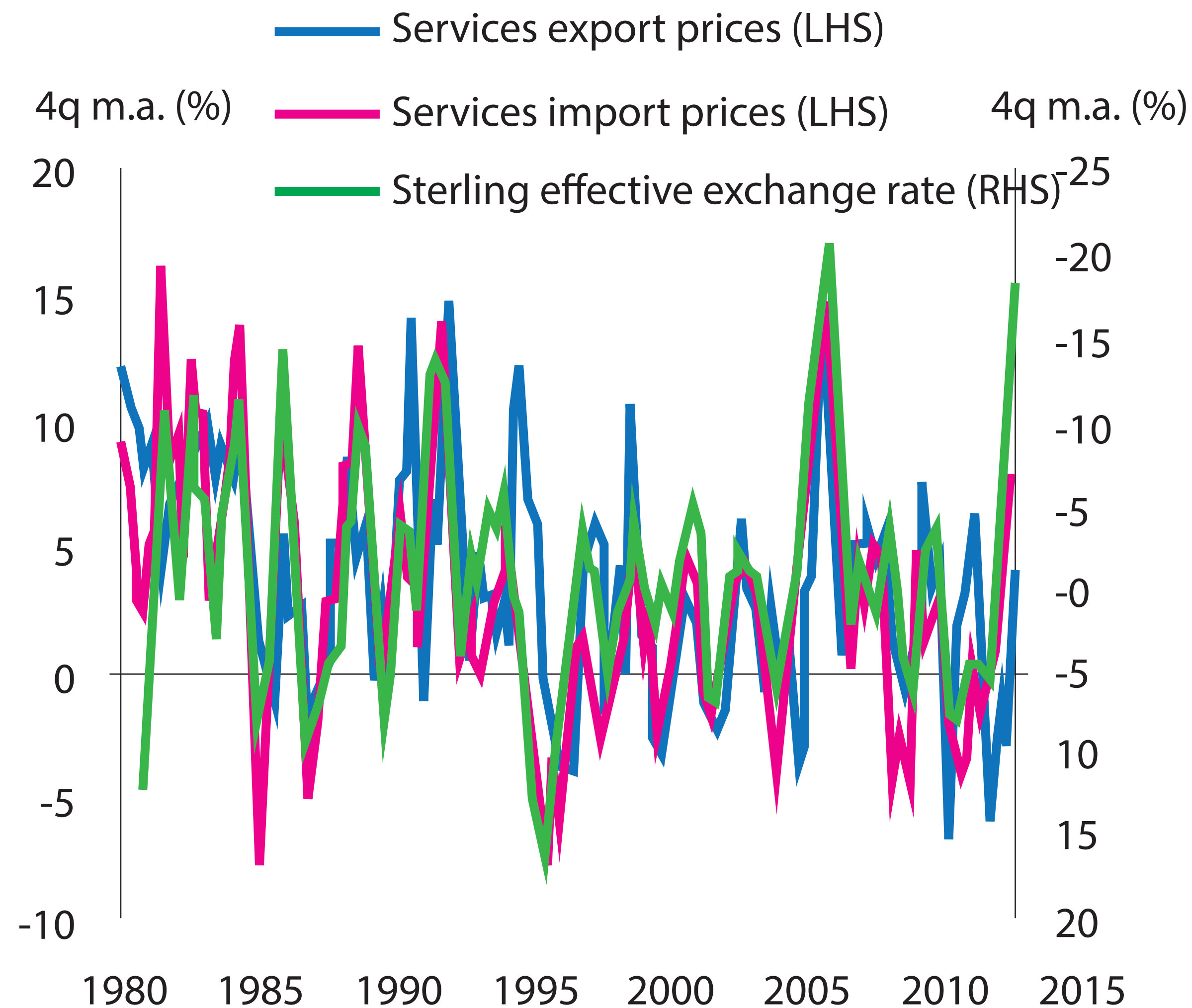


Chart 7. Depreciations push up the sterling price of goods exports as well as those of imports



*Source: ONS and Thomson Reuters Datastream. * excluding oil and erratics*

Chart 8. Sterling price of services exports more stable



Source: ONS and Thomson Reuters Datastream

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Admittedly, the behaviour of the sterling price of services exports is rather different. They're more stable in the face of exchange-rate movements (Chart 8), implying that depreciations do indeed reduce them in foreign currency terms. I think this is understandable. Services are less homogenous than goods and there's more room for non-price competition. The UK has a larger presence in this area, accounting for 7% of global services trade in total, 12% for business and financial services specifically. Those wholesale services are relatively specialised.

Equally, and for many of the same reasons, the evidence suggests that service export volumes are much less sensitive to any cross-country variations in prices than in goods markets. Indeed it's only because of this relative insensitivity that such variations can persist for any length of time.

At any rate, my main point here is that the positive effects of a currency depreciation depend at least as much on the response of domestic firms as on that of foreign buyers. If firms in the tradable sector have

plenty of spare capacity you'd expect net export volumes to rise significantly; once capacity constraints start to bind you'd expect greater investment; in general, given that the degree of spare capacity is bound to vary across firms, you'd expect to see both.

I think this is what you have seen in the past – in both directions. The data are limited. Detailed sectoral numbers on profits and investment exist only from the early 1990s and until 2014. But that period does at least cover two significant moves in the currency, even before the financial crisis: the big drop when sterling fell out of the European Exchange Rate Mechanism (ERM) in 1992, after which the exchange rate remained relatively low for a few years; and the equally large re-appreciation in 1997 and 1998.

As it happens, I think these swings can be traced back to the demand-side influences I discussed in the last section. Subdued domestic consumption, public as well as private, suppressed the exchange rate in the years after sterling exited the ERM; much stronger growth, associated in part with the revival in the housing market, helped to push it back up later that decade (you can see these broad movements back in Chart 3). And if you define the 'tradable' part of the economy as those sectors with above-average trade shares, 'non-tradables' the rest, they behaved broadly as you might expect. Aggregate profits recovered strongly in the early 1990s, as they tend to in the early stage of economic recoveries. But, thanks to a jump in the sterling price of their output, the rise was most marked for firms exposed to international trade (Chart 9).

There was plenty of slack in the economy (Chart 10 uses the balances on capacity use from the BCC surveys). Within the tradable sector in particular this allowed for a marked rise in net export volumes. In the three years after ERM exit the UK's trade balance improved by close to 2% of GDP. Furthermore, despite that spare capacity, business investment too began to accelerate – and again it was the tradable sector whose spending grew fastest (Chart 11).

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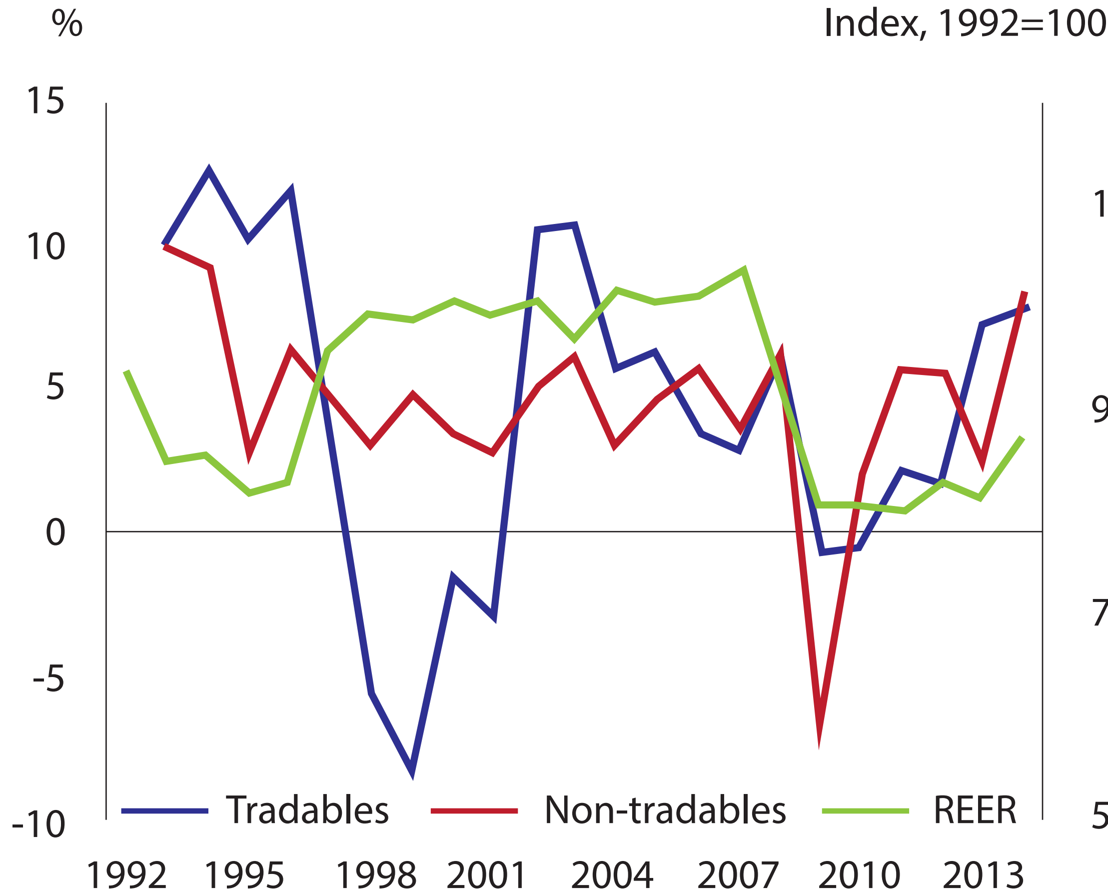
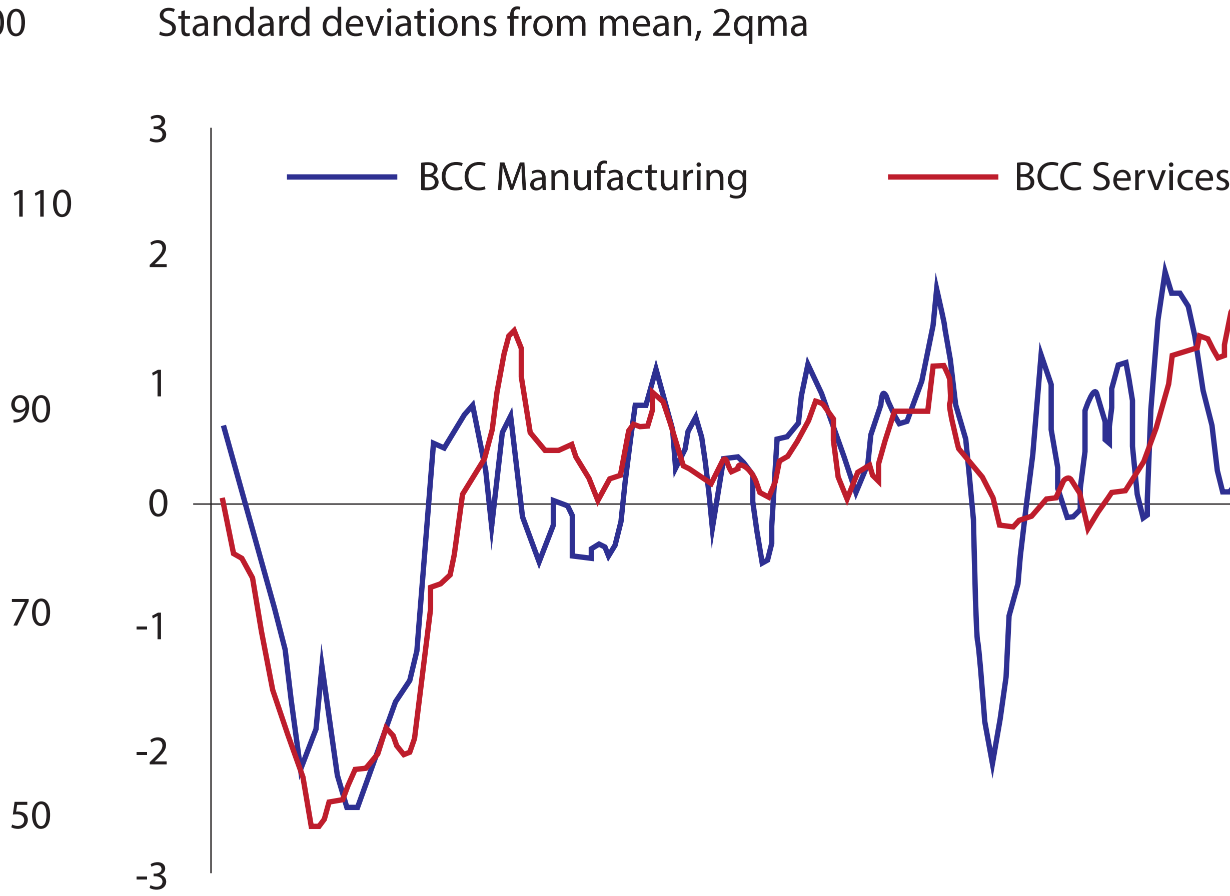
Chart 9. Profits in tradable sector boosted by depreciation in early 90s, hit by later appreciation



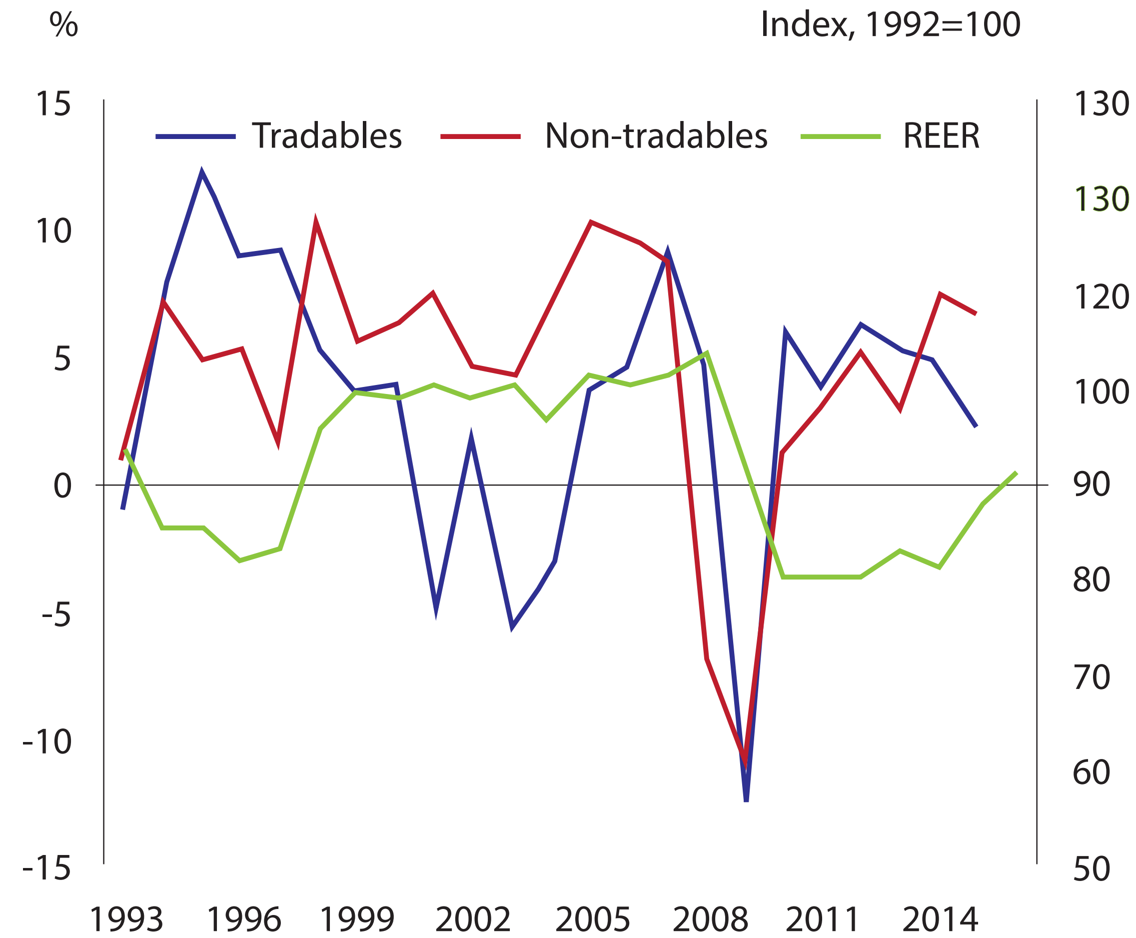
Source: ONS and Bank of England calculations

Chart 10. Unlike early 1990s, there is now limited spare capacity, including in tradable sector



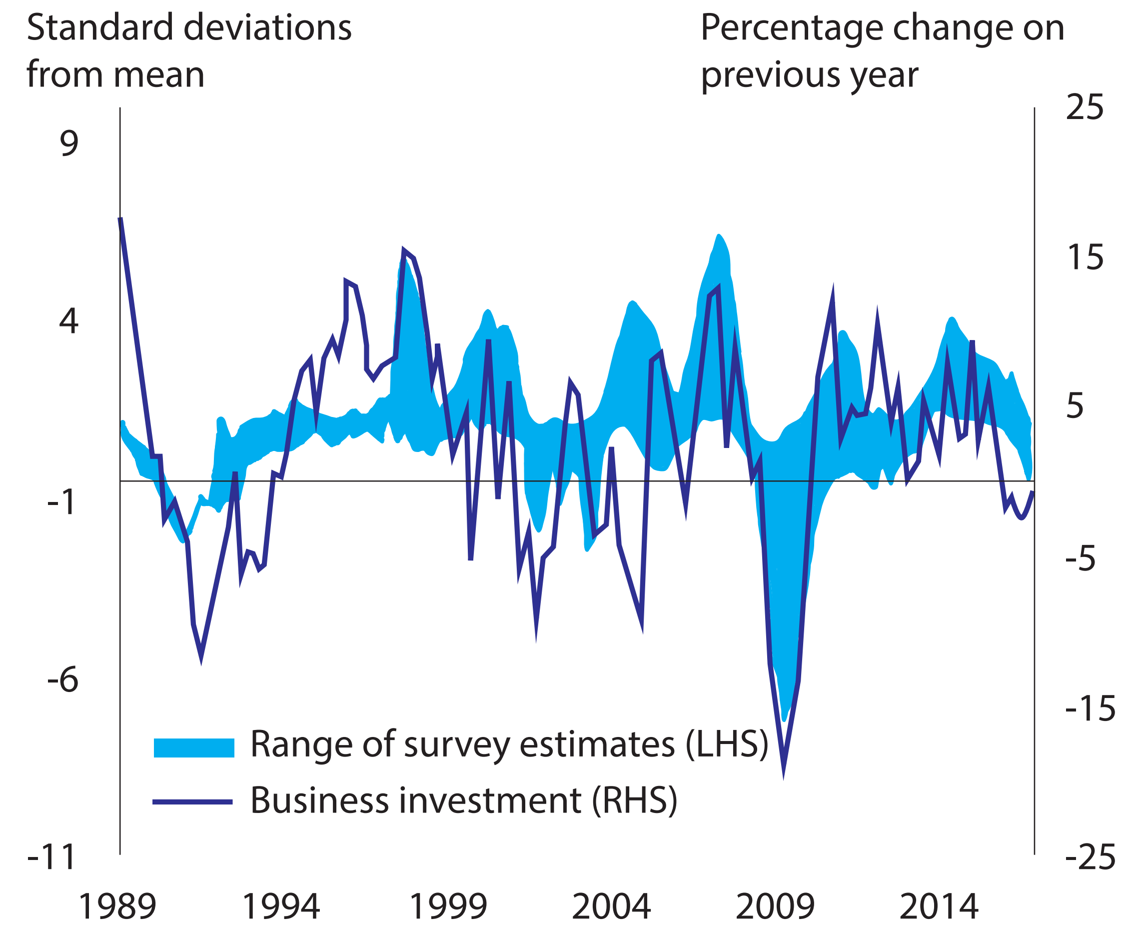
Source: BCC and Bank of England calculations

Chart 11. Investment in tradable sector also sensitive to exchange rate



Source: ONS and Bank of England calculations

Chart 12. Business investment growth weak in 2016



Source: ONS, CBI, BCC and CIPS

These trends then went into reverse after sterling's re-appreciation later than decade. If subdued domestic consumption had allowed the economy to 'rebalance' through the 1992-97 period, the opposite occurred over the following few years. Stronger domestic demand growth 'crowded out' the tradable sector by helping to push up sterling's exchange rate. This led to falls in prices, profits and investment in the tradable sector.

What about today? Sadly we don't have such detailed information on anything like a real-time basis. Indeed we have very little data of any kind, even at an aggregate level, to tell us how profits and investment have behaved since last summer. But here's my take on what we do know:

- First, it's likely that profitability has improved significantly in the tradable sector of the economy. We know that non-financial corporate profits in aggregate rose 10% in the year to Q3. We know too that export prices rose strongly last year, much faster than those of domestic-facing firms[11]. At a rough guess, and relative to that in the non-traded sector, this will have pushed up the rate of return in the traded sector by 2-3 percentage points[12].
- Second – and this is in sharp contrast to the early 1990s – there is only limited spare capacity in the economy, including in its more tradable sectors (Chart 10 again). One would certainly expect net export volumes to improve this year. But one would also expect a greater share of the response to the depreciation, compared with the early 1990s, to come via stronger investment, less of it from higher output in the tradable sector. There is less room to raise output but more of an incentive to add to that capacity.
- Third, and despite these incentives, growth of overall business investment in the UK was relatively weak last year. Early official estimates say it shrank slightly in the year to Q4, by around 1%. (This compares with positive growth of 2% or so in the euro area.) And although those estimates are particularly prone to revision, the various survey indicators also subsided in 2016 (Chart 12).

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This last point is the critical one. The world economy is looking better than it has done for some time. Against this backdrop, and given the existing capacity constraints, the fall in sterling provides a powerful incentive to invest in the UK's tradable sector. All else equal, it would make sense for existing exporters to expand; for domestic-facing firms to think about entering new markets; and for multinationals to shift production to the UK.

Yet some caution would also be understandable. All else is not equal. While much is at stake, no-one can be sure about the eventual outcome of the Brexit negotiations. The evidence suggests that investment is less responsive to these commercial incentives the greater the degree of uncertainty about future returns[13]. Nor is it just a matter of uncertainty: it's unlikely that these propitious conditions will last forever. Either the currency market is right about the consequences of Brexit, in which case the UK's trading relationships will become less favourable; or it's wrong, in which case sterling is likely to recover. Yet even in normal times, currency moves generally have to endure for quite a while before multinationals decide to shift production from one location to another[14].

So these are not straightforward decisions. Put simply, firms in the tradable sector, and those thinking of entering it, will be weighing the boost in the current rate of return against any additional risk premium they currently require of such investments. The question is whether the first is big enough to compensate for the second.

Summary and conclusion

The adjective 'post-Brexit' is bandied around quite a bit these days. The term's a bit previous. A better description of the UK's current economic circumstances is 'post-referendum' but 'pre-Brexit'.

The result is something of a sweet spot for exporters. Sterling fell sharply after the referendum and, despite the strength of consumption since then, has remained close to record lows. The most likely explanation is that the foreign exchange market believes that, when it does actually occur, leaving the EU will raise costs in the UK's tradable

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sector. Whether this occurs through explicit tariffs, non-tariff barriers or lower productivity growth, the currency would need to be weaker in compensation.

But the UK's trading rules are for the time being unchanged. The result is that the costs and ease of exporting are unchanged but the returns to it significantly higher. With the world economy looking better than for some time the circumstances for the tradable sector could hardly be more propitious. One would expect firms in the more open parts of the economy both to use up any spare capacity and, in the normal course of events, to invest significantly more in that capacity as well. Over the longer run, this reallocation of resources is what the positive impact of an exchange-rate depreciation relies upon.

It's possible, of course, that Brexit won't be as bad as the foreign exchange market appears to believe. If the government succeeds in negotiating a *"new, comprehensive, bold and ambitious free trade agreement*[15]*"* with the EU, and in opening up trade with non-European countries, the UK's overall degree of openness may not worsen and it could improve. If so, and all else equal, the currency should in time rebound.

But this makes longer-term investment in the tradable sector a somewhat tricky decision. Either the currency market is too pessimistic, in which case sterling's depreciation is likely to be reversed over time. Or it's not, in which case the costs of exporting will eventually go up. Barring some other source of exchange rate weakness, such as a sharp rise in the household saving rate (which would have its own implications for the economy), the sweet spot is unlikely to last indefinitely. So while investments with shorter-term payoffs make commercial sense, especially for those already running up against capacity constraints, the uncertainties involved in longer-term decisions could temper the usually positive response of business spending to depreciations in the exchange rate. Indeed they're probably already doing so somewhat.

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In its latest forecasts the MPC expects this caution to persist. That's why, in the central projection in the February Inflation Report, growth slows slightly this year, from 2.0% at the end of last year to 1.7% by 2017Q4. Though there are plenty of other variables to consider, the negative effects of the depreciation on consumption (via import prices and household income) are expected marginally to outweigh its more positive effects on other parts of demand.

If only implicitly the consensus forecast seems to attach more weight to this Brexit-related caution. My guess is that financial markets do so as well. Despite higher profitability, business investment is projected to stagnate or fall this year even as it accelerates significantly further in other developed economies. The more negative effects on consumption clearly predominate and growth of aggregate demand is projected to slow reasonably sharply, to 1.2% by the end of this year.

Yet there are clearly risks to both. If businesses share the view of financial markets, and in particular the foreign exchange market, the risks around EU exit could persuade them to cut investment further this year. If they side more with consumers – who, as we've noted before, appear to have taken such uncertainties very much in their stride – they will respond more to today's favourable conditions than to any caution about the longer-term future and instead raise investment spending. ■

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Endnotes

1. I'm interested here in the real forces driving the exchange rate. The nominal rate, $e = \varepsilon P^*/P$, where P^* and P are price levels at home and abroad respectively, also depends on relative inflation rates. And in the shorter run, when those prices

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are sticky, monetary events can and do affect real exchange rates. But over time, the real exchange rate depends more on non-monetary things. And in this particular instance, sterling's fall had essentially nothing to do with differences in monetary policy (as measured, for instance, by shifts in relative short-term interest rates). Note too that, judging by the behaviour of forward inflation rates, financial markets too consider this to be a real phenomenon: five years ahead, the expected value of eP/P is around 16% lower than it was at the start of 2016.*

2. This ratio then has to be divided by the same ratio in our trading partners. Obviously for every domestic shock described here, the exchange rate is affected symmetrically, and in the opposite direction by the same phenomenon in the rest of the world.

3. The ease with which this happens is what determines the slope of the supply curve in Charts 2 and 4. In the limit, if resources can move seamlessly and costlessly between sectors, the supply curve is flat. But this reallocation could take a long time. Empirically, over cyclical horizons, the correlation between exchange rates and demand disturbances is clear.

4. Arguably, the recent appreciation of the US dollar owes something to the expectation that the incoming administration will loosen fiscal policy.

5. The word 'relatively' is important here – what matters is the behaviour of domestic demand compared with that in other countries. If demand weakens in other countries the home country's exchange rate will still appreciate even if nothing happens to domestic savings rates. [More here on global imbalances]

6. For a thorough treatment of the relationship between imbalances and the exchange rate – and specifically the chain of causation running from the former to the latter – see Obstfeld and Rogoff (2000), Obstfeld and Rogoff (2007).

7. Sometimes this point is expressed in terms of the 'sustainable' current account deficit but it amounts to the same thing.

8. Cost is inversely related to productivity.

9. Note that a contraction in tradable productivity, which is the denominator in the SNT/ST curve, shifts it to the right.

10. In economics the impact on the exchange rate of variations in tradable versus non-tradable productivity is known as the 'Balassa-Samuelson' effect (Samuelson (1964); for a survey of the evidence see Egert et al (2006)).

11. While export prices rose 12% in the year to 2016Q4, gross output prices across the economy as a whole, excluding the government sector, rose by around 4½% (by gross I mean including the cost of imports). With exports worth around one quarter of gross output, this would imply output-price inflation in the rest of the economy of less than 2%.
12. Higher prices boost profits, and disproportionately so, given the operational gearing. On the other hand exporting firms will also be paying more for their imports, on which they rely more than others. To work out the overall impact on profits you need to net out the extra cost of imports. We've done this by passing the rise in both export and import prices through the UK's input:output tables and used the same definition of tradables and non-tradables as before.
13. Bloom et al (2007); for more on the impact of uncertainty on sunk-cost investment decisions see Dixit and Pindyck (1994); Handly and Limao (2013) consider the specific case of uncertainty about tariffs.
14. For example Goldberg (2007).
15. This is the Prime Minister's phrasing in her speech on 17 January

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Based on a speech given at Imperial College, London, 23 March 2017

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International arbitration is the way to settle the UK's Brexit bill

The UK-EU financial settlement risks becoming a toxic stumbling block in Brexit negotiations. André Sapir writes that to diffuse the issue both sides should agree to independent international arbitration

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The Brexit negotiations have not begun well. Instead of focusing on what really matters, the two sides (the European institutions and the UK Government) are publicly exchanging blows. The *Financial Times* reported that Donald Tusk, the European Council president, has called for a ceasefire in the war of words over Brexit, saying that the *"negotiations are difficult enough as they are. If we start arguing before they even begin they will become impossible".*

What really matters in the Brexit negotiation is the future relationship between the EU and the UK, and what it implies for citizens and business. There are roughly 3 million EU citizens living in the UK and about 1 million UK citizens living in the EU, who are anxiously waiting to know their status and rights after Brexit. There are also thousands of companies producing in the UK and trading with the EU27 or producing in the EU27 and trading with the UK, which are eagerly waiting to know what sort of trade and investment deal will be agreed.

What matters much less, but seems to be one of the main sources of the current tension between the two sides, is the UK's Brexit bill. The EU and the UK will have to agree on a financial settlement of assets and liabilities linked to the UK's EU membership at some point before the country leaves the EU.

Agreeing on the scale of the UK's divorce bill will not be easy. One reason is that estimates of the bill vary a great deal depending on various assumptions. According to my Bruegel colleague Zsolt Darvas and his co-authors the upfront gross payment that Britain will have to make upon exit could range between €54bn and €109 billion. This would translate into a net payment ranging between €25 billion and €65 billion once the UK receives its share of EU spending, assets and repaid EU loans.

The difficulty in finding an agreement on the Brexit bill should not come as a surprise. Any divorce procedure involving money is complicated for the simple reason that it is a zero sum game: if one sides gets more the other gets

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less. This is why such procedures typically end up in front of a judge or an arbitrator. And the same should apply to the EU-UK divorce.

Asking a judge or an arbitrator to resolve the size of the Brexit bill would free negotiators from a thorny issue and allow them to concentrate their political capital on what really matters to citizens and business: the future EU-UK relationship. And it's not just a question of political capital. Time is also of the essence. Michel Barnier, the EU's chief Brexit negotiator, has rightly underlined that getting a deal done and ratified within the two-year deadline imposed by Article 50 means that negotiations need to be concluded by autumn next year.

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Asking... an arbitrator to resolve the size of the Brexit bill would free negotiators from a thorny issue and allow them to concentrate their political capital on what really matters to citizens and business: the future EU-UK relationship

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Who should the judge or arbitrator be? Viewed from Brussels, the obvious choice would be the European Court of Justice in Luxembourg, but this would clearly be unacceptable to London where the ECJ is viewed as partial.

A more suitable choice would be the International Court of Justice (ICJ) in The Hague. The ICJ is the principal judicial organ of the United Nations, and its role is to settle, in accordance with international law, legal disputes submitted to it by states.

But probably the best choice of all would be the Permanent Court of Arbitration, which is also located in The Hague but is independent from the ICJ. The PCA was established in 1899 to facilitate arbitration and other forms of dispute resolution between states. It is not a court in the traditional sense, but a permanent framework for arbitral tribunals constituted to resolve specific disputes. Currently, the PCA has 121 Contracting Parties including all EU27 states and the United Kingdom.

Arbitration typically involves three or five arbitrators. In the case of three (five) arbitrators, each party appoints one (two) arbitrator(s). The two (four) appointed arbitrators then choose the third (fifth) arbitrator who acts as the presiding arbitrator of the tribunal.

The PCA is no stranger to disputes between EU member states. For instance, in 2003 the PCA handled the Iron Rhine Arbitration between Belgium and the Netherlands. The case description on the PCA's website indicates that:

> *The Iron Rhine is a railway linking the port of Antwerp in Belgium to the Rhine basin in Germany via the Netherlands. Its origins lie in the 1839 Treaty of Separation ('1839 Treaty') which conferred certain transit rights on Belgium. Following World War II, parts of the Iron Rhine gradually fell into disuse and during the 1990s the Netherlands took legal steps to designate nature reserves that lay across its route.*

The Parties disagreed as to the allocation of costs and risks for works necessary for the long-term use of the railway. In particular, the Parties disagreed on the interpretation of Belgium's right of transit under the 1839 Treaty in light of subsequent developments, including environmental protection measures and the requirements of European law.

A second example concerns a case in 2001, when the PCA was asked to handle a dispute between Ireland and the United Kingdom concerning the OSPAR Convention. According to the PCA's website:

This matter concerned a dispute between Ireland and the United Kingdom in connection with the commissioning of the mixed oxide nuclear fuel reprocessing plant ('MOX Plant') in the United Kingdom on the coast of the Irish Sea in 1996…

Ireland objected to the commissioning of the MOX Plant and requested access to [certain] information…under Article 9 of the 1992 Convention for the Protection of the Marine Environment of the North-East Atlantic signed at Oslo and Paris ('OSPAR Convention'). The United Kingdom denied that the information fell within the ambit of Article 9 of the OSPAR Convention.

The PCA has even handled a dispute between the European Union and one of its member states in the 2013 Atlanto-Scandian Herring Arbitration between Denmark (acting on behalf of the Faroe Islands) and the European Union. The case description on the PCA's website indicates that:

The Kingdom of Denmark in respect of the Faroe Islands instituted arbitral proceedings against the European Union under Annex VII to the United Nations Convention on the Law of the Sea (the 'Convention'). The dispute concerned the interpretation and application of Article 63(1) of the Convention in relation to the shared stock of Atlanto-Scandian herring.

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Obviously it can be argued that none of these cases concerned EU membership and more generally that the PCA, contrary to the ECJ, has no experience in handling disputes that concern EU membership. But this virginity should be viewed as a plus in handling the Brexit financial settlement case, since it concerns leaving the EU rather than EU membership per se, and since the departing state would not accept the involvement of the ECJ.

Finally, one may legitimately ask why the two parties should be willing to forego their efforts to find a political settlement and turn instead to arbitration. The answer is that it would save them the type of acrimony that has been building up recently and which is sure to increase as time goes on – given the zero-sum nature of the exercise. The two parties should recognise this and seek arbitration as soon as possible. They would then be able to concentrate their efforts on finding a political solution to the future EU-UK relationship and remove uncertainty about the rights and obligations of citizens and business in the EU27 and in the UK after Brexit. This would be a win-win situation for the two sides compared to the alternative of no deal at the time of Brexit. ■

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