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The EU-UK Trade and Cooperation Agreement

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The EU and UK concluded a new Trade and Cooperation Agreement on 24 December 2020, avoiding the damaging prospect of a no-trade deal WTO Brexit. Even with the agreement, EU-UK trade and migration flows will be subject to a raft of new impediments arising from the UK's exit from the Single Market and Customs Union. This Box summarises the main changes to EU-UK trading arrangements in place since 1 January and reviews the estimated impact on the UK economy and on Ireland in the long run.

Following a negotiation period which formally began on 2 March 2020, on Christmas Eve the EU and UK reached agreement in principle on a Trade and Cooperation agreement.[1] The Brexit transition period ended on 31 December 2020 and the new agreement took effect from 1 January 2021. The agreement is being provisionally applied while procedures to conclude it are completed. The deal reduced the uncertainty and disruption that would have occurred at the end of the transition period in the absence of a deal. The agreement preserves the zero tariff and quota free trade in goods that existed under EU membership and goes beyond EU free trade agreements with Canada or Japan by allowing for tariff and quota-free access on all goods that comply with the appropriate rules of origin. This is especially important for exposed sectors such as agri-food. Without the agreement, exports of certain meat or dairy products would have faced tariffs above 40 per cent under WTO rates. The deal also allows for cooperation in other areas such as investment, competition, State aid, air and road transport, energy and sustainability.

Even with the agreement, the degree of trade and economic integration between the EU and UK will be greatly reduced compared to what existed while the UK was an EU member. The UK has left the EU Single Market and Customs Union, as well as all EU policies and international agreements. This puts an

[1] See https://ec.europa.eu/commission/presscorner/detail/en/IP_20_2531

end to free movement of persons, goods, services and capital within the EU. Instead of harmonised rules and standards, the EU and the UK will form two separate markets and two distinct regulatory and legal spaces. This inevitably creates new barriers to trade in goods and services, and to migration, affecting citizens and businesses.

Focusing on trade, the following is an overview of the new frictions that face firms trading under the terms of the new EU-UK agreement:

1. **Rules of Origin:** Rules of origin are a key component of Free Trade Agreements (FTAs). The purpose of the rules are to ensure that the products benefiting from the terms of the free trade agreement (in this case, zero tariffs and quotas) are either wholly obtained from or manufactured in the free trade area itself (in this case, the EU and the UK), or sufficiently manufactured or processed there. The rules of origin certify that the trade preferences granted under the Agreement benefit EU and UK operators rather than third countries. Due to the complexity of modern supply chains, which sometimes span multiple countries around the globe, establishing the economic nationality of a product can be highly complex and costly. Estimates of the cost of compliance with rules of origin requirements vary but have been estimated at between 2 and 6 per cent of a product's final value.[2] On top of the direct costs, the additional border administration can also disrupt just-in-time supply chains. According to Lowe (2018), the sectors which typically find rules of origin most burdensome include vehicles, textiles, food and machinery.[3] There is already some evidence of disruption to the EU-UK food supply chain as a result of new rules of origin checks since 1 January.[4]

2. **Customs controls:** With the UK outside the EU Customs Union, all customs controls and formalities required under EU law (as set out in the Union Customs Code), including entry and exit summary declarations, apply to all goods entering the EU from the UK, or leaving that customs territory to the UK. Products exported from the EU to the UK will need to comply with UK technical regulations and will be subject to any applicable regulatory compliance checks and controls. Similarly, goods imported from the UK to the EU will be subject to regulatory compliance obligations, checks and controls for safety, health and other public policy purposes.[5] The UK's border operating model allows for a phasing in of controls on EU to GB trade, partly because some border infrastructure has yet to be constructed. In relation to the movement of goods from GB into the EU, Hayward (2020) notes that the new EU-UK agreement contains few friction-reducing measures with no adaptation period, no substantive

[2] See Keck, A and A. Lendle. 2012. "New Evidence on Preference Utilisation". Available at: https://www.wto.org/english/res_e/reser_e/ersd201212_e.pdf
[3] See Lowe, S. 2018. "Brexit, rules of origin and barriers to trade." Available at: https://encompass-europe.com/comment/brexit-rules-of-origin-and-barriers-to-trade
[4] See https://www.ft.com/content/c068fc5f-dfe4-4890-8153-a59e1833c100
[5] See https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_2532

derogations and few of the legal means of reducing the need for checks and controls.[6] For traders in the UK and EU, compliance with the new customs controls will require additional resources, paperwork and cost. Firms in Ireland who previously used the UK landbridge to transport goods to and from the continent face particular difficulties as the movement of goods via this route will be subject to new checks and delays. New direct shipping routes to the continent have commenced as an alternative to the use of the landbridge. These routes, however, involver longer shipping times and additional costs may be incurred transporting goods in this way.

3. **Sanitary and Phytosanitary (SPS) requirements:** Along with customs controls on all goods described in (2), agri-food products are subject to additional SPS checks. SPS measures are rules defined by the importing party necessary for the protection of human and animal health (“sanitary”) and plant health (“phytosanitary”). The EU, like all developed countries, has extensive regulations on food and drink products to ensure high levels of food safety and to reduce possible health risks to citizens. With the UK outside the Single Market, UK agri-food producers will be treated similarly to food exporters from any other non-EU country and will need to prove that their products meet all EU SPS import requirements. In the same way, EU agri-food exporters will need to meet UK SPS import requirements. These controls include the verification of health certificates as well as, in some cases, physical inspections by vets at border control posts.

4. **Services:** As an EU member, UK businesses could supply services freely across the EU based on common rules, a single supervisory framework and a common jurisdictional system. From 1 January, UK service suppliers lost the automatic right to sell services across the EU. UK service firms trading in the EU will have to comply with host-country rules in each Member State and will no longer benefit from the country-of-origin principle or passporting rights for financial services. Automatic mutual recognition of professional qualifications no longer applies which means that doctors, nurses, vets, engineers, architects etc. must have their qualifications recognised in each member state that they wish to practice in. For financial services, the EU-UK agreement does not include any elements related to equivalence frameworks for financial services. Equivalence decisions in respect of 28 areas are currently outstanding by the European Commission pending further clarifications from the UK. Equivalence decisions are unilateral decisions of each party and are not subject to negotiation. To continue operating, some UK firms may need to establish a presence in an EU country and some financial sector firms have already relocated from London to Dublin and other EU locations prior to the end of the transition period in December 2020.

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[6] See Hayward, K. 2020. “What Brexit Means for Britain’s Borders.” Available at: https://ukandeu.ac.uk/what-brexit-means-for-britains-borders/

In summary, while EU membership minimised trade frictions between countries, the new EU-UK FTA – although it eliminates tariffs – reintroduces a series of barriers to trade. Moreover, while this Box has focused on trade flows, the mobility of people between the EU and UK will also be restricted relative to EU membership.[7]

Estimating the precise impact of the non-tariff restrictions to goods and services trade flows described above, as well as the effect of reduced EU-UK migration flows, is a difficult task and any estimates are subject to considerable uncertainty. For instance, by how much and when will trade be reduced due to rules of origin checks, customs procedures and SPS checks? What will be the impact of the new barriers to services trade? The answers to these questions will depend on a range of considerations, including the underlying viability of certain sectors and their capacity to absorb or pass on higher trade costs, how individual firms and citizens adapt over time to the new restrictions and the degree to which public authorities and others involved in the logistics of trade can minimise the impact of new controls and border checks.

Table 1: Estimated Impact of a FTA on UK GDP relative to EU Membership

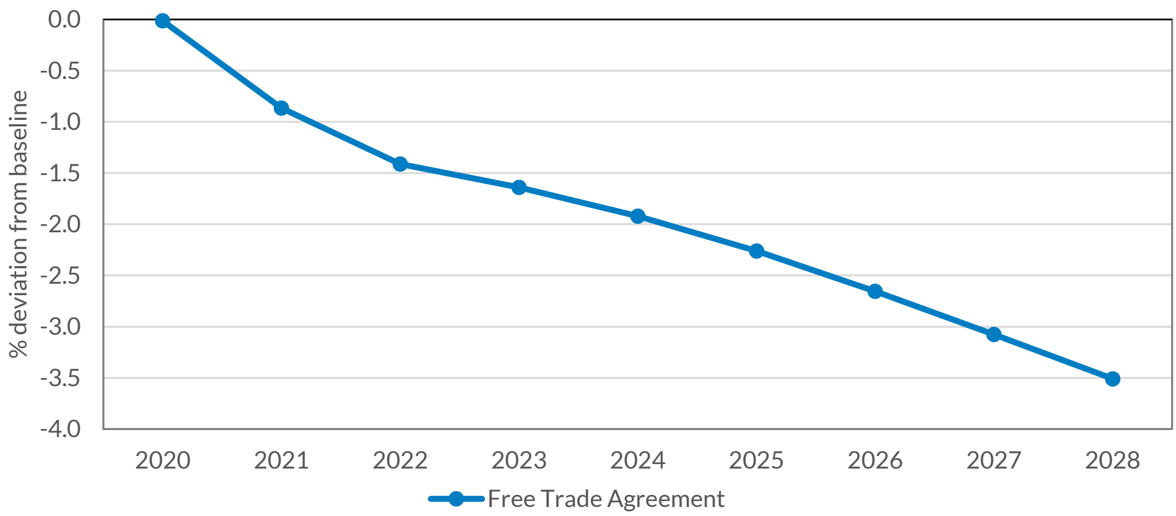
Source	Published	Estimated long-run impact on UK GDP
Bank of England	Nov-18	-3.75
HM Government	Nov-18	-3.4 to -6.4
IMF	Nov-18	-2.6 to -3.9
NIESR	Nov-19	-3.5
OECD	Oct-20	-3.5 to -4.2
UK Trade Policy Observatory (U. of Sussex)	Dec-20	-4.4

Notwithstanding these uncertainties, there is consensus from a range of official estimates that trading under the less comprehensive terms of the new EU-UK FTA – and the more distant economic relationship it embodies – will have a negative impact on economic activity relative to EU membership. Although estimates of the impact of the specific new EU-UK trade agreement have yet been published, several studies have modelled the effect on the UK economy of a basic FTA (Table 1). These studies incorporate estimates of the effect of the non-tariff barriers to goods and services trade described above along with the effect on the UK of lower FDI and migration. While there is significant variation across studies, the range of estimates shown in Table 1 indicate that moving from EU membership to a FTA would reduce UK GDP by over 3 per cent in the long run.

[7] The provisions in the Northern Ireland protocol mean that new customs and regulatory checks will not apply to Ireland-Northern Ireland trade.

Although the importance of the UK market has declined over time, it is still the destination for around 10 per cent of Irish goods exports and 15 per cent of services. For some firms and sectors, the exposure to the UK is larger than indicated by these economy-wide figures.[8] If there is a negative impact on the UK economy from the new EU-UK FTA in line with the estimates in Table 1, then this will reduce UK demand for Irish imports thereby lowering output and employment in Ireland.

Figure 1: Estimated impact of EU-UK FTA on Irish Output, % deviation from no-Brexit Baseline



Source: Conefrey and Walsh (2020).

In addition, the new customs and regulatory barriers are likely to reduce Ireland-UK trade directly. As well as affecting exports, around one quarter of Irish goods imports come from the UK. Half of these imports are intermediate goods used as inputs in the manufacturing sector in Ireland.[9, 10] An increase in the cost of sourcing these intermediate goods as a result of supply chain disruption could damage the international competitiveness of the traded sector in Ireland. Putting these different effects together, previous Central Bank estimates using NIESR (2019) suggest that moving to a FTA would reduce Irish output by just under 1 per cent in the first year and by around 3.5 per cent in the long-run

[8] See Smith, D., Fahy, M., Murphy, G. and B. O'Connor. 2017. UK EU Exit: Trade Exposures of Sectors of the Irish Economy in a European Context. Available at: https://assets.gov.ie/7020/674061271c784b90a2dd9a4a65b8053d.pdf ; Lawless, M. 2018. "Intermediate Goods Inputs and the UK Content of Irish Goods Exports." Available at: https://www.esri.ie/system/files/media/file-uploads/2018-06/BKMNEXT362.pdf and Conefrey, T. (2018). "Irish Agriculture: Economic Impact and Current Challenges." Available at: https://bit.ly/3iqrzQJ

[9] See Central Bank of Ireland. 2020. "Risks Facing the Irish Economy at the End of the Brexit Transition Period." Quarterly Bulletin No. 4 2020. Available at: https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/boxes/qb4-2020/box-a-risks-facing-the-irish-economy-at-the-end-of-the-brexit-transition-period.pdf

[10] See Lawless (2018).

relative to EU membership (Figure 1).[11] In the absence of a trade deal and where WTO arrangements had applied, the losses would have been significantly larger. Due to the disruption and uncertainty that would have materialised without a trade agreement, it is also likely that the fall in output in Ireland would have been front loaded. In contrast, the reduction in output under an FTA is expected to be smaller and to cumulate more gradually over time.

The new EU-UK Trade and Cooperation Agreement averted the threat of a no-deal WTO Brexit and means that the significant disruption to economic activity that would have accompanied such an outcome has been avoided. The agreement allows for the continuation of a basic economic relationship between the EU and UK and there are likely to be some opportunities for the Irish economy in the long run as the agreement becomes established. Nevertheless, the EU-UK FTA makes trade in both goods and services more cumbersome and costly relative to EU membership. In the short run, this is likely to be associated with continued supply-chain disruption. In the long run, the negative impact of the UK's EU exit on trade flows, migration and productivity will reduce output in the Irish economy.

[11] See Conefrey, T. and G. Walsh. 2020. "EU-UK Trade and the Irish Economy after Brexit." Available at: https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/quarterly-bulletin-signed-articles/dealing-with-friction-eu-uk-trade-and-the-irish-economy-after-brexit-(conefrey-and-walsh).pdf?sfvrsn=5