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Implications of Potential EU-UK Trade Arrangements at the End of the Brexit Transition Period

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Following the UK's exit from the EU on 31 January 2020, negotiations are ongoing between the two parties with the aim of concluding a Free Trade Agreement (FTA) before the end of 2020. With the UK's decision not to seek an extension to the current transition period, the EU and UK could move to trading on WTO terms from January 2021 if there is no agreement on a new FTA. This Box provides a brief update of the macroeconomic implications of the ongoing Brexit negotiations and the potential outcomes which could result when they conclude. It also considers how the economic challenges of the COVID-19 crisis could interact with the effects of Brexit.

The aim of the ongoing negotiations between the UK and the EU, as envisaged in the agreed Political Declaration, is to conclude a FTA with no tariffs or quotas on goods before the end of the transition period on 31 December 2020. COVID-19 has impeded the negotiations on the new EU-UK economic relationship, with the teams from both sides meeting less frequently. Even prior to the emergence of COVID-19, a question mark existed as to whether it would be possible to conclude talks on the future relationship in time for an agreement to take effect by the end of this year. Drawing on international evidence, analysis published by the Central Bank in January 2020 showed that the average duration of bilateral trade negotiations worldwide took 40 months while multilateral trade negotiations lasted 48 months.[1] From the commencement of the EU-UK negotiations in March 2020, the timeframe to

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[1] See Conefrey, T. and G. Walsh. 2020. "Dealing with Friction: EU-UK Trade and the Irish Economy after Brexit." Available at: https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/qb-archive/2020/quarterly-bulletin---q1-2020.pdf#page=87

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complete a new trade deal is less than 10 months. Although the UK is starting from a position of alignment with the EU, the short time available to negotiate a new EU-UK FTA could result in a bare bones agreement, if one is reached before the end of the year.

Free Trade Agreement

Even if a FTA is successfully concluded before the end of 2020, such an arrangement would imply significantly higher trade costs relative to the status quo. Free trade agreements typically allow for tariff- and quota-free trade in goods and in this regard a FTA is an improvement relative to trading under WTO terms. Nevertheless, firms would still face significantly more frictions in trading with the EU than under current arrangements.

A basic free trade agreement would lead to higher non-tariff barriers (NTBs) to EU-UK trade due to the introduction of customs procedures and other trade costs as EU and UK economic regulations diverged over time. Because the UK would no longer be part of the EU customs union, exporters would need to prove that their products meet the "rules of origin" criteria of the EU-UK FTA. Compliance with such rules comes with complications, paperwork and cost.[2] Businesses trading between the EU and UK will be required to manage new import and export formalities, including customs and security declarations, risk-based inspections and the payment of tariffs (for any goods not covered by the FTA) and other taxes payable on import such as VAT and excise duty. Unless the UK agrees to adhere fully to the EU's sanitary and phyto-sanitary regime (for food and plant hygiene), trade in agri-food products will require export health certificates and there will be a need for veterinary border inspections.

In relation to services trade, it is likely that the UK financial services sector would lose its ability to trade freely across EU member states and there would be new regulatory barriers to trade. Some recent FTAs, such as the Canada-EU FTA, go beyond tariff-free goods trade and include some provisions to increase trade in services. Such an arrangement, however, enables significantly less comprehensive trade in services than is possible with Single Market membership. In addition, recent research has demonstrated important interlinkages between goods and services trade whereby large amounts of services trade is generated by the activities of firms in the manufacturing sector who export goods.[3] This bundling of goods and services trade in Global Value Chains (GVCs) could amplify the overall economic impact of any new disruption to goods trade after the end of the transition period.

[2] See Lowe, S. 2019. "What a Boris Johnson EU-UK Free Trade Agreement means for Business." Centre for European Reform Insight. Available at: https://www.cer.eu/sites/default/files/insight_SL_5.11.19_2.pdf
[3] See https://blogs.sussex.ac.uk/uktpo/2020/06/11/foreign-investment-as-a-stepping-stone-for-services-trade/

Trading on WTO Terms

If the UK and EU do not agree a new trade deal, then trade between them would be on WTO terms only. This would introduce additional frictions on top of those that would apply in the case of a FTA. The EU and UK would have to treat each other like any other trading partner with whom they do not have a trade agreement. Imported British goods would be charged tariffs according to the EU's Most Favoured Nation (MFN) terms and vice versa. In the case of cars, for example, there would be a 10 per cent tariff. The UK set out its proposed tariff schedule to the WTO in 2018. In May 2020, it announced a new "UK global tariff" that eliminates a number of low tariffs, but leaves others in place on goods such as cars and ceramics and on many agricultural goods. [4] The aim of these tariffs is to protect the UK industry in these goods from cheaper imports.

The UK's services trade would also be subject to WTO rules. The EU's regime for the free movement of services is much more extensive than the WTO's. In the EU, there is an extensive programme of mutual recognition of qualifications making it much easier to provide services across borders. Since the WTO has made significantly less progress than the EU in liberalising trade in services, this would mean much reduced access to EU markets for UK service producers.[5]

Economic Implications for Ireland

In January 2020, the Central Bank published estimates of the impact of different post-Brexit trade arrangements (Conefrey and Walsh, 2020). That analysis takes into account the effect of Brexit on the UK economy and on Ireland through the following main channels: trade, foreign direct investment, migration and productivity. The evidence from the literature underpinning the assumptions on these key channels refers generally to long-run changes in trade and FDI but there is uncertainty over the short-run adjustment. The analysis suggested that, in the long run, Irish output could be reduced by between 3.5 per cent in the case of an FTA and 5 per cent if trade moves to WTO terms.

There is significant uncertainty around the short-run economic impact of whatever EU-UK trading arrangement will replace the status quo from 1 January 2021. Relative to a baseline where the UK remained an EU member, our estimates indicate that a FTA would knock just under 1 percentage point off the growth rate of the economy in 2021. In comparison to a FTA, a move to WTO terms implies an even larger degree of divergence from the trading arrangements that existed under EU membership and, therefore, a more distant EU-UK economic relationship. This increases the uncertainty regarding the economic impact of a WTO outcome in six months time.

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[4] See https://www.gov.uk/check-tariffs-1-january-2021

[5] Dhingra, S., Huang, H., Ottaviano, G., Pessoa, J., Sampson, T. and J. Van Reenen. 2017. "The Costs and Benefits of Leaving the EU: Trade Effects." Centre for Economic Performance, Discussion Paper No. 1478. April 2017. Available at: http://cep.lse.ac.uk/pubs/download/dp1478.pdf

The approved Withdrawal Agreement provides detailed provisions that allow for the orderly winding down of ongoing EU-UK processes and arrangements. The Withdrawal Agreement also provides legal certainty in relation to citizens' rights, the financial settlement and the arrangements for Northern Ireland.[6] As a result, the first year losses from trading on WTO terms from January 2021 should be less than in the case of a disorderly WTO outcome with no Withdrawal Agreement.[7]

Nevertheless, a move to WTO terms on 1 January 2021 could cause significant economic disruption. The very short transition period may not give firms and authorities sufficient time to adjust to the unprecedented change in trading arrangements. The magnitude of the disruption would depend on factors such as by how much and how quickly trade flows would be affected by the imposition of WTO tariffs, what would be the scale of logistical and supply-chain disruption and possible border delays and how would financial markets and exchange rates react.

Given the uncertainty around the impact on the Irish, EU and UK economies of a transition to trading on WTO terms in 2021, we consider two variants of this outcome in order to provide a range for the possible impact of a WTO scenario in the near term. It is important to note that these scenarios are not forecasts. The variants shown make different assumptions about the impact on uncertainty of a WTO outcome in January 2021 and the degree of short-run disruption to trade that would arise. The scenarios illustrate what could happen under these assumptions rather than representing a forecast of what will happen. Since the scenarios being modelled have no historical precedent, there is considerable uncertainty around the estimates presented.

Our modelling approach follows that in the Bank of England's "Transition to WTO" scenarios published in 2018.[8] In the disruptive WTO case, the profound change in trading arrangements compared to the position that applied while the UK was an EU member is assumed to result in a significant increase in uncertainty. The rise in uncertainty reduces consumer spending by households while firms respond by cutting investment. In addition, the disruptive WTO variant assumes that the initial decline in trade in a WTO outcome is sharper than in the alternative more benign WTO scenario. This could arise if the impact of tariffs and non-tariff barriers on trade flows is front-loaded or if trade is disrupted due to border delays or other bottlenecks caused by the introduction of new infrastructure. The assumptions underpinning the impact of a WTO outcome on trade, FDI,

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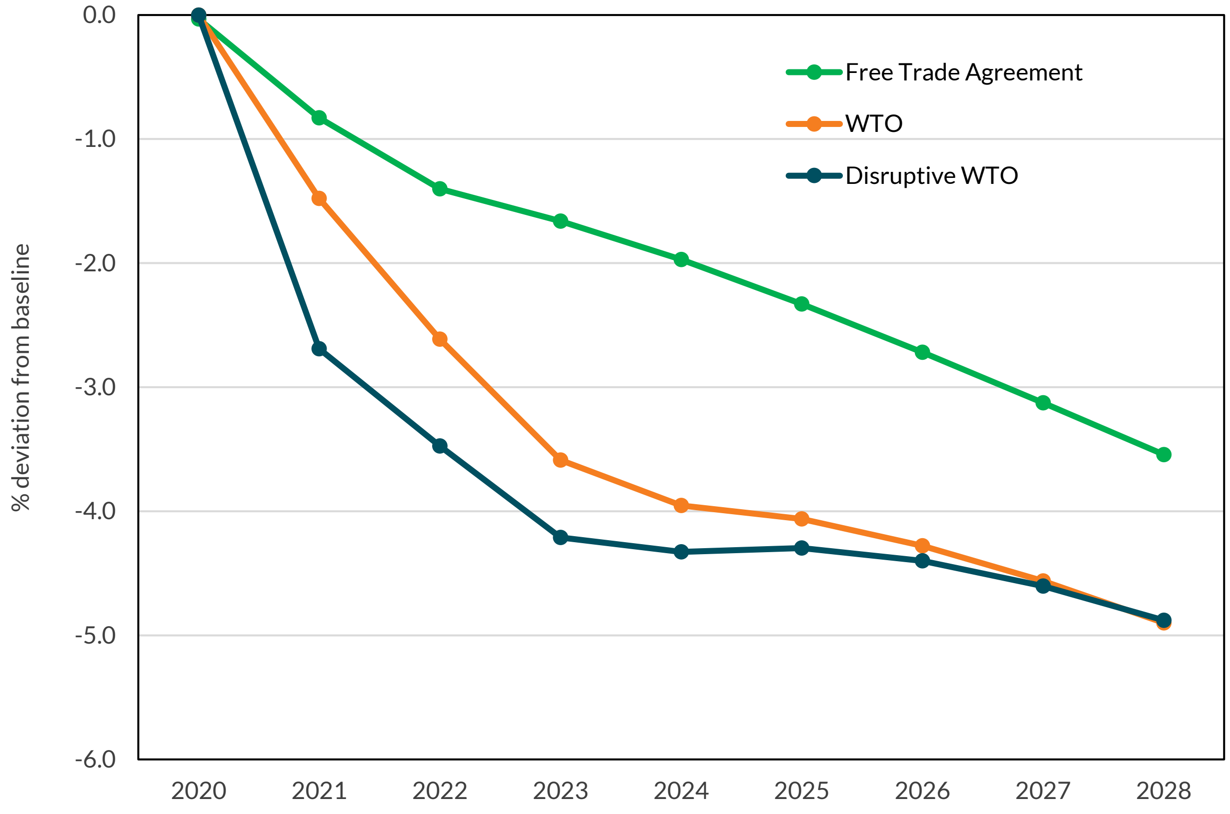
[6] See EC (2019). "The revised EU-UK Withdrawal Agreement Explained." Available at: https://ec.europa.eu/commission/sites/beta-political/files/slides_the_wa_explained.pdf

[7] In addition, regardless of whether a new trade deal is agreed or not, the UK government recently announced that it would implement full border controls on imports coming into Great Britain from the EU on a phased basis until 1 July 2021. This gives UK firms some additional time to prepare for the introduction of border controls. Nevertheless, despite this phased introduction, tariffs would still apply from 1 January 2021 and firms would be required to complete new customs declarations and other formalities.

[8] See Bank of England (2018). "EU withdrawal scenarios and monetary and financial stability". Available at: https://www.bankofengland.co.uk/-/media/boe/files/report/2018/eu-withdrawal-scenarios-and-monetary-and-financial-stability.pdf

productivity and migration in the long run is the same in both variants and in line with those used in Conefrey and Walsh (2020).

Figure 1: Effect of Brexit Scenarios on Irish Output, % Deviation from Baseline



Source: Own Calculations based on COSMO model.

The estimate from our previous analysis of the effect of a disorderly Brexit – i.e. a move to WTO terms with no withdrawal agreement and no transition period – indicated that such a scenario could have reduced growth in the economy by up to 4 percentage points in the first year, relative to a baseline where the UK remained an EU member. In the case of an orderly WTO arrangement – i.e. a move to WTO terms after a transition period – our estimate indicates that the reduction in growth in the first year would be around 1.5 per cent, slightly higher than the losses in the case of a FTA (Figure 1). In the disruptive WTO variant – where trading on WTO terms leads to an increase in uncertainty and additional disruption to trade flows – the short-run economic impact is more severe with output being reduced by around 2.7 per cent in the first year. The additional shocks which give rise to the more severe initial output loss in the disruptive WTO scenario are assumed to fade out over time so that, in the long-run, the impact on Irish output in both WTO variants is broadly the same.

The Interaction of Brexit and COVID-19

The emergence of the COVID-19 crisis has increased the uncertainty around the short-run effects of Brexit. It is unclear how some of the specific economic effects triggered by a transition to a FTA or WTO arrangement in January 2021 will interact with the global pandemic. For firms, the necessity to deal with the immediate challenges created by the COVID-19 crisis is likely to have disrupted or potentially halted the planning underway for the new EU-UK trading arrangements. This may apply in particular to firms in the SME sector with already limited staffing and other resources available for Brexit contingency planning. The majority of firms will have experienced reductions in revenue in 2020 and some will have accumulated losses, leaving them in a weaker position to withstand further economic disruption from a move to either a FTA or WTO arrangement in 2021. The preparations of governments and public authorities are also likely to have been significantly curtailed by the need to re-direct resources to tackling the COVID emergency.

The global recession currently being experienced and the collapse in world trade could amplify the negative consequences of Brexit in some sectors, although it is unclear whether the economic impact of Brexit in overall terms will be more severe than in the absence of the COVID-19 pandemic. With some vulnerable sectors already facing large demand shortfalls (for example tourism and accommodation and food services), it is possible that losses that would have been triggered by Brexit effects have been brought forward due to the impact of COVID-19. This will not be the case in other areas and, for the UK, recent analysis indicates that the sectors that have suffered least during the COVID-19 lockdown are the ones exposed to larger negative shocks from Brexit.[9]

The COVID-19 crisis may hinder the ability of firms attempting to diversify into new markets if it results in higher company debt. Expanding into new export markets is expensive and risky and involves incurring extra costs. As a result, there is evidence that more financially constrained firms may be less likely to break into new markets.[10] This could make it difficult for Irish firms wishing to diversify beyond the UK market and UK firms attempting to increase their non-EU exports after Brexit.

For the agri-food sector in Ireland – the part of the economy with the largest reliance on the UK market – the COVID crisis could amplify the impact of Brexit. The sector is likely to experience significant losses this year due to the impact of COVID-19 on demand and prices of the main commodity outputs of Irish agriculture.[11] In the case of a FTA, the new non-tariff barriers that would apply to Ireland-UK goods trade are most onerous for this sector. These NTBs could reduce or

[9] See De Lyon, J. and S. Dhingra. 2020. "COVID-19 and Brexit – Contrasting Sectoral Impacts on the UK." Available at: https://voxeu.org/article/covid-19-and-brexit-contrasting-sectoral-impacts-uk
[10] See Winters, Di Ubaldo and Konara (2020). Available at: https://blogs.sussex.ac.uk/uktpo/2020/05/27/covid-19-will-reinforce-the-brexit-shock/#_ftn10
[11] See Donnellan, Hanrahan and Thorne (2020). Available at: https://www.teagasc.ie/media/website/publications/2020/Covid19TeagascfinalMay1.pdf

eliminate trade in certain goods. In a WTO scenario, tariffs would also apply which would further reduce trade flows. It is important to note that the imposition of tariffs and NTBs would negatively affect both importing and exporting. Over 20 per cent of imports of Irish-owned firms are either completely or very highly reliant on imports from the UK, with the majority of these imports being intermediate inputs used for further production in Ireland.[12]

While the COVID-19 crisis may pre-empt the short-run losses that Brexit would have caused in some sectors, the longer-term consequences of the UK's exit will impair economic growth. These include a permanent reduction in EU-UK trade and lower productivity. Both of these effects are likely to reduce output in the Irish economy in the long run separate to the impact of the COVID crisis. These long-run losses could be mitigated by Irish exporters finding new markets or by an increase in foreign investment and inward migration.

In relation to the short-run outlook, the scenarios for the economy presented in the Quarterly Bulletin (QB3 2020) assume that a FTA is concluded between the EU and UK in time to take effect in 2021. If an agreement is not reached, both WTO variants examined in this analysis imply that growth in the Irish economy in 2021 and 2022 would be weaker than outlined in the Quarterly Bulletin scenarios.

[12] See 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