Durham University
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Future UK Trade Arrangements: 'No Deal' Mitigation

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This policy note is based on academic work being carried out at Durham University Business School. At the time of writing, the underpinning research is in working paper format and hence it represents work in progress. The findings reported in this note are based purely on independent academic work and therefore do not reflect the feasibility or desirability of any political views. Any remaining errors are ours.

EXECUTIVE SUMMARY

This Policy Note addresses the gap in the public discourse in relation to the impact of 'No Deal' Brexit on the UK economy, by presenting a trade policy recommendation which could mitigate in the short run the sharp and significant negative effect of 'No Deal' Brexit that the UK Government could consider.

The proposed trade policy recommendation seeks to provide the Government with a straightforward way to mitigate the 'No Deal' effect on the UK economy. Adopting *temporary unilateral reductions in barriers to imports* would delay the majority of and reduce the size of the expected fall in UK GDP for the length of time over which the temporary unilateral reductions in barriers to imports are in place.

Under this policy, the UK chooses to continue recognising the product standards of the EU on a temporary basis, as well as continuing to allow tariff free flows of imports from the EU into the UK. To ensure that the UK remains in compliance with WTO rules, the UK would also have to drop tariffs on non-EU goods to 0; however the lost income from tariffs (approximately 0.16% of UK GDP) would be more than compensated for by the smaller fall in UK GDP under this policy. Adopting this policy would ensure that all imports continue to flow freely into the UK, ensuring the continued, uninterrupted supply of goods such as pharmaceuticals, livestock, food and drinks, etc., for as long as the temporary unilateral reductions in barriers to imports are in place.

While this proposes a short term solution to mitigate the effects of 'No Deal' Brexit, it is not a long term solution for the UK as the UK would lose the ability to negotiate Free Trade Agreements, and would remain bound by EU rules for as long as the unilateral reductions in barriers to imports were in force.

OVERVIEW

This briefing presents the implications of four possible future trade scenarios, based on a bespoke macroeconomic model of international trade developed at Durham University. The scenarios are:

1. **'No Deal'**
2. **'No Deal' followed by an FTA with the EU**
3. **Mitigated 'No Deal' followed by WTO rules**
4. **Mitigated 'No Deal' followed by an FTA with the EU**

Appendix 1 provides a full description of each of the four scenarios presented here.

The two **Mitigated 'No Deal'** scenarios show the impact of adopting our policy recommendation, temporarily unilaterally lowering the barriers to imports into the UK from both EU and non-EU countries, on UK GDP. In these scenarios the UK chooses to continue recognising the product standards of the EU on a temporary basis, as well as continuing to allow tariff free flows of imports from the EU into the UK, ensuring that imports from the EU continue to flow as freely into the UK after Brexit as before Brexit on a temporary basis. To ensure that the UK remains in compliance with WTO rules, the UK would also have to drop tariffs on non-EU goods to 0 %, again on a temporary basis.

These temporary unilateral reductions in barriers to imports are possible as:
- after the UK's exit from the EU on 29th March 2019, the UK can keep unchanged barriers to imports with the EU and all the other countries with which the EU has FTAs. However, according to WTO rules, the UK will have to adopt the same import tax/barriers with all countries it is importing from. Therefore, under these scenarios, after the UK's withdrawal in March 2019, the tariff barriers to imports from non-EU countries to the UK are unilaterally lowered to the same level as pre-withdrawal imports from the EU, i.e. to zero. The unilateral reductions in tariffs on non-EU goods ensure that the UK remains in compliance with WTO Most Favoured Nation regulations (MFN);
- the UK has already passed a bill that translates all EU law into UK law after Brexit. This allows the UK to let EU goods enter the UK markets freely, as they are guaranteed to already meet UK product standards, and would continue to do so, for as long as the UK did not impose any new standards. In the scenarios below it is assumed that no new standards are imposed between the present day and December 2020. Given that the EU goods are guaranteed to already meet UK product standards, letting them into the UK more freely than non-EU goods would not be in breach of WTO rules.

In the analysis below, for illustrative purposes, it is assumed that the temporary unilateral reductions in barriers to imports take place over the length of time currently proposed as the 'transition' period according to the ***Government's proposed Withdrawal Agreement and the joint Political Declaration**, i.e.* until December 2020. It is also assumed that in the **'No Deal' followed by an FTA with the EU**, **Mitigated 'No Deal' followed by WTO rules** and **Mitigated 'No Deal' followed by an FTA with the EU** scenarios, the UK is able to grandfather all EU FTAs with non-EU countries from January 2021. Finally, in the **'No Deal' followed by an FTA with the EU**, and **Mitigated 'No Deal' followed by an FTA with the EU** scenarios it is assumed that the UK is able to negotiate a Canada Style FTA with the EU coming into force in January 2021.

Using the macroeconomic model of international trade developed at Durham University, it is possible to simulate a range of scenarios based on various lengths of time for the temporary unilateral reductions in barriers to imports and various styles of FTAs with the EU, with or without grandfathering of the EU's FTAs; what is presented in this policy note are a series of illustrative examples.

The macroeconomic model used for these forecasts is based on a unique combination of the following key features:

(1) differentiation between exports and imports;
(2) trade between more than two countries simultaneously;
(3) an analysis of the short-term, as well as long-term, behaviour of the main UK economic variables;
(4) differentiation between tariffs and non-tariff barriers to trade.

All these features are crucially important for an appropriate and thorough analysis of the effects of changes in barriers to trade with Non-EU countries following the UK's withdrawal from the European Union.

IMPACT ON THE UK ECONOMY

1. Under the *'No Deal'* scenario:

Given that there is no transition period, a sharp fall in GDP will take place immediately after the UK's exit from the EU in March 2019. Thus, GDP is expected to fall by up to 9.1% in the *short run* (April-June 2019) and by up to 5.1% in the *long run* relative to its January 2019 level; this scenario shows the dramatic effects of **'No Deal'**, driven by no transition period in the short run and its significant long run effect. The short run behaviour of UK GDP under this scenario is different than under the scenarios in which temporary unilateral reductions in barriers to imports are considered with respect to the sharp immediate fall in GDP after March 2019, but also in terms of the much larger magnitude of the reductions in GDP.

2. Under the *'No Deal' followed by an FTA with the EU* scenario:

GDP is expected to fall by 9.1% in the *short run* (April - June 2019) and by 2.2% in the *long run* relative to its January 2019 level; this scenario shows again the dramatic effects of **'No Deal'** driven by no transition period, but also the beneficial effect that a negotiated Canada-style FTA with the EU starting January 2021 could bring relative to trading under WTO rules alone, reducing the long run drop in GDP by 2.9 percentage point relative to the **'No Deal'** scenario.

3. Under the *Mitigated 'No Deal' followed by WTO rules* scenario:

GDP is expected to fall by 6.8% in the *short run* (January-March 2021) and by 4.1% in the *long run* relative to its January 2019 level; however, implementing unilateral reductions in barriers to imports until December 2020 (when the currently proposed transition period in the ***Government's proposed Withdrawal Agreement and the joint Political Declaration*** is due to end – adopted here for illustrative purposed), delays the drop in GDP until January 2021. It is assumed that this is followed by WTO rules with grandfathering of EU FTAs from January 2021.

4. Under the ***Mitigated 'No Deal' followed by an FTA with the EU*** scenario:

GDP is expected to fall by 2.9% in the *short run* (January-March 2021) and by 2.2% in the *long run* relative to its January 2019 level; as in the previous scenario, unilateral reductions in barriers to imports are assumed to be in place up until December 2020 and the drop in GDP is delayed up January 2021, after which UK GDP would drop towards it long run level, which, given the assumption that the UK would trades with the EU under a Canada-style negotiated FTA with the EU including grandfathering from January 2021 onwards, would be higher than under scenarios 1 and 3.

Figure 1. *Short-term and long-term behaviour of UK GDP under scenarios* ***'No Deal'*** *and* ***Mitigated 'No Deal' followed by WTO rules***

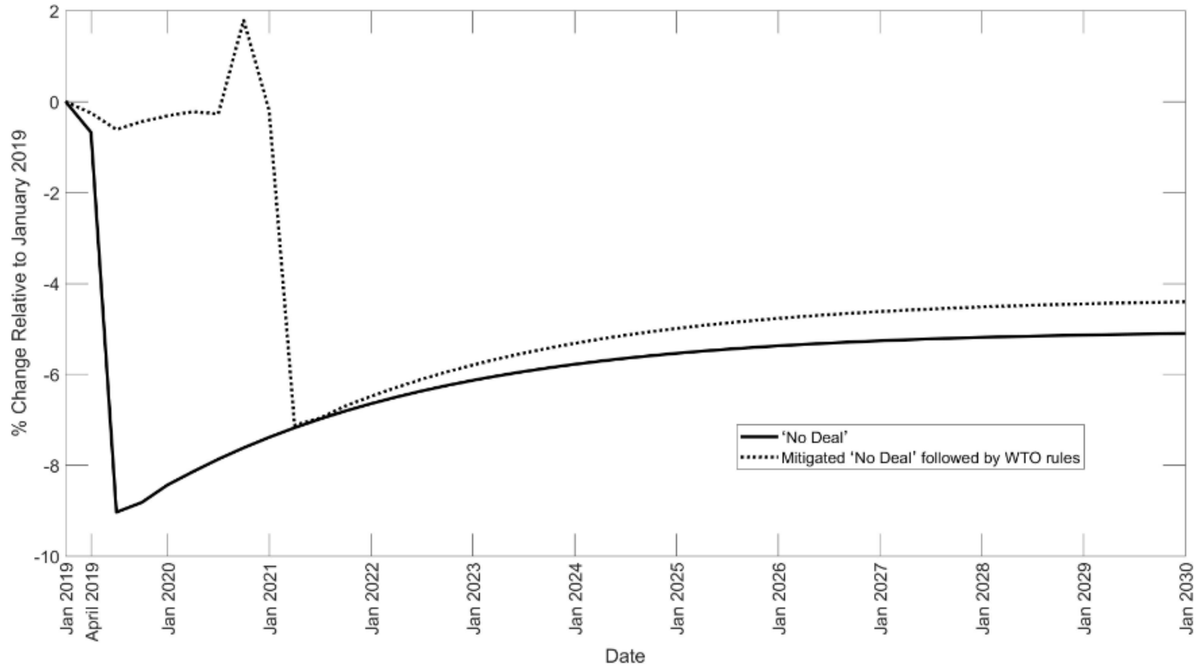

Figure 2. *Short-term and long-term behaviour of UK GDP under scenarios* ***'No Deal' followed by an FTA with the EU*** *and* ***Mitigated 'No Deal' followed by an FTA with the EU***

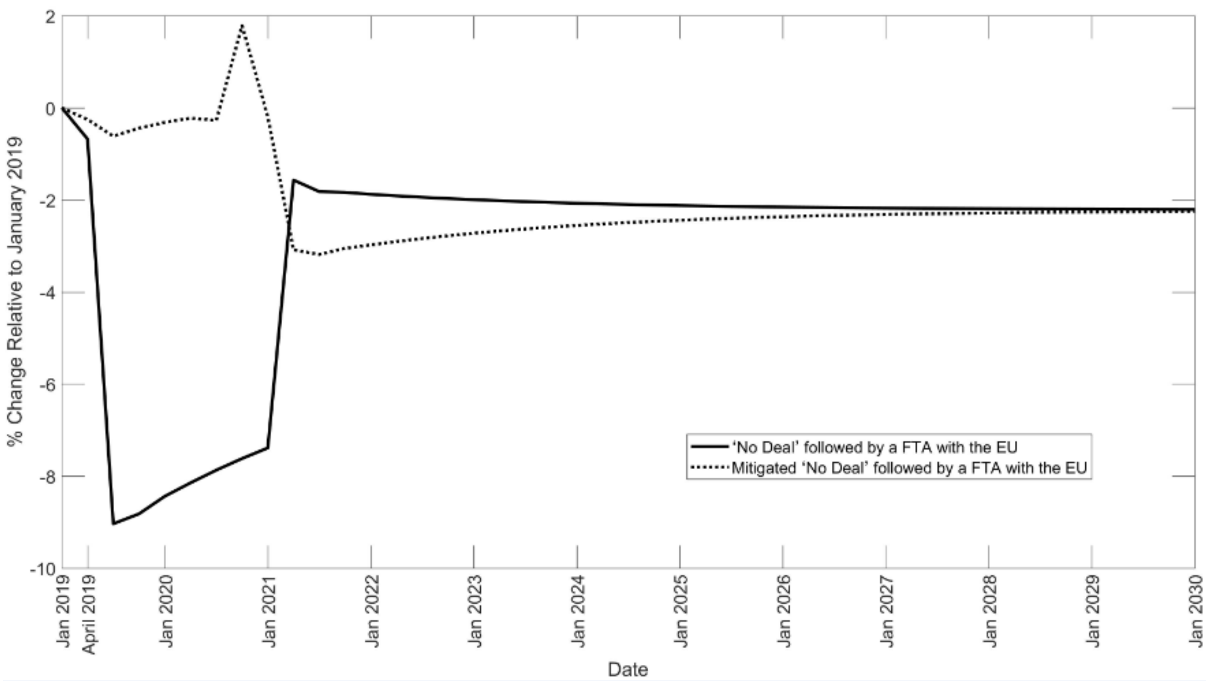

Figure 1 presents the short and long-term behaviour of UK GDP under the scenarios of **'No Deal'** and ***Mitigated 'No Deal' followed by WTO rules***. The figure shows that immediately after the new barriers to trade come into force in April 2019 under the **'No Deal'** scenario, GDP is expected to register a sharp and significant fall before slowly recovering to its new equilibrium level, 5.1% lower than its January 2019 levels. **<u>However, if the Government would consider adopting *unilateral reductions in barriers to imports* up to December 2020 or when the UK starts trading under WTO rules (assumed in the scenario to also include the grandfathering of EU FTAs), this will delay the fall in GDP until after January 2021, and also reduce the size of the fall by more than 2 percentage points.</u>**

Figure 2 presents the short and long-term behaviour of UK GDP under the scenarios of ***'No Deal' followed by an FTA with the EU*** *and* ***Mitigated 'No Deal' followed by an FTA with the EU***. The figure shows that under the **'No Deal' followed by an FTA with the EU**, after a significant and sharp fall in GDP, this can recover once the negotiated (Canada-style) FTA with the EU (and grandfathering of EU FTAs) comes into force, in January 2021 according to the assumption of the scenario. **<u>However, the significant and sharp fall in GDP can be avoided if the Government would consider adopting *unilateral reductions in barriers to importsb (at least)* up to December 2020, or up to the point at which the newly negotiated (Canada-style) FTA with the EU and grandfathering of EU FTAs comes into force from January 2021.</u>**

The response of UK GDP under the **'No Deal'** and **'No Deal' followed by and FTA with the EU** scenarios is driven by two main changes due to take place after end of March 2019: (a) lower demand for labour from UK exporters and (b) lower competition on the UK domestic market, both of which lead to a decline in UK GDP:

(a) decreasing labour demand from UK firms exporting to non-EU countries (under the **'No Deal'** scenario where there is no grandfathering of EU FTAs) and to the EU (under both scenarios) leads to a rise in unemployment and a fall in the average real wage, which leads to a drop (under both scenarios) in average household income, which in turn leads to a further fall in the average real wage, as more workers need to work due to the fall in average household incomes. This downward wage spiral will encourage new firms to enter the UK market, and will cease only when a large enough number of new firms enter the UK domestic market. The decreased profits from exporters, coupled with the lower wage would lead to a decrease in UK GDP.

(b) Lower competition on the UK domestic market following higher trade barriers allows firms with relatively lower productivity to enter the market, driving down labour productivity and the average real wage (as less productive firms are not able to afford the higher wage paid by the more productive firms).

However, under the scenarios in which temporary unilateral barriers to imports reductions are assumed (**Mitigated 'No Deal' followed by WTO rules** and **Mitigated 'No Deal' followed by an FTA with the EU**), alongside the lower demand for labour from UK exporters (leading to a decline in UK GDP), instead of lower competition on the UK domestic market following higher tariff barriers to imports, <u>there will be higher competition on the UK domestic market following lower tariff barriers to imports</u>, from lowering the tariff barriers to imports with non-EU countries while maintaining the same barriers to imports with the EU (leading to an increase in UK GDP).

Higher competition on the UK domestic market following lower tariff barriers to imports drives firms with relatively lower productivity out of the market, increasing labour productivity and the average real wage (as less productive firms pay a lower wage more productive firms), and leads also to a decrease in the number of UK firms. The redistribution of labour to more efficient firms, coupled with the higher wage would lead to an increase in UK GDP.

The positive effect of higher competition on the domestic market on GDP is dominated by the negative effect on UK GDP of lower labour demand from UK exporters, hence the overall lower decline in UK GDP up to the point in which higher tariff and non-tariff trade barriers will come into place once the assumed 'transition' period ends, when the two effects are working again in the same direction.

APPENDIX 1 – DESCRIPTION OF THE FOUR SCENARIOS

1. **'No Deal'**: the UK leaves the European Union (EU) on March 29th 2019 without a trade agreement with the EU and also ceases to be a party to the EU Free Trade Agreements (FTAs) and to all other trade-related treaties with non-EU countries to which the EU is a party. The UK will therefore trade with both EU and non-EU countries under World Trade Organization (WTO) rules after leaving the EU.

2. **'No Deal' followed by an FTA with the EU**: the UK leaves the EU on March 29th 2019 with No Deal and in the meantime negotiates a Canada-style FTA with the EU with grandfathering, which is announced at the beginning of October 2020 and comes into force at the end of December 2020. It is further assumed that the UK grandfathers all EU FTAs with non-EU countries from January 2021.

3. **Mitigated 'No Deal' followed by WTO rules**: the UK leaves the EU on March 29th 2019 but unilaterally keeps barriers to imports from the EU at their current level until December 2020 at which point WTO rules ensue. This includes a commitment to regulatory alignment for that period in both goods and services (ensuring no non-tariff barriers to imports) and a 0% tariff environment as well. The 0% tariff environment does mean that tariffs on imports from non-EU countries must be set to 0% as well, under WTO rules. It is further assumed that the UK grandfathers all EU FTAs with non-EU countries from January 2021.

4. **Mitigated 'No Deal' followed by an FTA with the EU**: the UK leaves the EU on March 29th 2019 but in the same way as in the previous scenario, unilaterally keeps barriers to imports from the EU at their current level, and reduces tariffs on imports from non-EU countries to 0%, until December 2020 and then negotiates a Canada-style FTA with the EU which is announced at the beginning of October 2020 and comes into force at the end of December 2020. It is further assumed that the UK grandfathers all EU FTAs with non-EU countries from January 2021.

APPENDIX 2 – HEADLINE FIGURES

	GDP		
Scenario	Short Run		Long Run
	April-June 2019	January-March 2021	
'No Deal'	-9.1%	N/A	-5.1%
'No Deal' followed by an FTA with the EU	-9.1%	N/A	-2.2%
Mitigated 'No Deal' followed by WTO rules	-1.1%	-6.8%	-4.1%
Mitigated 'No Deal' followed by an FTA with the EU	-1.1%	-2.9%	-2.2%

Note: The figures in the table present the departure of UK GDP from its level when the post-withdrawal terms of trade are announced, according to each of the four scenarios presented here.

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