Can the UK secure free trade outside the EU?

By

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If Britain votes to leave the EU, the country will face some difficult decisions on 24th June. None will be more important than determining the principles behind the UK's new national external trade policy.

It will have to do this with limited policy capability, given that the UK has not conducted any trade negotiations of its own for forty years. And it will no doubt have to do so against a turbulent background, and with partners who will not necessarily be wanting to make things easy. This is a mammoth undertaking. Simply setting out the task underlines how risky a decision to Vote Leave will be.

But if it happens, how will the country go about it? In trying to reach the decisions set out above, two questions are relevant. First, can any future trading arrangements, as a matter of theory, be as good as the current ones provided by membership? Second, is it possible to negotiate such arrangements, as a matter of practical politics? I have doubts on both points.

THE FUNDAMENTAL TRADE-OFF

There's a very simple trade-off in this area.

It is that the more independent your national trade policy is, the more difficult it is to negotiate completely barrier-free access to any other country.

If a country gives up a national trade policy in favour of a customs union with others, in this case with the EU, it can in principle have completely free access to those others' markets. There are no tariffs, no paperwork, and no administrative barriers: the same rules apply to all goods wherever they are made, and changes in rules or standards do not create barriers to trade because they instantly apply to everyone. In return, that country has to accept that it can't have any separate arrangements with any other countries – in other words, its external tariff arrangements have to be the same as everyone else's.

In contrast, if a country has a national trade policy, its tariffs, rules, and standards are likely be different to those of other countries. Indeed that is the point of a national policy – if you don't want this freedom then there is little point in having the policy.

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So although it is possible to negotiate bilateral trade agreements with other countries, the customs and administrative barriers will never disappear completely. And every time either country changes its internal rules (for example on the standards for a product or the way a service must be delivered) a trade barrier is created. Of course, a country has the freedom to lower or abolish barriers into its own market, and it will definitely get some benefit from doing so, but there is no guarantee that any other country will do so in return.

Neither approach is inherently better. Which makes sense depends on a country’s situation. But if, as in the case of the UK, a country is already part of a customs union and has already adapted its trading arrangements to it, the case for change has to be overwhelming. It isn’t.

“Can any of these be economically better for Britain? It’s fairly easy to see that the answer must be...

no.”

"Trade is no longer about making one product and sending it across one border. Most modern products are made up of components from many other countries."

CAN "OUT" EVER BE AS GOOD AS "IN"?

The three models for the future relationship with the EU of an independent UK are well-known: they are the examples of Norway, Switzerland or Canada, and Turkey. (Some of the Leave campaign argue that Britain's relationship would be sui generis, different to any of these, though it usually emerges from discussion that they really mean simply a more generous version of the Swiss or Canadian arrangements.)

All these represent different trade-offs between the options above. Accordingly, all give only imperfect access into the single market, and no say in setting its rules, in return for greater freedom in trade policy with other countries.

A Swiss or Canadian-type arrangement involves a bilateral Free Trade Agreement, or a series of sectoral agreements, with the EU.

Even if this eliminated all tariffs on every product (and that has never happened in an FTA), it would still leave UK exporters facing customs administrative barriers and rules of origin enforcement, said by economists overall to be equivalent to 4-8% of the value of the goods traded.

In services, there are formidable intellectual difficulties in negotiating a durable FTA, since the issues are about internal rules rather than tariffs. Put simply, either you accept that both sides have the continued right to change their internal rules, in which case a trade barrier is created if it happens; or you restrict the right to change the rules, in which case you have lost some of the freedom you were trying to gain through having a national policy.

A Norway-type arrangement involves accepting all single market rules in return for access to the single market in goods and services,

so in that sense is economically better than the Swiss deal. But it still doesn't get rid of customs administration and rules of origin.

The Turkey arrangement makes the country part of the EU's customs union such as the single market, for trade in goods. (It does not even attempt to cover services.) So the administrative barriers problem is eliminated, but at the price of losing the freedom to have separate trading arrangements in goods. In fact, the Turkey arrangements have never functioned well, Turkey's trade policy is not equivalent to the EU's, and even the theoretical gains have not been achieved.

For all these it's also important to remember that trade is no longer about making one product and sending it across one border. Most modern products are made up of components from many other countries. A car finished in Germany might have components made in Italy, incorporated into a larger component in the UK, be re-exported to France and incorporated again, be sent back to the UK and incorporated in (say) the final car engine, before going back to Germany for final assembly.

The result is that it would cross the UK border more than once and the administrative costs of doing so would keep mounting up. That would be a barrier, over time, to making the components in the UK in the first place.

So all these arrangements would leave the UK with less access to the single market than before. Would this be outweighed by freedom to negotiate our own trading arrangements with other countries? A simple bit of maths shows the answer is no. The EU already has FTAs covering nearly 60% of the UK's trade, including the EU itself. If TTIP and the EU/Japan FTA can be negotiated soon, that figure goes up to 80%. It can't possibly make sense to have less good arrangements with the 60% or 80% in return for slightly better arrangements with the 20%.

Or alternatively, look at the orders of magnitude. The single market is plausibly worth 5% of GDP. The Commission says an ambitious EU deal with the US will boost GDP by 0.5% in ten years' time. With Japan by a bit more, 0.8%. With India about 0.1%. The orders of magnitude are different and it simply isn't worth jeopardising access to the single market for the sake of global trade.

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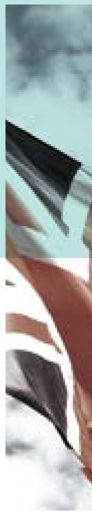
WHAT ARE THE NEGOTIATING REALITIES?

That’s all the more true when one considers the negotiating realities. After leaving, the UK will have to renegotiate trading arrangements simultaneously with many major countries, including the EU, in a two-year window. There may not be goodwill. Britain will be demandeur and so it will be Britain that has to make the concessions to get the deal. True, other countries will want deals too, but they won’t be under anything like the same time pressure and can afford to make us sweat.

This is also a formidable administrative task. Trade negotiations are complex and a good modern trade agreement requires many stakeholders within a country to be involved in the negotiations and be ready to implement the result. That is why negotiations take years not months. The EU is involved in perhaps a dozen live FTA negotiations at any one time and even that puts strain on the system. The UK would have to do many more, with few experienced trade negotiators at our disposal.

In reality therefore what we can negotiate will fall short of the theoretical ideal. Our FTAs are bound to leave tariffs on some sensitive goods, even if we get tariff-free access for most. We are bound to have imperfect arrangements for services access, our real competitive strength, and this would be particularly risky in financial services given the ease with which firms could decamp to (say) Dublin.

In short, even the best-case outcome can’t be as good as what we have now; and we won’t be able to negotiate the best-case outcome anyway, because in real life you never can.



HOW TO STABILISE THINGS

Moreover, these negotiations would not be happening in a vacuum. There would be political turbulence in Britain and, no doubt, the EU. Firms and other countries would see that the future arrangements for British trade were up in the air and that existing tariff-free access could not be ensured. So it could be a traumatic and difficult period, with no guarantee of a good outcome.

If I were a UK negotiator in these circumstances, I would be thinking about how to bring stability and predictability to this period. My recommendation would be two-fold:

First, think hard about a transition via a Norway-type arrangement, if only as a staging post. Exit from the EU to a Norway model is probably the easiest thing to negotiate, because the model already exists, it would be hard to refuse us, and Britain would keep access to the single market and apply single market legislation. It could plausibly be done within two years. It would therefore enable UK negotiators to focus in the short run just on third-country trading arrangements, i.e. moving from the EU's FTAs to the UK's own, probably via some kind of transitional arrangements.

Thereafter, it could be possible to unwind the ties further over time to something like a Swiss arrangement, but without the time pressure of negotiating exit, and allowing the immediate bad feeling between Britain and the EU to subside.

Second, make sure we pursue a liberal external trade policy of our own. We should commit to a glide path towards a tariff regime and access policy that is clearly more liberal than the rest of the EU, to keep the UK attractive, to minimise barriers, and to get the economic benefits of more competition on our own market to make up for the shock of disrupted access to others'.

And there should be no talk about retaliating against other countries if their tariffs go up: this would be completely self-defeating.

All this said, there is no doubt that leaving would be fraught with economic risk. It would be a step into uncertainty and, in many key respects, into the unknown. If this is the situation on 24th June, we will face an anxious and potentially turbulent time. It will require politicians and businesses to unite and work together to find the best possible route to a more settled future.