Brexit Monitor
The impact of Brexit on (global) trade

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The outcome of the UK's EU referendum and looming exit negotiations, are already affecting trade flows between the UK and the EU. In this issue of PwC Europe's Brexit Monitor, we will discuss current trade flows and possible effects of Brexit on intra-European trade.

A free internal market

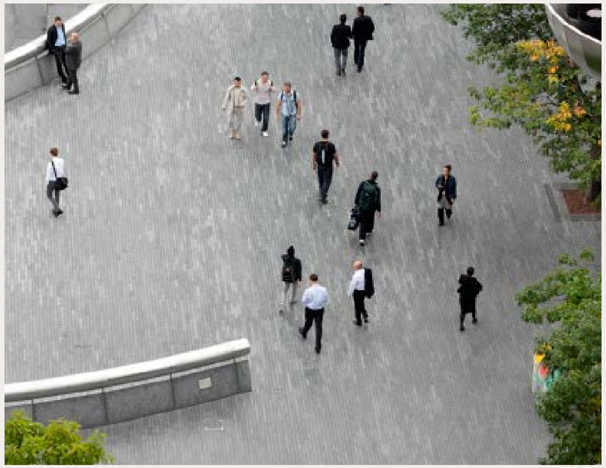
At present, EU countries including the UK, fully benefit from the EU's Single Market. This includes the absence of duties and quotas for EU Member States doing business and trading throughout the EU. The principle of free movement of people also facilitates access for workers and services. In addition, simplified customs procedures reduce the administrative burden for companies trading within the EU to a minimum.

Countries most impacted include Belgium, the Netherlands and Germany

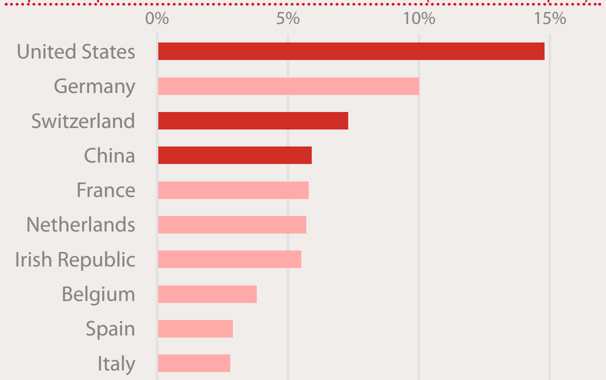
Among the top-10 trading partners of the UK in 2015, seven countries are part of the EU. In the same year, about 44% of UK export was directed to EU Member States, while approximately 53% of total imports originated in EU countries. Countries that have deep trade ties to the UK are also most vulnerable to immediate economic impact when the UK leaves the EU. Although Germany is the UK's largest trading partner in the EU by volume, Ireland is by far the most dependent on UK trade in terms of shares of total imports and exports.

Among western European countries, Belgium, the Netherlands and Germany export significantly more to the UK than they import from the UK. Depending on the price elasticity of the export products, these countries might witness a deterioration of their terms of trade with the UK. Post-Brexit outcomes which significantly increase the cost of trade between the UK and the rest of the EU will be damaging for both sides.

Among EU countries that export the most to the UK, relative to the size of their economies, Ireland sits at the top of this list, followed by Cyprus, the Netherlands and Belgium. While German export volumes are the largest in Europe, due to its sheer size, Germany has many other important export destinations which could compensate for a decline in UK bound exports post-Brexit.

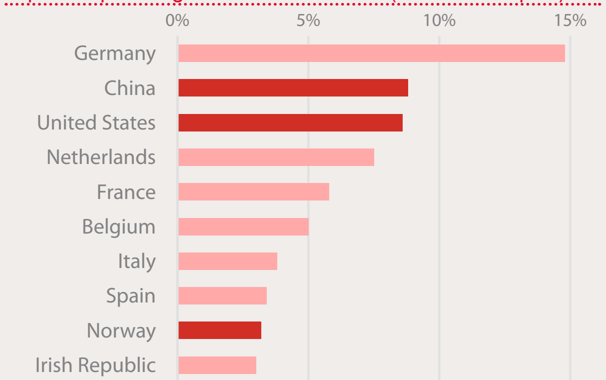


Top-10 export destinations of the UK in 2015 (% of total export)



Source: HM Revenues & Customs, PwC analysis

Top-10 import origins of the UK in 2015 (% of total import)



Source: HM Revenues & Customs, PwC analysis.

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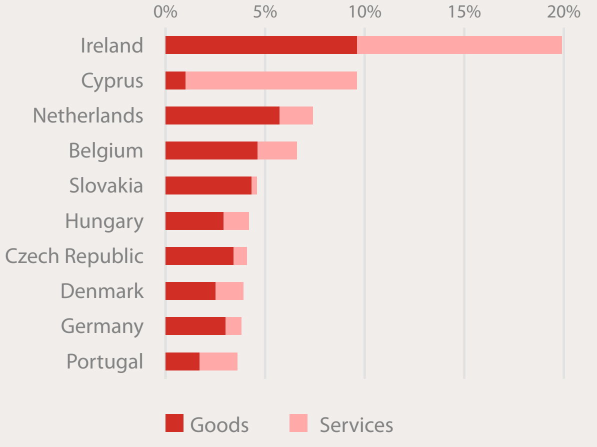
Ireland is the most exposed EU country from a trade perspective



Note: Spain, Luxembourg, Malta and Finland are excluded from our analysis due to data limitations

Source: PwC analysis

Ireland's economy has a particularly strong orientation to exports. It depends on the UK for 14% of its exports and 34% of its imports. Beyond trade disruptions, the re-introduction of the customs border would impose new costs and lost time to cross-border transactions. On the flipside, Ireland could benefit from larger inflows of investments and alternative locations, as foreign companies may seek other access points to the EU Single Market.

The Netherlands is the UK's second largest EU trading partner, in terms of both volume and proportion of exports and imports. The country also has close investment ties with the UK: the UK is the most popular destination for Dutch investors and the Netherlands is the second most popular destination for UK investors. The increase in the value of the Euro versus Sterling is an important factor affecting UK-Dutch trade. Dutch flower exporters reported a decline in demand from the UK for relatively expensive flowers and plants already in the weeks immediately after the Brexit vote.

Belgium will be affected to a large extent by Brexit. 9% of the Belgian exports of goods is shipped to the UK. In terms of exports relative to size of the economy, Belgium ranks fourth among EU countries most affected by Brexit. 5% of total Belgian imports come from the UK. For imports, Belgium therefore occupies a fifth place. In the services sector, both on the supply and buy side, Belgium is also in forth position among EU countries.[1]

Germany is the largest trading nation in the EU in terms of volume. Brexit would remove a lot of the benefits of the Single Market for German industry, especially in the automotive sector. German exports will likely suffer more than its imports. But as Germany is the EU's largest economy, it has a relatively low dependency on its trade with the UK.

1 Statistical memo of the Belgian Foreign Trade Agency on the impact of Brexit on the trade between Belgium and the UK, PDF.

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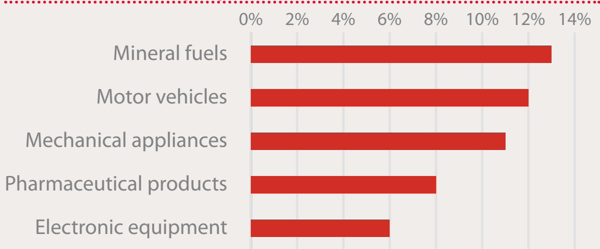
Future UK trade flows

Some sectors will be hit harder than others once the UK leaves the EU. Sectors that may experience the biggest export impacts are motor vehicles and parts, electronic equipment, as well as processed foods. Motor vehicles in particular stand out as the commodity with the highest share of trade between the UK and EU, as the UK is both an important producer of motor vehicles and parts, and an important sales market for vehicles (the second in Europe behind Germany). The EU is the main export market for the UK, accounting for 57.5% of vehicle exports.

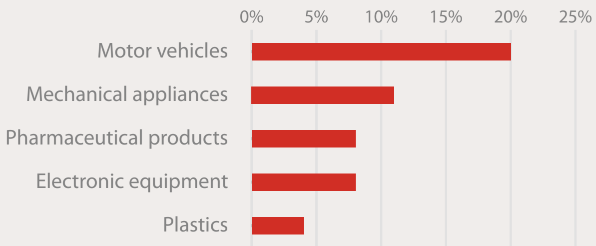
For the UK, the services sector is the sector which will be most impacted post-Brexit. The services industry constitutes almost 80% of the total UK economy, according to a recent HM Treasury analysis. London is a global financial centre and is the largest in Europe. About one third of insurance and financial services exported from the UK are exported to the EU and the UK has a trade surplus with the EU of GBP 19.8 billion. More detailed information of the impact of Brexit on the financial services industry is available here.

UK exports to EU by top 5 commodities, July 2016



Source: HM Revenues & Customs

UK imports from EU by top 5 commodities, July 2016



Source: HM Revenues & Customs

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Trade costs will increase

The impact on EU-UK trade will depend on the relationship between the UK and the EU after Brexit. In the most likely scenarios – either a comprehensive free trade agreement (FTA) or a fall-back to WTO rules – the costs of trade between the UK and the EU will increase. These costs can be broadly defined as market access measures (tariffs and quotas), increased administrative burden (including customs formalities and VAT), and behind-the-borders rules that define the extent of non-tariff barriers (NTBs) to trade. Examples of NTBs are health, safety and environment standards as well as rules of origin requirements. These increased costs will be borne by businesses and most likely passed on to consumers.

Under a Free Trade Agreement (FTA) based relationship, the UK and the EU would negotiate the terms of access for specific sectors, including the standards and regulations that apply in those sectors. The EU tradition of harmonization, rather than mutual recognition, means the choice for the UK would likely be to either adopt the EU standards or for firms to bear the cost of meeting two sets of standards. Tariffs negotiated under a free trade agreement are likely to be negotiated to a level close to the current next to zero levels.

However, in the WTO scenario, tariffs would increase to WTO's most favoured nation (MFN) levels. These are higher than the current levels (see table below), and may impact trade flows.

In terms of timing, business can expect new trading regime(s) to be in place any time between 2019 and 2029. The UK is set to trigger Article 50 before the end of March 2017 and will thereby exit the union no later than the end of March 2019. From this date, trade between the EU and the UK may either be subject to an interim regime (for example based on EEA rules) or trade may revert back to WTO rules as the fall-back option in the case no comprehensive new deal has been reached.

Past experience shows that multilateral FTAs take between five to ten years to negotiate and may need to be ratified by national, and even regional, parliaments. As such it is unlikely that a comprehensive new agreement will be in place on the day that the UK exits the EU. More likely is some sort of temporary regime while the two parties negotiate further future terms. A final deal can therefore be expected at the earliest in 2024, but it could take up to 2029 for both parties to agree on and ratify a new deal at the national level.

Estimated MFN tariff levels by sector, in percentages

Sector	*UK imports*	*EU27 imports*
Agriculture	4.517	2.564
Primary energy and mining	0.003	0.001
Energy	1.568	0.988
Processed foods	7.848	7.075
Low-tech manufacturing	4.692	6.672
Metals and minerals	1.639	1.523
Chemicals, rubber and plastics	2.800	2.890
Motor vehicles and parts	7.200	7.360
Electronic equipment	0.840	0.910

Source: Centraal Plan Bureau (2016) Trade effects of Brexit for the Netherlands

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Transfer pricing may be impacted

Brexit would also affect trade-based fiscal regulation. Companies transporting products and services to and from facilities in different EU countries need to pay taxes in these countries. Due corrections to intercompany transactions, products are often double taxed by different tax authorities. However, companies can currently avoid this double taxation through the EU arbitration convention.

Brexit will affect trade-based fiscal regulation as well. Companies transporting products and services to and from facilities in different EU countries need to pay taxes in these countries. Due corrections to intercompany transactions, products are often double taxed by different tax authorities. However, companies can currently completely avoid this double taxation in the EU through the EU arbitration convention.

After the UK leaves the EU, the UK would no longer be party to EU fiscal legislation. It can be questioned whether Brexit would affect the EU arbitration convention as it is a treaty concluded among the Member States. The convention is not within the remit of the EU. In principle, a revision of this convention can only be asked by the contracting Member States and the revision has to be approved by the contracting Member States. The question is however how this will be dealt with as part of the Brexit negotiations and the subsequent views and willingness of Member States in practice on resolving double taxation through arbitration although they would remain obliged to do so under the Convention.

Reconsidering locations in supply chain and value chain

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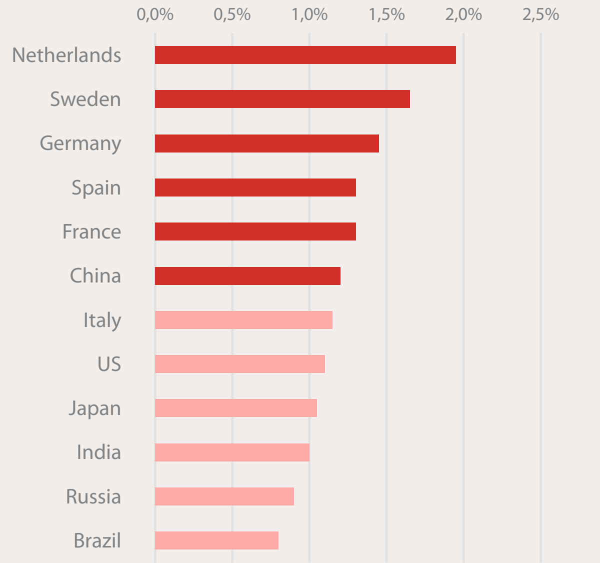
Supply chains are becoming more important for competitiveness. Supply chains are increasingly globalised as companies want to decrease costs of sourcing, production and delivery. Added to this, companies aim for higher service levels as consumer expectations related to quality and speed of delivery increase.

According to research by boutique consultancy firm Global Council, the high ratio of gross trade relative to the value added suggests that much of the UK's trade is connected to global supply chains. 41% of the value added in its exports comes from the EU and 12% from the US. The importance of the UK in the international supply chains is particularly concentrated in some sectors. The UK's financial services and professional services industries, exports in mining and chemical products, transport, telecom, as well as wholesale and retail sectors, are very important to international supply chains.

After the UK leaves the EU, current global supply chains for the EU market may need to be rebalanced. Uncertainty about trade policies and their effect on trade between the UK and the EU may impact investments in the supply chain footprint. Companies making strategic capital investment decisions about warehouses, factories or logistic capabilities, would normally consider the UK as location. Pending the uncertainty after the Brexit vote, these decisions may be postponed. Decisions that cannot be postponed may instead become biased in favour on non-UK locations.

In supply chain management companies frequently calibrate the cost levels versus service levels of one's nodes in the supply chain. If transaction costs of trade become too high, companies may reconsider their current or planned locations in the UK.

EU supply chains are important to the UK
Gross exports divided by value-added exports by destination



Source: Global Council (2015) Brexit: the impact on the UK and the EU

In value chain transformation, not only the supply chain of source-make-deliver, but also enabling functions such as sales, marketing and R&D will be considered when evaluating the most cost effective and most strategic locations for trade to and from the EU.

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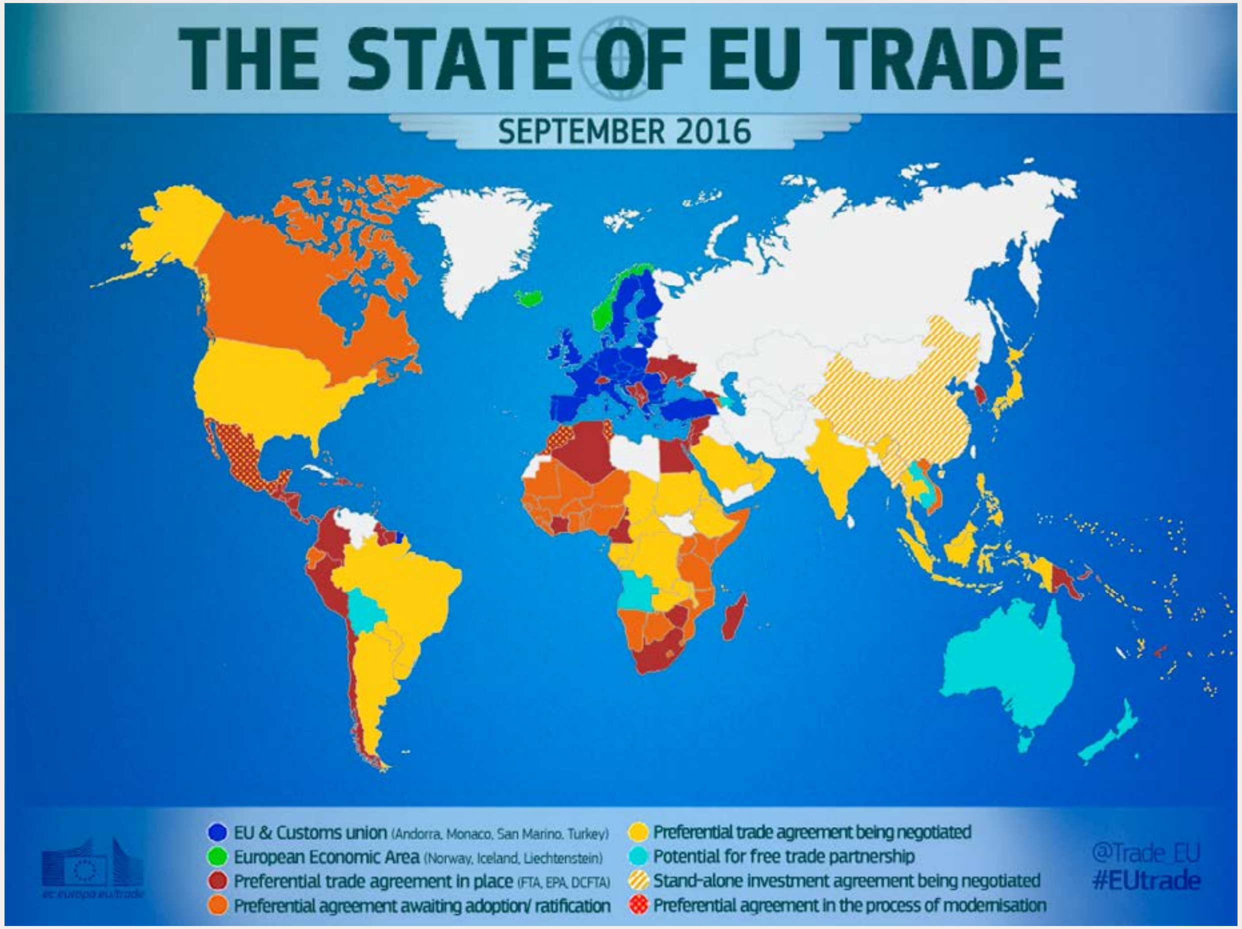
Future UK trade flows

Brexit will also affect the UK's trade with the rest of the world. Over the past twenty years, the EU has negotiated 36 free trade agreements with 58 non-EU countries, as the map on the right indicates. Several other trade agreements are in the process of being ratified or are under negotiation. The UK would not benefit from those agreements once it leaves the EU.

The UK may choose to renegotiate trade deals with all these countries, but this will be a very time-consuming and costly process. In a context where the UK would have limited access to the EU markets, multinationals and major supply chain anchors may re-assess the attractiveness of the UK as a foothold in Europe.



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Macro-economic effects

Research from the Netherlands Bureau for Economic Policy Analysis (CPB) shows that Brexit is likely to reduce bilateral trade between the UK and the EU. This would translate into significant reductions in GDP and in real income per capita as the higher costs of trade between the UK and the EU would translate into a less efficient allocation of resources across industries.

The extent of the losses is directly related to the kind of post-Brexit EU-UK trade deal that would be achieved. In the case where trade between the EU and the UK would revert to WTO rules, the remaining 27 EU countries would experience a 0.8% GDP reduction in 2030. The Brexit losses from an FTA scenario are likely to be less severe, depending also on the details of the particular agreement achieved. In the FTA scenario assumed by the CPB, the UK would face a 3.4% GDP decrease, versus a 0.6% decline for the EU27 countries in 2030.

Countries that would experience the highest losses to GDP are Ireland, the Netherlands and Belgium. As outlined above, there is a relatively large amount of trade between these countries and the UK, making them particularly vulnerable to Brexit.

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Political implications

How will the EU react to a future free trade agreement with the UK? The one thing to remember in the pending negotiations between the EU and the UK is that the EU is not a monolith. On the one hand, many EU countries would want to avoid Brexit setting a precedent, or encouraging other Member States to pick and choose from the different benefits and costs of EU membership. To avoid this, there would be an incentive not to make any exit terms too favourable for the UK. On the other hand, many EU countries trade closely with the UK and any increase in tariffs or NTBs would also hit those countries. A favourable FTA with the UK would indeed also reduce costs for the EU.

In general, EU Member States in eastern and southern Europe are less connected to the UK through trade. Those countries, therefore, would benefit less from a new free trade agreement than countries such as the Netherlands, Ireland, Belgium or Germany. Divisions in Europe on how to tackle negotiation with the UK, can therefore be expected along those lines.

Any final agreement with the UK will be subject to unanimity voting in the European Council, in addition to scrutiny by the European Parliament, as well as possibly by national and regional parliaments. This shows the magnitude of the task and points to a challenging and potentially protracted negotiation period that lies ahead.

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