Technology Across Borders: A Rejoinder

By David Hearne, Researcher, Centre for Brexit Studies

I'd like to thank Nigel for kindly letting me comment on his blog post in this fashion. Whilst we disagree about many aspects of Brexit, our discussions (in contrast to so much of the frenzied public discourse) have never been any less than civil and have always been interesting. There are also important areas where we agree. We share an optimism that in the medium term, technology has the potential to greatly reduce trade barriers around the world, including the UK – whether it is inside various EU structures or not.

I also agree that there is a risk of "over-hyping" elements of Brexit, particularly in the event of a "no-deal" scenario. There are some actions that the UK is able to take unilaterally in order to mitigate the pain of 'no deal' and the starting position of equivalence is helpful in certain respects. This is particularly true for inward-bound goods. Moreover, there are actions that can (and probably would) be taken on the part of the EU as a whole and certain EU27 states (notably France and the Netherlands) to facilitate trade. It will be difficult and it will be painful, but it is likely to fall short of the Armageddon predicted by some.

Nevertheless, just because I'd rather lose 3 fingers than my arm this does not make it sensible to take a hacksaw to my digits! It is true that only 6-8% of businesses export to the EU, but these tend to be larger and more-productive firms in sectors that engage in international trade. What about the myriad of businesses that are suppliers to those firms (or even those in tier-3 and below)? In fact, many businesses may be unaware that an export-intensive business (possibly even in another sector) accounts for a non-trivial part of their total turnover. The reality is that this 6-8% can be multiplied, particularly if one looks at employment (on average, larger firms trade more intensively). Chen et al. (2018), for example, find that some 12.2% of the UK's GDP faces trade-related exposure to Brexit with the figures in many regions much higher than that.

Focussing on the fact that the UK runs trade deficit with the EU27 and a surplus with the rest of the world is an economic fallacy. This is why:

- A UK car manufacturer buys parts worth £20,000 from Germany and uses them to build a car.
- The car is then exported from the UK to the USA and sold for £25,000.
- The workers from the factory then buy £5,000 of wine from France.

In this example, the UK has a trade deficit of £20,000 with Germany and £5,000 with France and a surplus of £25,000 with the USA. Does this mean we should prioritise trade with the USA? *No!* The trade with the USA quite clearly depends on the parts from Germany and if these become more difficult to import or more expensive to obtain then the British manufacturer will lose out (either having to pay lower wages or reduce profits – perhaps to the point of shutting down).

What about trade with France? Well, the UK is clearly not dependent on French parts to sell vehicles into the USA. Should we therefore only permit British wine drinkers to drink American wine (after all, we have a surplus with them!) Clearly not: the trade deficit would remain the same but UK consumers benefit from being able to drink French wine. There are gains from trade specialisation (interestingly recent research suggests that modelling trade to include intermediate goods gives even greater gains (Soo, 2018)) and the benefits to UK consumers are substantial. It is both normal and healthy to run a trade deficit with some partners and a surplus with others, just as I run a surplus with my employer and a deficit with my local supermarket.

What about the fact that the UK's deficit with the EU is larger than its surplus with the rest of the world? Ultimately, this is not an EU specific issue but a very British one: we run a trade deficit (and, indeed, a current account deficit) with the world as a whole. It makes no sense to split this into specific trading partners, but rather needs to be seen as a coherent whole. An increase in gross exports to countries outside the EU may only have been possible due to an increase in imported components from the EU: far from being disgraceful, that CAGR of 20% may in part have facilitated the rapid growth of non-EU exports that has been so lauded by Brexiters. Equally, if British IT staff have been particularly successful at exporting computer games to the US, and use the proceeds to buy a Porsche, should we force them to buy Cadillacs instead (so as to even out our bilateral trade deficits?) Similarly, the “suspiciously low” Euro-Sterling exchange rate is set not by some nefarious Commissioner in Brussels but rather by market forces. True, central bank policy has an impact on this but that has nothing to do with the EU. If the UK Government were so minded, it could order the Bank of England to peg Sterling to the Euro: membership of the EU is simply irrelevant in this respect.

This then leads us to the fundamentals of what leaving the EU entails for trade: increasing trade barriers with the EU. I agree that in the event the UK remains completely aligned with EU standards (particularly sanitary and phytosanitary standards) then frictions would not be as great as if they were changed wholesale. Nevertheless, the EU might still wish to certify that products do meet the relevant standards. Such certification should be relatively seamless but in order for this to be true, the UK would have to completely adhere to EU regulations (and a mutual-recognition agreement signed with the EU would be deeply beneficial in this regard).

It is difficult to see how this would sit with “taking back control” as the UK would essentially be agreeing to adhere to EU legislation but giving up its vote. Moreover, whilst the Technical Barriers to Trade Agreement rules against unjustified or arbitrary additional barriers, it allows enormous scope to countries seeking to impose “justifiable” standards (e.g. safety standards, animal welfare standards etc.) and the UK would need to maintain complete alignment with these as they changed (again with no say). This might not be as straightforward as some believe: the EU would need to be satisfied with UK implementation of any new directives. As with phytosanitary standards, certification might be an issue. Spot-checks would also need to occur to ensure that the correct customs duties have been paid (the case of smuggled garlic nicely illustrates just how difficult policing often is (Paladini, Forthcoming)). As the case of the Norwegian-Swedish border illustrates, these alone can cause delays at peak times.

Similarly, WTO status implies the UK leaving a host of other things (at least unless and until arrangements to the contrary are negotiated). There is no guarantee that UK-issued Community

Licenses would remain valid (in which case UK hauliers would need to default to either ECMT permits, which are dramatically limited in number or old bilateral agreements negotiated with EU member states). In and of itself this could add significant trade frictions at those borders where speedy movement is key (most notably the Chunnel). The EU might choose to recognise these permits but it is not automatic and for it to do so would be an essentially benevolent act (albeit perhaps in part a self-interested one given a mutual desire to avoid trade frictions).

Leaving to WTO status would also end the UK's membership of all EU regulatory agencies. Losing membership of the European Aviation Safety Agency and the European Chemicals Agency would be particularly critical, as has been pointed out in evidence to Parliament (Business Energy and Industrial Strategy Committee, 2018). Once again, it might be possible to come to an arrangement that would minimise disruption but this would be the EU's gift to give and not something the UK could do automatically. Leaving the European Medical Agency could also present issues.

Likewise, leaving to WTO status would mean being outside of the Single Market for services, creating problems for the significant number of broadcasters who broadcast from the UK into continental Europe (thanks to the Audio-Visual Media Services Directive). The loss of passporting for the financial services industry has been widely covered, but some also raise some issues for insurers and certain legal professionals. No doubt insurance policies can be transferred but the key question is whether this can be done in time in the absence of a Withdrawal Agreement.

The WTO has *nothing* to say about any of the above issues, all of which create potential additional barriers to trade. A WTO-Brexit wouldn't stop trade, nor would we all drop down dead. However, there is a very real chance of substantial short-term disruption and there are very real long-term costs to making trade more difficult even if these are more insidious than many acknowledge. Ultimately, therefore, leaving the EU will entail an economic cost but it is first and foremost a political decision taken by the UK populace.

Appendix

In macroeconomic terms, the following mathematical expression is true by definition (and can be derived from the income and expenditure definitions of GDP):

In other words, the trade deficit grows when domestic net saving is negative.

References

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