ECO FLASH

N°22-15 30 November 2022

UNITED KINGDOM: FOREIGN TRADE DECLINES DUE TO BREXIT

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The United Kingdom's exit from the European single market and the customs union on 31 January 2020 caused a significant economic shock which has had an adverse impact on growth and inflation in the UK, particularly on foreign trade.

Since 1st January 2021 and the coming into effect of the post-Brexit Trade and Cooperation Agreement (TCA), bilateral trade in goods between the United Kingdom and the European Union has fallen sharply.

The United Kingdom has made changes which mean that some of its imported goods now come from countries outside the European Union.

UNITED KINGDOM: TRADE BALANCE IN GOODS AND SERVICES

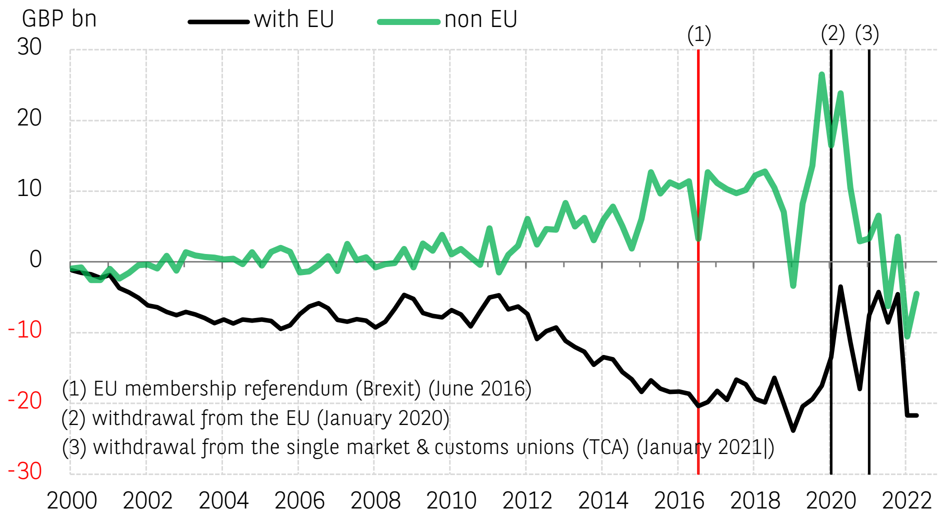

CHART 1 SOURCE: ONS, BNP PARIBAS

Brexit is an unprecedented event, with the UK leaving such a major and important area of deep economic integration as the European single market. This break-up is having very significant effects on the UK economy at multiple levels.

Firstly, the significant uncertainties that were in evidence throughout the negotiations on the exit from the EU have weighed on corporate investment and, as a consequence, on economic growth. According to a study carried out by the think tank Centre for European Reform (2022), UK GDP in Q4 2021 was 5.2% lower than it would have been had Brexit not happened.[1]

This lower growth can be explained in part by a drop in productivity, as a result of Brexit, in the region of 2 to 5% between 2016 and 2019[2]. Among other things, companies will have spent a significant amount of time planning ahead and reorganising their activities with a view to leaving the EU, to the detriment of the rest of their business activities.

1 John Springford, What can we know about the cost of Brexit so far, Policy brief, Centre for European reform, 9 June 2022.

2 Nicholas Bloom, Philip Bunn, Scarlet Chen, Paul Mizen, Pawel Smietanka and Gregory Thwaites, Thel mpact of Brexit on UK Firms, National Bureau of Economic Research Working Paper, no. 26218, 2019.

Secondly, while Brexit drags growth down, it also pushes inflation up. The introduction of customs and non-customs barriers with the UK's largest trading partner has inevitably led to an increase in import costs, which has had an impact on UK consumer prices[3]. According to the think tank The UK in a Changing Europe, this increase would be around 6% for the food sector alone.[4] Furthermore, the exit from the single market has reduced supply in the UK labour market. In 2020 around 94,000 European workers left the country, which has led to labour shortages, particularly in low-skilled jobs. More broadly, the ageing of the population is leading to a structural decline in the size of the active workforce, which is not being compensated by immigration and which is having an adverse impact on potential growth[5]. Finally, the withdrawal from the EU limits the United Kingdom's ability to make use of the European workforce, which also increases the strain on the labour market.

Thirdly, and this is the central topic of this article, Brexit has had a significant adverse impact on UK foreign trade. Effective from 1st January 2021, the Trade and Cooperation Agreement (TCA) sets out the new regulatory framework for future trade between the UK and the EU. While the EU is the UK's largest trading partner, the TCA introduces trade barriers (implementation of quotas, introduction of regulatory and health standards, etc.) which not only hinder trade but also increase the cost. However, the United Kingdom's exit from the single market has made it possible for new trade agreements to be negotiated between the United Kingdom and countries outside the EU[6], which over time could counterbalance the effects of leaving the single market and strengthen non-European trade relations.

A decline in trade between the UK and the EU has already become very apparent since the TCA came into effect, a fall that can be attributed, at least in part, to the TCA, although the difficult economic context (health crisis, consequences of Russia's invasion of Ukraine) may also be a contributory factor.

Prior to the implementation of the TCA the impact of Brexit on foreign trade was difficult to determine, but the effects on investment are clearly evident

Since the early 2000s, UK trade has primarily been with the EU. However, the gap between trade with European and non-European partners has tended to narrow since the 2010s, and it reversed in 2021.

From the point of view of the external trade balance, i.e. exports less imports of goods and services, the situation of the United Kingdom *vis-à-vis* the EU on the one hand and non-EU countries on the other has changed significantly (*Chart 1*). On the one hand, the external balance with EU member states was largely in deficit and has tended to widen since the 2000s; exports of services were not enough to compensate for the high levels of imported goods. On the other hand, the external balance in relation to non-EU countries was in surplus, with a clearly upward momentum. Indeed, exports, mainly of services, easily counterbalanced the import of goods.

The vote in favour of Brexit in 2016 was a major political and economic shock (*see Box 1*). Given the numerous uncertainties surrounding the future negotiations, the United Kingdom experienced a drop in private investment of around 11% between 2016 and 2019[7].

UNITED KINGDOM: TRADE IN GOODS

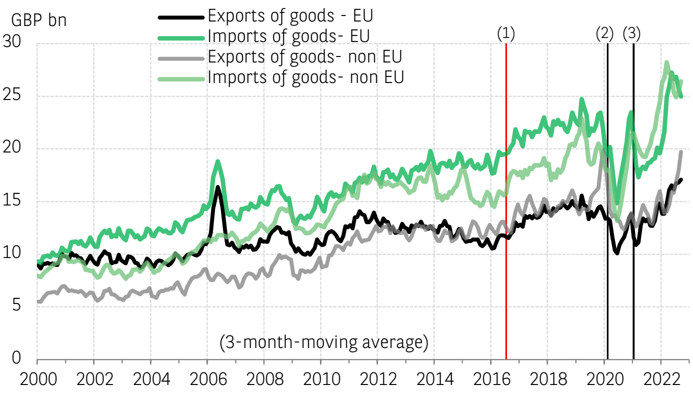

CHART 2 SOURCE: ONS, BNP PARIBAS

BREXIT

Following the referendum on 23 June 2016, the United Kingdom activated Article 50 of the Treaty on the Functioning of the European Union (TFEU) on 29 March 2017, resulting in its withdrawal from the European Union.

After numerous ups and downs during the negotiations, on 19 December 2019 the British Parliament finally voted in favour of the Brexit Bill giving effect to the withdrawal agreement negotiated between the United Kingdom and the EU. On 31 January 2020 the UK officially left the EU, but the trading arrangements between the two parties were to continue for a transitional period.

The negotiations during this period resulted in the Trade and Cooperation Agreement (TCA) on 24 December 2020, thereby avoiding a return to basic WTO rules for trade between the UK and the EU. This agreement came into effect on 1st January 2021*, but still represented a relatively "hard" Brexit as the withdrawal from the single market and the customs union represented a significant shock to the UK economy.

For more details, Hubert de Barochez, *"Brexit: the worst has been avoided"*, BNP Paribas Ecoflash, 2021.

*The TCA came into effect on 1st January 2021 through an early provisional application, to avoid a shock when the UK exited the single market on that same date. Its effective

BOX 1 SOURCE: BNP PARIBAS

However, this decrease in investment, significant as it was, took longer to materialise than was anticipated when the referendum result was announced, suggesting that the scale and persistence of the uncertainties may have delayed corporate investment choices.

3 Adam Posen and Lucas Rengifo-Keller, Brexit is driving inflation higher in the UK than its European peers after identical supply shocks, PIIE charts, 2022.
4 Jan David Bakker, Nikhil Datta, Josh de Lyon, Luia Opitz and Dilan Yang, Post-Brexit imports, supply chains, and the effect on consumer prices, UK in a Changing Europe, 2022.
5 Michael Saunders, "Some reflections on Monetary Policy past, present and future", Speech to the Resolution Foundation, 2022.
6 At 5 May 2022 the UK had 67 trade agreements in force, 5 under negotiation and 6 mutual recognition agreements.
7 Nicholas Bloom, Philip Bunn, Scarlet Chen, Paul Mizen, Pawel Smietanka and Gregory Thwaites, op. cit.

On the other hand, the high degree of uncertainty and the expectation of future customs and non-customs barriers resulted in an increase in the number of foreign direct investment (FDI) from the UK to the EU of around 17% (equivalent to around GBP 21.2 billion)[8]. Conversely, FDI from EU member countries to the UK fell by 9% (GBP 13.1 billion).

In terms of British foreign trade, the referendum had an apparently limited impact until the actual implementation of Brexit in 2020-2021[9]. The external trade deficit with EU countries fell slightly to below GBP 20 billion, while the surplus with regard to non-EU countries fell significantly, to under GBP 10 billion. Given the uncertainties of the terms of the agreement for exiting the EU, imports from the EU contracted more strongly than exports to the continent, which explains the reduction in the imbalance in the external balance.

During negotiations on the exit from the single market (2020), the deficit in the balance of goods and services reduced to a low level, a development that was difficult to interpret in terms of Brexit given the concurrent health crisis and the resulting disruptions to global trade. The Covid-19 pandemic and the restrictive measures taken by the United Kingdom largely explain this misleading improvement in the trade balance: imports of goods fell more sharply than exports of services. At the end of 2020, however, the approaching effective exit from the single market heightened concerns about a withdrawal without an agreement[10]. Against this backdrop, companies stocked up very significantly, leading to a sharp rise in imports, mainly from Europe (but also from non-European countries), in Q4 2020[11].

Since the TCA, trade between the UK and the European Union has contracted more sharply

The actual withdrawal of the UK from the single market (2021) resulted in a more obvious shock to trade with EU countries. The withdrawal from the European customs union has been accompanied by non-tariff trade barriers, such as health and phytosanitary checks, as well as checks on origin and destination. Although UK customs do not yet apply to all the checks provided for by the TCA (unlike European customs), the introduction of these barriers has already reduced trade considerably (longer delivery times, increased costs, etc.).

As regards the external balance (trade in goods and services), the TCA has resulted in lower trade with EU member states to the benefit of other countries. Overall, exports of goods and services have fallen sharply from their pre-Brexit level in 2018[12]. Exports of goods to both EU and non-EU countries were 8.3% below their pre-Brexit level in 2021 (*Chart 3*). According to the INSEE[13], the fall is more pronounced for the export values of goods to the EU (-14.3% between 2018 and 2021) than to non-EU countries (-9.8%).

This significant fall in UK exports of goods to the EU was due mainly to the impact of the health crisis, but can also be attributed to the coming into effect of the TCA. While exports of goods from the main Eurozone countries bounced back in 2021, UK exports have continued to fall.

UNITED KINGDOM: TRADE IN SERVICES

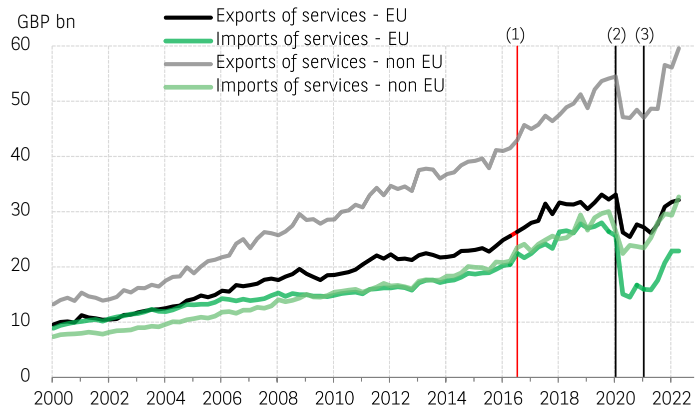

CHART 3 SOURCE: ONS, BNP PARIBAS

BRITISH POUND EXCHANGE RATES

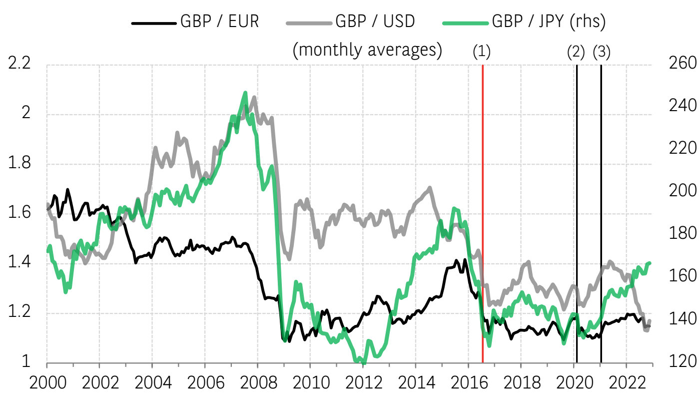

CHART 4 SOURCE: BOE, BNP PARIBAS

According to a recent study by the London School of Economics, this decline in exports of goods to the EU may only be temporary[14], except for certain products which are subject to particularly significant non-customs barriers.

In terms of trade in services (*Chart 4*), the consequences of Brexit are less detrimental than for goods, but they are still significant. Exports to non-EU countries are continuing to grow while exports to EU countries are falling sharply. This decline can be explained in part by the transfer of business activity from the UK to the EU, particularly in the finance and corporate services sectors.

8 Holger Breinlich, Elsa Leromain, Dennis Novy and Thomas Sampson, "Voting with Their Money: Brexit and Outward Investment by UK Firms", European Economic Review, No. 124, 2022.
9 Joseph Steinberg, "Brexit and the macroeconomic impact of trade policy uncertainty", Journal of international economics, no. 117, 2019.
10 A no-deal Brexit would mean that trading relations between the UK and the EU are regulated by World Trade Organisation (WTO) rules. In those circumstances the UK would not benefit from any advantages in its trade with the EU (and vice versa).
11 INSEE, "*Brexit* caused inventory activities by British companies at the end of 2020, then a probable contraction in trade at the beginning of 2021", ***Economic outlook summar***y, March 2021.
12 "2018 is taken as the pre-Brexit reference year, due to the disruption caused by the successive postponements of Brexit in 2019 (inventory effects as the March and October 2019 deadlines approached), and the effects of the health crisis on trade in 2020." INSEE, War and Prices, Economic outlook summary, June 2022.
13 INSEE, War and Prices, Economic outlook summary, June 2022.
14 Rebecca Freeman, Kalina Manova, Thomas Prayer and Thomas Sampson, "Unravelling deep integration: UK trade in the wake of Brexit", Discussion paper of the Centre for Economic Performance, no. 1847, 2022.

The consequences of the TCA on trade with the EU are even more significant in relation to UK imports. The reduction in imports of goods and services from the EU is particularly substantial (-19.8% between 2018 and 2021) while imports from outside the EU are increasing (+10.9%). According to a counterfactual study, the introduction of the TCA is likely to have reduced UK imports from the EU by 25% in 2021 compared to UK imports from non-EU countries[15]. Also according to INSEE, imports of goods from the EU have fallen sharply (-18.4% compared to 2018) in favour of imports from non-EU countries (+6.3%). In terms of services, the transfer of the sourcing of imports to non-EU countries is also evident. By Q4 2021 imports of services from non-EU countries had increased to almost their pre-crisis level (Q4 2019). By contrast, imports of services from the EU have failed to recover since the Covid-19 crisis and remain well below their pre-Brexit level.

The small decline in exports compared to imports can be explained by a foreign exchange effect, benefiting from the depreciation of the pound sterling following the referendum. The National Institute of Economic and Social Research (NIESR) points out that this depreciation has also made the UK more competitive in terms of exports, while reducing domestic demand due to the increased cost of imports[16].

Behind the general decline in trade with the EU, bilateral trade between the United Kingdom and the various European partners has not evolved in the same proportions. Imports of goods from Germany and France saw the largest falls, -18.6% and -14.1% respectively between 2018 and 2021 (compared to -10.7% on average for the EU as a whole). Conversely, British exports to France fell less (-13.5%) than those to the rest of the EU (-25.2%).

Ultimately, the implementation of the TCA has had a significant negative impact on the UK's trade with the EU, particularly in goods. The introduction of non-customs barriers with its main trading partner has also caused an increase in import costs and a drop in UK growth, both actual and potential. While the previous Prime Ministers, Boris Johnson and Liz Truss, had stated their willingness to renegotiate the TCA (or to withdraw from it in the event of refusal by the EU), the subject is still on the table for the new Prime Minister, Rishi Sunak. Will he decide to reopen discussions on the TCA and the Northern Ireland Protocol (*see Box 2*)? What new commercial, industrial and budgetary measures could be put in place to mitigate the impacts of Brexit on the economy? So Brexit is far from complete.

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NORTHERN IRELAND PROTOCOL

In the negotiations on the United Kingdom's withdrawal from the EU, both parties recognised the unique situation of the Republic of Ireland and Northern Ireland, requiring a particular solution in order to reconcile the various interests.

In the context of the Good Friday peace agreement (Belfast Agreement) of 10 April 1998, the Protocol on Ireland and Northern Ireland, effective from 1st February 2020, provides for three main measures.

Firstly, it avoids the establishment of a physical border between the Republic of Ireland and Northern Ireland in accordance with the Good Friday peace agreement.

Secondly, it preserves the integrity of the EU's single market as well as its safeguards in terms of consumer protection, public and animal health and the fight against fraud and trafficking. These customs checks on persons and goods are to take place at the sea border between Northern Ireland and Great Britain, and not at its land border with the Republic of Ireland (which would be contrary to the 1998 agreement).

Thirdly, it maintains Northern Ireland in the customs territory of the United Kingdom so that it can benefit from future free trade agreements concluded by the United Kingdom. In addition, the UK and the EU have created a so-called "consent" mechanism in order to give the Northern Ireland Assembly a decisive vote regarding the long-term application of relevant EU legislation in Northern Ireland*. Every four years, the Assembly may agree (by simple majority) that the relevant EU legislation will continue to be applied or it may decide to terminate it.

As soon as the TCA came into effect, the United Kingdom challenged the terms of the Protocol and was notified of a breach of the provisions of the Northern Ireland Protocol.

* Alignment with European regulations on goods and customs, the single market for electricity, value added tax (VAT) and State aid.

BOX 2 SOURCE: BNP PARIBAS

15 Rebecca Freeman, Kalina Manova, Thomas Prayer and Thomas Sampson, op. cit.

16 Paul Mortimer-Lee, "Improved trade balance with the European Union raises challenging Brexit questions", UK Economic Outlook Box Analysis, National Institute of Economic and Social Research, 2022.

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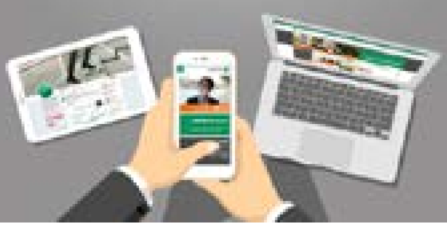

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