Losing Preferential Access to Third Countries after Brexit - What is at stake?

With the re-election of David Cameron as prime minister in 2015 it became clear that he will hold a referendum that questions the current status of the UK as an EU member. This has immediately triggered a lot of research about the possible economic consequences of a British exit (Brexit) from the EU. In March 2017 Theresa May, who followed David Cameron, has formalised the exit by invoking Article 50 of the Treaty of the EU. The negotiations, which started in June 2017 have, however, proven to be difficult due to widely divergent requests of both parties. That is why we still lack knowledge about the precise conditions of a Brexit, implying that in order to simulate the economic effects of a Brexit, assumptions about the negotiations outcomes have to be made. In a nutshell most Brexit studies assume the following options: a "hard" and/or a "soft" version of the Brexit. The former implies imposition of Most Favoured Nations (MFN) tariffs between the UK and the EU countries whereas the latter assumes some sort of Trade Agreement (TA), see e. g. Aichele and Felbermayr (2015), Boulanger and Philippides (2015), Rojas-Romagosa (2016), Freund et al (2017), Dhingra et al (2017), Yu et al (2017), Felbermayr et al (2017), Vanzetti (2017) and Bellora et al (2017).

A pending question concerns the UK's future status of TAs that have been negotiated between the EU and third countries.[1] Legally those contracts are only valid for EU members and leaving the EU while retaining the status quo enshrined in the TAs would contradict with the MFN principle. This is true as long as the UK decides either to treat all WTO countries equally or ceases to be a WTO member. In order to retain TAs, the UK will have to re-negotiate these trade deals - a difficult task given that the EU has negotiated 36 TAs with 58 different countries.[2] In a similar vein the UK would also legally be excluded from EU's Generalized System of Preferences (GSP), where the EU unilaterally opens its markets for about 90 developing countries, see e.g. Molinuevo (2017). In this regard, looking at potential effects of changing trade relations between the UK and third countries seems to be a scenario worth looking at, which has not drawn so much attention in the literature so far. Exemptions are Aichele and Felbermayr (2015), Felbermayr et al (2017), Vanzetti (2017) and Yu et al (2017), who also impose MFN tariffs between the UK and third countries in their "soft" and "hard" Brexit scenarios. However, since the authors include third-country MFN tariffs in all of their Brexit scenarios, it is not possible to delineate the single effect of losing preferential access to third countries negotiated under the auspices of the EU. This paper contributes to this discussion by specifying appropriate scenarios that allow to disentangle these effects. This is important since we lack an understanding of how significant these effects might be relative to the changing trade environment vis-à-vis the EU. Additionally, there might be interesting trade diversion effects. For example, it could be beneficial for the United States (no TA with EU) if the UK and Canada (TA with EU) impose MFN tariffs on each other's imports as a consequence of the Brexit.

From a methodological point of view we employ a systematic way to calculate trade-weighted MFN tariffs that are part of all Brexit scenarios. Therefore, we compile a list of "MFN-countries" that trade

[1] The term "third countries" refers to all countries that are not member of the EU.

[2] This is also the position of the House of Lords (2016): "On the balance of evidence, we conclude that the UK is unlikely to be able to retain access to the EU's FTAs with third countries following Brexit"[HoL(2016), p.49].

with the EU/UK on MFN basis in a first step, excluding all countries with preferential access like TAs or GSP. Then we calculate average MFN tariffs for the EU/UK where the imports from the "MFN-countries" are used as weights in a second step. The same procedure is applied to compute the MFN tariffs of third countries vis-à-vis the UK. This is in line with the approach presented by Yu et al (2017). In addition to Yu et al (2017), we also assume that the UK will not remain part of the GSP after Brexit. This means that all GSP beneficiaries will export on a MFN basis to the UK after Brexit.

The following scenarios are considered in this study:

- **Base**: A baseline-scenario is constructed where macroeconomic projections for GDP and population are considered in the period of 2017-2027. Additionally, all currently decided trade agreements by the EU (including CETA) are sequentially introduced until the projection horizon in 2027. A Brexit is not assumed in the baseline.
- **S1**: "Soft" Brexit-scenario where we abstract form tariffs but assume an increase in trade costs that are associated with leaving the principles of the EU Single Market. These trade costs include administrative costs that can be attributed to rules of origin.
- **S2**: "Soft" Brexit as in S1 but the UK loses its preferential access to third countries and turns away from GSP.
- **H1**: "Hard" Brexit-scenario where the UK and the EU reciprocally invoke MFN tariffs on each other's imports. Regulatory trade cost will rise due to leaving the single market in addition to MFN tariffs.
- **H2**: "Hard" Brexit as in H1 but the UK loses its preferential access to third countries and turns away from GSP.

This scenario set-up allows us to deduce the causal effect of UKs loss in preferential market access to third countries on all variables in the model. This may be accomplished by comparing S1 with S2 and H1 with H2 respectively. To quantify our scenarios, we employ the Modular Applied General Equilibrium Tool (MAGNET), a global computable general equilibrium model which is based on the GTAP9 model and database, see Woltjer et al. (2014) and Hertel (1997). Table 1 illustrates the consequences that the different scenarios might have on GDP. Besides the UK and EU we portray results for European Free Trade Agreement (EFTA) area where a TA with the EU exists and Australia and New Zealand where there is no TA. First of all, Brexit is most harmful for the UK since the EU is relatively more important to the UK than vice versa. The GDP losses in the UK range between 2.31 and 3.17 %. The EU loses unanimously from a Brexit. On the contrary some countries outside the EU stand to benefit from a Brexit because now some trade is diverted to them, e.g. Australia and New Zealand. Under the "soft" as well as in the "hard" Brexit case additional GDP losses are about 0.8 percentage points due to reciprocal imposition of MFN tariffs with third countries. In percentage terms this is more than the loss for the EU. In the full paper we will focus more on the consequences of losing preferential access to third countries by looking on the disaggregated model results, i.e. we will have a closer look at sectoral and country level effects.

Table 1: Changes in GDP relative to Baseline, in %

	UK	EU	EFTA	AUS & NZL
S1	-2.31	-0.63	0.20	0.21
S2	-3.11	-0.60	0.10	0.23
H1	-2.42	-0.81	0.24	0.26
H2	-3.17	-0.79	0.13	0.29

In summary: in this paper we extend the existing literature by focussing on the impact of changing trade conditions - concerning RTAs and GSP - with third countries following Brexit.

Literature

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