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TRADE WAR : BAD TIMING FOR BREXIT 'TAKE BACK CONTROL'

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The British domestic political crisis has overshadowed the quick transformation of the broad political economy of Brexit. Yet, 'take back control', the very purpose of the Brexit vote in June 2016, turns out to be more challenging today in a more chaotic international framework.

Obviously, withdrawing from the EU happens to be more difficult than expected. The Irish border issue was not anticipated at the time of the referendum and squaring the circle of the exit still continues to fuel intense debates after more than three years.

In addition, the exit does not provide a strategy for a post-Brexit economy. 'Global Britain', the motto set to keep up the momentum on the withdrawal process, remains a nostalgic aspiration to recover the British empire's influence by "secur[ing] ambitious new trade deals with all partners across the world",[1] rather than a concrete plan to be more attractive once out of the EU.

But above all, the global economic framework is more adverse for an autonomous UK.

Brexit was voted in a time of "globalisation as usual". Value chains had started shortening with the stop of the decrease of offshoring costs in the early 2000s, but opening markets worldwide remained the main trend.

Today, Brexit would materialise in a more fragmented world with a regionalisation of value chains suggesting a *slowbalisation* and a growing role for the geopolitical dimension of trade. While much of the growth in global trade will come from the service sector dependent on geographical proximity, the resurgence in demand in the US and the EU for an identity based approach of production and consumption and increasing public support to climate change mitigation should increase this trend of regionalisation. In addition, Trump's aggressive "America first policy" and his push-back on Chinese economic power based of force rather than on rule-based regulation are producing unpredictability and much turbulences for business. Forced alignment on the American or Chinese interests is becoming the new rule to avoid sanctions and/or to secure foreign direct investment. In this troubled global framework, with technological leadership contest reshuffling economic dependencies, taking back control is a different challenge for the UK.

1. Queen's speech, 14 October 2017.

The mutual spill-over effect of Brexit and the 2020 global economic framework call thus for greater attention.

The disruption caused by a disorderly Brexit - which cannot be ruled out today-, or an important post-Brexit divergence from EU norms, could derail an already gloomy global economic forecast, creating a more adverse framework to 'take back control'. For a country weighting on its own 2.2% of global GDP (PPP), decoupling from the EU norms might also not be enough to become an autonomous rule setter. It might well lead to a more constraining alternative alignment.

1 . The global spill-over effect of Brexit

Despite a new withdrawal agreement, a no-deal scenario still remains on the table. Without a clear Tory majority coming out from the 12 December 2019 general elections, a vote on Boris Johnson's deal, agreed with the EU-27 on 17 October 2019, remains hypothetical. Alternatively, a Labour majority opening the way to a second referendum would not guarantee a Remain vote and could still end with a disorderly Brexit, following a fourth extension of article 50 period that Europeans would grant for the organisation of the referendum.

In all estimates, no-deal remains the worst-case scenario, with major frictions brought back between the UK and the EU-27 - or other countries - leading to the highest GDP loss. By hitting immediately, without transition, it would have the greatest distortive effect, adding unpredictability to the immediate negative impact of the exit. Considering the risk of UK recession spiralling into a Eurozone recession, it is the global economy that could be thrown off-course by a no-deal Brexit.

Alternatively, a vote on Johnson's deal would open the way to a transition period, intended to be short but which could last two and most probably more years to deliver on the future relationship. It would postpone the withdrawal impact, with the UK remaining in the Single market and the Customs union for the duration of the transition and with a limited negative impact due to the unpredictability of the outcome of the negotiation.

Yet, according to a first estimate, Boris Johnson's deal would have an impact much closer to the one of the no-deal than Theresa May's deal. The latter planed a close cooperation and minimum trade frictions combined with a backstop for the Irish border that would have ensured the UK's participation to the EU Customs union, level playing field guaranties and an extended free trade agreement. On the contrary, in Johnson's deal, the UK would have no customs union with the EU, a limited free trade agreement, a potential large divergence from EU norms and yet no clear level playing field arrangements. The higher range of negative economic impacts would be: - 8.7% GDP per capita ten years after Brexit for no-deal, - 7% for Johnson's deal and - 5,5% for May's deal.[2] The spill over impact of Johnson's deal could thus be quite similar to a no-deal Brexit if Johnson was to largely decouple from EU norms.

1.1. UK, the biggest loser

The next day the UK leaves the EU without a deal and becomes a third country, customs controls are restored between the UK and the EU-27 to ensure the compliance control and the tariffs collection. The mobilisation of the technological and human resources required to re-establish these controls is a major challenge in itself. Congestion and bottlenecks at the borders would hit value chains. This accumulation of logistical problems, the additional supply delays, the increase in customs tariffs and new non-tariff barriers resulting from the end of regulatory alignment with the EU would seriously undermine bilateral trade and

2. "The economic impact of Boris Johnson's deal", *UK in a Changing Europe*, 13 October 2019.

the flows of foreign direct investment. On top of those well anticipated issues, there are numerous pending regulatory issues that would add disruption, starting with the personal data transfer on hold as well as with intelligence data share.

The UK would be the most affected country. It is more dependent on the EU than the EU or any single member state is dependent on the UK, with the exception of Ireland, which could be almost as badly hit as the UK. Exports to the EU represent 12.2% of UK GDP, while exports from the EU-27 to the UK represent 2.6% of EU GDP.[3] The EU is by far the UK's first trading partner: in 2018, trade accounted for 63% of the British economy[4] and UK exports to the EU were 46% of total UK exports, while UK imports from the EU accounted for 54% of all UK imports.[5] The UK relies largely not only on the Single market, but also on EU FTAs, with around 15% additional UK exports heading to countries that already have a trade agreement with the EU[6].

Contingency planning in the UK, as much as in the 27 member states, would mitigate those frictions. Between November 2018 and October 2019, the Bank of England's estimate of a disorderly divorce has thus been scaled down for the UK, from 8% to 5.5% of GDP loss in the next two years[7].

Yet, the OECD recently anticipated that, with a loss of 2% of GDP growth over the period 2020-2022, the UK could fall into recession in the near term.[8] The total export volumes from the UK would drop by 8% in the short term, and down by 15%-20% in the medium-long term.[9] Similarly, business investment in the UK would fall by 9% as soon as in 2020.[10]

1.2. Lower exposure of EU-27

Considering the close ties between the two blocs, EU-27 would also be affected by a no-deal. But EU's value chains are less exposed than the UK's ones. In 19 member states, the level of trade-related exposure to Brexit is less than 2% of national GDP, and it is less than 1% in 12 member states.[11] The EU value added share in EU exports to the UK is not higher than 2%, whereas the UK value added share in UK exports to the EU is 9%.[12] In addition, the total effect of tariffs on production costs in a no-deal would be inferior for the EU producers (+ 0.08 %), compared to the UK (+ 0.86 %).

Overall, EU exports to the UK are likely to drop by 1% immediately after a no-deal and by 16% in the medium-long run.[13] On the business investment side, the EU would lose 2% in 2020-2021.[14] And it would suffer from a GDP loss by 0.5% in the near term.[15] Ireland, the Netherlands, Belgium, Germany and France would suffer the greatest GDP

3. "Cost of No Deal revisited", *UK in a changing Europe*, 2018, p18
4. « What Would a No-Deal Brexit Look Like?", Andrew Chatzky, Council of Foreign Relations, 28 August 2019.
5. « Statistics on UK-EU trade », Matthew Ward House of Commons Briefing Paper, 7851, November 2019.
6. « Of transition and trade deals », Samuel Lowe, Centre for European Reform, 16, 2018. For example, in 2017 almost 4% of UK exports went to Switzerland, 2.3% to Japan, 1.5% to Canada and 1.4% to Singapore, all countries that signed an FTA with the European Union.
7. « BoE trims forecast of pain in no deal scenario », Valentina Romei, *The Financial Times*, 4 September 2019.
8. OECD Economic outlook 2019, September 2019.
9. OECD, September 2019.
10. OECD, September 2019.
11. *The UK in a Changing Europe*, 2018.
12. "EU-UK global value chain trade and the indirect costs of Brexit", Rita Cappariello, Michele Mancini, Filippo Vergara Caffarelli, *Vox CEPR Policy Portal*, 22 March 2019.
13. OECD, September 2019.
14. *Idem*.
15. *Idem*.

loss. Ireland would experience the worst GDP loss (1½%) in the near term,[16] but Germany could well be the Achilles' heel of the Eurozone.

1.3. Downside risks for Germany and spill-over effect on the Eurozone

A no-deal would cause a major disruption on such an export-based economy, which is already suffering from the Brexit unpredictability and the US-China trade war, cutting German-UK exports by over 50%[17] and causing losses of over €3.5 billion for German exporters.[18] While Germany's Central Bank warns that the country may have already entered into recession in September 2019, a no-deal would directly push into recession the fourth economy in the world, which represents 3.22% of global GDP (in PPP).[19]

This would have a direct spill-over effect in an already stalling Eurozone. The European Central Bank estimates that even if the Eurozone would only feel a hit equivalent to 10%-30% of what the U.K. suffers, the slowdown could lead to a recession.[20]

In addition, a coincidence of a no-deal Brexit and of a 25% increase of tariffs on automobile and intermediate parts imported in the US, as threatened by Donald Trump, would directly increase the risk of recession of the Eurozone. The US is the largest market for German auto exports, worth EUR 27.2 bn,[21] and increased tariffs would entail a loss of 0.2% of the GDP of the first economy of the Eurozone. A Single market suffering a recession of the Eurozone would accelerate the drop out of imports of UK goods.

Should the UK benefit from an exemption of auto tariffs in the framework of a close cooperation with the US, it would still be affected by its impact on global auto value chains, as the biggest spill-over effect of these potential auto tariffs would be felt at the level of global value chains: 1.5 times greater than direct effects on the German auto industry.[22] The overall impact on the global economy would be significant as the global auto trade accounts for 8% of total world trade.[23]

1.4. Risk of global recession

In July 2019, the IMF outlook for global growth considered a no-deal Brexit as one of the main events that could add risk aversion on an already strained global market, with highly leveraged borrowers and indebted governments, to the point that it could make the global economy derail.

With a new escalation in the US-China confrontation at the turn of the summer, the warning is taken more seriously: a no deal could kick-start a downward spiral for the global economy. It remains to be seen whether the conclusion of a US-China mini-deal can mark a truce in the escalation of reciprocal sanctions ahead of the December deadline for new US tariffs on $300 bn Chinese imports and new Chinese tariffs. Indeed, the confrontation between the two big powers turns out to be more structural, with not only a trade war but a contest for technological leadership and competition between two opposed systems of values[24]. Yet, in addition to the indirect impact of the US-China tariffs via the global value chains, it is the unpredictability created by the mutual

16. OECD, 2019, *idem*.
17. « The German economy is slowing. Brexit could make it worse », Azhar Sukri, *Al Jazeera*, 28 January 2019.
18. « German businesses already incurring Brexit losses, says industry boss », Srinivas Mazumdaru, *DW*, 7 October 2019.
19. *Statista*, H. Plecher, 28 October 2019
20. « How a No-Deal Brexit May Become a Problem for the World Economy », David Goodman, Craig Stirling, and Liz McCormick, Bloomberg, 4 October 2019
21. « Factbox: German exposure to U.S. tariffs on European car imports », Ilona Wissenbach, Jan Schwartz, Edward Taylor, Reuters, 22 February 2019
22. « Trade Wars 3.0 », Goldman Sachs, 6 June 2019
23. « US-EU Auto Tariffs: What's at Stake? » , Ole Moehr, Atlantic Council, 28 August 2019.
24. Frederic V. Malek Memorial Lecture. Mike Pence, Wilson Center, 24 October 2019.

retaliation of tariffs that is responsible for the decrease of the global foreign direct investment and for the global economic slowdown. Any additional uncertainty added by a no-deal Brexit is therefore feared as the extra straw that broke the camel's back.

In case of no deal, developing countries would be particularly hit not only by a spectacular decrease in aid to development by 8%, exacerbated by a devaluation of the pound,[25] but by potential distortive effect on the preferential regime of new imports tariffs imposed by the British government, despite the roll over the European Generalised system of preferences (GSP).

While a derailing global economy would hardly be helpful for a transitioning UK, it remains to be seen how it can navigate in the turbulent waters of fierce competition between regional trade powers.

2 . Global Britain or loss of leverage?

Trade partners are vocal about their willingness to cooperate with post-Brexit UK. But they are cautious. They first need to know what will be the new UK-EU relationship to assess the UK's attractiveness. In other words, they need to see what the final trade-off between the recovery of British sovereignty and the loss of access to the European market is. Any divergence from EU regulation would result in limiting access to the EU market. Third countries would consider the sole British market instead of looking at it as a door gate to the Single Market. Rather than a springboard for a Global Britain, legal autonomy could well mean a loss of leverage.

2.1. The weight of UK outside the EU

For many years the UK has been considered by third countries as a gate-way to Europe offering competitive advantage to international firms and has been appealing for inwards foreign direct investment. However, the weight of the UK's economy on the next day after a disorderly withdrawal would be directly downgraded from the world trade "premier league" - the US, the EU and China – to the second division trade powers.

Together in 2018, the US (15%), the EU-27[26] (14%) and China (19%) command 48% of the global GDP (PPP),[27] 45% of global trade in goods and 42.6% of global trade in services (in both cases not counting internal EU trade). The EU-27 represents 13.1% of global trade in goods and 17.6% of global services. With or without the UK, the EU would remain the world's second largest economic power after China in GDP (PPP) terms.

The EU has been able to negotiate for its member states some 40 trade agreements worldwide with almost 80 partners, notably thanks to the harmonised regulations of its internal market, still the largest one in the world, by number of consumers and by purchasing power.

Outside the EU, the UK represents 1.9% of global trade in goods, 4.9% in global trade in services, and hardly 2.2% of global GDP (PPP).[28] As such, the UK would still be the sixth largest economy in the world after India,[29] but it would be a second-tier economy, close to South Korea 1.58% of global GDP (PPP).

If the UK were to decouple from EU norms, it would lose the EU's bargaining power in trade negotiation with third countries, whatever

25.« Brexit and development : How will developing countries be affected? », Max Mendez-Parra, Phyllis Papadavid and Dirk Willem te Velde, Overseas Development Institute, 2016.

26. For the purpose of this analyse intended to provide an order of magnitude, data corresponding to EU27 has been calculated by withdrawing the UK data.

27. *Idem*.

28. IMF, 2019.

29. The UK and the France remain shoulder to shoulder in the global economic ranking.

successful economic policies are conducted by the British government. The difficulties encountered by the British government to roll-over current EU FTAs, with trade partners willing to review the agreements with a more bargaining approach, are already a glimpse at this post Brexit reality. The UK's downsized leverage will be less of a problem when negotiating with economies of equivalent size like South Korea, but a more obvious one with the three powers: EU, US and China.

2.2. The temptation of differentiated regulatory divergence

While Theresa May's intention to keep the UK aligned on EU regulations could have led to a *Brino*[30] with little 'take back control', Boris Johnson presents himself as willing to recover legal autonomy. He is obviously tempted by some sort of differentiated regulatory divergence allowing to balance costs and benefits gained from regulatory dumping – i.e. the so-called 'Singapore-on-Thames' scenario.

This could echo what Robin Niblett, director of Chatham House,[31] suggested, as soon as in December 2017, as the scenario of a "sensible Brexit", which would be a combination of independence, equivalence and subservience to EU regulation.[32] The UK could differentiate three baskets of regulations:

- Take back regulatory control in sectors that have little impact on bilateral trade (such as workplace safety, air and water quality),
- Adopt its own rules where the country has a comparative advantage and regulatory expertise, such as for financial services and climate change mitigation, etc., while ensuring that the level of precaution of its rules is equivalent to that of European legislation. Should the UK diverge from EU regulations in these sectors, it would lose access to the single market.
- Commit to full alignment with EU regulations in the sectors that are heavily dependent on the single market (agricultural produce, pharmaceuticals, chemicals, aviation, cars, … perhaps competition policy, including state subsidies), but with British courts enforcing EU rules.

This scenario would allow the British to recover their sovereignty in some areas, while British regulators would guarantee the same level of precaution set by European standards. At the time of the proposal, the main stumbling block acknowledged was the Europeans' trust in UK regulators to prevent any risk of additional regulatory divergence, a trust which may well not be enough glue to keep the system together and which would require a complex control and a dispute settlement system.

Yet, beyond the intractable challenge to determine which regulations are essential for the functioning of the single market, preserving a level playing field between the UK and the EU-27 is now a major objective for the Europeans. Environmental or social standards cannot be considered optional. Not only the single market's coherence and integrity would be called into question, but also the unfair competition from the UK would be at stake. If Johnson's deal is voted, the EU-27 made clear that during the transition period, it will take care that the future relationship is based on a level playing field conditionality. As the EU negotiator, Michel Barnier, put it: "zero tariffs and zero quotas" could only go along with "zero dumping". The leeway for differentiated regulatory divergence would obviously be restrained.

30. Brexit in name only.
31. Robin Niblett, "Finding a Sensible Brexit", Chatham House, 12 December 2017.
32. Joe Owen, Alex Stojanovic, Jill Rutter, "Trade after Brexit. Options for the UK's relationship with the EU", Institute for government, 18 December 2017. Denis Staunton, "UK looking for allies – but what about Ireland's friends in the EU?", 22 January 2018.

If alternatively, Johnson was resolute to push for full divergence from the EU regulations and intended to compensate the immediate economic loss with a negotiation with an old ally and attractive market like the US, it would expose the UK to a more constraining alignment.

Since he arrived in power, Donald Trump welcomed a close cooperation with the UK. His Secretary of Commerce, Wilbur Ross made it clear when, on the 21 October 2019, he called to "team up with the UK against the EU".

However, the US offer goes along with alignment on US regulations and has to be considered in the framework of the power competition requesting from US partners to align more systematically on American interests and politics. A close partnership with the US might as well suggest an alignment on US policies, including aggressive policies towards the EU and China, based on unilateralism, protectionism, retaliation and a weakening of rule-based regulation.

2.3. Forced regulatory alignment

The UK would be much more economically dependent on the US than the opposite. The urgency of striking a deal after a disorderly Brexit, or in the case of large divergence from EU norms, would leave the UK with even less leverage in a bilateral negotiation. Trump has already been vocal on his willingness to gain access to the British market for US agriculture exports and to the NHS for US pharmaceuticals. He would most probably leave the UK with little possibility for cherry picking. The gains for Britain from a US-UK deal in terms of GDP growth have been estimated as lower than 0.2% over a 15-year period,[33] clearly not enough to counteract the Brexit effects on the short and long run. But above all, the recently British recovered sovereignty might be eroded by forced alignment on US geo-political and geo-economic priorities.

A close cooperation with the US might notably limit the UK's autonomy vis à vis the Chinese market. The new USMCA (United-States-Mexico-Canada Agreement), following the renegotiation of NAFTA, includes a provision impeding Canada and Mexico to start free trade negotiations with China or they would lose their preferential treatment. This might set a precedent for other US bilateral agreements. The trade war is now doubled by a leadership contest over technologies calling US business to disengage from strategic technological value chains that involve specific Chinese firms. While Washington "urge[s its] allies around the world to build secure 5G networks",[34] pressure on other countries and multinationals to avoid having business with companies like Huawei or ZTE could turn out to be a more systematic forced alignment with the US approach of strategic autonomy. Would- be/potential partners or allies might have, as well, to adopt US export control and investment screening rules.

On its side, the EU - as a regional power – is developing its own approach. It builds its resilience capacity on WTO compatible retaliation measures and notably refuses to add its agriculture and food market in a bilateral negotiation to avoid lowering its sanitary and phytosanitary regulations. Europeans share US criticism of Chinese unfair competition practices, but they do not follow the Trumpian approach of a unilateral force-based confrontation that infringes multilateral rules. The European Commission has now put forward an offensive agenda to tackle trade distortions exercised by China, designated as a "systemic rival". While pressing Beijing for more reciprocity and level playing field in their own bilateral negotiation, Europeans opt for a rule-based global order and call for more multilateral rules to ensure level playing field for all. If they stick to this challenging objective to bring back the US and China to the negotiating table to agree on new multilateral norms, it is precisely because their regional power leverage allows

33. « EU exit analysis, Cross Whitehall Briefing », House of Commons, UK, January 2018.
34. *Idem*, Pence, 2019.

them to develop an autonomous policy and to stand with a leadership position rather than only align on the US or the Chinese interests.

The paradox is that the current global turmoil tends to give more evidence that a shared sovereignty, while being member of the EU preserves a country's ability to be a rule setter and provides it with more grip than as a sovereign state out of the EU. While the US, as much as China, are building their resilience capacity for a long lasting confrontation of economic competitors and value systems rivals, the EU shield appears more meaningful for its member states.

Conclusion

In 2016, Brexit vote was meant to allow Britain to regain legal autonomy away from the exclusive competences of the EU. It happened then to be more clearly understood as a trade-off between the recovery of the British sovereignty and the economic cost of the withdrawal from the EU. At the turn of 2020, the reality of the global stage, with a technological war engaged, is now adding new constrains on Britain's 'take back control'. While alignment on regulations creates a level playing field, the tendency from the US and China to weaponise it in a more aggressive geopolitical confrontation of rule and value systems might be complex to manage for a post-Brexit UK if it wants to preserve itself from forced alignment.

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