4 – UK trade prospects after Brexit[1]

Key points

- World trade growth has slowed relative to global GDP growth since the financial crisis. This slowdown has been exacerbated recently by weaker growth in emerging markets and the commodity trade cycle.
- UK export performance since 2007 appears to have been stronger outside the EU than within the Single Market. This could reflect an advantage to euro area members have from using a common currency or the inflexibility of trade linked to European supply chains. The UK also has a strong comparative advantage in services trade, which is growing more strongly globally than trade in goods.
- Medium-term growth prospects remain strong in key emerging market regions, including Asia, Africa and the Middle East. That suggests that the recent downturn in trade growth outside the developed economies should prove temporary, and that UK export growth to markets outside the EU should soon resume momentum.
- The key policy priorities for improving UK trade prospects after Brexit should be: securing the best possible access to the Single Market; a programme of trade promotion in non-EU markets; supply-side reform; and active engagement with other major international institutions – including the World Trade Organisation.
- New Free Trade Agreements with countries outside the EU will take a long time to secure and are therefore likely to offer limited benefits to UK trade in the immediate aftermath of Brexit.

Introduction

The referendum decision to leave the European Union (EU) raises questions about the UK's future trade relationships with the rest of the world. At present the UK enjoys full access to the Single European Market. Other EU countries account for 44% of our total exports of goods and services and 53% of imports. Countries trade more readily with their nearest neighbours, so the rest of the EU will continue to be a significant trading partner for the UK. But if access to European markets is more restricted in the future, then the UK will become more reliant on other more distant markets to support the growth of trade.

Forging new trading relationships with other countries outside the EU is a major challenge. The UK's current trade agreements exist via its EU membership, and complex trade agreements are not easy to negotiate and agree. So there is also a big question-mark over the UK's future trade relationships with the rest of the world as an independent trading nation outside the EU.

This article looks at how the UK might meet this challenge in a post-Brexit world – reviewing recent trends in world trade and the future prospects for export market growth.

Section 4.1 considers the recent pattern of world trade growth, where there has been a noticeable slowdown since the financial crisis. This appears to reflect the fact that world trade enjoyed a particularly strong boost in the 1990s and early 2000s from the process of globalisation. In the absence of a new wave of trade liberalisation, world trade growth is unlikely to return to the strong dynamism that we saw in the past.

Section 4.2 discusses the pattern of UK trade growth in recent years. Here there are mixed messages. The UK has done well in recent years in tapping export growth opportunities outside the EU and has a strong position in services industries. However, in Asia and other emerging markets, import growth has slowed sharply over the past couple of years. So future prospects for UK exports outside of the EU hinge on whether this is a temporary slowdown or a more sustained weakening of import growth.

Section 4.3 looks ahead at future UK trade prospects, both in the EU and externally, and the final section aims to draw conclusions about the UK's policy options outside the EU.

1 This article was written by Andrew Sentance, Senior Economic Adviser at PwC and former member of the Monetary Policy Committee.

4.1 - World trade has been sluggish since the financial crisis

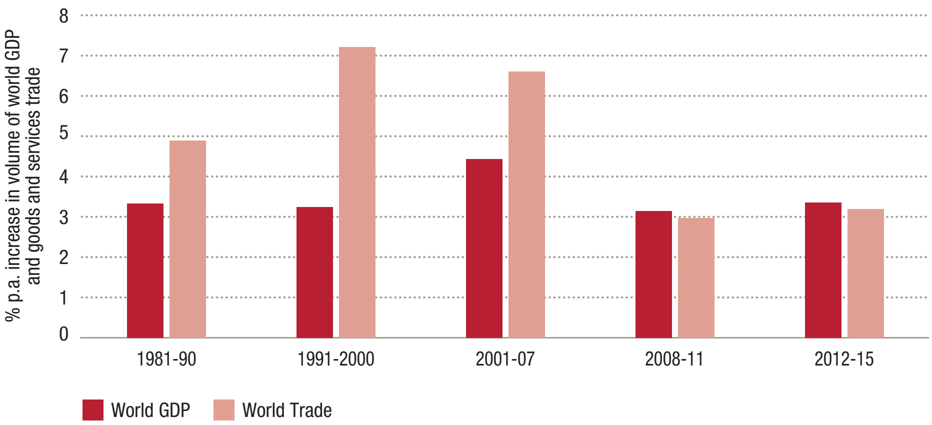
In the 1980s, 1990s and in the 2000s before the financial crisis, we became accustomed to world trade increasing at around 1.5-2 times global GDP growth, as Figure 4.1 shows. The period from the early 1990s until 2007 saw a particularly strong expansion of trade across the world economy. In the fourteen years 1994 to 2007, the IMF's measure of world trade (which includes services as well as goods) increased on average by nearly 7% a year, compared to world GDP growth of around 3.5%. World trade was very volatile during and immediately after the financial crisis, but since 2012 has averaged just over 3% - slightly below the rate of growth of global GDP (3.4% using the IMF's preferred measure).

Various hypotheses have been put forward to explain the relatively sluggish performance of world trade in recent years, particularly compared with the period 1980-2007. The latest report from the World Trade Organisation (WTO) pointed to a number of factors: changes in the import content of demand; absence of trade liberalization; creeping protectionism; a contraction of global value chains (GVCs); and possibly the increasing role of the digital economy and e-commerce. The WTO's conclusion is that all have most likely played a role[2].

Another factor which has acted as a drag on world trade growth recently has been the slowdown in China and the associated commodity price downturn – which has reduced import demand from many commodity-producing countries.

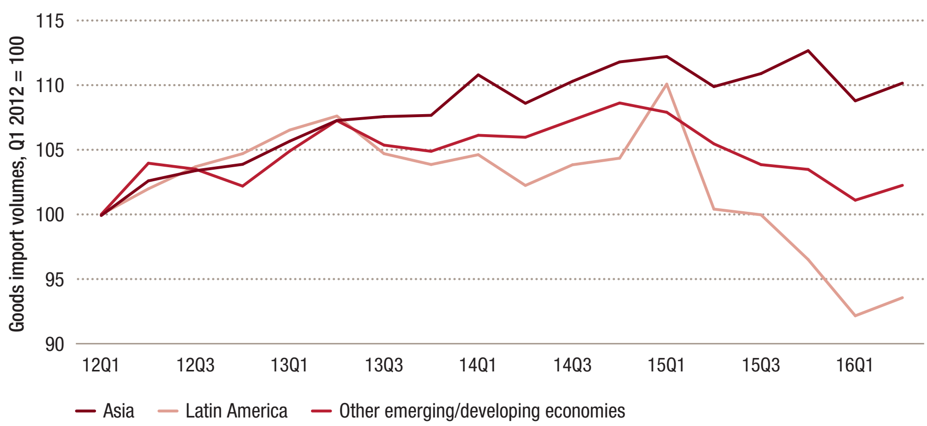
Figure 4.2 shows the level of merchandise import volumes since 2012 in the key emerging market regions of the world. In South America, import demand peaked in mid-2013 and has since fallen by 13%. In Asia, goods import volumes have been relatively flat since 2014 and, in the rest of the emerging and developing markets, import volumes peaked in late 2014 and have since fallen by around 6%. In the more mature western markets, however, import growth has been much stronger as falling energy and commodity prices have boosted consumer incomes. Since mid-2013, import growth has averaged nearly 4% per annum in North America and around 3% in Europe.

Figure 4.1 – World GDP and trade growth



Source: IMF World Economic Outlook, October 2016

Figure 4.2 – Import volumes in emerging/developing regions



Source: World Trade Organisation

2 WTO Trade Outlook, 27 September 2016.

A key question in terms of the outlook for world trade is the extent to which these regional movements are signalling long-term trends, or whether they are just part of the swings and roundabouts driven by the recent commodity cycle. We will return to this issue later in the article.

The other feature of recent trade performance which deserves some comment is the growing importance of services trade. World goods trade has increased by an average of just over 4% per annum in dollar terms over the past decade, while world services trade has increased by 8% - nearly twice as fast. Currently, commercial services trade – as measured by the WTO - is around 28% of the value of goods trade. But this figure was just 20% ten years' ago.

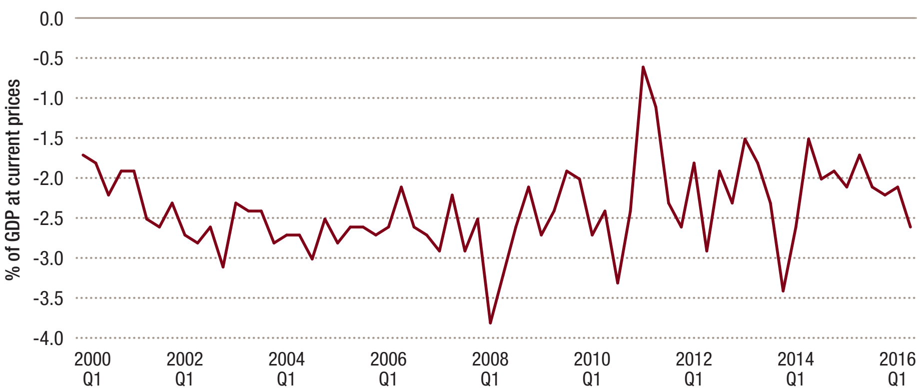
Trade in services has the potential to become much more important across the world economy, as the digital economy grows in significance and regulatory and other barriers to services trade are reduced. In most major economies, services activities account for around 70% or more of GDP. For the UK, which has a strong comparative advantage in many tradable services industries, this is a major area of opportunity.

4.2 - Recent UK export performance

Against this background, how have UK exports been performing? One of the key economic policy concerns since the financial crisis has been that the UK has experienced a widening current account deficit. That has been mainly due to changes on the income side of the balance of payments, reflecting profits paid abroad or received here in the UK by international companies. The UK's trade deficit – including both goods and services – has been more stable in recent years than the overall balance of payments position, with the gap between exports and imports fluctuating around minus 2-2.5% of GDP (see Figure 4.3).

The period since the financial crisis has featured volatility and disappointing trade growth, as we have seen. So the key issue for the UK is how well its exports have performed in relation to key indicators of world trade. One obvious benchmark is how UK trade volumes have increased relative to world trade more generally. Another key indicator is to measure the UK's trade performance relative to its trade partners within the EU. It is informative to do this in terms of both EU internal trade and exports to non-EU countries.

Figure 4.3 – UK trade balance in goods and services since 2000



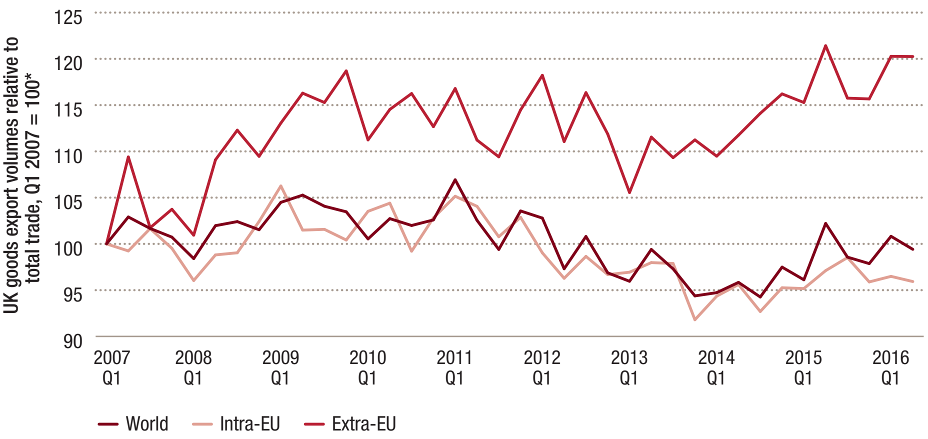
Source: Office for National Statistics

Figure 4.4 shows these comparisons, going back to the beginning of 2007 before the financial crisis hit and before the pound started sliding against other currencies. UK exports have broadly kept pace with world trade volumes since 2007 and have slightly underperformed within the European single market. It is in markets outside the EU where UK exporters appear to have outperformed their counterparts in the European Union. UK exports to countries outside the EU have grown by about 20% more than the average of European exports to third party countries. This is an encouraging indicator of the ability of the UK to grow its trade with non-EU countries.

The absolute growth of export volumes supports this view of better UK performance in markets outside the EU. Compared to the level in the first quarter of 2007, UK exports to the rest of the EU were actually 1.7% lower in volume terms (in Q2 2016) according to the latest figures. By contrast, UK exports to non-EU countries are now 43% higher than in early 2007.

Why do UK exports appear to have performed better in markets outside the EU than within the single European market? We know, of course, that European economic growth has been sluggish since the financial crisis, particularly in southern Europe. But that does not explain the picture shown by Figure 4.4, which is one of relative underperformance – i.e. with UK exports growing more slowly than the general level of intra-EU trade. Nor does the decline in the sterling exchange rate offer an obvious explanation – sterling has declined against both the euro and non-euro currencies since the financial crisis.

Figure 4.4 – UK relative trade performance since 2007



Source: PwC calculations based on data from World Trade Organisation and ONS

Note*: UK total exports relative to total world imports and UK intra-EU and extra-=EU exports relative to EU totals

One reason could be that countries in the euro area have a trade advantage within the Single Market relative to countries outside the euro like the UK because of the stability and predictability of operating in a common currency. Another potential explanation is the nature of trade between the UK and other EU countries. UK manufacturers exporting to the rest of the EU are often part of complex supply chains, which are relatively inflexible and do not allow businesses to take advantage of changes in competitive advantage, such as a fall in the value of the currency.

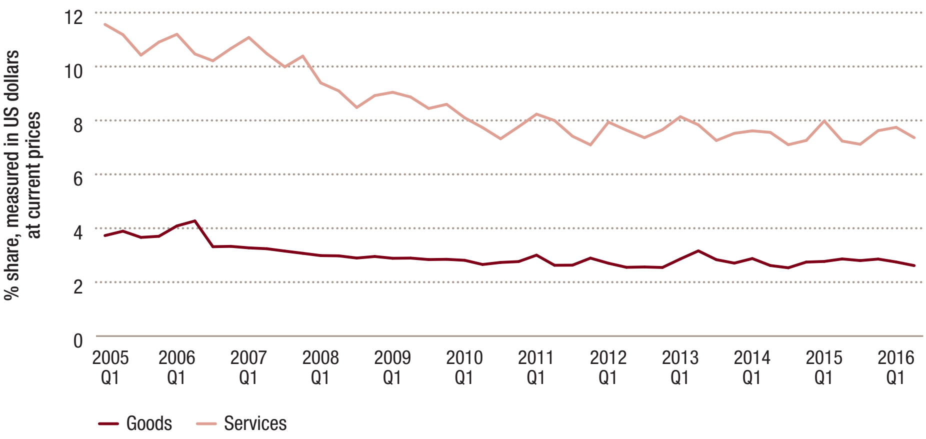
Both of these explanations could also help account for the fact that UK exporters appear to have been more successful outside the European Union than within the Single Market. If countries within the euro area have focussed their efforts on intra-EU trade, it is perhaps not surprising that a country outside the euro area like the UK has performed better outside the EU. In addition, if UK exporters were constrained by complex supply chains in terms of their exports into the Single European Market, they may have been able to exploit non-EU markets more flexibly.

Whatever, the reason, this record of relative export success outside Europe is a positive signal for the trade performance of a UK economy which is no longer a member of the EU.

The data shown in Figure 4.4 and discussed above relate, however, solely to exports of goods. The UK is a particularly successful exporter of services – with a strong comparative advantage in a range of sectors, including financial services, business and professional services, IT and communications, design and media, and travel and tourism. These tradable services play a strong role in the UK services sector, with the result that the UK exports a higher share of GDP than any other G7 economy. Our services export share is around 12% of GDP, compared to about 8% in Germany and France, 4% in the United States and 3% in Japan[3]. In absolute terms, the UK is the second-largest exporter of services in the world behind the United States.

3 UK services trade trends were discussed further in a previous UK Economic Outlook article by Andrew Sentance here: http://www.pwc.co.uk/assets/pdf/ukeo-jul2015.pdf

Figure 4.5 – UK shares of total world trade in goods and services



Source: World Trade Organisation

As we noted earlier, services trade has been much more dynamic than goods trade across the global economy. Figure 4.5 shows the UK's relative share of world trade (measured in dollar terms) in goods and services. Both the UK goods and services shares of world trade have declined by about a third since before the financial crisis. The decline in the value of sterling has contributed to this downward shift, as has the decline in financial services exports since the 2008/9 crisis. But the UK continues to hold a stronger position in global services trade than in goods, with over 7% of global exports of services compared with just over 2.5% in goods. With the UK accounting for around 3.5% of global GDP, it is fair to say that it punches below its weight in the world economy in goods trade, but significantly above its weight in the services industries.

4.3 - Prospects for UK trade after Brexit

The nature of the UK's separation deal with the European Union will clearly have an important bearing on our trade with the rest of the EU, but nothing dramatic is set to change in the short-term. The UK remains a full member of the EU until Article 50 negotiations are concluded, which is not expected to be the case until 2019. Then, there will need to be a transitional period for both the UK and the rest of the EU to adjust their administrative systems and laws and also to negotiate any new UK-EU trade deal. Trade arrangements during this transitional period remain to be negotiated.

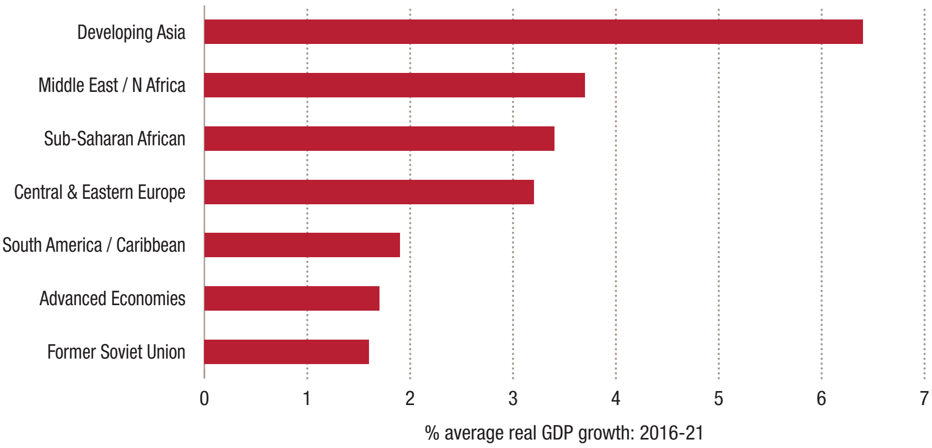
However, even before any formal separation, there could be impacts of the EU referendum decision on trade and foreign direct investment flows. These could arise because firms start to relocate their activities in anticipation of any formal separation between the UK and the rest of the EU.

It is very early days to assess how significant these shorter-term changes in trade flows might be. They are probably likely to be happen more quickly in the services sector - where activity can be moved more easily in and out of countries – than in manufacturing, where export activity is determined by long-term investment decisions.

In addition, as we have seen in the recent case of Nissan, the UK government appears keen to offer reassurances to major investors to prevent any major exodus of economic activity from the UK – particularly affecting regions outside London and the South East. This will act as a further countervailing impact on any quick diversion of trade activity. The recent decline in the exchange rate could also offer some short-term relief to exporters, though the UK mainly exports high value-added goods and services which are not especially price sensitive. The most likely scenario is that any Brexit impacts on trade flows in and out of the UK are likely to be slow-burning and not felt in a significant way until 2020 or later.

In the 2020s, the UK could find itself outside of the European Union Single Market and the EU Customs Union. This raises the prospect of tariff and non-tariff barriers to trade being higher than now with the UK's main European trading partners. On the other hand, other European countries would then face higher trade barriers in terms of their access to the UK market. So a policy of general trade restrictions between the UK and the rest of the EU is not the most likely outcome. But it is quite possible that some sectors will face much more restricted access to the European market than at present in the 2020s.

Figure 4.6 – Medium term regional growth prospects



Source: IMF World Economic Outlook, October 2016

The potential offset to this negative trade impact within the EU is the prospect of better export growth in markets outside Europe. This does not hinge on striking new free trade agreements with non-EU countries, however. As we have seen, the UK has been quite successful in achieving strong export growth outside the EU under the current set of trade agreements and partnerships with other countries.

What, then, are the consequences for the UK of the fact that imports from Asia, South America and other parts of the emerging world have slowed or turned down quite sharply in the past 2-3 years? Though this is a worry, there are good reasons to believe that this downturn in the emerging market contribution to trade is related to the commodity cycle and the adjustments taking place in the Chinese economy. As the latest IMF forecast showed, the broader economic prospects for economies in Asia, the Middle East, Africa and Central Europe are still quite strong (see Figure 4.6).

We should beware of reading too much longer-term significance into recent emerging market import trends.

Even before the Brexit decision, our latest analysis of export prospects[4] suggested that the share of EU markets as a destination for UK exports of goods and services would fall to around 37% by 2030. If the UK faces additional barriers to accessing EU markets post-Brexit, then this share could drop more quickly – possibly to 30-35% by 2030. UK exporters would face the challenge of increasing exports to other geographical markets to compensate.

Where might exporters look beyond Europe to develop overseas sales? Despite all the talk of new trade deals with Australia and other Asian economies, the trade opportunities available to the UK may lie closer to hand. First, over 20% of UK exports of goods and services already go to the United States and Canada. The UK is well placed to access North American markets because of geography, language, strong historical ties and a common business culture. But a more protectionist attitude to world trade following Donald Trump's victory could limit these opportunities within the US and in other countries, for example if a change in US policy starts to undermine the global trading system based on the WTO. On the other hand, President-elect Trump has previously suggested that he might be open to a trade deal with the UK after Brexit, so there are possible upsides as well as downsides in terms of future US-UK trade relations.

Second, Africa and the Middle East are our next closest geographical markets after Europe. Together, these markets currently account for just over 6% of world GDP but they are home to around 20% of the world's population.

Third, the UK can reach out to countries on the eastern fringe of Europe – including Turkey and central European countries which have not yet joined the EU. Some of these economies have strong growth potential as long as they can remain stable politically.

4 See the article in our November 2015 UK Economic Outlook report for details of these long term UK export projections by destination: http://www.pwc.co.uk/assets/pdf/uk-economic-outlook-full-report-november-2015.pdf

4.4 - Policy implications

The notion that the UK needs to wait to strike a new set of trade deals with other countries outside the EU to protect and enhance its trade relationships with the rest of the world does not reflect current economic and political realities. Trade agreements take 5-10 years to agree and implement and the UK would be starting from a relatively weak position. The UK's current trade relationships depend on its membership of the European Union – either through the Single Market or other trade deals negotiated by the EU. Talk of striking new trade deals with Australia, India, China or any other country is not the best way of safeguarding UK trade interests in the next 5-10 years.

Instead, the UK government should be focussing on four key policy priorities to ensure that export opportunities are maximised and consumers are safeguarded from tit-for-tat protectionism and new tariff barriers.

First, the UK needs to secure the best possible access to the Single European Market once it has left the EU.

One way this could be achieved is through a transitional arrangement which allows the UK to remain as a member of the European Economic Area (EEA) until a new comprehensive Free Trade Agreement is negotiated between the UK and the EU. This could be a basis for the "soft Brexit" which many in business favour.

An alternative scenario is that there is a much more fundamental break between the UK and the Single Market, but that could still be cushioned by securing deals which protect key sectors – like the automotive industry and financial services. This sectoral approach, however, contains the danger that the UK government is drawn into a more interventionist strategy in terms of individual investment and business decisions. While this may be attractive in terms of short-term politics, it threatens to undermine the principles of market forces and competition which the UK promoted in the 1980s and 1990s to establish the single market in the first place.

Second, trade promotion – rather than ambitious new trade deals – should be the focus of government activity to support exports in countries outside the EU.

The UK's success in developing export markets outside the EU in the past decade suggests that the current world trade environment – overseen by the WTO – has not hampered the ability of the UK to grow exports in non-EU markets. In addition, the UK has a strong comparative advantage in trade in services, where trade agreements have historically been less important in facilitating new export market opportunities. Most trade agreements tend to focus on trade in goods.

Clearly, the UK should be an active participant in the WTO and support the development of free trade in both goods and services globally. But these objectives may be better achieved by supporting broader multilateral trade agreements involving a number of countries, rather than single-handedly trying to negotiate deals with much stronger countries like the US and China.

Third, the UK economy will continue be an attractive base for trade and a magnet for investment if the conditions under which business operates are attractive to domestic and overseas investors.

This means having a positive "supply-side" agenda aimed at overcoming existing constraints to economic growth and creating new business opportunities.

The UK benefited from a radical programme of supply-side reform in the 1980s and 1990s, which addressed historic failings in industrial relations and introduced market disciplines into sectors of the economy which had been dominated by the public sector. But, since then, a number of other economic constraints have emerged on the supply-side of the UK economy. The supply of housing is not able to respond to demand, in part because of planning constraints. There have been prolonged delays in developing new infrastructure. The tax system has become over-complicated and offers confused economic signals to individuals and businesses. And the UK skills and education system would benefit from further adaptation to the demands of a modern economy – particularly in terms of vocational education and apprenticeships, as argued in our recent Young Workers index report[5].

A government which is openly and actively committed to addressing these supply-side issues would put the UK economy in a strong position to attract investment and activities which contribute to international trade. As discussed in Section 3 above, this should be a priority for the Chancellor in his Autumn Statement and beyond.

Finally, the UK needs to work actively to maintain areas of economic and political co-operation outside the structures of the European Union.

One of the features of the UK which has made it attractive as a location for trade and international investment is that it has been a key contributor to a wide range of international forums, including the EU. This includes security and defence co-operation (via NATO and the UN Security Council) as well as more mundane activities like the development of international standards. The UK needs to ensure its decision to leave the EU is not seen as undermining its broader status and policy of engagement in the global community – which is a feature of the UK economy which attracts much international business activity.

Conclusion

There are clear risks to the UK's trading position created by the referendum vote for Brexit – particularly in relation to the Single European Market. But there are also some offsetting strengths which have underpinned recent UK trading performance. The UK has achieved strong export growth in markets outside the EU. And it has a strong position in tradable services.

The challenge for policy-makers now is to maximise the opportunities and limit the damage from severing close economic and political ties with the EU. This will require skilful political negotiation and an economic policy mix which supports business competitiveness and investment. The UK's trade performance in the years ahead and its ability to strengthen its position in non-EU markets will be a key indicator of how successfully this issue is being managed.

5 This report is available here: http://www.pwc.co.uk/services/economics-policy/insights/young-workers-index.html

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