The UK and the European Union Insights from ICAEW – Trade

The issues at the heart of the debate

This paper is one of a series produced in advance of the EU Referendum on 23 June 2016 looking at the nature of the relationship between the UK and the EU for trade.

What the Remain Campaign says

The EU is the UK's main trading partner, worth more than £400bn a year, or 52% of the total trade in goods and services. The idea that the UK alone could hold sway in an increasingly fractured trading system dominated by the US, the EU and China is misconceived.

What the Leave Campaign says

The EU is not as important to British trade as it used to be, and continuing turmoil in the eurozone will make it even less so. The UK would be free to establish bilateral trade agreements with fast-growing export markets such as China and India through the WTO.

On 23 June, the British people will have their opportunity to decide whether to stay in or leave the European Union (EU). ICAEW would like to see a wide-ranging evidence-based debate over the coming months so that our members, as well as the wider electorate, can make an informed choice when casting their votes. To achieve this, ICAEW has produced a series of reports focusing on the UK's relationship with the EU in three areas: trade, employment and financial services.

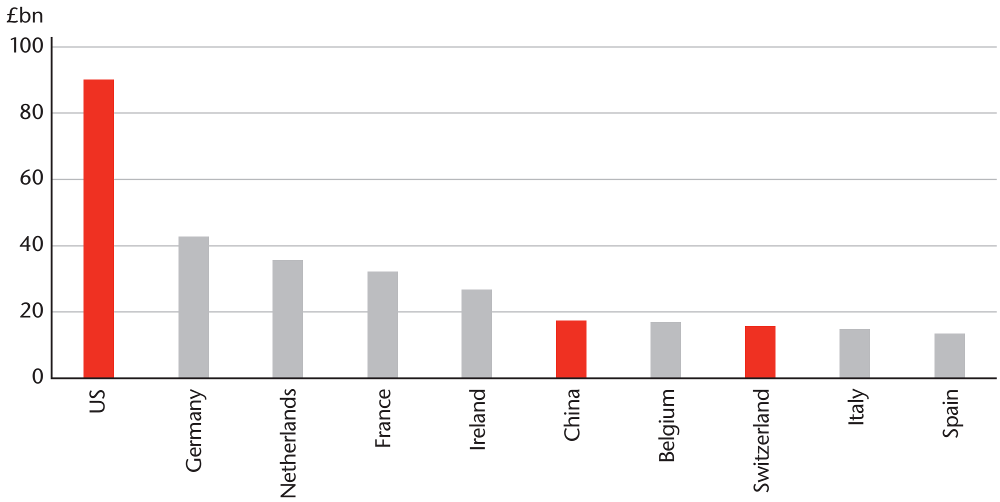
In this report, we look at a number of key aspects of trade including the current nature of trade between the UK and EU (goods and services), the reliance of different UK industries on trade with the EU and the impact of EU membership on foreign direct investment.

The impact of a UK exit of the EU on the UK's trade would depend, to a large extent, on the trade deal the UK is able to secure in exit negotiations. If the UK voted to leave the EU on 23 June, there would be a two-year period during which the current rules governing trade between UK and EU companies would not be altered. Further analysis should focus on what a tailored trade agreement between Britain and the EU might look like and how a change in the status quo could impact overall UK trade.

Impact on trade

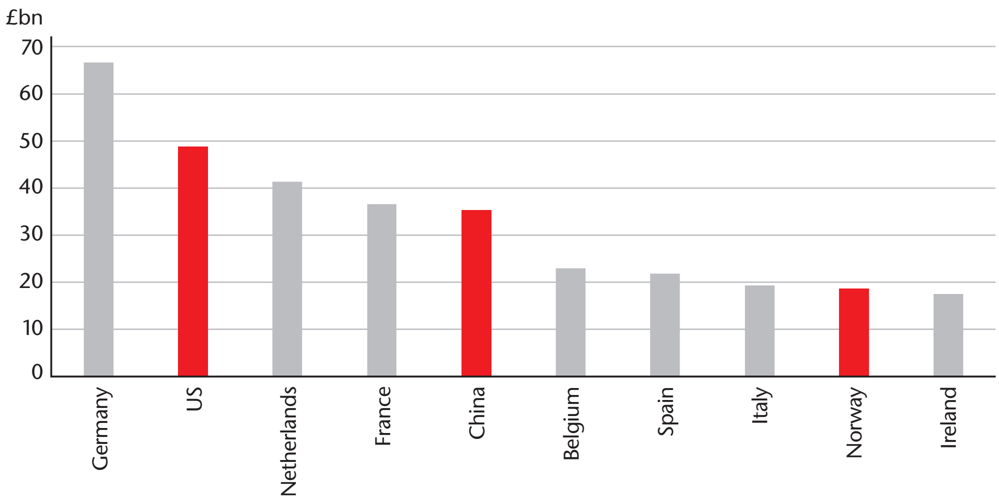
Trade is an important part of the UK's relationship with the rest of the EU. The internal market, which seeks to guarantee the free movement of capital, goods, services and people between member states, is at the core of the EU project. The EU is the UK's single largest trading partner and UK exports and imports together account for around 60% of UK GDP. In 2014, the EU accounted for 44.6% of UK exports of goods and services and 53.2% of UK imports of goods and services.[1] As shown in Figure 1 and Figure 2, 7 of the UK's 10 largest import and export markets are other countries within the EU.

Figure 1
Top 10 UK export destinations in 2013 (£bn)



Source: Office for National Statistics Pink Book 2014, Cebr analysis

Figure 2
Top 10 nations for UK imports in 2013 (£bn)

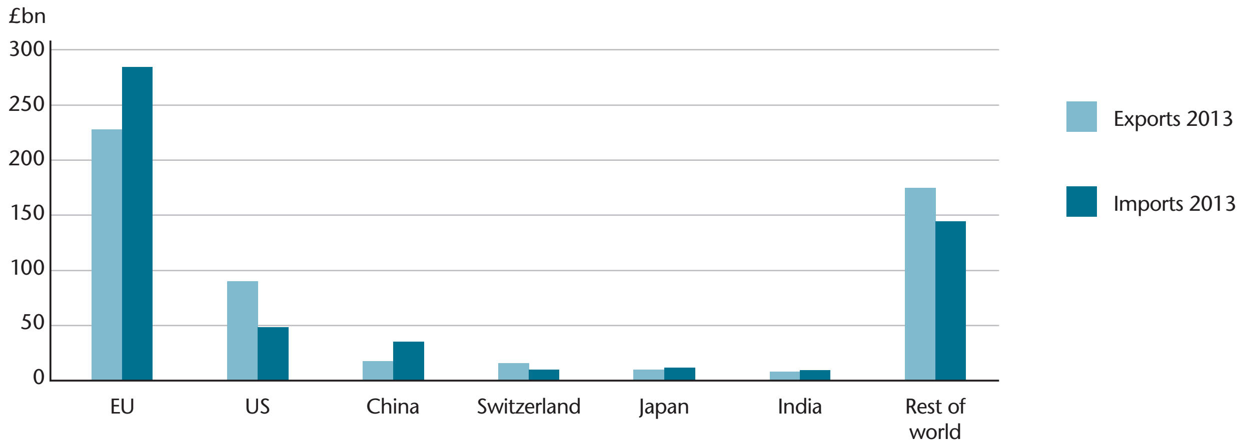


Source: Office for National Statistics Pink Book 2014, Cebr analysis

1 2014 figures show only the EU–non-EU split in UK exports. 2013 figures show the full breakdown.

Figure 3 shows the UK's trade with the EU when viewed as a single entity against trade with other major economies. Both imports and exports to the EU are over twice the size of those to any other market. It also shows that we run a large trade deficit with the rest of the EU, importing £56bn more than we export. This is partially offset through surpluses versus the US and the rest of the world, although the UK still runs a substantial trade deficit overall.

Figure 3
Exports to and imports from the EU shown against other major world markets (£bn)

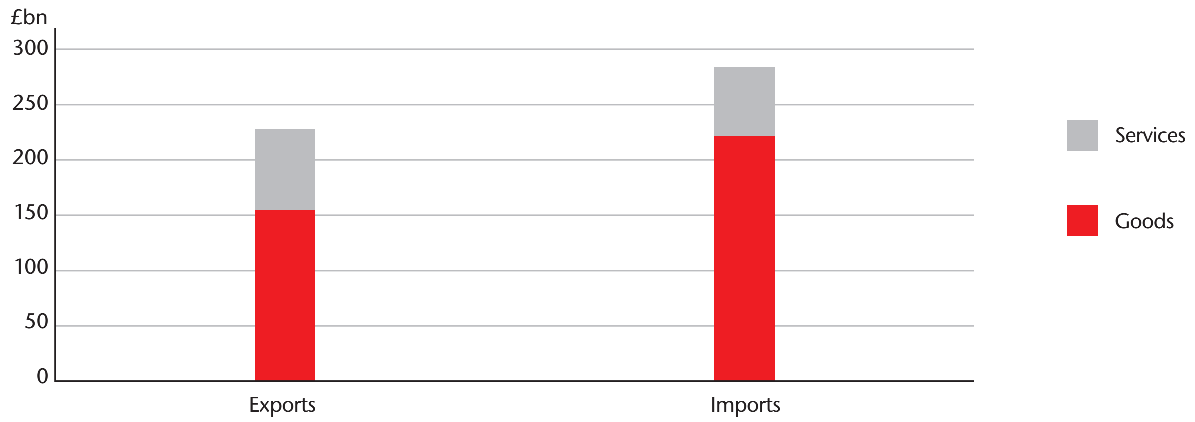


Source: Office for National Statistics Pink Book 2014, Cebr analysis

Nature of trade between the UK and EU

As shown in the diagram below, UK trade with the EU is still dominated by goods, despite both economies being heavily service-oriented. Imports are more strongly skewed towards goods, at a 78% share versus 68% for exports. The UK runs a large deficit in trade in goods and a modest surplus in services, which amounts to a sizeable deficit overall.

Figure 4
Breakdown of trade with the EU by goods and services (£bn)

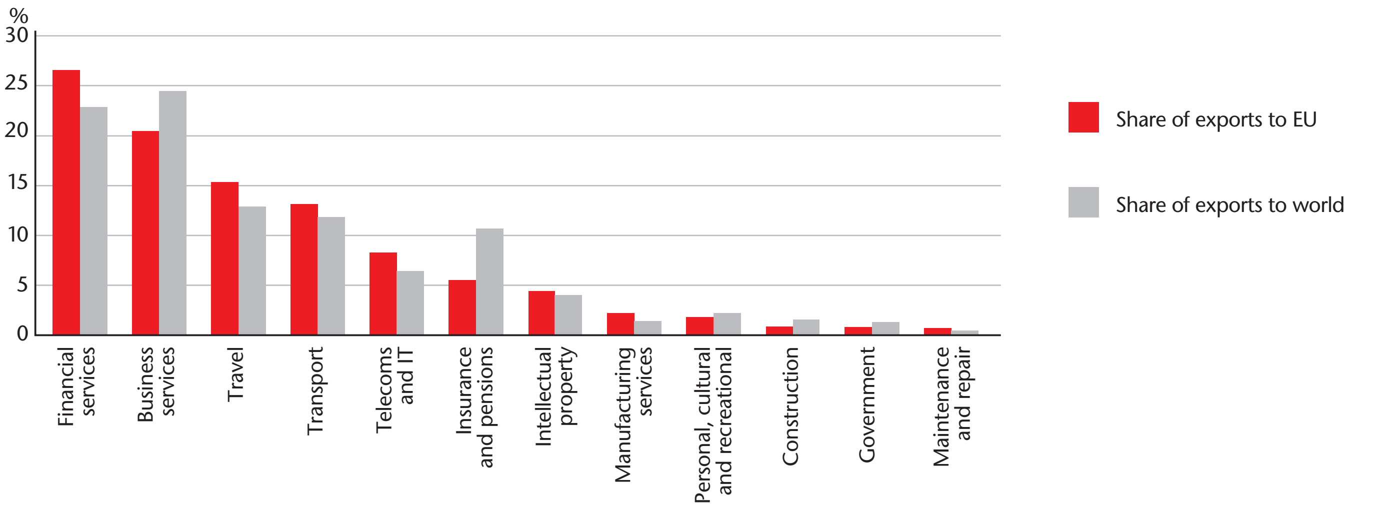


Source: Office for National Statistics Pink Book 2014, Cebr analysis

Trade in services

Figure 5 shows the UK's service exports by sector, both to the EU and to the rest of the world. The dependence between the financial services sector and the EU is clearly visible (see our report dedicated to financial services for more on this). Financial services and business services are far ahead of the rest of the categories. The UK also makes significant export earnings from travel. Since tourism is an export from the point of view of the host country, much of the money that EU and other foreign citizens spend while visiting other countries shows up here.

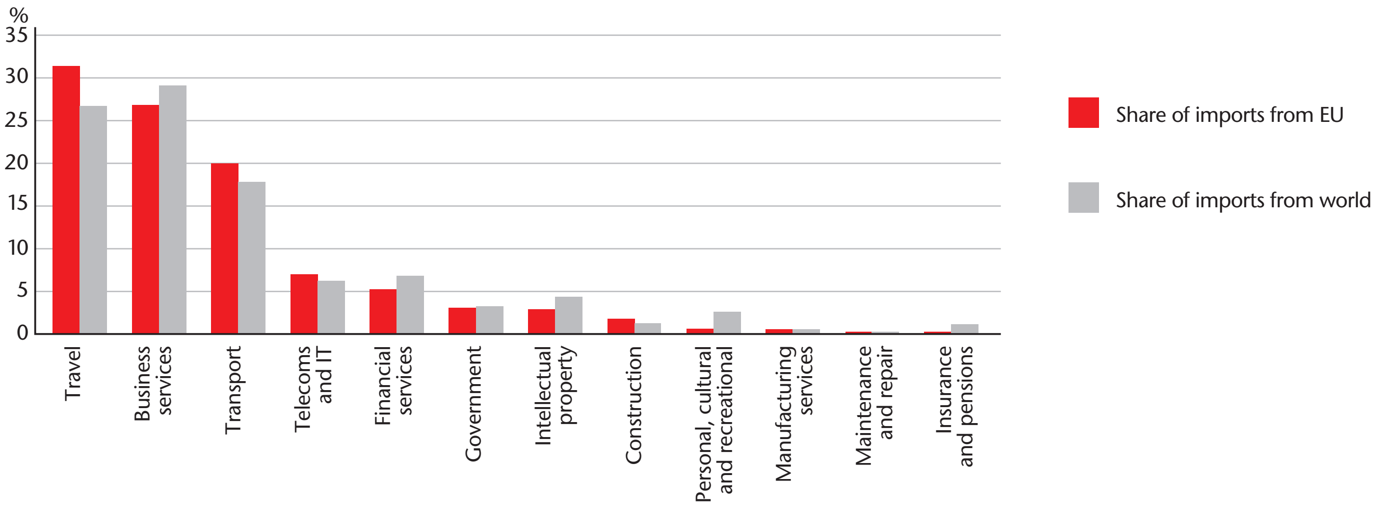
Figure 5
UK service export shares to the EU and to the world, 2013



Source: Office for National Statistics Pink Book 2014, Cebr analysis

The graph below analyses the shares of the UK's service imports from the EU, comparing it to the same categories' shares in all imports. The largest import is travel. Almost 80% of service imports from the EU into the UK are in three categories: travel, transport and business services.

Figure 6
UK service import shares by sector from the EU and from the world, 2013



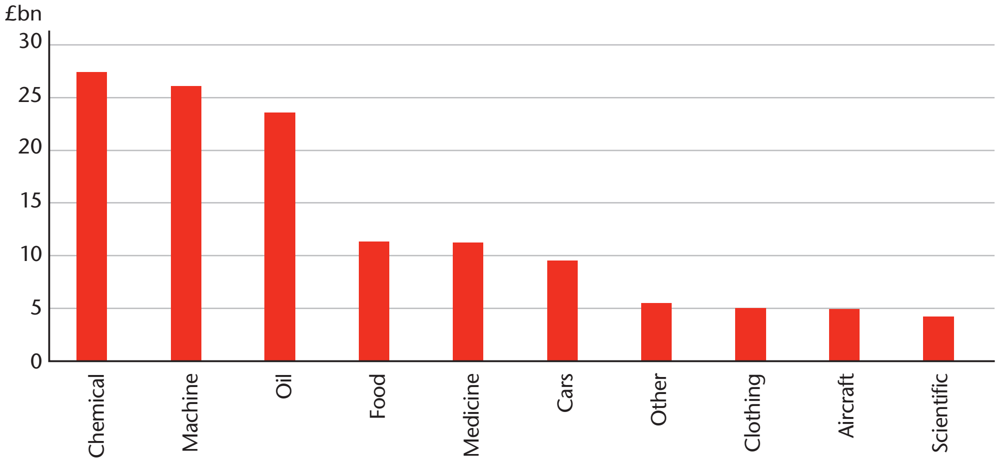
Source: Office for National Statistics Pink Book 2014, Cebr analysis

Trade in goods

Figure 7 shows the 10 largest categories of goods the UK exports to the rest of the EU. The top-level categories in the trade in goods classification can be very broad (e.g., 'manufactures' and 'intermediate manufactures'), in which cases we report the subcategories in order to give more insight. This demonstrates that oil is still an important export for the UK, while chemicals and machinery top the list. Since the decline in the oil price during 2014 and 2015, this will be a smaller part of UK exports to the eurozone by value. Hence the size of the trade deficit in goods will further increase, on average.

Figure 7

UK exports to the EU by product, top 10 categories, 2013, £bn

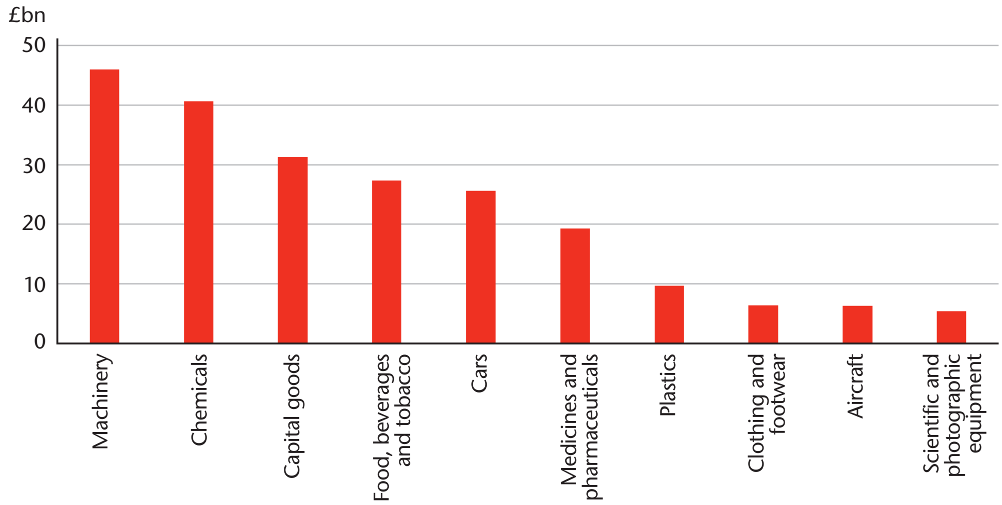


Source: Office for National Statistics, Trade in goods dataset, Cebr analysis

The main products that the UK imports from the EU are machinery, chemicals and capital goods. Oil is a much less important import from the EU as it is an export to it. A significant amount is still sourced from Norway.

Figure 8

UK imports from the EU by product, top 10 categories, 2013, £bn



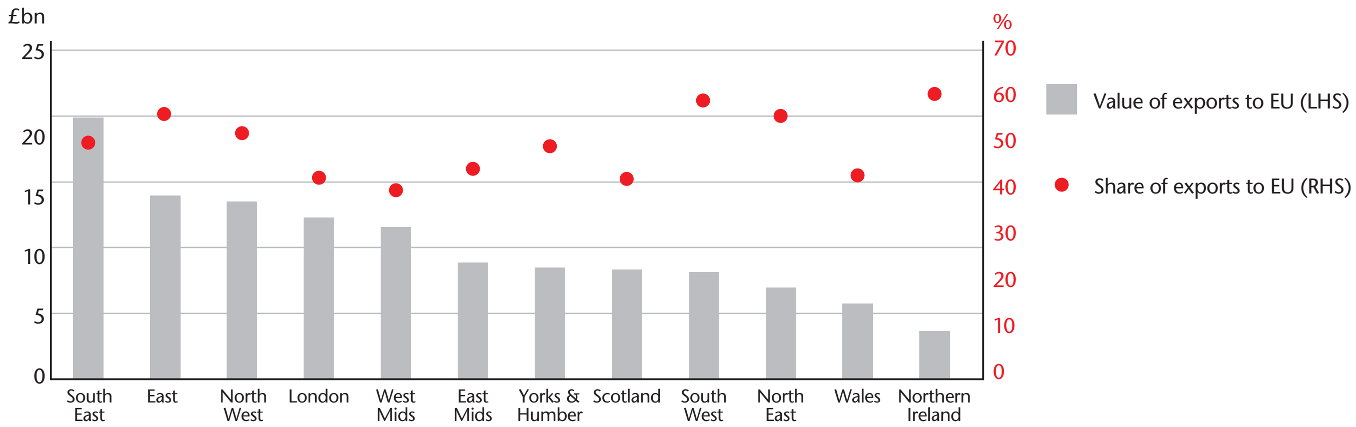
Source: Office for National Statistics, Trade in goods dataset, Cebr analysis

UK regional trade in goods patterns with the EU

Most regions of the UK send between 40% and 60% of their goods exports to the EU. Northern Ireland has the highest rate at 61%, due to its close economic links with the Republic of Ireland. London, which sends 43% of exported goods to the EU, comes low in the rankings when considering shares. Only the West Midlands and Scotland have a lower exposure to the EU.

Figure 9

Goods exports to the EU, total and as share of all exports, by region, £bn

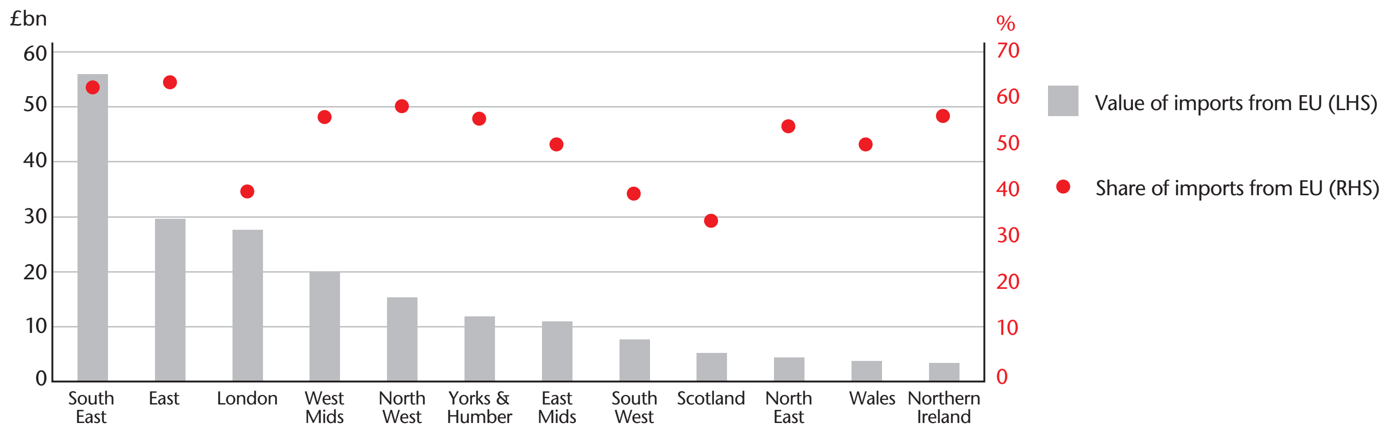


Source: HM Revenue and Customs UK Regional Trade in Goods Statistics, Cebr analysis

In terms of imports, East of England sources a higher share from EU economies than any other region of the UK. Scotland, London and the South West are in this sense relatively weakly connected to the continent, with 34%, 40% and 40% of their imports from the trading bloc respectively.

Figure 10

Goods imports from the EU, total and as share of all imports, by region, £bn



Source: HM Revenue and Customs UK Regional Trade in Goods Statistics, Cebr analysis

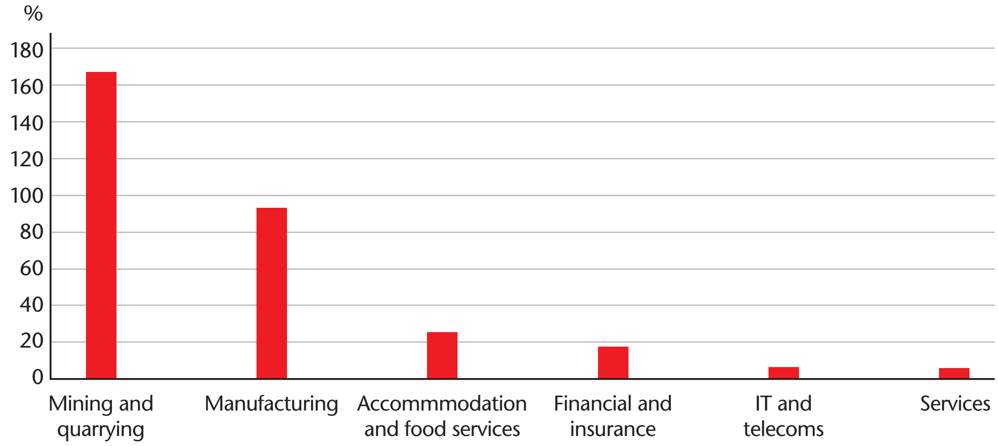
Reliance of different industries on trade with the EU

Figure 11 shows the size of various sectors compared to the value of their exports to the EU.[2] The huge difference between the trade activity that goes on in the manufacturing sector and that in the service sector is apparent, where the size of EU exports compared to the output of the sector is around 93% for manufacturers versus 6% for services. This also demonstrates the extent to which EU manufacturing is integrated, with supply chains spread across the continent. Even one of the UK's more internationally successful service sectors – IT and telecoms – exports to the EU a figure worth only 6% of its value.

Mining and quarrying exports are far greater than the value added of the sector itself. This is possibly because exports are measured on a gross basis, whereas the sectoral output is calculated by subtracting the value of all input products to arrive at the value added.

Figure 11

Exports to the EU compared to the size (measured by gross value added) of various sectors



Source: Office for National Statistics GVA low-level aggregates, Trade in Goods Statistics, Office for National Statistics Pink Book 2014

2 Because the two source datasets are not exactly aligned in their definition of the sectors used, the figures are indicative rather than precise.

How export trends vary by firm size

Large firms are far more likely than small ones to export to the EU. Of the smallest firms, only 5% export to the EU. This rises to 41% of firms with over 250 employees. Small firms are much more prevalent across the whole economy, meaning the overall average across the size classes is just 7%.

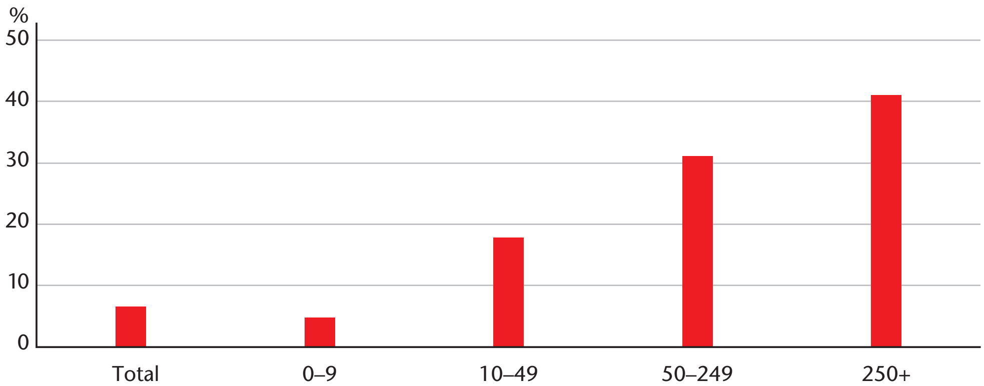
Currently, small businesses face fewer barriers to export to EU member states than they do when exporting to countries outside the single market. Nevertheless, Figure 12 shows that many fewer export to the EU. Though the Single Market can remove formal barriers to trade, linguistic, cultural and certain legal barriers between the UK and the rest of Europe persist. These could present larger obstacles for small firms than for larger ones, which are more likely to hire foreign-language speakers or to have operations across countries. There is also a good deal more liberalisation, especially in the services sector, that has not yet been implemented.

For example, a European Parliament study[3] on the cost of non-Europe quantifies the costs of various shortcomings of the Single Market. Equivalently, it identifies the most promising opportunities for increasing the future economic benefits of the EU. Improving the harmonisation of services regulation is a key area for reforms. The Parliament's report finds that 'a fully functional Services Directive and its correct implementation may yield benefits of 0.3% to 1.5% of [EU] GDP per year in the long term', a figure worth €100bn–€300bn across the Single Market. The UK's gains would be large in absolute terms due to its heavily service-based economy and the scope for it to increase service exports. However, the fact that the UK already has one of the more liberal services markets will constrain these benefits in relative terms.

The Digital Single Market is another sector in which there are large potential economic gains and in which the UK is competitive. EU GDP could increase by 0.4% by 2020 if three specific reforms were completed relating to cloud computing, payments and postal and parcel delivery.

There is no comprehensive study to date quantifying the benefits of service harmonisation on the Member State level. However, it is likely to exceed the 0.5% of UK GDP that the European Parliament estimates as the available gains from further liberalisation of trade in goods.

Figure 12
Proportion of firms that export to the EU by number of employees, 2011



Source: OECD Structural Business Statistics[4]

3 European Parliament, *The Cost of Non-Europe in the Single Market*, 2014

4 These statistics differ from those given in other datasets (e.g., HMRC Regional Trade Statistics) because the OECD does not include firms that export small volumes below a certain threshold.

Impact on foreign direct investment

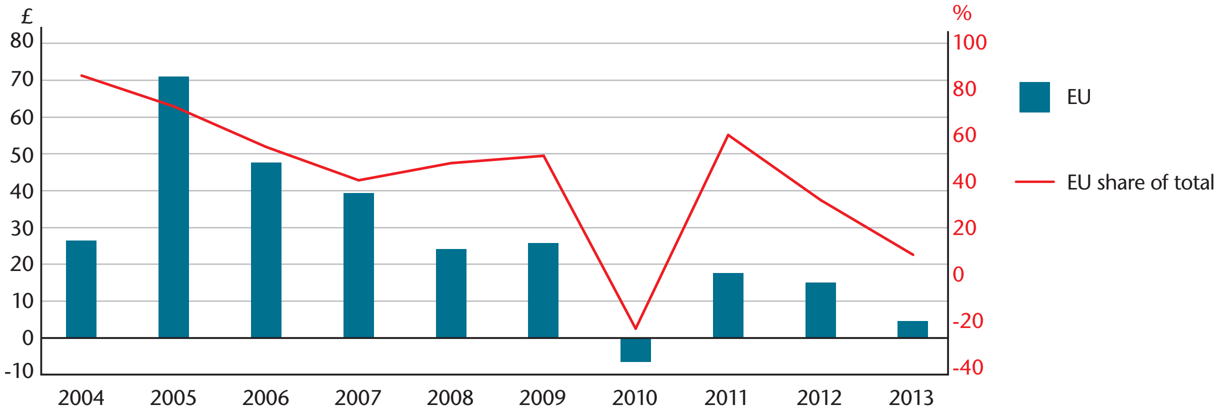
Figure 13 shows flows of foreign direct investment (FDI) into the UK from the EU.

On average over the period, the EU has provided 48% of UK FDI. The total from the EU has been on a declining trend over the past decade, while the EU's share of global FDI into the UK has been on an even steeper downward trend. From the world as a whole, FDI into the UK has also been lower since 2007, but broadly flat rather than declining.

Investment in the real economy by European firms has fallen significantly since 2007 compared to before it, as has FDI into the UK. From supplying 86% of UK inward FDI in 2004, the EU supplied just 11% in 2013. This was the lowest share of the whole period apart from 2010. The weakness of the European economy since the financial crisis has made firms more reluctant to invest. Firms have also had to consolidate their balance sheets, which many did by making fewer acquisitions and disposing of foreign subsidiaries. The figures represent FDI less withdrawals of past investments, so show a negative total in 2010.

Figure 13

FDI flows into the UK, and EU share thereof, 2004–2013, £bn



Source: Office for National Statistics FDI Involving UK Companies, Cebr analysis

Impact of the UK leaving the EU on trade and investment

Part of the appeal of the UK as a place to trade and invest capital is due to its membership of the Single Market. However, the economy has many other strengths and advantages and it would be incorrect to assume that the UK would lose all its appeal if it left the EU. In terms of trade, London would probably remain a world-class financial services hub and the UK in general would retain its significant (and often under-appreciated) manufacturing strength. Much of the UK's capability in these areas derives from having good skills and a strong reputation in certain sectors, rather than simply its membership of the trading bloc. On the other hand, this report demonstrates that membership shapes the UK's trading patterns in terms of skewing them towards the continent and away from the rest of the world.

There is economic merit to the argument that the UK could benefit from trading more with the rest of the world. The eurozone is a slow-growing economy in global terms, especially compared to emerging markets. However, exit would cause short-term pain and re-distribution of exports would take some time. In the long run, redirecting towards emerging

markets makes sense, but it need not involve exit from the EU. With an intense focus on building trade links with China, the government has raised considerably the amount of exports that the UK sends to the world's second-largest economy. In addition, the US Trade Representative has commented that the US would not seek a trade deal with a post-exit UK which undermines the claim that trading with the rest of the world would become easier. The US is currently negotiating the world's largest free-trade deal, the Transatlantic Trade and Investment Partnership, with the EU.

The World Trade Organisation, of which all of the UK's major trading partners are members, ensures tariffs and non-tariff barriers are very low by historical standards. Even between countries that are not within a free trade area, mutual tariffs cannot exceed the 'most-favoured nations' tariff (ie, the lowest tariff applied to a non-FTA partner). This means that tariff barriers would not be large. However, the more important barriers to trade today are non-tariff barriers such as regulatory divergence, especially as services become more important. This means that the UK would likely forgo significant future benefits from closer integration, estimated recently at £10.3bn for the UK by RAND Europe.[5]

Another option which would be available if the UK left the EU would be to sign up to the European Free Trade Association (EFTA) and then enter the European Economic Area (EEA). A 'Norway-style' relationship, where the UK leaves the EU but remains in the EEA, would mean that the UK's product and labour regulations remain closely aligned to those of the EU. This would ensure that trade barriers remain minimal and the UK would capture the putative future gains. However, it also means that the UK would pay a fee to the EU and would have to observe most of the same regulations, which are some of the key concerns for those seeking a Brexit. The specifics, such as the size of the fee and which regulations would be retained rather than scrapped, would be conditional on post-exit negotiations.

Investment is arguably more reliant than trade on the UK's position within the Single Market. Multinationals wishing to have a foothold within the EU often base themselves in Britain in order to gain access to the 500 million-strong consumer market. The UK has other advantages such as high-quality human capital and low corporation taxes, but large corporations are generally against Brexit because automatic access to the whole of Europe is very important. Certain large banks, often headquartered in the US, see Ireland as a viable alternative as it has similar advantages such as being anglophone and being in a convenient time zone for trade. On the other hand, many hedge funds – which are less likely to be multinational – are in favour of leaving and argue that the UK would prosper outside the EU. Outside of finance, manufacturers are reliant on harmonised product markets. An EEA-style relationship would ensure that disruption to trading links remains minimal, reducing the risks to investment

If British voters decide to leave the EU, the UK will have to strike a new trade arrangement with the remaining 27 EU member countries. Much of the impact on trade will therefore depend on what this deal entails and those wishing to explore this issue further should discuss what a post-UK exit landscape would look like.

5 European Parliament, *The Cost of Non-Europe in the Single Market*, 2014

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