What's the problem with Super Canada?

December 1st, 2018

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Super Canada or Canada+++ is referred to by Hard Brexiters as their idealised trade deal with the EU. It would be an elaborated and bespoke variant of the Comprehensive Economic Trade Agreement (CETA) recently struck by the EU with Canada. Absent Super Canada, they would be happy to default to a relationship with the EU governed by basic WTO trading terms. This paper explores the four principal claims that Hard Brexiters make about the desirability of a Super Canada trade deal. The views expressed in this paper are those of the author and do not necessarily reflect those of the CGE. They are a contribution to the debate.

Claim 1: There is a Super Canada trade proposal sitting in a cupboard at DExEU ready to be agreed

Nobody has seen this proposal. Its supporters are unable to produce or replicate it, which suggests that it is at best a wish list. The EU has talked about a Canada-style deal but it comes with a Northern Ireland backstop, as the UK would be outside the Single Market and Customs Union. As the Prime Minister pointed out recently, the Canada-style deal on offer is on offer to Great Britain (the UK excluding Northern Ireland) not the UK as a whole, AND there will be no Canada-style deal on offer without a Northern Ireland backstop, however much Hard Brexiters want such a deal.

Claim 2: We do over half of our trade under WTO rules. There is nothing to worry about no deal.

In fact, 54% of our trade (49% of our exports and 58% of our imports - 2017 data) is conducted with EU/EFTA countries under internal market trade rules. A further 14% of our trade is with other countries with which the EU has negotiated trade deals. Over 27% of UK trade is conducted with 21 countries with which the EU is negotiating agreements (including those that are paused or suspended). Even for the key markets without a EU preferential trade agreement, hundreds of bilateral agreements are in place with the EU to facilitate trade.

One could in fact invert the Hard Brexiter WTO claim and assert that just 23% of UK total trade is NOT covered by EU membership or EU trade agreements (this is generous because it includes the US which has several bilateral agreements with the EU to facilitate US-EU trade) or those in negotiation. These are figures from the Pink Book for 2017 trade. We care about total trade (exports plus imports) because it tells us how integrated our economy is with other economies. What we export is often a product not just of value added in the UK, but other countries governed substantially by existing EU trade deals and arrangements.

In all, 68% of UK total trade (exports plus imports) in 2017 was either with the EU or countries that have agreements with the EU (including those provisionally applied and pending, like Canada, Singapore and Japan).

- 58% related to Europe (EU27, EFTA, Crown Dependencies, Gibraltar, Turkey, Russia etc.)
- 10% of UK trade related to other trading partners with preferential EU trade arrangements.

A further 9% of UK trade was with countries that are in live negotiations with the EU for preferential trade. 18% was with countries that have suspended or paused negotiations (including the US which accounted for 15% of UK trade).

Only 5% of UK trade was with other countries.

* Note: not all agreements are free trade agreements, for example Turkey is in a customs union with the EU and Russia has a partnership and cooperation agreement

UK trade in Europe vs. Rest of the World:

UK world trade and the EU - 2017*

	Countries	Exports £bn	% of total	Imports £bn	% of total	Total trade £bn	% of total
UK world trade		616		642		1258	
EU 27	27	274	44%	341	53%	615	49%
EFTA	4	26	4%	34	5%	60	5%
EU27+EFTA	*31*	*300*	*49%*	*375*	*58%*	*675*	***54%***
Other Europe**	N/A	18	3%	8	1%	26	2%
European countries with EU deals	12	14	2%	17	3%	31	2%
Europe	*43*	*332*	*54%*	*401*	*62%*	*732*	***58%***
RoW with EU deals - in place	20	24	4%	18	3%	42	3%
RoW with EU deals - partially applied/pending	62	43	7%	37	6%	80	6%
Europe + countries with EU trade deals	*125*	*399*	*65%*	*456*	*71%*	*855*	***68%***
RoW in live negotiation with EU	11	48	8%	69	11%	116	9%
RoW in suspended/paused negotations w EU	10	139	23%	88	14%	227	18%
Europe+countries w deals+countries negotiating w EU	*146*	*586*	*95%*	*612*	*95%*	*1198*	*95%*
RoW - other	-	30	5%	30	5%	60	**5%**
UK world trade		**616**	100%	**642**	100%	**1258**	100%

Data sourced from 2018 Pink Book, Chapter 9 and ONS trade statistics.
* For some small countries the latest available data from ONS is for 2016; any reconciliation differences are included in RoW - other.
** The Other Europe category covers a number of territories and its UK trade predominantly relates to the Crown Dependencies and Gibraltar. At the time of writing, ONS was unable to provide trade by territory for 2017 for "Other Europe".

The UK economy is materially invested and integrated in the Single Market. Moving rapidly from an integrated harmonised economic relationship to a very basic one would severely damage many cross-border business models. The estimates from Brexit-WTO-supporting economists that a no-deal outcome would not materially impact the UK economy depend on wildly unrealistic and optimistic assumptions such as: no non-tariff barriers to trade; immediate roll over of existing EU trade deals; and, an ability to slash our own tariffs and product safety standards without adversely impacting our own domestic businesses.

The WTO option raises the highest trade barriers possible with the EU and the countries with which the EU has trade agreements. These will include tariffs on UK goods exports to the EU27 and a battery of new customs and regulatory checks.

There would be substantial damage to the UK's trade in services, which benefits from many common regulatory frameworks and standards in the single market. There is a general failure to consider the impacts on the service sector, which accounts for 80% of the UK economy. Many banks have already made provisions to move business activity out of the UK, or have already transferred functions, to the EU27. In the event of a no-deal Brexit, they simply could not continue to operate many of their European activities from the UK. They would have to move business on day one from the UK to a regulated entity within the EU27 as the existing EU framework would no longer apply to the UK, for example passporting would become illegal. To mitigate Brexit risk, business is already moving out of the UK, often under the radar.

Regulation for the sake of regulation is clearly bad for competition and enterprise, but harmonised rules across 28 countries (and wider) expand the size of the marketplace, promote competition and efficiency. Markets and clients that would be otherwise expensive for small businesses to reach become accessible. Exports that we make to the rest of the world will often be substantially assisted by advantages gained from operating at scale in the Single Market with its more efficient supply chains, using components supplied from within the EU.

A No-Deal arrangement, which would be outside the customs union and would introduce other non-tariff barriers, would fundamentally disrupt these logistical and competitive advantages. These are advantages that could only be retained by staying in the EEA under the EFTA pillar while leaving the EU.

Claim 3: A Bespoke Canada-style deal meets the needs of UK business

There are important differences between Canada's trading relationship with the EU and ours. Just 10% of Canada's exports go to the EU representing a little over 3% of Canada's GDP. This compares with around 45% of the UK's exports going directly to the EU, representing 13% of our GDP. Most of Canada's trade takes place within the NAFTA framework while most of the UK's trade takes place within the EU/EEA internal market framework and under Trade deals and Partnership Agreements negotiated by the EU.

UK exports to the EU differ substantially from Canada's.

- Canadian exporters do not have the complications of integrated industry supply chains with the EU as the UK does.
- Canada does not export a substantial volume of services to the EU, as the UK does under single market arrangements allowing (for example) the unimpeded provision of legal, aviation, and road haulage services across the EU by UK firms.
- Non-tariff barriers will be a major issue with a Canada style deal because of the frictions they introduce for goods and services. Non-tariff barriers would be a major issue for auto companies in particular as companies like JLR, Nissan, and BMW have made clear.
- The Canada deal is by its nature a much smaller trade deal than the UK would require. The order of magnitude is substantial.
- The EU is unlikely to open up all services sectors to the UK because it would need to MFN (Most Favoured Nation) the same privileges to Canada and Japan.

- Super Canada is therefore less than "Super" and puts at risk the UK trade surplus with the EU on services. Even if a Super Canada deal was possible for the UK, it would still fall a long way short of the services access that the UK enjoys as an EU member. This is because such a piecemeal deal, negotiated sector by sector, lacks the 'architectural' (over-arching) aspects of the Single Market which are of particular importance in services trade – the unified court system, the free mobility of labour and data mobility.

This would be less of an issue if Britain were to remain in the EEA transitioning to the EFTA pillar, as an internal market member, but under the arbitration of the EFTA court (rather than the ECJ).

Claim 4: A Super Canada deal is just a matter of cutting and pasting the Canada CETA agreement, adding a few UK relevant parts and telling the lawyers to get on with it. We are already 100% regulatory aligned with the EU so a deal will be easy

There is an awkward juxtaposition in this argument**.** We become a third country, so alignment has to be demonstrated. It is not assumed. Moreover, there is very limited evidence of the EU accepting regulatory compliance across a broad range of sectors on the basis of outcomes or equivalence rather than harmonised rules. Regardless, this equivalence can be withdrawn with just 30 days' notice.

The Super Canada advocates adopt a contradictory stance on regulation. They push for the freedom to diverge from EU regulation, but they also cite regulatory convergence as assisting a trade deal with the EU. Simultaneously they reserve the right to diverge from these same rules in order to strike deals elsewhere. These two contradictions sit uncomfortably and will force the EU to tie the UK tightly to the regulatory aspects of any deal. They are likely to want commitments and obligations from the UK, as a large neighbouring economy, to maintain a level playing field with the EU. The EU has flagged that it is likely to seek these commitments from the UK in relation to tax, labour standards, environmental and social protections and state aid. The EU will clearly interpret the "+++" in Canada+++ very differently to the UK!

The EU-Canada CETA deal took 7 years to negotiate and runs to nearly 1600 pages. Even with the CETA framework in place, most estimates suggest that it would take a minimum of 4-5 years for Britain to negotiate the equivalent detail with limited bespoke (mainly service) add-ons. Given the agreed 21 month transition period, this means that the UK will only be able to negotiate a very poor version of the EU-Canada CETA or, more likely, nothing substantive at all.

To the extent that there is any thinking behind this argument that a deal can be pulled off in short order, it appears to be that, starting from regulatory alignment and a CETA template, the exercise is seen as little more than populating a very large spread sheet. That is wrong for multiple reasons, including:

- Absent a massive level of renegotiation, there will be a major regulatory discontinuity, as the UK becomes a '3rd country'. The 'alignment' simplification is a chimera.
- The agreement of the EU27 is required and the process will inevitably be slow.
- Even without the pluses, CETA is a much smaller trade agreement than UK-EU would be in terms of trade volume and scope. Its provisions relating to services are minimal and will not protect the position of UK services exporters to the EU. There will be plenty of new issues to address.

- The pluses will tend to be the hard bits: if easy they would likely have been built into the Canada-EU deal already.
- Because of trade volume and scope - this really would be a 'mega' trade deal – affecting a vast number of interest groups significantly. That would slow things down a lot -- politicians are very interested in the effects on their domestic interest groups.
- There would be a whole new adjudication system to negotiate. Again because of the economic significance of the agreement, the ECJ might be expected to take a keen interest. That's another potential delaying factor, as it was when establishing the EEA.
- The existence of MFN clauses in recent major EU trade agreements requires the EU to offer any improved terms negotiated by the UK to other parties. This will slow down negotiations substantially as the EU is forced to consider the wider implications of extending the same privileges to Canada, Japan and South Korea.

Thinking through the impacts on the UK economy:

So, if the EU is unlikely to agree to Super Canada because of its altogether different and more wide ranging needs, which would take many years to deliver, where would a very basic CETA, or perhaps a "Canada-minus" deal, put in place during the 21-month transition, leave the UK economy? Failing that, what would "no deal" mean?

The profile of consequences might be divided into the immediate and longer run impacts of unravelling 45 years of economic integration either via a 21-month transition to some form of CETA-minus or via an immediate default to WTO trading terms at the end of March 2019. The longer-run economic profile would then be determined by how the UK economy then grew from a lower base in absolute and relative terms.

It is possible to argue that the Canada-minus and WTO growth profiles would be similar, but of differing magnitude. The WTO-option clearly carries the worst immediate consequences i.e. facing the EU external tariff, substantial friction to trade from non-tariff barriers, the (hopefully temporary) loss of trade deals negotiated with the rest of the world, a collapse in investment, reduced FDI and a falling currency, potentially requiring higher short-term interest rates.

Given that our sizeable current account deficit is substantially funded by FDI, the currency would inevitably bear the brunt. It would impart an economic shock and impose substantial reorganisation costs on many businesses. Because of the complicated nature of modern international supply chains and business value added, a lower currency might not be the unambiguous good that Brexiters often argue it is.

Long-run modelling of the economic impact of Brexit relative to EU membership is complicated, but we can be certain that much reduced market access will have immediate adverse consequences. The longer-run impacts would likely relate to:

- Reduced FDI from international businesses that use the UK as a hub from which to export to the EU27;
- Reduced volumes and profitability of international trade
- Significant costs to UK business associated with Non-Tariff Barriers to trade
- Lower productivity (See: Credit Suisse Brexiting the Supply Chain);

- The loss of the net positive contribution from EU migration to UK GDP and taxation
- Moderation by a lower exchange rate and partial movement of operations to the UK by some EU27-based exporters focussed on the UK. (It's important to keep in mind that these relocation dynamics are asymmetric against the UK because the EU27 is a bigger market for us than we are for them).

The Government and a number of independent organisations have estimated the longer run impact of different trading arrangements to 2030 that generally range from a 2% cumulative drag on growth from an EFTA-EEA Brexit outcome to an 8.5% drag on GDP for a no-deal scenario. The UK Treasury model sees a cumulative 10.7% drag on UK growth over 15 years from a no deal scenario. The UK is a developed economy and can therefore expect low single digit growth to persist in this latter scenario. This means there is no cushion to absorb any immediate loss of growth or even outright recession due to Brexit. Long-run forecast differences resolve substantially around the estimated adverse consequences for productivity and growth, resulting from lower FDI, increased trade friction, and lower migration. It is important to appreciate that a period of long-run relative under-performance will have substantial adverse fiscal consequences and ensure that the UK slips further from its position as the sixth largest economy in the World (measured in USD market prices). This in turn will have adverse consequences for our leverage in international trade negotiations.

The Bank of England published its results of a No-Deal stress test on 28 November. The results indicate that a recession would occur and the peak-to-trough fall in short-term GDP could range from 3-8%. This is of the same scale as the impact of the global financial crisis of 2007/8. It is important to understand that this kind of modelling is very difficult, but that the significance and the direction of travel are unambiguous. Sterling would weaken and inflation rise sharply, accompanied by a spike in the unemployment rate to around 6%. The BoE assumes a default to WTO terms. If a Canada-minus deal is negotiated, it seems reasonable to assume that the impact on GDP would be similar to the Government's figures for the trade effects of an FTA with a long-run loss to GDP growth of 5%; although the limited scope of such a deal might well lead to a more adverse outcome.

No Deal would lead to very serious short-to-medium-term economic dislocation. UKTPO see medium-term work-place losses associated with an orderly No Deal amounting to around 750,000, with potentially more in the interim in the event of a disorderly departure. There would be a substantial short-term hit to GDP, but it is really impossible to model this with any confidence. It seems plausible to argue that a rushed Canada-minus styled deal would fall somewhere in the upper half of that 2-8.5% drag on GDP range to 2030, contingent on the limited bespoke elements that could be negotiated. (see references for further exploration of these issues).

It seems likely that in the short to medium term, after an initial absolute hit to UK growth, a period of prolonged relative economic underperformance, much as the UK has seen over the last two years (post-referendum economic growth has underperformed trend by over 2%), will follow, exacerbated by downward pressure on real wages and household incomes primarily via the weaker currency effect on inflation and continued restrained business investment. Given that 30% of consumption is imports this seems inevitable.

Conclusion:

A Super Canada deal even in its most idealised form would fall substantially short of the economic access that Britain currently enjoys to EU markets with adverse immediate and long-term consequences for economic growth, Foreign Direct Investment and trade.

Super Canada is a deal that:

- Cannot be delivered in the transition timeframe in any meaningful way.
- Denies us frictionless access to the Single Market and does not address supply chain issues.
- Is inadequate for an economy as services focused as the UK.
- Does not solve the Irish Border problem.

The idea that a deep and comprehensive deal of this kind can be negotiated from the perspective of current regulatory alignment while allowing the UK the opportunity for regulatory divergence in pursuit of other trade deals is nonsensical. Substantially, for a medium-sized open economy like the UK, regulatory divergence is an illusion. There are three dominant regulatory regimes in the world: the EU, US and China. The UK's regulatory standards will tend to comply with those of its largest proximate markets and these rules will permeate our domestic economy. The enormous size of a Super Canada deal with the EU in any case, even starting with the established CETA framework, would take many years to negotiate, and involve substantial regulatory alignment of the UK with the EU (like Switzerland, for example).

The extent of our economic integration with Europe and countries operating in the extended internal market or via rules and agreements made with the EU, means "no deal" would deliver substantial short and long-term damage to the UK's economic growth prospects, tearing apart 45 years' worth of economic integration overnight, creating huge legal and commercial uncertainty while erecting high barriers to trade.

I leave the final word to Professor George Yarrow, Chairman of the Regulatory Policy Institute and Emeritus Fellow of Hertford College Oxford:

> *"Markets are economic institutions and the Single Market is the biggest and most complex market in history. The idea that you can just abandon such an institution when it is not itself failing in any bad sort of way, and can then quickly replace at least its good points, is pretty much the antithesis of Burke. We don't have the detailed knowledge to be able to be confident of doing that with any degree of success."*

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Acknowledgements:

I would like to thank Richard Barfield for his help with the data tables and for casting a critical eye over the piece. Professor George Yarrow and George Peretz QC have assisted me in exploring a number of themes. I am obliged to Neville Hill at Credit Suisse for expanding on his work on Brexit Supply Chains, FDI & productivity. James Barty has, as ever, been a useful sounding board. All opinions, errors and omissions remain my own.