Part 1: The Impact of Brexit on Trade in Goods:
Trade relationship between the UK and the EU27

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Introduction

Trade in goods is one of the areas most significantly affected by Brexit. The UK's departure from the EU will profoundly redefine its trade relations not only with the EU27 but also with the rest of the world.

A huge task lies ahead for the UK - and indeed for the rest of Europe. After 40 years of the UK's participation in the Single Market, in which markets for goods and services of the UK and the other 27 Member States have been almost completely integrated, the eggs must now be unscrambled and the details of a new relationship must be laid out and agreed upon. As discussed in greater detail in our Brexit White Paper, the timing for doing so is extremely tight. Brexit is to become reality on 29 March 2019, and this fast-approaching deadline has been rendered all the more pressing by the fact that formal negotiations on a future trade relationship have not even started. The EU's position has always been that these negotiations can only start if "sufficient progress" has first been made on the UK's "divorce agreement" with the EU. So far, in the opinion of the EU, this has not been the case. The current consensus is that a breakthrough must occur within the next few weeks, in order for trade talks to begin in January.

Brexit however entails much more than a redefinition of the UK's relationship with the EU. On trade matters in particular, it will also affect the UK's position in the WTO, reshape the way it trades with the rest of the world and require it to adopt a comprehensive domestic trade policy. Finally, Brexit will affect—albeit to a rather limited extent—trade relationships between the EU27 and other third countries.

This paper discusses the impact of Brexit on trade in goods. This first part examines how trade between the UK and the EU27 is likely to be affected by Brexit. The second part, which will be published shortly, will deal with the impact of Brexit on trade between the UK and third countries and between the EU27 and third countries, respectively.

Frictionless trade today

Currently, the UK is part of the EU Customs Union and the Single Market. Goods obtained or produced in the EU, as well as those imported from a third country and put in free circulation in one Member State, can be traded freely across all Member States without any tariffs or quotas whatsoever. Trade is also frictionless customs-wise, as there are no border or customs checks on goods traded between Member States, as well as no routine customs processes (including the need to provide customs declarations). This is of enormous benefit to the many companies operating pan-European supply chains. Moreover, legislation applicable throughout the Single Market has eliminated virtually all non-tariff barriers through the harmonization of regulation or the adoption of mutual recognition procedures.

Come Brexit day, such frictionless trade will be a thing of the past for trade between the UK and the EU27. Based on what we know today, it seems certain that the UK will leave both the EU Single Market and the EU Customs Union. What is less certain is whether the EU and the UK will be able to forge a deal on their future trade relations and what that deal will look like and whether there will be a transition agreement.

In the following sections, we will first look at the consequences of the UK leaving the EU Single Market and Customs Union and then discuss how a possible trade deal could mitigate the impact that this will have on trade between the UK and the EU27.

Re-introduction of tariffs

With respect to trade in goods between the UK and the EU27, the most important consequence of the UK's exit from the EU would be the re-introduction of tariffs—and to a lesser extent quotas—as the EU27 and the UK would treat each other like any other third country. Most likely, the UK will impose duties of the same amount as currently applied by the EU on third countries. This would mean that, for example, duties on the import of cars of 10% would be levied both ways.

This could have profound consequences for certain business sectors as can be illustrated by the car industry. Currently, German, French, or Italian car manufacturers can sell their cars in the UK without paying duties. While this does not provide them with an advantage over UK manufacturers, they do enjoy a cost advantage over imports from China, Korea, Japan or the U.S. whose cars are subject to a 10% import duty. Post Brexit, that advantage will disappear and all non-UK car manufacturers will compete in the UK on an equal footing. In the upcoming battle for the market for e-cars, this could be an important factor.

Massive disruptions caused by customs procedures

Another major—and very visible—consequence of the UK leaving the Customs Union and the Single Market would be the re-introduction of border checks and customs procedures for trade between the UK and the EU27. Both sides would have to undertake significant investment in infrastructure and new personnel to cope with the heavy additional workload. Long queues of lorries and trucks at borders and ports are expected to be the norm.

A few figures can illustrate the magnitude of the problem. Today, approximately 11,500 trucks are crossing the Channel between Calais in France and Dover (by boat) or Folkestone (through the tunnel) every day (including weekends and holidays). Assuming a 15 minute processing time per truck and 24/7 operations, this would require installing parking spaces, facilities, and personnel capable of performing checks and paperwork at a rate of 480 trucks / hour. Similarly, based on current figures, Dublin harbor would have to install customs facilities capable of handling about 2,600 trucks every day. To some extent, the burden on both the customs authorities at the border and the economic operators can be reduced by applying the authorized economic operator (AEO) procedure. However, this procedure is only open to those companies meeting the AEO criteria.

Ireland would be hit particularly hard, because most goods shipped between Ireland and the EU27 transit through the UK and would therefore have to go through customs procedures four times.[1] The alternative would be to ship goods by boat to France but this would add between 10 and 20 hours to the journey.

[1] Leaving Ireland, entering the UK, leaving the UK, and entering continental Europe.

The re-introduction of these customs procedures will profoundly impact cross-border supply chains involving the UK, on the one hand, and other EU Member States, on the other. Many goods are shipped back and forth multiple times between different production facilities before being sold to customers or incorporated into the final product (e.g., a car). While companies may be able to avoid paying duties by making use of specific customs procedures, such as the inward processing procedure, this comes at a high administrative cost and a substantial customs risk. In light of the likely significant delays at the border, companies who rely on just-in-time deliveries will be especially affected.

Re-appearance of non-tariff trade barriers

As noted above, non-tariff barriers within the Single Market have been largely eliminated. While the UK's separation from the EU will not immediately result in the adoption of differing standards, such divergence may happen over time and unless agreed otherwise, mutual recognition procedures would cease to apply following the UK's withdrawal from the EU. The effect will be particularly pronounced for highly regulated industries such as medicines or medical devices.

Speculation on a possible trade deal

Ever since the Brexit referendum result, the EU has consistently stated that the UK's continued access to the Single Market would only be possible if the UK accepted all four freedoms of the Single Market, notably the free movement of persons, as well as all EU Single Market regulations and the jurisdiction of the Court of Justice of the EU (CJEU). There is general agreement, expressed by Prime Minster May and others in the UK, that the UK cannot agree to these conditions, since accepting them would be contrary to the will of the British people as expressed in the Brexit referendum and would frustrate the very rationale of their vote to leave the EU. Indeed, limiting immigration, including from the EU, and escaping the jurisdiction of the CJEU were key objectives of the Leave Campaign.

Importantly, and contrary to what some politicians in the UK say, it seems highly unlikely that the EU will change its position and soften the conditions for continued access to the Single Market. This does not constitute bad faith or revenge. Rather, the above conditions represent the essence of the Single Market and compromising on them would endanger its very existence.

Various options have been discussed on how to mitigate the consequences of Brexit on trade and, more generally, on the economic relationships between the UK and the EU27. On numerous occasions, Prime Minister May has said that the UK's objective is to seek the greatest possible access to the Single Market through a "new, comprehensive, bold and ambitious" free trade agreement (FTA) with the EU. Such an FTA, she specified, should not be a mere replica of a pre-existing model. It would need to be bolder than CETA, the new free trade agreement concluded by the EU and Canada, because simply duplicating it would represent an unacceptable restriction on the mutual market access from which both parties currently benefit. At the same time, however, it should be less encompassing than the model adopted by Norway, which has access to the Single Market through its participation in the European Economic Area (EEA), because membership to the EEA requires the UK to accept the above mentioned conditions. As discussed, the UK cannot accept them and the EU cannot compromise on them.

Based on what is known today, the most likely solution would be an FTA that is more far reaching than CETA but falls short of full access to the internal market. The FTA would cover all categories of goods; there would not be individual agreements for specific sectors such as, for example, medicines or cars. Moreover, as is typically the case with FTAs, it must be assumed that nothing will be agreed before everything is agreed. And finally, depending on the issues and sectors covered, the EU may not have exclusive jurisdiction to agree on all aspects of the agreement, in which case the agreement would either have to be concluded by the EU27 and its Member States as a so-called "mixed agreement" or, more likely, there will be separate agreements between the UK and the EU27 and between the UK and each of the Member States of the EU27.[2]

Because the time left to negotiate and ratify such a comprehensive FTA before 29 March 2019 is much too short, it will be necessary to agree on a transition period. The most likely scenario is a two-year transition agreement, pursuant to which the UK would remain a member of the Customs Union and the Single Market (with the above mentioned conditions) but would no longer take part in the work of the EU institutions. Thus, during that time the UK would not be able to influence EU legislation and would not have a Commissioner or a judge at the CJEU. Yet, it still would have to comply with any new EU legislation, decisions of the Commission, and judgments of the CJEU.

Free-trade scenario no panacea

With respect to trade in goods in particular, an FTA would be a major improvement to the "no-deal" scenario discussed above. CETA, for example, provides for the abolition of close to 98% of all tariffs on trade between the EU and Canada and it can be assumed that an EU-UK FTA would go further, thus practically eliminating all tariffs on trade between the EU and the UK.

Such an FTA, however, would still represent a significant setback from the current trade conditions. For example, the tariff reductions under the FTA would only apply to goods originating in the EU27 and the UK. Preferential rules of origin, which are notoriously complicated and entail significant customs risks, would need to be determined and applied. Second, it has to be seen whether and to what extent the FTA will cover agricultural products, which are always the most sensitive in any trade negotiation. Third, unless the UK agrees a mutual recognition procedure applying EU standards, the emergence, over time, of diverging standards and non-tariff trade barriers is likely to occur.

Moreover, an FTA will not eliminate the need for border or customs checks in UK-EU trade, for example to verify compliance with the preferential rules of origins. Over the years, various measures have been put in place by parties to FTAs around the world to expedite these checks and lighten the paperwork burden. In a "Future Partnership" White Paper published during the summer, the UK Government itself proposed a series of measures in order to streamline the customs process and simplify the requirements for moving goods between the UK and the EU. These measures include the bilateral implementation of a technology-based solution which could consist of pre-arrival notification of consignments on a port IT system, linked to customs declarations and vehicle registration numbers, allowing traffic to flow more smoothly at the border. However, even if these or similar trade facilitation measures were to be adopted, this would still cause a significant administrative burden. For example, it is expected that approximately 300 million customs declarations will have to filed and treated annually. Also, there will be a physical border and there will be border checks and ensuing delays. The notion of a "frictionless border" (put forward by some) is illusory.

[2] Mixed agreements are agreements concluded and ratified by the EU and the Member States together because their subject matter falls partly under the jurisdiction of the EU and partly under the jurisdiction of the Member States. They must therefore be ratified by both the EU and each Member State. In the light of recent experiences, where the unwillingness of national parliaments to ratify FTAs concluded as mixed agreements jeopardized the entire agreement, the Commission now seems to prefer split agreements.

The UK "Future Partnership" White Paper also proposes, as an alternative, to explore with the EU the implementation of more "innovative" approaches. This could involve for instance the UK acting in partnership with the EU to operate a regime for imports that aligns precisely with the EU's external customs border for goods that will be consumed in the EU market, even if they are part of a supply chain in the UK first. Under this approach, the UK would need to apply the same tariffs as the EU, and provide the same treatment for rules of origin for those goods arriving in the UK and destined for the EU. By mirroring the EU's customs approach at its external border, the UK would ensure that all goods entering the EU via the UK have paid the correct EU duties. This would remove the need for the UK and the EU to introduce customs processes between them, so that goods moving between the UK and the EU would be treated as they are now for customs purposes. The White Paper acknowledges however that this is an untested approach which would take time to develop and implement. So far, EU Member States have publicly expressed very little appetite for exploring that route.

Next steps

Attention will now turn to the approaching December European Council meeting where the EU will decide whether sufficient progress has been made on the "divorce agreement" to start negotiations on an FTA and a transition regime in January. The biggest obstacle seems to be the Irish border question, which is part of the divorce negotiations and with respect to which little progress has been made. If the Heads of State of the EU conclude in December that the time is not yet right to begin negotiations on the future trade relationship with the EU, businesses may feel the need to start putting contingency plans into place, which may decrease the value of any transition agreement. This would require a business-specific assessment of the risks associated with a "no-deal" Hard Brexit and the adoption of measures to mitigate those risks. These measures are likely to vary from one industry, and one business, to the other as there are no "one-size-fits-all" solutions in these matters.

For more information about our European Trade practice, please click here.

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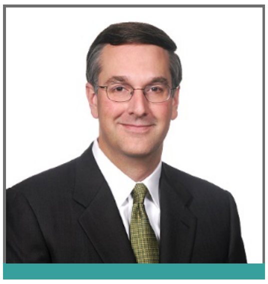

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