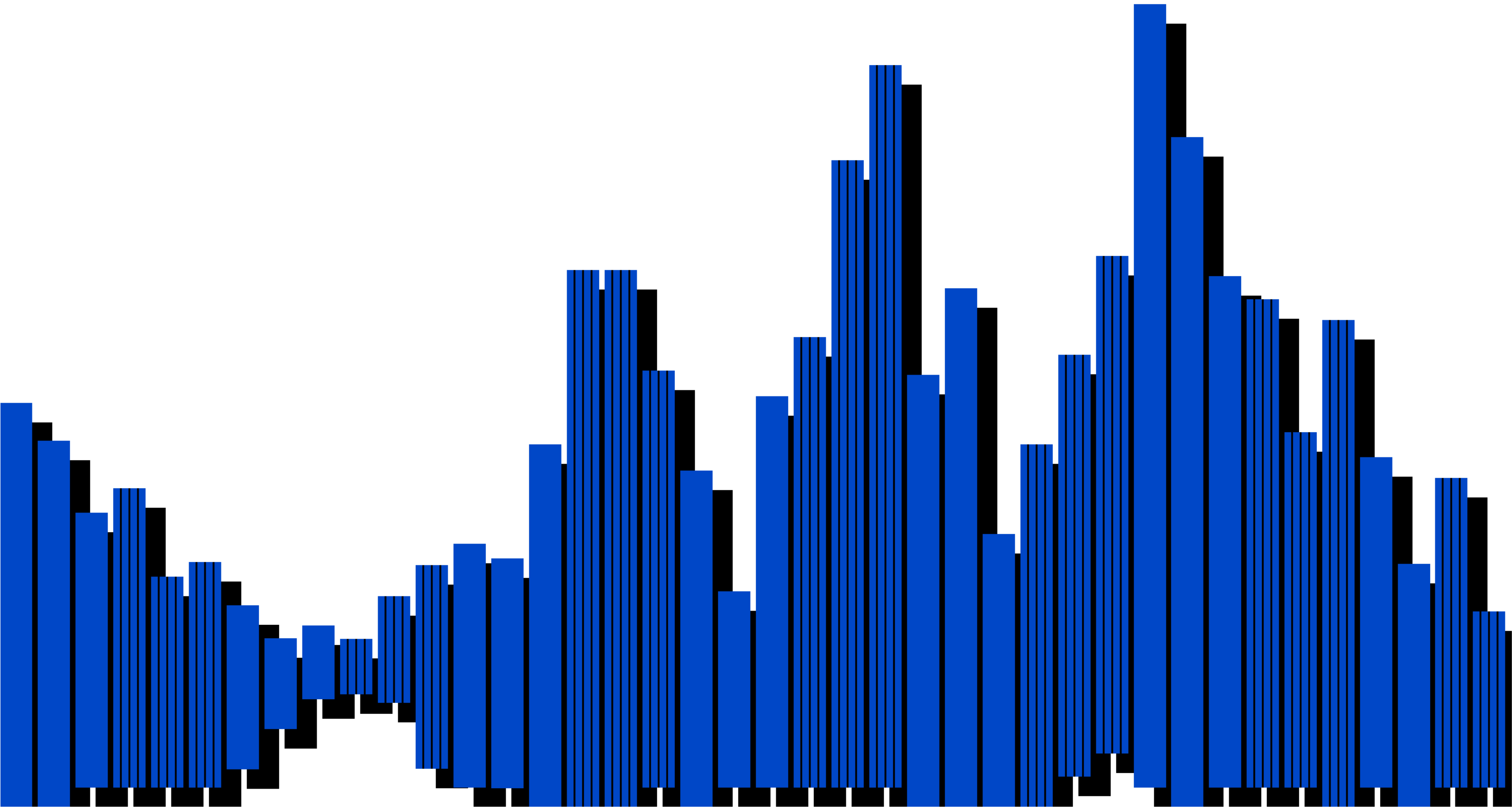
UK IN A CHANGING EUROPE

UK TRADE TRACKER
Q3 2023



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INTRODUCTION

The UK in a Changing Europe trade tracker is now being produced quarterly and in a new format. The new format trade tracker will focus on three key areas: UK trade and its performance relative to historical data; UK trade in a global context and how it compares to the G7; and finally, newsworthy developments which have occurred within trade in the last quarter.

This quarter we look at how UK trade measures compare to 2019 as well as the proportion of total UK trade made up of trade with the EU. In addition, we look at the UK's trade balance and trade openness compared to the G7.

Lastly, we summarise the India-UK free trade agreement that has been in the works for the past few years. We consider whether it is close to signing and what impact it might have on UK trade, as well as what elements are hotly debated.

Nearly all trade is down for Q2 2023 compared to the same time period in 2019

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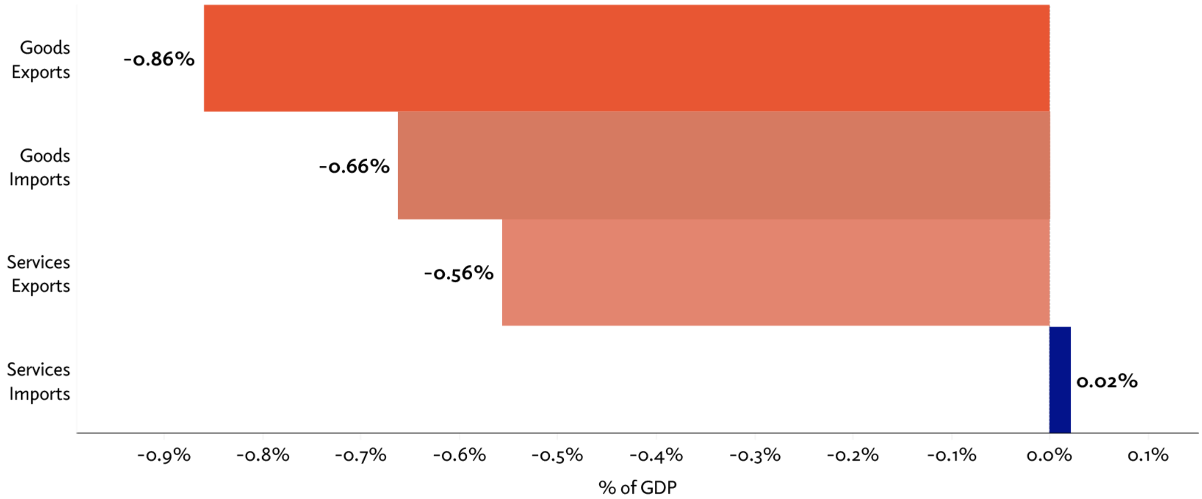
Comparing chained volume measure of UK import and export of goods and services between Q2 2019 and Q2 2023 as a % of GDP.



Source: ONS UK trade: goods and services publication tables. Chained volume measure. ONS GDP data tables using ABMI (CVM) GDP. Blue Book 2023 GDP corrections used. For GDP after Q4 2021, growth rate of previous GDP figures to 2023 corrections was taken and multiplied by unrevised GDP figures for Q1 2022 to Q2 2023.

UK trade is below pre-pandemic/pre-TCA levels, with the exception of import services.

First a look into how trade is faring in relation to the same time four years ago. 2019 is used as a base year as it was the last year where data was unimpacted by either the COVID-19 pandemic or the introduction of the Trade and Cooperation Agreement (TCA) between the UK and the EU. Therefore, comparing current trade data with 2019 data can provide us with some of the clearest insights into how well trade is currently going for the UK.

Exports fell the most, with goods and services both down from 2019. While exports have increased since 2019 in current prices, when adjusted for inflation, they have fallen by 0.62% of GDP compared to Q2 2019.

For export services this is somewhat surprising since they have been the strongest point of UK trade for some time. Especially after 2020, when goods trade was in decline, services remained strong. However, the service market is starting to show signs of slowing.

The UK's trade deficit continues to grow as export goods and services have fallen more than both import goods and services, highlighting a widening gap in trade balance. Services also continue to perform better than goods further cementing the UK as a service-oriented economy and indicating there is a higher demand for foreign services. With financial, legal, accounting, and travel services benefitting the most from the focal shift.

To compare 2019 and 2023 results on an equivalent scale two approaches are taken. First, they are converted into a percentage of GDP for the corresponding quarter of that year. Second, we also used chained volume measures instead of current price value which allows for the effects of inflation to be removed.

Trade with the EU continues to make up a majority of UK total trade

Percentage of UK total trade (imports and exports) with the EU compared to the rest of the world using chained volume measure.

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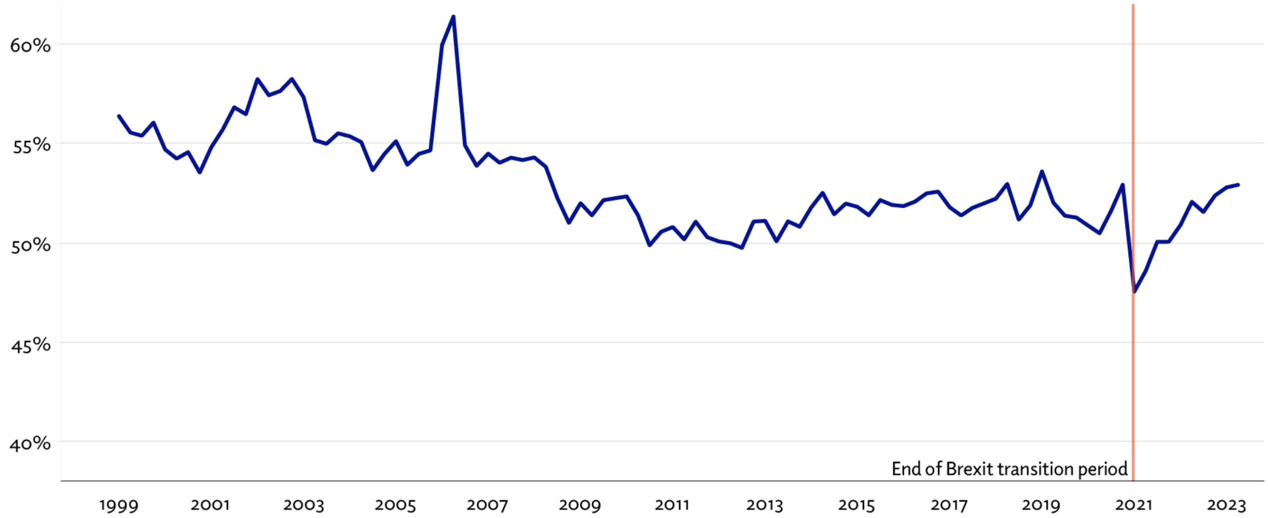


Source: ONS UK trade: goods and services publication tables. Chained volume measure. Large spike in 2005 was due to Missing Trader Intra-Community VAT fraud.

The EU has historically been the UK's largest trading partner. This continues to be the case despite the UK having left the EU. While the EU's share of total UK trade is down from its peak in the 2000s when it was at 55%, it still represents a majority of UK trade.

It was with the introduction of the TCA that the UK saw for the first time in decades the share of trade with the EU drop below 50% of total trade. In Q1 2021, the EU made up 48% of trade, and the following quarter 49%. However, by Q3 2021 it returned to 50%. This was largely due to business in the EU temporarily pulling back trade with the UK in anticipation of the new trading arrangements under the TCA.

One explanation for the quick return to pre-TCA levels of trade is that most businesses did not find the non-tariff barriers, such as new paperwork and potential delays at border checks, to be a so much of a hindrance as to change decisions to trade in the UK. However, while larger companies have resumed trade across the channel, many smaller companies seem less able to cope with the new requirements and have stopped trade. This has been the case more for small UK exporters to the EU than vice-versa.

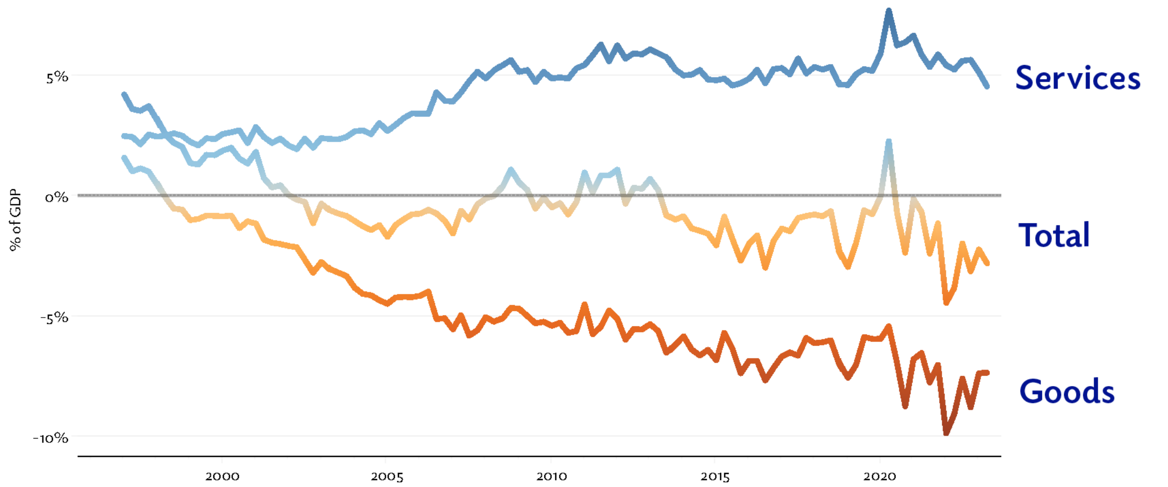
The use of preferences, or paperwork needed to make a product tariff-free, by UK exporters is more concentrated in larger transactions than it is for EU exporters. The use of preferences by UK exporters in the textile and clothing sector are particularly low with only around half utilising the tariff-free regime.

Despite all of this, since the TCA came into force in 2021, the share of EU trade increased to 53% by Q2 2023. This has shown that on both sides of the channel trade with partners of such close proximity will remain the preferred choice.

TRADE BALANCE

UK total trade deficit remains high even with strong services trade

Trade balance (exports - imports) using chained volume measure for services, goods, and total trade as a % of GDP for the UK between 1997 and Q2 2023.



Source: ONS UK trade: goods and services publication tables. Chained volume measure. ONS GDP data tables using ABMI (CVM) GDP. Blue Book 2023 GDP corrections used.

The UK has developed into a strong service exporter over the past decades, in large part due to the performance of the financial, legal, accounting, and travel services sectors in the UK and particularly those based in London. However, goods exports have been on the decline, running a trade deficit since 1998, due to globalisation and the transition of domestic industrial production from goods to services and consumer preferences for international products that come with the increase of the import of non-domestic products.

While services have maintained strong performance, even throughout the pandemic and Brexit, the fast decline of the trade balance for goods has pulled the UK's total trade balance down to record lows in the past two years. While the UK saw its first positive trade balance in Q2 2020, it quickly began to fall again before hitting a record low in Q1 2022 with a total trade balance of -4.4% of GDP. This is also taking into account recent corrections for GDP by the Office of National Statistics (ONS), which saw UK GDP increase instead of decrease in 2021.

However, even with that correction, UK trade balance as a per cent of GDP remains negative, signifying that the UK continues to import more than it exports and therefore is running a large trade deficit. A trade deficit is not in itself a bad thing, it can lead to cheaper good prices, and can indicate a strong consumer market. However, a trade deficit can sometimes be associated with job losses in certain industries, particularly if domestic producers cannot compete with cheaper imports. This is something that the UK is acutely aware of in regard to sectors like manufacturing. A trade deficit also brings up debate over reliance on external partners for essential goods, in the case of the UK, its trade reliance on China.

GLOBAL CONTEXT

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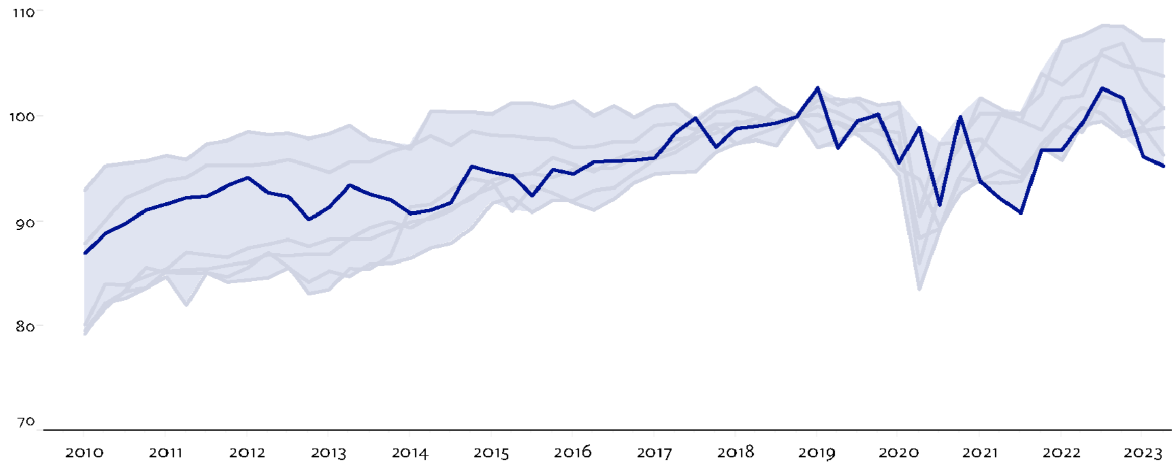
The UK had the biggest fall in trade openness in the G7 this quarter

Index of trade openness (trade volumes divided by real GDP) of the G7 between 2010 and Q2 2023 (Q4 2018=100). UK represented by dark blue line.



Source: OECD Quarterly National Accounts data. Trade openness calculated as imports and exports in chained volume measure divided by real GDP (in US dollars, volume estimates, fixed PPPs, OECD reference year, annual levels, seasonally adjusted). Shaded area is G7 min and max range with dark blue line representing the UK.

In the global context, the UK recently had the biggest fall in trade openness of the G7 the last two quarters. Trade openness is a measure calculated by taking exports and imports and dividing them by real GDP. Trade openness is an important economic indicator because it reflects a country's level of integration into the global economy.

The UK was lagging behind the rest of the G7 throughout all of 2021 and half of 2022. However, in Q3 2022, the UK saw an increase in trade openness, climbing above Canada, France, and the US. However, in the first quarter of this year, UK's trade openness compared to Q4 2018 fell the most and has remained there in Q2 2023. This trend of having the biggest fall in trade openness in the the G7 has largely been seen to coincide with the introduction of the TCA in Q1 2021. Prior to the TCA the UK had fared better than most of the G7, especially at the beginning of the pandemic.

Note on GDP revisions:

The Office of National Statistics (ONS) release revised initial GDP figures for 2020 and 2021. In 2020, average volume GDP is now estimated to have fallen by 10.4%, which is a revision upwards of 0.6 percentage points. In 2021, average volume GDP is now estimated to have increased by 8.7%, revised up from a previous estimate of 7.6%. While these revisions do place the UK in a better economic position coming out of the pandemic than previously thought, according to counterfactual models the UK is still performing worse than if it had not left the EU.

MAJOR DEVELOPMENTS

THE INDIA TRADE DEAL

Trade deals remain a focus of the current government because they are seen as an opportunity to take advantage of Brexit. The government had indicated that it expected to sign a free trade agreement (FTA) with India by the close of 2023. However, even this aspirational goal has been **quietly pushed** after Sunak's visit to Delhi. This comes after a year of delays and on the back of criticism over the recently agreed FTAs with Australia and New Zealand.

Both sides have shared their hope that a deal can be signed by the end of this year, with PM Rishi Sunak visiting India for the G20 summit in September with the hope of furthering negotiations. However, no visible progress was made at the summit. Additionally, there has been talk that he might also be **returning to India** in October to sign a deal (and potentially also catch a match of the Cricket World Cup which is being held in India). But with little progress made at the G20 summit that is looking more unlikely.

Downing Street has been quiet as to when the deal will be signed, potentially trying to avoid the mistake made by Boris Johnson in promising a deal by Diwali in October 2022. Trade Secretary Kemi Badenoch has stated that there will not be an arbitrary deadline put on the deal and, instead, the focus will be on getting the best deal for Britain. The House of Commons Select Committee on International Trade has continually reiterated the need to maintain strong **'red lines'** on non-negotiable interests. This has been even more firmly emphasised since the UK farmers sharply criticised the FTAs with Australia and New Zealand as damaging to their industry by raising the risk of cheaper, lower-quality beef flooding the UK market.

Unlike the other two new free trade agreements the UK has signed since Brexit, India poses to be significantly more impactful, not just due to the size of India's economy but also because of the protectionist approach India has typically had to trade. Only 3% of UK exports to India are currently tariff-free, compared to 60% of Indian exports to the UK. In comparison, Australia and New Zealand had barely any tariffs on UK exports before the FTAs.

For the UK, a trade deal with India would also be a momentous step not only because India is now the fifth largest economy in the world (pushing the UK to 6th), and because of its prior protectionist policies, but also because few countries have a free trade agreement with the country. India only has 13 FTAs (or comparable deals) with a little over 20 countries, three were signed in the last two years but prior to that, very few deals had been signed within the last 10 years. The US, China, and EU have not signed a free trade agreement with India, with only the EU currently in negotiations.

What that deal looks like in detail is yet to be seen but there are clear signs of what it will contain and what are the sticking points in the ongoing negotiations. Since the beginning, the UK's goal has been for India to agree to lower tariffs, especially on key British exports of whisky and cars.

India currently imposes a 150% tariff on alcoholic beverages, which has had a particularly negative impact on the Scotch whisky industry. The UK side wants to see that cut to 75% when the deal is signed with a sharp cut down to 30% over three years. However, India has countered by wanting to see the tariff only reduced to 100% when the deal is signed and then slowly cut to 50% over 10 years.

The second main point of contention is on rules of origin. The UK is seeking more liberal rules of origin on whiskey from Northern Ireland due to the whiskey being produced in both the Republic of Ireland and Northern Ireland.

Similarly, the UK is looking for more liberal rules of origin for vehicles, as many UK automotive products have high levels of non-UK inputs. Equally important is also the current tariff barriers UK car manufacturers face when trying to import UK-made vehicles into India. Currently, vehicles face an average tariff of 59%, with as high as 125% for electric vehicles. More progress has been made on this front with the Society of Indian Automobile Manufacturers accepting a **phased tariff reduction** to 30% over 5 years, following a grace period of five years after signing with no tariff reductions.

More than just cars and whisky though, the UK is seeking agreements on issues from intellectual property rights, to foreign direct investment treaties, to ensuring sanitary and phytosanitary standards (SPS) are upheld.

For India, the goal is to agree to a deal that would increase exports of textiles, food and beverages, tobacco, leather and footwear, while at the same time not allowing anything that would cause India's generic drugs industry to become more expensive. India is also looking for mutual recognition of professional qualifications and the granting of temporary visas allowing businesspeople, especially in the digital services and IT sector, to work in the UK.

The mobility of persons has been seen as one, if not the top issue for India. India has stated that it is not looking for permanent immigration visas under an FTA but instead mobility on temporary visas for businesspeople, young professionals and students.

However, this has led to public criticism from cabinet officials. Home Secretary Suella Braverman has repeatedly **criticised the deal** and conjects that the deal will lead to 'an open borders migration policy with India'. Trade Secretary Kemi Badenoch has emphasised that no such policy would come out of a deal with India. However, the issue remains to be one of the biggest sticking points in negotiations.

One area that the UK has been concerned about is India's desire for the removal of the tariff on milled rice. The UK is concerned about the effect it would have on the domestic rice industry, even though the industry is incredibly small. It is also concerned with the quality and safety checks at the border that would need to be put in place to test the rice for pesticide residues.

The likelihood of an India/UK trade deal seems to be more of a reality than ever; however, the final roadblocks, like migration and visas, could lead to the deal being delayed even further. If the Labour Party wins the next election there is a high likelihood that its focus will not be on new free trade agreements, instead focusing on trade with the EU and how to improve the TCA to make that trade route easier.