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The European Union's New Trade Relationship With the United Kingdom

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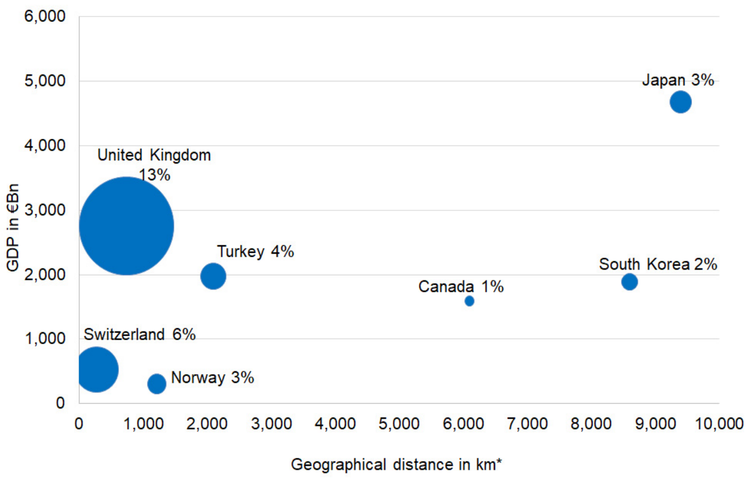
- The talks following the United Kingdom's decision to leave the European Union (EU) were unprecedented insofar as, unlike usual trade negotiations, the goal was to outline a looser relationship whilst mitigating adverse effects on trade and investment.
- The negotiations, which were conducted in double-quick time – under a year – culminated in an innovative agreement that factors in the UK's desire to take back full decision-making control, its close economic and geographic proximity to the EU (see chart below) and the need to safeguard the integrity of the European single market.
- In respect of market access, the agreement is similar to the so-called "new generation" free trade agreements that have been executed with, for instance, Canada and Japan. One of its main features is the lack of customs duties and quotas for all goods provided they meet "economic nationality" criteria or rules of origin. In addition, UK-based financial firms no longer benefit from the EU passport for cross-border financial services and there are specific rules of origin to spur the emergence of a European electric battery sector for the automotive industry.
- The agreement's provisions on fair competition are especially innovative. To ensure open and fair competition and that trade and investment take place in a manner conducive to sustainable development, the agreement determines a framework for subsidies and sets minimum levels for labour, social and environmental standards. Compliance with these provisions is guaranteed by the dispute settlement procedure and by the option of taking unilateral sanctions. On environmental matters, it marks the first time an agreement mentions the Paris Agreement in a key clause.

EU27's share of trade in goods with the rest of the world
Main partners with which the EU has a bilateral trade agreement



Sources: OECD for the GDP (average 2016-2019) and Eurostat for trade in goods (average 2016-2019), trade excluding EU27 only.
* Distance between the capitals of non-EU countries and the EU's centre of gravity weighted by the Member States' share of EU GDP.
How to read this chart: With GDP of over €2,500bn and a capital 740 km away from the EU's centre of gravity, the UK accounts for 13% of the EU27's trade in goods with the rest of the world.

1. Unprecedented trade and economic negotiations

1.1 Economic repercussions for both parties despite an unbalanced trade relationship

The EU is the UK's main trading partner; in 2019 their trade in goods and services stood at €754bn,[1] i.e. 47% of British foreign trade. For the UK, the EU is pivotal for export opportunities and import supply. In 2019, the European market was the destination for 46% of exports of British goods, with the figures being even higher for manufactured products (52%) and agricultural and agri-food products (68%). On the supply side, the UK's dependency is even more marked, with 53% of its imports coming from the EU and the percentages rising to as much as 70% for agricultural and agri-food products and 76% for chemical products.

The UK represents a much smaller share of the EU's foreign trade. In 2019, the UK accounted for 15% of extra-EU exports of goods and 10% of imports. The UK is the leading recipient of EU exports of services, which represented €224bn in 2019, i.e. 21% of total extra-EU exports of services, but the United States (19%) is not far behind. The UK is the EU's second largest service provider (18% of total imports) behind the US (€222bn, i.e. 23%).

The EU is also by far the leading direct investor in the UK with an FDI stock of €800bn in 2019, i.e. 44% of the total stock in the UK. Balancing things out, the EU is the primary destination for British FDI, with 40% of the UK's stock (€707bn) having been located in the EU in 2019.

Despite this imbalance, the economic impact for the EU in the event of a no-deal Brexit, although much less than the impact on the UK, warranted the trade talks. With a no-deal scenario, it was estimated that, in 2030, the EU's GDP would have been between 0.5% and 1.5% lower than the level that would have been reached with an agreement in place. The impact on the UK within the same time period was estimated to be much greater (between 2.9% and 13%) compared to a situation with an agreement.[2]

1.2 Atypical negotiations for the Trade and Cooperation Agreement

Following the referendum held on 23 June 2016, the UK triggered Article 50 of the Treaty on the Functioning of the European Union on 29 March 2017, thus paving the way for its withdrawal from the EU, which ultimately took place on 31 January 2020.

There were two phases of Brexit negotiations (see Chart 1). The first was geared towards the UK's orderly withdrawal from the EU and culminated in the Withdrawal Agreement, which took effect on 1 February 2020. This "divorce agreement" governs the fallout from Brexit in respect of a vast array of situations having arisen during membership of the EU. It also contains unprecedented provisions[3] concerning Northern Ireland as it was unthinkable to reintroduce a land border in Ireland, the absence of which was laid down in the Good Friday Agreement of 1998. The Withdrawal Agreement also stipulated a transition period[4] from 1 February to 31 December 2020 which generated a temporary status quo and allowed for talks to outline the future relationship.

(1) The Eurostat data used here was established from data provided by the national authorities tasked with accounting for trade statistics. Due to different accounting rules, divergent methodologies and unreported data, there may be imbalances between reference countries.

(2) These figures were taken from a number of studies on the impact of Brexit on the UK and EU that were conducted between 2016 and 2018, including Mulabdic et al., World Bank (2017), "Deep Integration and UK-EU Trade Relations", Vandenbussche et al. (2017), "Global Value Chains, Trade Shocks and Jobs: An Application to Brexit" and Cambridge Econometrics (2018), "Preparing for Brexit".

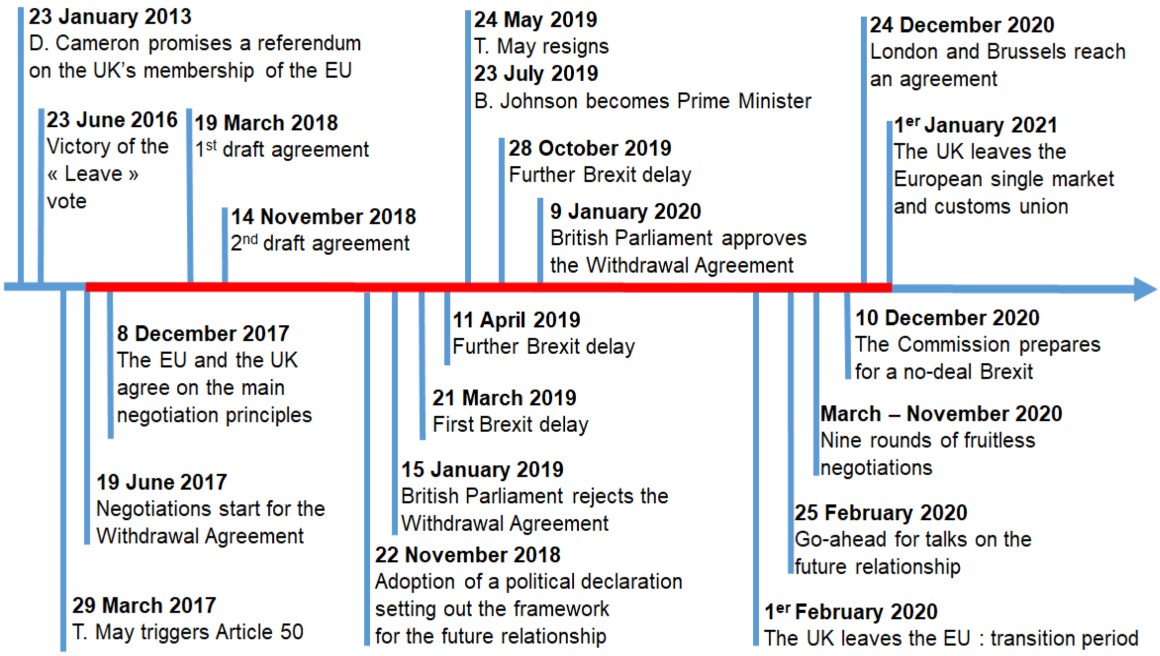
(3) In particular, the introduction of customs inspections and regulatory controls based on European standards in the Irish Sea and in Northern Ireland's airports for all goods imported into Northern Ireland from non-EU countries.

(4) This second phase was also used to temporarily, and subject to reciprocity, mitigate the effects of the UK's withdrawal from the EU with or without an agreement. This meant that a large number of contingency measures were provided for at European and national levels, especially in respect of financial services.

Negotiations for the Trade and Cooperation Agreement (TCA) were remarkable on several fronts. Firstly, unlike what is aimed for with a standard trade agreement, the negotiations could only have led to a worsening of trade relations between the parties as no trade agreement could have replicated the economic relationships in the EU's internal market, which the UK had decided to leave (see below). Moreover, trade talks were held in conjunction with negotiations in other fields such as fishing, transport and energy,[5] as the agreement had a far larger scope than a standard trade agreement. Lastly, the schedule for negotiations was squeezed into ten months whereas trade talks usually last several years.

A number of institutional aspects demonstrate how the EU adjusted to the strategic nature of these talks. This included the preeminent role of the European Council,[6] the position adopted by the task force, reporting directly to the President of the European Commission, and the choice of a political figure, the former European Commissioner Michel Barnier, as chief negotiator. The UK also set up a specific institutional structure with its chief negotiator, David Frost, having his own negotiating team and reporting directly to Prime Minister Boris Johnson instead of to the Department for International Trade.

Chart 1: Timeline of EU/UK negotiations



Source: DG Trésor.
How to read this chart: The negotiation period appears in red.

2. Expectations were unitialy far apart

As early as 2018, the EU had flagged up the risks it would face in the event of an unsatisfactory agreement on the future relationship with the UK.[7] It was looking to forge a bold partnership to limit the impact of Brexit for both businesses and citizens whilst ensuring balanced rights and obligations for the parties.

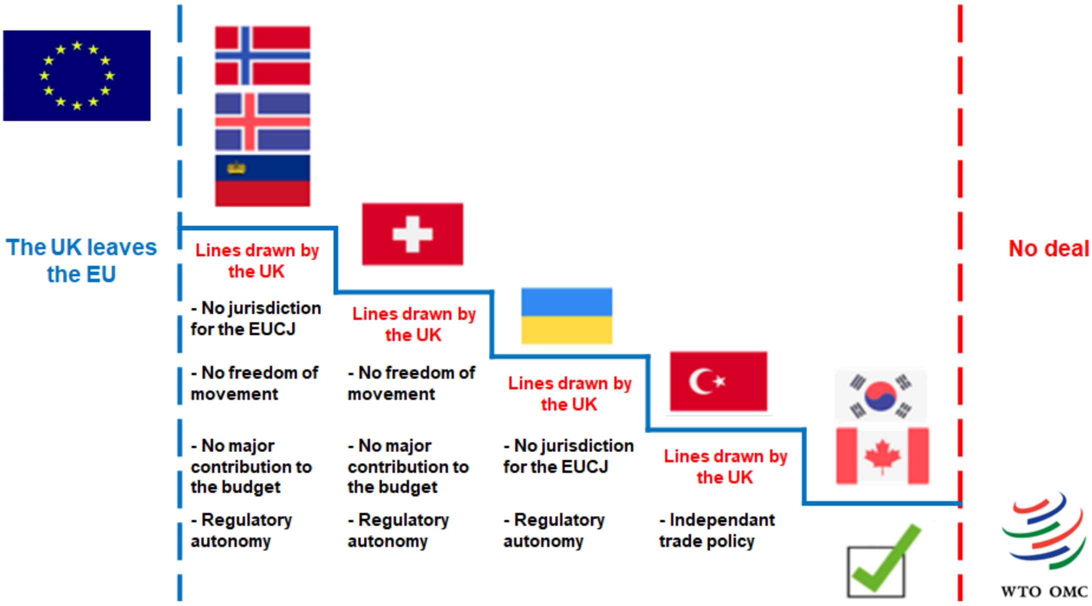
First, the EU's four fundamental freedoms (goods, capital, services and persons) are inseparable. The UK could not stay in the EU's single market for goods and services whilst refusing the free movement of persons. Nor could it continue to benefit from the mutual recognition principle[8] as it was leaving the single

(5) This issue of Trésor Economics does not address sector-based cooperation but focuses on the agreement's trade component.
(6) Between June 2016 and October 2020, the European Council adopted no fewer than 13 guidelines on negotiations for the Withdrawal Agreement and, subsequently, the Trade and Cooperation Agreement with the UK.
(7) European Council (Article 50) guidelines of 23 March 2018.
(8) This principle originates from the 1979 "Cassis de Dijon" judgment handed down by the Court of Justice under which the Member States must eliminate all restrictive measures on goods provided they comply with regulations in another Member State, unless the measure serves a purpose which is in the general interest.

market. Second, the EU had to safeguard its independence in decision-making. As a non-EU country, the UK would be unable to take part in European rule-making as this is the sole remit of Member States. Third, the agreement would have to set out robust guaranties in terms of fair competition. The UK could not allocate substantial State aid or undermine its labour, social and environmental standards, thus granting its businesses an unfair competitive advantage.

For its part, the UK had drawn a number of clear lines: no free movement of persons between the EU and UK, no major contributions to the EU budget, full regulatory autonomy and refusal to recognise the jurisdiction of the Court of Justice of the EU. This precluded templates for highly integrated trade relations such as those of the EU with Norway, Switzerland or even Ukraine. A Customs Union, such as the arrangement the EU has with Turkey, was also ruled out by the UK as it would have involved it abiding by the common commercial policy with respect to goods vis-à-vis other non-EU countries. From the EU's standpoint, the only option was a "new generation" trade agreement (see Chart 2), along the lines of those executed with Canada (CETA) and South Korea. This type of agreement involves the reinstatement of regulatory procedures for goods and services, particularly for customs operations, from which the EU's abovementioned partners (Norway, Switzerland, Ukraine, etc.) are partially exempted.

Chart 2: Templates for the relationship between the EU and UK



Source: European Commission.

As opposed to the other "new generation" agreements with Canada and South Korea, the EU considered it essential to stipulate special provisions on fair competition. Due to the UK's proximity and the extent of its trade relations with the EU, it could have gained a significant competitive advantage from the relaxing of its regulations in comparison to the EU rules that had been binding on it up to then (see chart on cover page). The EU therefore strove to ensure the UK's de facto application of EU rules on State aid and to prevent the undermining of British tax, labour, social and environmental standards in relation to those of the EU.

The British Prime Minister had stated that safeguarding the UK's sovereignty was an imperative for negotiating the agreement on future relations. This position went against European requests for the UK's regulatory alignment, a central issue of talks on the TCA. During the negotiations, the EU had warned that, if the UK failed to make solid commitments on fair competition, it would fall back on a trade relationship based solely on WTO rules and the UK would not have preferential access to the European market. The agreement that was ultimately reached avoided this situation, which would have had economic repercussions for both sides (see below in 3.2).

3. Preservation of the internal market and unprecedented provisions on fair competition

3.1 Market access similar to that provided for in the EU's agreements with Canada and Japan

Regarding market access, the TCA contains the majority of the EU's initial proposal based on the "new generation" agreements that it had previously concluded.

But it is regarding goods that the TCA breaks new ground. For tariffs, it stipulates that there should be zero customs duties or quotas for all goods. This amount of liberalisation is unheard of for a European agreement, although it is similar to the EU's commitments vis-à-vis Japan and Canada (see Table 1). In those two agreements, the EU undertook to eliminate customs duties for around 99% of tariff lines[9] in eight years as from the effective date of the agreement with Canada and in 16 years for Japan. That said, the EU has maintained quotas with Canada for certain sensitive agricultural products. These quotas provide for an overall reduction of customs duties on imports into the EU, but limited to a determined volume.

As with all agreements, this preferential treatment is contingent on compliance with rules of origin allowing for confirmation that only goods with UK "economic nationality" may be exempted from EU import duty and vice versa. The idea is to ensure that only goods with a "real" economic link with the EU and UK are covered by the agreement. As an example, a car manufactured entirely in Asia with only the paint having been applied in a British factory cannot be exported without customs duties being paid in the EU. The TCA sets out specific rules of origin to protect the electric vehicle industry, which is seen by the EU as a major industrial issue for the coming years. British manufacturers must use British or European batteries in their vehicles to be able to export them to the EU without customs duties and vice versa.

From a non-tariff standpoint, the TCA does not remove customs, sanitary or phytosanitary inspections on goods.[10] As with all trade agreements, none of its provisions amend the standards laid down by EU law concerning the marketing of products, especially agricultural and agri-food products. This means that risk-based physical and documentary inspections are conducted at the borders in the same manner as for all goods imported from a non-EU country.

Table 1: Percentage of liberalised tariff lines in EU trade agreements

Country	All sectors	Agricultural goods and agri-food products	Industrials goods
Canada*	98.7	94.5	99.9
Japan	99.1	95.8	100.0
United Kingdom	100.0	100.0	100.0

Source: European Commission.
* In the EU/Canada agreement, the EU maintained quotas for certain sensitive agricultural products. These quotas provide for an overall reduction of customs duties on imports into the EU, but limited to a determined volume.
How to read this table: In the long-term, the EU/Canada agreement provides for the elimination of customs duties on European imports from Canada for 98.7% of tariff lines across all sectors.

In respect of services, the TCA provides for the reciprocal opening of markets and non-discrimination between European and British operators. The parties did however set out a large number of reservations, which is common practice in trade agreements, in order to be able to depart from the agreement in certain sectors such as audio-visual or legal services. It is of particular note that the agreement does not contain provisions to ensure the continuity of trade in financial services between the UK and EU; the UK no longer has preferential access to the EU's internal market. The arrangements to which the UK is now subject, in the same way as all non-EU countries, are based on the notion of the equivalence of regulatory frameworks, safeguarding the EU's decision-making autonomy. Announcements by British leaders of potential

(9) In the customs nomenclature, a tariff line is a product code based on which customs tariffs are determined.
(10) The TCA nevertheless sets out specific provisions for certain sectors (motor vehicles, medicinal products, organic products and trade in wine) which reduce regulatory procedures without eliminating them completely.

regulatory divergence have raised questions and slowed down the technical analysis of equivalence at European level. As of February 2022, only one temporary equivalence decision on clearing houses is still in force. London-based financial institutions have tweaked their operational plans to factor in this situation.

The TCA also stipulates broad reciprocal opening of public procurement and ensures robust protection for all intellectual property rights with the exception of geographical indications, which are covered by the Withdrawal Agreement. Moreover, the TCA contains a section on digital trade, like the EU's most recent agreements: recognition of contracts concluded by electronic means and electronic signatures, no customs duties on electronic transmissions, regulation of requests for access to businesses' source codes by the public authorities, and minimum standards for anti-spam and online consumer protections. Lastly, for the first time in a European trade agreement, this section sets out horizontal provisions on data flows which, in line with the EU position, prohibit the main barriers to flows whilst reiterating the parties' right to regulate.[11]

3.2 Unprecedented provisions on fair competition in trade and investment

The TCA contains binding provisions on environmental, labour and social standards, even though the agreement does not provide for the UK's full and continuing regulatory alignment with the EU in this respect.

Regarding subsidies, the agreement stipulates that State aid, without being broadly prohibited as is the case under EU law, must comply with a number of principles: (i) pursue a specific public policy objective; (ii) be proportionate; (iii) bring about a change of economic behaviour; (iv) not create a windfall effect; (v) not replace less distortive means; and (vi) not cause negative effects to outweigh positive effects, in particular between the EU and UK. If a company is adversely affected by a State aid measure, it may also bring challenges before the courts for the recovery of undue amounts by the government that granted the aid. Lastly, in the event of a significant negative effect on trade or investment, the injured party may take unilateral remedial measures.

In respect of environmental, labour and social standards, the agreement advocates a principle of non-regression, which prevents the level of protection in effect on 31 December 2020 in the EU and UK from being reduced but does not require the UK to align itself with future European standards. Nevertheless, if there is excessive divergence in levels of protection that has significant effects on trade or investment, unilateral measures to offset these effects can be taken. Lastly, for the first time in a trade agreement, the Paris Agreement is referenced as an essential element, alongside democracy and countering the proliferation of weapons of mass destruction, and failure to comply with it could lead to the suspension of all or part of the TCA.

4. A changing trade relationship

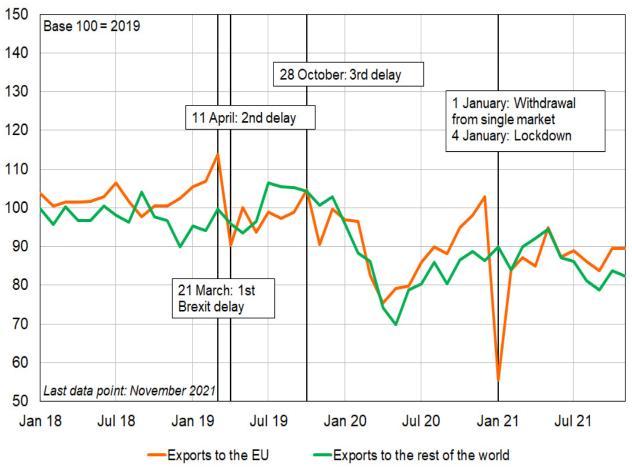
4.1 Both Brexit and the COVID-19 pandemic have affected trade between the EU and UK

In early 2021, trade in goods between the EU and UK fell substantially due to the stepping up of COVID-19 restrictions, the reintroduction of customs inspections and the impact of stockpiling ahead of actual withdrawal from the Customs Union at the end of 2020. It is, however, impossible to pinpoint the precise contribution of each of these factors. In January 2021, compared to their average 2019 levels, exports of British goods to the EU were down 45% (see Chart 3) and British imports of goods from the EU had fallen by 30% (see Chart 4). The lesser fall in British imports was due to the fact that customs inspections were only reintroduced gradually in the UK and to the problems faced by the UK in finding suppliers outside the European market.

(11) Under the GDPR, the free movement of personal data between the UK and EU is only possible if the EU unilaterally decides that British regulations offer an adequate level of protection, and vice versa. On 28 June 2021, the Commission adopted an adequacy decision, noting that the UK provides an adequate level of protection for personal data.

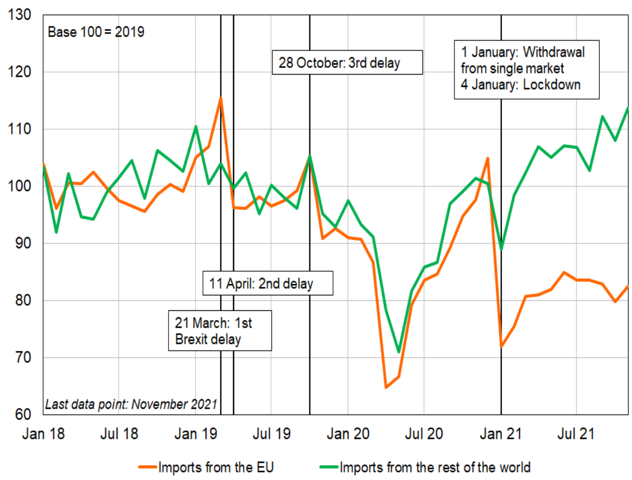
During 2021, exports of British goods to the EU recovered rapidly but were still 10% below their average 2019 levels in November 2021. This drop was slightly less than that for exports to the rest of the world. British imports of goods from the EU also picked up but at a far slower pace and were still 17% below their pre-pandemic levels in November 2021. On the other hand, British imports from the rest of the world increased sharply and were 14% above their average 2019 levels. This gap between imports from the EU and the rest of the world was due to a major upswing in market share for China since 2020. Between Q1 2018 and Q1 2021, British imports from China jumped by 65%, meaning that China became the leading import partner ahead of Germany. But as trade flows are still being disrupted by the COVID-19 pandemic, it is too soon to determine any structural changes to trade. Trade in services data also shows a decline compared to the situation prior to the pandemic: imports and exports of services were respectively 32% and 21% down on their 2019 levels in Q2 2021.

Chart 3: British exports of goods by partner



Source: Office for National Statistics, DG Trésor calculations.

Chart 4: British imports of goods by partner



Source: Office for National Statistics, DG Trésor calculations.

Scope:Chain-linked volumes of goods restated to exclude non-monetary gold.

4.2 A major trade partnership which could be further expanded

Having been provisionally applied as from 1 January 2021, the TCA came into force on 29 April 2021 following its approval by the European Parliament and the Council. The EU, and France as a Member State, remain attentive to its due and proper implementation, especially regarding fair competition issues. The relationship between the EU and UK is part of the governance structure provided for by the agreement, and a Partnership Council, chaired jointly by the European Commission and the British government, supervises a large number of specialised committees dealing with matters such as customs cooperation, sanitary and phytosanitary measures and technical barriers to trade.

The agreement also provides for the possibility of activating a number of cooperation clauses (social security coordination) and introducing regulatory cooperation on financial services between the parties. Lastly, and if necessary, additional agreements may be negotiated, for instance, in respect of the mutual recognition of professional qualifications (qualifications acquired prior to 2021 are still recognised under the Withdrawal Agreement).

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