The future of the UK and Europe

Deconstructing a trade deal
March 2018
Eighth edition

By your side

LLOYDS BANK
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Cover image: Getty images library
Welcome to the eighth edition of 'The future of the UK and Europe'. For this edition, with the UK and EU on the verge of engaging in trade negotiations, we focus on trade deals. What is involved and what is the process? Rather than focus on the minutiae of the specific negotiations, which as we have seen are likely to ebb and flow right until the final moment, we have focused on some of the fundamental questions about how and why trade deals come to exist. What is the role of the business community? And how can firms ensure that their priorities are taken into consideration? What else should businesses be mindful of?

To help explain this, we sought out two of the highest profile former trade negotiators. Pascal Lamy, former director-general of the World Trade Organisation, and Miriam González Durántez, both of whom have extensive experience of working with the European Commission’s trade delegations, impart first hand knowledge of what it takes to put a trade deal together. They provide a clear point of view on what businesses should be doing at this stage to prepare for Brexit, and influence negotiations.

Angus Armstrong, our Chief Economic Advisor, provides his view of the UK’s economic outlook to 2019, and beyond. Benedict Brogan provides his usual insightful round-up of the latest political developments, following the Prime Minister’s Mansion House speech.

We also outline a revised view of the timeline, based on what we have heard from the UK’s Department for Exiting the EU (DxEU) and the EU’s Article 50 task force.

If you have any comments or questions on the content of this briefing note please discuss them with your Relationship Manager, or contact the editors – their details are on page 26. Alternatively, find us on LinkedIn and Twitter, and at lloydsbank.com/brexit

At a glance

- Stock markets globally were shaken by marked sell off from late January onwards
- GBP climbed to its highest level versus USD since the referendum (1.42) before falling back slightly
- The Bank of England held its base rate steady at 0.5% for the first two months of the year but at least one rate rise is expected later in the year
- The UK unemployment rate fell to 4.4% at 4Q 2017

Key market movements

<table>
<thead>
<tr>
<th>Indices</th>
<th>As at end Feb 2018</th>
<th>Δ since 22/06/2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ / $</td>
<td>1.38</td>
<td>-6.12%</td>
</tr>
<tr>
<td>£ / €</td>
<td>1.13</td>
<td>-13.08%</td>
</tr>
<tr>
<td>FTSE 100</td>
<td>7232</td>
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</tr>
<tr>
<td>FTSE 250</td>
<td>19687</td>
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<tr>
<td>S&amp;P 500</td>
<td>2714</td>
<td>30.17%</td>
</tr>
<tr>
<td>EuroStoxx 50</td>
<td>3439</td>
<td>15.48%</td>
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<tr>
<td>UK 10YR</td>
<td>1.50%</td>
<td>14.5%</td>
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1 The eve of the EU referendum
With phase two of the Brexit talks set to begin this month, you could forgive the Prime Minister for wondering how it has been only three months since she successfully concluded phase one. Following a positively received Budget in November, the European Commission agreed at its December summit that ‘sufficient progress’ had been made on the ‘divorce bill’, the respective rights of citizens and a preliminary agreement on the Irish border. From this starting point, the Government was supposed to be spending the first quarter of 2018 focused on the meaty topics of a transition period and the future UK/EU relationship. That new year optimism lasted until January 8.

By reshuffling her Cabinet on the first working Monday of 2018, Theresa May managed to lose the political momentum she had accrued toward the end of 2017. Jeremy Hunt refused to be moved from Health and Justine Greening resigned rather than be ‘demoted’ from Education. With stories reporting the Prime Minister’s weakness in the face of defiance from her ministers through January, Michel Barnier published the EU’s guidelines for phase two, stating that a withdrawal deal must be completed by the October Council Summit and any agreed transition period must be completed by December 2020.

The Government had been hoping for an implementation period of ‘approximately two years’ after the UK leaves the EU in March 2019, but 20 months has been universally acknowledged as a very tight timeframe for the phased implementation of agreements reached this year. The Commission is also insisting that the UK be fully compliant with the EU acquis after it leaves, until the transition period ends, while offering the UK no formal role in EU decision-making procedures. The detail of agreements reached in principle this year, such as those on financial services, will also have to be ironed out during the transition period, and will likely involve several more years of negotiation after 2020 to complete.

To compound the Prime Minister’s problems, an official Whitehall impact study of three possible Brexit scenarios (an EEA type agreement keeping the UK in the Single Market, a free trade agreement, and ‘no deal’) over a 15 year period, was also leaked and outlined that each scenario would bring about a reduction in UK economic growth of 2%, 5% and 8% respectively over that time-frame.

Crunch time at Chequers
With Cabinet and party division on Brexit rapidly increasing over the past three months, and the start of phase two talks rapidly approaching, the Prime Minister called a Cabinet meeting at Chequers to thrash out a broad pitch to Brussels on which Ministers could all agree. The meeting was deemed a success, with one unnamed Minister describing an “outbreak of unity, for now”.

This common accord revolves around the principle of ‘regulatory divergence,’ where the UK will stick closely to the EU in some areas, but on its own terms, and go its own way on others.

Initial analysis of the agreement at Chequers yielded that ‘regulatory divergence’ would likely be construed in Brussels as cherry-picking...
cherry-picking of the best bits of EU membership while diverging from the worst. This was confirmed in a tweet from European Council President Donald Tusk, who dismissed the Government’s proposals as “pure illusion”, a statement that Mr Barnier later agreed with before stating himself that “significant points of disagreement” still existed between the UK and the EU.

May’s speech at Mansion House
However, this fresh Cabinet unity allowed the Prime Minister to deliver her third major speech outlining the Government’s Brexit priorities on 2 March. Mrs May was clear in stating that both sides would have to accept “hard facts”. She said that the UK could not expect to “enjoy all the benefits without all of the obligations” of EU membership and that Single Market access in future would be “less than it is now”. But the Prime Minister also made clear to Brussels that the UK would want its own bespoke trade deal, and not an “off-the-shelf model”, such as the EU-Canada agreement. She said that banks located in the City of London will lose the right to ‘passport’ into EU member states, but that a new system will be brought in to allow “the same regulatory outcomes over time”. Mrs May said that by keeping regulatory standards “as high as the EU’s”, the UK would ensure smooth trade once we leave and that while UK law may not be “identical” to EU law “it should achieve the same outcomes” over time. Mrs May also said she was confident that the remaining differences over a draft EU legal agreement on the Northern Irish border would be resolved, allowing trade talks to soon get under way.

The political context in Europe
Once they do, Mrs May will find Michel Barnier as resolute as ever in arguing for the EU’s interests. However, Mr Barnier’s job is set to become a trifle more difficult and the Prime Minister may be encouraged to find a European Union less united than during the phase one negotiations. With the common causes of making certain the UK paid a large sum to the EU as it left and ensuring that the reciprocal rights of citizens would be guaranteed, EU member states were uncommonly aligned last year. But when faced with the diverging impacts of Brexit to different national economies and the turnover of European national leaders, there is the flicker of potential discord among the EU27 as member states may seek to drive their national Brexit agendas in the European Council. When one adds the ingredient of a weaker Angela Merkel whom – with a tricky new coalition agreement that has ceded the Finance, Foreign and Home Affairs Ministries to her SPD partners – is perhaps not in the position to lead Europe as she once was, the Prime Minister may notice opportunities where there were none before as the ground moves beneath Mr Barnier’s feet.

Jeremy Corbyn
This brings us to Jeremy Corbyn. While the Government has been struggling with its Brexit policy, so too has the Labour Party. The Prime Minister ruled out future membership of the Customs Union in her Florence speech in September 2017, in order for the UK to be able to negotiate its own trade deals once the UK leaves the EU. Since then, Shadow EU Exit Secretary, Sir Keir Starmer, has been advocating to his party leadership of the need for the UK to remain part of it. On 26 February Sir Keir officially won the argument, and Labour changed its position. In a speech, Mr Corbyn outlined the Labour position that the UK should seek a new economic arrangement with the EU that will “do the work of the current Customs Union,” to ensure that tariff-free trade continues with the Single Market and the wider EU Customs Union. Mr Corbyn believes that such an arrangement would ‘fix’ the Irish border issue and would allow the UK to remain part of the international trade deals the EU holds, and part of future deals that the EU is currently negotiating with China, Japan and the United States. There is some speculation that Mr Corbyn’s move is a prelude to an even more bullish Labour position on the Single Market.

By supporting ‘a’ customs union, Mr Corbyn has seemingly increased the prospect of the Government suffering a significant defeat in the House of Commons on the EU Withdrawal Bill, or one of its ‘flanking’ bills on immigration, data protection and customs, as the number of Conservative MPs who would support remaining in a customs union is thought to be increasing. The prospect of the Prime Minister losing a parliamentary vote on the future withdrawal agreement, once it is concluded in October, has also increased, as has the likelihood of a no confidence vote should the Government lose that vote in the Commons.

The first two months of 2018 proved difficult for Theresa May, the next nine months look tougher still.
The road to Brexit

Two year window under Article 50

Key milestones

- 23 Jun 2016: UK votes to leave the EU
- 29 Mar 2017: Article 50 triggered
- 19 Jun 2017: Phase 1 negotiations start
- 14 Dec 2017: ‘Sufficient progress’ reached on phase 1
- 29 Jan 2017: Phase 2 negotiations start
- 14-15 Dec 2017: European Council Meeting
- 22-23 Mar 2018: European Council Meeting

UK legislation required as a result of Brexit

European Union (Withdrawal) bill
Other Brexit-related legislation

House of Commons
House of Lords
Royal Assent
Agriculture
Customs
Fisheries
Immigration

Broader political context

- 17 Jan 2016: PM’s Lancaster House Speech: Government’s negotiating objectives
- 22 Sep 2017: PM’s speech in Florence: the new era partnership
- 23 Feb 2018: Chequers summit on Brexit negotiations
- 8 Jun 2017: UK general election
- 2 Mar 2018: PM’s speech at Mansion House: UK / EU future economic partnership
- 22-23 Mar 2018: Italian general election (hung parliament)

Sources: Institute for Government, DeEU, European Commission, EY, PWC
### The future of the UK and Europe – The road to Brexit

#### Secondary legislation & statutory instruments

- **Nuclear Safeguards**
- **Trade**

#### Key Dates

- **28-29 Jun 2018** European Council Meeting
- **18-19 Oct 2018** European Council Meeting
- **13-14 Dec 2018** European Council Meeting

#### Tentative Timeline

<table>
<thead>
<tr>
<th>Q1</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan</td>
<td>6 months for ratification in the parliaments of the UK and the EU27</td>
</tr>
<tr>
<td>Feb</td>
<td>Oct 2018 Deadline set by Michel Barnier for Article 50 negotiations to conclude</td>
</tr>
<tr>
<td>Mar</td>
<td>29 Mar 2019 Two-year window provided by Article 50 expires</td>
</tr>
</tbody>
</table>

#### Important Events

- **Transitional period commences (if agreed)**
- **No deal. UK exits the EU**
- **Nov 2018 to March 2019 (date tbc)**
- **UK parliament vote on withdrawal agreement**
- **Presidential election in Republic of Ireland**
- **Deadline for Spanish general election to be held**
The UK economy has been resilient to the uncertainty around the future constitutional arrangements with the EU. Key to this resilience is the performance of the labour market. Despite record low unemployment, modest wage growth has enabled the Bank of England to extend its accommodative monetary stance. The Government’s Industrial Strategy aims to improve the lacklustre productivity performance by broadening the economic base across the UK. As we look ahead, our working assumption is that the Government delivers on its policy of an uninterrupted transition to a comprehensive Free Trade Agreement with the EU.

UK resilience
Economic growth is estimated to have been 1.7% in 2017. This is slightly lower than in 2016, but close to many forecasters’ estimate of the sustainable rate of growth. The composition of demand has changed significantly, in part due to a lower value of Sterling as a consequence of the EU referendum. Higher import prices pushed up inflation sharply. Consumer spending growth of 3.9% in 2017 translated into only 1.8% growth in volume. This is the weakest consumer spending growth in four years. Households also reduced their propensity to save, suggesting that either the fall in Sterling is expected to be reversed, or more likely that they are spreading the adjustment to higher prices over a number of years.

By contrast, there has been some improvement in trade – faster growth in export volumes and slower growth in import volumes. In addition to the lower exchange rate, demand in our main export markets – in particular, the rest of the EU and the US – has improved considerably. The lower value of Sterling also supports the returns on our overseas assets, of which a large share are denominated in foreign currencies. The UK’s international investment position – our stock of foreign assets less our stock of foreign liabilities has improved markedly. We expect to see our current account deficit as a share of output narrow further as a result of this rotation in demand.

Economic resilience rests with the performance of the labour market. Unemployment has continued to fall, down from 4.8% at the end of 2016 to 4.4% at the end of 2017. Companies’ plans for increasing employment and investment are close to the long run average in services, and well above average in manufacturing (see chart). The number of under-employed workers, those who seek to work more hours, has fallen steadily over the last two years. Even with these buoyant employment prospects, there has been surprisingly little upward pressure on wages. This has enabled the Bank of England to be supportive of the economy even as unemployment has continued to fall.

Favourable global backdrop
Global output has accelerated over the past year. The Eurozone is now in a self-sustaining expansion which is expected to continue for at least another year before capacity constraints start to raise inflationary pressures from the current low level. The US is providing extra stimulus to its economy through tax cuts and spending increases, despite a risk of ‘over-heating’ the economy given that unemployment is only 0.2% above its 40-year lowest point. Demand in the developed economies will provide a stimulus to emerging markets. The IMF is forecasting above-trend growth for the world economy in 2018 and 2019, the most promising economic outlook for more than a decade.

Persistent above-trend global growth eventually brings rising cost pressures. This is where the synchronisation of economic cycles across countries may be more powerful than the pockets of strength over the last decade. International conditions matter more than ever. Interest rates across advanced economies remain at, or close to, record low levels and central banks have created vast amounts of banking sector reserves through quantitative easing programmes. As economies absorb spare capacity and commodity prices rise, official policy interest rates are likely to rise further.

Investors may soon change from asking whether interest rates will rise, to asking what level they will eventually reach. This will challenge some valuations of assets, as investors take into account the new investment context. The return of volatility in financial markets since the start of the year may last throughout the year as positions taken on the expectation of permanently low interest rates are eventually unwound. An unknown risk is the extent to which lower asset prices could yet feedback onto the performance of real economies.
**March 2019**

A particular political and economic issue facing the UK is its withdrawal from the EU. The UK’s withdrawal agreement (under Article 50 of the EU Treaties) must be ratified by 29th March 2019 to avoid departure without the continuity of existing trade and investment arrangements or appropriate infrastructure. In practice, this means an effective deadline of October 2018 as the agreement has to be ratified by ‘super qualified majority’ voting: in other words, 20 of the 27 remaining EU member states, or 65% of the EU population, and the European Parliament.

**Beyond March, 2019**

The medium term outlook depends, in part, on the outcome of the Brexit negotiations. It is worth keeping in mind that the EU (and countries with which the EU has Free Trade Agreements) accounts for 56% of UK exports (see chart) and an even higher share of imports. EU countries are also collectively the largest foreign direct investors into the UK. Because eight out of every ten jobs in the UK are in the services sector, the question of ‘behind the border’ regulatory barriers is important to the UK. The future governance arrangements will be important for trade, investment and productivity. The greatest impact will be distributional, creating winners and losers, rather than in the aggregate.

Perhaps more important than Brexit is the extent to which the disappointing productivity performance over the past decade can be reversed. Technological progress continues apace and, now that lingering effects of the financial crisis are waning, companies have the opportunity to harness that progress more effectively. But doing so requires consideration of those for whom technology proves a threat to employment. Pro-growth policies require the inclusion of all parts and peoples of the UK – a point recognised in the Government’s Industrial Strategy.

**UK outlook and risks**

Incorporating the full range of political and economic risks into a central forecast cannot be achieved easily. The impact of each possible outcome is quite different. We therefore present our modal, or most likely, view as a central forecast. We assume that the Government’s policy stance is successful and that there is a smooth transition towards a deep and comprehensive Free Trade Agreement. On this basis we continue to project that the economy grows close to its lower long-term trend rate of around 1.7% over the next three years. Inflation is likely to be slightly more persistent and hence we expect the Bank of England to continue its path of gradually tightening interest rates.

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**UK companies’ investment and employment expectations**

(standard deviations from long term average)

![Chart](chart.png)

Source: Bank of England Agent’s survey, Lloyds Bank calculations

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**UK exports by destination, %, 2016**

<table>
<thead>
<tr>
<th>Exports to the EU27</th>
<th>EFTA</th>
<th>Trade &amp; customs agreements in place e.g. Korea, Turkey</th>
<th>Partnership &amp; cooperation agreements in place e.g. Russia, Kazakhstan</th>
<th>Trade &amp; customs agreements partly in place e.g. Canada</th>
<th>Trade &amp; customs agreements pending Japan, Vietnam, Singapore</th>
<th>Exports to EU17 and countries where the EU has trade agreements</th>
<th>Exports to countries where the EU has no trade agreement (e.g. US, China)</th>
</tr>
</thead>
<tbody>
<tr>
<td>43.1</td>
<td>0.5</td>
<td>3.9</td>
<td>1.6</td>
<td>3.3</td>
<td>1.7</td>
<td>56.1</td>
<td>43.9</td>
</tr>
</tbody>
</table>

Source: European Commission, ONS, Lloyds Bank calculations
Tom Edwards provides a view of what British businesses think about a Brexit transition period, and fresh insight on employee recruitment and retention since the EU referendum.

**Business sentiment towards a transition period**
Agreeing a transition period is high on the priority list for both the UK and EU negotiators, prior to discussions on the future trade deal beginning later in March. British businesses favour a transition period, as opposed to a swift exit from the European Union and Single Market in March 2019. 40% of businesses surveyed indicated a transition period would have a positive impact. However, a material minority (18%), indicated that they expected a transition period to have a negative impact for their business. Of those firms, many are concerned that the transition period may prolong uncertainty over the eventual end-state deal.

Firms also told us that a time-limited transition period was favoured, with 60% favouring a transition period of up to three years. Perhaps inevitably, a third of businesses advocated a longer transition period, with 17% asking for a transition period of more than five years (and potentially no Brexit at all). Critically, 69% of businesses need a transition period to be confirmed by June 2018 – providing them with the certainty that there will be no ‘cliff-edge’ changes in March 2019.

40% of firms told us that a transition period would be positive for their businesses. Firms indicated that a transition period would materially help in areas that were impacted by the referendum result.
The future of the UK and Europe – Insights from British businesses

Firms have found it easier to recruit colleagues over the past 18 months, possibly explained by higher turnover across Britain

Drivers of recruitment challenges across the UK

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Description</th>
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<tbody>
<tr>
<td>50%</td>
<td>Fewer applications by EU citizens</td>
</tr>
<tr>
<td>48%</td>
<td>Quality of the applications hasn’t been good enough</td>
</tr>
<tr>
<td>46%</td>
<td>Lack of desired skills</td>
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</table>

Source: Lloyds Bank / London First, Building the Workforce of the Future report, March 2018
Our theme for this edition is ‘deconstructing a trade deal’. As the UK prepares for its first independent trade negotiations since joining the European Economic Community in 1973, Oliver Jordan explains who is involved in trade deals, the key steps in the process, and what need to be covered.

In terms of its future trading relationships, Britain has two sets of negotiations to run in parallel.

Firstly, establishing a new trade agreement with the European Union, and reaching agreements on broader elements of future co-operation beyond trade – examples include security and anti-terrorism and collaboration in academic research.

Secondly, negotiating trade agreements with ‘third countries’ – other nations beyond the EU, where there are opportunities for Britain to expand trade. As we explain, businesses have a key role to play in these negotiations, and having an understanding of the process is going to be critical.

Beyond WTO membership – the context of bilateral trade negotiations

For the 164 nations that are members of the World Trade Organisation, its rules and obligations provide the framework within which any trade negotiations start. If the UK and Europe fail to agree a deal (and ratify it) by March 2019, WTO ‘most favoured nation’ rules will govern how we trade with the EU. However, WTO rules also define the parameters within which its members agree bilateral and plurilateral trade deals, beyond the core terms of membership.

Who is involved?
Typically trade negotiation starts ‘at home’. Governments respond to the needs of their consumers (be they individual, or businesses), and producers, and explore opportunities to open up trade with other countries accordingly. Engaging domestically with voters, businesses and other representative groups has become increasingly important in trade negotiations, both during the preparation phase, and throughout the process. Negotiations have gradually become more transparent. The negotiating team needs to know what they are aiming for and why, and what they can offer up in return. This sets the political mandate within which negotiations take place.

Engagement between civil society and the negotiating team typically occurs at each level of the pyramid.
The future of the UK and Europe – Deconstructing a trade deal

In terms of the core participants ‘in the room’, there are:

1. Politicians
   - Elected and answerable to voters
   - Responsible for overall policy direction – this provides the parameters within which negotiations happen
   - Act as the key point of escalation – and step in to try and resolve deadlock if negotiations further down the ‘pyramid’ become unstuck
   - Responsible for getting a deal ratified via parliament once there is tentative agreement

2. Trade negotiators
   - Civil servants
   - Experts in trade negotiation and trade law; responsible for taking policy priorities set by the political layer and ‘making them real’
   - Usually a lead trade negotiator supported by a team of experts in each specialist area, e.g. regulatory standards, dispute resolution

3. Technical experts
   - Experts sourced from the civil service, public and private sector
   - Work through the myriad of technical detail with their colleagues and with counterparts on the other side of the negotiation
   - Work within a fairly tight mandate as prescribed by the trade negotiators – it is to them that they escalate issues for resolution

What is the process?

1. Prepare and scope
   - Engaging with business and civil society
   - Setting the objectives, and determining the scope of negotiations
   - Building a business case – understanding the potential benefits and costs
   - 6 months - 2 years

2. Negotiate
   - Meetings between each delegation to work through the areas being negotiated
   - Successive rounds of bargaining – bid / offer
   - The process continues until there is a tentative deal
   - <2 years to 5 years or more

3. Draft and finalise the legal text
   - If a tentative deal is reached, legal representatives from both sides ‘polish up’ the negotiating text (known as ‘legal scrubbing’), and perform due diligence
   - Several months

4. Ratify agreement
   - The deal agreed in principle between the two delegations then has to be ratified, usually by the parliaments on each side. In the UK, an Act of Parliament is required. In Europe, the process is particularly complex
   - < 1 year

5. Enact agreement
   - The trade deal comes into force at a date agreed between both parties, once the deal has been ratified on each side
   - There is often a considerable delay between ratification and enactment
   - 2 years – 10+ years from the start of the overall process

Timeline (NB: these vary heavily between different trade deals)

Source: European Commission, ‘Negotiating EU trade agreements – who does what, and how we reach a final deal’
What are the component parts of a trade deal?

The negotiation between the UK and EU will need to cover many of the usual topics covered in free trade agreements. However, whilst talks usually focus on reducing barriers to trade, the forthcoming UK/EU negotiations will be unique in reversing the process, negotiating divergence from a point of alignment.

In normal circumstances, trade negotiators would 'build up' a new trade agreement, based on the principle of lowering trade barriers and bringing two trading nations closer together. A deal is therefore constructed by making provisions to lower tariff and non-tariff barriers which currently exist. This list of dimensions of a trade negotiation is heavily simplified and indicative, but calls out some of the areas that would usually be worked through. In terms of the scope of the deal – all of these issues will need to be covered. By contrast, in these negotiations, the UK and EU are negotiating to be further apart, not closer together. The onus will sit with the UK to propose areas where it intends to materially deviate from existing EU rules and regulations, and the EU will determine what forms of trade barriers and protections are required to safeguard a 'level playing field' in response.

1. Scope of the deal – what will be traded?

- **Goods**
  - Goods are subject to comparatively low average tariffs under WTO rules (c.5% post Uruguay round in 1999) meaning negotiations on goods are usually focused on non-tariff barriers, see opposite page.

- **Agriculture, textiles and fisheries**
  - Agriculture, textiles and fisheries are commonly treated differently in trade negotiations to manufactured goods.
  - Agricultural products are subject to the highest WTO tariffs, and other non-tariff barriers (e.g. government subsidies to ensure domestic food security, such as the Common Agricultural Policy in Europe)

- **Services**
  - Trade barriers under WTO rules for services remain substantially higher than those for goods, yet services account for 70% or more of economic activity in developed countries. Services are treated in trade negotiations as distinct from goods in part because they are:
    1. Intangible, and therefore difficult to monitor, measure and tax
    2. Produced and consumed at the same time
    3. Bespoke, so therefore vary widely across geographies

2. Tariffs and quotas

- **Tariffs**
  - A tax imposed on imported goods and services. Their purpose is to make imported goods appear less attractive to consumers than those produced domestically. Tariffs generally favour domestic producers not consumers.

- **Quotas**
  - A limited quantity of a specific product which is permitted to be imported. Like tariffs, quotas generally favour domestic producers rather than consumers.

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[Hoekman & Kostecki, p328.]

Source: Institute for Government, Trade after Brexit: options for the UK’s relationship with the EU, December 2017

Source: World Trade Organisation, "Non-tariff barriers – red tape, etc."
### 3. Non-tariff barriers

**Border and customs controls**
- Borders and customs controls regulate goods arriving at point of entry into a country.
- Rules of origin determine whether a good to be exported is actually a product of the country from which it was imported. These rules are very complex—put simply, what makes a Mini Cooper ‘British’? Whilst assembled in the UK, Minis consist of parts manufactured all over Europe, and beyond. More broadly, ‘frictionless borders’ are one of the key benefits of Customs Union membership. The extent to which these benefits can be maintained after Brexit will be one of the key topics of UK / EU negotiations.

**Regulatory standards**
- Regulations protecting consumers from imported goods perceived to be of low quality, or potentially unsafe. The recent debate over chlorinated chicken exports from the US is one example.
- These include product packaging and labelling standards and quality kitemarks (e.g. the CE certification).
- Regulatory alignment also protects producers, e.g. labour standards protect domestic producers from price advantage gained by foreign exporters from exploitative labour practices (e.g. very low wages or unsafe working conditions).

**Trade-related intellectual property (TRIP)**
- In the context of international trade, intellectual property rights protect domestic producers from counterfeited imports. An example is Jaguar Land Rover’s dispute with Jiangling, a Chinese car manufacturer, in June 2016 over the ‘Landwind X7’, a car remarkably similar in design to JLR’s Evoque.

**Trade related investment measures**
- Regulations governing foreign investment—typically used to limit the ability of foreign companies to enter or expand in a particular market. One example is the US Federal Aviation Act, which prohibits foreign investors from owning more than 25% of the stock (voting shares) in a US airline.

### 4. Safeguards and trade defence

**Anti-dumping**
- Dumping is defined as an exporter selling a product into a foreign market for less than the usual price for which it would be sold domestically.
- A recent example: Boeing alleged that Bombardier had sold its C series aircraft to Delta Airlines in the USA for less than the unit cost of production.

**Competition / anti-monopoly**
- Regulations to ensure effective operation of competitive markets, the interplay between antitrust and competition laws and international trade policy are one of the ‘new issues’ at the WTO.

**State aid, subsidies and countervailing duties**
- Rules determining the level of support domestic producers can receive from their government. These rules help ensure a ‘level playing field’.
- Countervailing duties are a trade defence measure, through which a government levies a duty on an imported good or service to counteract (i.e. countervail) dumping or subsidies of a foreign producer.
- In the Boeing / Bombardier trade dispute, the US Commerce department applied a 220% countervailing duty on Bombardier’s jets.

### 5. Governance and oversight

**Dispute resolution**
- Both parties in a trade deal need an escalation mechanism, i.e. an arbiter, in the event that a dispute occurs with the other side.
- Expected to be one of the main sticking points in UK / EU negotiations. Three conceivable options:
  1. European Court of Justice: a ‘red line’ for the Conservative government
  2. Refer to WTO dispute resolution process: many bilateral trade deals refer to the WTO’s arbitration mechanism
  3. Establish a new alternative, as proposed between the EU and USA in TTIP (Transatlantic Trade Investment Partnership) negotiations

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3 Sky News, 4 Reuters, 5 Flightglobal, 6 Bloomberg, 7 Bloomberg
The UK is aiming to negotiate a bespoke trade deal, rather than be constrained by precedents of what has existed before.

**Customs union, e.g. the European Union**

- A customs union is a group of two or more countries with a common external tariff. This means that all members of the union treat imports from outside the union in the same way, with the same tariffs.
- In practical terms, member states share a common trade policy, and can’t establish separate agreements, individually, with other countries.
- No internal borders for goods are needed between members of the union.

**Free trade area, e.g. EEA (‘Norway’)**

- The European Economic Area (EEA) is one example of a free trade area, which usually provide for free trade in goods, though rarely if ever in services. The EEA is bound to the ‘four freedoms’ of the single market, including free movement of goods, capital, people, and freedom to establish and provide services.
- EEA members contribute to the EU budget, are subject to oversight by the European Court of Justice (ECJ), must abide by EU laws and regulations, but do not have the right to vote in the European Parliament or Council.
- However, unlike full EU members, EEA members can independently agree trade deals with other countries.

**Bilateral deals – precedents in Europe**

The EU maintains 30+ bilateral trade agreements with individual nations. These are bespoke deals, with a balance of benefits and obligations. These deals are more limited in scope than either option above:

- **Switzerland**
  - Bespoke deal on terms that the EU is unlikely to extend more broadly to other countries.
  - Liberalised trade in certain sectors for goods (though not for most services).

- **Ukraine**
  - Both parties worked to establish a free trade area known as the Deep and Comprehensive Free Trade Area (DCFTA). To be implemented through a 10 year transition period which started 1st January 2016. The agreement aims to boost trade between the EU and Ukraine by gradually cutting tariffs and bringing Ukraine’s rules in line with the EU’s in certain industrial sectors and agricultural products.

- **Japan (subject to ratification)**
  - Japan Economic Partnership Agreement (EPA)
  - Formally agreed an outline free-trade deal in July 2017.
  - Important sectors include Japanese cars into Europe and EU farming goods into Japan.

- **Canada (CETA)**
  - CETA: Comprehensive Economic Trade Agreement.
  - New trade agreement between the EU and Canada (September 2017).
  - Removes duty on 98% of products (tariff lines).

- **All the others...**
  - EU has trade agreements with 70 countries, but generally more limited in scope than those mentioned above.

**World Trade Organisation membership**

- 164 members, who are committed to the rules of the organisation, and bound by the main underlying agreements (including GATT and GATS).
Beyond trade - a broader future partnership

Membership of the European Union involves many broader aspects of collaboration beyond trade. This list covers some of the areas where the UK is aiming to ensure continued co-operation with the EU after Brexit.

The European Union is much more than a Single Market or Customs Union. Members of the EU collaborate in a wide variety of initiatives and programmes. Over the past six months, David Davis and DxEU have released a series of ‘future partnership position papers’, which outline areas in which the British government is aiming for continued collaboration with the EU after Brexit.

On the basis that ‘nothing is agreed until everything is agreed’, negotiation in these areas will be conducted at the same time as the trade deal as part of one all-encompassing negotiation.

In several of these areas, there are existing precedents for collaboration between the EU and ‘third countries’ – take the Erasmus programme, which enables cross-border exchange opportunities for students. Over twenty-two additional countries beyond the EU and EEA participate in the programme to some extent. An agreement on academic exchanges may therefore be fairly straightforward, given a precedent already exists. In other areas, such as EURATOM, negotiations may be considerably more complex.

<table>
<thead>
<tr>
<th>Area</th>
<th>Description</th>
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<tbody>
<tr>
<td>Citizens’ rights</td>
<td>The rights of EU citizens in the UK, and vice versa, to live, work and study, are a key part of the proposed future partnership. A tentative deal on citizens’ rights was agreed in December 2017</td>
</tr>
<tr>
<td>Nuclear energy and research</td>
<td>The existing EURATOM treaty covers nuclear regulation and safeguards, the trade of nuclear fuel, and disposal of nuclear waste. How will the UK and Europe work together on nuclear issues after Brexit?</td>
</tr>
<tr>
<td>Security, law enforcement and criminal justice</td>
<td>The UK has proposed continued collaboration in crime-fighting and counter-terrorism, including continued membership of Europol, sharing of DNA, fingerprints, evidence etc. The Prime Minister highlighted ‘the importance of a strong and dynamic relationship’ at the Munich Security Conference in February</td>
</tr>
<tr>
<td>Foreign policy, defence and development</td>
<td>The UK has proposed continued collaboration with the EU to work together on anti-terrorism, cyber threats, space exploration and international development</td>
</tr>
<tr>
<td>Judicial co-operation cross-border</td>
<td>Once the UK is a non-member state outside the direct jurisdiction of the Court of Justice of the European Union (CJEU), it will seek new arrangements for civil judicial cooperation with the EU. The UK has placed particular importance on citizens and businesses continuing to have confidence in their capability to interact across borders</td>
</tr>
<tr>
<td>Academia, science and innovation</td>
<td>Priorities for the UK include continued participation in EU research programmes, and facilitating movement of academics and researchers across borders</td>
</tr>
<tr>
<td>Sharing data across borders</td>
<td>The EU’s General Data Protection Regulation (GDPR) strengthens personal data protection across Europe. Data may only be transferred to third countries which offer a similar level of protection as the GDPR. The British Government is keen to ensure that data can continue to move between the UK and Europe after Brexit</td>
</tr>
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</table>
Bringing trade deals to life

Pascal Lamy is widely acknowledged as one of the world’s pre-eminent trade negotiators. Director-General of the World Trade Organisation for two terms, he previously served as the EU’s Trade Commissioner. We interviewed him at the Jacques Delors Institute in Paris in late February, a week before his appearance at the Brexit Committee of the House of Lords.

Why do a trade deal?
We began by reviewing, very simply, the key drivers for nation states to agree trade deals, and lower trade barriers. Lamy explains, “Trade negotiations are about levelling the playing field. I’m producing something in a country, whether a good or service, and I want to reach out to another country, another market, and there are costs to do that. So, let’s assume I export beef to Ireland.

In theory, Ireland has lots of beef producers who won’t like more imports, because this will be competition for them, so Ireland would usually ask for a tariff. So, if I want to send beef to Ireland, I usually will have to pay a tariff. That’s the obstacle.”

“If I’m in Ethiopia and I want to export flowers, I’m the poor country, people will say, ‘Maybe we shouldn’t have a tariff for exports from poor countries, but there is a pesticide residue standard which needs to be administered at the border.’ It’s not to protect European producers of flowers, it’s to protect European consumers from the negative impact of pesticide on health. So, that’s roughly the issue, and trade negotiations are about levelling the playing field, i.e. reducing obstacles of the first category, which is a sort of trade-off – I will reduce my protection of my producers if you reduce the protection of your producers. That’s the first category.”

The second category, which is about protecting consumers, is very different. You don’t reduce a measure that protects the health of your consumers, for the sake of opening trade. You’re not going to do that, because your parliament has not agreed to that, because your parliament believes health is more important than efficiency of international trade. So, then the way to reduce obstacles to trade is about regulatory convergence: ‘Let’s try and have the same standard for pesticide residue,’ and usually the country with the lower standard would adopt the stricter standard of the other. Or let’s find a way, which we call mutual recognition, where I accept you do it one way, I do it another way, but we trust each other. So, this is, in a way, the universe of trade negotiations.”

Drivers of trade – geographic proximity, or cultural ties?
One of the key areas of debate in the context of Brexit is whether the UK, by establishing an independent trade policy, can grow its trade with countries further afield than Europe – be it the US, Canada, China or Australia / New Zealand. I asked Pascal the extent to which geography determines which countries trade with each other. “Geographical proximity, of course, is less important than in the past. And why is it so? Because the cost
of distance, which as a producer, I measure with the cost of transport for goods, and as we know, most services are not transported, they are virtual, they are information-based, and this is shrinking, as compared to the Middle Ages, for example. But still, all serious economic trade studies show that there remains a strong preference for proximity, for a variety of reasons. These have to do with culture, with language, with food habits, with consumers’ taste, which may be similar in nearer civilisations and different in more distant civilisations. We have a European civilisation, and whether the UK is in or out of the EU, or whether Switzerland is in or out, or whether Norway is in or out, they are European. So, there is a proximity bias, which will remain. My guess is that the UK, ten or twenty years from now, will still have more than 50% of its trade with the European continent.”

Beyond proximity, Lamy is clear that market size is critical in determining the appetite for nations to lower trade barriers. “What matters for trade deals is, first and foremost, the size of your market. I am a producer, I want to reach out to a market, I will look for large markets, because I want economies of scale. Let’s assume I have a transport cost to bear, I’ll make sure that this transport cost is offset by large volume. So, volumes matter a lot. The UK is a 60+ million consumer market, the EU is a 500 million consumer market, so this asymmetry will be there.”

Negotiating a new trade deal
Having understood the basic drivers for countries coming together to trade, and lower trade barriers, we discussed how the negotiations actually work. “It’s a question of balance concession. It’s a bit like in a bazaar, there is a price and if, let’s assume you produce scrap metal and I produce bicycles, it’s obvious that my bicycles will be cheaper if the scrap metal they are made of is cheap. So, my rational interest is for me to reduce my protection for scrap metal, because you are producing scrap metal more efficiently than I am, but I’m producing bicycles more efficiently than you are. So, the deal will be: I reduce my tariff on scrap metal, you reduce your tariff on bicycles, we’re both happy, my scrap metal for your bicycles will be cheaper, the bicycles you will buy for your consumers will be cheaper. That’s how it works. Then it’s a question of equivalence. And the secret of the trade negotiation is, how much of a reduction of a tariff on scrap metal for how much of a reduction of a tariff on bicycles?”

“In all trade negotiations, the most important part...is the negotiation within your country, with your producers and with your consumers, because this is where you get your political mandate”

“It’s the same for services, although there are no tariffs on services. Services for accounting, for dredging, for telecommunications are regulated in such a way that, usually, national producers have easier production than foreign producers. So, if there is a negotiation about dredging and accounting, I will ask you that my accountants can access your clients across border, so that your clients can import from me an accounting service, and the other way around with dredging. Now, how much of opening the market for accounting for how much of opening the market for dredging? Again, same sort of balance, although it’s not a tariff, but it’s a regulation.”

Making a success of trade negotiations
Businesses across the UK, and indeed many in Europe, are desperate to see trade negotiations succeed. Reflecting on his experience leading negotiations over the past twenty years and beyond, Lamy is clear that the key lies not in the negotiating room, but in understanding, before negotiations commence, what domestic voters and business interests need from a potential deal, and what they are prepared to offer. “There is a little secret – most people believe that the most important part of a trade negotiation is the negotiation between trade negotiators. Now, this is not the reality. I’ve done this for many years of my life, either as Trade Minister for Europe, or as Director-General of the WTO. The reality is that, in all trade negotiations, the most important part of the negotiation is the negotiation within your country, with your producers and with your consumers, because this is where you get your political mandate. 80% is my negotiation with my constituency, 20% is my capacity to convince my counterpart in the negotiation that I’m giving a good price and asking for a good price.”

‘Managed regulatory divergence’ – a basis for a future model?
It is well understood that agreeing a future framework for aligning regulations between the UK and Europe, or indeed any other country, is an important precursor to maintaining or expanding free trade. “Levelling the playing field will be about market access, that’s one thing, and in my view it’s the relatively simple thing, but it will also be about standards, norms that protect the consumer. And this will be much more difficult, because then you create, or not, a discrepancy in regulatory regimes. This is a big problem, because if regulatory regimes are not matching each other, you need controls [i.e. barriers to trade]. We’ve all been in this business of organising and promoting convergence, so the notion that you now have to organise divergence, maybe we’re a bit old for that and need a lot of young, fresh imagination. But my experience is that the more divergence there will be, the more this will result in cost to trade.”

See interview online
How trade delegations are organised

“Generally speaking, every trade negotiation is organised along a pyramid with three different levels. At the bottom you have the technical experts, and they deal with really nitty gritty stuff like controls on specific products. Then, you have the layer of the negotiators themselves; they take into account all that data, and work out the technical trade solutions. Then, at the top, you have the political masters and their task is two-fold. First to ensure that there is a good trust and understanding among the different teams. They are also the people who work out any kind of problems that come up in the negotiation; they are a course of last resort.”

How trade negotiations normally work

We moved on to discussing the negotiating process itself. “Generally speaking, countries spend a lot of time understanding where each other is, we tend to call that the ‘photograph face’, we try to send a picture of ‘this is how much we trade’, ‘this other interest’ etc. I think that in this case [the UK/EU negotiations], frankly, this is done. Then, each of the parties needs to understand where their interests are.”

Miriam explains the delicate balancing act required in establishing a trade delegation’s priorities. “The negotiators need to understand from businesses, ’what are the real issues at stake? What are the barriers that you’re encountering in lots of other countries? What are we ready to give in exchange for dismantling these barriers? Somehow you get all of that picture and you apply your sound judgement with some political understanding as to where, ideally, you can go in a way that is reasonable. Not everybody’s going to win, hopefully not everybody’s going to lose, and you bring it to a middle point.”

“From that point onwards, the technical work really starts at the trade level. How do I translate this into an agreement? The trade drafting that basically encapsulates those objectives. Ideally, we find an agreement, if we don’t, we bring it up the pyramid to the political masters. You are constantly going up and down that pyramid – that is the dynamic of the negotiation. Business should be interacting with each one of those three levels.”

The human factor – what it takes to get to a deal

“In order to negotiate anything, including this, you negotiate with people, this is not done by computers. Therefore, when you are in the negotiating room, you need to get on with the other side, you need to not be on the fence, you need to trust each other. The best conditions for a negotiation is no rhetoric, just take it out of the room.”

The political context in Europe

Miriam is thoughtful about the balance of power in Europe, and what this means for the negotiations. “All the negotiations come from setting up your own position, and that you do at home. For the European Union it is done in the different capitals, and then it is agreed at European level. There are obviously some countries in the European Union that have a lot of political weight.”

“What we are seeing lately is that, with the UK leaving the European Union, this is coming back to a two-pole structure, articulated around Germany and France. France is in the ascendant, but after spending a few years where they didn’t really have a very big position in the EU, it’s coming back to what it was, twelve years ago (taking the UK out of the equation). It is also true that there could be some member states that have a particularly strong interest in one specific sector, and those interests, normally, are taken into account by the negotiators of the European Commission. To give you an example, Greece and Spain could have a much bigger interest in tourism than...
The future of the UK and Europe – Playing your part – the role of businesses in trade negotiations

Germany, so the Commission would be going to them in terms of what needs to be negotiated on tourism services with the UK.”

The alternative to a deal – reverting to WTO rules

Whilst the tentative deal on withdrawal issues in December has given many people more comfort that a trade deal will be agreed, it remains important to understand the implications of trading without a deal, under WTO rules.

Miriam mentions the services sector, and explains why they would be particularly impacted. “The UK, the EU and many other countries have committed themselves to certain terms of openness of their markets in the World Trade Organisation. A lot of that covers goods; the main area of goods that hasn’t been as open so far is agriculture. What has not really been done properly in the WTO, because it’s very difficult to do that without a good neutral referee, is the regulation on services. That is why most of the barriers that we find on trade are on services regulation.”

A plan of action for businesses

We moved on to discuss Miriam’s advice for businesses, considering their next steps on Brexit. Her first area of advice is proactive, front-footed engagement with the negotiating delegations. “The initiative has to come from the business side. It is important that they provide the work for the pyramid. For anything that the pyramid cannot do itself, industry should be there thinking, ‘What can I do?’

“Businesses need to understand, very clearly, what their interests are in the negotiation with the EU, but also in the negotiation with third countries. If, for example, we want to offer agriculture to developing countries, we are not going to offer such an attractive package on agriculture to the European Union. Everything is interlinked.”

“I think that it is also important that they look at their own red flags. For some of them, it could be valuation for customs, things that they haven’t really taken into account for trade with the European Union. For others, it may be cumulative rules of origin. With some of those issues, the solutions may be different, some of the solutions may need to come through the negotiation, some of the solutions may come through some of the restructuring of their supply chains, for example. Some others may be just technical understanding of different provisions, but all that homework needs to be done now because I think that, otherwise, they may be taken by surprise once the real negotiations start. The negotiations could go much faster than they think.”

We also discussed the perspective of European businesses; I was curious about the extent to which Miriam sees companies on the continent preparing for Brexit, and how British businesses are working with them to get ready. “I think that not very much is happening. Part of the problem is that while in the UK Brexit dominates the news every single minute of the day, that is not the case on the other side of the Channel. Brexit doesn’t figure up high in the level of priorities. You can see that not only in the attitudes of the governments but also business and, in particular, business associations. So, I think that a lot of the work that needs to go into this from the government and from the business associations themselves is on trying to wake up the European business side, to say, ‘Come on, we have a common interest together’. It seems to me that it is essential that every single business association or any business here in the UK that has a base, or customers, or suppliers in Europe, is trying to tell those on the European side that there is a common interest.”

Cumulative rules of origin allow the product of one country in a free trade area to be further processed or added to products in another country of that free trade area, as if they had originated in the latter country. Source: World Customs Organisation
The Prime Minister, in her Mansion House speech on 2 March, provided the clearest view yet of what the Conservative Government is aiming for in terms of the UK’s future economic partnership with the EU, building on the position papers from last year. The government has been clear that it intends to remove the UK from the Single Market and Customs Union, and has proposed instead:

1. A highly streamlined customs arrangement that makes substantial use of technology to reduce friction at borders
2. A new customs partnership with the EU that, in effect, continues to give the UK access to the Customs Union (along with the current tariffs applied to non-EU countries), with the ability to negotiate bilateral free trade agreements.

This leaves the UK with several possible outcomes:

1. The UK successfully establishes an arrangement that essentially maintains most of the market access provided by the Customs Union, enabling tariff-free trade on goods and relatively low friction at borders
2. The UK and EU revert to trading on WTO trade rules – the ‘no deal’ scenario
3. A ’middle option’, either aligned to an existing agreement (e.g. CETA), or an entirely bespoke new deal, recognising the UK’s unique position as an existing member of the EU.

For the purposes of this article, we focus on the two extremes, which are the basis of many firms’ contingency plans.

Winners and Losers
In either of these scenarios, there will be winners and losers, and winning or losing will be based on the value chains that a company maintains today, and their ability to adapt, de-risk, and build new value chains in the future.

Let’s take a look at the UK automotive industry, for instance: car companies that manufacture in the UK often source numerous individual parts from across the EU – the brake pads might come from Germany, whilst the dashboard display might come from Poland, for example. The smooth and efficient operating of these car manufacturers requires the ability to quickly and cheaply move their inputs of production, without building up excess inventory. Once cars have been manufactured, often the biggest markets for sales are EU countries, given strong consumer spending. For such companies, their main concerns will include avoidance of layering on additional tariffs, managing currency risk, and minimising friction at borders to ensure the speedy movement of car parts and finished vehicles.

What is a Value Chain?

value chain (noun) – the process or activities by which a company adds value to an article, including production, marketing, and the provision of after-sales service

Renowned academic Michael Porter defined the key steps in the value chain in his book ‘The Competitive Advantage of Nations’. See below for a simplified explanation of the key steps in the value chain.10

Supply chain: procuring raw materials, components and inventory from suppliers, and moving to factories, storage or points of sale

Operations: turning inputs into products and services

Distribution: moving completed goods or services from production to the consumer

Marketing and Sales: making buyers aware of the products available, encouraging them to buy them, and enable the transaction

Service: after-sales support to maintain a product or service

10 Institute for Manufacturing, University of Cambridge
On the other hand, raw materials (such as metal) are often imported from emerging markets across Africa, Latin America and Asia, rather than Europe. If we consider the automotive sector again, a UK company that manufactures car parts, as opposed to finished vehicles, will often almost exclusively buy raw materials. If their client base comprises car manufacturers in the US or Asia (where no EU Free Trade Agreement exists, and the UK operates under WTO Most Favoured Nation tariffs today), they will have little or no reliance on access to the EU Single Market, or any future Customs Union relationship (except, potentially, for importing machinery and plant equipment). They may also have relatively low currency exposure and benefit from natural hedging, their metal inputs may be sourced in USD, and given their revenue is USD-denominated, their currency exposure is limited.

For such companies to win substantially under Brexit two things must happen: 1) the UK must make a decision to either unilaterally or selectively lower its own WTO Most Favoured Nation (MFN) tariffs (helping reduce costs on the inward supply chain), and 2) negotiate bilateral free trade agreements with markets within which the car parts manufacturer sells its goods.

In reality, as a company gets larger their value chains can become increasingly complex – often touching numerous countries around the globe. If we look at a car manufacturer such as Jaguar Land Rover, their value chain literally spans the globe – you can walk into a show room on most continents and pick up the keys to a new Range Rover or Jaguar F-Type, and the parts and materials for these cars are similarly sourced from all over the world.

This presents UK-based car manufacturers with a true conundrum – can their value chains be amended or adapted in such a way that they can de-risk or take advantage of the potential outcome of the negotiations? The difficulty is the sheer number of considerations that a complex company will face.

To bring this to life with a real world example, we asked one of our clients, a Mid Market UK manufacturer, how they are looking to adapt their value chain for Brexit – see the diagram below.
Non-tariffs barriers and standards
The ability to move goods and services across borders smoothly and efficiently is important to most businesses. Critically, it is often non-tariff barriers, such as technical specifications and rules of origin, that create the greatest obstacles to trade. In our research with YouGov last year, 21% of companies that export called out the administrative costs of customs as the biggest barrier for their ability to trade. Given that 85% of respondents trade with the EU, it’s possible that even the Single Market is not as easy to navigate as one might expect.

For non-EU companies trying to sell goods to the EU, the process can be challenging. For example, citrus fruits imported into the EU are subject to complex marketing standards – phytosanitary requirements in addition to tariffs and duties. These marketing standards include requirements such as fruit being free from abnormal surface moisture and blemishes, and having the requisite sugar to acid ratio and colour. If the UK fails to secure the model set out in the position paper, British farmers (and indeed, everyone else that exports to Europe) will quickly need to become familiar with these requirements.

The story for services firms – ‘GATS all, folks’
For service companies the challenges are slightly different, as we explain on page 14. Mutual recognition of regulatory equivalence is an essential precursor to maintaining the status quo. Financial services firms currently benefit from ‘passporting’, which enables them to serve clients all over Europe from the UK – and there is no precedent for the EU to provide these privileges to any country outside the Single Market. Many financial services firms have established subsidiaries on the continent in order to retain these rights.

Careful reading of the EU GATS schedule is required for a UK service company that is preparing for a worst-case scenario

In the event of ‘no deal’, British services exporters will operate under the WTO ‘General Agreement on Trade in Services’ (GATS). In a nutshell, GATS is a broad framework that covers the provision of services under four models of supply:

1. Cross-border supply (where provision of services happens remotely, such as a lawyer giving legal advice over the phone)
2. Consumption abroad (where a tourist or patient travels to another country to receive a service)
3. Commercial presence
4. Presence of natural persons (where someone travels to another country to perform a service e.g. a doctor or a teacher).

The main issue with GATS is that, unlike WTO MFN Tariffs, it enables a wide degree of latitude for a country to define how it is implemented across its different service industries. Each member is able to apply exceptions, which are often referred to as ‘limitations’ or ‘reservations’. Even the absence of such exceptions in a country’s GATS schedule does not necessarily mean that certain industries are or will be deregulated. The EU’s list of exceptions is substantial (94 pages in length). Each service has its own unique restrictions across each model of supply. Careful reading of the EU GATS Schedule is required for any UK service company that is preparing for a worst-case scenario, with no trade agreement on services.

Trade in Services Agreement (TiSA) represents an attempted move by a number of WTO members (some 23 in total, including Europe) to move towards freer trade in services, but given that negotiations have been ongoing since 2013, with 21 rounds of negotiations to-date followed by a general agreement to put the negotiations on hold, there is relatively little further comfort for companies facing a cliff-edge scenario.
Next steps
We at Lloyds Bank firmly believe that companies that proactively manage their value chain risk will be more likely to thrive from March 2019. Companies may be able to significantly reduce their value chain risk by focusing on the following key steps.

1. Do your homework
Conduct a thorough review of your value chain. Look at your routes to market and distribution channels, and understand what you need to do to continue to reach customers in Europe. Conduct a similar analysis across your supply chain. Identify the impacts and mitigating actions, and crucially, discuss these with your customers and suppliers sooner rather than later. Keep an eye on lloydsbank.com/brexit for more on this over the coming months.

2. Stick to your customers and suppliers like glue
What would WTO rules mean for them? Will your proposition still be attractive to all of your customers? Talk to them now and identify attrition risk before it materialises. Understand what you need from your suppliers in Europe and identify risk. Trade with the world, not just the EU — businesses need to understand how to trade on WTO terms with Europe, in the event that there is no deal. These are the same rules that apply when British companies trade with the US, China, Canada etc. today. If businesses are doing their homework to prepare for Brexit, they’re also getting themselves ready to trade further afield.

3. In the face of uncertainty, manage your trade risk exposures carefully
Greater macroeconomic uncertainty could lead to greater client payment delays or failures, and new markets mean new risks and ways of doing business. Firms need a resilient risk management strategy in place, particularly when looking at trading with different markets outside the EU for the first time. Consider your options to mitigate trade finance risk, from Letters of Credit and Guarantees, through to Credit Insurance and UK Export Finance.

4. Optimise your working capital
There is a very real possibility of ‘no deal’, and a very real possibility that ‘no deal’ results in significant challenges at points of exit and entry (both in the UK and in Europe). Businesses with tight cash-flow need to think about the implications of having goods delayed or stuck in transit for their working capital. Companies that have strong working capital positions will be better able to weather whatever challenges the future might bring. There are many ways to unlock working capital, including renegotiating payment terms, stronger credit control, and bank financing.
You’ve told us clearly since our last edition that you are keen to understand more about how trade negotiations work, and the role businesses have to play – we hope you’ve found this briefing useful. As both Pascal Lamy and Miriam González Durántez point out in their interviews, businesses have a key role to play in supporting the negotiations, providing constructive input both in the UK and in Brussels. Lloyds Banking Group is focused on doing its part, and is committed to supporting British trade, both in Europe and around the world. Miriam’s advice for British businesses – to engage early with your European customers and suppliers, feels more salient than ever.

The political and economic issues presented by Brexit will continue to be hot topics for some months yet, but despite the uncertainty, the business environment is proving to be resilient. The importance of focusing on those issues we can affect and not being distracted by the maelstrom going on around us has never been clearer.

Lloyds Banking Group’s primary objective continues to be our commitment to Helping Britain Prosper. The purpose of this report is to provide you with objective and practical information that will help to advance your understanding of the issues and how they might impact your firm. We welcome your thoughts and questions on the issues covered in this report. In the first instance, please contact your relationship manager, or feel free to contact the editors listed below. We look forward to receiving your feedback.

The editors

We would like to hear your views and answer any questions that you have regarding the content of this report. Please contact either your relationship manager or one of the editors listed below.

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Sources of further information

Further material from beyond Lloyds Bank

The list of further reading below covers a range of additional sources which may help you. We have tried to include an objective balance covering a number of themes. The views expressed in the material below are those of their respective authors. Lloyds Banking Group does not endorse these views.

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<th>Author</th>
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<td>Institute of Directors</td>
<td>‘Settled Status’ – What will happen to EU Nationals living and working in the UK as a result of Brexit</td>
<td>Feb-18</td>
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<td>European Commission Directorate-General for Trade</td>
<td>Overview of FTA and other trade negotiations</td>
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<td>Open Europe</td>
<td>The Brexit regulation debate pits short-term disruption against future prosperity</td>
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