European & International Analysts Group

UK trade policy in an age of change and fragmentation

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Introduction

A recent International Monetary Fund (IMF) paper warned that after decades of increasing global economic integration, the world was now seeing global economic fragmentation. Following what it described as a "shallow and uneven recovery" from the global financial crisis, a series of global events and policy shifts have slowed or reversed economic integration. The events the IMF highlighted included the pandemic, Brexit and the invasion of Ukraine but they also noted a levelling-off in global trade flows since the financial crisis, the rise of US-China trade tensions and a growth in trade protectionism around the world.

According to the IMF's analysis, the slowing or reversal of global economic integration has brought with it reductions in trade and economic activity which is likely to mean lower economic output.[1] In short, global economic trends suggest that globalisation has plateaued or even declined and this – in the view of the IMF – will make us all poorer.

But while some would contest the views expressed in the IMF paper – it could also be argued that the current evidence of a slowdown in the world economy is the result of a various inter-related factors of which a decline in economic integration is only part – that report is just one of many indicators that the global economy (and with it world trade) is going through a period of upheaval, change and fragmentation.

The purpose of this paper is to look at UK trade policy in this period of undoubted change. There are particular trade risks for the UK. These include the fact that one of the clear trends is towards greater protectionism by the three big blocs (US, EU and China) and the UK is not in any of these blocs. The UK could be squeezed (for example) between the US and the EU in a developing subsidy war between them. This risks further disinvestment from the UK and a worsening tendency to fail to attract new investment on top of a period of declining foreign direct investment since 2016.

Trade is also changing. Trading in goods across borders where the barriers were (and often still are) import duties, import quotas and regulatory requirements still matters but the export of services has become as or even more important for many developed countries (including the UK) over the last 30 years. Digitisation now affects all trade (goods and services) and means further change in trade policy and practice and a degree of mismatch with traditional trade rules.

[1] See Shekhar Aiyar et al., *Geoeconomic Fragmentation and the Future of Multilateralism*, International Monetary Fund, SDN/ 2023/001, 15 January 2023

The adoption by many countries of sustainability policies and net zero targets are driving further significant changes in both trade policy and practice with impacts that are not yet fully realised or understood.

Before looking at UK trade policies in terms of threats and opportunities, the paper looks at the contemporary global economic background. It also mentions some important economic policy developments in the European Union which will have a wider impact, including on the UK.

The global economy in 2023

<u>Overview</u>

Evidence has been growing that globalisation – the steady expansion and diversification of the sources of goods and services – has slowed or, in some sectors, begun to reverse. The debate about the explanations for this phenomenon has continued alongside growing scepticism about the benefits of multilateral trade rules. This scepticism is often associated with Trump's period in the White House but it could also be seen in the UK, some EU countries and elsewhere. The political consequence of this has been rising protectionism, seen in onshoring (ensuring that essential goods and services can be produced nationally or within the bloc), reshoring (bringing production back to the country or bloc of origin) and the increased use of national security exemptions to exclude foreign competitors.[2] The sectors affected by this shift in policy are not just food and energy but also automotive, pharmaceuticals and technology.[3]

In the last two years there has been a shift in several countries' economic policies towards greater government intervention to boost the development of the green economy and to tax or discriminate against imports on the grounds of their carbon cost. This has been seen particularly in the United States with the adoption of President Biden's Inflation Reduction Act, which includes local content rules in violation of those of the World Trade organisation (WTO).[4] And the EU's Carbon Border Adjustment Mechanisms (CBAMs) policy due to be introduced in 2026 is another case in point.

Some of these trends are unavoidable. The Covid pandemic underlined the risks of being reliant on imports of vital goods, in that instance, medicines and PPE. The Russian invasion of Ukraine in February 2022 highlighted the importance of both food and energy security. And both those events followed the global financial crisis which exposed the risks inherent in the inter-dependence of the world's banking and financial system.

In any case, public opinion was questioning the benefits of the global multilateral trade system long before Covid and the Ukraine war. This had been apparent since the Seattle trade summit in 1999 and the subsequent failure of WTO members to reach agreement in the Doha world trade negotiations only compounded the problem. Globalisation also became unpopular because of its perceived unfairness as between countries, associated with the tendency towards the concentration of wealth in the hands of a small number of

[2] For detailed statistics, see Figures 6, 7, 8 and 9, *ibid.*, p. 11

[3] As an example of how national security can be used to justify protectionist policies, see US Department of Commerce, *The Effect of the Import of Automobiles and Automobile Parts on National Security*, 17 February 2019

[4] Timothy Conley & Kimberley Botwright, 'What do green subsidies mean for the future of climate and trade?', World Economic Forum, 13 March 2023

wealthy individuals (the "super rich") and the relative decline of the middle classes in the US and UK.[5] Greater migration has also been associated with globalisation and this has proved unpopular in many countries.

The Western response to the invasion of Ukraine was a massive increase in economic sanctions directed against the Russian economy. These sanctions came during an unprecedented period of sanctions since 1945. International economic sanctions now apply to Russia, Belarus, Syria, Libya, Iran and China (amongst others). The United States, for example, currently has 38 sets of economic sanctions.[6] While there is little research on the impact of sanctions on the global economy and the scale of any impact is hard to calculate, extensive sanctions are likely to impact growth in some countries and this effect is likely to increase. This is partly because businesses are increasingly faced with complex cross-cutting sanctions which can make international investment a strategic risk.

Growing bilateralism/unilateralism and the decline of the WTO

The WTO has been going through a period of uncertainty for several years and a review is now underway that was agreed by its member countries. The difficulties that have prompted this review include: the practical problems of reaching agreement in an organisation of 164 diverse countries; the crisis in the appellate body after Trump refused to co-operate in making new appointments; the rarity of new general trade agreements; chronic unresolved issues such as the moratorium on customs duties on electronic transmissions; and the growth of coalitions within the WTO making their own agreements (plurilateralism).

Perhaps the greatest of the difficulties of the WTO has been the failure to maintain the momentum of the era from the 1960s to the 1990s when successive rounds of trade talks reduced barriers to trade. The inability to reach a new multilateral agreement since the failure of Doha round has been the crucial setback (although some other agreements have been reached on trade facilitation and on services). There are many reasons why this should have happened, including the difficulty of reaching agreement in a WTO of 164 members.

A more recent development has been the growth of plurilateral agreements between WTO member countries, that is, agreements involving more than one WTO member country. While these are less good than multilateral agreements, they could help to improve trade in the absence of wider agreements if they are open to other WTO member countries to join.

The world is seeing the development of what amounts to three large trading blocs, China, the EU and the US. These blocs have economic influence beyond their national territories, including the potential to set regulatory norms by bringing smaller trading partners to adopt their rules. With enlarged economic power comes greater political influence – this can be seen in the UN, in the WTO and in the G20.

The prominence of these trading blocs makes the trade policies of those countries not in those blocs uncertain; as outsiders they are likely to find their influence in the WTO and the G20 has reduced. This situation has led to a tendency of such marginalised countries

5 See Resolution Foundation & Centre for Economic Performance, LSE, *Stagnation nation: Navigating a route to a fairer and more prosperous Britain*, Resolution Foundation, 13 July 2022

6 US Treasury, Office of Foreign Assets Control, 'Sanctions Programs and Country Information', 3 March 2023

to join a bloc or to position themselves alongside a chosen party (*i.e.* making their regulatory and tax policies similar).

Changing trade patterns and requirements

Sweeping new developments in the nature of trade are impacting on all trade partners. These range from changing trade flows between deep water ports to data-related developments affecting all trade. Among the most important are: the digitalisation of trade (*e.g.* payment systems); digital trade (commerce of all kinds enabled by electronic means); and potential conflicts between the need for freedom of movement of data, on the one hand, and various forms of data protectionism (including data localisation) on the other.[7] These changes have differentiated effects for goods and services and for large corporates and smaller businesses. There are also important linkages with WTO issues (*e.g.* the WTO E-Commerce Programme and the Moratorium on customs duties on electronic transmission) where WTO rules need to keep pace.

Linkages between trade and investment

Trade and investment, and the policies for them, are intimately linked. For any country the ability to trade competitively and the ability to attract investment, and to invest in other markets, are linked objectives that need to be met together for economic success.

Trade developments in key markets

China

China saw a sharp slowing of its growth rate because of the pandemic – down to an expected 2.7 per cent in 2022 – but is now growing again albeit at lower rates than in the recent past.[8] This slower rate of growth reflects domestic factors, such as a significant correction in the housing and construction sectors and a persistent problem of youth unemployment but also ambivalence within the leadership as to China's trading relationship with the world.

Global dependency on Chinese manufacturing had been an issue before the pandemic but the pandemic exposed just how dependent the Western world had become on China, and that, along with concerns about shifts in Chinese foreign and security policy, led to a rapid change in policy towards China in some countries, including the UK. This policy shift has already led to restrictions on the import of Chinese made goods (for example, in telecommunications and security) and on the ability of Chinese companies to invest. While China is not a fully open economy it has benefited considerably from the opening up of trade following its accession to the WTO; and it is these export interests that mean that it is likely to continue to support open trade.

India

The big question is whether, and in what way, Indian trade policy will change. India has a long history of trade protectionism and contrarian attitudes to the WTO. Since the 1990s

7 Data localization means a requirement that data be stored in a particular country or jurisdiction and may include restrictions on the processing or transfer of that data internationally.

8 World Bank, 'China Economic Update', 15 December 2022

the Indian economy has grown fast with its large internal market but there is a sharp contrast between its 17 per cent global share of population and its two per cent share of goods trade and four per cent share of services trade. While this growing economy makes India increasingly a global power, and there have been further liberalisation moves within India (such as abolishing internal tax barriers), it is unclear whether India will open up to international investment and to easier trade.

USA

The US is going through a period of adjustment as it sees its own declining industrial competitiveness and global reach challenged by increased economic and military threats from China. It responded to these by pursuing protectionist policies under Trump, as noted – although Trump would have been likely to pursue protectionist policies anyway as they appealed to his supporter base.

Trade policy under Biden had been more nuanced and in some cases more obscure with the creation of the EU-US Trade & Technology Council as an example of greater US engagement and co-operation but the local content measures (in particular) in the Inflation Reduction Act have re-opened the debate in the EU and elsewhere as to whether the US is going to be a competitor or a partner as the global economy evolves. And there has been an intensification rather than an easing of the trade restrictions on China.

The EU

The European Commission has recently raised its forecast for growth in the EU for 2023 and 2024 and cut its inflation forecast. After a good recovery from the pandemic, with 3.5 per cent growth in 2022, the Commission is now forecasting EU growth of just 0.8 per cent in 2023 and 1.6 per cent in 2024. The EU has been hit much harder than the US by the war in Ukraine because it had a far greater volume of trade with Russia (Russia was the EU's fifth largest trade partner in 2021 but the US's 40th, EU exports amounted to €99 billion, US exports to just $6.4 billion[9]). The EU imported €98 billion of Russian fossil fuels in 2021 and the loss of that energy supply triggered rising prices for consumers and businesses, resulting in an inflationary surge across the EU. But food, fertilizer and other commodities have been affected too, as sanctions have restricted imports and Ukraine has been unable to maintain exports of key products as a result of wartime damage and disruption.

It is too early to tell how long this disruption to the EU economy will last. Member States have made good progress in reducing their dependence on Russian energy imports but this in turn is leading to further challenge to the EU's traditionally open trading policies.

Pressure to adopt further interventionist measures in order to protect supply chains and to develop new capacity and technology within the EU has grown sharply. Many EU members want to reduce their dependence on Russian energy and Chinese manufactured goods over the long-term. They also see the US as a rival, particularly in the light of the US Inflation Reduction Act (but also because of the policies of the Trump administration in the past).

[9] See US Office of Technology Evaluation, *2021 Statistical Analysis of US Trade with Russia*, 26 May 2022; for Russia-EU trade, see European Commission, 'EU trade relations with Russia: Facts, figures and latest developments', 29 April 2023

Unprecedented levels of state aids and other forms of intervention were accepted during the global financial crisis and the pandemic and there is a danger that such practices will become ingrained. There is a developing concern that new measures to tackle climate change will be used as protectionist devices. For example, CBAMs may be a justified policy tool to encourage foreign producers to reduce their carbon footprint but it could easily be used to reduce competition. The debate about state aids and intervention is a lively one inside the EU and the policy direction is not yet decided.

UK trade policy: threats and opportunities

All the global and regional developments outlined above affect the scope of UK trade policy.

Threats:

Low growth

The UK has experienced 15 years of relative economic decline combined with greater inequality than other comparable countries. During the 1990s and the early 2000s, the UK economy caught up with those of more productive countries such as France, Germany and the US but it has declined since. For example, in 2007 – just before the financial crisis – the *GDP per capita* in the UK was just six per cent lower than in Germany, but this gap rose to 11 per cent by 2019. The *productivity gap* between the UK and France and Germany almost closed in the period 1990-2005 but has nearly tripled since 2008 from six per cent to 16 per cent. This productivity gap is the result of labour productivity growing at just 0.4 per cent a year in the UK dozen years after the financial crisis compared to more than double that in the richest 25 countries in the OECD.[10]

The impact of that poor economic performance has been felt in the wage packets of British workers and consumers. Real wages grew by an average of 33 per cent a decade from the 1970s to 2007 but fell below zero in the 2010s. By 2018, wages in Britain were 16 per cent lower than in Germany and nine percent lower than in France. The only group to be better off are the top 10 per cent of households, who are richer than in other comparable countries but middle income households are (for example) nine per cent poorer than those in France. Strikingly, the poorest fifth of households in the UK are now over 20 per cent poorer than their French or German equivalents.[11] There are also sharp income and productivity gaps between regions as well as people. These disparities are greater than in other countries.

Whatever the rights and wrongs of Brexit, the Office for Budget Responsibility calculation that Brexit has reduced UK trade by 15 per cent in long run means that the UK must do more to make up for that lost trade in the years ahead.[12]

Declining investment

Part of the explanation for the UK's relatively poor economic performance has been the recent decline in investment. The UK attracted high levels of investment in the period 2012-16, comparable or better than similar countries (*e.g.* France, Germany, US) but since

[10] Figures from Resolution Foundation & Centre for Economic Performance, LSE, *op. cit.*, n. 5, p. 8

[11] *Ibid.*

[12] Office for Budget Responsibility, 'Overview of the November 2022 Economic and fiscal outlook', 17 November 2022, p. 26

2016 UK investment has fallen dramatically. The Bank of England has estimated that the UK has lost £29 billion of investment since 2016 as a result of this fall.[13]

The lack of clarity about UK trade and economic policy direction, and the absence of co-ordinated strategies to attract it, has been hampering investment since Brexit. Overseas investors want clarity about the UK's attitude to national security policy restrictions (*e.g.* the Government decision to allow a Chinese firm to buy a semiconductor factory in Wales and then its change of mind following a previous policy U-turn over Chinese telecoms equipment), migration policy, including the movement of business personnel and taxation.

Big but not big enough

The UK is the sixth largest economy in the world, which makes it a top 10 economy but not big enough to dominate in a world split into three large economic blocs.[14] Those blocs are vying for trade and regulatory dominance and the UK is in danger of being squeezed between them and the UK offers no large internal market. These risks have recently been seen in the EU-US arguments over the Biden Inflation Reduction Act subsidies to green industries and its likely effect on Europe's economy. The UK found itself excluded from the transatlantic discussions as it is not in the EU or EEA.

Getting good bilateral FTAs

Since Brexit the main focus of UK trade policy has been securing an agreement with the EU and then rolling over existing EU trade agreements with third countries. The Government has moved on more recently to trying to secure good bilateral FTAs in terms of economic benefit to UK. That this is an objective more difficult than some realised was demonstrated by the Australia/NZ FTAs which will generate only a small economic benefit to the UK (0.08 per cent of GDP by 2035 in the case of the Australia FTA[15]) – as former DEFRA Secretary of State (and Brexit supporter) George Eustice MP recently pointed out. The reluctance of the US to conclude an FTA with the UK has been especially disappointing. Third countries will often want to see what sort of trading relationship the UK has with the EU (given that it's the UK's largest trading partner) before concluding bilateral agreements with the UK.

Difficulty in expanding exports of services

It is often said that the UK is a "services superpower" as the second largest services exporter in the world but the difficulty is how to improve on that.[16] Increasing services exports often requires other countries to alter their domestic laws to let your businesses compete, something many countries find unappealing. But services are 80 per cent of the UK economy, so there is an urgent need to do better here. One of the big disappointments was the fact that the UK-EU Trade & Co-operation Agreement (TCA) largely excludes services.

[13] 'The Bank of England's Jonathan Haskel on Inflation, Productivity, Brexit, and More', Matthew C. Klein, *The Overshoot*, 13 February 2023
[14] See HM Government, *Global Trade Outlook*, 28 February 2023
[15] HM Government, 'Impact assessment of the FTA between the UK and Australia: executive summary', 10 May 2022
[16] HM Government, 'Trade Secretary welcomes record year for services exports', 10 February 2023

Opportunities:

Chance to set the UK's trade policy

The UK now has the chance to set its own trade policy but it needs to do so based on a realistic understanding of the threats and opportunities. The UK is not part of any large bloc but nor does it have a large internal market so we need to make clear policy choices. This point was raised in connection with the UK-Australia FTA: which is the priority, food security or cheap food imports? That agreement prioritised food imports at the likely expense of our own farmers.

There are also choices about whether we focus our efforts on expanding manufacturing through goods exports or promote services. In the 1980s the UK managed to do both by promoting the UK as a manufacturing location while simultaneously liberalising our service sector (*e.g.* through the "Big Bang") but that was inside the Single Market. And today, goods or services maybe a false choice as so often the two are tied together (*e.g.* exporting goods with embedded services).

Relative regulatory independence

Another potential UK opportunity is to adopt a middle path on regulation – not so distant from the EU's approach as to put at risk trade with EU but a less deregulatory model (*e.g.* in tech) than the US. Combined with rule of law, high quality legal and accounting services, the English language, and a convenient time zone, this could prove attractive to investors.

Boosting investment

The improvement in UK-EU relations since the Windsor Framework, the accession to the Pacific Partnership treaty (the CPTPP) and the steadying of economic management since the autumn of 2022 could lead to an improvement in investment picture. The risk in the medium to long-term is that foreign direct investment (FDI) will not be attracted back because the UK is a less attractive location now that it is outside the Single Market. The Government needs to identify policy options that would overcome potential investor resistance to being outside the Single Market – the regulatory environment is possibly one of them.

Science, research and innovation

The UK has world-class universities and highly skilled workers in many key fields. It could expand education in science, technology, engineering and mathematics (STEM) subjects to create a larger pool of workers in what are commonly global shortage sectors. This would make the UK attractive to FDI in new industries. The Prime Minister has indicated that this is one of his policy ambitions but while the creation of the new Science Department is a symbolic step, a lot of further work is needed. The risks of exclusion from international research co-operation while the UK remains outside the EU/EEA Horizon programme and has no viable alternative to it could undermine this opportunity significantly.

New free trade agreements (FTAs)

Historically a strong supporter of multilateralism and the WTO, the UK moved towards bilateralism since Brexit. While this is understandable in the shorter-term, the UK has always benefited from multilateral trade agreements and could do so again in future.

Provided UK policymakers are clear as to what they want, some new FTAs are possible but they are largely limited to small and medium-size countries at present. It is important to note that FTAs are always limited by what the other party wants and because the UK is already a very liberal, open economy which may not have much to offer the other party. UK concerns about immigration are a complicating factor when dealing with some countries (notably India).

The Government's successful bid to join the Comprehensive & Progressive Agreement for Trans-Pacific Partnership (CPTPP) is a valuable first step beneficial to UK because it will enable increased access to growing Asian markets. It also means the opportunity to negotiate new agreements inside the CPTPP and the opportunity to influence regulatory policies in Asia, which could have global implications over time.

Build a better relationship with EU

The Windsor Framework with the EU offers the possibility of a better relationship with the UK's largest market. This is important because EU policy is evolving quickly in many fields including energy, automotive, tech and the climate. Developments in all these sectors could be to the disadvantage of the UK economy. For example, the EU is planning to introduce a carbon border adjustment mechanism (CBAM) in 2026, which would put tariffs on carbon intensive products exported to the EU. Given that the UK's is the EU's main trading partner in carbon intensive goods, this could have a significant impact. Any CBAM tariff would make UK exports more expensive and therefore less attractive to buyers in the EU. The Government has launched a consultation on UK CBAM policy and this provides an opportunity to take a position that will facilitate co-operation with the EU in future.[17]

The UK could build on the TCA without the need for new treaties. There are opportunities within the TCA consultative structures to ease trade and co-operation in fields such as financial services and science that would be to the UK's advantage.[18] The review of the TCA in 2026 will provide an opportunity to discuss wider issues with the EU. There are more radical measures, such as joining the European Economic Area (EEA) or establishing a customs union, which would expand trade further with the EU and which would increase FDI in UK but there is no political consensus in UK at present that would enable such a development.

Time for a new direction in UK trade policy?

After a period of exceptional economic and political upheaval, the UK has an opportunity to redefine its economic priorities. The current cost of living crisis is particularly difficult because it has followed 15 years of low growth, meaning the financial position of UK families and businesses are less robust than those in several competitor countries. The UK has to do better in future and further political turmoil could follow if governments fail to improve the current economic situation.

Across the political spectrum, politicians need to ask what could the UK do to improve its economic and trading position in the medium to long-term? A series of measures would help:

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[17] See Josh Burke *et al.*, *What does an EU Carbon Border Adjustment Mechanism mean for the UK?*, Grantham Research Institute on Climate Change and the Environment, LSE, 1 April 2021

[18] See European & International Analysts Group, *Improving the UK-EU Relationship*, 6 June 2022

- adopting a clear, credible, stable economic policy with sustainable medium-term and long-term goals – this means policies that reflect the UK's comparative and competitive advantages and which go beyond the political cycle of three to five years, preferably seeking a degree of consensus so policies endure;
- establishing a clearly defined relationship between trade and investment policies and linking those to other related policies, such as sustainability and net zero;
- pushing a revival of multilateralism in the WTO – the WTO is going through a difficult period but the world would be worse-off without it and while plurilateralist agreements could improve things, multilateral agreement would be more powerful;
- building on its current limited trading agreement with the EU starting the existing TCA framework – the UK has to accept the facts of its geography and recognise that a positive relationship with its largest trading partner is essential;
- making itself a powerful voice for open trade and investment in Europe and the world – which would appeal to many EU countries (*e.g.* the Nordic, Baltic and Eastern European members in particular), the European Commission and beyond;
- continuing to contribute to the debate around the digitalisation of trade – so that the UK is a leading participant in a developing policy area;
- integrating sustainability and net zero in to trade policy – so that, again, the UK is a participant in the global debate about this and so that it has fully articulated policies on issues such as CBAMs;
- addressing key supply chain issues – this is partly a matter of security (in energy and food as well as semi-conductors and other key components) but it also means recognising that outside the big trade blocs the UK is vulnerable in key sectors and that there are supply chain choke points.

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European & International Analysts Group

The European & International Analysts Group are an independent group of former British officials, both civil servants and diplomats, including former officials in the EU institutions and several former UK ambassadors to the EU.

The group publishes high-quality, evidence-based briefing materials on issues concerning the UK's new, external relationship with the EU, developments in the EU itself and on broader international issues that affect the UK and its neighbours.

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