



Select Committee on the European Union

Goods Sub-Committee

Corrected oral evidence: Beyond tariffs: facilitating UK-EU trade in manufactured goods

Monday 8 June 2020

11.50 am

Members present: Baroness Verma (The Chair); Lord Berkeley; Baroness Chalker of Wallasey; Lord Faulkner of Worcester; Lord Inglewood; Baroness Kramer; Lord Lamont of Lerwick; Lord Lilley; Lord Russell of Liverpool; Lord Shipley; Lord Turnbull; Lord Wood of Anfield.

Evidence Session No. 2

Virtual Proceeding

Questions 11 - 19

Witnesses

I: Dr Meredith Crowley, Reader in International Economics, University of Cambridge, and Fellow, St John's College; Shamik Dhar, Chief Economist, BNY Mellon Investment Management.

USE OF THE TRANSCRIPT

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Examination of witnesses

Dr Meredith Crowley and Shamik Dhar.

- Q11 **The Chair:** Welcome to our session. Thank you very much for joining us. It is an important session and we really look forward to hearing from you. I will ask both of you to give a very brief introduction, because time is not on our side this morning, I am afraid. We will not be broadcast, however, there will be a transcript later. On completion, when you get your transcript, if you feel some corrections need to be made, please send those back to us as soon as possible. That would be very helpful.

Dr Meredith Crowley: I am university reader in international economics in the faculty of economics at the University of Cambridge. I am also a senior fellow at UK in a Changing Europe. I am a research fellow at the Centre for Economic Policy Research. I serve on a number of scientific advisory panels for non-profit think tanks as well as for government departments. My academic research focus is on international trade agreements, trade policy and firms' engagement in international trade.

Shamik Dhar: I am chief economist at BNY Mellon Investment Management, but I am appearing here in a personal capacity, so please remember that. I have been an economist for over 30 years. I have worked with the Treasury, the Bank of England and various consultancy and City firms in the past. Most recently, between 2014 and 2018, I was chief economist at the Foreign and Commonwealth Office. I came back to the city in 2018. I am a macroeconomist by training, so a lot of my comments will be macro in nature. Meredith is much more of a trade expert than I am, so I will stick to that speciality.

- Q12 **The Chair:** How significant are non-tariff barriers as a potential obstacle to future UK-EU trade?

Dr Meredith Crowley: I will preface my remarks by saying that there is a challenge for economists to come up with a precise quantitative answer to this question. Trying to assess how significant non-tariff barriers are to the free flow of goods in a trade agreement is difficult in that, when we have a trade agreement that reduces tariffs, we typically have a number of provisions that simultaneously remove non-tariff barriers.

In a comprehensive review article that Limão published in 2016, he argues that the gains from preferential trade agreements are substantial. We know that the gains to trade are too large to be ascribed to the reductions in import tariffs alone. When we try to quantify how significant the gains are from the reduction of non-tariff barriers, there is a wide range of estimates. But, typically, economists find that the gains from the reduction of non-tariff barriers range from roughly equal value to the liberalisation associated with tariffs to about half of that value.

To give you one example, in an article published in 2009, Hiau Looi Kee from the World Bank looked at 78 economies and changes in import tariffs relative to liberalisations of non-tariff barriers. She found that the liberalisation of both tariffs and non-tariff barriers increased trade among

these countries by an average of about 12%. She ascribes 7.4% of that to the reductions associated with tariffs, whereas about 4.6% is associated with the reduction in non-tariff barriers. That is just to give you a ballpark size of where we think the reduction in non-tariff barriers can be.

An additional study that I will cite is from 2018 and is by Dhingra, Freeman and Mavroeidi. They found that roughly 30% of the increased flow in trade between the UK and the EU had to do with the beneficial effects of agreements between the UK and the EU on services, competition policy and investment.

There are two distinct types of non-tariff barriers that we can think about. First are the specific things, such as product standards and rules of origin, that get into the nitty-gritty of moving goods across borders. But we understand from this large literature on preferential trade agreements that complementary components, such as a liberalisation of services trade that would allow easier distribution of services, easier movement of goods between two areas, and complementary rules on investment seem also to be a stimulant to trade. The best estimate I can give you for the UK-EU relationship is that about 30% of the goods trade flow can be ascribed to this beneficial effect of competition policy, services policy and investment policy as part of the UK-EU relationship.

Shamik Dhar: There is a huge amount of uncertainty associated with this, but I tend towards the relatively sanguine, at least when it comes to the potential re-imposition of non-tariff measures on our exit from the EU. Why do I say that? There are a few reasons. First, the fact that we start from a position of full regulatory convergence suggests that it will be pretty difficult for the EU to impose significant new non-tariff measures behind the border, at least immediately. To do so would violate a number of WTO non-discrimination rules. That is not to say that they will not try or whatever, but I suspect it will be quite difficult for them to do that.

You might find that costs at the border, as opposed to behind the border, go up. They may well go up if customs officials decide to raise inspection rates or are instructed to do so. One study by Byrne and Rice, a couple of Irish economists, looking initially at UK-Ireland trade but then extending it to the EU as a whole, concluded that border delays could roughly double in time once the UK leaves. Interestingly, they found that the economic effect of that is actually pretty small, at least over time. When they extended their analysis to the EU as a whole, assuming that the UK put up border restrictions in the same way we suspect the EU might, they found that the EU-wide hit to exports on average was just 0.7%; exports fell by 0.7% across the EU as a whole. The biggest effect they found was on Latvia, which was 1.5%.

If you reverse all that and think about what might happen to UK exports, it is hard to think that the impact would be a lot bigger than that; 1.5% to 2% off exports is probably worth avoiding, but it is not a huge deal. It is also worth remembering that a rise in at-the-border costs would be

challengeable at the very least under the terms of the WTO technical barriers to trade and trade facilitation agreements.

That is an idea to bear in mind that tends me towards the sanguine. We will also see a lot of competition over time between the likes of Calais and Rotterdam. That might keep those kinds of costs down. Overall, it is hard to see how behind-the-border costs could emerge straightaway. At-the-border costs could increase, but I suspect the economic impact of that would be relatively small.

On your supplementary question about how important non-tariff measures are, most studies find that they are now much more important than tariffs as an impediment to global trade. UNCTAD estimates that non-tariff measures in high-income economies amount to the equivalent of a 7% tariff. That is roughly double the common external tariff that the UK would face if it left the EU. That common external tariff averages about 3.5%.

To finish on a macro point, trying to quantify the effect of that on the economy is quite important. In the event of no deal, the worst case, imagine you saw an increase in the common external tariff of 3.5% and an increase in the non-tariff barriers of 7% to 10%. You are then talking about a 10% to 15% increase in the cost of trading with the EU. Imagine there is a so-called elasticity of one, which is quite high. That would mean a 10% to 15% fall in our exports to the EU. Our exports to the EU are about 44% of our total exports, so that is a 4.5% to 6% fall in total exports. Exports are roughly 25% to 30% of GDP, so that is a 1.5% to 2% fall of GDP. That is assuming no offsetting effects from import substitution or exports to other countries.

Sorry, I have gone on a bit there. Bottom line, I am relatively sanguine about both the size of non-tariff measures and their impact on the economy after we leave.

The Chair: Thank you. I suspect colleagues will be thinking of several questions to come back to you with.

Q13 **Lord Lilley:** As Secretary of State for Trade and Industry, I had to introduce the single market programme, which aimed to remove many non-tariff barriers facing UK goods exports to Europe and vice versa. I made lots of optimistic speeches about how wonderfully that would increase our exports. In practice, they have increased by less than 1% a year since then. Why has the removal of non-tariff barriers, arising from our membership of the single market, had so little impact, and does that provide some gauge of how much impact there will be if some of those non-tariff barriers are reinstated once we leave? If you think it will be bigger this time round, why?

Dr Meredith Crowley: I will start by making a few empirical observations. I looked at overseas trade statistics from Her Majesty's Revenue and Customs. Between 2012 and 2019, the average annual growth rate from UK exports to the EU is about 1.4% per annum. This is

much lower than, for example, the growth rate to the United States, 4.5% per annum; to China, 11.5% per annum; and to Japan, 4.5% per annum. This is an artefact of calculating growth rates. When you start on a small base, you get a high level of growth. If we look at the level increase in trade over this seven-year period, UK trade to the EU increased by £19 billion. Exports to the US increased by £17 billion, exports to China by £14 billion and exports to Japan by only £2 billion.

Part of the reason we have this low per-annum growth rate is that we are coming from a very high base of trade with the EU. On the related question of why it has not been greater, some of the economies in the EU are very mature and themselves have had slow growth rates. A lot of this slow growth rate has to do with slow growth rates to the Netherlands, Germany and France, the largest partners. The growth rate to Poland has been much higher. Will removal of some of these non-tariff barriers significantly impact us on the exit side? I would not expect them to have a big impact immediately. I think they could come on gradually if there is a separation in regulatory and product standards between the two areas.

There will also be distancing between large multinational firms, which will handle any emerging differences between the two economies very easily. The same companies that are already trading with Japan and the United States already deal with complex customs rules. They already deal with multiple product standards in multiple jurisdictions, so handling it in one more large trading partner will not be that complicated. It will just impose an additional administrative cost.

Where I am worried about the non-tariff barriers coming to bite is for small and medium-sized firms. If these firms are not already trading with countries outside the EU, it is precisely because they find these additional customs barriers quite burdensome and they find it difficult to deal with things like multiple product standards. For these companies, the challenge will be how we can facilitate their continued trade with the EU after exit. What can government do to help new, developing companies facilitate better trade linkages? Private operators certainly exist in this space to facilitate trade for small firms.

However, the concern is that the additional cost that that involves might lead these firms to exit the market entirely and choose not to participate. That is my biggest concern.

Shamik Dhar: The main reason why our exports to the EU have been weak is because EU domestic demand growth has been weak for quite some time now. On top of that, I suspect that we have suffered a little from competitiveness. For a long period, from about 1996 through to at least the financial crisis, it is pretty clear that sterling was overvalued to some degree. That will not have helped us with our market share.

When it comes to the specific question about the impact of NTBs, I like to quote Paul Krugman, who is probably the pre-eminent trade theorist—and Nobel prize winner—of the past 40 years. He calls his trade “dirty little secrets”. This is the idea that the opening up of trade improves, over

long periods, the allocation of resources, et cetera, but the impact on growth is not always as dramatic as we might think. As it happens, most studies, including ones that Meredith has quoted, conclude that the creation of the single market boosted intra-EU trade quite significantly, by 25% or even more over the past 30 years or so, boosting EU GDP by between 5% and 10%.

However, there is also evidence that the bulk of those gains accrued to countries that were more heavily regulated before accession to the single market, and to smaller accession countries that came in a bit later. To be honest, greater access to a larger product market operating under unified product standards would have benefited them in any circumstances. The UK being a large player, and less heavily regulated when we went in, might account for some of Lord Lilley's observation.

Entering a customs union and single market with a common external tariff and product standards clearly boosts trade within the union. That is what I have just told you about. It potentially also diverts trade away from the union, depending on how heavily protected the union is itself. Some measures suggest that, although tariff rates have come down, protection levels remain pretty high for the EU as a whole, particularly in agriculture and manufacturing.

Most of the empirical analysis does not suggest that trade diversion has been large, but I find that hard to square with two observations. First, the UK's share of trade with the EU has risen quite significantly over that 30 to 40-year period. Secondly, the trade share with the rest of the world has started to rise just as common external tariff rates in the EU have started to come down. It is only a hunch, and others are better placed to judge, but I suspect that there has been more trade diversion than we think. Both those effects—rather less trade creation in the case of the UK and possibly a bit more trade diversion—on top of the impact of low demand and low competitiveness, explain Lord Lilley's numbers.

Q14 Lord Inglewood: It strikes me that we are talking in very broad terms about trade, but trade flows are simply the aggregate of a lot of individual deals done by people. Those deals depend on things such as price, quality, who else is competing, whether you can enforce the legal provisions of the arrangement if something goes wrong, and so forth. In the context of this report, we are looking at the reintroduction of non-tariff barriers with the EU. It therefore seems to me that the important point we want to address is whether the introduction of these non-tariff barriers will help or hinder trade.

Dr Meredith Crowley: If significant non-tariff barriers come on board, they will hinder trade. The question is precisely what form these barriers will take. I would imagine that the most likely one to cause a problem for an individual firm will be a change in a product standard in the European Union. A firm will then have to document that its product meets any applicable consumer safety standard. To do this, it will need to seek a conformity assessment from an institution in Europe. At the moment, none of this is necessary.

If we do not have some sort of arrangement in place beforehand, product standards are the biggest area where we will run into problems. If we want to mitigate this, the way forward is to come up with a mutual recognition of conformity assessment procedure and agreement between the EU and UK, and then make it as easy as possible for UK firms that have not needed to seek this previously to do so. At some initial point we may need to offer financial support to small firms that have not had to pay these types of fees before.

Q15 Lord Lamont of Lerwick: Meredith may have answered this question already. Looking at the short term, how could any disruption of NTBs be mitigated? What unilateral measures could the UK take, and would they be effective?

Shamik Dhar: The short and long-term distinction is important. There will be a lot of focus on short-term disruption. There undoubtedly will be some. To answer the previous question—I apologise; I am a macroeconomist—yes, non-tariff barriers will hinder trade, but the question is by how much. That is the question I have been trying to get at.

Again, Meredith is probably better placed to talk about the detail. In the short term, if there are rigidities or costs of adjusting that mean that firms have to respond to a rise in trading costs by cutting output, the economic impact on output, employment and trade could be quite significant. Even there, as I have pointed out before, it will probably not be as big as some have suggested.

The long run is really different. As soon as you have free entry and firms getting used to the environment, optimising their production, using the new logistics and recognising that there is a new pattern of costs, certainly bigger firms will tend to adjust, probably more rapidly and easily than we think, and more than most trade models tend to incorporate. Trade models tend to take these rigidities and push them out quite a long way.

There is quite a lot of flexibility in the long run for firms themselves to solve their problems. Meredith is quite right that we can help them along the way by introducing particularly finance-friendly measures. There is a whole different issue for small businesses, but, broadly speaking, firms will adjust over the longer run.

Q16 Baroness Kramer: Can I follow up on that last question by moving over to rules of origin? This is one of the non-trade barriers that have concerned people the most. What are your thoughts on the implications for the UK economy of the UK-EU negotiations on that issue? Which sectors might be particularly affected? When you look at sectors, could you address the issue of small businesses in the supply chain? It needs some exploration.

When we talk about sectors, we rarely talk about the cross-cutting sector of people who produce highly customised products. Do they fall into a different category? Your comments on all those would be appreciated.

Dr Meredith Crowley: There is a lot to unpack there. First, the best empirical study of rules of origin is by Conconi in 2016 in the *American Economic Review*, in which she looked at the impact of Mexico joining the North American Free Trade Agreement. She found that the rules of origin in NAFTA reduced Mexico's imports of intermediate goods from non-NAFTA countries by 45%. It reduced the growth rate of Mexican imports from non-NAFTA members quite substantially.

The implication of this type of study for the UK is that if the UK has similar very restrictive rules of origin with the EU, this could have a very negative impact on its trade with external partners. The NAFTA rules of origin are generally more demanding than those in other trade agreements. When we define rules of origin, we can say that if a product is made within a country and the product changes its tariff classification, we can consider that product as domestic for the rules of origin of a trade agreement.

An alternative way is that we require a minimum amount of 'value added' in a product to be produced within trade agreement partners. Typically, most trade agreements require this to be around 40%. Some trade agreements do a hybrid. The first thing is that rules of origin dissuade trade from non-trade agreement members.

We also know, from a study by the Inter-American Development Bank in 2017 looking at preferential trade agreements across Latin America, that although there are 33 free trade agreements among different Latin American countries, most trade within Latin America does not take place under these preferential trade agreements. Basically, in Latin America, aside from very large agreements like Mercosur, the rules are so complex that most traders do not even seek tariff-free access when they could, because it is too complicated for them to figure it out. For them, it is easier just to pay the tariff at the border and not seek tariff retreatment.

That is another issue that could come up in a UK-EU free trade agreement. Smaller firms—these could be firms feeding into supply chains—might realise, "If the tariff on my exports to the EU is only 2.5% or 3.5%, I might be better off just absorbing that cost, because the cost of satisfying the documentary evidence for rules of origin exceeds that". Typically, we think that rules of origin are taken advantage of by large multinationals that are quite sophisticated and can employ a huge staff to satisfy this. The smaller firms either rely on a multinational that is purchasing to help them smooth this out, or do not bother at all and just pay the tariff.

In terms of the industrial sectors where this is likely to be the biggest problem, and I do not have very good evidence to support this, the biggest tariff preference to be gained in a future free trade agreement with the European Union will come in the transportation equipment automobile sector, because that is where the tariffs are the highest. That is where you will have the biggest gains from satisfying rules of origin, so that is where the most problems could arise. I would be worried about

small producers in the automobile sector, or part of the supply chain feeding into autos.

Shamik Dhar: Meredith has outlined very nicely how bilateral trade agreements can also involve trade diversion. That is an important thing to take account of when thinking about this. To generalise a bit, rules of origin will mostly affect firms that are effectively assembly operations and import parts from around the world. If they are prevented from doing that or the cost of doing that is prohibitively high, it is hard to say what the impact will be. Some of that trade may well revert to within the EU. Some of it might come back home. Working out the effects of all that is quite difficult, but it is important to think about trade diversion in the context of a bilateral treaty as well.

Q17 **Lord Wood of Anfield:** Building on Meredith's reply to Baroness Kramer on Mercosur, I am interested more generally in what lessons we can learn from other trade agreements that have been a success or have at least tried to mitigate the economic impact of non-tariff barriers. I am thinking not just of EU trade treaties, for example the emerging one with Japan, which has tried to grapple with some of this. Are there inspiring examples elsewhere of attempts, through the trade treaty process structure, to mitigate these barriers?

Dr Meredith Crowley: The issue is that we have a hard time determining which provisions of a trade agreement are the most beneficial in reducing non-tariff barriers. As I said earlier, the European Union is largely regarded by economists to be the most successful example of an agreement that facilitates the greatest amount of trade. Part of the understanding is that it has to do with these synergies.

If we want to think specifically about an abstract component, we could think about the role that mutual recognition agreements play in facilitating trade. There is a study by Chen and Mattoo in 2009, which I may have already referenced. When we think about establishing mutual recognition agreements, these can either have rules of origin in them or be open. Say, for example, we had a mutual recognition agreement between the US and the EU that did not have rules of origin. If a firm in Japan wanted to export to the US and sought approval of its product from a US-based conformity assessment organisation, the Japanese firm could then also seek a conformity assessment certification from the same American firm to sell its product in Europe. It would have to meet the European standards.

Chen and Mattoo found this type of mutual recognition agreement, which does not have closed rules of origin but has open rules of origin, to have extraordinarily stimulating effects on third-country trade flows. There are complicated things here. If two countries form a mutual recognition agreement of conformity assessment between themselves, they find that the beneficial effect is increased trade between the two by 42%. However, if those mutual recognition agreements are open, it has a much smaller impact on trade between the two parties and raises trade by only 20%. Why is it smaller when they have the open agreement? It is

because third countries can also participate and benefit from the system. It is raising trade not simply between the bilateral pair but between the bilateral pair as well as between other pairs going off in both directions.

In that sense, most modern mutual recognition approaches try to take the open approach. If the UK wants to have this outward focus in developing its relationship not just with the EU but with other countries, this aspect of the agreement could be put forward. Let us try to have mutual recognition of conformity assessment that is quite open with regard to rules of origin.

Lord Wood of Anfield: That was a great answer. Thank you very much.

- Q18 **Lord Berkeley:** Following on from a response by Meredith and other witnesses, if there was a comprehensive trade agreement with the EU that addressed most of the non-tariff barriers we have been talking about this morning, what would the consequences be for UK trade with third countries? If we did not have a comprehensive agreement with the EU and were under WTO, how much difference would it make to our trade with third countries?

Shamik Dhar: There are three points in relation to that. We have already made one: there could be an element of trade diversion, depending on the terms of that trade agreement and how important rules of origin turned out to be. We would need to keep an eye on that.

Looking at the big picture, it ultimately depends on what kind of rules and regulations we choose to follow as part of that trade agreement. Dynamic alignment, to use the phrase, matters a lot. If we end up replicating, broadly speaking, EU levels of protection through existing regulation, by implication you will end up, broadly speaking, with the current pattern of trade with the EU and very little change in trade with the rest of the world. By contrast, if we go for something that allows a bit more dynamic realignment, we can expand our trade, both in parts and in final goods, with the rest of the world.

Which is the right approach to take? Economists are still debating, and politicians will debate, but undoubtedly the form of the trade agreement we make will determine how much trade we end up doing with the rest of the world, both in parts and in final goods.

- Q19 **Lord Turnbull:** Responding to Dr Crowley's remarks about third-country trade, it seems that the logic here is that the Commission will play tough on rules of origin thresholds. As the UK, it is in your own hands. If you divert more of your purchasing and inputs through the EU, you can get your goods through these hurdles. It is a form of secondary protectionism. We will be encouraged not to buy from third countries but to buy from elsewhere in the EU to satisfy the rules of origin.

Dr Meredith Crowley: It is difficult to ascribe blame. The argument about having these restrictive rules of origin is one of fairness, in that you do not want one member of a trade agreement reducing its tariffs to close to zero on third-country partners, having these parts come in and

then essentially sneaking them through into the other parts of the trade agreement area. The US was concerned about Mexico importing lots of cheap parts from China and basically passing them on to the US without enough Mexican value-add being part of the product coming in. This is why they put these rules of origin on.

In the European Union, the rules of origin are in some sense complicated but also extend to countries in north Africa through various trade agreements, where they allow other agreement partners to cumulate their rules of origin with different European countries. If, for example, I have some fabric in Morocco and I can import it to the European Union, I can then further process that within the Union and maybe send it back to Morocco for another stage of processing. Free trade is allowed to cumulate, so we do not have successive iterations of tariffs going back on the product every time the next iteration comes in from Morocco.

In some sense, one idea behind these rules of origin is to allow a set of countries, not just those in the European Union, but the peripheral countries that have free trade agreements with the EU, to share their trade among themselves. To some extent it works. However, rules of origin are a significant barrier to trade with countries outside the agreement, and that will always be the case. That is how countries set these things up. You are correct that it is a secondary barrier.

On third countries, I do not have much to add beyond what Shamik and I have said already. One of the issues here has to do with product standards as a non-tariff barrier. Quite a few of the disputes that have played out at the WTO over the last 20 years have been about product standards, product labelling, phytosanitary measures and animal welfare measures. These problems are being litigated at the WTO and, as one can imagine, it has been quite a contentious area already. The EU does not want to be constantly litigating on these issues at the WTO if it does not have a settlement before the UK leaves. It can already see other WTO members litigating these issues time and again, and it can be quite wasteful.

The Chair: Thank you very much. Thank you, Dr Crowley and Shamik Dhar, for coming in today. It has been a really useful session for us all. Colleagues have found a great insight from you on these very difficult and challenging questions that we are facing. I will just repeat that the transcript will be sent to you. If you could send it back with any corrections as soon as possible, that would be very helpful. Thank you very much for joining us this morning.