Box A: Improved trade balance with the European Union raises challenging Brexit questions[1]

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Summary

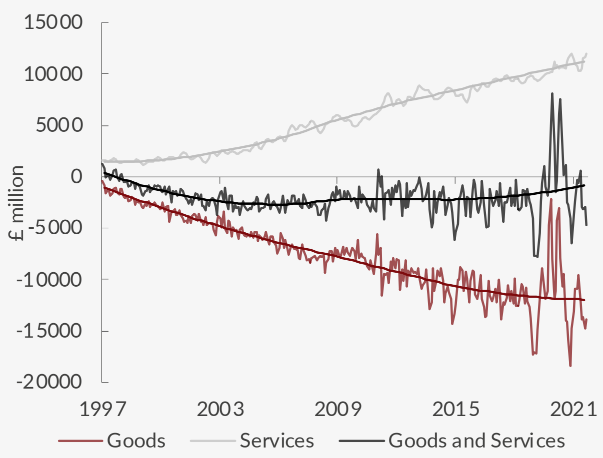
There has been a significant improvement in the UK's net trade performance with the European Union (EU) since the 2016 Brexit vote. The previous negative trend in the real net trade balance with EU has not only stopped but is improving. The gap between recent numbers and the previous trend in the trade balance with the EU is equivalent to just over 2 per cent of GDP. A plausible reason for these developments is that the Brexit vote led to a sharp sterling depreciation, making the UK significantly more competitive while crimping domestic demand. However, Covid-19 and a dramatic drop in the EU's overall trade balance are also likely important influences.

Introduction

Most analysis ahead of Brexit predicted a substantial hit to the economy (Erken et al., 2018; Hantzsche et al., 2018). Much recent comment claims a negative effect (Giles, 2021) and the Office for Budget Responsibility (OBR) recently opined that it expected GDP to be 4 per cent lower than otherwise because of Brexit. The Centre for European Reform (CER) said that "isolating the Brexit effect suggests a drop of 11 to 16per cent in the amount of UK trade" (Springford, 2021). Worse trade performance was at the heart of most of the pre-Brexit gloomy predictions about its economic impact.

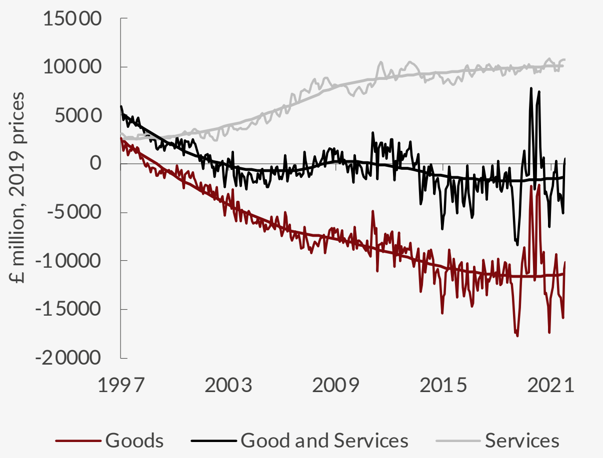
However, poorer trade numbers have failed to materialise. The trade position with the EU has improved substantially since 2016. This raises the question of whether analysts have been looking in the right place when searching for economic losses due to Brexit.

Figure A1 UK Nominal Trade Balances: World



Source: ONS; NIESR

Figure A2 UK Real Trade Balances: World



Source: ONS; NIESR

Analysis

Figure A1 looks at the UK nominal trade balance, split between services and goods. The longer run trends are for an increasing surplus on services offset by a trend increase in the goods deficit, delivering a more or less consistently stable deficit. However, that balance has improved over recent years. In 2015 and 2016, the overall trade balance was in deficit by £30 billion and £33billion, respectively. In 2017 and 2018, the deficit was slightly

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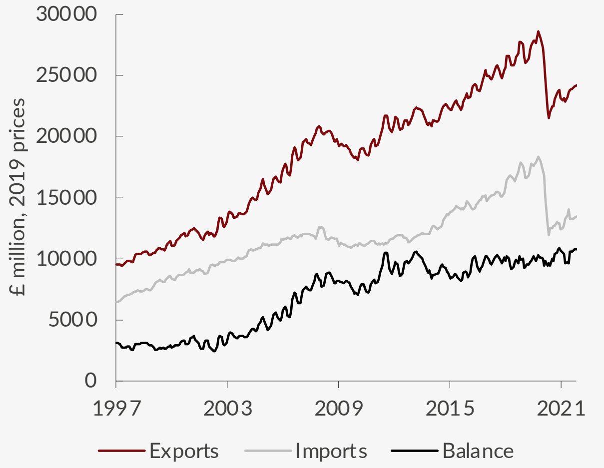
smaller, at £26 billion and £28 billion, with a fall to under £21 billion in 2019. In 2020, the year of Brexit and Covid-19, there was a surplus of £3 billion, and in the first eleven months of 2021 a deficit re-emerged, running at an annual rate of £21 billion. In 2020 and 2021 taken together, the trade balance looks likely to average a deficit of £10 billion a year, compared with a deficit three times as large before Brexit.

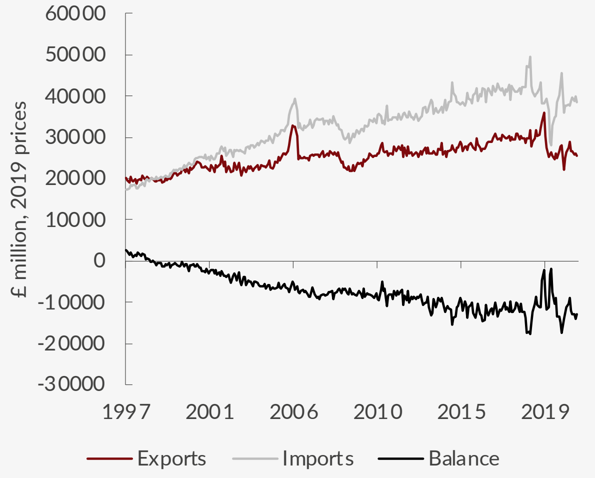
Figure A2 presents a very similar picture when the data are in real terms (2019 prices), except that all the trends look flatter – the services surplus is on a much flatter improving trend than in nominal terms. Since 2020, services volumes have stepped down on each side of the external accounts, leaving the balance unchanged (Figure A3).

Figure A3 UK Real Services Trade: World



Source: ONS; NIESR

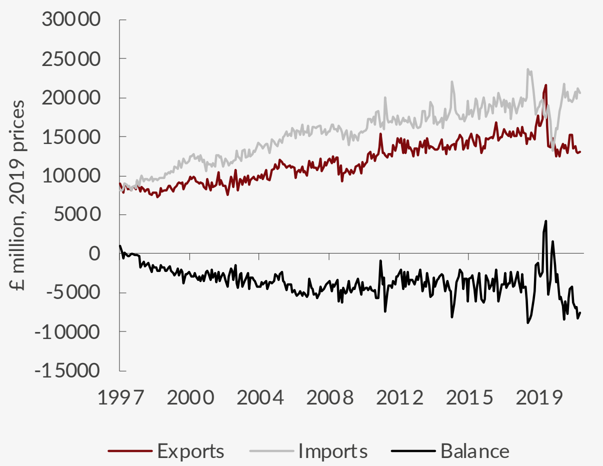
Figure A4 UK Real Goods Trade: World



Source: ONS; NIESR

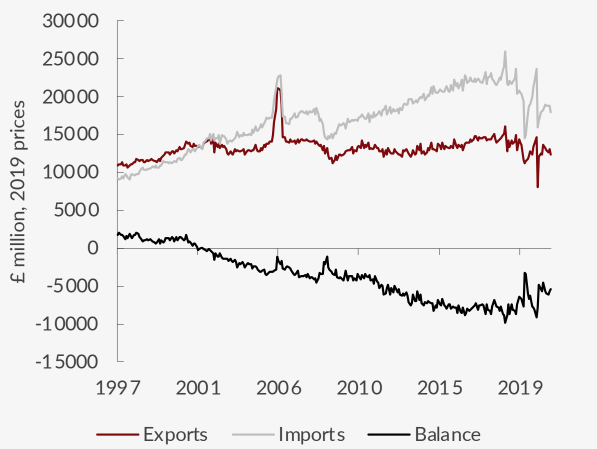
It is, of course, changes in net trade on the external accounts that affect growth, not the gross flows, which is why looking at the sum of imports and exports is grossly misleading as a guide to how Brexit may have affected the economy. This is especially the case as Covid-19 has impacted global value chains, notably transactions in the automotive sector, which is important on both sides of the UK's external accounts.

Figure A5 UK Real Goods Trade: Non-EU



Source: ONS; NIESR

Figure A6 UK Real Goods Trade: EU



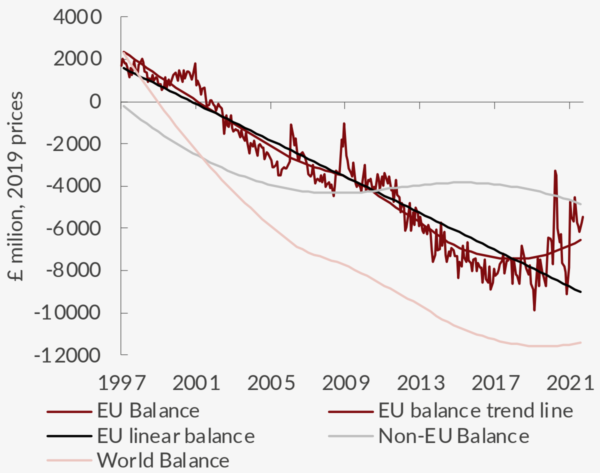
Source: ONS; NIES

Figure A4 shows more volatility in goods, but again a broadly offsetting shrinkage since 2020 in both imports and exports.

All the flows have fallen since 2019, with imports from the non-EU recovering best (Figure A5) and imports from the EU suffering the most sustained fall (Figure A6).

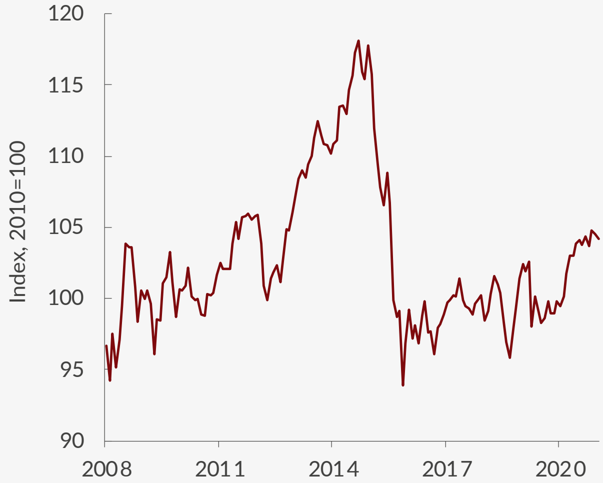
Figure A7 shows that the pre-2016 downward trend in the EU balance has turned. While the recent improvement may be due to Covid-19, the improvement started in 2016, and may well stem from the sharp improvement in UK competitiveness following sterling's fall on the Brexit vote (Figure A8).

Figure A7 Trends in Real Goods Balance



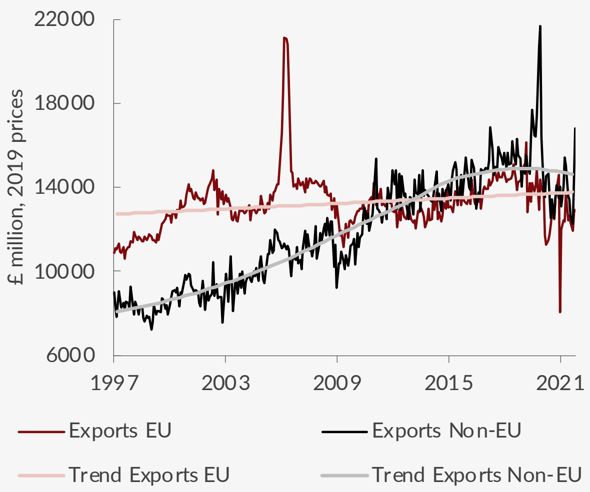
Source: ONS; NIESR

Figure A8 UK Real Effective Exchange Rate (2010 = 100)



Source: Federal Reserve Bank of St. Louis; NIESR

Figure A9 UK Real Exports



Source: ONS; NIESR

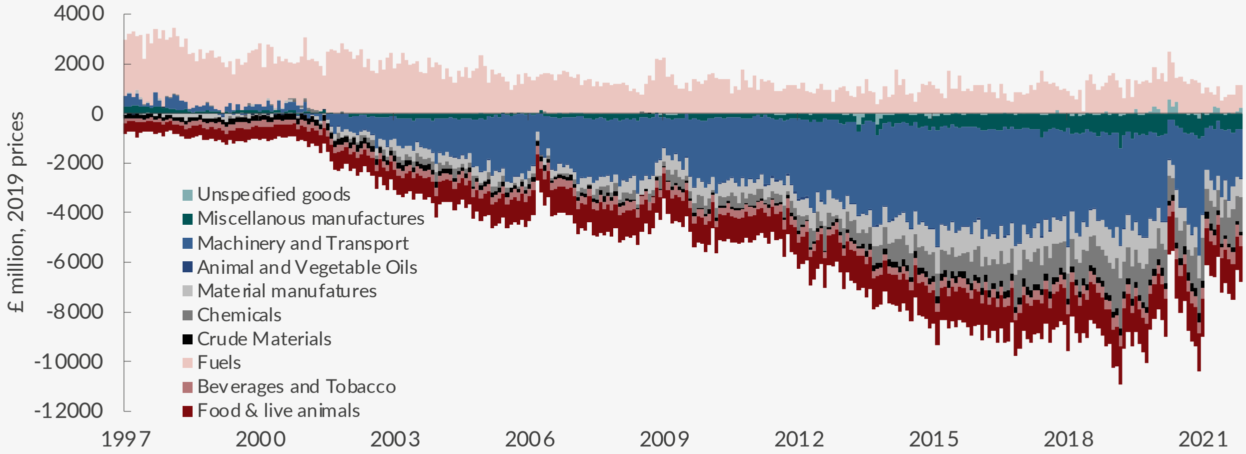
Figure A9 shows that Covid-19 flattened the previous upward trend in non-EU exports. However, the flat trend in exports to the EU has not turned down as the damage from Brexit argument would have suggested. Exports to the EU appear to have fared no worse than exports to the non-EU, contradicting hypotheses about a negative effect from Brexit so far. Having said that, the trade figures will have been affected by uncertainty over Brexit, including anticipatory inventory building around the end of the transition period.

Conclusions

The evidence in actual UK trade data shows that the net goods trade position of the UK with the EU, which was deteriorating this century, flattened off following the Brexit vote in 2016 and began to improve even before Covid-19 reduced trade volumes and muddied the statistical waters. The facts challenge claims of an adverse net trade effect from Brexit so far.

However, Covid-19 has distorted trade flows severely, so any conclusions are necessarily tentative. For example, analysing UK net trade performance with the EU shows that a good part of the improvement since 2020 was in machinery and transport equipment (Figure A10). We know that motor vehicle manufacturing was adversely affected by chip shortages and, therefore, so was trade in motor vehicles. Thus, some of the improving trend in the net trade position with the EU since 2020 is probably attributable to Covid-19, making it tough to separate Brexit from Covid -19effects. Having said that, the trade trend began to turn significantly prior to the pandemic.

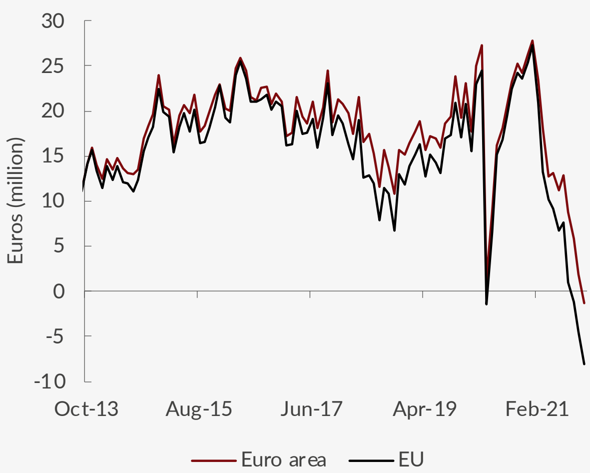
Figure A10 UK Real Balance of Goods Trade: EU



Source: ONS; NIESR

The analysis thus far has taken a UK perspective, but a trade balance is two-way. It is not solely with the UK that the EU's goods trade balance has been deteriorating, but with the world. Figure A11 shows that this fall in the balance has been dramatic, with the massive EU trade surplus evaporating since Covid-19 hit, which raises a further set of questions as to why this has happened, and making conclusions over the effects of Brexit more uncertain.

Figure A11 UK Real Balance of Goods Trade: EU



Source: Eurostat; **NIESR**

Our analysis of the developments in UK/EU trade raises a slew of questions and challenges many previous assertions about the adverse effects of Brexit on UK trade. Definitive answers are not in the data because Covid-19 and the vanishing EU trade surplus with the world are major influences on the UK/EU trade balance in addition to Brexit.

This analysis raises questions of whether trade is the right place for look to find Brexit effects. If the exchange rate moves to offset much of the ex ante Brexit effect on net trade, then the correct place to look ex post is elsewhere. Specifically, it is in the consumer sector where adverse effects of Brexit may be felt. The hypothesis is that a weaker exchange rate due to Brexit has pushed up import costs and raised consumer prices, thereby crimping real incomes. The resultant lower level of consumption reduced import volumes and, together with the improved competitiveness effect noted above, offset the initial adverse net trade effects. More light will be shed on the issue as Covid-19's impact on trade fades during this year, and we will be watching the data closely for clues.

References

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