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Committee Secretary
Joint Standing Committee on Foreign Affairs, Defence and Trade

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Re: Additional submission (to original Submission 6) to the Parliamentary Inquiry into Australia’s trade and investment relationship with the United Kingdom

Disclaimer: This additional submission was written by Associate Professor Melatos in his personal capacity as an academic in the School of Economics at the University of Sydney. The opinions expressed in this article are the author's own and do not necessarily reflect the views of the University of Sydney.

In what follows, TA = trade agreement.

<u>It will be difficult to achieve a negotiated Brexit outcome:</u>

- It is not a simple matter for one party to *unilaterally* choose to exit a *multilateral* TA
    - ✓ The “no deal” option often mentioned in discussions, in fact sounds like “breach of contract” and will have costly consequences for the UK.
    - ✓ As such, there appear to be only two possible broad outcomes to the Brexit process: negotiated exit or the status quo (i.e. remain)
- A negotiated outcome, however, seems difficult to imagine because of the positions and asymmetric bargaining power of the parties involved.
    - ✓ The UK has committed to break its EU contract but it has little (or no) leverage and few (if any) outside options. The UK, therefore, is unlikely to be able to force an end to negotiations on its own terms.
    - ✓ The EU, on the other hand, does not want its EU contract with the UK broken. Not only does the EU have significant leverage in negotiations (e.g. access to the common market), it also does not want the precedent of a successful Brexit to be set. The EU, therefore, has little reason to facilitate a deal with the UK.
- In summary, the UK does not seem to have the *ability* and the EU is unlikely to have a sufficient *incentive* to force a negotiated outcome.
- So what might happen?
    - ✓ The EU is likely to make a series of niggardly “take-it-or-leave-it” offers that the UK Government cannot plausibly sell to voters.
    - ✓ The 2-year negotiation deadline is likely to be extended, probably more than once.
    - ✓ To avoid the “no deal” scenario, the UK needs to convince the EU that, at this point, UK-remain is too costly an outcome for other EU members. It is not clear how the UK could achieve this.

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Brexit will create additional uncertainty

- TAs negotiated under uncertainty are likely to be sub-optimal. This can be mitigated by making them more flexible.
- Brexit is likely to increase global trade uncertainty in the following ways:
  - ✓ It will create a precedent for countries to leave TAs
  - ✓ As such, future TAs are likely to be designed to make exit explicitly more (or less!) difficult. Existing TAs may have to be retro-fitted to account for the new risks associated with the potential exit of members.
  - ✓ These developments might discourage the creation of TAs – they will be more costly to negotiate and probably less valuable once implemented either due to: (i) reduced flexibility (from the inclusion of a no-exit clause) or (ii) insufficient integration (from the inclusion of a facilitated-exit clause).
- Countries, therefore, will need to be cautious about committing to new TAs.
  - ✓ The largest traders are best resourced to resolve these new uncertainties and, in any case, will set the new TA design standards post-Brexit.
  - ✓ Small traders, like Australia, should be cautious signing up to new TAs until the new TA architecture has been clarified. TAs should only be concluded where the strength of the business case is impossible to ignore. A TA with a UK (ex-EU) is unlikely to pass this business case test. A TA with a EU (minus-UK) most likely would.
- The UK's bargaining power over trade and investment is likely to be weaker post-Brexit as it will be a distressed negotiator.
  - ✓ The extent and nature of this weakness will be clarified once bilateral TA negotiations commence (or do not) with the UK's largest trade partners.
  - ✓ Small traders, like Australia, do not have the resources to test the UK's post-Brexit negotiating weaknesses adequately (i.e. across the broadest range of products, services and factors of production).

Australia's response to Brexit

- In order to maximise its return from any TA with the UK post-Brexit, Australia should:
  1. Wait for uncertainties in global trade architecture to be (at least, partly) clarified, including clarification on the UK's trading relationship with the EU.
  2. Wait for the extent and nature of UK weaknesses to be (at least, partly) clarified.
  3. Wait for the likely negative economic impact of Brexit to become apparent
     - Likely lower economic growth due to reduced labour movement, reduced trade on less favourable terms, more contested role in financial services.
  4. Design the most flexible TA (and investment agreement) consistent with this new reality.
     - Piggy-back off any UK trade negotiations with larger economies (including the EU) in order to ensure a more advantageous negotiating baseline.
     - The UK is unlikely to make significant trade and investment concessions to Australia if these preferences must then be extended (at much greater cost) to TAs with larger countries.

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5. Prioritise negotiating a TA with the EU (which can begin immediately) over a TA with the UK (which cannot start until Brexit concluded).

An important point to note:

- The UK’s current importance as Australia’s 5th largest trade partner is artificially inflated by its membership of the EU. The value of the UK as a trade partner to Australian firms is mostly as a gateway to accessing the EU common market. Post-Brexit, the UK’s value to Australian firms (and as a TA partner) is likely to be greatly diminished.
- Other countries (e.g. the EU) are better placed than Australia to extract trade and investment concessions from the UK.
  - ✓ UK exports to EU comprise approximately 13% of UK GDP while EU exports to the UK comprise approximately 3% of EU GDP. On this coarse measure, therefore, the UK Government is likely to face more lobbying from exporters to conclude a post-Brexit TA with the EU than the latter is likely to feel from its own exporters. This will put the UK at a relative negotiating disadvantage in negotiating a TA with the EU post-Brexit.
  - ✓ Moreover, in the UK’s case, exporter lobbying will be concentrated in one voting jurisdiction (i.e. the UK) while, in the EU, exporter-lobbying is dispersed among 26 voting jurisdictions and the technocratic European Commission. Again, this is likely to give the EU a significant negotiating advantage over the UK.
  - ✓ In contrast, note that Australian exports to the UK comprise approximately 1% of Australian GDP, while UK exports to Australia amount to approximately 0.4% of UK GDP. Purely on this measure (and notwithstanding the fact that Australia’s exports to the UK are likely to shrink post-Brexit), Australia is in a much weaker negotiating position vis-à-vis the UK, than, for example, the EU.

Yours Sincerely,

Mark Melatos