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

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Re: Submission to the Parliamentary Inquiry into Australia's trade and investment relationship with the United Kingdom

Disclaimer: This 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.

Summary

While the idea of a UK- (or EU-) Australia trade agreement (TA) is a good one in principle, Australia should not rush into a TA in anticipation of Brexit. This is for two reasons:

1. Any negotiations between Australia and the UK (or EU) are likely to be influenced by the nature of Brexit and so should only begin once the UK's post-Brexit trading status is clarified.
2. There is likely to be only a negligible first- or early-mover advantage for Australia in negotiating a TA with the UK before others. Rather, Australia should wait for larger trading nations to negotiate TAs with the UK first and then use the outcome of those negotiations to enhance the baseline for its own negotiations.

Brexit uncertainty demands a cautious response

1. Negotiating TAs under uncertainty leads to sub-optimal outcomes (Appelbaum and Melatos, 2016). This is because a TA, once signed, cannot be easily renegotiated to take account of changed circumstances.
2. As such, in order to design an optimal TA in a world characterised by uncertainty, negotiators should either: (i) wait for the uncertainty to be resolved (not very likely or politically feasible in the real world) or (ii) design a flexible TA that allows members to respond to the resolution of uncertainty ex-post.
3. Flexible TAs have an "option value" for members (Appelbaum and Melatos, 2016). The greater the flexibility built into a TA, the greater is this option value and the higher is the expected welfare that a member country gains from the agreement.



4. The difficulty with Brexit is that no one as yet knows what the UK's trade status will be once it has left the EU (House of Commons Library, 2017). Nevertheless, this status is crucial in determining how much flexibility should (or can) be built into any Australia-UK TA.
 - ✓ If there is no preferential TA between the UK and the EU post-Brexit, then UK-EU trade will be based on WTO rules and the UK would have complete freedom to conclude a TA with Australia. In turn this would allow Australia to push for the most aspirational TA possible.
 - ✓ If there is a preferential TA between the UK and the EU post-Brexit, then Australia's ability to push for the deepest possible trade and investment integration with the UK would be compromised. Any agreement between the UK and EU would place direct and indirect constraints on the types of concessions the UK (or EU for that matter) could make with third parties (like Australia).
5. In short, there is little value in trying to conclude a UK-Australia TA before the UK's post-Brexit trading status has been determined. In any case, and notwithstanding political statements to the contrary, the UK will not be in a position to promise much to a putative TA partner before its post-Brexit status has been clarified.

There is no need to rush ... Australia should exploit its late-mover advantage

1. The UK is likely to be a "distressed" negotiator post-Brexit – the UK government will need (in both political and economic terms) to quickly demonstrate progress towards concluding TAs to replace EU membership.
 - ✓ Moreover, once Article 50 has been activated, the 2-year clock on an agreement with the EU will be ticking. The closer we come to this deadline, the weaker the UK's bargaining position will be, not just vis-à-vis the EU but also with respect to other potential TA partners.
 - ✓ It should be possible, therefore, for countries that negotiate with the UK to extract significant trade and investment concessions in any preferential TA.
2. Having said this, there are many countries that are better placed than Australia to exploit the UK's weakened bargaining position post-Brexit.
 - ✓ The United States for, example, will almost certainly be able to wring more significant intellectual property concessions from the UK than Australia. Canada, which has recently concluded a TA with the EU, might be able to obtain more significant concessions on agriculture market access from the UK than Australia.
 - ✓ Australia should then use these concessions to form a more advantageous baseline for its own TA negotiations with the UK.
3. In economic terms, there is likely to be only a temporary and minimal first- or early-mover advantage for Australia in negotiating an early FTA with the UK.



- ✓ Australia's firms may obtain preferential access to the UK market for a time but this advantage is likely to be short-lived and will likely be overwhelmed by deeper (discriminatory) concessions subsequently made to trade partners in stronger bargaining positions.
 - ✓ In this case, Australia would not be able to seek an adjustment of its own trade preferences to mimic those granted to others.
4. The greatest risk for Australia post-Brexit, is not that it may not conclude a TA with the UK soon enough (or not at all). Rather, the greatest risk is that Australia does not extract the maximum possible trade and investment preferences from the UK following this once-only event - Brexit.
- ✓ The UK is unlikely to make significant trade and investment concessions to Australia (even if their cost is insignificant) if there is some risk that these preferences will then be subsequently demanded by much larger trade partners (i.e. at much higher cost).
 - ✓ The best way to mitigate this risk for Australia is to allow countries with better bargaining positions to take the lead in concluding TAs with the UK and then piggy-back off their negotiations to create a more advantageous negotiating baseline for Australia.
5. Australia does not need to rush into negotiations. It currently receives limited preferences in its trade with the UK (i.e. with the EU).¹ So, even in the absence of a TA with the UK (or EU) it will continue to trade with both partners according to the status quo. On the other hand, the UK stands to lose significant market access to the EU via Brexit and will be keen to replace this, if not in the EU, then elsewhere.
6. Simply by waiting while the Brexit shock and related uncertainty is resolved, Australia maintains an (increasingly) valuable "option" to commence TA negotiations with the UK.

Yours Sincerely,

Mark Melatos

References:

- Appelbaum, E. and M. Melatos (2016) "How Can Uncertainty Affect the Choice of Trade Agreements?" *Economic Record*, 92(297), 153-172.
- Webb, D. (2017) "Brexit: trade aspects" *House of Commons Library Briefing Paper*, Number 7694, January 2017.
- Ungphakorn, P. (2016) "The Hilton beef quota: a taste of what post-Brexit UK faces in the WTO" *Trade Beta Blog* posted August 10, 2016. Accessed February 15, 2017. (<https://tradebetablog.wordpress.com/2016/08/10/hilton-beef-quota/>)

¹ Regarding many agricultural exports, such as beef for example, Australia has a guaranteed share of the EU's tariff rate quotas (Ungphakorn, 2016).