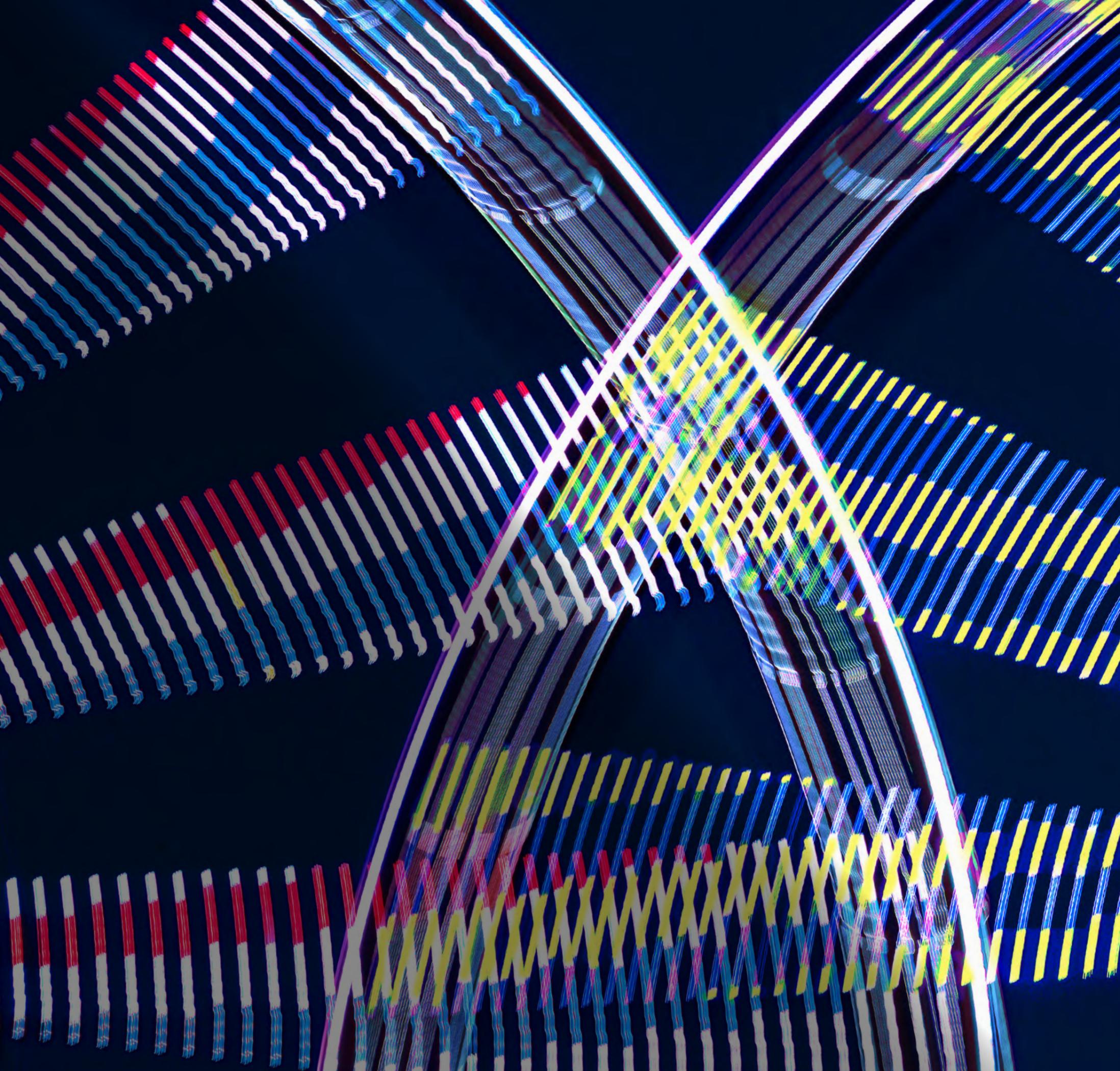




**Baker
McKenzie.**

**The Future of UK Trade:
Merged Realities of
Brexit and COVID-19**



Foreword

The combined impacts of the COVID-19 pandemic and Brexit present significant challenges for UK businesses, but new policy freedoms offer the potential to chart a new course for the UK and the economy. Amongst these, the negotiation of new trade deals with non-EU countries is identified as providing a potential offset to the negative impact of new barriers to trade with the EU.

The anticipated loss in output due to Brexit reflects not only the loss of unfettered access to the EU Single Market and Customs Union, but also the UK's decision to adopt a more restrictive immigration policy post Brexit. The current UK government has demonstrated that it places great weight on securing policy freedoms. As such, it may not be prepared to make the concessions necessary to strike a Free Trade Agreement (FTA), meaning that a No-Deal outcome has become more likely.

Contents

What's next for UK business? Conversations on post-Brexit reality centre on these areas of concern:

- What is the impact of COVID-19 and Brexit on the UK economy?
- How will UK manufacturing be affected?
- Which new trade deals could provide some offsetting relief for exports?
- How can the UK government use its new policy freedoms to boost UK growth and competitiveness?

Together with Oxford Economics and insights from Baker McKenzie's experts from London, we've put together a report on "The Future of UK Trade: Merged Realities of Brexit and COVID-19".

This report follows our previous report on [trade after Brexit](#), addressing the main concerns shared above. It measures the combined economic costs of Brexit and the COVID-19 crisis on the UK economy as well as UK exports of four key manufacturing sectors: automotive, technology, healthcare and consumer goods. It also explores potential policy options for mitigating the resulting damage to business activity, including two specific FTAs: a trade deal with the US and membership of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).¹

While there are opportunities arising out of Brexit, the immediacy of the current circumstances leads us to focus this report on the challenges that companies will face as a result of the combined effects of Brexit and COVID-19. These findings should enable businesses to best prepare for the road ahead, including considering the mitigation strategies that can be adopted.

We hope you find these insights useful and look forward to keeping the conversation going.

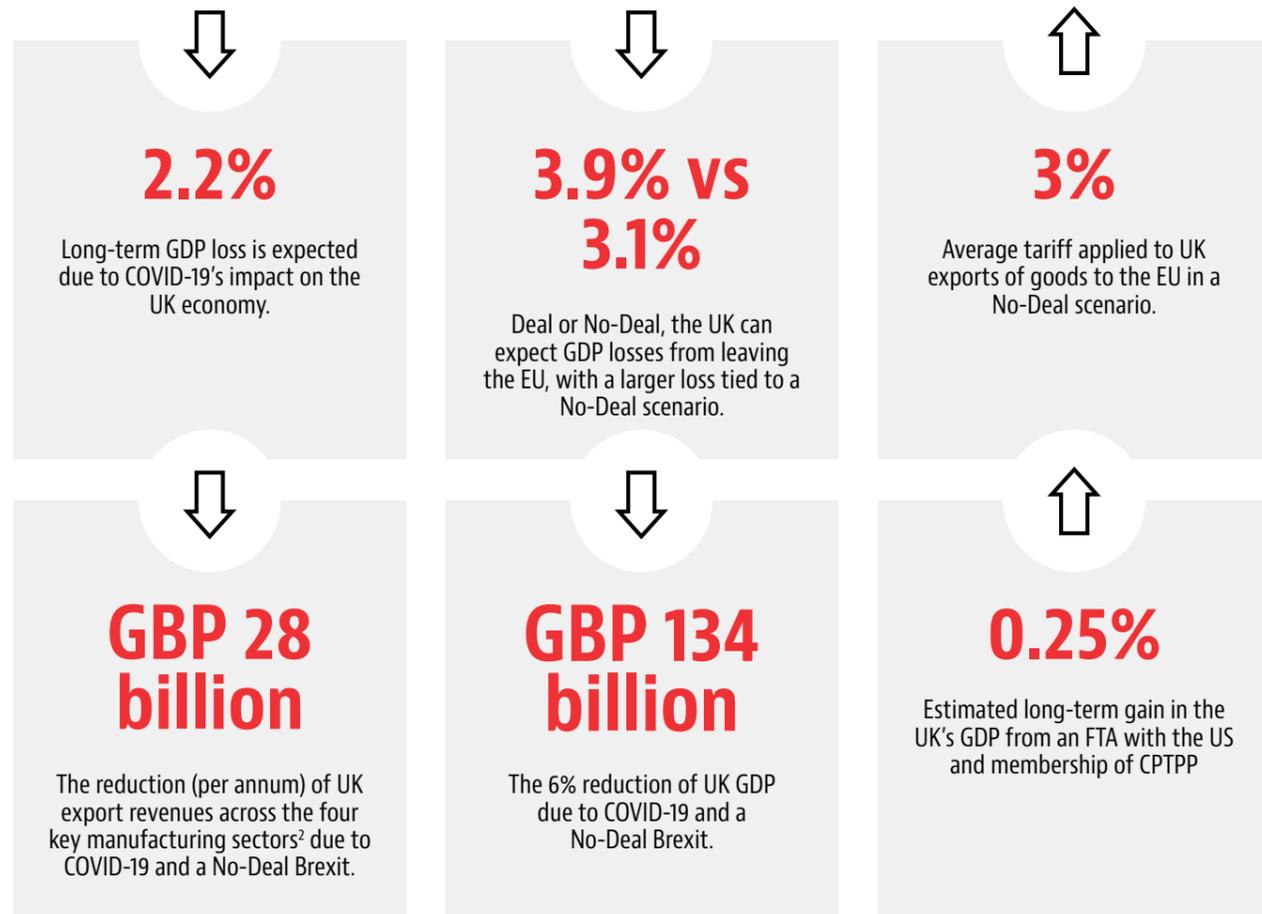


Jennifer F. Revis

Head of Customs & Excise and International
Commercial and Trade Partner, London
jenny.revis@bakermckenzie.com

¹ The CPTPP is a free trade agreement between 11 countries around the Pacific Rim: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.

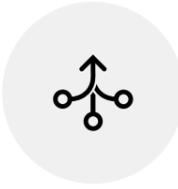
Key Statistics at a Glance



All data forecasts and monetary values in this report are provided by Oxford Economics and have been benchmarked to the level of GDP and exports in 2019. Monetary values are rounded.

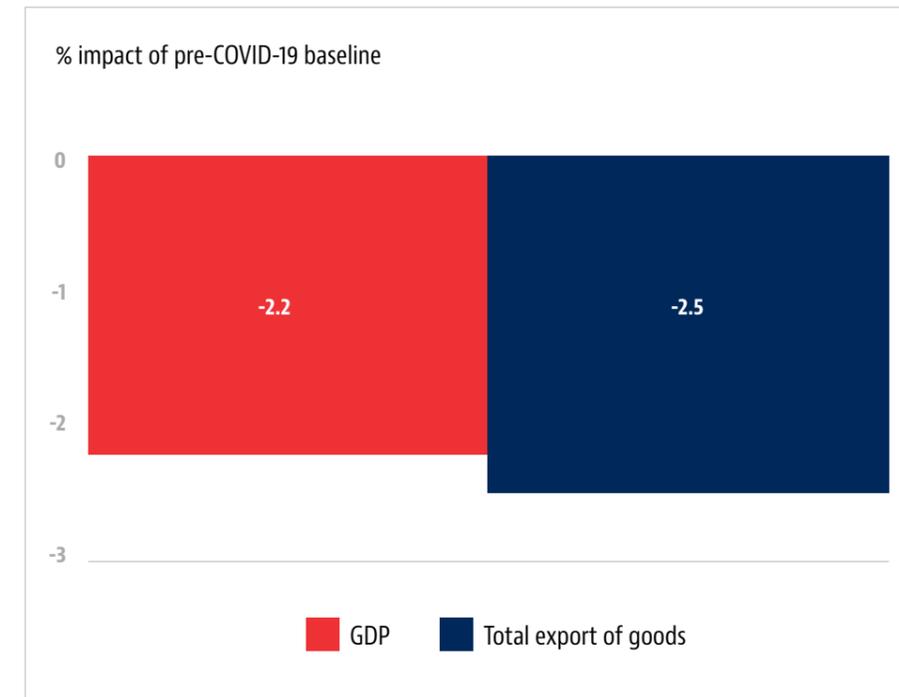
² The four key manufacturing sectors featured in this report are technology, automotive, consumer goods and healthcare.

1. Dual Blows of COVID-19 and a "No-Deal" Brexit



1.1 COVID-19 has changed the rules of engagement

Data Dive
Figure 1: Long term impact of COVID-19 on the UK
 Source: Oxford Economics



UK GDP is expected to be about **2.2%** below the levels anticipated before COVID-19 (valued at about GBP 50 billion), although risks to this projection are skewed to the downside.

The UK's total export of goods across all sectors will be about **2.5%** below the levels we had anticipated before the outbreak, valued at about GBP 9 billion.

Across the four key manufacturing sectors discussed in this report, COVID-19 will result in a reduction of GBP 2.7 billion per annum in UK export revenues.

Recovery, employment and GDP

The pandemic has led to slashed economic forecasts. With the UK economy now gradually re-opening, there is hope for a strong and broad-based recovery.

But while the early stages of the recovery will be strong, the pace of expansion is likely to tail off in coming months, reflecting the likelihood that

some social distancing restrictions will remain in place until a vaccine is widely available. Until then, many businesses are likely to operate below normal capacity, limiting the pace of the recovery.

Some longer-term³ damage will therefore be hard to avoid, as sharp rises in unemployment and business insolvencies will cast long shadows over future growth. On the other hand, the government's large

³ Throughout the report the phrase "long-term" refers to a period of around ten years after leaving the EU.

stimulus package — in particular, the introduction of the Coronavirus Job Retention Scheme — will help to limit the degree of “scarring” of the economy’s productive potential.

Trade, supply chains and exports

The COVID-19 crisis has also had a significant near-term impact on trade flows through the unprecedented scale of the disruption to both supply and demand, as well as the rise in trade costs due to restrictions on movement and social distancing. In turn, labour supply, transport and travel have all been directly affected.

More broadly, the crisis has exposed the fragility of many globally dispersed supply chains, where the pre-pandemic focus on cost control has often inadvertently resulted in a lack of diversification in the supplier base.

In the current COVID-19 environment, producers are expected to seek to shorten and/or diversify their supply chains to improve reliability. This may be expected to dampen the international trade intensity of production as it further encourages the regionalisation of manufacturing capacity and

reshoring of some production. These trends will also be facilitated by a new wave of advanced automation systems.

While Brexit will no doubt serve as a hurdle to supply chain stability, it comes as the latest development in a time where trade tensions, shifting national policies and COVID-19 have thrown a spotlight on the importance of supply chain to a company’s overall business health and accelerated the need to reassess models as well as the opportunity to transform for the future. Our recent [Supply Chains Reimagined report](#) explores how shifting trade trends are affecting supply chains and the opportunities to transform operations.

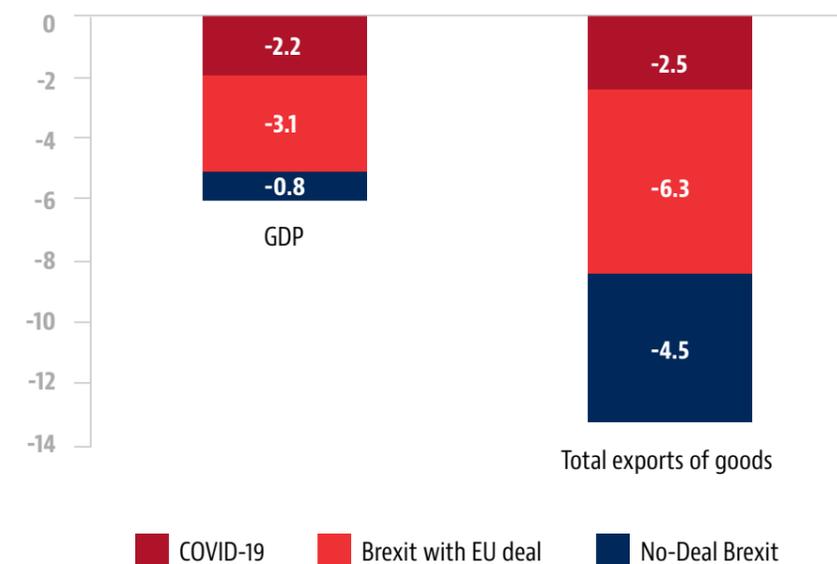
In the near-term, companies are expected to begin seeking out a more diversified supplier base, while looking to develop a change-ready, but cost efficient, supply chain. For the longer-term, however, companies will need to undertake a more holistic analysis, which may lead to drastic changes, such as moving supply chains nearshore or to different countries as well as increasingly digitalising supply chains. Companies will also need to consider how these changes help them create more sustainable operations in the future.

“Global fluctuations in supply and demand mean that many businesses are managing complex supply chain disruptions and looking to shockproof their operations through increased diversification of their supplier base: shortening their supply chain and digitalisation. These trends may dampen international trade flows. Businesses who have the liquidity and agility to pivot to changes are most likely to see recovery and some form of stability sooner, rather than later”.

Jennifer F. Revis
 Head of Customs & Excise and International Commercial and Trade Partner, London

1.2 Brexit negotiations will determine the UK’s future trade relationship

Data Dive
Figure 2: Long term impact of COVID-19 and Brexit
 Source: Oxford Economics



Brexit with an EU Deal:

UK’s GDP will fall by **3.1%** in the long-run relative to a hypothetical scenario where the UK remained in the EU, while exports of goods would be 6.3% lower.

No-Deal Brexit:

We estimate that such an outcome would reduce the UK’s GDP by **3.9%** in the long-run.

Currently, the UK and EU are aiming to agree to a deal on trade and the future UK-EU relationship, to come into effect when the transition period expires at the end of 2020. However, if negotiators fail to reach a deal before this date, the majority of the UK’s goods exports to the EU would be subject to tariffs.

While the average tariff on UK exports to the bloc would be around 3%, tariffs on certain goods — including agriculture, automotive and textile products — would be significantly higher.

A UK-EU trade deal still implies a step change in market access

Deal or No-Deal, there will be new restrictions concerning immigration, while exporters will face new non-tariff barriers that increase costs such as customs formalities and regulatory barriers.

Even with an EU deal, the UK economy’s productive capacity will be undermined by the “trade destruction” resulting from the loss of unfettered access to the EU Single Market and Customs Union. This will limit future productivity gains, as without

access to the EU Single Market and Customs Union, there will be reduced competition and less scope for firms to benefit from economies of scale. Investment will also be negatively affected, as the expected future rate of return will be lower, thus incentivising firms to scale back capital spending.

A No-Deal outcome would have more serious consequences for the UK's exports of goods, which we estimate would be reduced by around 11% in the long run (compared to 6.3% with an EU FTA).

Sunny Mann, EMEA Head of International Commercial and Trade, London, notes that "in a No-Deal scenario, businesses will face additional costs from trade tariffs and other non-tariff barriers. Rising costs, coupled with reduced labour, will amplify output loss, which will further depress export revenues. A negative investment outlook, combined with stricter foreign investment controls, will also put a strain on businesses seeking recovery in the post-COVID-19 landscape, especially those who need liquidity or need to divest assets."

Labour constraints will also affect the economy

The UK's new immigration policy from January 2021 (regardless of Brexit negotiations) will involve

a points-based system and without the benefit of the EU's Freedom of Movement rules, EU nationals will be subject to the same immigration protocols as citizens of countries. This will result in lower levels of net inward migration into the UK.

This will mean the UK's working age population will grow more slowly than it would have, had freedom of movement been maintained, and growth in the size of its labor force will also be weaker. The UK's change of approach to migration will therefore have important implications for the UK economy's future productive capacity. A weakened labor force alone will result in an estimated 1.1% loss of output for the UK economy over the long-run, valued at GBP 24 billion.

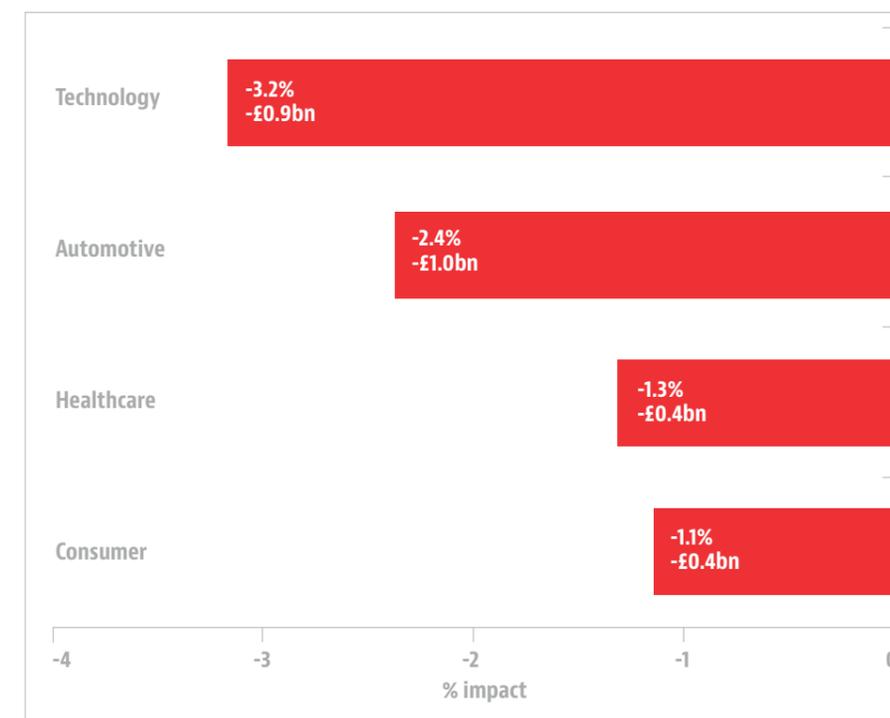
Stephen C.M.Ratcliffe, Employment and Benefits Partner, London, notes that, "The announcement of the UK's new immigration policy confirms what most employers were expecting: that the labour pool will shrink post-Brexit, in some sectors materially so. Employers need to act now to assess how their workforce model will need to change from January 2021. "Homeworking" is not a panacea."

2. Surveying the Outlook for UK Trade/Industry



2.1 COVID-19 will impact technology and automotive significantly

Data Drive
Figure 3. Long-term impact of COVID-19 on UK Exports
 Source: Oxford Economics



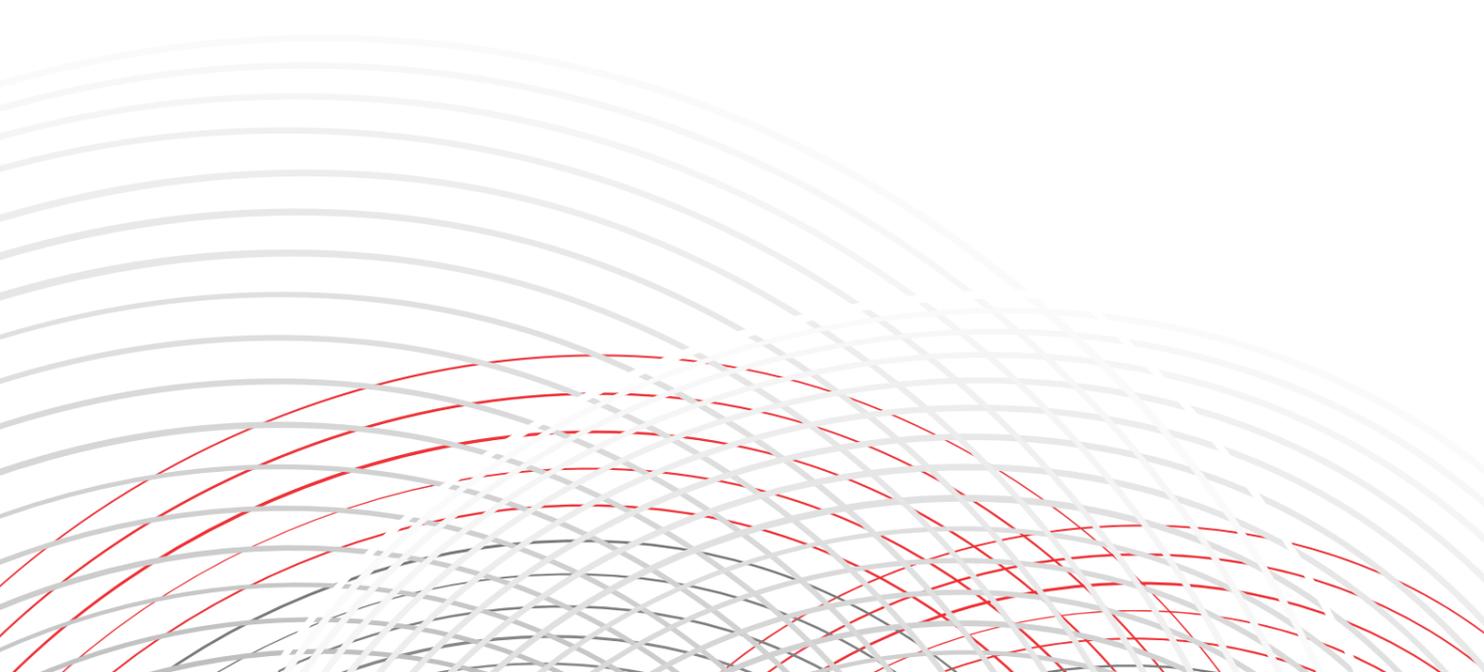
The COVID-19 pandemic has hastened a retreat from globalisation and increased regionalisation. This has emphasised the importance of the EU as a key economic partner for the UK in coming years. Globally, declines in trade intensity are more likely to be observed in the most heavily traded and complex global-value chains, such as those in cars and electronics.

Significant loss to export revenue

Across the four sectors modelled, these losses equate to a reduction of GBP 2.7 billion per annum in UK export revenues when benchmarked against the level of trade in 2019, due to COVID-19.

Amongst the four key manufacturing sectors in our study, the technology (3.2% drop worth GBP 0.9

billion) and automotive industries (2.4% drop worth GBP 1 billion) are expected to suffer the sharpest long-term declines in export revenues, in both percentage and monetary terms. Least affected in percentage terms is the consumer industry, reflecting shorter and less complex supply chains in the apparel and agro-food sectors.



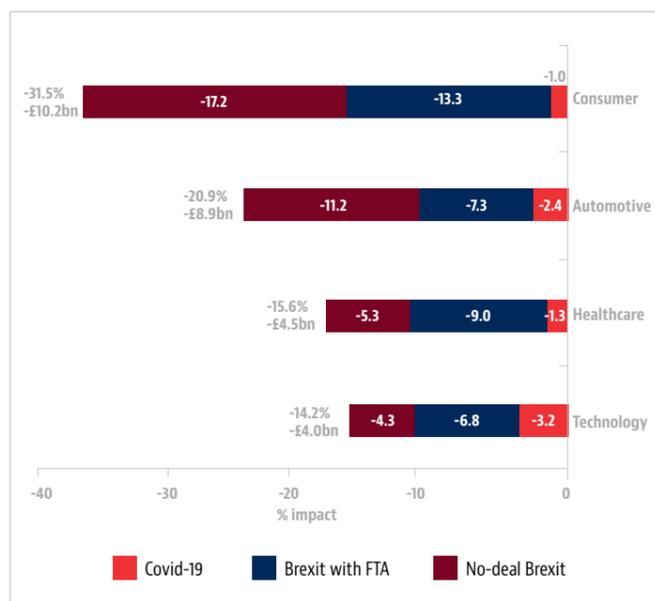
2.2 Brexit impact varies significantly across manufacturing sectors

Despite businesses taking steps to offset the added costs of Brexit by reconfiguring supply chains, the decline in export revenues for UK manufacturers will be substantial. However, the vulnerability of individual industries varies significantly, depending on the share of trade with the EU: the level of trade barriers resulting from alternative Brexit outcomes and trade-cost elasticity.

Future of manufacturing uneven with or without deal

The combined impacts of COVID-19 and a No-Deal Brexit outcome equate to a reduction of GBP 28 billion per annum in export revenues across the four named sectors, when benchmarked against the level of trade in 2019.

Data Dive
Figure 4: Impact of COVID-19 and Brexit on UK exports
 Source: Oxford Economics



If the UK leaves the EU with an FTA deal, the healthcare sector would be harder hit than automotive. This reflects relatively high non-tariff barriers in the pharmaceutical industry. But the impact of a No-Deal outcome is relatively higher for the automotive sector, as it would likely disrupt the operation of the industry's cross-border 'just-in-time' production systems and make the UK a significantly less competitive place to assemble cars.

Jannan Crozier, Industrials, Manufacturing and Transport (IMT) lead for EMEA and Corporate Partner, London, suggests that, "a No-Deal Brexit would be a severe blow to the UK auto industry. With the UK's high export of vehicles to the EU, simply put, higher tariffs would result in higher costs leading to less demand, lower outputs and loss of jobs."

With or without a Brexit deal, the consumer sector is projected to experience the largest decline in export revenues, both in percentage and monetary terms. Large losses of GBP 10 billion reflect the fact that the EU agricultural sector is highly regulated (implying high non-tariff barriers to trade, even with an EU deal). Both food and apparel sub-sectors would be subject to relatively high Most-Favored Nation (MFN) tariffs in the event of a No-Deal outcome.

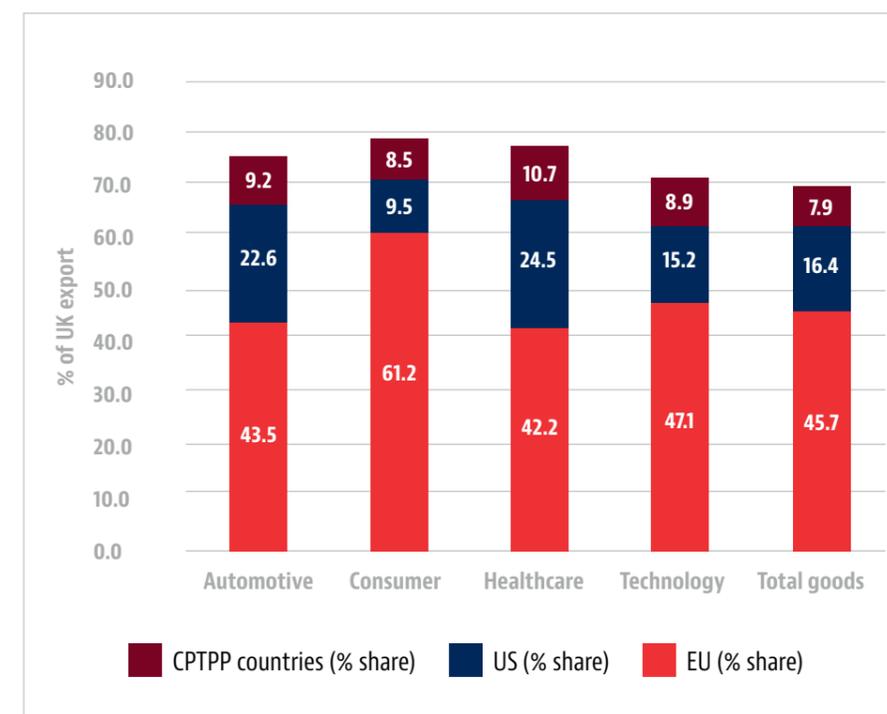
Julia L. Hemmings, who is based in London and is an IT/Commercial Partner and co-head of the Consumer and Commercial Advisory practice, suggests that, "in the event of a No-Deal Brexit, the impact on consumers will be heightened with increased retail costs and reduced availability as consumer goods are subjected to extensive border checks and supply chain disruption. With the lion's share of UK food imports originating from the EU, the impact on the grocery distribution industry will be amplified."

3. Future Paths for Business: Third-Party FTAs and Government Intervention



3.1 Considering the benefits and challenges of FTAs

Data Dive
Figure 5: UK Export Locations Related to Third-party FTAs



Replicating existing terms of the UK's EU membership is no easy feat. In a No-Deal scenario, UK's "Global Britain" policy will be dependent on the extent to which it is able to enter into new trade agreements with non-EU countries. But there also remain significant challenges to simply replicating existing EU deals with non-EU countries.

By virtue of its EU membership, the UK is currently a party to over 40 FTAs that the EU has signed, but unless it can reproduce these agreements, they will expire on 31 December 2020; same as when the UK's Brexit transition period ends.⁴

Beyond "replicating" existing EU agreements, the UK has identified the negotiation of a new trade deal with the US as a priority, as well as considering membership of the CPTPP. Together, the US and CPTPP 11 member countries account for close to a quarter of the UK's exports of goods.

⁴ Oxford Economics modelling assumes that the UK manages to replicate all existing EU deals.

Potential economic benefits of FTAs may be relatively modest

But the potential economic benefits from these trade deals are likely to be relatively modest, especially when compared to the potential losses resulting from Brexit. Estimates based on data from Oxford Economics suggest that a US-UK deal would provide a boost of only around 0.2% to the UK's GDP, while membership of the CPTPP would raise GDP by a marginal 0.05%.⁵

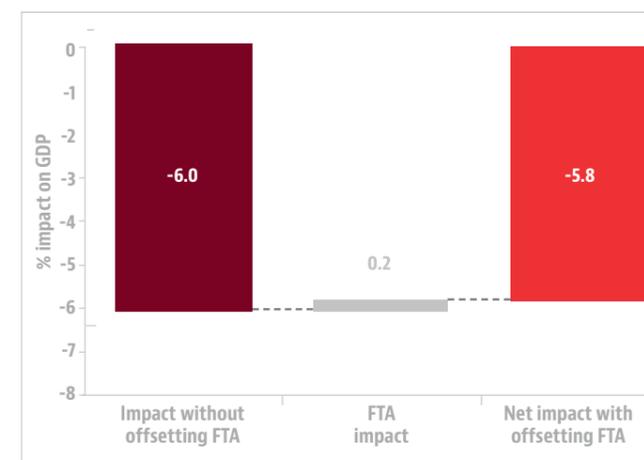
“Any formal request by the UK to join CPTPP and commence negotiations would be followed by a decision of the existing members on whether or not to commence the accession process. At present, the UK (through membership of the EU) benefits from existing FTAs with several CPTPP countries, such as Canada, Chile, Mexico, Peru, Singapore and Vietnam. The UK is currently negotiating “continuity” provisions with these countries to allow the UK to continue to benefit from the FTAs after the end of the Brexit transition period, which it deems to be complementary to CPTPP membership. The UK is also beginning the process of negotiating new bilateral FTAs with other CPTPP member countries, including Australia, New Zealand and Japan.”

Jessica Mutton
International Commercial & Trade Senior Associate, London

⁵ In light of the uncertainties surrounding these deals, modelling results should be interpreted as providing indicative orders of magnitudes.

Further barriers to reap benefits

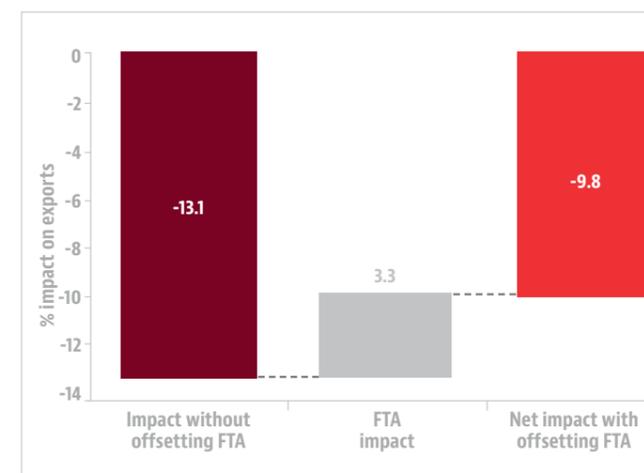
Data Dive
Figure 6: UK: Offsetting Impact of Third-party FTAs (GDP)



In part, the anticipated small economic benefits arising from these deals reflect that these deals would not affect migration flows. And whilst exports of goods receive a boost, the net impact on the UK's overall trade balance would be relatively modest at best.

The UK is also unlikely to secure significant liberalisation of trade flows in some of the professional services industries where it has a competitive edge.

Data Dive
Figure 7: UK: Offsetting Impact of Third-party FTAs (Total export of goods)



Moreover, the potential benefits from CPTPP membership will be limited by the fact that the EU already has FTA deals with all CPTPP members (which we assume the UK will be able to replicate) except for Australia, New Zealand, Malaysia and Brunei. Additionally, with all of these potential partners being located a long way from the UK, the potential to increase the level of bilateral trade is more limited.⁶

⁶ An extensive literature demonstrates the importance of distance in trade. Click to view example [here](#).

3.2 A sectoral approach may be more prudent

While the net economic impact of these FTA deals may be muted, estimates suggest that certain UK manufacturing sub-sectors have more to gain.

Data Dive

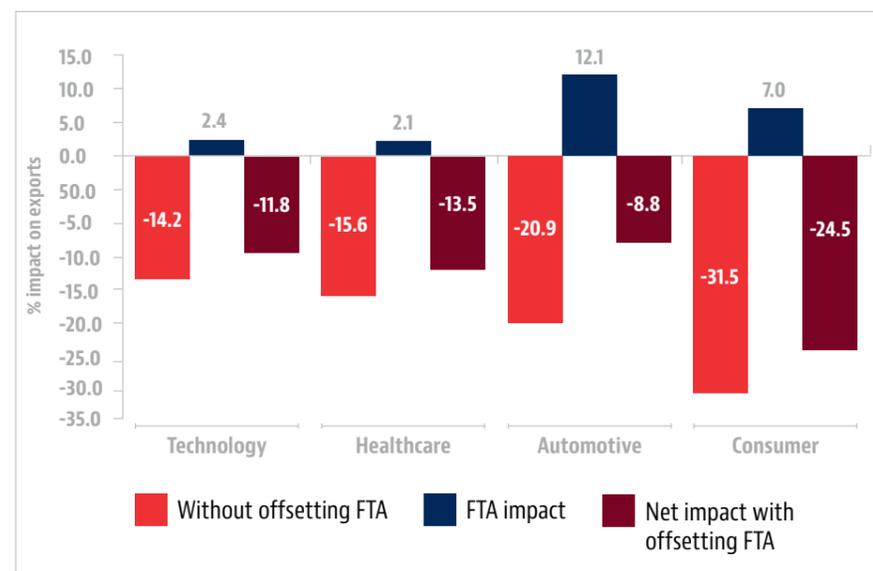
Figure 8: Impact on Export Revenues by Sector

Source: Oxford Economics

Sector	Impact of COVID-19 and No Deal Brexit on export revenues*	Impact of UK-US FTA and CPTPP on export revenues*
Automotive	- GBP 8.9 billion	GBP 5.1 billion
Consumer	- GBP 10.2 billion	GBP 2.3 billion
Healthcare	- GBP 4.5 billion	GBP 0.6 billion
Technology	- GBP 4 billion	GBP 0.7 billion

Figure 9: UK Offsetting Impact of New Third-party FTA deals by Sector

Source: Oxford Economics



In a No-Deal scenario, a focus on third-party FTAs could help to mitigate the negative impact on export revenues. This would be particularly beneficial for the automotive industry, with the potential to reduce the projected loss in export revenue (from Brexit and COVID-19) by over half, worth about GBP 5 billion. Specifically, for motor vehicles, a combination of high elasticities and high existing barriers to trade means that an ambitious US trade deal has the potential to provide a significant offset to Brexit.

However, this outcome very much depends on whether the UK is able to achieve significant concessions from the US when negotiating the FTA, which may not be possible in practice.

And while an FTA with the US and CPTPP membership could together potentially offset over a fifth of the projected loss in the consumer sector's export revenue resulting from Brexit and COVID-19 (GPB 2.3 billion) this sector is set to be hit the hardest.

Overall, estimates indicate that the third-party trade deals considered here only have the potential to mitigate around 30% of the total expected loss in export revenue due to COVID-19 and Brexit across these four key manufacturing sectors (worth GPB 8.7 billion).

A sector-level trade strategy may be more productive

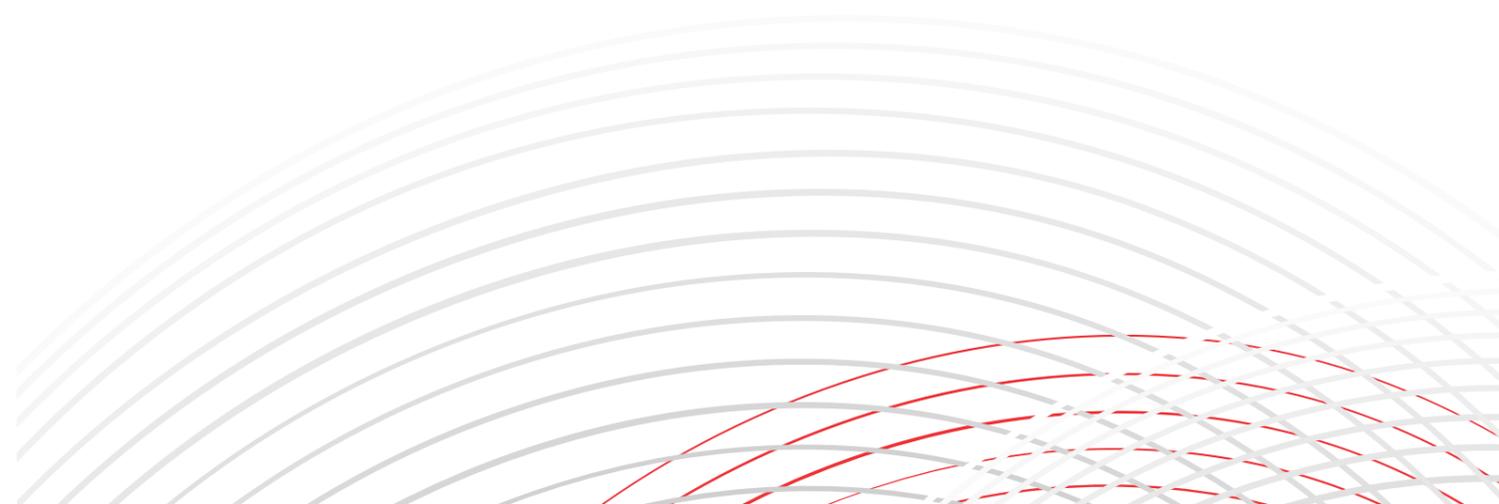
Alongside trade deal negotiations, the UK is also in talks to secure several mutual recognition agreements (MRAs) to assure acceptance by UK and partner country regulators of each other's product testing and inspections in specific sectors.

According to Graham J. Stuart, a partner in Baker McKenzie's London office specializing in product regulation, "MRAs are key tools to promote international trade in regulated products. MRAs lay

down the conditions under which each party accepts the reports, certificates and conformity assessment of the partner country, thereby reducing costs for manufacturers and facilitating market access by removing duplication of inspection or certification — and reducing time to market. They are particularly beneficial for automotive, technology, consumer and healthcare products, but they do become challenging for heavily regulated product sectors (such as automotive and healthcare) because of the considerable degree of regulatory alignment that has to take place."

With average tariffs being relatively low, modern trade agreements are largely about regulation and the lowering of non-tariff barriers to trade. This implies some difficult political trade-offs for the UK in upcoming FTA negotiations with non-EU countries. This will create an unavoidable tension between the UK retaining its regulatory sovereignty and its goals of securing a large number of ambitious new trade deals.

Hence, the most productive strategy to cushion the impact of both COVID-19 and Brexit on UK trade is for the UK government to focus on dismantling non-tariff barriers in sectors where tangible economic gains can be achieved. In this context, a trade negotiation strategy targeting specific sectors or mutual recognition agreements would be more practical than pursuing full FTA negotiations.



3.3 Government intervention will soften the blow

Government intervention through policies, deals and negotiations will ultimately shape the extent to which COVID-19 and Brexit affect UK trade.

GDP and export trade estimates shared in this report do not take into account potential new post-Brexit UK policies that the government may introduce to boost competitiveness and build upon existing strengths in these sectors.

For example, in the case of a No-Deal Brexit, the UK would have greater flexibility to embark on an active industrial policy, as EU laws on state aid and procurement would no longer apply. The government could use its new freedoms to subsidise key industries and build upon existing strengths in future high-growth sectors of the economy.

Further gains could be realised through targeted deregulation, which could reduce costs for firms and introduce greater flexibility into the UK economy — for example, the UK is one of the world leaders in artificial intelligence and could potentially enhance its competitive advantage by avoiding costly obstacles such as the EU's framework for data protection.

Samantha J. Mobley, Antitrust and Competition Partner, London, shares that “with the UK deciding to follow World Trade Organization (WTO) subsidy rules, replacing the EU state aid laws, from 1 January 2021, there is the potential that the government will intervene in the economy by handing out subsidies to protect jobs and support new and emerging industries. We will need to wait for published guidance on the WTO rules before the end of the year to see precisely what the government has in mind although we are told that there is no intention on the part of ministers to run the economy or bail out unsustainable companies.”

How possible is an EU deal?

- There is a short deadline till October 2020 for the UK and EU to strike a deal and fundamental differences remain between the demands of the two sides.
- The EU's stated focus is on maintaining a “level playing field” through UK commitments not to seek a competitive advantage by deregulating its laws on the environment, labor, taxation or state aid.
- Conversely, the UK government has said that being able to diverge from these EU rules and standards is a core requirement of its post-Brexit vision.

How can you prepare your business?

Given that the chances of the EU and the UK trading on a “No-Deal” basis as of 1 January 2021 have increased, it is vital for companies to address the challenges to their business stemming from a No-Deal scenario and prepare for such an eventuality.

Find out key actions for businesses to take by 1 January 2021, with our resource, [Brexit: Actions You Need to Take](#).

See outlined recommendations for areas such as immigration, commercial contracts, intellectual property, customs, employment tax, export controls and more in our [No Deal Brexit Checklist](#). This resource identifies key challenges surrounding crucial business topics such as supply chain restructuring, border control on imports and exports, protecting your UK/EU workforce as well as lobbying and trade agreements.

Conclusion

With UK businesses facing unprecedented headwinds from the combined impacts of COVID-19 and Brexit, it is imperative for the government to shape a credible economic strategy to mitigate the economic damage.

The analysis presented in this report suggests that the negotiation of new FTAs with non-EU countries will only partially offset these losses. Alongside trade policy, the government will also need to use its full range of new policy freedoms in the wake of Brexit to boost UK competitiveness and productivity in key industries.

“In addition to working on their own Brexit-readiness plans, companies must actively engage with the UK government to ensure that it delivers on its commitments to boost UK growth and competitiveness, such as promptly negotiating and concluding FTAs with key trading partners, notes Jennifer F. Revis, Head of Customs & Excise and International Commercial and Trade Partner, London. Revis says that “this is absolutely crucial to mitigate the dual impact of COVID-19 and Brexit and to accelerate the UK economic recovery.”

Absent a formal trade deal, there are other steps companies can take to build relationships in third markets, including considering the types of barriers that would need to be knocked down to facilitate those arrangements. Companies can also seek to identify the third country markets of greatest importance to their business models and work the lobbying position from both sides.

With or without a deal, Brexit will herald a decade of potentially profound structural change for the UK economy. It presents significant challenges, but also offers significant opportunities for policymakers to chart a new course for the UK and the economy. With the costs of the UK's departure from the EU likely to be very high, the government will need to use all the tools at its disposal to help mitigate the economic damage.

Explore our [Brexit Hub](#)

Visit the Brexit Hub to find additional resources as your business navigates the road ahead. This includes our Brexit checklists and curated insights for your industry across a range of competition and trade issues.

Key contacts

London



Jennifer F. Revis
Head of Customs & Excise and
International Commercial
& Trade Partner
+44 20 7919 1381
jenny.revis@bakermckenzie.com



Graham J. Stuart
Product regulation
Partner
+44 20 7919 1977
graham.stuart@bakermckenzie.com



Jannan Crozier
EMEA Industrials,
Manufacturing & Transport (IMT)
Lead & Corporate Partner
+44 20 7919 1195
jannan.crozier@bakermckenzie.com



Jessica Mutton
International Commercial &
Trade Senior Associate
+44 20 7919 1909
jessica.mutton@bakermckenzie.com



Julia L. Hemmings
IT/Commercial Partner &
co-head of the Consumer &
Commercial Advisory Practice
+44 20 7919 1619
julia.hemmings@bakermckenzie.com



Samantha J. Mobley
Antitrust and Competition
Partner
+44 20 7919 1956
samantha.mobley@bakermckenzie.com



Stephen C.M. Ratcliffe
Employment & Benefits
Partner
+44 20 7919 1691
stephen.ratcliffe@bakermckenzie.com



Sunny Mann
EMEA Head of International
Commercial & Trade
+44 20 7919 1397
sunny.mann@bakermckenzie.com

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