NZIER INSIGHT

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Do you think you're better off alone?

Impacts of Brexit on New Zealand

Key points

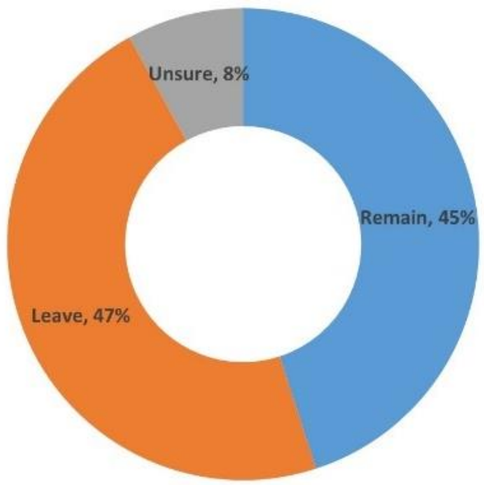
- Recent polls suggest the chances of Brexit is a 50-50 call. This means we have to start contemplating what Brexit might mean for New Zealand.
- The post-Brexit picture is horribly murky. No one knows how it might play out.
- But there is no free lunch. The UK simply can't have all of the benefits of easy access to the EU Single Market without bearing the costs of the free flow of people across its borders.
- When the smoke clears, the most obvious impact on New Zealand of a Brexit vote will be on our exports to the UK, which could drop by $190 million per year due to slower UK income growth.
- Brexit could also dampen investment flows from the UK, push up costs in global value chains and restrict the movement of people between New Zealand and the UK.
- Brexit would also be a further stinging slap in the face of ongoing economic integration initiatives at a time when the political discourse is already turning against deeper trade liberalisation.
- None of this is good news for New Zealand, but the overall economic impacts should be limited.

There is a real chance that the UK could leave the EU

Britain goes to the voting booth on 23 June 2016 to decide whether the UK should remain in or leave the EU. The rhetoric on both sides is reaching fever pitch and polls suggest the vote is likely to be a close run thing. Views on the referendum vary considerably, with the young, Labour supporters, Scottish and richer voters most likely to tick 'Remain'. The trend in recent weeks has been towards those favouring a 'Leave' vote.

Figure 1 Too close to call

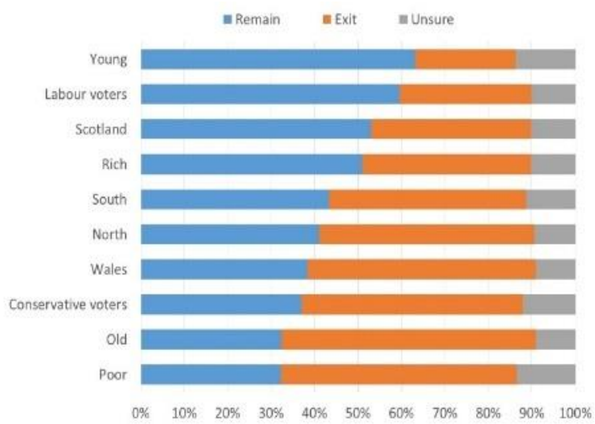
% of voters



Source: Financial Times (2016)

Figure 2 Divergent views

% of voters by type



Source: The Economist (2016)

The high-level trade-off is clear

The decision really boils down to a fairly simple conceptual trade-off: are voters prepared to lose some of the benefits of free access to EU markets for goods, service and people in exchange for an increase in their sovereignty, especially as related to the movement of people from the EU to the UK?

As Dhingra and Sampson (2016) note, “inside or outside the EU, this trade-off is inescapable”.

This trade-off is not new of course – all international agreements involve ceding a degree of sovereignty in exchange for expected economic or social benefits. The UK will still be subject to numerous other international treaties should Brexit occur, so there is no absolute sovereignty available.

There is certainly no free lunch – despite the arguments of the Leave camp, it is difficult to see a viable alternative that delivers the benefits of being in the Single Market without imposing the costs of immigration (see Figure 3 below).

How we might think about Brexit

When considering how Brexit might impact New Zealand, it is useful to think about the key economic linkages between New Zealand and the UK (and the EU). The key takeaway from the table is that the UK remains an important economic relationship for New Zealand, despite the general shift of our trade towards the Asia-Pacific.[1]

Table 1 How does the New Zealand economy interact with the UK?

Trade data is for calendar year 2015; investment data is for year ended March 2016

Linkages	Why is this important?
Exports of goods	UK accounts for $1.7 billion (3.4% of total) of goods exports; important items are sheepmeat, wine, apples and pears, wool and honey. Most primary products enter UK under preferential arrangements negotiated with EU.
Exports of services	New Zealand exports $1.6 billion of services to the UK (7.7% of total), primarily tourism-related services (around 75% of total, for over 200,000 UK tourists) but also business services (legal, advertising, architecture, engineering) and audio-visual services.
Imports	UK supplies $1.3 billion (2.6%) of our goods imports, largely vehicles, engines, machinery, spirits and books. Most imports are important intermediate inputs to New Zealand firms' production. We import $970 million of services from the UK (primarily tourism, insurance, broadcast rights, business services).
Foreign Direct Investment into NZ	UK has a stock of $4.2 billion (4.4% of total) of FDI in New Zealand.
Outward Direct Investment into UK	New Zealand has a stock of $1.5 billion of ODI in the UK (6% of total).
Permanent migration	Over 13,000 UK residents permanently migrated to New Zealand last year (11% of the total migrants). Almost 10,000 Kiwis went in the opposite direction.

Source: NZIER, Statistics New Zealand (2016)

The post-Brexit picture is unclear but the short term impacts on New Zealand should be limited in terms of market access

Precisely what will happen if the UK decides to leave the EU is far from clear.

There is little precedent to guide commentators – no independent European country has ever left the EU (Dhingra and Sampson, 2016). The UK government has chosen not to map out any post-Brexit plan (mainly because there

[1] The successful reorientation of New Zealand's trade and investment relationships away from the UK from the mid-1970s onwards is perhaps an argument to support the views of those who believe that the UK could similarly thrive post-Brexit, although New Zealand's experience was that the adjustment was not simple or rapid.

is no consensus within the ruling Tory party) and supporters of the Leave campaign have a range of views about how it might play out.

However, the Brexit process in the short term should not result in any significant impact on New Zealand firms in terms of getting out goods and services to market.

The UK effectively has two years to negotiate its departure, under the 2009 Lisbon Treaty. It can depart the EU when a withdrawal agreement is reached and agreed on by all EU members, or after two years, whichever happens first.[2] Until any withdrawal, the UK remains bound by all EU treaties, including its World Trade Organisation (WTO) commitments.

Given the likely complexity of negotiating any withdrawal agreement – and we shouldn't expect the EU to make it easy, given the UK is thumbing its nose at the status quo[3] – it seems a fairly safe bet to assume that existing arrangements would continue in the near term. This means that New Zealand exporters should see no material change in the market access arrangements (i.e. tariffs, quotas, etc.) they have with the UK.

But New Zealand firms should expect weaker demand…

New Zealand will not be able to escape scot-free however. As HM Treasury (2016a) points out, during the negotiation of the withdrawal agreement, there are likely to be negative impacts on the UK economy through three transmission channels:

- **The transition effect** – UK businesses are likely to start investing and hiring less in anticipation of slower export demand and higher import costs following withdrawal.
- **The uncertainty effect** – if there is any theme emerging from the Brexit demand, it is uncertainty. UK firms and households will have little clue, at least in the short term, as to how post-Brexit regulatory and policy settings in the UK will evolve.

  For example, what will the UK's economic relationship with the EU look like? And what about the UK's relationships with the 50+ countries with which the EU currently has preferential trading agreements, which will need to be renegotiated? How will domestic regulatory settings be implemented?

  The natural response to uncertainty is inaction: firms and households will delay major spending decisions and hunker down until the business environment becomes clearer.
- **The financial conditions effect** – financial markets don't like uncertainty. UK assets would likely take on a higher risk premium to compensate investors as a result. This will push up interest rates and depreciate the pound, both of which dampen domestic spending (and especially the demand for imports).[4]

There have been multiple studies on both sides of the argument on how the UK economy might be impacted after Brexit. The vast majority of them point to a slowing in the UK's economy relative to a business-as-usual situation through these channels, both in the short term (1.3% to 5.5% drops in GDP by 2020) and the long term (1.2% to 7.5% drops by 2030).[5]

...as uncertainty dominates the UK's trading arrangements

After the withdrawal, the UK will need to consider how it engages with its trading partners, including New Zealand.

2 An extension on the two-year period can also be granted if all EU members agree to it.

3 This is a bit like leaving a nightclub in a huff and complaining to the bouncers because the music wasn't to your liking, and then turning around and begging to come back in from the front of the queue when the DJ drops a tune that you feel like dancing to.

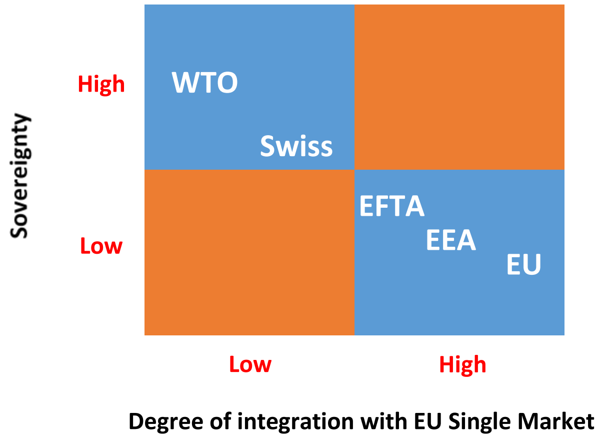
4 This effect can already be seen: the pound has depreciated some 4% against the Euro in 2016; the kiwi dollar is at its highest level for 13 months against the pound.

5 See summary table in OECD (2016, p.35).

This is crucial because as a member of the EU, the UK has free trade for all goods and services within the EU, and also has free trade agreements (FTAs) with 58 non-EU countries. A further 67 countries are currently negotiating FTAs with the EU. This preferential access for UK exports and imports will cease after a Brexit withdrawal.

Unless it negotiates a continuation of existing EU access arrangements, which on the face of it seems unlikely in the two-year period, we consider there are four broad options.[6]

Figure 3 Sovereignty vs. access to EU Single Market



Source: NZIER

1. It can negotiate a **Switzerland-style arrangement** with the EU, whereby the UK negotiates various bilateral treaties with the EU covering the UK's participation in specific EU policies and programmes. It can only choose to be in or out of these programmes; it can't influence the regulations. It contributes to EU funding for the programmes in which it participates. But allowing unfettered immigration is a central part of the existing Swiss model – and that is likely to be unpalatable to the UK.

2. It could re-join the **European Free Trade Association** (ETFA) with Iceland, Lichtenstein, Norway and Switzerland. EFTA allows non-agricultural goods to be traded duty-free between the EU and the EFTA members (subject to rules of origin requirements), but doesn't go as far as allowing participation in the Single Market. It is therefore a very narrow form of economic integration.

3. It could join the **European Economic Area** (EEA) like Norway, Iceland and Lichtenstein. Under the EEA, members receive unfettered access to EU markets for goods (again, subject to rules of origin requirements), services and people movement, but do not have to participate in other forms of EU integration (e.g. the Common Agricultural Policy). But these countries have to adopt EU Single Market regulations while having no ability to influence them, and they must contribute significantly to the EU budget.

4. Default to **World Trade Organisation (WTO)** arrangements – if no trade agreements are negotiated within the two-year withdrawal period or no extension to EU membership agreed, then all of the UK's trade would revert to being governed by WTO 'Most Favoured Nation' (MFN) rules. UK exporters would face tariffs in any market, including the EU, that has them in place. This would place them at an immediate disadvantage to competitors who have FTAs with these markets.

   And the UK would have to decide whether or not to impose tariffs on its imports. Unless it takes a Singaporean approach and unilaterally removes all tariffs, which would seem highly improbable as it would remove all negotiating coin for any future FTA negotiations, the UK's tariffs would probably be

6 See OECD (2016) for further discussion. Other post-Brexit alternatives are also available, such as a Turkey-style Customs Union or a Canadian-style FTA, but we focus on these options.

set at the EU's WTO rates until it was able to renegotiate its tariff schedules with all 161 other WTO members, including New Zealand.

Whatever the re-negotiated schedules look like, the outcome will push up the costs of imports, reducing UK households' purchasing power[7] and lifting intermediate input costs for UK businesses.

Unless it has an existing WTO preferential commitment, the UK would have no ability to lower tariffs on imports from certain markets (such as the EU or even New Zealand) on a discriminatory basis – it would have to then offer these lower tariffs to all other WTO members too.

The UK could then seek to **negotiate FTAs** with key trading partners such as China, the US, Japan and others to secure preferential access for its exporters. This sounds fine in theory, but is subject to a number of challenges:

– The UK will have less bargaining power than the EU due to being much smaller, so is unlikely to be able to negotiate FTAs that are as advantageous as the EU.[8]

– The UK has a very limited number of trade negotiators because the EU has negotiated on its behalf for decades, and trade negotiating is a specialist skill that can't be learnt from a textbook.

– FTAs take many years to conclude, and many of the UK's target countries are already negotiating with the EU, so would likely seek to finish those deals first.

Table 2 Overview of options for UK's post-Brexit trading arrangements

Option	Free EU access for industrial goods?	Free EU access for agricultural goods?	Unrestricted EU services trade?	Unrestricted EU worker movement?	Able to restrict EU immigration?	Able to avoid EU budget contributions?	Able to avoid EU Single Market regulations?	Able to influence EU regulations?	Access to EU FTAs?
EFTA model	✓	✓✗ [9]	✗	✗	✓	✓	✓	✗	✗
Bilateral treaty (or Switzerland) model	✓	✗	✗	✓	✗ [10]	✗ [11]	✓✗	✗	✗
EEA (or Norway) model	✓	✗	✓	✓	✗	✗ [12]	✗	✗	✗
WTO model	✗	✗	✗	✗	✓	✓	✓	✗	✗

Source: NZIER

What does this mean for New Zealand's access to the UK market?

Currently, Kiwi firms' access to the UK market are either determined by the UK's WTO commitments (mainly industrial goods) or by decades-old preferential arrangements for most of our primary products initially negotiated after the UK joined the EEC in 1973.

7 The WTO (2016) estimates that the UK applying MFN tariffs would cost £9 billion (although some of that additional cost would be borne by the exporting countries' firms). It also estimates that UK exporters would face additional tariffs of some £5.6 billion.

8 That said, it could also be argued that, unshackled from the more protectionist elements of the EU, the UK could be more ambitious in its FTA proposals.

9 Access varied by type of agricultural products, particularly processed (largely liberalised) versus basic products (less liberalised).

10 Note the Swiss held a referendum in 2014 that resulted in a decision to impose restrictions on EU immigration. Quite how this will work in practice is yet to be seen, but one can be assured that the EU will retaliate via changes to market access if Switzerland seeks to put up barriers to immigration. It has already cut Swiss access to EU educational and research funding. See HM Treasury (2016b).

11 Switzerland pays about 40% of the UK's net contribution to the EU (Dhingra and Sampson, 2016, p.6).

12 Norway pays about 83% of the UK's net contribution to the EU (Dhingra and Sampson, 2016, p.4).

Post-Brexit, what will these access arrangements look like? Will they be better or worse than the status quo of the UK staying in the EU? Again, there are multiple potential outcomes, but some are more likely than others.

Pint of bitter half full…

In an ideal world for New Zealand, New Zealand and the UK could quickly negotiate a bilateral FTA that reduced tariffs on industrial goods and possibly expanded quota access for key agricultural products such as lamb.

But it's hard to see New Zealand being near the top of the UK's list of potential FTA partners, due to our limited market size, an export profile that tends towards some of the UK's more sensitive sectors[13] and the fact that we are currently seeking to open negotiations with the EU as a priority. It would take a bold bid from New Zealand's politicians and officials to put a 'take it or leave it' agreement in front of their UK counterparts to secure a quick but high quality deal.

Alternatively, the UK could unilaterally lower or remove all of its tariffs to all WTO members, including New Zealand, under the WTO model discussed above.

While this is conceptually possible, it's unlikely to occur in practice, because even if the UK did this, it would not be guaranteed any reciprocal market access for its exports. Given the increasingly protectionist tone of much of the trade and foreign policy debate at the moment, it would be hard to imagine UK politicians opening up its borders so brazenly. It would also make negotiating FTAs more difficult. And of course, New Zealand would not have any better access than all of its competitors, so it's difficult to see how such an outcome would make New Zealand exporters much better off.

…or half empty (possibly)

A more likely scenario – fully appreciating that our guess is as good as any other commentator's – is that New Zealand's existing UK market access arrangements would not get better any time soon. New Zealand's industrial goods exports would likely see no change, as most already trade across the UK's adopted EU MFN tariffs, which would be the likely default under this scenario.

The access arrangements for New Zealand's agricultural products would also fall under the UK's WTO commitments. The problem is, the UK doesn't have its own commitments – its commitments were negotiated by the EU at the 1994 Uruguay Round of GATT.

Quite what a post-Brexit set of WTO commitments on the UK's agricultural imports will look like is anyone's guess, but it is likely that the UK and EU would have to negotiate over how to divide up the EU's country-specific tariff quotas (CSTQs), and that both would then have to consult with other WTO members, including New Zealand, to negotiate any amendments.

Generally, the WTO renegotiation process would seek to ensure that any changes that are "not less favourable to trade than that provided for… prior to such negotiations".[14] That sounds promising, but will undoubtedly be subject to game-playing. For example, the EU may seek to push more of its CSTQ to the UK so that the EU can effectively increase its import protection for farmers, especially if they need to be appeased after Common Agricultural Policy subsidies cease to be available.

Given the WTO focus on not making countries worse off after commitment renegotiations, or requiring compensation when it does happen, one might expect that New Zealand's exporters should fare OK. The New Zealand government has committed to engaging in any necessary processes to safeguard New Zealand's interests.

13 UK farmers are not known to be much more open-minded about imports than their EU counterparts, though agriculture accounts for a smaller part of the UK economy than in the EU.

14 GATT Article XXVIII, para 2. https://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_10_e.htm#article28. As always, there are conflicting legal interpretations left, right and centre that will complicate any renegotiation, especially since there is very little precedent to work on – WTO members tend not to renegotiate their multilateral commitments between Rounds.

But given how fiendishly complex current market access arrangements are for New Zealand exporters selling to the EU (and UK), the post-Brexit outcomes may be difficult to compare to the status quo with any degree of certainty.

In short, the theme of uncertainty shines through brightly for New Zealand exporters should Brexit occur. In theory, market access arrangements should be no worse than they are now. In practice this will depend crucially on the withdrawal agreement negotiations around agricultural products.

This will depress the UK's demand for New Zealand's exports

With market access expected to stay largely stable, the biggest effect on New Zealand's exporters from Brexit is therefore likely to be due to a slowing in the UK economy, and hence weaker demand for imports by UK households and firms.

To get a sense of how significant this slowdown might be for Kiwi firms, we have developed some 'back of the envelope' estimates based on the relationship between the UK's economic size (i.e. its GDP) and the demand for New Zealand's exports.[15] This calculation, which takes a relatively moderate GDP impact estimate from the OECD (2016), suggests a drop in New Zealand's goods exports to the UK of around $190 million by 2020.

This is not to say that New Zealand's overall exports would fall by this value. We would expect these goods previously destined for the UK to be diverted to other, albeit less profitable, markets, but this will be still cause New Zealand exporters a headache.[16]

Other Brexit impacts could also affect New Zealand

There are a number of other channels through which Brexit may have negative consequences for New Zealand, although they are difficult to quantify without a much more detailed piece of analysis.

Investment into New Zealand could soften

The uncertainty associated with Brexit is likely to have an impact on UK investors, who account for $4.2 billion (4.4% of total) of FDI in New Zealand. They may look to re-orient their investments to less risky destinations as they wait for the political and economic dust clouds to clear. Since New Zealand is rarely seen as a low-risk investment destination due to our small scale, geographic location and susceptibility to global economic shocks, this could see a marginal dampening of investment flows into New Zealand.

People flows could also be affected, but the net impact is unclear

The impacts of Brexit on the flow of Kiwis looking to work in the UK is difficult to determine, but we might expect fewer job opportunities to be available in the weaker UK economy, and potentially stricter entry requirements. That said, and perhaps a little over-optimistically, if there are shortages of labour, then maybe UK officials will look to less controversial sources of migrant labour than EU workers (i.e. from the wider Commonwealth) to fill the gaps.

Will there be an increase in UK residents looking to leave as the economy worsens? Again, it is hard to know, but we know that in an increasingly mobile global labour market, workers seek out economies which offer strong job growth and opportunities. New Zealand may look attractive as a destination to live and work if Brexit causes an economic downturn and ongoing uncertainty.

[15] Specifically, we draw on the gravity modelling parameters contained in model 2 of Law and Genc (2014) that show the responsiveness of New Zealand exports to a decrease in size of key markets such as the UK. We use the results from OECD (2016) that suggest the UK economy could track lower by 3.3% by 2020 after a Brexit, assuming a short term reversion to WTO MFN arrangements and then a subsequent entry into an FTA with the EU. We do not attempt to consider the impacts on New Zealand's exports of change to non-tariff barriers, migration, investment, exchange rates, etc.

[16] A fuller analysis of the net effects would require the use of a global Computable General Equilibrium model such as GTAP, which is an option for extending this note.

There is a mixed picture for New Zealand's export competitiveness

If the UK resorts to being governed by WTO rules following Brexit, this will likely push up the costs of goods and services exported and imported along the global value chains in which UK and New Zealand firms participate. This is because the UK will no longer be able to export to and import from the EU and its FTA partners duty-free. Intermediate goods that are traded across borders from the UK will face higher tariff and non-tariff barriers. Given such inputs often move through many economies before ending up with the final consumer, such costs tend to accumulate along value chains, and decrease the price competitiveness of the final product.

The net impacts on New Zealand will be determined by the balance between gains from New Zealand exports being more competitive where they compete with UK exports, and the losses associated with New Zealand products that use UK intermediate goods and services becoming less competitive.

The signalling effect of Brexit may dampen enthusiasm for further integration

As noted earlier, the Brexit debate is centred on the extent to which domestic political and economic sovereignty should be traded off against the benefits from deeper economic integration. Should Brexit occur, this will send a message – no matter how jumbled – that a major developed country has withdrawn from a major integration initiative, preferring instead to try and make its own way in the world.

Even though the EU experience is not identical to other economic (and political) integration exercises occurring around the world, such as the Trans-Pacific Partnership or the Transatlantic Trade and Investment Partnership, Brexit could potentially lead to a risk of more governments and populations entering a period of internally-focused navel-gazing, where domestic political interests start to take a greater weight in trade and foreign policy decision-making processes. It wouldn't be hard to imagine Spexit or Grexit re-emerging as viable options should the UK votes to leave.

None of this is likely to be good news for New Zealand.

Conclusion

The complexities of the Brexit debate don't allow any simple conclusions to be drawn. There is little legal or economic precedent to draw on to determine how a post-Brexit world will pan out. The sheer volume of acronyms used in the discussion alone is enough to cause a migraine.

The only certainty is uncertainty. And this uncertainty is unlikely to be good for New Zealand's interests.

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