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Research Report

How Brexit affects Least Developed Countries

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How Brexit Affects Least Developed Countries

Summary

Following the decision of the British referendum on 23 June 2016, the United Kingdom (UK) plans to exit the European Union (EU). Article 50 of the Lisbon Treaty was invoked at the end of March 2017 and the UK will officially leave the single market and customs union in March 2019. Brexit negotiations have proven difficult due to diverging positions of the two partners on many issues, such as freedom of movement, financial contributions and the potential re-emergence of a tough border between the Republic of Ireland and Northern Ireland. Despite the successfully negotiated Withdrawal Agreement and Political Declaration, there is still considerable political uncertainty about the final EU-UK deal.

Regardless of the final outcome of the negotiations, Brexit implies fundamental changes in the British trade regime concerning third countries. This starts with a negotiation of national terms of access for World Trade Organization (WTO) membership and extends to renegotiation of the numerous EU free trade agreements. Moreover, the UK will no longer be part of the European Generalised Scheme of Preferences (GSP) or the Everything But Arms (EBA) treaty, which allow vulnerable developing countries to pay fewer or no duties on their exports to the EU. The Economic Partnership Agreements (EPAs) between the EU and African, Caribbean and Pacific countries will not apply to the UK either.

While the negative effects of Brexit on the UK and EU are in the limelight, the implications for third countries receive less attention. This paper puts the spotlight on these often-overlooked issues by presenting new findings on Brexit implications for Least Developed Countries (LDCs) and discussing policy recommendations.

Developing countries with close ties to the UK will suffer from Brexit as import duties are once again imposed.

In particular, 49 of the world's poorest countries presently benefit from preferential treatment that covers 99% of all products under the EBA agreement. Although these countries account for only 1.15% of the UK's imports, the share of their exports to the UK exceeds 35% in apparel, 21% in textiles and 9% in sugar (calculations based on the UN Comtrade data for 2013-2015). Our findings show that losing these preferences together with the UK's withdrawal from the EU may cause EBA countries' GDPs to fall by -0.01% to -1.08%. Our simulations also indicate that the highest losses will occur in Cambodia and Malawi, where dependence on the UK market is strong. Moreover, Brexit may cause the number of those living in extreme poverty (PPP \$1.90 a day) to rise by nearly 1.7 million in all EBA countries. These are conservative estimates of Brexit's negative impacts; they do not take into account the additional implications of uncertainty, depreciation of the pound sterling, reduced aid spending, remittances and investments.

The UK must act to mitigate the adverse effects on economically vulnerable countries. Such action may include replicating existing EU treaties that grant preferential access to goods from LDCs, creating a more development-friendly UK trade policy with preferential access to services imports and cumulative rules of origin, as well as offering better-targeted aid for trade initiatives. The EU could also support LDCs by implementing liberal cumulative rules of origin and applying its preferential treatment partly to goods with a low value-added content from considered countries.

In addition, developing countries should diversify their export destinations and industries as well as engage in economic transformation that makes them less dependent on UK trade, aid and foreign direct investment (FDI).

Potential Brexit deals

Brexit poses an extraordinary challenge to the global community as such high-level economic disintegration is unprecedented. Over the past century trade liberalisation and economic integration has shaped the international landscape. Europe has played a major role as a pioneering force, beginning with establishing the European Coal and Steel Community in the 1950s, and setting best practice standards since then. The arduous steps to create such deep economic integration are necessarily difficult to disentangle and reverse; Brexit negotiations have proven painstaking and lengthy. Independent of the final outcome, none of the potential deals can replicate the current depth of integration between the two partners.

The potential Brexit outcomes are extensively discussed in the literature and policy debates. In general, the options include the UK's participation in (i) the EU customs union or single market (similarly to Turkey); (ii) the European Free Trade Association (EFTA) (like Norway); (iii) a deep free trade agreement, such as the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada; or (iv) the WTO with the most-favoured-nation (MFN) treatment.

The Withdrawal Agreement and Political Declaration that were settled in November 2018 aim at close economic ties between the EU and UK and imply a transition period lasting until the end of 2020, or longer, to allow for a detailed negotiation of an ambitious trade and investment agreement. However, as long as this agreement remains unratified by the British and European parliaments and the final framework of the EU-UK relationship is still being negotiated, there is room for a "no deal" scenario without any transition period or no Brexit at all. The European Court of Justice confirmed that the UK can unilaterally cancel Brexit without permission from the other 27 EU members.

UK politicians often erroneously portray the WTO rules as providing a safety net for continued trade among countries in the event of a "no deal" scenario. The UK's MFN tariff and quota schedules are currently being negotiated among the members and, given the poor progress so far, are unlikely to be settled before March 2019. This raises the question of what the worst-case scenario might look like.

Empirical studies investigate the potential impact of Brexit focusing mainly on two scenarios – a soft Brexit and a hard Brexit. Despite the varying assumptions, a soft Brexit is usually associated with an ambitious free trade agreement between the EU and UK, as suggested by the Withdrawal Agreement. This scenario can be compared to the current arrangement between the EU and Norway. A hard Brexit, in contrast, assumes a reversion to the WTO rules as the worst-case scenario.

According to the extensive literature, Brexit will be extremely harmful to the UK economy and the EU. Moreover, studies illustrate an asymmetrical negative effect with higher losses for the UK than for the EU because of the stronger dependence of the UK on trade with the EU-27. In particular,

GDP losses from a hard Brexit range from 1.2% to 4.5% in the UK and from 0.1% to 0.6% in the EU-27 across existing quantitative studies. If macro shocks (e.g., uncertainty, exchange rate changes), unemployment and out-migration are included in the macroeconomic models, the GDP loss of the UK increases by up to 8%. A soft Brexit would dampen the harm to both parties by cutting losses roughly by half (Lattore et al., 2018).

Brexit implications for third countries

The majority of existing studies focus on the effects of Brexit on the UK and the EU-27. Even if other countries are included, there is no change in the UK's trade policy against them within simulations, thus, the quantified Brexit impact is very limited. However, this assumption is very unrealistic since the UK will need to invent an entirely new trade policy: it will need to negotiate its national terms of access for the WTO membership and renegotiate all existing EU free trade agreements.

The impact on developing and emerging countries remains largely unconsidered in the literature. Without any additional action of the British government, Brexit will result in the reimposition of duties on imports from 116 developing countries that currently benefit from preferential market access to the UK under different European treaties. In total, these countries constitute an average annual value of imports into the UK of €43 billion between 2013 and 2015, with clothing and textiles being the most significant sectors accounting for around 37% of the total value of imports (Grady, 2017). According to Mendez-Parra, te Velde and Winters (2016, p. 13), the world's poorest countries could lose more than €385 million per year if preferences under the EU's GSP and EBA treaties are not maintained. Apart from potentially increased tariffs, Mendez-Parra, Papadavid and te Velde (2016) suggest that devaluation of the pound sterling and lower UK growth will additionally reduce exports of all LDCs by 0.6% in the short term.

Economic effects of Brexit on EBA countries

EBA countries represent the poorest economies of the world and currently enjoy the best preferential access to EU markets with duty-free and quota-free trade covering 99% of all products. Many of these vulnerable LDCs still suffer from supply-side constraints and are in the process of fully integrating into the global economy. Moreover, many of them represent former British colonies with traditionally close ties to the UK, including language, diaspora and business networks. Thus, an investigation of the Brexit impact on these countries is of great importance.

To provide the first detailed quantitative evaluation of Brexit implications for the aforementioned LDCs, we apply an innovative multi-region and multi-sector general-equilibrium simulation model incorporating heterogeneous manufacturing firms and FDI in services. In addition, we conduct a set of microsimulations to quantify the poverty implications of Brexit in the considered LDCs. Hereby, we investigate the

effects for a soft and a hard Brexit between the EU and UK assuming an increase in trade barriers against the EBA countries. In particular, we increase the UK's import tariffs to the trade weighted average MFN level based on the external tariff rates of the EU and UK's imports from non-EU countries. Furthermore, we additionally increase the non-tariff barriers (NTBs) that EBA countries face in the UK to the same level as for the rest of the EU.

The empirical results across all Brexit simulations suggest that the emergence of trade barriers leads to a strong decrease in bilateral exports to the UK in the considered LDCs (Figure 1). Among the examined scenarios, the strongest impact occurs in the hard Brexit simulation with increased tariffs and higher NTBs against the EBA countries. Hereby, the fall of bilateral exports ranges between -20% in Ethiopia and more than -60% in Malawi, Burkina Faso and Zambia. This strong impact is quite intuitive given the assumption of the highest increase of trade barriers: a tariff rate of up to 21.6% for food products and an NTB of 28.4% in agriculture and food processing. The decline of bilateral exports also leads to a reduction of total exports for almost all considered LDCs with the largest fall of aggregate exports occurring in Cambodia (-1.7%). The only two LDCs with slightly higher aggregate exports across different scenarios are Zambia and Burkina Faso, they are the least dependent on the UK market, with export shares of 0.5% and 1%, respectively. Therefore, they can redirect their exports to the EU-27 and other EBA countries, such as Malawi, Mozambique, Madagascar and Nepal.

In terms of GDP and welfare, we also observe decreases for the majority of EBA countries. In general, real GDP losses range from -0.01% in the event of Brexit and increased tariffs to -1.08% in the event of Brexit and both increased tariffs and NTBs. The highest losses by far occur in Cambodia, which has the highest dependence on the UK market according to the share of its exports to the UK of 7.7%. In terms of welfare, Cambodia's household consumption falls by 1.4% in our hard Brexit scenario with increased tariffs and NTBs. The second

highest losses occur in Malawi, which is also relatively dependent on the UK market (3.4% of its exports). Malawi's lower dependence translates to much smaller losses, with the maximal reduction of GDP and welfare in our hard Brexit scenario with increased tariffs and NTBs by 0.14% and 0.17%, respectively. For the rest of LDCs the losses are quite limited (up to -0.06% for real GDP and -0.07% for welfare).

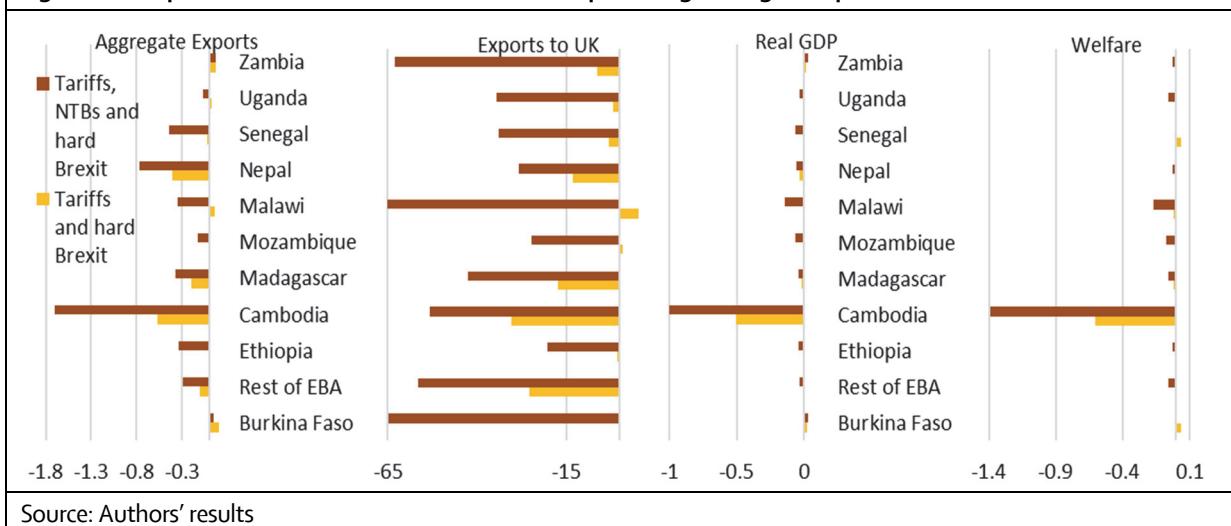
The welfare losses tend to be higher than the GDP decline mainly for two reasons. First, reduced production and trade decrease the variety of goods available for consumption and therefore lead to a welfare loss along the extensive margin. Second, reduced production also diminishes household income, especially due to lower returns from unskilled labour (up to -0.79% in Cambodia). This illustrates the specialisation of the LDCs in goods produced with intense use of unskilled labour as well as their better endowment of unskilled labour than skilled labour and capital. Thus, this rather strong decrease in unskilled labour income has a significant impact on total household income and reduces consumption possibilities.

At the sectoral level, the food and textile industries are the most affected sectors for all included EBA countries. The greatest decline in aggregate exports is -4.14% in food processing and -2.93% in textiles. The maximal reductions in output are -1.13% in textiles and -0.14% in food processing. This large impact is mainly driven by both the highest potential protection and a high initial share of exports to the UK. Looking at the country-specific results, the highest reductions in exports and output of food products occur in Malawi, Cambodia and the rest of the EBA countries. For textiles, the highest losses are observed in Madagascar, Cambodia, Ethiopia and the rest of the EBA countries.

Poverty implications for EBA countries

Using the internationally comparable poverty line of \$1.90 a day at 2011 purchasing power parity (PPP), Brexit may increase the EBA population living in extreme poverty by up to 1.7 million. The most affected countries would be Cambodia

Figure 1: Impact of Brexit on selected EBA countries, percentage change compared with the benchmark



and Ethiopia with poverty headcount ratio increases of up to 1.02 and 1.12 percentage points, respectively. The main reasons for these adverse results are quite different for the two LDCs. In the case of Cambodia, the cause is mainly a relatively high loss of welfare, whereas for Ethiopia it is an increase in food relative to non-food prices. Such changes in relative prices strongly affect the Ethiopian poor, who tend to dedicate a larger share of their budget to food items.

Conclusions and policy implications

Brexit represents an extraordinary challenge for the EU and UK since none of the debated deals can replicate the current depth of integration between the two partners. Empirical studies clearly suggest a negative impact of Brexit on the UK and European economies, with the highest losses in the event of a "no deal" scenario (return to WTO rules). However, the losses from a completely unregulated Brexit might be even higher.

Regarding third countries, the LDCs with close economic ties to the UK will suffer most from Brexit. Among the poorest countries currently benefiting from the EBA treatment, the highest losses are expected in Cambodia and Malawi. Moreover, Brexit could increase the population living in extreme poverty in EBA countries by nearly 1.7 million. These estimated negative effects result only from changes in the UK's trade regime and therefore underestimate the overall impact, given the additional implications of uncertainty, depreciation, shrinking aid, remittances and investments.

These findings highlight a need for action by the UK to mitigate the adverse effects of Brexit on economically vulnerable countries. Such actions may include a replication of the existing EU treaties that grant duty-free and quota-

free access for goods from LDCs (e.g., EBA, GSP) or even a creation of a more development-friendly UK trade policy that extends non-reciprocal access to services imports and incorporates liberal cumulative rules of origin. All these provisions must comply with WTO rules concerning exceptions from the negotiated MFN regime. Alternatively, the UK may draw up new free trade agreements with individual developing countries, but that is unlikely given the short notice and it would limit the number of countries covered. Another means of preventing the negative impacts on LDCs would be providing better-targeted aid for trade initiatives to address supply side constraints. However, a lower GDP and the depreciation of the pound sterling due to Brexit will have a contracting effect on the UK's aid budget.

The EU could also increase its support to developing countries. Since the European unilateral preferences for goods from the poorest countries will remain unchanged, the EU could increase the number of eligible goods by implementing liberal cumulative rules of origin. Moreover, to help these economies engage in global value chains, the EU could apply its preferential treatment to the value-added content of final goods produced in considered countries. This would reduce the final price of goods and thus provide additional incentive for producers from other countries to either replace some intermediate goods with those from developing economies or to outsource some production steps to those countries.

In addition to the UK and EU provisions, developing countries should diversify their export destinations and industries as well as engage in economic transformation that will make them less dependent on UK trade, aid, remittances and investments.

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