Intelligence MEMOS

From: Dan Ciuriak

To: The Minister of International Trade, Chrystia Freeland

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Re: Breaking up can be hard to do – Brexit and Canada's Trade Interests

With the UK outside of the European Union (EU), what do possible European trade policy frameworks mean for Canada? Two broad options have already been studied: Exit without a free trade agreement with the EU ("pure" Brexit); or with an arrangement similar to the trade deal between the EU and the European Free Trade Area (EFTA), which includes Norway, Switzerland, Iceland and Liechtenstein (BREFTA).

I think there is a third, more likely option: a contemporary "deep and comprehensive FTA" (DCFTA) between the EU27 and the UK.

This is because a DCFTA would preserve as much of the current bilateral market access as possible, without the UK being bound by the EU regulatory regime and commitment to unfettered movement of persons, or being required to make a contribution to the EU budget. These are the very EU arrangements the "Leave" proponents campaigned against; yet, within a BREFTA, these obligations would substantially remain.

To be sure, the DCFTA would still result in significant GDP losses for the UK and the rest of the EU, probably somewhere between what a BREFTA and a pure Brexit scenario would entail *in the long run*. In the study mentioned above, the trade-related costs of these options were estimated, respectively, at 1 and 3 percent of GDP for the UK, and 0.1 and 0.4 percent of GDP for the rest of the EU.

For Canada, the important thing would be to ensure that both the EU and the UK honour their commitments under CETA as, effectively, the successor entities to the EU28, which signed the agreement. But the devil could be in the details because of managed market access in sensitive agricultural sectors. In this divorce, the squabble will be about who gets the quotas.

Cross-cumulation of value-added in products for satisfying the rules of origin could be included in the successor agreements. For example, under cross-cumulation, a UK product with a considerable share of inputs sourced from the continent would qualify as a UK-originating product in Canada under a CETA-successor, Canada-UK FTA. The same would be true of an EU product that sourced heavily from the UK, under the CETA itself. The UK and the EU27 agreeing to such cross-cumulation would largely preserve for Canada the value of the CETA as originally negotiated.

Cross-cumulation would also work under the BREFTA, however unlikely such an arrangement. But it would not be possible under a Brexit for the simple reason that it would constitute a back door into the European (respectively UK) market for UK (respectively European) products that are incorporated in Canadian products.

So, Canadian interests could be preserved. Indeed, under a pure Brexit scenario, some Canadian producers could benefit as the UK and the rest of the EU erect trade barriers against each other, even as potential European and UK GDP drop and cross-channel value chains unravel.

However, calculations of long-run costs and benefits ignore the fall-out from possible disruptive economic or financial turbulence triggered by Brexit *in the short run*. The cumulated income losses of a crisis scenario would take a very long time to recoup for Canada – and, of course, such a recoupment would not in the cards for the UK and EU. Breaking up can be hard to do – and expensive.

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