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Policy Brief

Brexit and Canada-Europe Economic Relations: One Year Into the EU-UK Trade and Cooperation Agreement

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Executive Summary: To manage their economic relationship after Brexit, the European Union (EU) and the United Kingdom (UK) negotiated the Trade and Cooperation Agreement (TCA), which began applying provisionally on January 1, 2021. This policy brief summarizes the TCA's impact on Canada's economic relations with the EU and the UK.

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Introduction

Canada's transatlantic economic relationship occupies an important place in its international trade balance as well as in its participation in global value chains. Despite Canada's trade taking place largely with the United States (US), the European Union (EU) represents the second largest market for Canadian goods after the US. The Comprehensive Economic and Trade Agreement (CETA) only reaffirmed the strong historical ties between Canada and the EU. Within the Canada-EU economic relationship, the United Kingdom (UK) played a predominant role until it left the EU as a result of the Brexit referendum vote in June 2016. The UK was the primary source and destination for trade and investment between Canada and the EU.

To manage their economic relationship after Brexit, the EU and the UK agreed to the Trade and Cooperation Agreement (TCA). On January 1, 2021, the TCA began applying provisionally; it entered into force on May 1, 2021.[1] In the European Commission's words, the TCA "sets out preferential arrangements in areas such as trade in goods and in services, digital trade, intellectual property, public procurement, aviation and road transport, energy, fisheries, social security coordination, law enforcement and judicial cooperation in criminal matters, thematic cooperation and participation in Union programmes".[2]

The TCA, which compares to the CETA in many parts, represents a significant setback from the single market, whereby UK firms wanting to do business with the EU, and vice versa, now face a series of non-tariff barriers to trade (varied rules and regulations, customs checks and paperwork) that increase costs and cause delays. These new transaction costs should ultimately reduce trade and investment flows between the EU and the UK, especially in service sectors.

Although the TCA's main economic effects concern trade and investment between the EU and the UK, it also has consequences for third countries that do business with them. One of those third countries is Canada, which is an important economic partner to both the EU and the UK as well as vice versa. It is therefore important to analyse the TCA's impact on Canada's economic relations with the EU and the UK. Therefore, this brief analyzes the TCA's early effects on the EU's and the UK's economic relations with Canada.

Canada's economic relations with the EU and the UK after one year into the TCA

Trade theories suggest that changing trade and economic rules between two parties (countries or groups of countries) have consequences for both their domestic as well their other international economic transactions. Free-trade agreements (FTAs) are expected to increase trade between their member states. This increase in trade flows between an FTA's member

[1] The UK officially left the EU at midnight (Central European Time) on 1 February 2020; however, it remained part of the EU's single market (and customs union) until 30 December 2020 under the Withdrawal Agreement negotiated between the EU and the UK.

[2] https://ec.europa.eu/info/strategy/relations-non-eu-countries/relations-united-kingdom/eu-uk-trade-and-cooperation-agreement_en.

economies is the result of newly created trade but also of diverted trade from third countries since it becomes relatively cheaper to trade with an FTA's partners. The higher the tariffs before the FTA, the greater the trade diversion since there is a bigger incentive for firms to move their business to an FTA's partners and away from third countries. Trade creation is generally greater than trade diversion, especially if an FTA eliminates or significantly reduces non-tariff barriers.

In the TCA's context, the above logic should work in reverse, because the TCA imposes non-tariff barriers when compared to the EU's single market, which the UK left because of Brexit. Therefore, the TCA should reduce trade and investment flows between the EU and the UK, especially in service sectors, as well as lead to greater trade with third countries by the EU and the UK (reverse trade diversion). In this regard, the TCA should have trade-creation and trade-diversion effects (with associated effects relating to investment) on the EU's and the UK's economic relationships with Canada. In this policy brief, we present trade data that were available at the time of writing (April 2022). No data on direct investments between Canada and its European (EU and UK) were yet available.

Trade in goods

Canada's monthly trade data after one year under the TCA regime show the emergence of trade diversion and creation effects. Figures 1 and 2 in the appendix show that between January 2021 and January 2022 Canada's trade with the UK shrunk by C$800 million while trade with the EU-27 increased by C$394 million. These results suggest that the TCA had a trade-diversion effect on Canada's trade with the UK and a trade-creation effect on Canada's trade with the EU-27.

Regarding Canada's trade with the UK, trade diversion has been observed mainly in the exports of industrial machinery (-53 percent), precious metal (-38 percent), and electrical equipment and components (-36 percent). These industries correspond to the ones that had a high share of value added in the UK's and the EU-27's 2018 gross exports. Therefore, these trends suggest that Canada's trade with the UK, especially in the transport and equipment sectors, may have been diverted to EU-27 countries. Indeed, data from trade data online show that Canada's export of transportation equipment to the EU-27 increased by 64 percent while it dropped by 2 percent to the UK.

However, the chemical and pharmaceutical industry in Canada has recorded an impressive growth in export to the UK and the EU-27 between January 2021 and January 2022. Data show that Canada's transatlantic export of chemical and pharmaceutical products grew by 342 percent overall. This increase was led by the export of pharmaceutical and medicine manufacturing industry with a growth of 630 percent.[3] This is probably explained by the increasing demand for medical products in response to the Covid-19 pandemic.

[3] https://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/home.

Trade in services

Canada's trade in services with the UK and the EU-27 demonstrated little change under the TCA's first year. Table 1 in the appendix shows that, although trade with the EU-27 recorded slightly higher growth than with the UK, the difference is not significant and may be explained by the EU-27's greater market size. Notably, Canada's payments for services from the EU-27 saw growth at 8.6 percent between Q4 2020 to Q4 2021.

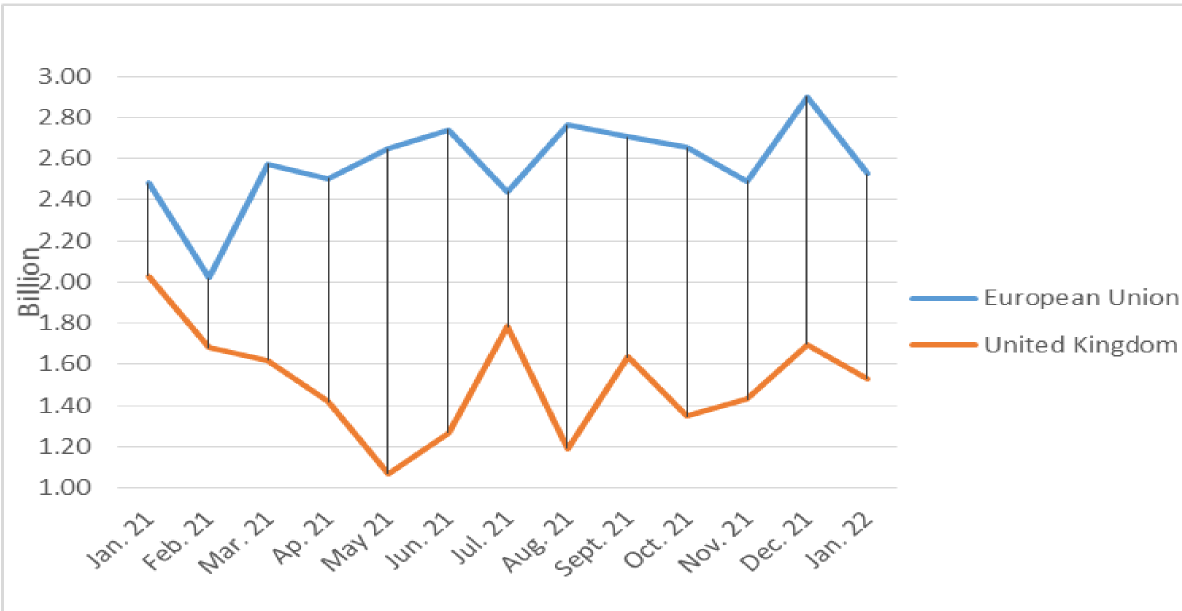
Conclusion

The evolution of Canada's economic relationship with the EU and the UK in the years prior to the TCA entering into force indicates that, while the UK was Canada's most important trade partner within the EU, there was a rapid decline of manufactured goods flowing between the two countries while trade in services continued to grow. Therefore, since the TCA brought little change in terms of merchandise trading rules, except for border delays for goods traded between the UK and the EU, this decline for manufactured goods is likely to continue with the TCA in place. Given the limited coverage of TCA provisions on services and the expanding share of domestic firms in the UK service sectors, Canadian service firms are likely to shift their trade and investment activities toward the EU's single market.

Because the TCA has been in place for only a bit more than one year, it is too early to discern its structural (i.e., long-term) impact on Canada's trade with the EU and the UK. This should not be surprising since businesses can be slow to react to such structural change to their trading and investment activities. However, available Canadian trade data show early signs of reverse trade diversion away from the UK and trade creation with the EU-27. These effects should deepen overtime as companies adapt and find new business partners, negotiate contracts and develop new working relationships. In a few years' time, we should get an accurate assessment of the scale and scope of value-chain shocks caused by the TCA for transatlantic trade and investment between Canada and its European partners (the EU and the UK).

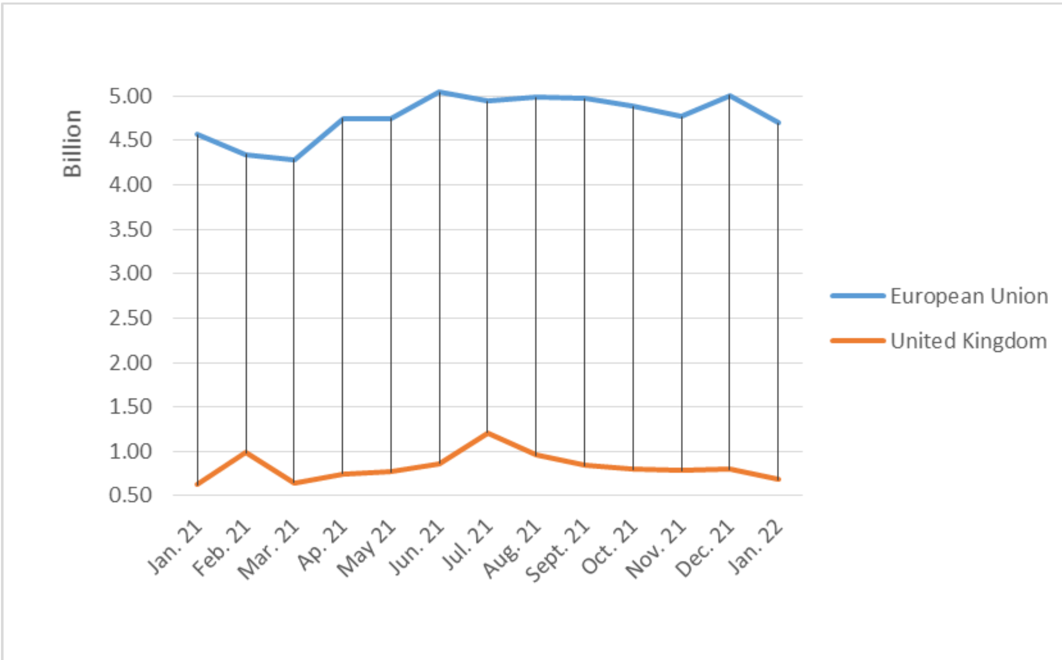
Appendix

Figure 1. Canada's international merchandise exports, January 2021 to January 2022 (in billion C$)



Source: Statistics Canada (Table 12-10-0011-01)

Figure 2. Canada's international merchandise imports, January 2021 to January 2022 (in billion C$)



Source: Statistics Canada (Table 12-10-0011-01)

Table 1. Canada's international receipts and payments for trade in services with the UK and the EU-27, as per the balance of payments (in billion C$)

	TRADING PARTNERS	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	%CHANGE 2020-2021
RECEIPTS	EU-27	3,659	3,781	3,610	3,708	4,097	5.65
	United Kingdom	1,419	1,463	1,407	1,511	1,584	5.49
PAYMENTS	EU-27	3,971	4,202	4,350	4,802	4,726	8.68
	United Kingdom	1,987	1,852	2,030	2,144	2,015	0.70

Source: Statistics Canada (Table 36-10-0024-01)