Brexit: Trade diversion due to trade policy uncertainty

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The unexpected vote of the United Kingdom (UK) electorate to leave the European Union (EU) initiated a negotiation period in which uncertainty about trade relations between these regions was very high. Protracted uncertainty could affect trade patterns of firms. For example, firms could partially replace the British market for alternative ones, what is known as "trade diversion". In our recent paper (Gutiérrez et al., 2021), we explore the effect of uncertainty on bilateral trade and the firm's ability to divert trade away from UK to other markets, using Brexit as a quasi-natural experiment and Spanish firm level data.

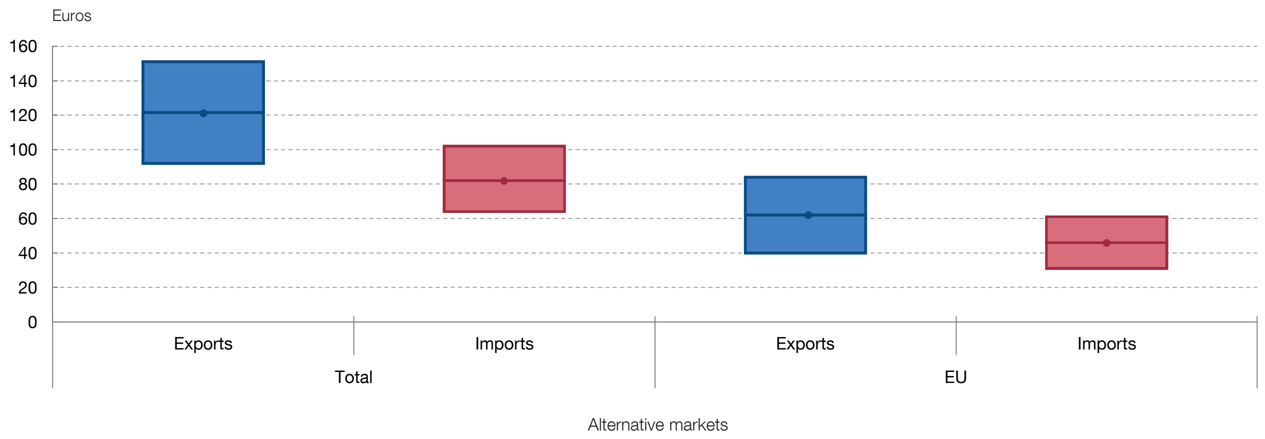
Our results indicate that Brexit had significant trade diversion effects. Indeed, it was higher for i) those firms highly exposed to trade with the UK before the referendum (above 10% of foreign sales and purchases); ii) for exports (than for imports); iii) and to/from EU countries

DATA AND FRAMEWORK

We employ three different data sources to assess trade diversion patterns. First, we use customs agency information on monthly declared exports and imports between Spain and the UK, the EU (excluding the UK) and Rest of the World per each operator exposed to the UK between 2015 and 2018. Second, an annual firm level database including their sector of activity, turnover, and number of employees coming from the Central Business Register (National Statistics Institute - INE). Third, we construct sectoral tariffs by exploiting World Trade Organization (WTO) data on Most Favored Nation tariffs. These are the tariffs that would apply in the absence of a trade deal between the EU and the UK.

With respect to the analytical framework, first we estimate the effect of uncertainty on the intensive margin (change in trade flows of those firms already trading) of bilateral trade with the UK. Firm level uncertainty is measured as the interaction between its relative trade exposure to the UK before the referendum – the share of British flows in total flows on 2015 – and potential sectoral tariffs that would apply between the EU and the UK in the absence of a

Figure 1
HIGHER SALES TO OR ACQUISITIONS FROM OTHER MARKETS AFTER A €100 DECLINE IN TRADE WITH THE UK



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1 The views expressed in this Research Feature are solely those of the authors' and do not necessarily represent those of Banco de España or the Eurosystem.
2 After four years of negotiations, the EU and the UK finally reached an agreement on 24 December 2020, whereby no bilateral tariffs have been established.

trade deal. In the second step, we quantify trade diversion patterns, by regressing changes in Spanish trade with non-UK countries on the changes of Spanish exports to and imports from UK predicted in the first stage. This strategy is called difference in difference since we exploit the trade diversion changes of firms with different characteristics (in our case different degrees of uncertainty to Brexit). Those firms which would face higher tariffs in case of no trade deal might have reduced their trade with the UK more intensely and replaced, at least partially, the British market with other alternative destinations. Additionally, a higher firm's relative exposure to the UK increases the risks associated with Brexit, which could lead in turn to a higher trade diversion.

TRADE DESTRUCTION AND DIVERSION PATTERNS

In the case of exporters highly exposed to the UK, bilateral trade declined as a consequence of increased uncertainty during Brexit negotiations. In particular, our estimations suggest that the growth rate of sales to the UK for those exporters decreases by 2.6pp in response to a 1% potential tariff hike. In the case of importers, this reduction reaches 3.6pp.

These results are used in the second step in order to quantify trade diversion patterns. Our results indicate that trade diversion is significant: for highly exposed firms, a drop of 100 euros in their exports to the UK due to uncertainty would lead to an increase in exports to other markets between 92 and 151 euros (see Figure 1). This means a close to full diversion of exports. Trade diversion is lower for imports. In particular, a decrease of 100 euros in imports from UK would lead to between 64 and 100 euros increase in imports from other markets. The EU is the region benefiting the most from this trade diversion. Indeed, the EU is Spain´s main market, accounting for around 60 % of Spanish goods exports in 2019. Potential explanations are the significant percentage of firms that has stable trade relationships with the EU, and its level of development and demand preferences, similar to those of the UK.

To sum up, the uncertainty around the future of trade relations between the EU and the UK generated by the Brexit referendum could have affected bilateral trade flows. Indeed, a no trade deal, would have implied the introduction of high bilateral tariffs. Using Spanish firm data, our paper shows that those firms very exposed to the UK, and therefore facing high potential losses, have reduced their trade with the UK and diverted trade to other markets. This diversion has been more pronounced for exports than for imports.

REFERENCES

Gutiérrez Chacón, E., Lacuesta, A., & Martín, C. (2021). Brexit: Trade diversion due to trade policy uncertainty.