Bulletin

Je t'aime, moi non plus

BREXIT, FRANCE AND THE EU

The UK government has invoked Article 50 of the Lisbon Treaty, starting the process through which the UK will exit the European Union. It has also published its negotiating priorities, and called a snap general election to bolster its mandate. Across the Channel, the forthcoming presidential elections in France are now also raising the question of France's future relationship with the EU, with one leading candidate promising a referendum on whether the country should leave the club, and another raising the possibility of leaving if negotiations fail secure radical reforms. This bulletin explores the potential impact of various Brexit and French exit ("Frexit") scenarios on France's trade.

The referendum of 23 June 2016 saw a majority of the UK voters opt in favour of leaving the European Union. The UK parliament subsequently passed an Act allowing the Prime Minister to notify, under Article 50 of the Lisbon Treaty, the UK's intention to withdraw from the EU. This was done on 29 March 2017.

Various studies, including several prepared by Frontier Economics, have considered the impact on the UK of its decision to leave the EU. The impact depends centrally on the future arrangements between the UK and the EU once arrangements for the UK's exit have been completed. The UK government's negotiating principles set out the aim of securing a deep Free Trade Agreement (FTA) with the EU, while also allowing for the possibility of a "hard" exit in which trade between the UK and the EU takes places on a Most-Favoured Nation (MFN) basis under WTO rules.

In parallel to the process followed by the UK, the issue of France's position within the European Union has also become an issue in the run-up to the 2017 Presidential Elections. The platform of one of the leading candidates, Marine Le Pen of the far-right Front National, has as its first point a commitment to renegotiate France's relationship with the EU, followed by a referendum on France's membership of the EU. Opinion polls have varyingly placed Mrs Le Pen on top or in second position in the field of candidates. Her scepticism of the European Union also finds an echo on the hard left, notably in the candidacy of Mr Jean-Luc Mélenchon.

The purpose of this bulletin is therefore, first, to extend previous analyses of "Brexit" to consider its impact on France i.e. to quantify the impact on *France's trade* under various projections for the *UK's* future relationship to the EU. Secondly, we also consider the impact on France of France leaving the European Union ("Frexit"). The analyses are not intended as forecasts: rather, they are estimations of impacts under different scenarios. We consider three scenarios for both "Brexit" and "Frexit":

- a close integration/ soft-exit scenario in which the leaving parties negotiate a deep FTA that replicates most aspects of single market arrangements. This is the baseline case in that it does not entail a significant change to current trade
- a "hard scenario" in which no free trade arrangement is struck with the remaining members of the EU and trade with the EU reverts to MFN principles;
- an intermediate scenario in which leaving parties negotiate a FTA with the EU remnant, but this agreement falls short of current single market arrangements and is more in line with "vanilla" free trade agreements observed in the rest of the world outside the EU.

An overview of France's trade with the UK and the EU

Figure 1 provides a break-down of the direction of France's merchandise trade. Total French exports are around $574 billion and total imports around $693 billion. The EU-27 (i.e. excluding the UK) accounts for just over 55% of French exports and close to 66% of imports to France. Around another 10.5% of exports and 7.5% of imports are accounted for by European Free Trade Association (EFTA) countries and other countries with which the EU-27 has currently has a free trade agreement.

Figure 1. French goods trade breakdown

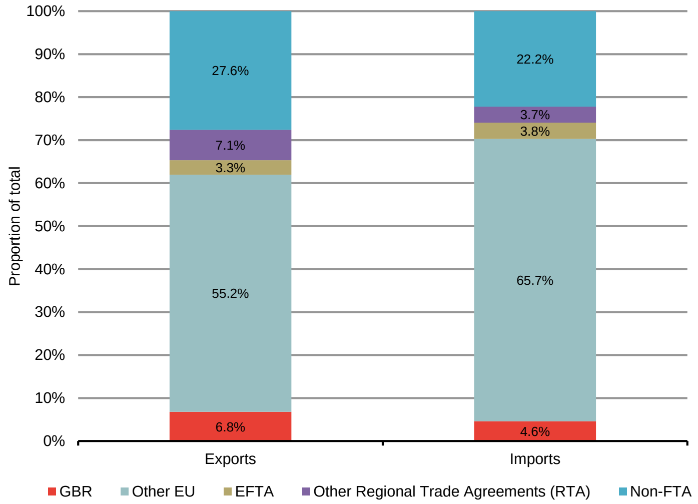
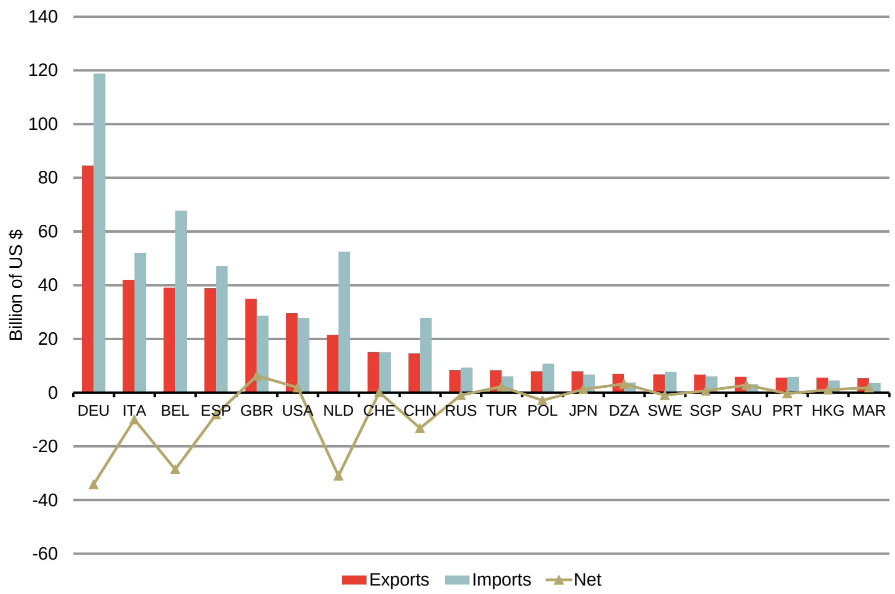


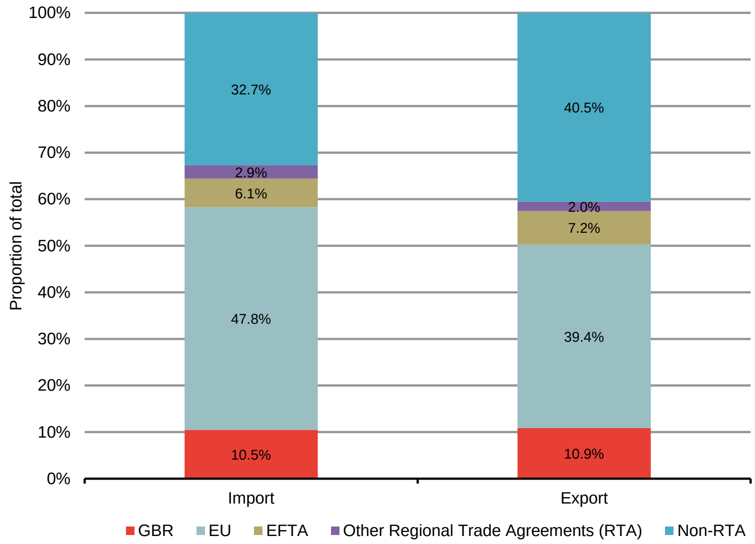
Figure 2 provides a more detailed breakdown on France's trade by trading partner, and its overall balance of trade with these partners. The UK is France's fifth largest trading partner and the only one of its top 5 trading partners with which it has a surplus on merchandise exports. Six of France's top 7 trading partners are within the EU (the US is the exception) and a further partner (Switzerland) is one which has a free-trade agreement with the EU covering non-agricultural products.

Figure 2. Goods trade with main partners



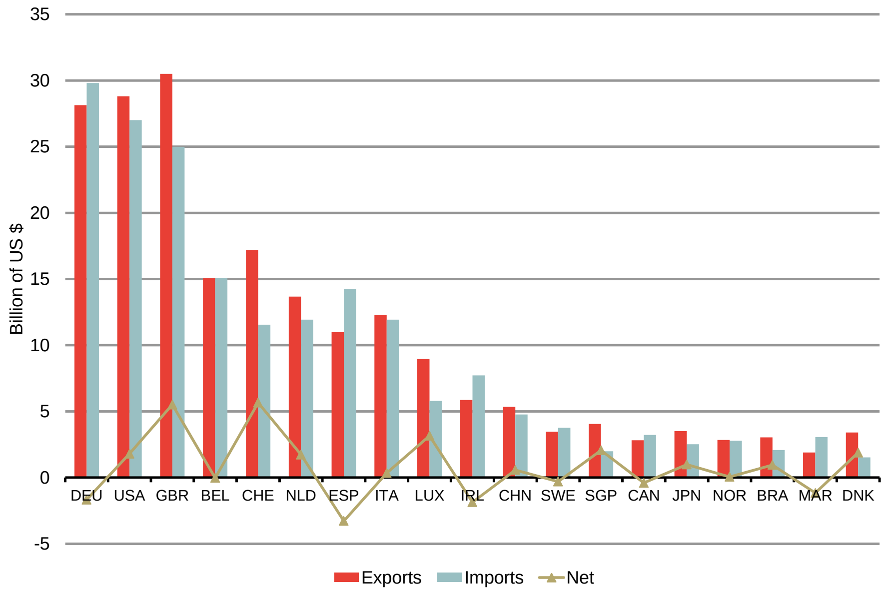
On the services side, France is a net exporter of services, with exports of $281bn vs imports of $238bn. Figure 4 shows that, as with goods, the EU 27, EFTA and countries the EU has signed free trade agreements with account for the bulk of exports and imports, around 56% and 49%. The main difference with goods lies in the share accounted for by countries with which France trades on MFN terms: around 40%, which is in fact roughly the same as the share accounted for by the EU 27.

Figure 3 Direction of French services trade by major groupings



As Figure 4 reports, the UK is the single largest export market for French services (roughly 10%), and the third largest source of France's services imports (again, roughly 10%), behind Germany and the United States.

Figure 4 Direction of French services trade by partner,



Modelling Brexit and Frexit

A widely accepted way of modelling the trade flows is to use a gravity model of trade. Gravity models show how much trade should be expected between countries, as a function of their size and their proximity. "Proximity" in this context refers to physical distance, as well as less tangible measures of proximity, such as a common language or a shared colonial history. Standard trade theory tells us that trade between countries will be driven by differences in their resource endowments and/ or consumer tastes. The intuition behind the gravity model is to qualify this prediction by proposing that countries will trade more with larger countries, and those that are closer in any of the senses described above. Even though trade is global, the biggest immediate opportunities may be those that are nearer to home.

To this basic model we can add the effects of trade policy restrictions. We thus include a variable reflecting whether pairs of trade partners are members of a FTA. Our approach is in line with several major studies on the effects of FTAs.[1]

In keeping with that literature, we include separate variables to capture for the EEA and for other types of FTA ("vanilla" FTAs). This mainly reflects the fact that the single market has brought about a depth of liberalisation through its four pillars that is not observed in other agreements, which are more limited in the depth and breadth of their coverage (notably in the areas of services trade, regulatory harmonisation and investment).

For merchandise trade, we find that moving from a deep, EEA-type FTA (the baseline) to a vanilla-type FTA gives a reduction of 15.9% in trade, while moving from a deep-EEA-type FTA to trade on a MFN basis gives a reduction in 36.4%. So, for example, given that the UK accounts for 6.8% of France's exports and 4.6% of imports into France, a hard Brexit scenario, in which the *UK* left the EU and trade between the two reverted to MFN terms, would reduce *France's* exports by around 2.5%, or around $12.7 billion, and France's imports by around 1.7%, or around $10.4 billion. Under a hard French exit scenario, we take into account that 60.2% of French exports are to the EU and that 70.3% of imports to France are from the EU, implying reductions in France's total exports of around 22% and imports of around 26% (or around, respectively, $116 billion and $160 billion).

We assign to each of France and the UK the possibility of a soft exit (in which a deep FTA is negotiated replicating single market arrangements), an intermediate scenario (with a vanilla FTA) and a hard exit scenario. This gives nine different combinations of scenarios, as described in Table 1 below. The top-left cell gives the baseline outcome in which both France and the UK manage to replicate single market outcomes as part of the future arrangements. Under such a scenario there would in theory be no impact on trade relative to the status quo (though in practice it is possible that such arrangements may create some administrative obstacles to trade). The bottom-right hand corner of Table 1 gives the outcome with the biggest impact relative to the baseline.

Table 1 Combination of post-exit scenarios for the UK and France vis a vis the EU

	France – Soft Exit	France – Intermediate	France – Hard Exit
UK – Soft Exit	UK, France agree deep FTA with EU	UK concludes deep FTA with EU, France a vanilla FTA With EU	UK concludes deep FTA, France trades on MFN terms with EU
UK – Intermediate Exit	UK concludes vanilla FTA with EU, France concludes a deep FTA	UK and France conclude vanilla FTA with EU	UK concludes vanilla FTA with EU, France trades on MFN terms with EU
UK Hard Exit	UK trades on MFN terms with EU, France concludes deep FTA with EU	UK trades on MFN terms with EU, France concludes vanilla FTA with EU	UK and France trade on MFN terms with EU

Figures 5 and 6 report the modelling results for exports and imports. They show how the outcome for each of the French exit scenario varies depending on the UK exit scenario. The left-most set of columns in both graphs (labelled) "France leaves soft" gives the pure Brexit effect on France. The red columns in both sets of graphs report the pure Frexit effect under the intermediate and hard exit scenarios.

[1] See notably Baier, S.L., J.H. Bergstrand, P. Egger and P.A. McLaughlin (2008) 'Do Economic Integration Agreements Actually Work? Issues in Understanding the Causes and Consequences of the Growth of Regionalism', *The World Economy 31(4): 461-97*; Magee, C. (2008) 'New Measures of Trade Creation and Trade Divergence' Journal of International Economics 75(2), 349-62.

Figure 5 **Impacts on French exports by France and UK exit scenario**

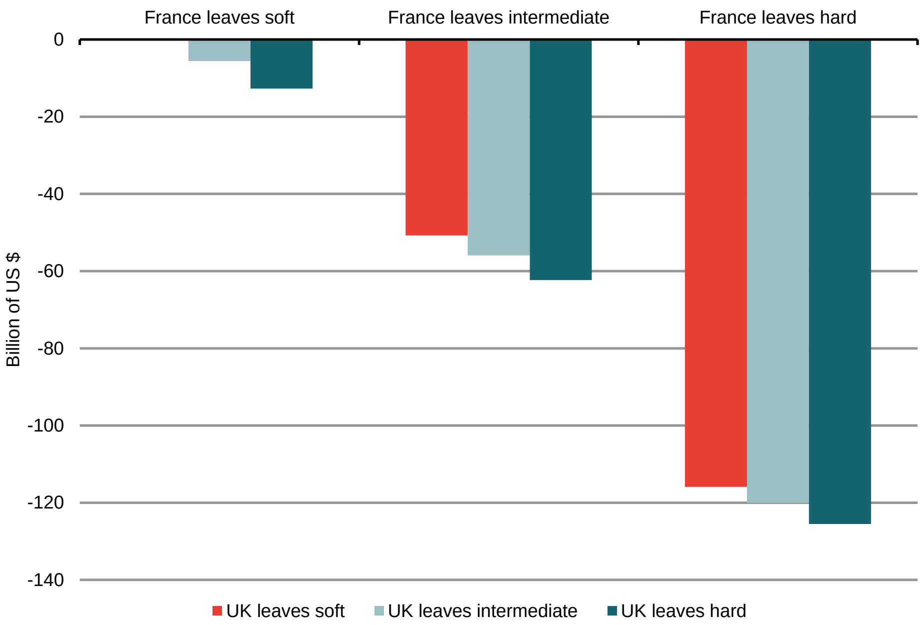
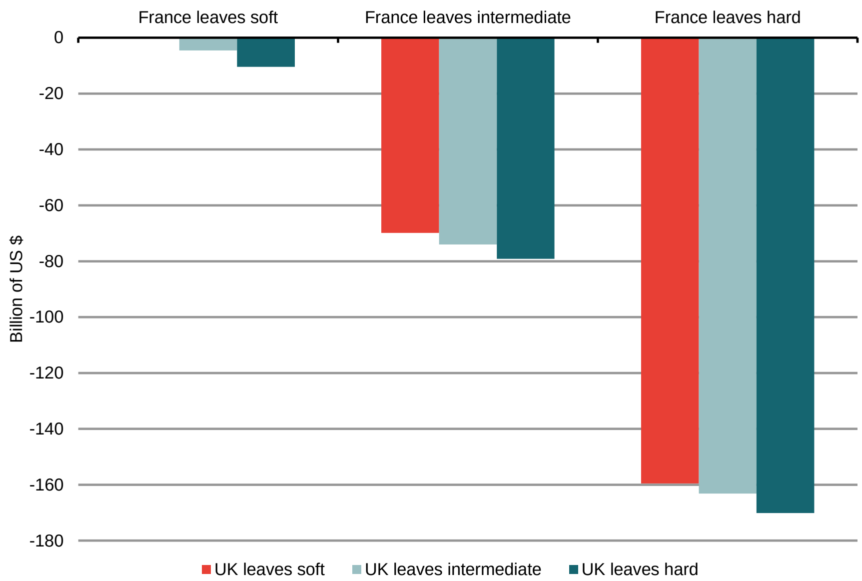


Figure 6 **Impacts on French imports by France and UK exit scenario**



Estimates for services trade are more complicated because of data issues. The OECD recently undertook work on measuring the impact of changes in the level of policy restrictions, measured by a services trade restrictiveness index, affecting services on trade in services.[2] The econometric research linking changes in services trade restrictiveness to changes in trade flows in still in its early stages, and there is uncertainty surrounding the strength of the effect. Taking a mid-point between different estimates, we find that a percentage point drop in services trade restrictiveness increases exports of services by 1.6% and imports by 1.1%.

Applying this approach to the effects of changes to the type of arrangement between a country and the EU is not straightforward, as it is not easy to use restrictiveness indices to disentangle general

[2] See notably Hildegunn Kyvik Nordås, Dorothée Rouzet (2015), The Impact of Services Trade Restrictiveness on Trade Flows – First Results, OECD Trade Policy Paper.

changes in services policy from those that are specific to a FTA. The approach we choose is to use a gravity model of services trade and apply variables to test for the effect of deep and “vanilla FTAs”.

Overall, we find that a vanilla FTA has insignificant effects on services trade. The result for a vanilla FTA is in line with the observation that most FTA’s do not have a significant effect on liberalising services trade. Rather, the services chapters in most FTAs set out commitments that are less liberal than actual policy applied on the ground. The commitments thus set upper bounds on how far actual liberalisation on the ground could be rolled back. They often represent a tighter constraint on policy slippage than multilateral commitments, and this (rather than actual liberalisation) is one the main benefits of services trade commitments under FTAs.

A deep EU-type FTA has the effect of increasing services trade, but there is a significant variation in the coefficient, depending on how data questions are handled. The upper bound of estimates suggests that joining or leaving a EU-type FTA would increase/ decrease services trade flows by around 146%.[3] In order to be conservative we use a mid-point of the range of estimate, which suggests that agreeing a deep EU-FTA increases trade by 73% and that leaving such an arrangement reduces services trade by 42%.[4]

In contrast to vanilla-FTA’s the EEA has stimulated services liberalisation on the ground (though imperfectly). This follows directive such as the Services Directive, and sector specific directives, such as the Telecommunications directive. But it also likely reflects broader aspects of the operation of the single market, such as regulatory convergence, and the effects of free movement of capital and labour (the latter has a direct liberalising effect on the supply of services through the movement of natural persons and by easing the conditions under which firms supplying services can transfer employees).

If we apply the deep FTA effects computed above first to bilateral trade between the UK and France (to measure the effects of Brexit on France) and then to France’s trade with the EU as a whole, we come up with the following effects:

- A hard Brexit reduces French services exports to the UK by around $11.8 billion and imports from the UK by $10 billion
- A hard French exit reduces France’s services trade by a further $113.3 billion for exports and around $95.8 billion in imports.

The figures help to provide an indication of the range of losses involved under French exit – the upper bound of $125.1 billion for services exports and $105.8 billion for services imports (respectively 44% and 48% of services exports and imports) reflects the cumulative impacts of a hard Brexit and a hard French exit. The results are likely an understatement of the full effect of leaving since they do not take account of impact increased level of services trade restrictiveness may have on *goods* trade.

Ne me quitte pas…

The findings in this bulletin help shed light on two current issues: the impacts of Brexit on EU partner economies (in this case, France), and the potential impact of political developments in France.

On the first, of these, the findings are in line with our previous research that demonstrated the importance to the UK of negotiating a deep and comprehensive FTA that replicates the trade liberalisation delivered through the single market. The projected impacts of Brexit on France show that this interest is shared by the UK’s partners. This in turn suggests that all parties have a motivation to strike an agreement that minimises disruption relative to the status quo.

On the second issue – the impact on France if it were to leave the EU -the findings highlight the important role EU membership has played in the growth of France’s trade. The effects of France leaving the EU without arranging a future deep FTA would therefore be profound as well, in terms of both goods and services trade. The combined effects of a hard Brexit and hard “Frexit” – the upper

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[3] The computed upper bound for the elasticity of the deep EU-FTA dummy is 0.9. Since the estimation is in logs, we work out the effect of joining as exp(0.9) +1 and the effect of leaving as 1- exp(0.9).

[4] The midpoint elasticity on the deep EU-type FTA is 0.55, which gives joining effects of exp (0.55) +1 and leaving effects of 1- exp (0.55).

bound on losses – would be losses of around $239 billion in exports and $265 billion in imports, or around 28% of the value of total exports of goods and services, and around the same percentage of total imports.

While negotiating a deep FTA is in the interest of all parties, doing so may be challenging for several reasons. First, as explained in a previous bulletin, it would be necessary to negotiate rules of origin between, on one hand, countries that have exited the EU and the EU itself. This adds an administrative hurdle to trade that is not present at the moment. Secondly, it assumes that partners are willing to negotiate on a deep FTA while relenting on matters such as the free movement of people, or the jurisdiction of the European Court of Justice ('ECJ').

Adding to these issues is that, in the French context, the main platform calling for leaving the EU does so on the basis of an overtly protectionist policy stance. Indeed, if the National Front's policy platform is taken at face value, it would involve a substantial withdrawal from many areas of current agreement with the EU: agriculture, free movement of workers and services, tariffs, investment, government procurement, and the jurisdiction of ECJ (not to mention membership of the euro). This is in contrast with the UK's leave campaign which predominantly favoured leaving on the grounds that the UK could pursue trade liberalisation more aggressively than they could as a EU member. One of the ironies in the situation is that the UK leave campaign portrayed itself as a rejection of Brussels "dirigisme", while the French leavers see themselves rejecting an "anglo-saxon"-inspired model of liberalism.

In any event, the key constraints on the National Front's policy platform are in many instances not from the EU but from commitments that France has made via the EU at the WTO. These commitments would still continue to apply following France's departure from the EU since France (like the UK) is a WTO member in its own right. Indeed, it is the ability to trade on MFN terms that provides an upper bound on potential trade losses following an exit from the EU. If the National Front were to apply its platform to the letter, this would require a substantial renegotiation of, or reneging on, WTO commitments, notably on tariffs and government procurement. This would invite changes by trading partners to the conditions of access they apply to French products either as a result of renegotiation, or of retaliation following dispute settlement procedures. This could substantially worsen the projected outcomes for French trade post-exit. While the National Front tries to couch its policy in terms of "intelligent protectionism", the reality is that this is an oxymoron twice over: first because of the costs it imposes on France itself, and secondly because it would invite reactions by partners that deepen these costs,

The push for France to leave the EU can be understood as part of an upswing in nationalist sentiment in a number of industrialised countries, which has combined with hostility toward international trade. The National Front's appeals to "economic nationalism" play to these trends. But while they may have proven to be politically expedient, they run counter to France's own economic self-interest. More generally, to the extent that they contribute to a weakening of the architecture for trade painstakingly put together since the Second World War at the global and European levels, they weaken the institutional frameworks that medium-sized economies such as France depend on for their prosperity and well-being.

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