BREXIT:

A New Challenge to Canada's European Trade Ambitions

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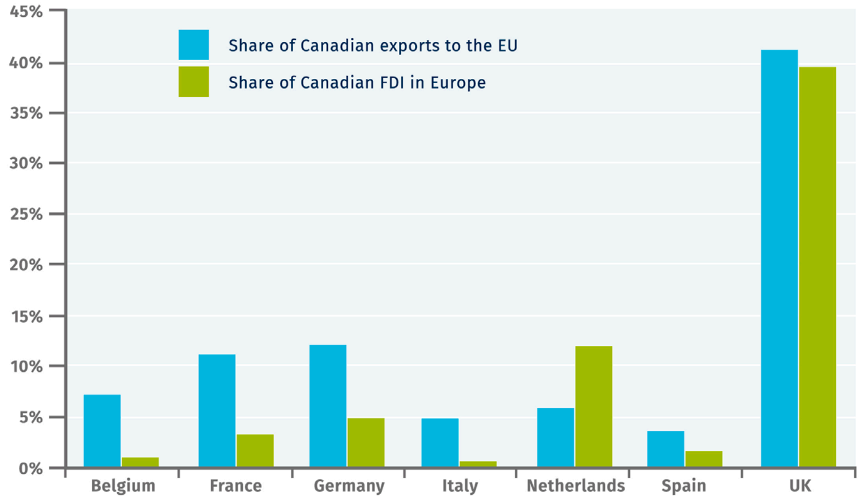
Canada was putting the finishing touches on a free trade deal with Europe when Brexit threw a spanner in the works. The Comprehensive Economic and Trade Agreement (CETA) provides substantial access in goods and services markets, eases labour mobility and opens up public procurement. Some of that access could be clawed back when the UK exits the EU. Not only will Canadian exporters be looking at a new trading relationship with the UK, but Canadian firms that have invested in the UK as a gateway to Europe will be subject to whatever trade agreement the UK and EU can work out.

The UK is Canada's most significant economic partner in Europe—that won't change overnight. However, the contrast between a more open EU market and uncertainty about UK access could see exporters shifting their focus to the continent, and Canadian businesses allocating more investment to the EU economies. CETA therefore comes at an opportune time, opening one door just as another could start to close. That doesn't mean Brexit is positive for Canada—a best-case scenario would see a CETA-like trade deal with the UK, effectively providing the access that was originally negotiated with all 28 EU member states.

Brexit will not be disastrous for the UK. The country's economy held up fairly well after the Brexit referendum, with GDP growth slowing only slightly over the second half of 2016. Activity has further moderated this year, mainly due to the impact of higher import costs on consumer spending. We expect the UK economy to expand 1.4% this year (compared with 2.3% in 2015) and 1.6% in 2018. Losing significant access to the EU could have a negative impact on the UK economy over the longer term, but that is unlikely to have much impact on Canada.

The UK accounts for 40% of Canadian FDI and exports to Europe

% share of European exports/investment, select countries

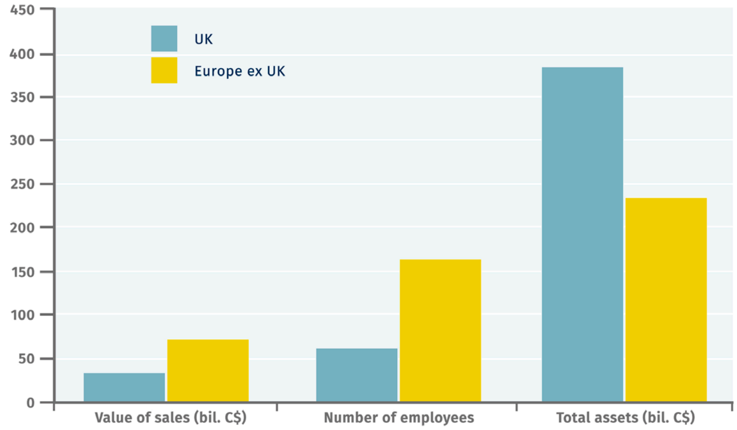


Source: Statistics Canada, RBC Economics Research

Canadian direct investment in the UK is most exposed to Brexit. Brexit will have a greater impact on Canadian firms that have invested directly in the UK than those that simply export goods and services across the Atlantic. Canadian majority-owned affiliates in the UK had $380 billion in assets and 60,000 employees in 2014. They also generated sales of $31 billion, about 40% more than Canada's goods and services exports to the UK that year. The UK is second only to the US in attracting Canadian foreign direct investment (FDI), and Canada's $98 billion invested in the UK accounts for 40% of FDI in all of Europe—even though the UK represents just 15% of the EU economy.

Spending is led by the financial services sector, although other industries have invested billions. Of the Canadian companies generating 10% or more of their total revenue in the UK, the majority are in the financial, industrials and technology sectors.[1]

The UK accounts for a good share of Canada's European affiliate operations
sales/assets in billions of Canadian dollars, number of employees



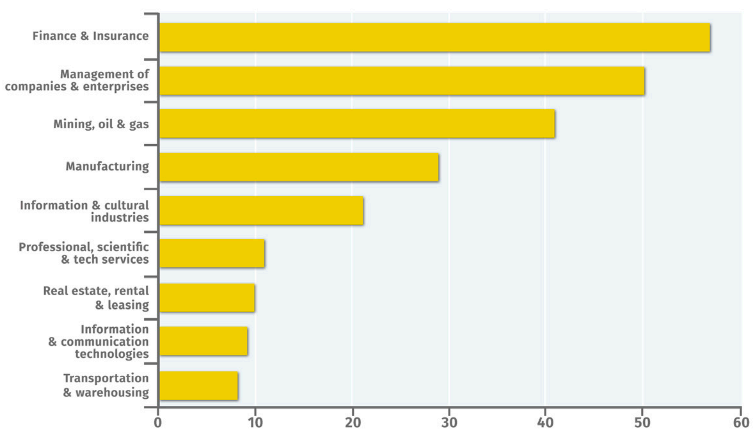
Source: Statistics Canada, RBC Economics Research

Many Canadian firms saw the UK as a springboard for accessing the larger EU market. Numerous factors—a skilled labour force, strong legal system, use of English and historic ties with Canada—have made the UK an attractive base from which to conduct business with Europe. Any loss of access to the EU's Single Market would make the UK a less enticing investment opportunity. That would be as true for Canadian businesses producing goods in the UK for export to the EU as for service providers relying on free movement of professionals.

Passive investors may have second thoughts about the UK. Canadian pension funds have invested heavily in UK infrastructure in recent years. Such deals will be less attractive going forward if Brexit reduces the flow of goods and people between the UK and Europe. Canadian real estate firms that have invested in assets in London could see property values decline if the financial-services hub takes a hit.

Brexit will not cause a mass exodus of Canadian investment from the UK. But it could shift the balance in favour of Europe. Investors seeking a home base that provides access to the EU's Single Market may turn to the remaining 27 EU countries where free movement of goods, services, people and capital are guaranteed, particularly if the UK does not replicate investor protections provided under CETA.

Canadian FDI in Europe is led by the finance & insurance sector
billions of Canadian dollars



Source: Statistics Canada, RBC Economics Research

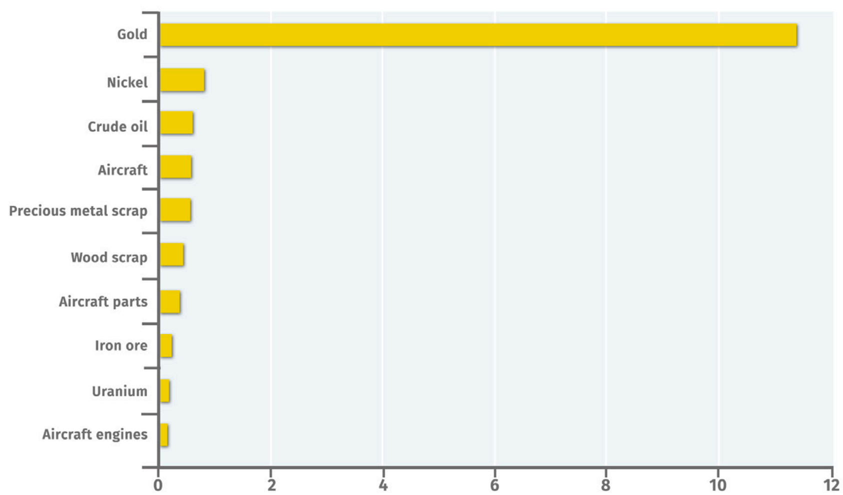
Canadian financial services firms are concerned about losing access to the EU's Single Market. Most of Canada's trade in financial services is conducted through affiliates—in 2014, the sales of Canadian-owned finance and insurance businesses in Europe totaled $6.9 billion, compared with just $1.9 billion in Canadian exports of financial and insurance services to the EU. Canadian FDI in Europe in the sector stood at $56 billion in 2016, and some of the additional $51 billion in investment falling under management of companies and enterprises likely reflects financial institutions using holding companies to set up foreign affiliates.[2] In recent years, nearly a third of Canadian FDI in UK affiliates was in financial services. Each of Canada's big six banks have affiliate operations in the UK, and Canadian pension funds, professional services firms and fintech companies also have a presence.

'Passporting' rights are a significant issue for Canadian financial institutions. Banking services, including wholesale and investment banking, are particularly reliant on the passporting system—nearly one-fifth of the UK banking sector's revenue depends on passport access.[3] Brexit could mean a loss of that access, and even advanced trade deals like CETA have few provisions for opening up cross-border trade or access in financial services. In some cases, such as for the capital markets functions that are central to most Canadian banks' UK operations, establishing regulatory equivalence will allow UK-based firms to continue providing services in the EU. But if equivalence cannot be established or for business lines where that is not an option, financial services firms will no longer be able to fully serve EU clients from the UK and will have to set up or expand operations in the EU, potentially at greater cost and regulatory burden, to gain passport access. Canadian firms may divert future investment to remaining EU countries where establishing a licensed subsidiary, as they have done in the UK, will allow them to provide their services across the continent.

Bilateral goods and services trade with the UK of $40 billion last year was third to Canada's trade with the US ($882 billion) and China ($65 billion). In terms of exports alone, Canada's $25 billion in sales to the UK rivaled its exports to China. The UK is also Canada's most significant trading partner in Europe, accounting for 30% of bilateral trade with the EU. That trade is now governed by CETA, meaning 98% of product lines are tariff free compared with just 25% prior to the agreement's provisional implementation. There is a risk that Canada-UK trade falls back to its pre-CETA framework after Brexit. The UK will be free to negotiate new agreements with its trading partners—Prime Minister Theresa May has already expressed an interest in using CETA as the starting point for a bilateral Canada-UK free trade deal. But absent any agreement, or while a new deal is worked out, Canada-UK trade would fall back on the countries' respective WTO profiles and most favoured nation (MFN) tariff rates. Even what those rates would be is not entirely clear.

Gold dominates Canada's goods exports to the UK

billions of Canadian dollars



Source: Statistics Canada, RBC Economics Research

Brexit is not a big risk to Canada's goods trade. Canadian goods exports to the UK were increasing at a 5% annual rate over the last decade, the best among its developed economy trading partners, prior to CETA's implementation. And much of the goods Canada sends to the UK moved tariff-free prior to CETA and should continue to do so after Brexit. Take gold exports, which have accounted for all of the increase in Canada's goods exports to the UK over the last ten years and now represent nearly two-thirds of Canada's merchandise trade to the UK. Those shipments, which reflect London's status as gold trading and storage hub, are unlikely to face tariffs under the UK's MFN profile. A number of other raw material exports to the UK—nickel (~5% of exports), crude oil (~3%) and wood scrap (~2%)—should continue to be tariff free.

Certain manufactured products and processed goods could be subject to tariffs after Brexit. Some machinery and equipment exports (~5% of goods exports to the UK) faced tariffs in the range of 4-5% prior to CETA, and aircraft and parts (~4%) were generally subject to tariffs around 1.7-2.7% and as high as 7.7% for some products. While those product lines are now tariff-free under CETA, tariffs would be reinstated if Canada-UK trade reverted to MFN rates. And other trade sectors will miss out on some of the opportunities afforded by CETA. Tariff elimination on agricultural and fisheries products and tariff quota access in beef and pork would have allowed for greater market penetration in sectors where Canadian exports to the UK are relatively small.

A return to pre-CETA MNF tariff rates on Canada-UK trade would not be disastrous given the makeup of Canada's goods exports. CETA only entered into force on a provisional basis on September 21, 2017, so the UK's exit would be a return to the recent status quo. However, CETA also helps facilitate trade via improved regulatory cooperation and other mechanisms, benefits that Canadian exporters to the UK will miss out on after Brexit. So as with investment, fewer barriers to EU trade alongside less favourable conditions for exports to the UK could see Canadian producers shift their focus toward the remaining EU countries. Only an ambitious trade deal between Canada and the UK, or a transitional agreement that maintains CETA's provisions, would keep the playing field level.

The impact of Brexit on Canadian trade is a services story. Canada's services exports to the UK have increased at just half the pace of its goods exports and underperformed relative to services trade with other economies. CETA will help with that—it opens the EU's services market to a greater extent than any previous trade agreement.[4] The agreement uses a negative list approach to services, meaning Canadian service providers will have a level playing field with their EU counterparts in all areas that are not explicitly excluded. But the UK will no longer be bound by that commitment after Brexit, allowing for barriers to be imposed in areas like commercial services—including financial and management services, research & development and technical services—that make up about two-thirds of Canada's services exports to the UK.

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Services industries will be affected by loss of access to the UK market and any restrictions on free movement of professionals. CETA eases labour mobility, making it easier for Canadian firms to temporarily move staff between Canada and the EU and for professionals to temporarily provide their services in the EU. It also facilitates mutual recognition of some professional qualifications. If those provisions are not featured in a new Canada-UK trade deal, Canadian professionals would have less access to the UK after Brexit—again making the EU a relatively more attractive trading partner. Finally, CETA provides greater access to public contracts at many levels of government, including member states and regional and local government entities. Any restrictions on access to the UK's £242 billion public procurement market after Brexit would represent a significant lost opportunity for Canadian companies.[5]

The bottom line: the centre of gravity could shift to the continent. Canada and the UK have significant ties in trade and investment that account for about 40% of Canada's relationship with the EU—well above the UK's 15% weight the EU economy. That relationship will be impacted on several levels by the UK's exit from the EU. Depending on the UK's future trading arrangements with the EU, Canadian businesses that have invested in the UK as a base for European operations might have to set up shop on the continent to avoid losing some access to the EU's Single Market. That is particularly true in financial services, where loss of 'passport' access might limit firms' ability to serve EU clients. For international trade, the UK's exit from CETA won't significantly disrupt the current flow of goods and services, but it increases the relative attractiveness of the remaining EU member states where access will be greater under the new trade agreement. The assurances on EU market access and investor protections provided by CETA, in contrast with uncertainty about the UK's position post-Brexit, could see Canadian exporters and investors focus more on the continent than they have in the past.

1 RBC Capital Markets, "The UK opts for Brexit", June 24, 2016.
2 The Conference Board of Canada and Toronto Financial Services Alliance, "Examining the international footprint of Canada's financial services sector", December 2014.
3 Open Europe, "How the UK's financial services sector can continue thriving after Brexit", October 2016.
4 Government of Canada, "Agreement overview", June 20, 2017.
5 House of Commons Library, "Public procurement", July 3, 2015.