Global Counsel

The future of UK trade policy: the case for regulatory diplomacy

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Summary

It is widely accepted that services, and financial services in particular, are a key comparative advantage of the UK. A full quarter of UK services exports are financial or insurance services. This is an asset and a liability. Much of this financial services trade is potentially exposed to the impacts of Brexit, where the loss or roll-back of the EU passporting regime for the UK would impact materially. Outside of the EU, these are the sectors for which market access is often patchy or constrained and where conditions of local regulation are often key to UK firm performance. These factors make a trade policy customised to opening up and deepening export markets for UK services a priority for the UK. So what might that mean in practice?

It is widely accepted that services, and financial services in particular, are a key comparative advantage of the UK. To greater or lesser effect, the UK has long been a champion of liberalisation of this kind of services trade, both within the EU single market and globally. If London is to build an autonomous trade policy outside the EU, services trade will be central to it, and financial services especially so. So what might that mean in practice?

This is an important practical question for London. The UK's trade balance is heavily shaped by services exports. A full quarter of these services exports are financial or insurance services. This is an asset and a liability. A large trade surplus in such services suggests a clear comparative advantage. But much of this financial services trade is also potentially exposed to the impacts of Brexit, where the loss or roll-back of the EU passporting regime for the UK would impact materially. Outside of the EU, these are the sectors for which market access is often patchy or constrained and where conditions of local regulation are often key to UK firm performance. These factors make a trade policy customised to opening up and deepening export markets for UK services a priority for the UK.

Open in practice, closed in principle

UK services export markets and emerging markets for financial services in particular can often be closed in principle but open in practice. This quirk is the result of a strong preference over the last three decades for unilateral liberalisation in banking and insurance in emerging markets, but not for binding this liberalisation in WTO GATS schedules. Two political factors explain this. First, an unbound liberalisation can be reversed if political or policy needs dictate. Second, because FTAs on services signed by these countries are expected to use GATS commitments as a baseline, keeping that baseline low also has a tactical value. The net result is that at no point since the inception of WTO negotiations on services in 1986 have total binding commitments offered multilaterally by the WTO membership even got close to what they actually provide in practice. In thirty years of trying, there has yet to be a serious prospect of actual new services trade liberalisation at the WTO level.

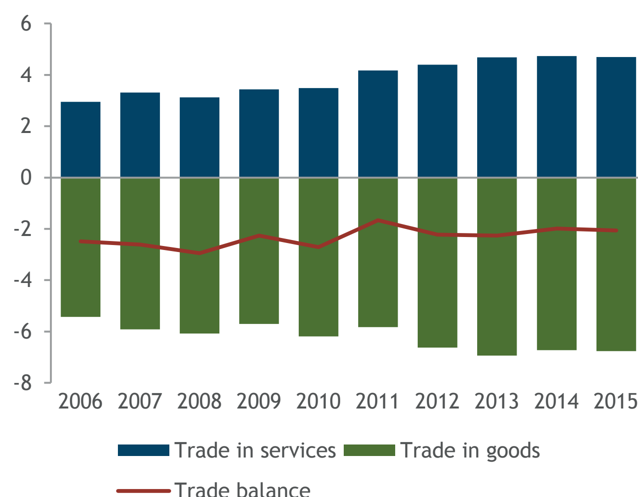

Fig 1. The UK trade balance, % of GDP
Source: ONS

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For businesses, this has often made the value of services trade negotiations seem academic: if markets are open in practice, does it matter that states reserve the right to reverse that openness in principle? Clearly it can. When Indonesia began debating foreign ownership in its revised insurance law during one of its recurrent moods of economic nationalism in 2014, its freedom to contemplate lowering the permitted levels of foreign ownership from 80% to less than 50% was enabled because its 2008 expansion of foreign ownership rights had never been bound. This policy uncertainty over market access can have a material impact on investment and export decisions of UK service providers, especially in the case of sectors with comparatively long-term investment horizons, such as life insurance or telecoms.

One aim of future UK FTAs should be not just to increase UK access to markets in valuable areas - such as public procurement, construction services and business services - but to drain some of this scope of policy adventurism from the system for UK firms by binding market access rights in these agreements. Because financial services are overwhelmingly delivered through local establishment in export markets, rules of majority ownership and control by foreign providers are disproportionately important here. The 2012 Australia-Malaysia FTA is a good example of how a bilateral deal can provide useful new certainty for firms on questions of majority ownership, or rights to expedited licensing processes, even if it does not immediately change the reality on the ground.

Beyond deals

Beyond these basic conditions of establishment and foreign ownership, the key interests of UK services exporters are generally in the day-to-day realities of local regulation and regulatory practice. These things can be much harder to tackle in trade deals and generally require a different approach. A few things will be important for the UK to focus on.

The first is simply continuing to encourage the process of unilateral reform and liberalisation that has ultimately been the key driver of expanding market access rights for UK firms over the last three decades. This might sound like a quixotic aim for trade policy, but unilateral opening has ultimately provided more opportunity for UK financial services firms since the 1980s than all trade agreements combined. Deepening capital markets to reduce reliance on local banks, encouraging the development of mobile banking services to leapfrog weak branch networks and grow financial inclusion, and encouraging insurance market capitalisation and consolidation to deepen penetration levels for basic insurance products are all entirely domestic development reforms on which UK firms have piggy-backed in Asia and Africa over the last two decades.

In all of these cases, strong but undogmatic regulatory dialogues can play a role in encouraging and consolidating domestic reform. The recent fintech bridge initiatives by the UK FCA are good examples of how engagement can potentially provide alternative routes for trade policy via the underused channels of regulatory diplomacy. Even where they are already strong, Brexit is likely to add an important new dimension to this, as the UK will need to develop its own formal systems for recognising – among other things – the banking and insurance standards, market infrastructure standards and data protection adequacy standards of many of its more advanced emerging economy trading partners. These assessments can make a material difference to UK firms with global operations at the level of prudential regulation and operational freedom. If the UK is able to preserve anything like its current access to the European single market for financial services, it will also need to be built on exceptionally close and effective regulatory cooperation. Even if it is heavily rolled back, this will still matter.

The second is a willingness to focus on day-to-day operational irritants for UK FDI in markets where firms are already established. FTAs can be useful in establishing a clear baseline of expectations in transparent and non-discriminatory regulation and practice for services exports, but most of the value of these sorts of agreements is in the after sales service and enforcement. The US State Department has always been notably persistent and strong on this sort of follow up and firefighting, where the EU trade diplomacy network has been under-resourced and undervalued at the centre in Brussels - often in part because EU firms will try to seek recourse for commercial irritants through their own embassies.

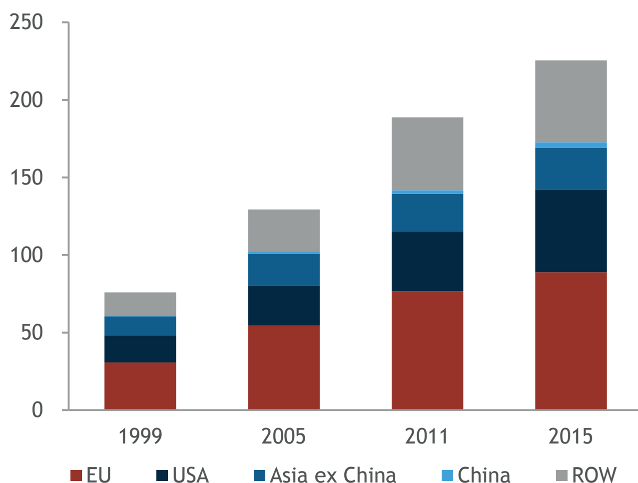

Fig 2. UK services exports (£ billions)
Source: ONS

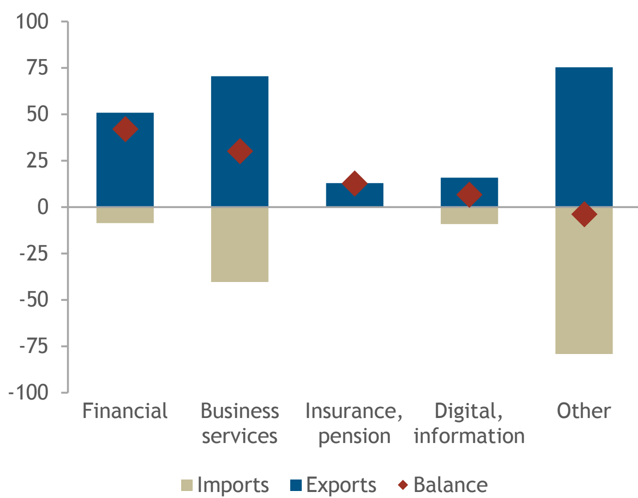

Fig 3. UK trade in services by sector, 2015 (£ billions)
Source: ONS

Regulatory diplomacy as trade policy

Conventionally, trade policymakers in services have seen their core role as getting their firms over the border via widening and locking-in establishment rights. Unilateral reform in many developing markets can make this seem redundant for businesses. Domestic reformers in export markets have, in the end, proven much better than foreign negotiators in opening markets for UK services firms over the last twenty years. However, as noted above, there is still a valuable role for bilateral and multilateral trade agreements in putting a ratchet in this reform and holding countries to their liberalisations. FTAs also play an important role in establishing core common principles and commitments to liberalised access and operation that are an important point of reference for commercial diplomacy. This is easily underestimated.

However, precisely because most services trade is conducted from inside the market of a trading partner, UK trade policy will always need to have a strong focus on conditions of operation and regulatory diplomacy. Building the UK's capacity therefore means focusing not just on hardball trade negotiators and dealmakers, but also on the ability of regulatory diplomats to build long-term collaborative relationships in markets where the UK presence is already established or aiming to grow.

The establishment of long-term regulatory cooperation frameworks with emerging markets can also, in turn, serve as an important asset in future FTA negotiations, not least by building valuable political capital for the UK. More practically, in helping emerging markets tackle important regulatory capacity deficits in services, and financial services in particular, the UK would also be addressing a key – and legitimate – concern often raised by emerging markets about opening markets and refusing to bind current levels of market access in trade agreements or regulatory quality.

If there is a weakness in both of these forms of regulatory diplomacy it is of course in the difficulty of ring-fencing subsequent gains for UK firms. This is simple via a preferential tariff cut or bilateral binding of higher levels of majority ownership, but largely impossible at the level of generalised improvements in operating conditions.

However, this can be overstated, especially where UK firms are already established in markets with sufficient branching and distribution networks that give them an important first mover advantage. Greater convergence with the UK's regulatory framework also facilitates the obtaining of operating licenses by UK firms and compliance with local regulatory requirements. A well-functioning and level playing field is generally better for UK firms than a badly functioning one.

One key conclusion from this is that for "trade policy" to be properly understood it will need to be conducted by the UK Treasury, the Bank of England and other UK regulators alongside their counterparts from a future UK trade ministry. Ideally this work will be closely integrated. Most OECD trade policy bureaucracies were built on and around the trade policy problems of the early GATT era – tariffs, quotas, bilateral and multilateral deals. All of these things will matter for the UK. But UK trade policy will also be shaped by services and service markets and the regulatory landscape of its trading partners. It will need an approach to match that.

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