

# NO MORE “BUSINESS AS USUAL”

The refrain “what a difference a year makes” does not even begin to capture the tectonic shifts in the transatlantic economy since our last annual survey. The decision by the United Kingdom to quit the European Union (“Brexit”) and the election of Donald Trump, an anti-establishment economic nationalist, as the 45th president of the United States, has rocked the very foundation of the transatlantic partnership at a time when the European Union is besieged by a daunting array of simultaneous challenges, from terrorism and refugee streams to tensions with Russia, turmoil across neighboring North Africa and the Middle East, and populist pressures at home.

The entire global economy has been thrown off kilter by the stunning events of the past year. The liberal economic order of the past seven decades now rests on some uncertain transatlantic foundations.

## Brexit and the Transatlantic Triangle

British Prime Minister Theresa May has made it clear that her government intends to take the UK out of the European Union (EU) and to end its participation in the EU’s Single Market for goods, services, people and capital as well as from the customs union for goods. She will not pursue partial or associate EU membership, nor will she seek special arrangements similar to those Norway and Switzerland have with the EU.

## Next Steps for Britain

The UK must not only negotiate its exit from the EU, it will also have to do three things that will affect U.S. and wider European economic interests. First, it will have to replace the EU’s common external tariff with its own customs tariff, and will also need to submit new tariff commitments for both goods and services at the World Trade Organization (WTO). Second, it will negotiate new trade arrangements between the UK and the EU 27. Third, it will want to negotiate new trade arrangements with the United States as well as many other non-EU countries.

Since the UK government does not seek to maintain its participation in the EU’s Single Market, it will need to

negotiate a new trade and investment agreement with the EU. Given the complicated issues and procedures involved, it is likely that such a new agreement would only take effect sometime in the middle of the next decade. This means there is likely to be a period of transition that could last as much as six years. Both parties will also have to negotiate trade and commercial arrangements for this transitional period.

A future UK-EU trade arrangement is unlikely to simply replicate UK access to the Single Market. The terms are likely to be less advantageous. While tariff-free access for goods is likely, firms based in the UK are likely to face some local content requirements within the EU. It is unlikely that there will be tariff-free access for services. UK financial services in particular are likely to lose their current right to “passport” financial services to the rest of the EU. Each of these provisions — as well as related provisions to be negotiated during the transition period — are likely to affect U.S. companies and banks with affiliates in the UK.

## What do these developments mean for the United States and a U.S.-UK deal?

First, EU rules mean that London cannot legally begin negotiating a trade deal with Washington before the UK leaves the EU, which at the earliest will be March 2019. When Washington sets out to negotiate a formal bilateral deal with the UK, it will want to understand the UK’s new WTO commitments and the nature of UK-EU transitional arrangements following Brexit, as well as London’s end goals with regard to a deal with the UK’s largest trade partner, the EU. This will all take time.

However, Washington and London can and are likely to move ahead with two types of discussions. Initially, the two sides intend to start on what the White House and the Prime Minister’s office are calling a “trade negotiation agreement” that identifies potential stumbling blocks and scopes what could be done before the UK leaves the EU. Based on these discussions, U.S.-UK “shadow” negotiations could create a basic framework for an agreement once such an agreement can be negotiated

officially, and to understand how UK-EU arrangements would also affect U.S.-UK considerations during what may be a six-year transitional period. That would mean getting a jump start on the negotiations while respecting the Brexit and WTO processes.

### Where Does Europe Fit?

The United Kingdom is a critical economic partner for the United States, and the U.S. should ensure that bilateral ties are strengthened, rather than disrupted, by Brexit. But America’s significant commercial and financial presence in the UK has been premised in large part on UK membership in the European Union — the largest, wealthiest and most important foreign market in the world to U.S. companies. For decades, the UK has served as a strategic gateway to the European Union for U.S. firms and financial institutions. The primary motivation of many U.S. companies to invest in the UK has not been to serve only the UK market but to gain access to the much bigger EU Single Market. Similarly, many U.S. banks and financial institutions have relied on “passporting” via London to access the Single Market. U.S. affiliates based in the UK export more to the rest of Europe, in fact, than U.S. affiliates based in China export to the rest of the world.

Just as the U.S. has an interest in ensuring that Brexit does not damage its strong commercial interests with other European countries, so too does the United Kingdom. The UK exports almost half of its goods and services to the EU — twice as much as to the U.S.

In short, as the UK and the U.S. pursue their exploratory discussions over a new set of economic arrangements, each is likely to have its own economic relationship with the EU in mind. Since many U.S. companies are based in the UK because of its role as a gateway to the Single Market, U.S. negotiators will want to know how open, wide and strong that gateway will be after Brexit. And while the UK will want to move quickly ahead with a deal with the U.S., it is also likely to condition its efforts on the nature of its parallel negotiations with the EU.

### The Negotiations Triangle

Brexit has huge implications for each point on the transatlantic triangle — relations between the UK and the EU, links between the UK and the U.S., and ties between the U.S. and the EU. The data we present in this annual survey underscore the vital interest each of the three major actors has in ensuring that each leg of this transatlantic stool remains strong and sturdy, particularly as the winds of global competition intensify.

### What would be the major issues in a U.S.-UK deal?

Agreeing on reductions in traditional trade tariffs is not likely to be very troublesome, since most tariffs are already quite small, with a few notable exceptions, such as agriculture. The much bigger gains from a bilateral deal would come from

- » reducing barriers to services, the “sleeping giant” of the transatlantic economy and where job gains are likely to occur;
- » recognizing that various regulatory procedures in one country essentially conform or are equivalent to those in the other country;
- » pioneering standards in new economic areas that could push the global frontier.

Keeping this in mind, in each of these tracks both the U.S. and the UK have more to gain from achieving some agreement with the EU than simply with each other, each will want to ensure that whatever agreements they reach with each other serve to strengthen, rather than disrupt, their more significant commercial connections with the EU. Similarly, the EU will want to ensure that a U.S.-UK agreement, as well as any separate arrangements it may advance with the U.S. and with the UK, will enhance its own economic ties with two of its most significant economic partners.

The intertwined nature of UK-EU, U.S.-UK, and U.S.-EU negotiations can be best understood by looking at financial services. When the UK leaves the EU, financial services institutions based in the UK will lose their “passport” to provide services across the Single Market. This will not only disrupt the UK financial services industry. Many U.S. banks and other financial services companies established a presence in the UK to take advantage of passporting via the City of London to access the Single Market. Unless similar provisions are incorporated in any new UK-EU arrangements, many of these U.S. firms will probably choose another entry point to access the Single Market in the future. This will make a huge difference with regards to London’s role as a financial hub, may accelerate the rise of other European financial centers, for instance Frankfurt, and will reinforce U.S. interest in strong and predictable financial services procedures with the EU. It will also affect the U.S. approach to financial services in any U.S.-UK arrangement. The EU has established an “equivalence” regime that extends limited access rights to non-EU countries, such as the U.S., that have rules that have been deemed “equivalent,” but this is a relatively new and somewhat inconsistent approach with rights that are weaker than those granted under full “passporting.”

With these considerations in mind, U.S.-UK discussions could productively focus on three lines of discussion/negotiation: market access, regulatory cooperation, and ‘rules’.

- » Market access discussions would focus on goods trade and customs duties; services trade; public procurement; and clear, simple and aligned rules of origin.
- » Discussions regarding regulatory cooperation would address issues of regulatory coherence; technical barriers to trade; sanitary and phytosanitary questions; and good practice in a range of sectors, from medical devices and chemicals to vehicles, pharmaceuticals, and financial services.
- » Discussions of “rules” could encompass such issues as intellectual property, digital trade, or state-owned enterprises that could create standards as orientation for many other countries around the world.

U.S.-UK discussions along these three lines would be compatible with the way the UK is likely to conduct its relations with the EU, and would be similar to how the U.S. and the EU have been conducting their own negotiations. In sum, this three-track framework (market access, regulatory cooperation with individual sectoral agreements, rules) could offer common orientation at each point of the transatlantic triangle — U.S.-UK, UK-EU, and U.S.-EU.

### **A North Atlantic Initiative for Jobs and Growth?**

This means that the U.S. and its partners should champion a multi-channel transatlantic economic initiative — a North Atlantic Initiative for Jobs and Growth — that generates synergies rather than competition among a

new U.S.-UK economic relationship and both post-Brexit UK-EU and U.S.-European ties. As the U.S. and UK move forward with their own discussions, the U.S. should also move ahead with a new agenda with its own European allies and partners as well.

To complete the negotiations triangle, the United States and the EU need to assess prospects for their own trade and investment framework. An immediate revival of the U.S.-EU Transatlantic Trade and Investment Partnership (TTIP) is unlikely, given a series of important European elections in 2017 in which trade is likely to be a contentious issue, as well as the fact that the two parties failed to complete negotiations on a Transatlantic Trade and Investment Partnership (TTIP) during President Barack Obama’s term, and that President Trump has canceled U.S. participation in the Trans-Pacific Partnership (TPP), initiated efforts to renegotiate NAFTA with Mexico and Canada, and has been cool to ambitious bilateral efforts with the EU, which he calls “the consortium.”

But at an early date the United States and the EU could issue a political statement affirming the value of transatlantic economic ties and a mutual commitment to strengthen the transatlantic economy, and use the Transatlantic Economic Council to move forward in areas where progress has already been registered or is likely.

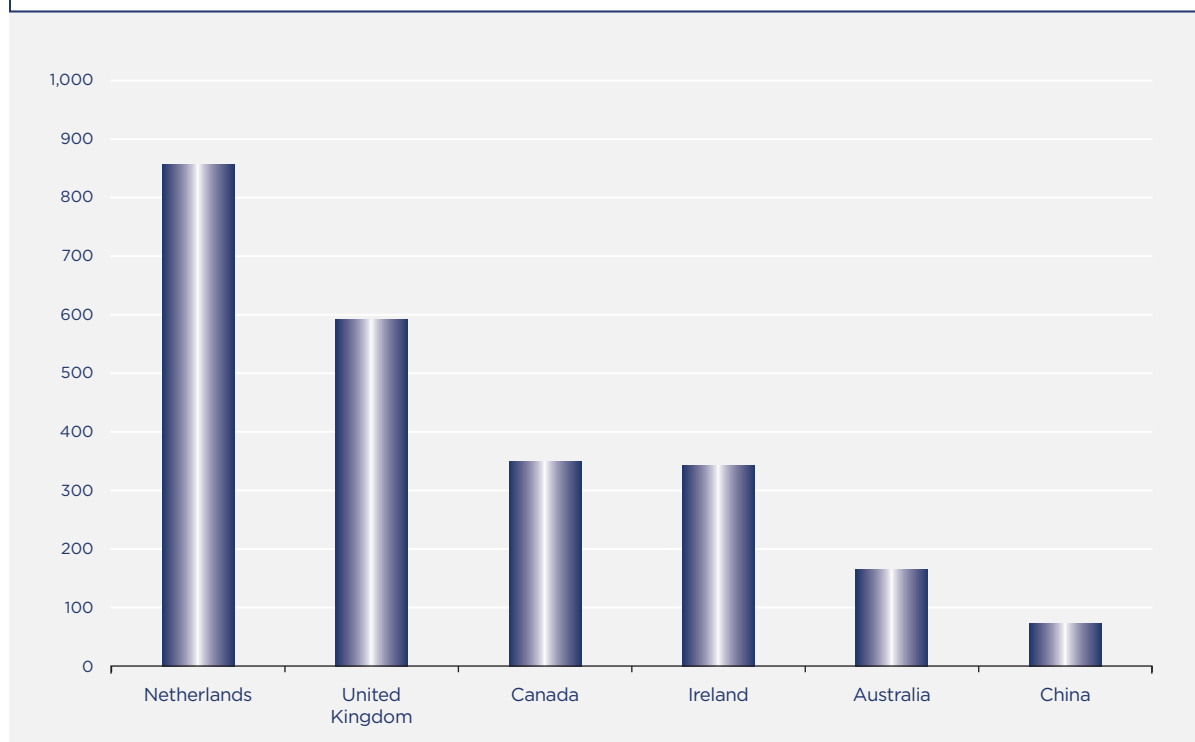
A multi-channel transatlantic economic initiative that generates synergies rather than competition between a U.S.-UK trade agreement and both post-Brexit UK-EU and U.S.-European ties is ambitious. It will be tough to manage and conclude. But the potential payoff is high, and the geostrategic impact of such an initiative could be as profound as the direct economic benefits.

## The Economic Special Relationship

The United Kingdom is a critical economic partner for the United States. Bilateral trade flows are strong. In 2015 the United States exported \$123.5 billion in goods and services to the UK, and imported \$111.5 billion worth of British goods and services. The United States is Britain's largest export destination after the EU.

U.S.-UK trade is significant. But the real driver of the British-American economy is investment. In 2015, U.S. foreign direct investment in the UK totaled a record \$593.0 billion and UK foreign direct investment in the U.S. totaled \$483.8 billion. Estimated sales of American affiliates in the UK and British affiliates in the U.S. totaled more than \$1.3 trillion. The UK accounted for 22% of overall global U.S. assets outside the United States. U.S. investment flows to the UK rose by nearly 30% in the first nine months of 2016, compared with the same period a year ago. UK affiliates domiciled in the United States improved the U.S. trade balance by exporting \$73 billion worth of goods from the U.S. in 2014.

**TABLE 1: TOTAL U.S. OUTWARD FDI POSITION (AKA STOCK) (BILLIONS OF \$, 2015)**



Source: Bureau of Economic Analysis.  
Data as of January 2017.

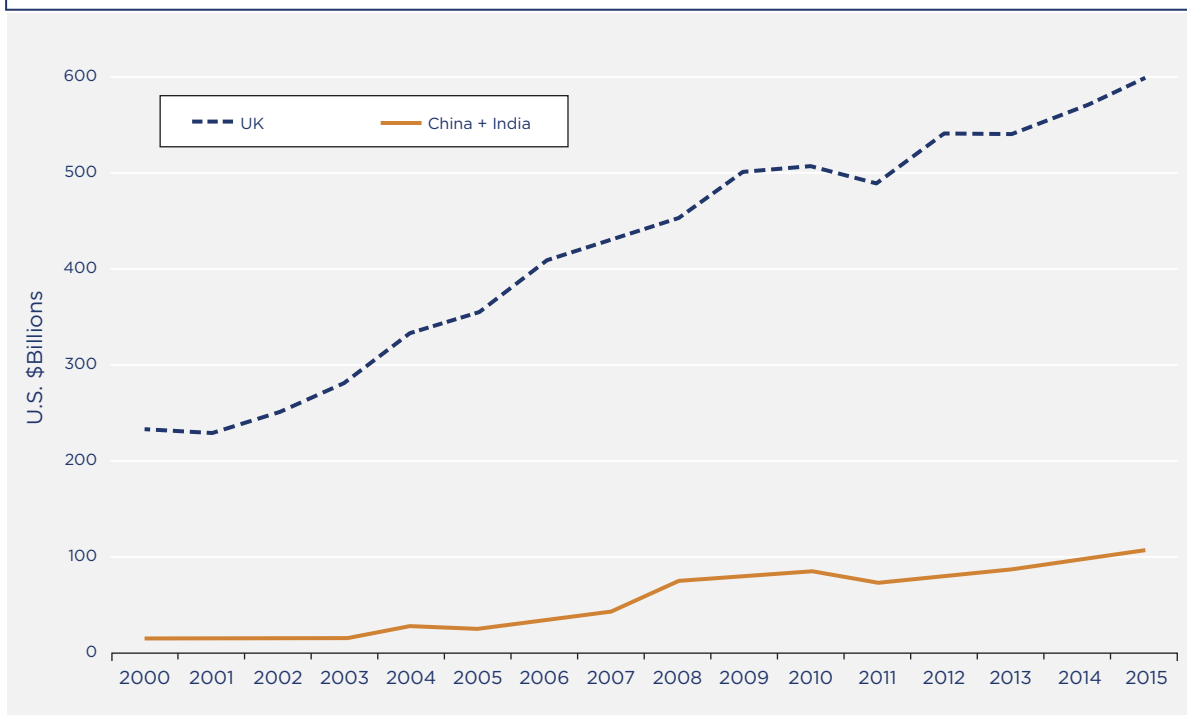
U.S. affiliates employed almost 1.4 million workers in the UK while UK affiliates employed roughly 1.1 million Americans, according to 2015 estimates. British firms were the #1 source of onshored jobs in 25 of the 50 U.S. states in 2014.

After the Netherlands, America's corporate stakes in the United Kingdom are among the deepest in the world (Table 1). Totalling \$593 billion in 2015, the last year of available data, America's capital stock in the UK is more than double the combined U.S. investment in South America, the Middle East and Africa (\$244 billion). Total U.S. investment stock in China was just 13% of the comparable figure in the United Kingdom in 2015.

Even when the U.S. investment position of China and India are combined—roughly \$103 billion in 2015—the figure is just 17% of total U.S. investment in the United Kingdom (Table 2).

Wealthy consumers, respect for the rule of law, the ease of doing business, credible institutions, membership to the European Union—all of these factors, and more, have long made the UK a more attractive place to do business for American firms than either China or India.

**TABLE 2: AMERICA'S PREFERENCE FOR THE UK VS. CHINA AND INDIA - U.S. DIRECT INVESTMENT POSITION\***



\*U.S. Foreign Direct Investment (stock).  
Source: Bureau of Economic Analysis.  
Data as of January 2017.

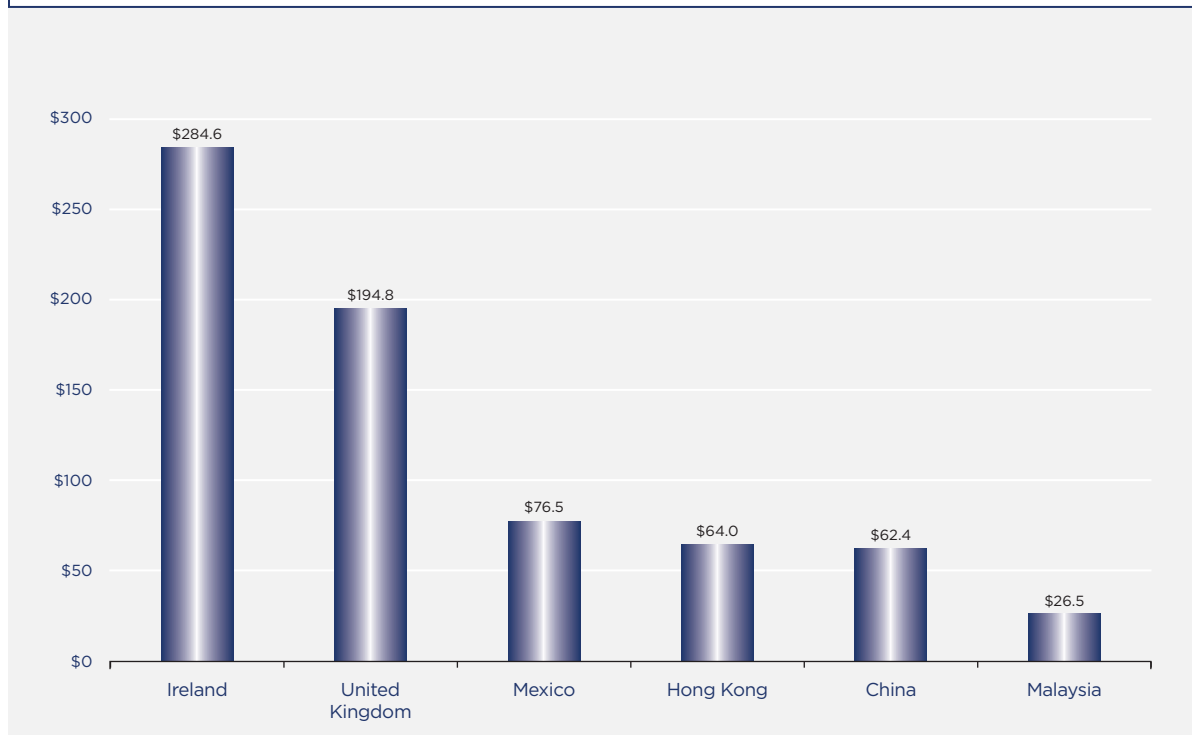
**TABLE 3: OPERATIONS OF U.S. FOREIGN AFFILIATES IN THE UK\***

	Billions of \$	% of Global Total	Rank
Total Assets	5,392	21.6%	1
Value Added (Output of Affiliates)	172	11.6%	1
R&D	6	12.1%	2
Capital Expenditures	22	9.1%	2
Foreign Affiliate Sales	668	10.4%	2
Employment (thousands of employees)	1,349	9.8%	2
Manufacturing (thousands of employees)	311	5.8%	5

*\*Data for Majority-Owned Foreign Affiliates, 2014.*

*Source: Bureau of Economic Analysis*

*Data as of January 2017.*

**TABLE 4: CORPORATE AMERICA'S FAVORITE EXPORT PLATFORMS\* (BILLIONS OF \$, 2014)**

*\*Exports of U.S. Foreign Affiliates.*

*Source: Bureau of Economic Analysis.*

*Data as of 2016.*

**TABLE 5: WHERE THE PROFITS ARE MADE IN THE WORLD: TOP FOREIGN MARKETS FOR U.S. FOREIGN AFFILIATE INCOME**

Rank	Country	2000-3Q2016 (\$ Billions)	% of World Total*
1	Netherlands	798.7	17.1%
2	United Kingdom	418.6	9.0%
3	Ireland	410.5	8.8%
4	Switzerland	280.9	6.0%
5	Singapore	255.7	5.5%
6	Japan	147.6	3.2%
7	Mexico	136.8	2.9%
8	Australia	117.2	2.5%
9	China	100.5	2.2%
10	Hong Kong	89.4	1.9%

*\*Excluding Caribbean and Other Western Hemisphere.*

*Source: Bureau of Economic Analysis.*

*Data as of January 2017.*

Whatever the metric—total assets, R&D expenditures, foreign affiliate sales and even affiliate employment—the United Kingdom is a key pillar of America’s global economic infrastructure and a key hub for the global competitiveness of U.S. firms. Since 2000, the UK has accounted for nearly 9% of the cumulative global income of U.S. affiliates, a proxy for global earnings. The UK ranks number one in the world in terms of U.S. foreign affiliate value added (or output). The output of U.S. affiliates in the UK totaled \$172 billion in 2014, about the same as the entire GDP of Vietnam or Ukraine (Table 3). U.S. affiliates in the UK produced three times more than U.S. affiliates in China.

The bulk of U.S. foreign affiliate sales in the UK, in other words, are for the local market, but the export-propensity of U.S. affiliates in the UK is hardly inconsequential. Indeed, while outranked by nearby Ireland, U.S. affiliate exports from the UK still totaled over \$190 billion in 2014, the last year of available data. That figure is more than double U.S. affiliate exports from Mexico and over three times greater than U.S. affiliate exports from China—two lower-cost nations more closely associated with U.S. affiliate exports (Table 4).

On a standalone basis, what U.S. affiliates export from the UK each year is greater than the total exports of most nations. Such is the export-intensity of U.S. affiliates in the UK; how U.S. firms leverage the UK’s access to the European Union is best seen through trade flows.