# An Indispensable Relationship: Economic Linkages between the UK and the rest of the European Union

[a report by Oxford Economics commissioned by Business for New Europe]

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# Forewords for Oxford Economics Report

**Roland Rudd, Chairman, Business for New Europe**

Last year, the UK marked 35 years of EU membership. Our relationship with the EU has been characterised by ambivalence and even antipathy at times. However*,* it is widely acknowledge*d* that the impact of the UK's growing relations with Europe has been remarkable and far-reaching, despite our periodic semi-detached approach to the continent.

This report, commissioned by Business for New Europe and *produced* by Oxford Economics, highlights many of the important economic linkages between the UK and the rest of Europe. It reveals the extensive trade, capital, investment, labour market and other flows between the UK and the continent. In so doing, it sheds light on the umbilical cord linking the UK with mainland Europe and the way our economies are increasingly dependent on each other for their well-being. The report emphasizes that despite not being a member of the euro, there has been a quiet economic "Europeanisation" of the UK.

While this year has started with the inauguration of President Obama and global efforts to tackle the credit crunch, it will end with a focus on the climate change negotiations in Copenhagen. Both the issues of the economic downturn and that of tackling global warming require international cooperation and the EU has been playing a leading role in meeting these challenges. European cooperation on banking bail-outs and fiscal stimulus plans has placed the EU *at the* centre stage *of the response to* the financial crisis, and the UK been a leading player on the European stage. By seeking cooperation with our European partners, the UK will be better able to help the recovery in its and Europe's economy.

We hope that this report serves as a statistical resource and an economic blueprint for anyone wishing to discover more about the UK's relationship with the rest of the EU. We are delighted that Accenture and Deutsche Bank supported the project, and that Clifford Chance and Vodafone wished to be associated with it. I would like to thank Oxford Economics for carrying out the research in such a professional and meticulous manner, and hope that it serves as a useful guide for politicians, researchers and students.

**Lord Aldington, Chairman, Deutsche Bank London**

As part of Deutsche Bank's commitment to the City of London, and the UK and European Economy, we are happy to have been able to support BNE in this major study by Oxford Economics.

**Vernon Ellis, International Chairman, Accenture, 1999-2008**

**Mark Spelman, Global Head of Strategy, Accenture**

In 1998, Accenture produced for the European Movement a pamphlet entitled Britain, Business and Europe: the first 25 years. The study revealed just how much Britain's external economic relations had changed in the years since Britain had joined the EEC. Deeper economic integration with her European partners—born of larger and more complex forms of trade and investment—was the hallmark. Equally obvious was the bridge that EU membership had provided to and from the world beyond. The report also described a virtuous circle of competitiveness: open economies and well-regulated markets keep businesses on their toes, reinventing business models and management approaches, increasing the growth potential of the economy and renewing pressure for continued market access and reform.

Eleven years on, these European hallmarks remain probably the most important imprint on the British economy. Yet the world seems both larger and smaller. Larger, because the manifest rise of a multi-polar global economy has eclipsed the old debates that saw Europe or the rest of the world as alternatives. Smaller, because the contagion of financial overstretch made possible by the globalisation of capital flows is now weighing heavily on growth everywhere. Many economic assumptions and policy positions are up for grabs. It is, then, perhaps an ideal moment for non-partisan, level heads once again to research and describe the benefits of Britain's relationship with the rest of Europe. The need for fresh evidence and analysis of the benefits of economic interdependence, near and far, is continual. Indeed, the output may even provide food for thought as policymakers seek appropriate reforms to global capital markets and globalisation more generally—something for which the European project was arguably a forerunner.

Accenture is pleased to support BNE in this study by Oxford Economics. Much of the economic activity it describes takes place in UK companies, large and small. The report is an important contribution to the bank of knowledge from which they can draw as they set and update their business strategy.

CLIFFORD
CHANCE

**Stuart Popham, Senior Partner, Clifford Chance LLP**

A well functioning and dynamic EU is extremely important for us, as my firm has 17 offices in the European Union and we employ 5,230 people in Europe, including someone from every EU member state. Turnover from our European offices represents over 75% of our global business.

At the heart of the UK's relationship with the rest of Europe is the single market. Over 50% of Britain's exports go to the EU, more than three times those to the US. And the UK is an important market for our EU partners. French President, Nicolas Sarkozy told the UK Houses of Parliament in March 2008: "We cannot build a prosperous, effective Europe without the United Kingdom". We agree.

In recent months, attention has necessarily focused on the global economic downturn and the interconnected nature of markets. Faced with a new reality, there is important work to be done by the EU as we look ahead. The services directive will be implemented in 2009 and should make it easier to trade services across European borders. It is forecast to boost UK GDP by £4-6 billion per year, and create up to 80,000 jobs in the UK.

The coming years will be particularly significant for the European Commission. In harsh economic circumstances, companies and consumers need to know that they can continue to benefit from the opportunities offered by the single market. Competition distortions resulting from actions of member states or companies would carry huge economic risks. The Commission must continue to wield its power, acting as arbiter between these players to make markets work.

And we, as market participants must continue to engage with decision and policy-makers so that - together - we can find a solution to the new challenges that lie ahead.

**Vittorio Colao, Chief Executive Officer, Vodafone**

As a company founded in the UK, which grew outwards through Europe and beyond, Vodafone is well-placed to appreciate the economic linkages which run from the UK across the European continent. The European mobile market has established itself as a global leader, and this has been stimulated by the EU's four freedoms – of goods, services, capital and labour.

# Executive Summary

- Business for New Europe has requested Oxford Economics to undertake a study detailing the economic ties between the UK and the rest of the European Union (EU), and where possible, quantify them according to a number of parameters such as trade, labour force, tourism, FDI, portfolio investments and banking linkages.

- In the context of the current economic situation, there is a growing need for increased economic integration and cooperation between partner countries. Therefore, it is particularly relevant to review the importance of the economic links between the UK and the rest of the EU.

- These inter-relations have come to the fore since the outbreak of the financial crisis. Analysing the impact of the credit crunch on UK-EU relations is not within the scope of this report.

**GAINS FROM ECONOMIC INTEGRATION AND EU MEMBERSHIP**

- The benefits of EU membership are large and varied, and some are more tangible than others. In this report, we have only focused on those that can be quantified.

- Benefits from EU membership derive from economic integration, and from the economic and political dimensions of the Union. While economic integration is not a consequence of EU membership, it has acted as a catalyst for greater economic integration.

- One of the main benefits of economic integration is increased productivity, which arises from specialization and an efficient allocation of resources. Economic integration creates new investment opportunities, and brings about benefits to all parties involved.

- The EU Single Market is the world’s leading example of economic integration. Its associated benefits include: economies of scale and scope, facilitating trade, promoting competition, allowing for technological and knowledge spillovers, and reducing compliance costs and regulatory risks through common regulations. It has also facilitated the growth of a pan-European market, with companies operating throughout Europe.

- EU Membership also provides the UK with institutional stability and the benefits of economic policy co-ordination. These are crucial to gain the confidence of financial markets, particularly in light of the current economic difficulties.

- The estimated gains from the EU Single Market amount to 2.2% of overall GDP in the Union (or 223 billion Euro), and 1.4% of total employment in the EU in 2006 (or 2.5 million jobs). This is despite the fact that the Single Market's full potential has yet to be realised.

**TRADE LINKAGES**

- With trade in excess of £400 billion (52% of the UK's total trade in goods and services), the EU is the main trading partner of the UK, with the volume of trade conducted increasing substantially over recent years. In comparison, emerging economies such as China or India only represent a small proportion of the external trade conducted by the UK (4.2% and 1.3% respectively).

- The UK's balance of trade (goods and services) with both the EU and the rest of the world has been negative during the last eight years. However, it is worth noting that these dynamics have been different for goods and services.

- In trade of goods, the UK has systematically recorded a deficit with both EU (£41 billion in 2007), and non-EU countries (£50 billion in 2007). However, despite conducting a larger share of trade with EU countries, the deficits recorded with non-EU countries are larger.

- The nature of products that the UK trades with the EU is very different from the products it trades with non-EU countries. For instance, the main imports from outside the EU are "Mineral Fuels and Oils", whereas those from the EU are "Vehicles and Parts". Therefore, the UK could not easily substitute its trade with the EU by trading with non-EU countries.

- In trade of services, the UK has systematically recorded a surplus with both EU (£4.6 billion in 2007) and non-EU countries (£37.6 billion in 2007). This is primarily due to the large surpluses recorded in the trade of financial services.

- Estimating the number of jobs dependent on EU trade is a complex issue for a number of reasons. Although the number of jobs relying on exports are easily determined (and amount to approximately 3.5 million), trade involves, to some extent, substitution of local production. However, UK imports are more labour intensive than exports, reflecting the fact that lower value-added and less knowledge intensive activities have been outsourced abroad. On the other hand, exports are made of high knowledge intensive, high value-added industries.

- However, trade enhances welfare and allows countries to specialize in what they do comparatively better. If imports were substituted for local production, resources would be diverted from more productive activities where the UK has a competitive advantage (higher-value added industries).

- Trade also improves consumer welfare, as it is a reflection of consumer preferences, and as such, it is consumers who are better off if they can chose to drive a German car, holiday in Spain, or drink Italian coffee.

**LABOUR FORCE**

- There are almost 2 million residents from EU countries in the UK (or 3.3% of the total UK population). Out of those, 1.25 million are originally from the former EU 14 countries, whereas 750,000 have come from the “new Member States” (such as Poland, Bulgaria, and Romania).

- EU residents in the UK tend to be younger than the general population, and as a consequence, are more likely to be in employment. EU citizens account for 4.46% of the UK labour force (or 1.2 million workers).

- Citizens from EU 14 countries tend to have higher level of skills than the general UK population, and are more likely to occupy managerial positions. Citizens from the “new Member States” are more likely to have technical qualifications, and occupy skilled trades than the general population.

- In general, EU citizens have a positive impact on the UK economy by contributing to the UK public finances (as most are of working age and in employment), and by bringing a high level of skills (for which the UK did not have to bear education costs).

- Additionally, there are 1.6 million British resident in the rest of the EU.

**TOURISM**

- The EU is the main destination for UK residents (74% of their visits abroad, with 51.2 million visits in 2007), while EU citizens make up the largest group of visitors to the UK (67% of the total, or 21.8 million visits in 2007).

- The emergence of low-cost flights has changed the travel patterns of both UK residents in the EU and EU residents in the UK, by encouraging more regular and shorter visits abroad. Tourism, beyond being a personally and culturally enriching experience, facilitate the exchange of ideas, and can be a source of inspiration for new businesses.

- EU citizens spent £7 billion on their visits to the UK in 2007, which amounted to 0.5% of GDP for that year (direct impact only).

**FDI LINKAGES**

- FDI creates jobs, stimulates innovation and competition, and raises productivity, as it makes available technologies and knowledge that has been successful in other countries.
- EU FDI stock in the UK accounts for half the total stock of FDI, and has been growing rapidly. EU FDI in the UK creates 50-60,000 jobs, and safeguards a further 40,000 - 50,000 jobs every year (equivalent to 0.34% of the labour force).
- The UK is home to the second largest stock of FDI in the world, after the US. The UK attracts such a high amount of FDI from both EU and non-EU countries, because international companies choose the UK as the gateway for their European operations. 26% of non-EU companies have their European Headquarters in the UK.
- Access to the single market is one of the main reasons why companies decide to invest in the UK. Other reasons are access to capital markets, a good pool of resources (labour skills, ICT, a strong R&D base) and a low level of regulation.

**PORTFOLIO INVESTMENT LINKAGES**

- Portfolio investments in the UK amount to 2.6 times the annual UK GDP. Of that amount, 41% originated in the rest of the EU.
- EU portfolio investments in the UK amounted to US$ 1.3 trillion, whereas UK portfolio investments in the EU equalled US$ 1.15 trillion. This makes a positive contribution of US$ 150 billion to the UK capital account, helping to balance out the UK current account deficit.

**BANKING LINKAGES**

- EU citizens and corporations held one third of all foreign deposits in the UK, and subscribed 48% of all the loans made to foreigners in the UK.
- The UK records a surplus in the trade of financial services of about £12 billion. Of this, the surplus from trade in banking services with EU countries accounts for about £1 billion.

# 1. Introduction

Business for New Europe has requested that Oxford Economics undertake a study detailing the economic ties between the UK and the rest of the European Union (EU).

Accordingly, the objectives of this report are to:

i) Provide an overview of the economic links between the UK and the rest of the EU; and,
ii) Quantify these links where possible

The rest of this report is therefore structured as follows:

- Chapter 2 sets out the theoretical rationale for economic integration, and analyses, at a very high level, some of the benefits of EU membership for the UK.
- Chapter 3 provides an overview of the trade linkages between the UK and the rest of the EU
- Chapter 4 discusses labour force issues
- Chapter 5 focuses on tourism
- Chapters 6 covers foreign direct investment (FDI) issues
- Chapter 7 investigates portfolio investment
- Chapter 8 examines banking linkages

While the purpose of this of this report is not to quantify the benefits of EU membership to the UK, we have provided an overview of them in order to place the issue into context. The benefits are many and varied but are less tangible than the costs. We do not deal with the economic implications of the EU's political dimensions.

Since the entry of the UK into what was then the European Economic Community (EEC) in 1973, membership of the Union has been a controversial issue in Britain. The recent economic downturn has also focused attention on the UK's ties with the EU. We have tried to present the facts and figures in an objective manner, so that the informed reader can reach his/her own conclusions.

Throughout the report, different references are made to EU 14, EU 15, EU 8, EU 25, and EU 27 countries. These acronyms are commonly used to refer to the size of the EU before each subsequent expansion.

The EU was composed of 15 countries from 1995 to 2004: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom. These countries are also called the "old Member States." EU 14 makes reference to the EU 15 countries without the United Kingdom.

In 2004, the eastern extension of the Union, brought in 10 new Member States: Cyprus, Czech Republic, Estonia, Hungary, Malta, Latvia, Lithuania, Poland, Slovenia, and Slovakia. These are referred to throughout the report as the EU 10 countries. When EU 8 is used instead, it refers to EU 10 countries without Cyprus and Malta (the two smallest states among the EU 10). When EU 25 is used, the EU 15 plus EU 10 countries are referred to.

Finally, in 2007, Rumania and Bulgaria also joined the Union. Therefore, where EU 27 is used, it refers to the EU 25 plus Romania and Bulgaria.

As some of the Member States have only joined the Union very recently, in some cases aggregate statistics for the EU 27 as a whole are not available. Therefore, although we have tried to use a consistent format for the presentation of the results throughout the report, different acronyms have been used, depending on the availability of statistics.

The UK's economic inter-relations with the rest of the EU have come to the fore since the outbreak of the financial crisis. Analysing the impact of the credit crunch on UK-EU relations is not within the scope of this report, but would be a very stimulating research project for a future occasion.

# 2. Rationale for Economic Integration

**KEY POINTS**

- The benefits of EU membership are large and varied, and some are more tangible than others. In this report, we have only focused on those that can be quantified.
- Benefits from EU membership derive from economic integration, and from the economic and political dimensions of the Union. While economic integration is not a consequence of EU membership, it has acted as a catalyst for greater economic integration.
- One of the main benefits of economic integration is increased productivity, which arises from specialization and an efficient allocation of resources. Economic integration creates new investment opportunities, and brings about benefits to all parties involved.
- The EU Single Market is the world's leading example of economic integration. Its associated benefits include: economies of scale and scope, facilitating trade, promoting competition, allowing for technological and knowledge spillovers, and reducing compliance costs and regulatory risks through common regulations. It has also facilitated the growth of a pan-European market, with companies operating throughout Europe.
- EU Membership also provides the UK with institutional stability and the benefits of economic policy co-ordination. These are crucial to gain the confidence of financial markets, particularly in light of the current economic difficulties.
- The estimated gains from the EU Single Market amount to 2.2% of overall GDP in the Union (or 223 billion Euro), and 1.4% of total employment in the EU in 2006 (or 2.5 million jobs). This is despite the fact that the Single Market's full potential has yet to be realised.

Economic integration is not a new phenomenon; it started hundreds of years ago when nations began trading with each other. However, the scale of economic global integration has accelerated in recent decades, following improvements in transport and communications.

The theoretical basis of economic integration derives from the gains that can be achieved through trade. Countries that trade can specialize in what they produce *relatively* better. Thus, all countries participating obtain gains through trade. Even if a country is more productive in all activities in absolute terms than other countries, it will derive gains from trade if it specializes in producing those goods that it is relatively better at. Inputs should be allocated where they are more productive, and to some extent, trade can be a substitute for input mobility (i.e. labour).

Traditionally, the main vehicle for economic integration has involved trade of goods. However, the increasing size of financial markets, FDI, portfolio investment and banking links means that these are now important mechanisms for economic integration. In any case, the same rationale applies for financial markets and for trade in services as for trade in goods: economic integration allows for inputs to be used where they are more productive and enables participants to specialize in those activities that they are better at. For instance, integration of financial markets and FDI flows allow countries to benefit from investment opportunities where resources are more productive, deriving benefits for both the originating and the receiving country.

## 2.1. The rationale for EU membership

The benefits of free trade do not necessarily mean that it enhances welfare in each and every circumstance. There may be specific cases where protectionism may have some advantages, such as protecting infant industries, national security, or strategic interests (e.g. the energy sector). However, some these concerns are less likely to apply among EU Member States, as they are broadly similar from a social, political and economic point of view, exhibit a similar level of development and share a common position on the international scene.

The European Union is a group of developed economies, with similar economic and social structures (post-industrial, social-market democracies), many of them with a similar level of technology and skills, who face comparable challenges - such as the emergence of new global powers and ageing populations. The potential gains from European economic integration do not only derive from being a free trade zone, but rather from being a single market, where there is free movement of inputs (capital, labour) and harmonized laws and regulations.

Nevertheless, while not the focus of this study, the benefits of EU membership are worth placing into perspective, in that they derive from European economic integration. In the following section a few examples are provided.

### 2.1.1. Benefits deriving from EU economic integration.

Being part of the single market allows member countries to benefit from being part of the largest consumer market in the world in terms of GDP, with more than 500 million consumers. A larger market allows for a more efficient allocation of resources, since there is a higher scope for specialization, and it allows for the allocation of resources where they are more productive. A larger market also has the benefits of economics of scale (i.e. the price of producing a unit is lower when larger volumes are produced). For instance, developing a certain technology has a fixed cost, but is only worth it if the potential number of users is large enough.

Being part of the single market also brings other benefits such as knowledge and technical spillovers between countries. One example of these is the free movement of labour inputs (i.e. when workers move to another country they transmits the knowledge and techniques learned before). As mentioned before, the fact that many EU member states have a similar level of technological development makes it easier for countries to benefit from the stock of knowledge available in other EU countries.

A large internal market is also associated with increased competition which, in turn, brings lower prices and increased level of innovation. The implementation of a common EU Competition Policy over the years has triggered entry and competition in many sectors across the Union, for the benefit of consumers. Harmonisation of product markets regulation provides for lower compliance costs, and higher regulatory certainty. Common consumer protection regulation facilitates trade. Common accounting and supervisory practices reduce the regulatory burden and the costs for companies to operate at a trans-national level.

For instance, the estimated gains from the Single Market in the period 1992-2006 for the EU 25 countries amount to 2.2% of EU GDP (or 223 billion Euro), representing an extra income of €1,450 per household, and 1.4% of total employment (or 2.75 million jobs)[1]. Further, consumers benefit from reduced prices: in those sectors more affected by the single market, price cost-margins declined by 3.9% during the period 1992-2003, and price convergence between member states increased, with price differentials decreasing from 20% in 1991 to 13% in 2005[2].

***Examples of benefits of financial market integration***

Financial integration allows for deeper financial markets, an improved allocation of capital, higher opportunities for risk-diversification and higher efficiency of financial intermediation. This in turn lowers the cost of capital and improves productivity. Harmonisation of laws and practices for financial markets, and mutual recognition of supervisory practices facilitates capital movements and increases transparency of financial markets, thereby reducing risk. A deeper financial market also allows for the reduction in the impact of external shocks, as in the current economic situation.

Financial integration allows for an optimal allocation of resources. Financial integration allows for countries with a need for net financing to access capital from countries with surpluses in savings. This will equalize cost of capital across countries, allowing for resources to be invested where the rate of return is higher.

Also, in isolation, countries are more vulnerable to the emergence of external or internal shocks (i.e. a financial crisis or a surge in unemployment), whereas financial integration allows for a higher degree of risk diversification. When financial markets are interconnected, the effect of an asymmetric shock in one country is borne by agents in different countries, so that the impact is relatively smaller as it is diluted among several economies.

Clearly, in the absence of an internal market, banks of different countries do still lend money to each

[1] "Steps towards a deeper economic integration: the Internal Market in the 21st century A contribution to the Single Market Review", European Economy: Economic Papers, January 2007.
[2] "Single Market for Goods, Information Pack 2008", European Commission, DG Enterprise and Industry.

other, but potentially at higher rates: this would be because of a variety of reasons, ranging from difficulties on the part of the lender in assessing the financial position of the borrower (i.e. because of different accounting rules) uncertainty about repossession of assets of the borrower if it does not service its debt obligations, because of different legal systems, or a lack of confidence in the financial market of another country because of different regulatory and supervisory practices.

Although the benefits derived from EU membership occur as a consequence of economic integration and not EU membership *per se*, this acts as a catalyst for economic integration, in that it facilitates and drives demand for it. For instance, it can be argued that knowledge spillovers occur as a consequence of labour movement and this is not a consequence of EU membership. However, labour movement is facilitated through the free movement of inputs and the mutual recognition of educational qualifications among Member States. In turn, labour movement will lead to increased trade in goods and services as migrants establish social and professional networks in other countries.

Similarly, it can be argued that capital movements are not a consequence of EU membership. However, harmonisation of EU accounting and banking legislation has acted as a catalyst for capital movements across the Union. Following the same line of argument, it could be said that the UK could abide by EU legislation, in the same way as Switzerland does, in order to achieve a similar level of economic integration. However, it has to be taken into account that Switzerland has also contributed financially towards the cost of the EU enlargement towards the east, as if it were another member state, in order to keep preferential access to the EU market. At the point where a country has to abide by EU regulation and has to contribute financially towards EU membership, it could be argued that by becoming a member state this country could at least have a voice in the law-making process, and could defend its interests in front of other Member States (evident in the current debate in Switzerland about whether to join the EU or not).

These are just a few examples of how EU membership has acted as a catalyst for economic integration, which in turn has brought benefits for all Member States. As it has been mentioned before, it is not the primary focus of the study to quantify the magnitude of these benefits. This would be an extremely complex task, among other reasons, because the benefits are often abstract and intangible.

#### 2.1.2. Other benefits from EU Membership.

In the context of the current economic downturn, there is an increased need for policy coordination between countries. The EU is the sort of supranational platform that could provide the right conditions for the countries to jointly address the challenges and cooperate. For instance, if a country unilaterally launches a rescue package for its economy, its impact will be limited if its economic partners do not do the same. If on the contrary, all partner countries launch a simultaneous rescue package, the stimulus for the economy will be much higher. When economies are integrated, a fiscal stimulus in one country will derive demand on its partner countries, and vice-versa, and thus the importance of economic policy coordination.

There are further benefits that derive from EU membership, and have to do with other aspects of policy coordination that arise from being an economic and political Union. There are many aspects of the political dimension of EU membership that have economic consequences, such as, the negotiating position that the Union has as a block to engage in trade deals with other countries. Some of these implications are even less tangible. For instance, a common external policy by the EU may help secure relations with strategically important partners given the energy dependence of the Union. Also, external aid or peace keeping conducted co-ordinately by EU peace-keeping forces may help strengthen the external image and legitimacy of EU diplomacy. This, in turn, may facilitate trade and investments and ultimately result in the award of contracts to EU companies in other parts of the world (an example could be the contracts between Airbus and Chinese companies that often occur in the context of EU-China bilateral summits). However, as mentioned, these types of considerations go far beyond the scope of this report, and it is not the task of this assignment to measure such benefits.

Finally, there are economic benefits of EU membership of a “social” nature, which have a positive impact on the life of citizens through reduced risks and lower transaction costs, such as the freedom by EU citizens to study on any member state, or receive free medical attention in other member state, or receive cheaper phone calls when abroad.

Although many of these benefits do not derive directly from EU membership, it is thanks to EU regulations and achievements, such as the EU internal market that further integration has taken place. This has meant that such benefits are more fully realised than would otherwise be the case. The magnitude of these benefits would be extremely difficult to estimate, as they are embedded into the UK economic system, and therefore difficult to isolate out.

# 3. Trade Linkages

**KEY POINTS**

- With trade in excess of £400 billion (52% of the UK's total trade in goods and services), the EU is the main trading partner of the UK, with the volume of trade conducted increasing substantially over recent years. In comparison, emerging economies such as China or India only represent a small proportion of the external trade conducted by the UK (4.2% and 1.3% respectively).
- The UK's balance of trade (goods and services) with both the EU and the rest of the world has been negative during the last eight years. However, it is worth noting that these dynamics have been different for goods and services.
- In trade of goods, the UK has systematically recorded a deficit with both EU (£41 billion in 2007), and non-EU countries (£50 billion in 2007). However, despite conducting a larger share of trade with EU countries, the deficits recorded with non-EU countries are larger.
- The nature of products that the UK trades with the EU is very different from the products it trades with non-EU countries. For instance, the main imports from outside the EU are "Mineral Fuels and Oils", whereas those from the EU are "Vehicles and Parts". Therefore, the UK could not easily substitute its trade with the EU by trading with non-EU countries.
- In trade of services, the UK has systematically recorded a surplus with both EU (£4.6 billion in 2007) and non-EU countries (£37.6 billion in 2007). This is primarily due to the large surpluses recorded in the trade of financial services.
- Estimating the number of jobs dependent on EU trade is a complex issue for a number of reasons. Although the number of jobs relying on exports are easily determined (and amount to approximately 3.5 million), trade involves, to some extent, substitution of local production. However, UK imports are more labour intensive than exports, reflecting the fact that lower value-added and less knowledge intensive activities have been outsourced abroad. On the other hand, exports are made of high knowledge intensive, high value-added industries.
- However, trade enhances welfare and allows countries to specialize in what they do comparatively better. If imports were substituted for local production, resources would be diverted from more productive activities where the UK has a competitive advantage (higher-value added industries).
- Trade also improves consumer welfare, as it is a reflection of consumer preferences, and as such, it is consumers who are better off if they can chose to drive a German car, holiday in Spain, or drink Italian coffee.

In this section the trade linkages between the UK and the rest of the EU are considered. This includes consideration of:

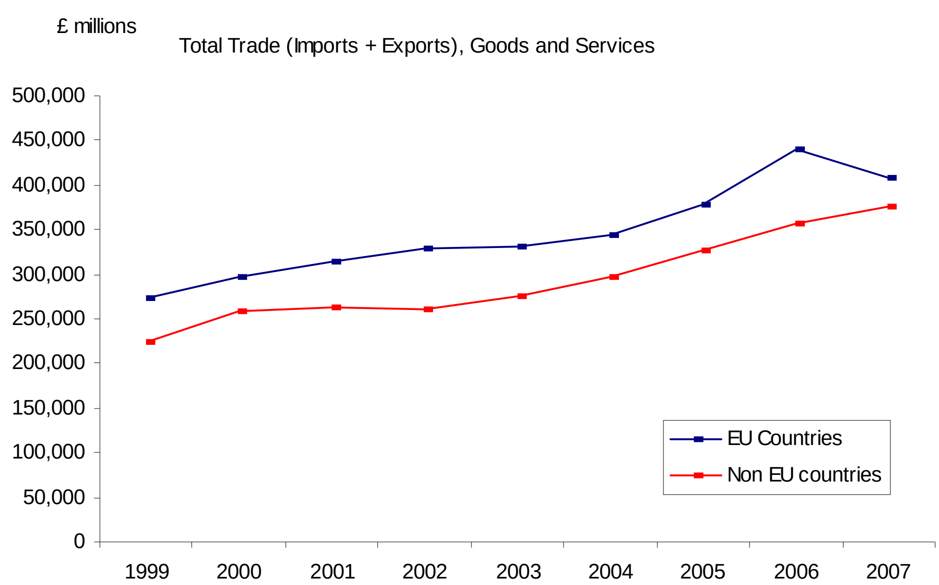
- total trade;
- trade in goods;
- trade in services;
- the jobs content of UK-EU trade.

### 3.1.1. Trade history

The value of trade between the UK and the rest of the EU has increased significantly during recent years, reflecting the increasing economic integration with the other EU countries. The value of the total trade (goods and services) with the rest of the EU - consisting of imports and exports - was £408 billion in 2007, and amounts to almost a third of the UK annual GDP (£ 1,229 billion in 2007) – see figure 3.1 below.

In the current economic climate, it could be expected that the volume of trade would contract. Whereas a weakening sterling[3] could potentially stimulate exports to the EU, the worsening economic conditions in the rest of the EU could offset this trend. However, UK imports from the rest of the EU should normally decline, given the weaker sterling, and the recessionary environment in the UK. Therefore, economic theory would suggest that the balance of trade of the UK with the rest of the EU should improve for the UK.

**Figure 3.1: UK trade with the EU and the rest of the world, goods and services.**




Source: ONS, Oxford Economics

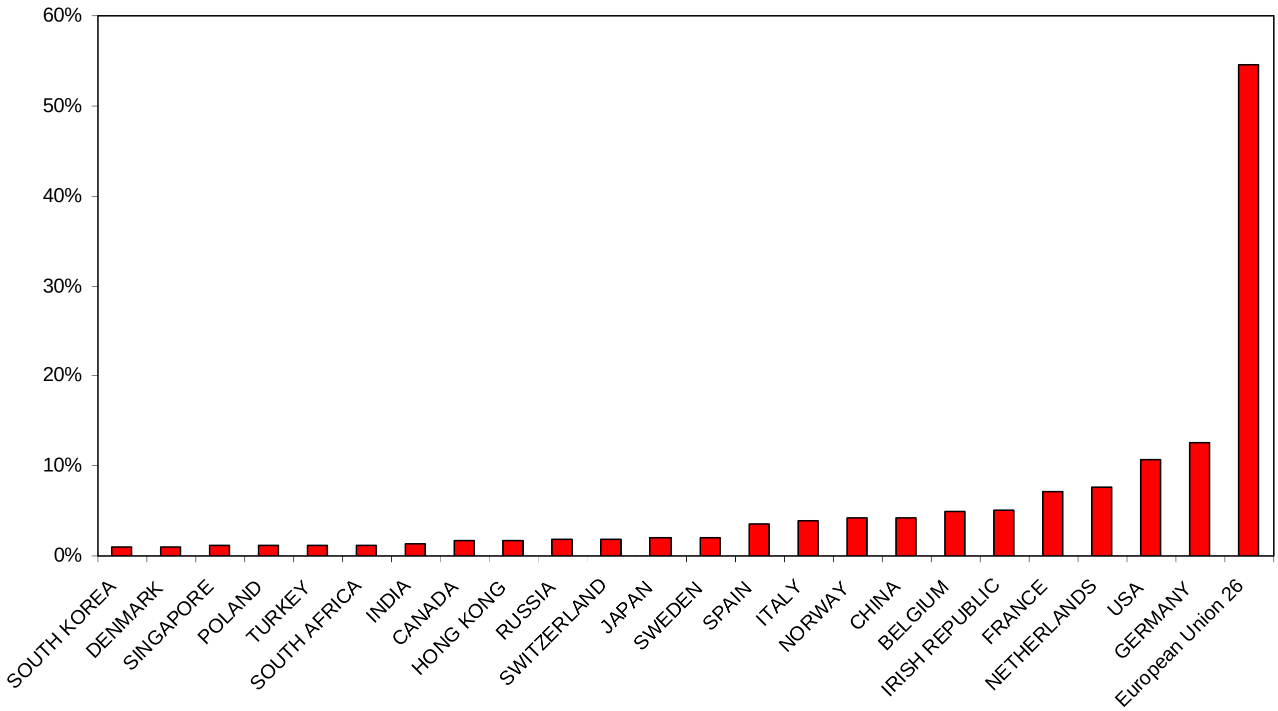
[3] At the time of editing this paper, the exchange rate GBP/EUR stood at 1.10

The UK conducts 52% of its total trade (exports and imports, goods and services) with the rest of the EU. 56% of total trade consists of goods, while 44% is made up of services.

The UK's main partners in the trade of goods are other EU countries, as can be seen in Figure 3.2 below. Emerging countries such as China, Russia or India, are in 8th, 15th and 18th position respectively, behind much smaller EU countries such as Belgium.

Alternatively, the UK's main trading partners can be accounted for on a per-capita basis. If this is done, out of the 25 countries which are the most intensive trading partners of the UK in per capita terms, 19 are other EU Member States. As indicated in Table 3.1, it is notable that some of the main trading partners of the UK in absolute terms, such as the US, are not significant trading partners in per-capita terms.

**Figure 3.2: Main UK trading partners (goods and services), total trade**




Source: UK Trade Info (HMRC), Oxford Economics

**Table 3.1: Main UK trading partners per capita (Total trade of goods / head).**

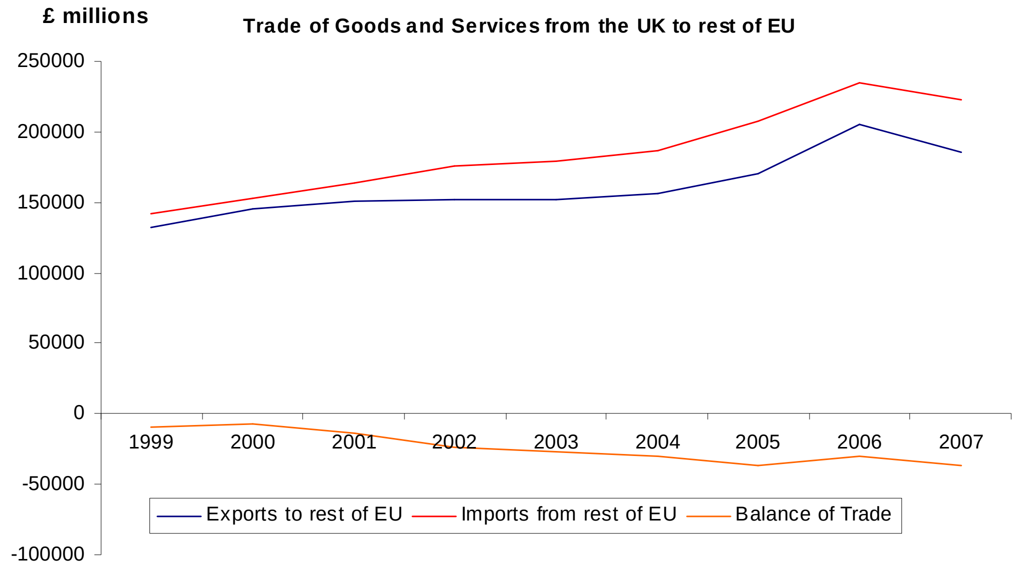
| Ranking of UK's trade partners by trade per capita | | | | | | |
|---|---|---|---|---|---|---|
| | | **Exports (£mn)** | **Imports (£mn)** | **Total trade (£mn)** | **Population (mn)** | **Trade per capita (£/head)** |
| 1 | Luxembourg | 2532 | 3283 | 5815 | 0.46 | 12614 |
| 2 | Ireland | 24156 | 13862 | 38018 | 4.24 | 8977 |
| 3 | Cyprus | 1289 | 3071 | 4360 | 0.77 | 5662 |
| 4 | Norway | 3970 | 15459 | 19429 | 4.64 | 4190 |
| 5 | Belgium | 16158 | 17806 | 33964 | 10.58 | 3211 |
| 6 | Netherlands | 23859 | 27055 | 50914 | 16.35 | 3115 |
| 7 | Denmark | 5985 | 7363 | 13348 | 5.43 | 2460 |
| 8 | Malta | 406 | 532 | 938 | 0.40 | 2357 |
| 9 | Singapore | 5229 | 4717 | 9946 | 4.42 | 2252 |
| 10 | Switzerland | 9135 | 6682 | 15817 | 7.29 | 2171 |
| 11 | Hong Kong | 4134 | 8217 | 12351 | 6.90 | 1790 |
| 12 | Sweden | 7152 | 7767 | 14919 | 9.09 | 1641 |
| 13 | France | 35691 | 40315 | 76006 | 63.03 | 1206 |
| 14 | Finland | 2982 | 3231 | 6213 | 5.25 | 1185 |
| 15 | Germany | 36770 | 50165 | 86935 | 82.29 | 1056 |
| 16 | Estonia | 518 | 820 | 1338 | 1.35 | 995 |
| 17 | Spain | 16664 | 23926 | 40590 | 44.14 | 919 |
| 18 | Latvia | 507 | 1418 | 1925 | 2.30 | 839 |
| 19 | Portugal | 2990 | 5006 | 7996 | 10.56 | 757 |
| 20 | Austria | 2304 | 3799 | 6103 | 8.26 | 739 |
| 21 | Italy | 13210 | 17643 | 30853 | 58.28 | 529 |
| 22 | Czech Republic | 1907 | 3113 | 5020 | 10.24 | 490 |
| 23 | Greece | 2321 | 2877 | 5198 | 11.15 | 466 |
| 24 | New Zealand | 749 | 1108 | 1857 | 4.15 | 448 |
| 25 | Australia | 5256 | 3981 | 9237 | 20.65 | 447 |

Source: UK Trade Info (HMRC), Oxford Economics

If we look at the decomposition of the total trade, we can see that UK has a negative balance of trade with both the EU and the rest of the world, as shown in Figures 3.3 and 3.4.

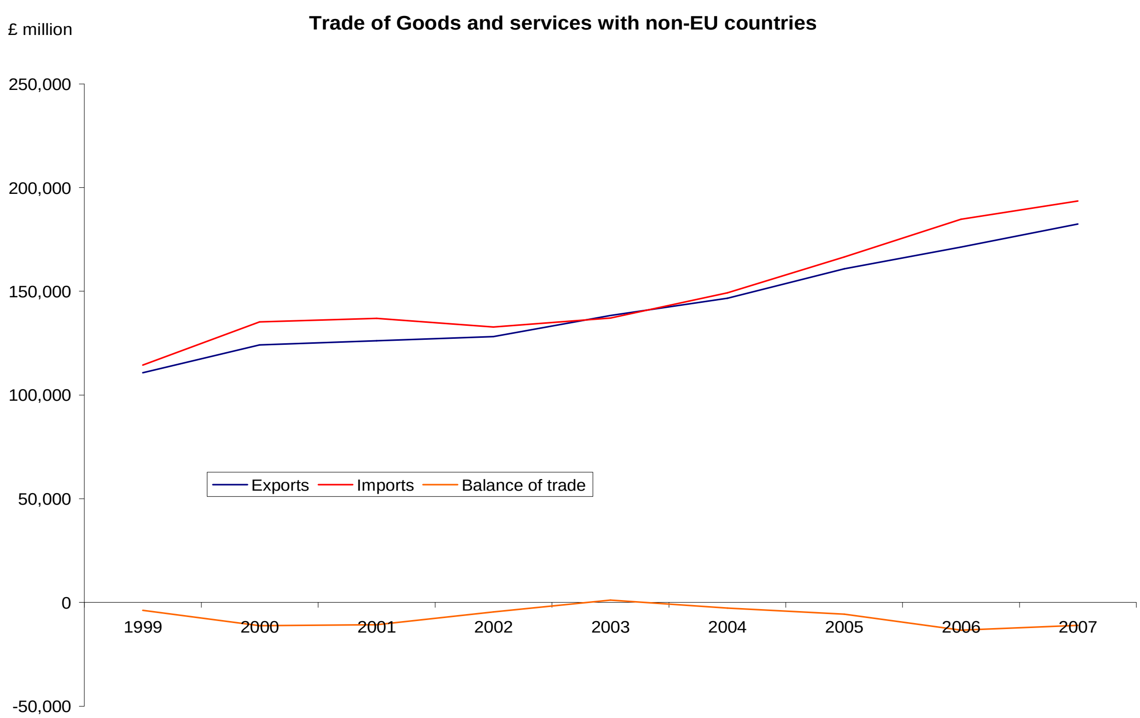
The UK's balance of trade has suffered a deteriorating trend with both EU and non-EU countries, reflecting a broader underlying macroeconomic phenomenon. The next sections provide a separate analysis of the trade in goods and services, as they respond to different economic fundamentals.

**Figure 3.3 Trade in goods and services with the rest of the EU**




Source: ONS, Oxford Economics

**Figure 3.4 Trade in goods and services with non-EU countries**

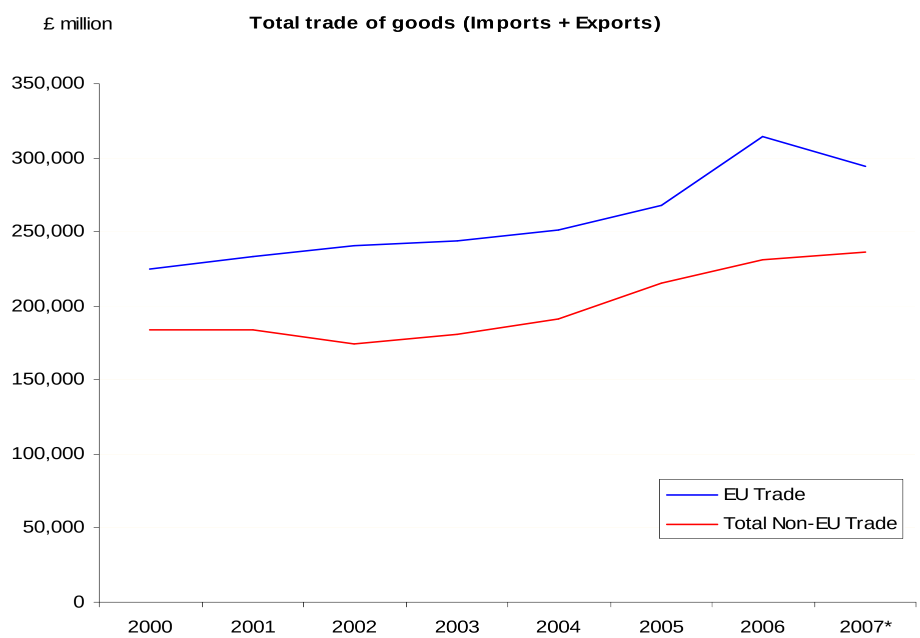



Source: ONS, Oxford Economics

### 3.1.2. Trade of Goods

Trade in goods amounts to 67% of the total trade conducted by the UK. As mentioned previously, the EU is the origin or destination of 56% of these goods. As it can be seen in Figure 3.5 below, trade of goods with the rest of the EU has increased rapidly in recent years.

**Figure 3.5: UK trade of goods with the EU and the rest of the world.**



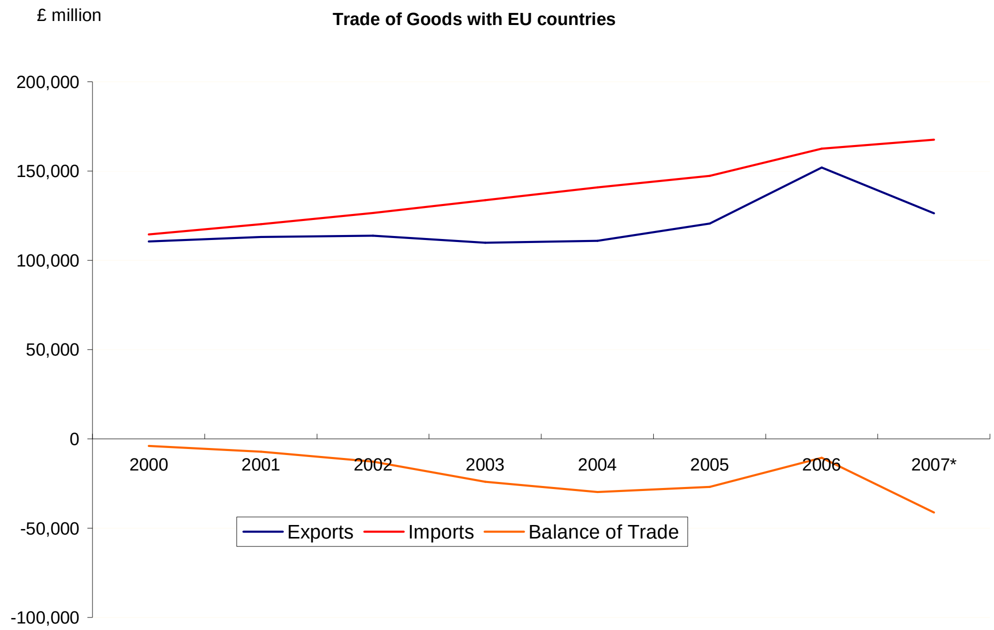

Source: ONS, Oxford Economics

Nevertheless, both imports from and exports to the rest of the EU decreased in 2007, following years of increase (see Figure 3.3 above), and this downward trend seems set to continue throughout 2008. For instance, during 2007 the UK exported goods to the rest of the EU to the value of £128 billion, and imported goods to the value of £169 billion, resulting in a trade deficit of £41 billion. However, in the year to August 2008 (September 2007 to August 2008), these values had decreased to £93 billion in exports and £120 billion in imports, resulting in a trade deficit of £26 billion.

In this context, the balance of trade with the EU, although negative for 2007, does not have a defined trend through time (Figure 3.6) and it is close to equilibrium in some years. For instance, in the year to August 2008, the trade deficit with the EU has halved (not depicted in Figure 3.7), as compared to 2007.

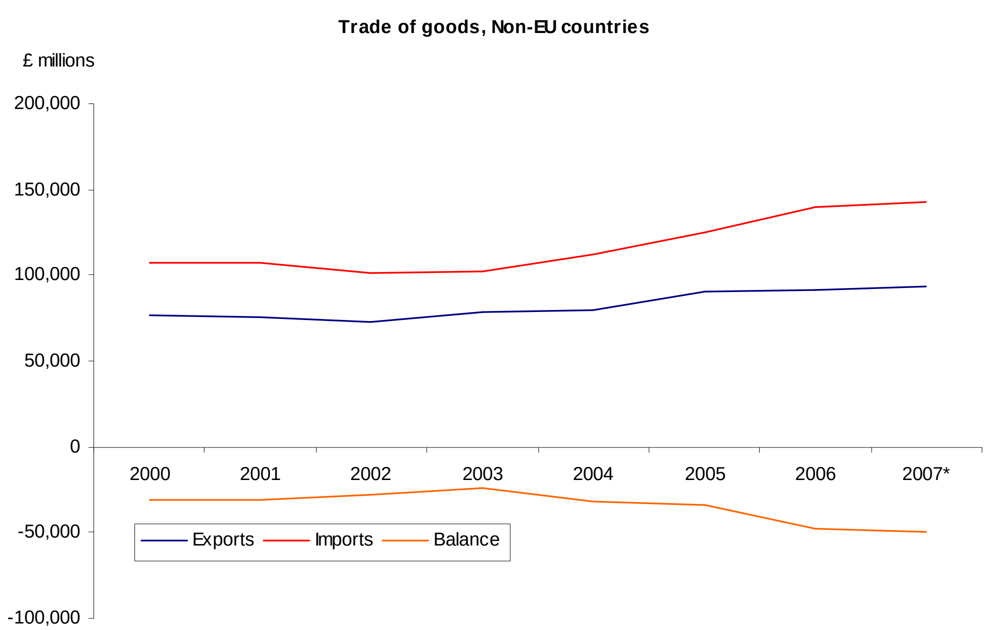
By contrast, the trade of the UK with the rest of the world has remained stable or increased slightly with the rest of the EU, although the UK balance of trade with the rest of the world has deteriorated over time (see Figure 3.7 below).

**Figure 3.6: Trade of goods with the rest of the EU**




Source: ONS, Oxford Economics

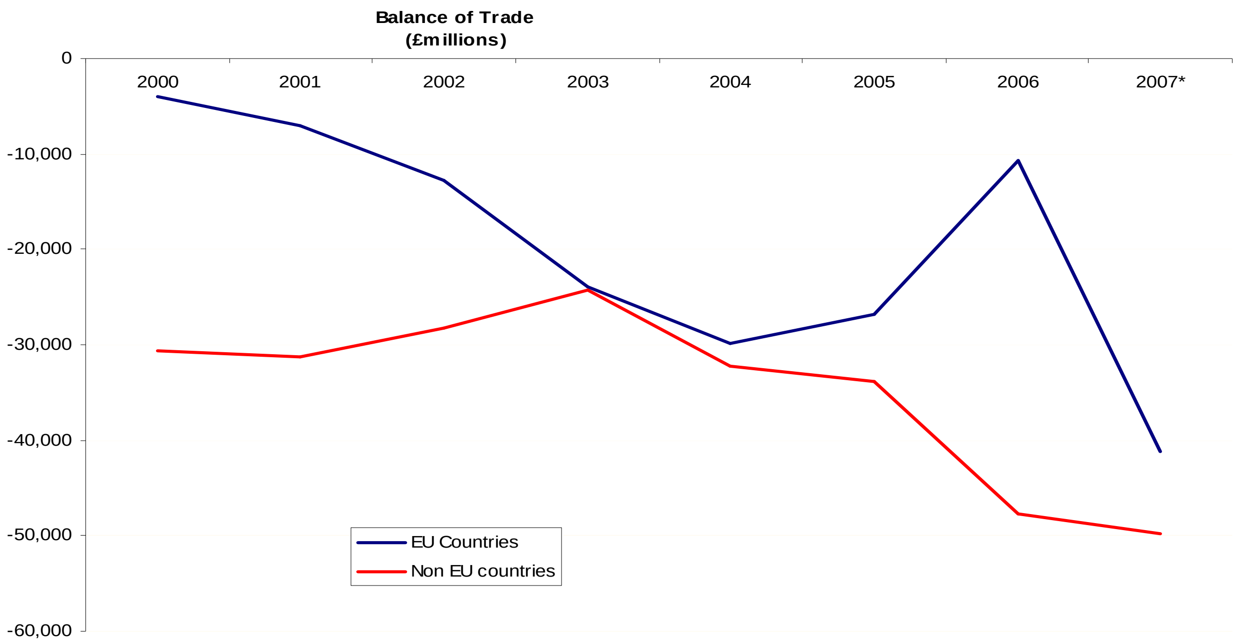
**Figure 3.7: Trade of goods with non-EU countries.**




Source: ONS, Oxford Economics

In recent years the UK's trade deficit with the rest of the world has been large and consistent, whereas in some years only a small trade deficit has been recorded with the rest of the EU (Figure 3.8).

**Figure 3.8: Balance of trade in goods of the UK with EU and non-EU countries.**




Source: ONS, Oxford Economics

If we examine products traded (Tables 3.2 and 3.3), an important feature emerges:

- The nature of the products traded with the EU and the rest of the world, differ to a great extent. For instance, while the main imports from the EU are "vehicles other than railway" (accounting for 18.4% of all imports from the EU) they only account for 3.4 % of imports from the rest of the world. Also, the main imports from outside the EU are Mineral Fuels and Oils, which account for 21.8% of all non-EU imports, whereas this figure is only 6.2% of EU imports. This may imply that the UK could not readily substitute trade with the EU by conducting trade with non-EU countries.

**Table 3.2: Main products imported from the EU (2007) – Source: UK Trade Info, ONS, Oxford Economics**

| | EU exports, £ millions | EU imports, £ millions | Exports of product as a % of All Exports to EU | Imports of Product as a % of all imports from EU | Exports of product as a % of all exports to rest of the world | Imports of product as a % of all imports from rest of the world |
|---|---|---|---|---|---|---|
| **Total** | **93,574** | **119,955** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |
| 87:VEHICLES OTHER THAN RAILWAY OR TRAMWAY ROLLING-STOCK, AND PARTS AND ACCESSORIES THEREOF | 9,735 | 22,093 | 10.4% | 18.4% | 9.5% | 3.4% |
| 84:NUCLEAR REACTORS, BOILERS, MACHINERY AND MECHANICAL APPLIANCES; PARTS THEREOF | 11,649 | 16,460 | 12.4% | 13.7% | 18.6% | 11.7% |
| 85:ELECTRICAL MACHINERY AND EQUIPMENT AND PARTS THEREOF; SOUND RECORDERS AND REPRODUCERS, TELEVISION IMAGE AND SOUND RECORDERS AND REPRODUCERS, AND PARTS AND ACCESSORIES OF SUCH ARTICLES | 6,790 | 11,140 | 7.3% | 9.3% | 7.6% | 8.9% |
| 27:MINERAL FUELS, MINERAL OILS AND PRODUCTS OF THEIR DISTILLATION; BITUMINOUS SUBSTANCES; MINERAL WAXES | 16,033 | 7,429 | 17.1% | 6.2% | 9.3% | 21.8% |
| 39:PLASTICS AND PLASTIC PRODUCTS | 3,105 | 4,723 | 3.3% | 3.9% | 2.0% | 1.5% |
| 30:PHARMACEUTICAL PRODUCTS | 5,866 | 4,444 | 6.3% | 3.7% | 6.6% | 2.4% |
| 29:ORGANIC CHEMICALS | 3,924 | 3,862 | 4.2% | 3.2% | 3.0% | 2.0% |
| 48:PAPER AND PAPERBOARD; ARTICLES OF PAPER PULP, PAPER OR PAPERBOARD | 1,110 | 2,943 | 1.2% | 2.5% | 0.7% | 0.7% |
| 90:OPTICAL, PHOTOGRAPHIC, CINEMATOGRAPHIC, MEASURING, CHECKING, PRECISION, MEDICAL OR SURGICAL INSTRUMENTS AND APPARATUS; PARTS AND ACCESSORIES THEREOF | 2,407 | 2,942 | 2.6% | 2.5% | 4.7% | 2.7% |
| 72:IRON AND STEEL | 3,467 | 2,586 | 3.7% | 2.2% | 2.4% | 0.9% |
| 73:ARTICLES OF IRON OR STEEL | 1,379 | 2,001 | 1.5% | 1.7% | 1.6% | 1.4% |
| 22:BEVERAGES, SPIRITS AND VINEGAR | 1,333 | 1,960 | 1.4% | 1.6% | 2.1% | 0.8% |
| 94:FURNITURE; MEDICAL AND SURGICAL FURNITURE; BEDDING, MATTRESSES, MATTRESS SUPPORTS, CUSHIONS AND SIMILAR STUFFED FURNISHINGS; LAMPS AND LIGHTING FITTINGS, NOT ELSEWHERE SPECIFIED; ILLUMINATED SIGNS, ILLUMINATED NAME-P | 645 | 1,920 | 0.7% | 1.6% | 0.7% | 1.9% |
| 02:MEAT AND EDIBLE MEAT OFFAL | 515 | 1,757 | 0.6% | 1.5% | 0.0% | 0.4% |
| 38:MISCELLANEOUS CHEMICAL PRODUCTS | 1,577 | 1,525 | 1.7% | 1.3% | 1.6% | 0.4% |
| 44:WOOD AND ARTICLES OF WOOD; WOOD CHARCOAL | 220 | 1,454 | 0.2% | 1.2% | 0.0% | 0.8% |
| 04:DAIRY PRODUCE; BIRDS' EGGS; NATURAL HONEY; EDIBLE PRODUCTS OF ANIMAL ORIGIN, NOT ELSEWHERE SPECIFIED OR INCLUDED | 433 | 1,339 | 0.5% | 1.1% | 0.2% | 0.1% |
| 33:ESSENTIAL OILS AND RESINOIDS; PERFUMERY, COSMETIC OR TOILET PREPARATIONS | 1,146 | 1,328 | 1.2% | 1.1% | 1.0% | 0.4% |
| 40:RUBBER AND ARTICLES THEREOF | 910 | 1,272 | 1.0% | 1.1% | 0.6% | 0.8% |
| 07:EDIBLE VEGETABLES AND CERTAIN ROOTS AND TUBERS | 108 | 1,240 | 0.1% | 1.0% | 0.0% | 0.3% |
| 76:ALUMINIUM AND ARTICLES THEREOF | 1,142 | 1,210 | 1.2% | 1.0% | 0.9% | 0.6% |
| 62:ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, NOT KNITTED OR CROCHETED | 765 | 1,118 | 0.8% | 0.9% | 0.5% | 2.9% |
| 19:PREPARATIONS OF CEREALS, FLOUR, STARCH OR MILK; PASTRYCOOKS' PRODUCTS | 569 | 1,111 | 0.6% | 0.9% | 0.2% | 0.1% |
| 71:NATURAL OR CULTURED PEARLS, PRECIOUS OR SEMI-PRECIOUS STONES, PRECIOUS METALS, METALS CLAD WITH PRECIOUS METAL, AND ARTICLES THEREOF; IMITATION JEWELLERY; COIN | 2,211 | 1,087 | 2.4% | 0.9% | 7.9% | 5.6% |
| 20:PREPARATIONS OF VEGETABLES, FRUIT, NUTS OR OTHER PARTS OF PLANTS | 150 | 980 | 0.2% | 0.8% | 0.1% | 0.2% |

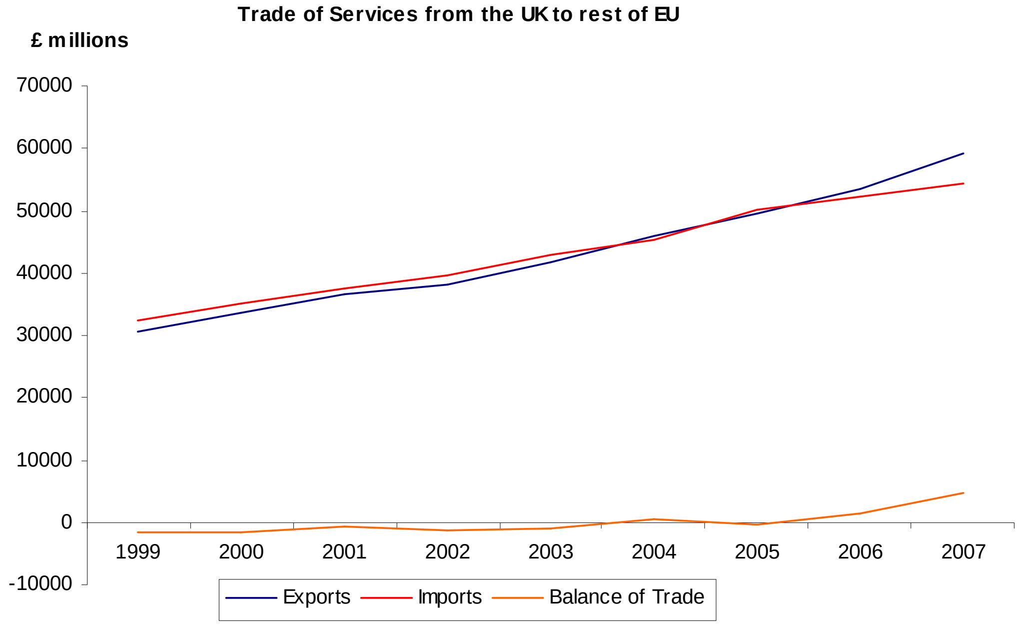
**Table 3.2: Main products imported from the EU (2007) – Source: UK Trade Info, ONS, Oxford Economics**

| | EU exports, £ millions | EU imports, £ millions | Exports of product as a % of All Exports to EU | Imports of Product as a % of all imports from EU | Exports of product as a % of all exports to rest of the world | Imports of product as a % of all imports from rest of the world |
|---|---|---|---|---|---|---|
| **Total** | **93,574** | **119,955** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |
| 27:MINERAL FUELS, MINERAL OILS AND PRODUCTS OF THEIR DISTILLATION; BITUMINOUS SUBSTANCES; MINERAL WAXES | 16,033 | 7,429 | 17.1% | 6.2% | 9.3% | 21.8% |
| 84:NUCLEAR REACTORS, BOILERS, MACHINERY AND MECHANICAL APPLIANCES; PARTS THEREOF | 11,649 | 16,460 | 12.4% | 13.7% | 18.6% | 11.7% |
| 87:VEHICLES OTHER THAN RAILWAY OR TRAMWAY ROLLING-STOCK, AND PARTS AND ACCESSORIES THEREOF | 9,735 | 22,093 | 10.4% | 18.4% | 9.5% | 3.4% |
| 85:ELECTRICAL MACHINERY AND EQUIPMENT AND PARTS THEREOF; SOUND RECORDERS AND REPRODUCERS, TELEVISION IMAGE AND SOUND RECORDERS AND REPRODUCERS, AND PARTS AND ACCESSORIES OF SUCH ARTICLES | 6,790 | 11,140 | 7.3% | 9.3% | 7.6% | 8.9% |
| 30:PHARMACEUTICAL PRODUCTS | 5,866 | 4,444 | 6.3% | 3.7% | 6.6% | 2.4% |
| 29:ORGANIC CHEMICALS | 3,924 | 3,862 | 4.2% | 3.2% | 3.0% | 2.0% |
| 72:IRON AND STEEL | 3,467 | 2,586 | 3.7% | 2.2% | 2.4% | 0.9% |
| 39:PLASTICS AND PLASTIC PRODUCTS | 3,105 | 4,723 | 3.3% | 3.9% | 2.0% | 1.5% |
| 90:OPTICAL, PHOTOGRAPHIC, CINEMATOGRAPHIC, MEASURING, CHECKING, PRECISION, MEDICAL OR SURGICAL INSTRUMENTS AND APPARATUS; PARTS AND ACCESSORIES THEREOF | 2,407 | 2,942 | 2.6% | 2.5% | 4.7% | 2.7% |
| 71:NATURAL OR CULTURED PEARLS, PRECIOUS OR SEMI-PRECIOUS STONES, PRECIOUS METALS, METALS CLAD WITH PRECIOUS METAL, AND ARTICLES THEREOF; IMITATION JEWELLERY; COIN | 2,211 | 1,087 | 2.4% | 0.9% | 7.9% | 5.6% |
| 88:AIRCRAFT, SPACECRAFT, AND PARTS THEREOF | 2,017 | 857 | 2.2% | 0.7% | 4.0% | 4.8% |
| 38:MISCELLANEOUS CHEMICAL PRODUCTS | 1,577 | 1,525 | 1.7% | 1.3% | 1.6% | 0.4% |
| 73:ARTICLES OF IRON OR STEEL | 1,379 | 2,001 | 1.5% | 1.7% | 1.6% | 1.4% |
| 22:BEVERAGES, SPIRITS AND VINEGAR | 1,333 | 1,960 | 1.4% | 1.6% | 2.1% | 0.8% |
| 28:INORGANIC CHEMICALS: ORGANIC OR INORGANIC COMPOUNDS OF PRECIOUS METALS, OF RARE-EARTH METALS, OF RADIOACTIVE ELEMENTS OR OF ISOTOPES | 1,156 | 778 | 1.2% | 0.6% | 1.1% | 0.9% |
| 33:ESSENTIAL OILS AND RESINOIDS; PERFUMERY, COSMETIC OR TOILET PREPARATIONS | 1,146 | 1,328 | 1.2% | 1.1% | 1.0% | 0.4% |
| 76:ALUMINIUM AND ARTICLES THEREOF | 1,142 | 1,210 | 1.2% | 1.0% | 0.9% | 0.6% |
| 48:PAPER AND PAPERBOARD; ARTICLES OF PAPER PULP, PAPER OR PAPERBOARD | 1,110 | 2,943 | 1.2% | 2.5% | 0.7% | 0.7% |
| 32:TANNING OR DYEING EXTRACTS; TANNINS AND THEIR DERIVATIVES; DYES, PIGMENTS AND OTHER COLOURING MATTER; PAINTS AND VARNISHES; PUTTY AND OTHER MASTICS; INKS | 930 | 649 | 1.0% | 0.5% | 0.6% | 0.3% |
| 40:RUBBER AND ARTICLES THEREOF | 910 | 1,272 | 1.0% | 1.1% | 0.6% | 0.8% |
| 49:BOOKS, NEWSPAPERS, PICTURES AND OTHER PRODUCTS OF THE PRINTING INDUSTRY; MANUSCRIPTS, TYPESCRIPTS AND PLANS | 864 | 433 | 0.9% | 0.4% | 1.1% | 0.6% |
| 62:ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, NOT KNITTED OR CROCHETED | 765 | 1,118 | 0.8% | 0.9% | 0.5% | 2.9% |
| 94:FURNITURE; MEDICAL AND SURGICAL FURNITURE; BEDDING, MATTRESSES, MATTRESS SUPPORTS, CUSHIONS AND SIMILAR STUFFED FURNISHINGS; LAMPS AND LIGHTING FITTINGS, NOT ELSEWHERE SPECIFIED; ILLUMINATED SIGNS, ILLUMINATED NAME-P | 645 | 1,920 | 0.7% | 1.6% | 0.7% | 1.9% |
| 61:ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, KNITTED OR CROCHETED | 612 | 760 | 0.7% | 0.6% | 0.3% | 2.7% |
| 74:COPPER AND ARTICLES THEREOF | 591 | 948 | 0.6% | 0.8% | 0.6% | 0.2% |

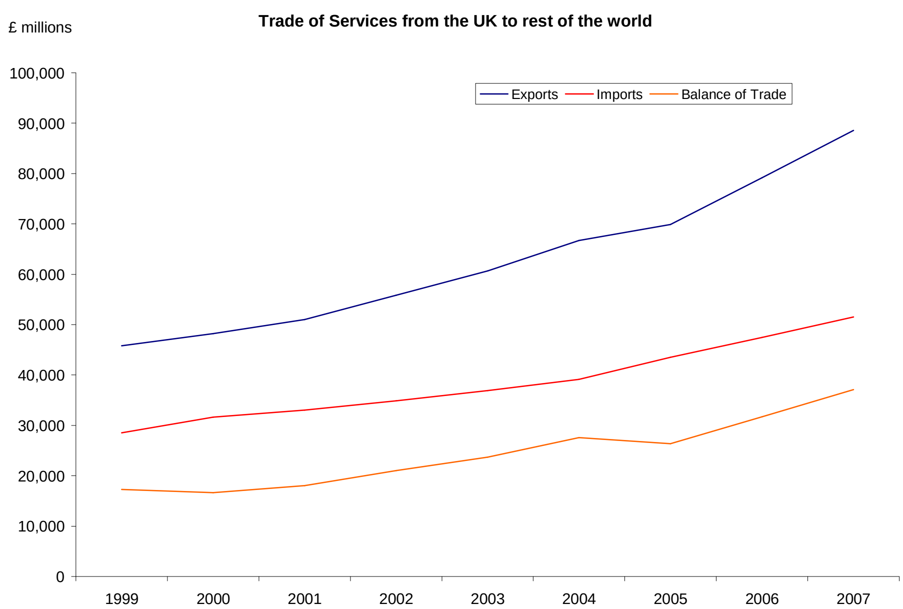
### 3.1.4. Trade of Services

The volume in trade of services with both EU and non-EU countries has increased in recent years (Figures 3.9 and 3.10 below). The UK records a positive balance of trade in services with both the EU and non-EU countries, although with the latter, the magnitude of the surplus is substantially larger (Figures 3.9 and 3.10).

**Figures 3.9 and 3.10: Trade of Services with EU and non-EU countries**




Source: ONS, Oxford Economics

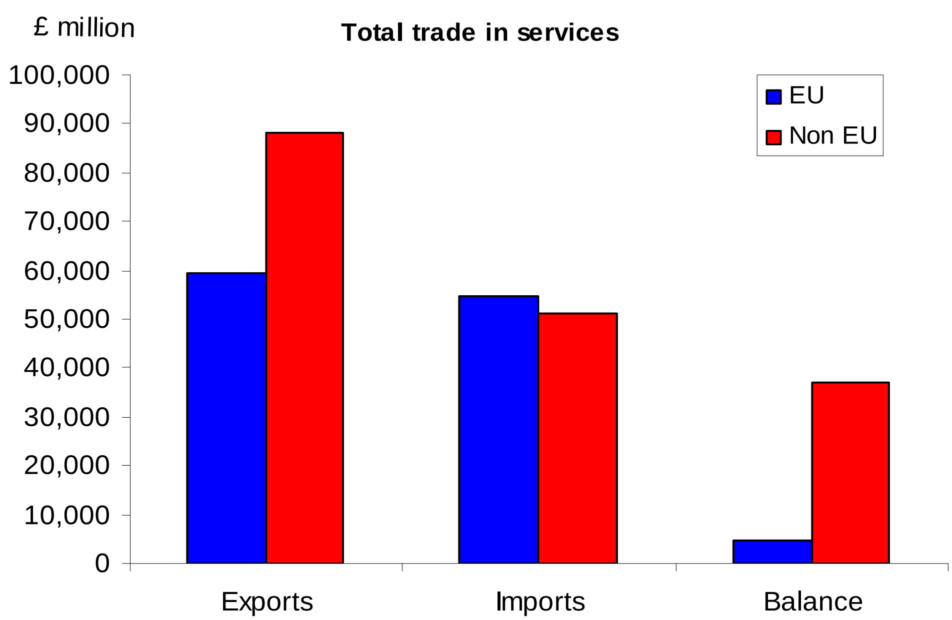



Source: ONS, Oxford Economics

As can be seen in the graphs above, the UK records a systematic surplus in the trade of services with both EU and non-EU countries (Figure 3.11). This could be due to structural differences in the economy: the UK exhibits a high degree of specialization in high value-added sectors such as financial and business services, research and development, or creative industries. These structural differences may explain why the UK records a negative balance of trade in goods, as lower value added activities in manufacturing have been relocated to lower cost countries, whereas it records a surplus in the trade of services.

Although these structural differences are smaller with other EU countries (which consist of advanced economies, sharing many common features) the economic structure of the UK is, nonetheless, still somewhat distinct from that of other advanced EU economies, such as France or Germany. This may be because UK manufacturing represents a lower share of GDP than in those countries, and because of the fact that the UK possesses a particularly highly specialized service sector.

**Figure 3.11: Trade of Services with EU and non-EU countries.**




Source: ONS, Oxford Economics

Trade in services can be decomposed in several categories. As can be seen in Tables 3.4 and 3.5 below, the UK records the largest surpluses in the trade of Financial Services, Business Services, ICT services, Insurance, and Royalties and licence fees, whereas it records a large deficit in Travel and Transportation services[4] (Tourism –trade in travel services- is discussed in greater detail in Section 5).

4 Data originating from the International Trade in Services (ITIS) Survey is broken down geographically. It does not, however, include trade in Banking and Financial Services, Transport, Travel, Higher Education, Charities, legal services, and the Film and Television Industry.

**Table 3.4: Trade in Services by industry with EU countries**

| Trade in Services by type in 2007 with the EU (£m) | Exports | Imports | Balance |
|---|---|---|---|
| Transportation | 6921 | 11012 | -4091 |
| Travel | 8775 | 20989 | -12214 |
| Communications | 2181 | 1710 | 471 |
| Construction | 335 | 430 | -95 |
| Insurance | 650 | 542 | 108 |
| Financial | 16900 | 4728 | 12172 |
| Computer and information | 3689 | 1447 | 2242 |
| Royalties and license fees | 2292 | 1677 | 615 |
| Other business services | 16041 | 10104 | 5937 |
| Personal, cultural and recreational | 846 | 281 | 565 |
| Government | 806 | 1914 | -1108 |
| Total Services | 59436 | 54834 | 4602 |

Source: ONS, Oxford Economics

**Table 3.5: Trade in Services by industry with non-EU countries**

| Trade in Services by type in 2007 for the rest of the world (£m) | Exports | Imports | Balance |
|---|---|---|---|
| Transportation | 9526 | 7624 | 1902 |
| Travel | 10051 | 15169 | -5118 |
| Communications | 1703 | 1828 | -125 |
| Construction | 572 | 323 | 249 |
| Insurance | 4879 | 474 | 4405 |
| Financial | 26155 | 7282 | 18873 |
| Computer and information | 3145 | 1378 | 1767 |
| Royalties and license fees | 5109 | 3472 | 1637 |
| Other business services | 24572 | 11650 | 12922 |
| Personal, cultural and recreational | 1208 | 645 | 563 |
| Government | 1278 | 1183 | 95 |
| Total Services | 88198 | 51028 | 37170 |

Source: ONS, Oxford Economics

As can be seen in the Tables 3.4 and 3.5, the main components in the trade of services are:

- **Financial Services.** No breakdown by country of financial services exports / imports is available. However, financial services make, by far, the largest contribution to the trade surplus in services with the rest of the EU and non-EU countries. This is not surprising given the status of London as one of the leading financial centres in the world, and its role as the largest financial centre for international transactions.

- **Transportation.** This includes both passenger and freight transport. For transport of goods, exports are the transportation of goods by resident carriers outside the frontier of the exporting country, whereas imports are transportation of goods by non-resident carriers outside the frontier of the importing country. For the transport of passengers, exports are international or national transportation services on behalf of non-residents by resident carriers, whereas imports are international or national transportation services on behalf of residents by non-resident carriers. For instance, a UK citizen travelling from Los Angeles to London with a non-resident carrier (i.e. American Airlines), is a UK import of transportation services; the same citizen travelling with a resident carrier (i.e. British Airways) would be domestic consumption - not an import or export-, as it would be a service by a resident carrier on behalf of a resident provided abroad.

- **Travel services.** Expenses incurred by residents abroad during visits of less than one year, excluding transportation services. Expenses by UK residents visiting abroad are an import of services, whereas expenses incurred by foreign tourists in the UK are an export of UK travel services.

- **Business Services.** These include Advertising and Market Research Industry, Management Consultancy Services, Engineering and Manufacturing Consultancy, among others.

- **Computer Services:** Trade in ICT services. This does not include trade in software, which is considered as a good, rather than a service.

- **Royalties:** Royalties are usually traded as fees or leases for the rights to use such things as franchises, copyrights, licences, patents, trademarks, etc, which together can be referred to as “intangible assets”. These cover transactions for items such as printed matter, sound recordings, performing rights, patents, licenses, trade marks, designs, copyrights, manufacturing rights, use of technical “know how” and technical assistance.

## 3.2. Jobs content of UK-EU trade

The main channels through which jobs are created in the external linkages between countries are Trade and Foreign Direct Investment (FDI). FDI will be analysed separately in Section 6.1.

A figure of 3.5 million jobs is widely quoted as a number for UK jobs dependent on EU trade[5] . This figure was reached by using exports of goods and services for 1997, and by calculating employment effects (both directly and indirectly through the value chain). This methodology is correct, although it is based only on exports, and it does not take into account the number of jobs “displaced” by imports (i.e. it arguably, considers only “half of the equation”).

Conversely, critics of the EU maintain that the UK has a negative balance of trade with the rest of the EU. Therefore, it is argued, jobs are lost in the UK due to trade with the rest of the EU and the UK would be better off if it had never joined. However, this conclusion is unlikely to be correct, for a number of reasons that are explained below.

[5] Brian Ardy, Iain Begg and Dermot Hodson, “UK jobs dependent on the EU”, Britain in Europe, 2000.

Estimating the number of jobs dependent on EU trade is a very complex task, and is outside the scope of this study. To start with, a counterfactual would have to be used (i.e. what would happen if the UK was not part of the European Union?). The conclusions would therefore depend on the assumptions around which this counterfactual is based. However, there are a number of considerations that would greatly affect this analysis, some of which are listed below:

- First of all, EU membership and trade are two separate issues, and the UK would continue to trade with the EU even if it was not a member, in the same way that the US or Switzerland does, albeit probably at lower levels.

- Trade is a welfare-enhancing activity, and if countries or individuals decide to trade, it is because they are better off by doing so. Trade therefore simply reflects the preferences of consumers and businesses. Therefore, if UK consumers prefer to drive German cars and holiday in Spain, it is because they chose to do so, and their welfare is improved. Therefore, lowering the barriers to such trade is *a priori* welfare enhancing.

- The UK has a deficit in the trade of goods with the EU, but a surplus in the trade of services. This is so because the UK economy is to some extent structurally different than the EU economy. The UK has a lower share of manufacturing in GDP, and a higher specialization in high value-added services.

- Many of the services that the UK exports (i.e. financial services), are of higher added value than the ones that the UK imports (i.e. tourist services), and therefore, add to productivity growth in the economy.

- UK imports partly involve unskilled jobs, whereas UK exports involve mainly highly skilled jobs. Therefore, it is not only the number of jobs, but the level of skills required and the nature of the jobs created that actually matters.

- It would be very inefficient for the UK to substitute imports locally, as most of the higher value activities have remained in the UK, whereas the lower added-value jobs have moved abroad. Substituting imports with low added value jobs would have a negative impact on UK GDP, lowering productivity, and diverting resources from more productive activities.

- Imports and exports from and to the EU are not easily substitutable for imports and exports from the rest of the world, as the nature of products traded is different.

- There is some degree to which imports could be substituted for by UK production, regardless of the loss in welfare associated with it, since, as indicated, given a choice UK consumers may prefer imported goods and services. Nevertheless, not all imports could be produced domestically, due to many factors (skills, know-how, investment requirements, natural resources, etc.).

In broad terms, as indicated, it is clear is that if countries trade it is because they are better off by doing so. Trade allows countries to specialize in those sectors in which they have a comparative and competitive advantage. As such it creates a “win-win” situation, which is enhanced through the operation of a customs union such as the EU.

In this context, should the UK have reduced trade with the rest of the EU (one probable consequence of never having joined the EU) it is likely that there would be substantial losses in consumer welfare for the same reasons (though it is not possible to ascertain what the magnitude of the loss would be within the scope of this report).

# 4. Labour force

**KEY POINTS**

- There are almost 2 million residents from EU countries in the UK, and 1.6 million British citizens living in EU countries. Out of the EU citizens resident in the UK, 1.25 million are originally from the former EU 14 countries, whereas 750,000 have come from the "new Member States" (such as Poland, Bulgaria, Romania).
- EU residents in the UK tend to be younger than the general population, and as a consequence, are more likely to be in employment. EU citizens account for 4.46% of the UK labour force. The productivity of these workers is likely to be higher than the average population, since they have a higher level of skills, and therefore, their contribution to UK GDP would be even higher than their proportion of the labour force would suggest.
- Citizens from EU 14 countries tend to have higher level of skills than the general UK population, and are more likely to occupy managerial positions. Citizens from the "new Member States" are more likely to have technical qualifications, and occupy skilled trades or plant operatives than the general population.
- In general, EU citizens have a positive impact on the UK economy by contributing to the UK public finances (as most are of working age and in employment), and by bringing a high level of skills (for which the UK did not have to bear education costs).

## 4.1. Citizens from the rest of the EU in the UK

Of the 5.682 million residents in the United Kingdom that were born outside the United Kingdom, at least a third (1.969 million) come from other EU countries. The actual number is likely to be higher, given that some EU short-time workers doing informal jobs or studying are unlikely to be registered as residents.

Of the citizens of other EU Member States resident in the UK (see list of countries for EU26[6]), 420,000 come from Ireland, 832,000 from the rest of the "older" Member States (see definition of EU13[7]), 589,000 from the countries that joined the European Union in 2004 (see definition of EU 8[8]), and 128,000 from the

[6] EU26 are all EU Member States except the United Kingdom: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Ireland, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden.
[7] EU 13: Former EU 15 countries except Ireland and the United Kingdom: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Netherlands, Portugal, Spain, and Sweden.
[8] EU 8: The countries that joined the European Union in 2004, except Cyprus and Malta: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.

countries that joined the European Union in 2007 (Bulgaria and Romania), plus Cyprus and Malta. This information can be found in Table 4.1 below.

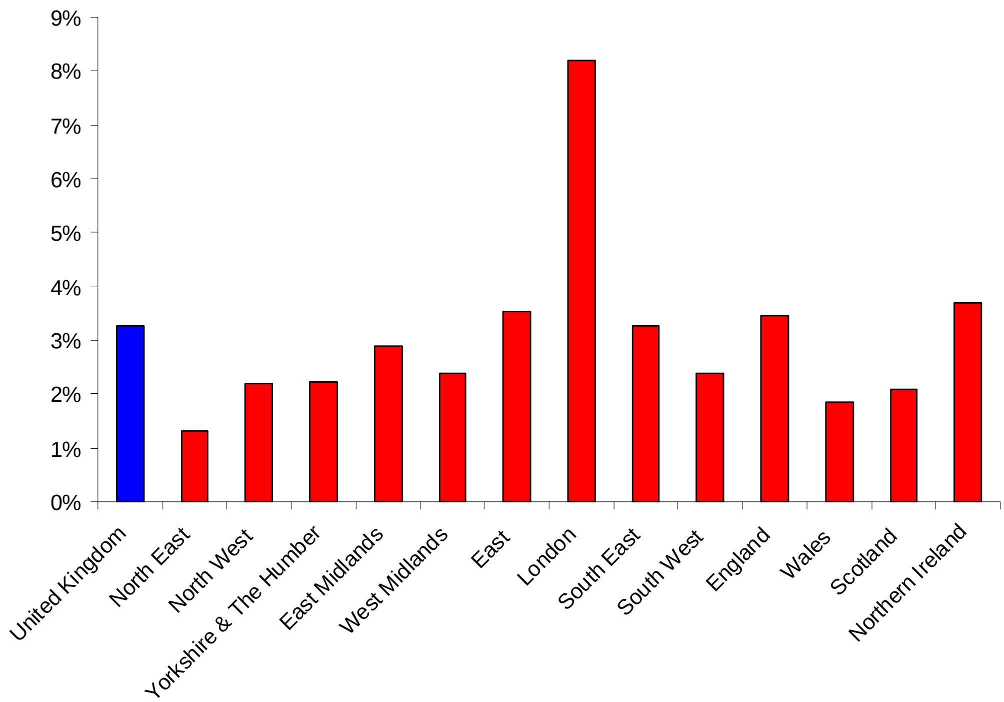
**Table 4.1: Resident population in the UK by country of birth and region**

| Countries of the UK and GORs of England | United Kingdom | Non-United Kingdom | Republic of Ireland | European Union 13[6] | European Union A8[7] | European Union 26[8] | Rest of the World | TOTAL |
|---|---|---|---|---|---|---|---|---|
| *Government Office Regions* | | | | | | | | |
| North East | 2,431 | 95 | 6 | 17 | 9 | 33 | 62 | **2,526** |
| North West | 6,328 | 451 | 46 | 59 | 37 | 148 | 303 | **6,779** |
| Yorkshire & The Hu | 4,743 | 367 | 16 | 41 | 51 | 113 | 254 | **5,110** |
| East Midlands | 3,991 | 348 | 20 | 42 | 58 | 126 | 222 | **4,339** |
| West Midlands | 4,816 | 501 | 40 | 38 | 43 | 127 | 375 | **5,317** |
| East | 5,054 | 526 | 37 | 89 | 62 | 198 | 328 | **5,580** |
| London | 5,021 | 2,474 | 119 | 271 | 162 | 614 | 1,860 | **7,495** |
| South East | 7,381 | 786 | 51 | 135 | 63 | 266 | 520 | **8,167** |
| South West | 4,758 | 315 | 21 | 63 | 29 | 121 | 193 | **5,073** |
| **England** | **44,524** | **5,862** | **356** | **754** | **514** | **1,745** | **4,118** | **50,386** |
| **Wales** | **2,813** | **129** | **11** | **25** | **16** | **54** | **75** | **2,942** |
| **Scotland** | **4,815** | **255** | **19** | **47** | **36** | **106** | **149** | **5,070** |
| **Northern Ireland** | **1,640** | **95** | **34** | **6** | **23** | **64** | **31** | **1,735** |
| **United Kingdom** | **53,791** | **6,342** | **420** | **832** | **589** | **1,969** | **4,373** | **60,133** |

Source: APS / LFS / ONS, Oxford Economics

EU citizens (excluding UK citizens) account for 3.27% of the UK population; however, regional disparities are high. Whereas in the North East, EU citizens only account for 1.3% of the population, in London 8.2% of the residents come from other EU countries. In fact, around a third of all EU citizens resident in the UK live in London (614,000). The percentage of EU-born population can be seen in Figure 4.1 below.

**Figure 4.1 Percentage of UK regional population born in other EU countries**




Source: APS / LFS / ONS, Oxford Economics.

Nevertheless, although EU citizens account for only 3.27% of the UK population, they make up 4.46% of the labour force, given that most EU citizens are of working age population, and their employment rates are relatively high. As shown in Table 4.2, employment rates are the highest for EU A8 citizens. EU 14 citizens also have higher employment rates than the UK-born population and the general UK resident population. This eases pressure on UK public finances, as EU citizens are more likely to be employed, and less likely to be unemployed or retired compared to the general UK population, as can be seen in Table 4.2.

As could be expected from a younger population group, EU citizens have higher fertility rates than the general population (accounting for 4.3% of all births in the UK in 2006[9]). In the context of an ageing population, this is a relevant issue, especially considering that migrants from EU countries have been easily assimilated within local populations and the UK labour market, due to their high level of skills and education, English language skills, and close cultural affinity.

[9] Citizens of EU 25 excluding United Kingdom. This figure underestimates the actual figure as it excludes citizens from Bulgaria and Romania, that joined the EU in 2007 (ONS, http://www.statistics.gov.uk/downloads/theme_population/FM1_35/FM1_No35.PDF, page 47)

**Table 4.2 Employment rate of UK residents by country of birth**

| Levels and rates of employment: by country of birth - January-March 2008 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Total | | UK | | EU14 (1) | | EU A8 (2) | | Rest of the World | |
| Employment ('000) | Employment rate | Employment ('000) | Employment rate | Employment ('000) | Employment rate | Employment levels | Employment rate | Employment ('000) | Employment rate |
| 29438 | **74.6** | 25755 | **75.5** | 698 | **76.5** | 510 | **82.8** | 2474 | **65.3** |

(1) EU 14: Former EU 15 countries prior to 2004 except the United Kingdom: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Netherlands, Portugal, Spain, and Sweden.

(2) EU 8: The countries that joined the European Union in 2004, except Cyprus and Malta: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.

Source: APS / LFS / ONS, Oxford Economics

Additionally, EU citizens tend to have high level of skills and qualifications. Here a distinction must be made between the citizens of EU 14 countries (old Member States) and the citizens of EU A8 countries. Whereas the former have higher average levels of education and are more likely to occupy managerial positions than the UK general resident population, the latter tend to hold a lower level of qualifications and skills, and are less likely to occupy managerial positions. However, a majority of citizens from EU A8 countries hold professional qualifications (typified as “Other qualifications” in Table 4.3 below), very much in demand by the labour market. As can be seen in the table below, citizens from the EU 14 countries are the most skilled group of workers in the United Kingdom, with 31% of them holding at least a degree qualification, compared to 23% for the UK labour force, and showing the lowest percentage of unqualified workers, at 7% (compared to a level of 9% for the UK labour force).

**Table 4.3 Highest qualification of UK labour force, by country of birth**

| People in employment aged 16 and over: by country of birth, highest qualification, October to December 2007 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Born in the UK ('000) | % | Born in EU A8 ('000) | % | Born in EU14 ('000) | % | Born in the rest of the world ('000) | % | Total ('000) | % |
| Total for period | 25878 | | 486 | | 671 | | 2450 | | 29488 | |
| Degree or equivalent | 5924 | 23% | 46 | 9% | 209 | 31% | 743 | 30% | 6922 | 23% |
| Higher education | 2614 | 10% | 11 | 2% | 57 | 8% | 219 | 9% | 2901 | 10% |
| GCE A level or equivalent | 6550 | 25% | 35 | 7% | 105 | 16% | 266 | 11% | 6956 | 24% |
| GCSE grades A* to C or equivalent | 6045 | 23% | 11 | 2% | 67 | 10% | 206 | 8% | 6329 | 21% |
| Other qualifications | 2424 | 9% | 293 | 60% | 179 | 27% | 750 | 31% | 3647 | 12% |
| No qualification | 2128 | 8% | 83 | 17% | 49 | 7% | 247 | 10% | 2507 | 9% |

Source: APS / LFS / ONS, Oxford Economics

This level of skills of the EU 14 citizens resident in the UK is shown by the fact that 57% of them occupy managerial, professional and technical positions, (against 43% of the UK labour force) and they are more likely to do so than any other groups for each category, as can be seen in Table 4.4 below. By contrast, citizens from EU A8 countries are less likely to occupy such positions than any other group. This may be so because most of these groups have only arrived recently to the UK, and because citizens from these countries tend to have trade qualifications, as is suggested by the high number of them working in skilled trades occupations, and plant and machine operatives relative to the general population.

**Table 4.4: Professional Categories of UK labour force, by country of birth**

| People in employment aged 16 and over: by country of birth, October to December 2007 | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Born in the UK ('000) | % of total | Born in EU A8 countries ('000) (1) | % | Born in EU14 countries ('000) (2) | % | Born in the rest of the world ('000) | % | Total ('000) | % |
| Total | 25878 | | 486 | | 671 | | 2450 | | 29488 | |
| Managers and senior officials | 3918 | 15% | 13 | 3% | 129 | 19% | 391 | 16% | 4452 | 15% |
| Professional and technical | 3258 | 13% | 18 | 4% | 119 | 18% | 422 | 17% | 3816 | 13% |
| Associate professional and technical | 3771 | 15% | 26 | 5% | 135 | 20% | 354 | 14% | 4286 | 15% |
| Administrative and secretarial | 3097 | 12% | 22 | 5% | 60 | 9% | 216 | 9% | 3395 | 12% |
| Skilled trades occupations | 2946 | 11% | 82 | 17% | 49 | 7% | 173 | 7% | 3251 | 11% |
| Personal service occupations | 2074 | 8% | 32 | 7% | 55 | 8% | 192 | 8% | 2353 | 8% |
| Sales and customer service occupations | 2052 | 8% | 19 | 4% | 29 | 4% | 155 | 6% | 2255 | 8% |
| Process, plant and machine opetatives | 1801 | 7% | 104 | 21% | 35 | 5% | 188 | 8% | 2128 | 7% |
| Elementary occupations | 2901 | 11% | 167 | 34% | 59 | 9% | 346 | 14% | 3472 | 12% |

Source: APS / LFS / ONS, Oxford Economics

This gap in skills and occupations between EU14 and EU A8 countries is also made evident if we look at the professional categories – the percentage of persons employed occupying managerial positions on a by-country basis (Table 4.5).

**Table 4.5: Managers and Senior Officials by country of Birth, citizens of EU 27 countries resident in the United Kingdom (Source: APS / LFS / ONS, Oxford Economics)**

| COUNTRY | MANAGERS / EMPLOYED | COUNTRY | MANAGERS / EMPLOYED |
|---|---|---|---|
| Austria | 23% | Latvia (**) | 0% |
| Belgium | 10% | Lithuania (**) | 7% |
| Bulgaria | 5% | Luxemburg | 0% |
| Cyprus | 15% | Malta | 25% |
| Czech Republic (*) | 4% | Netherlands | 15% |
| Denmark | 27% | Poland | 4% |
| Estonia (**) | 0% | Portugal | 16% |
| Finland | 27% | Romania | 3% |
| France | 23% | Slovakia (*) | 4% |
| Germany | 19% | Slovenia (***) | N/A |
| Greece | 20% | Spain | 24% |
| Hungary | 7% | Sweden | 24% |
| Ireland | 20% | **United Kingdom** | 16% |
| Italy | 22% | | |

(*) Former Czechoslovakia
(**) Former USSR
(***) Former Yugoslavia

Further, the fact that workers born abroad (including all countries, not only EU countries), are more likely to earn higher wages than their British counterparts with the same level of education, suggests that only the most productive workers are willing to relocate in order to pursue their professional careers.

Taken together these facts indicate that the UK may obtain benefits from EU migration into the UK in a variety of ways:

- By obtaining a pool of young, highly talented, highly productive, highly skilled labour force, for which it did not have to bear education cost, and who make a positive contribution to the UK public finances, coming mainly from the EU14 countries.
- By obtaining a pool of young, qualified and cheap labour force, mainly from the EU8 countries, and for which it did not have to bear the cost of education.
- By stimulating demand, therefore increasing economic growth, which in turn opens-up opportunities for existing businesses.

Some migration would obviously continue even if the UK were not a member of the EU (as was the case before its formation). However, the creation of a free market for labour as well as for goods enhances the benefits of such migratory flows.

Immigration continues to occupy a central position in the UK public opinion debate, but in the current economic climate, it could be expected that inflows of migrants from the "new Member States" will decline in the coming years. This could be attributed to several reasons including:

i) improved economic circumstances in the EU new accession countries;

ii) recessionary environment and growing unemployment rate in the UK;

iii) the recent decline of Sterling.

## 4.2. UK Citizens in the rest of the EU

There are globally almost as many British people living abroad (about 5.5 million), as foreigners living in the UK (about 6.5 million).

Although there is no data readily available about the size of the UK migrant community for the EU 26 countries, their labour status, or place of residence, estimates[10] for the EU 14[11] and EU 8[12] countries suggest that there are 1.5 million British living in EU 14 countries, and a further 65,000 in EU 8 countries. About 800,000 British people are resident in Spain, 300,000 in Ireland, 200,000 in France, and 100,000 in Germany.

[10] "Brits Abroad: Mapping the scale and nature of British Emigration", IPPR, 2006
[11] EU 13: Former EU 15 countries except Ireland and the United Kingdom: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Netherlands, Portugal, Spain, and Sweden.
[12] EU 8: The countries that joined the European Union in 2004, except Cyprus and Malta: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.

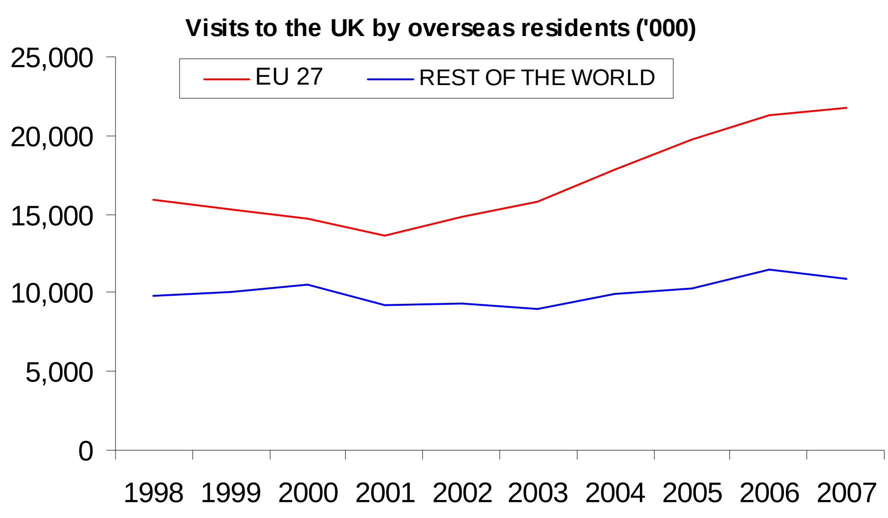
# 5. Tourism

**KEY POINTS**

- The EU is the main destination for UK residents (74% of their visits abroad), while EU citizens make up the largest group of visitors to the UK (67% of the total).
- The emergence of low-cost flights has changed the travel patterns of both UK residents in the EU and EU residents in the UK, by encouraging more regular and shorter visits abroad.
- EU citizens spent £7 billion on their visits to the UK in 2007, which amounted to 0.5% of GDP for that year (direct impact only)

Tourism, as previously stated, is a service that can be exported (visits to the home country by foreign residents), and/or imported (visits abroad by the home country's residents). While it may also have some negative aspects, in general, tourism is a culturally enriching activity that promotes the understanding and friendship of nations. Tourism, which includes business trips, can be a source of economic growth as it facilitates the exchange of knowledge and ideas, can be a source of inspiration, and may result in knowledge spillovers. An example of this could be a visitor being exposed to technologies or commercial ideas that are not available in his/her home country, and which may be applied on return.

**Figure 5.1: Visits to the UK by overseas residents**



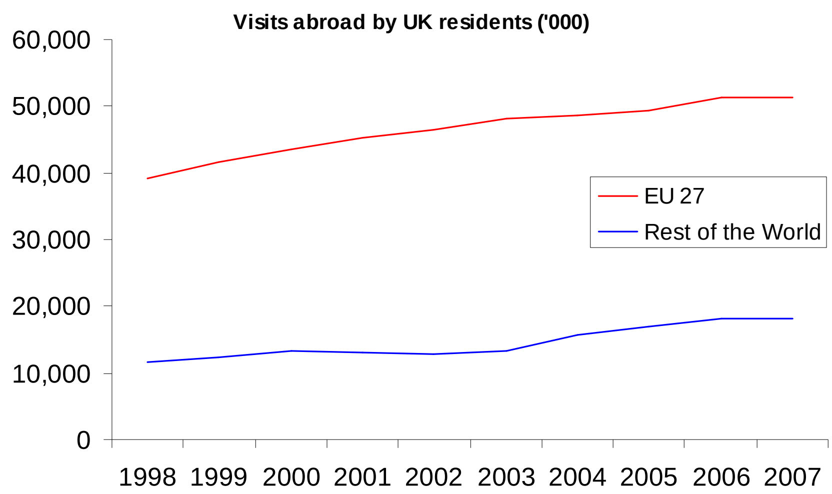

Source: International Passenger Survey (2007), Oxford Economics

The UK is the sixth most visited country in the world (behind France, Spain, US, China, and Italy), and London is the most visited city in the world. 67% of visitors to the UK, originate in EU 26 countries. Among those, an overwhelming majority (97%) come from the former EU 14 countries. As can be seen in figure 5.1 above, the number of visits by EU residents has increased significantly during the last few years, whereas the number of visits by residents from the rest of the world, has remained fairly constant.

The rest of the EU is also the preferred destination of UK residents, who make more than 50 million visits a year to other EU countries, as depicted in figure 5.2 (74% of their visits abroad). As can be seen in Figure 5.2, the number of visits to the rest of the EU by UK residents has increased during the last few years at a faster pace than the number of visits to the rest of the world.

The emergence of low cost flights may have altered the pattern of visits for both EU residents visiting the UK, and UK residents visiting the EU. The most significant change is that the number of visits has increased, whereas the length of the stay has decreased. Therefore, although the expenditure per day has increased during recent years, the total expenditure per visitor has remained stable. Nevertheless, due to the rising number of visits, the total expenditure by EU tourists has increased significantly, as can be seen in Figure 5.3.

**Figure 5.2: Visits abroad by UK residents**

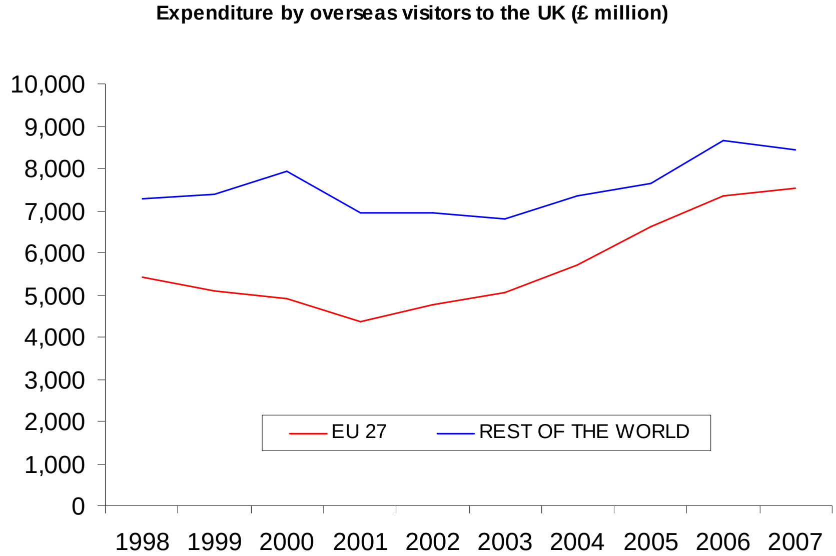



Source: International Passenger Survey (2007), Oxford Economics

More than £7 billion was spent in 2007 by EU residents visiting the UK, versus a total expenditure of over £8 billion for citizens from the rest of the world.  In 1998, the average length of stay in the UK for EU residents was 7 nights, whereas in 2008 it was 6 nights. For non-EU residents, these figures were 12 and 11 days respectively. Therefore, it is not surprising that residents from non-EU countries spend more in the UK than visitors from the EU (figure 5.4), given that they tend to make longer visits - this is likely to be due to the fact that the cost of visits from more distant countries is higher, and so such visitors tend to spend longer to make their trips worthwhile.

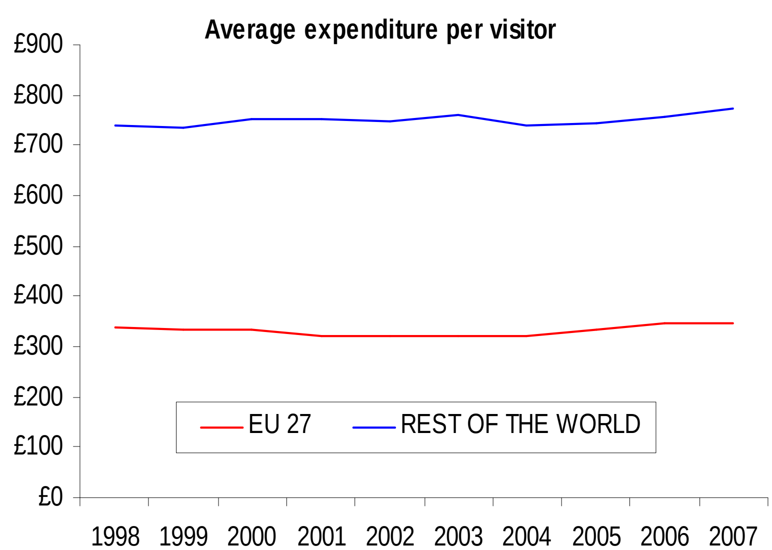
In any case, the expenditure of EU tourists has increased at a faster rate than expenditure by non-EU residents in recent years (figure 5.3).

**Figure 5.3: Overseas visitors' expenditure in the UK**




Source: International Passenger Survey (2007), Oxford Economics

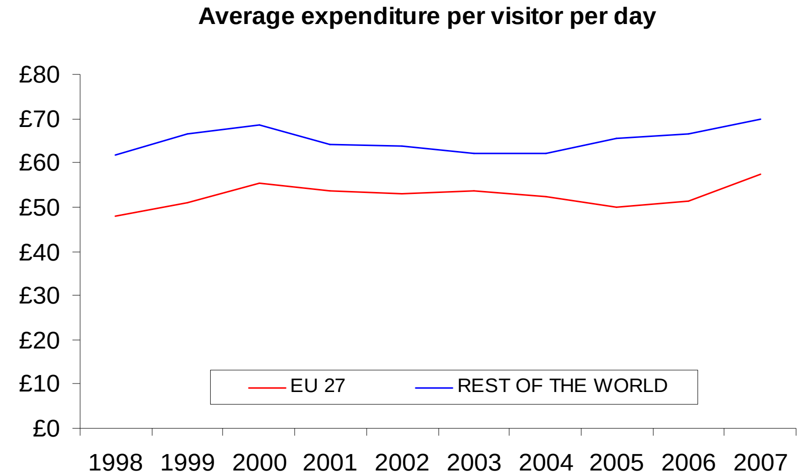
**Figure 5.4: Overseas Visitors' Expenditure in the UK**




Source: International Passenger Survey (2007), Oxford Economics

EU visitors spend slightly less per day than non-EU visitors (£57 vs. £70), as depicted in Figure 5.5. This could be related to the “higher fixed travel costs” issue, noted above.

**Figure 5.5: Overseas Visitors’ Expenditure in the UK**




Source: International Passenger Survey (2007), Oxford Economics

Tourist visits and expenditures could be expected to decline for both EU visitors in the UK and UK visitors in the EU, given the current economic circumstances. Also, the recent fall in Sterling against the Euro could prevent some UK citizens from holidaying in other EU countries, and at the same time stimulate EU tourism into the UK. However, the relative magnitude in the fall of each variable cannot be ascertained within the scope of this report.

# 6. Foreign Direct Investment (FDI) Linkages

**KEY POINTS**

- FDI creates jobs, stimulates innovation and competition, and raises productivity, as it makes available technologies and knowledge that has been successful in other countries.
- EU FDI stock in the UK accounts for half the total stock of FDI, and has been growing rapidly. EU FDI in the UK creates 50-60,000 jobs, and safeguards a further 40-50,000 jobs every year (equivalent to 0.34% of the labour force).
- The UK is home to the second largest stock of FDI in the world, after the US. The UK attracts such a high amount of FDI from both EU and non-EU countries, because international companies choose the UK as the gateway for their European operations. 26% of non-EU companies have their European Headquarters in the UK.
- Access to the single market is one of the main reasons why companies decide to invest in the UK. Other reasons are access to capital markets, a good pool of resources (labour skills, ICT, a strong R&D base) and a low level of regulation.

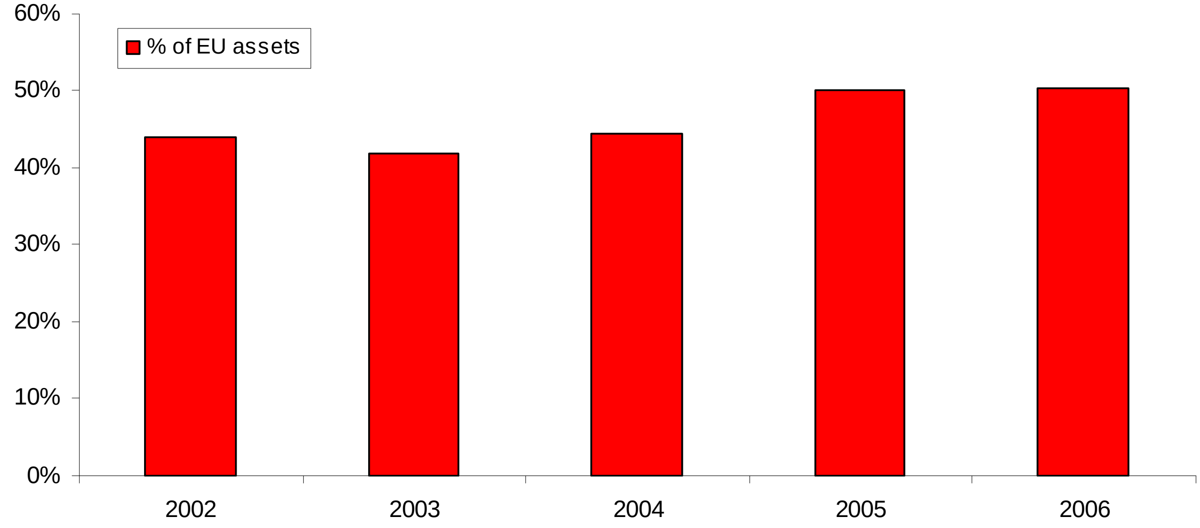
FDI creates jobs, and raises productivity as it stimulates the exchange of ideas, and makes available technologies, knowledge and strategies that have been applied successfully in other countries.

A substantial amount of foreign FDI into the UK from non EU countries is motivated by companies using the UK as a gateway to the European market and establishing their European headquarters here (26% of all European Headquarters of non-EU companies are based in the UK). The UK is home to the highest stock of FDI in Europe, and second in the world only to the US.

## 6.1. FDI stock

The stock of FDI in the UK that originates from the rest of the EU accounts for 50% of the total stock of FDI in the UK (Figure 6.1). This stock has increased in the last years, as the inflow of FDI into the UK from EU countries has increased more rapidly than those from outside the EU (Figure 6.2).

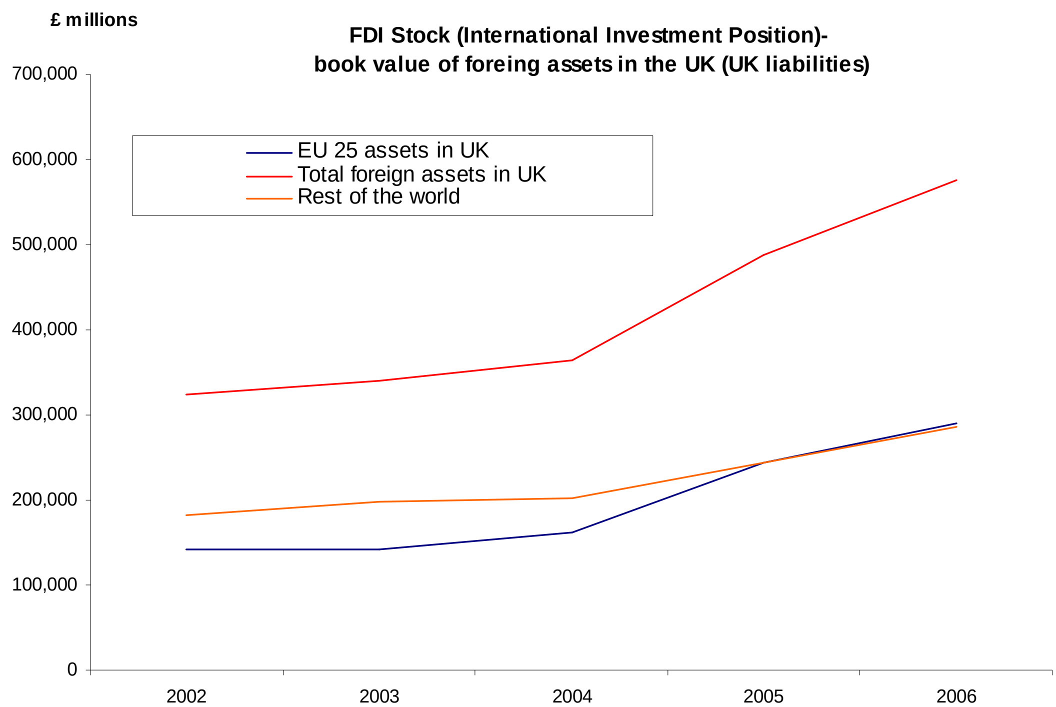
**Figure 6.1: Proportion of EU FDI stock in the UK as a % of all FDI stock in the UK**




Source: ONS, Oxford Economics

The stock of EU FDI in the UK in 2006, the latest year for which data is available, was £290 billion, up from £142 billion four years earlier – a 104% increase - and it amounted to almost a quarter of the UK annual GDP (£ 1,229 billion in 2007). The stock of non-EU FDI has increased throughout this period from £182 to £287 billion – a 57% increase.

**Figure 6.2: Evolution of FDI stock from EU and non-EU countries**



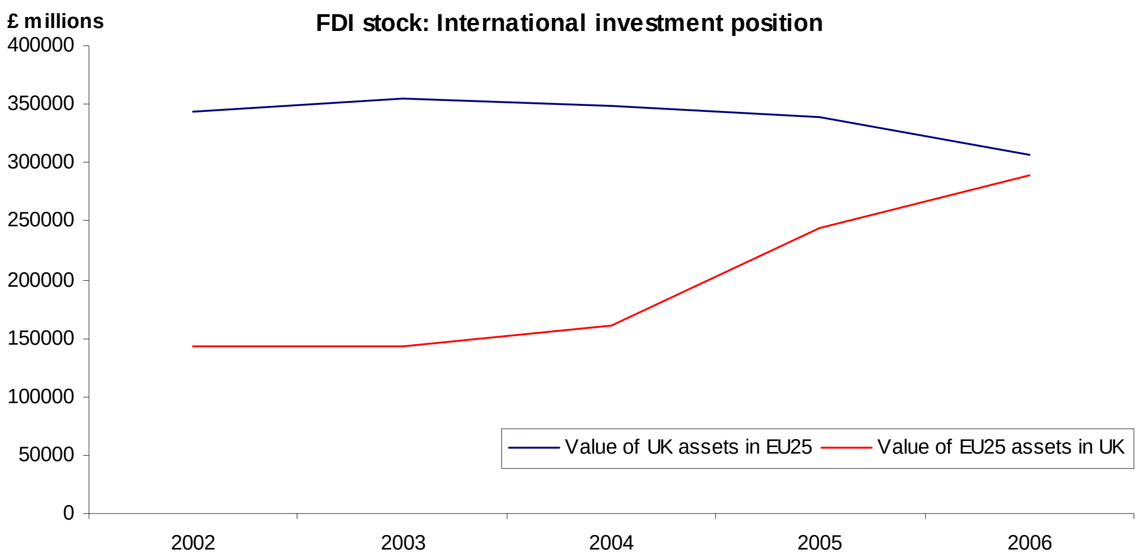

Source: ONS, Oxford Economics

Some of the main reasons why the UK attracts such a high amount of FDI, and acts as a gateway to the EU, are[13]:

- EU membership grants access to the internal market, the largest economic bloc in the world in terms of trade, GDP, and with a consumer market exceeding 500 million people.
- Access to capital markets (with London being Europe's largest financial centre).
- An excellent pool of resources (ICT infrastructure, a skilled labour force, the position of English and availability of foreign language speakers, the strength of the R&D base).
- Lower level of regulation, flexible labour markets, and lower taxation than in the rest of the EU.

The UK also possesses a substantial amount of FDI stock in the rest of the EU (Figure 6.3), although this stock has slightly decreased in recent years, whereas EU FDI stock in the UK has increased. Also, much non-EU FDI is channelled into the EU through the UK. For instance, a Japanese company with their European headquarters in London, and making an investment in Germany, will account as a FDI flow from the UK into the EU.

**Figure 6.3: FDI stock**



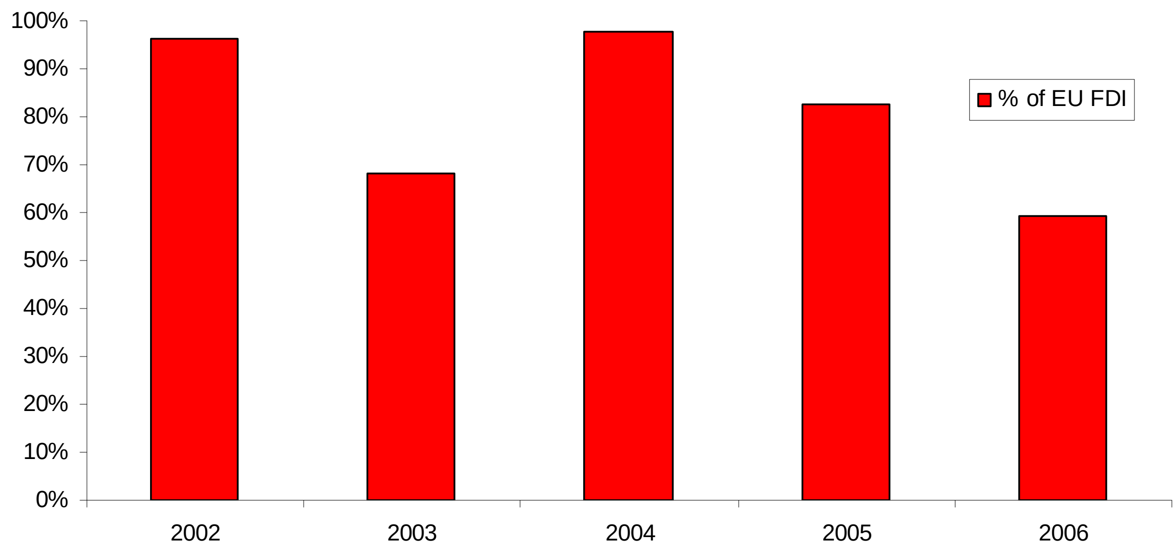

Source: ONS, Oxford Economics

[13] UK Invest, "A guide to Foreign Investment", 2005.

## 6.2. FDI flows

FDI flows are subject to a high level of variability, given that they are determined by cyclical factors such as macroeconomic growth, investment opportunities and exchange rates. Most of the FDI flows into the UK come from the rest of the EU. This proportion ranges from between 98% of all FDI in 2004, and 60% for 2006, the latest available year for which data exists (Figure 6.4).

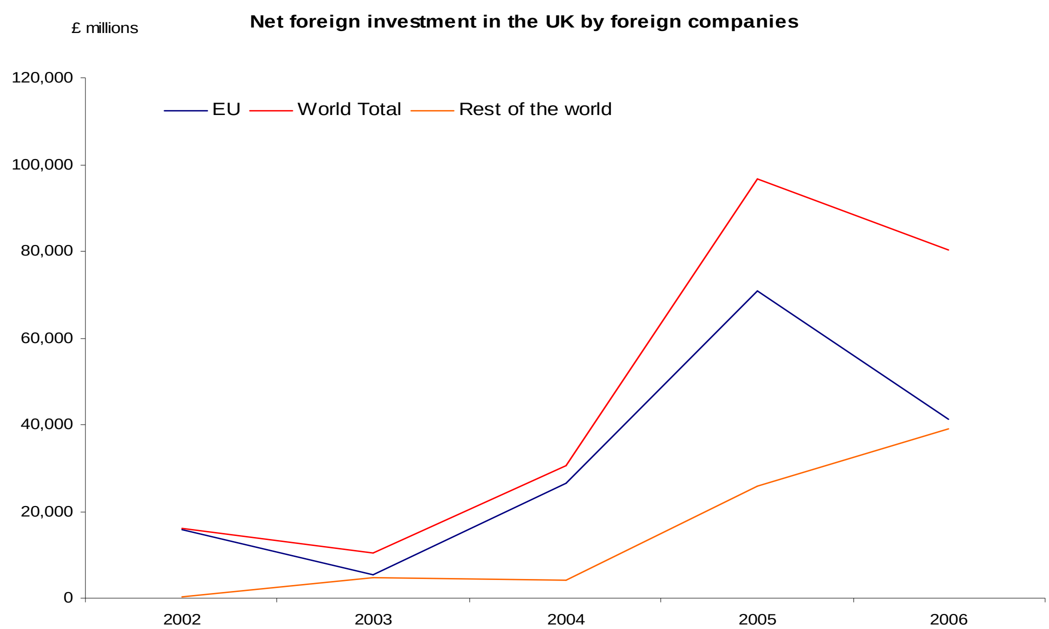
**Figure 6.4: Proportion of FDI flows into the UK originating in the EU**




Source: ONS, Oxford Economics

The flow of FDI from EU countries has grown more rapidly than those from non-EU countries, and now the EU holds now a larger part of the FDI stock in the UK than non-EU countries (Figure 6.5).

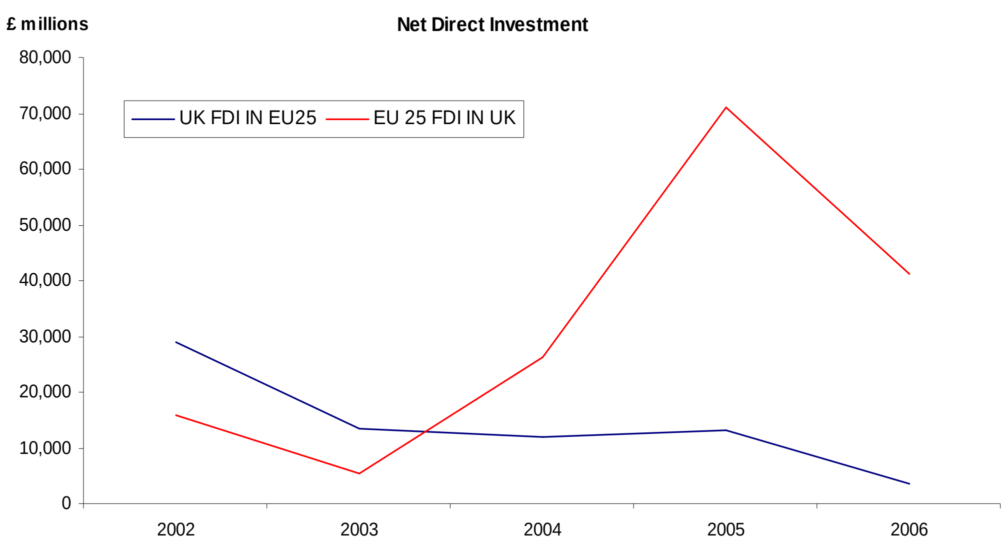
**Figure 6.5: FDI flows in the UK by origin – Source: ONS, Oxford Economics**



FDI flows from the EU into the UK accounted for £42 billion in 2006, or around 3% of the UK GDP, down from £71 billion in 2005 (around 5% of the UK GDP). As noted, FDI creates jobs, and raises productivity as it stimulates the exchange of ideas, and makes available technologies, knowledge and strategies that have been applied successfully in other countries. Furthermore, it encourages competition and spurs innovation within existing companies, as they try to keep up with newcomers. Also, a substantial amount of foreign FDI into the UK from non-EU countries may be motivated by companies using the UK as a gateway to the European market and establishing their European headquarters here. For instance, in 2007 19% of all FDI projects in the EU had the UK as a destination[14], and they accounted for 31% of all FDI in the EU in dollar terms in 2006[15].

In terms of volume, as stated, the UK is also a significant investor in the rest of the EU, since investment of the parent companies in their European subsidiaries is channelled through the UK if their European headquarters are established there. However, FDI flows from the EU to the UK were far larger than FDI flows from the UK to the EU between 2004 and 2006. This may have been motivated by the GDP growth differentials between the UK and EU in those years.

**Figure 6.6: FDI flows from and into the EU**




Source: ONS, UK Trade and Investment, Oxford Economics

As can be seen in Figure 6.6 above, until 2006 (the latest data available) the UK had a positive balance on FDI flows, that made a positive contribution to the capital account, and helped balance out the current account deficit[16].

[14] Ernst & Young, European Investment Monitor, 2008. http://www.eyeim.com/pdf/EIM%202008%20Report%20final.pdf, retrieved on 18th November 2008.
[15] The UK Company Bill and FDI, http://www.econtentaxis.com/images/econtentaxis.com_Finance_writing.pdf, retrieved on 18th November 2008.
[16] Balance of payments = Current account + Financial Account + Capital Account; Capital Account = FDI + Portfolio Investment + Other investments (Loans, bank accounts, currencies etc.).

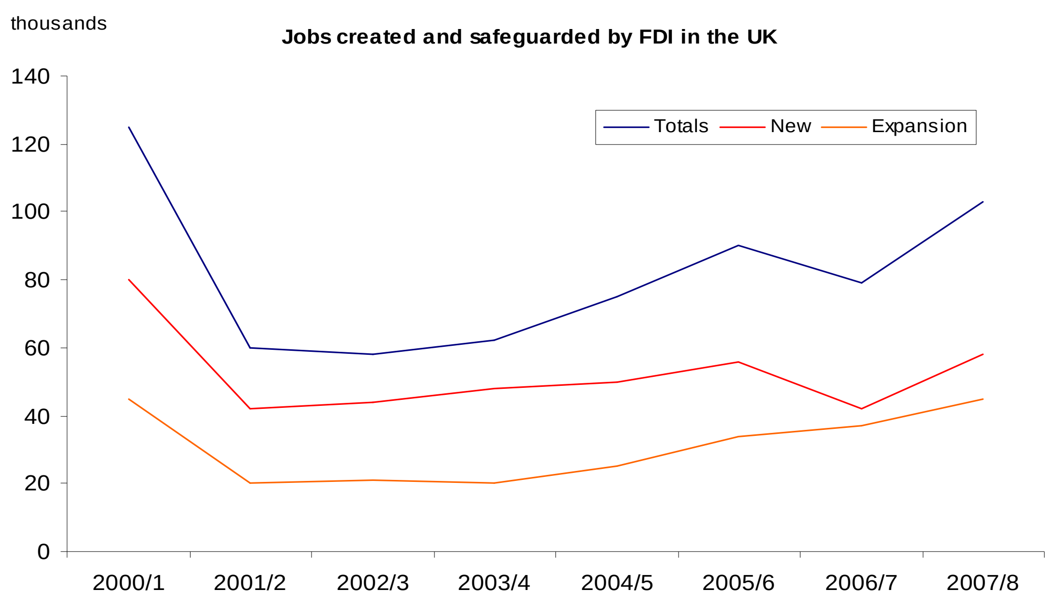
## 6.3. Jobs created through FDI

In terms of jobs creation, it is estimated that FDI into the UK creates around 50-60,000 jobs each year and safeguards a further 40-50,000. as indicated in Figures 6.6, and 6.7[17]. Given that the EU is the origin of a significant proportion of these investments, a significant amount of jobs are created by EU FDI in the UK (Figure 6.8).

It would be logical to think that, were the UK not be a part of the EU, some of these investments could be located somewhere else, as the UK would become a more peripheral market. Although many of the reasons that have attracted FDI in the UK would remain (such as flexible labour markets or low income taxation), a divergent regulatory and accounting framework, legal system, and financial environment, would imply that many companies could find it advantageous to have established their headquarters in other EU Member States.

For instance, it can be assumed that companies would want to establish very close ties with their bankers, lawyers and accountants. However, if the UK was not part of the EU, the best lawyers and accountants with expertise in EU regulation would probably be based in Brussels, Frankfurt, or Paris, rather than London. Also, companies tend to establish their headquarters close to decision centres, based on economic and political dimensions of businesses. Therefore, if the UK was not part of the EU, it could be that fewer companies would establish their European headquarters here. Furthermore, if the UK was not a member of the EU, it would still have to comply with many EU regulations in order to continue to do business with the rest of the EU, without having a say in its running (as EFTA countries currently do).

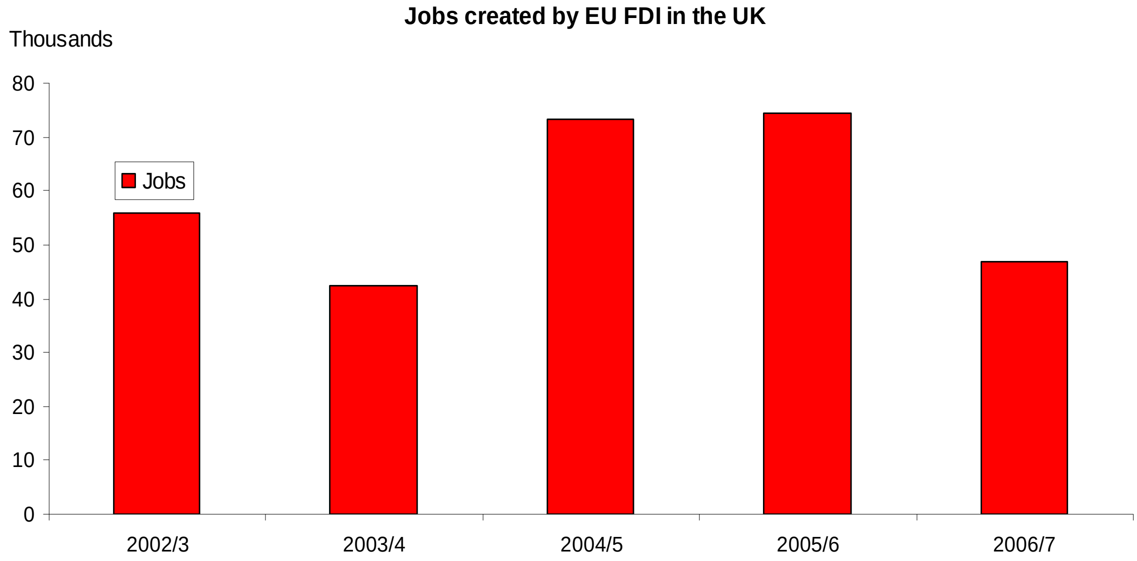
**Figure 6.7: Jobs created and safeguarded by FDI in the UK**




Source: ONS, UK Trade and Investment, Oxford Economics

[17] "UK Inward investment", 2004, 2005, 2006, 2007, UK Trade and Investment.

**Figure 6.8: Jobs created and safeguarded by EU FDI in the UK**[18]




Source: ONS, UK Trade and Investment, Oxford Economics

Looking forward, the current recessionary environment suggests that the amount of FDI from both EU into the UK, and UK into the EU, will decline in the coming year(s). On the other hand, the fall in Sterling makes investments in the UK cheaper than before, which could stimulate investment. However, it cannot currently be ascertained which effect will prevail.

[18] "UK Inward investment", 2004, 2005, 2006, 2007, UK Trade and Investment.

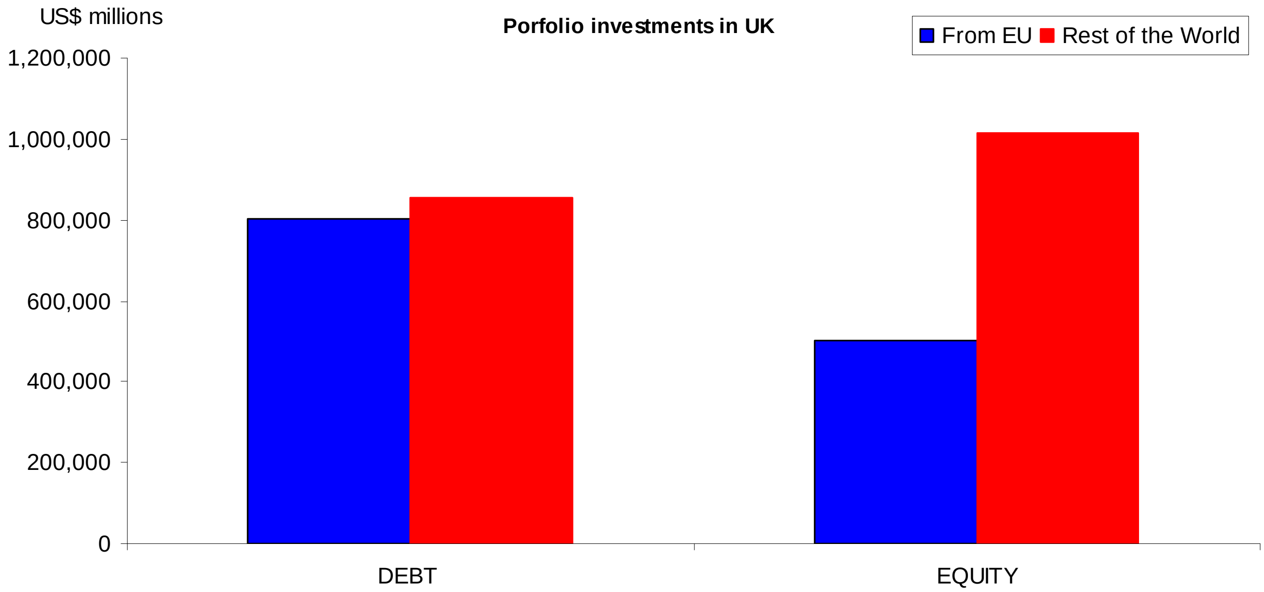
# 7. Porfolio investment linkages

**KEY POINTS**

- Portfolio investments in the UK amount to 2.6 times the annual UK GDP. Of that amount, 41% originated in the rest of the EU.
- EU portfolio investments in the UK amounted to US$ 1.3 trillion, whereas UK portfolio investments in the EU amounted to US$ 1.15 trillion. This makes a positive contribution of US$ 150 billion to the UK capital account, helping to balance out the UK current account deficit

Portfolio investments in the UK amounted in 2006 to US$3,17 trillion, that is, 2.6 times the annual UK GDP. Of that amount, 41% (or US$ 1.3 trillion) originated in the rest of the EU, representing 48% of all debt and 33% of all equity investments from non-residents.

**Figure 7.1: Portfolio investments in UK**



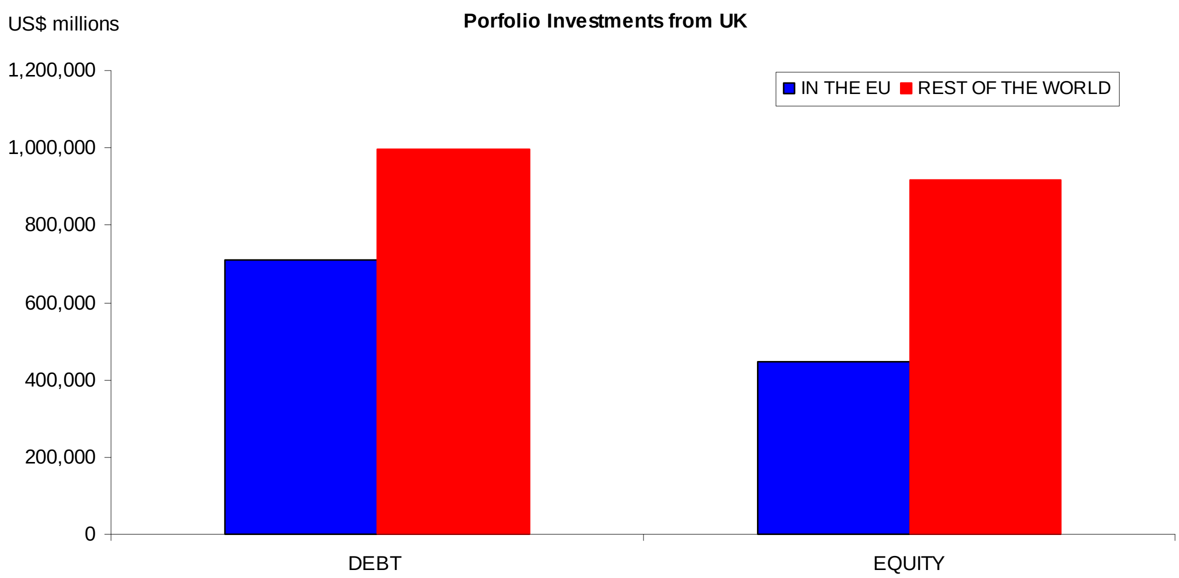

Source: IMF, Oxford Economics

Further, the UK was the destination of 19.1% of all portfolio investments made into the EU, This places the UK as the first recipient of portfolio investment in the EU (2006 data).

Additionally, the UK attracted 9.5% of all portfolio investments originating in the EU (excluding the UK). This places the UK as the second largest recipient of portfolio investments originating in the EU, after the US (US$ 1,795 billion in for the US vs. US$ 1,305 billion in the UK).

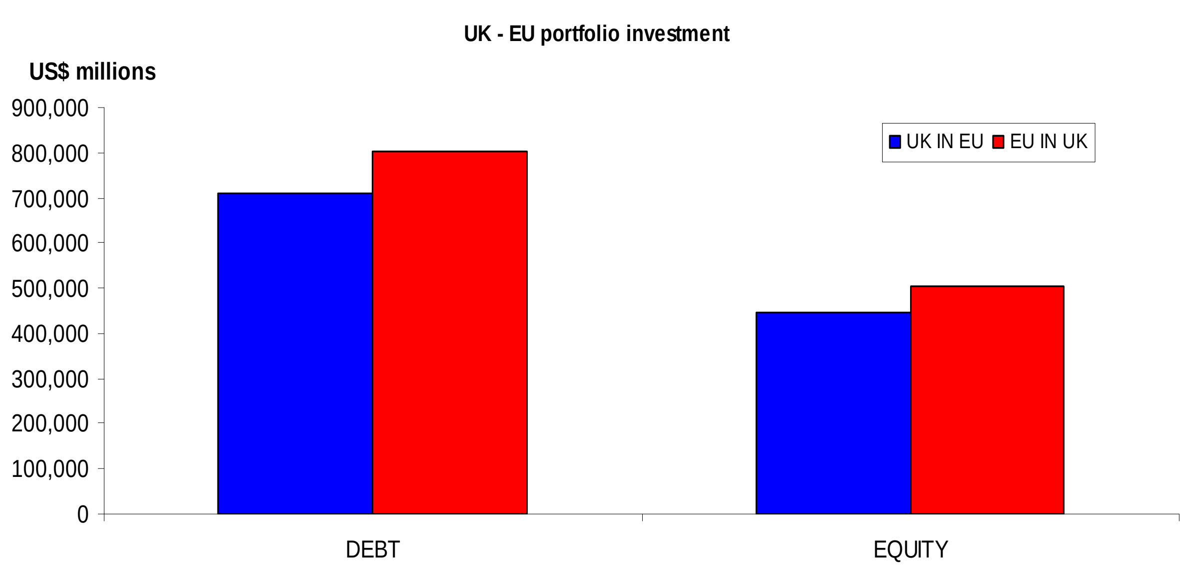
The relevance of the UK in attracting portfolio investments is, to some extent, related to the position of London as an international financial centre, and, as mentioned before, the role of the UK as a gateway to the European markets. Therefore, it can be expected that the UK is a large investor in the EU (Figure 7.2 below), as many of these investments take place through financial institutions based in the UK. Nevertheless, EU portfolio investments in the UK, exceed UK portfolio investments in the EU by US$150 billion (Figure 7.3). This figure contributes positively to the capital account, and helps balance out the UK current account deficit.

**Figure 7.2: Portfolio investments from the UK**




Source: IMF, Oxford Economics

**Figure 7.3: Balance of portfolio investments between the UK and the EU.**




Source: IMF, Oxford Economics

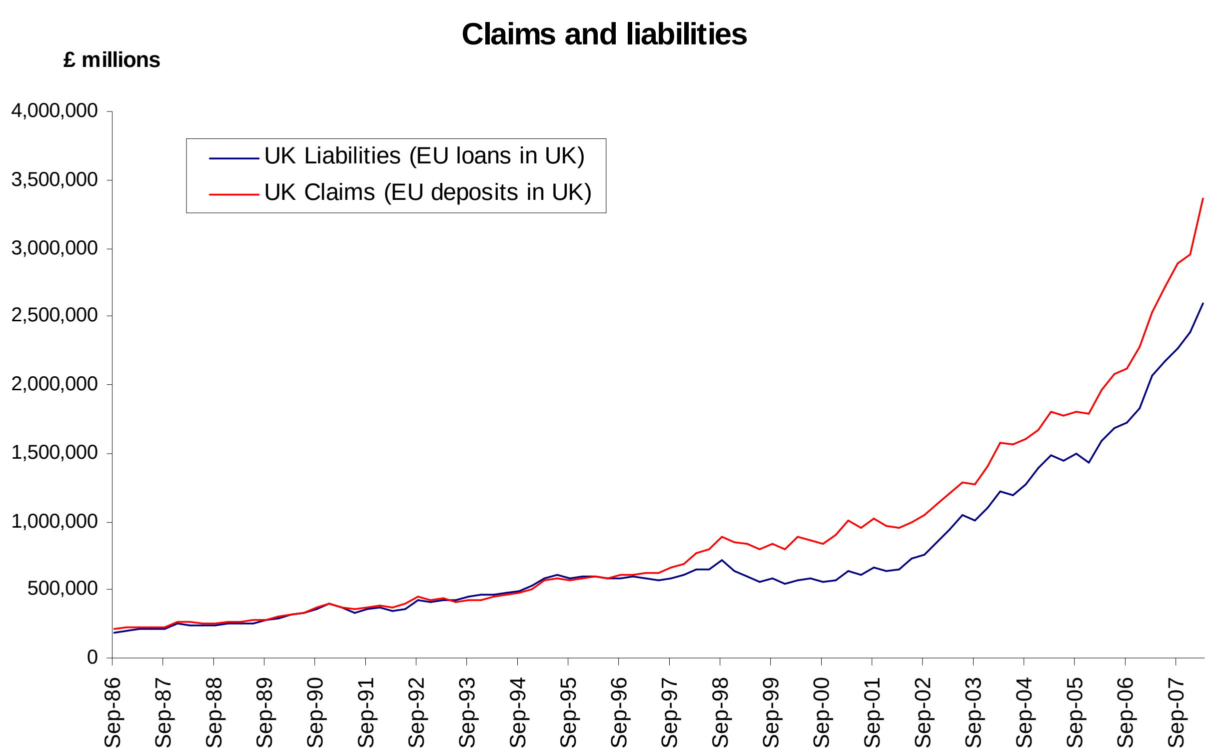
# 8. Banking linkages

**KEY POINTS**

- EU citizens and corporations held one third of all foreign deposits in the UK, and subscribed 48% of all the loans made to foreigners in the UK.
- The UK records a surplus in the trade of financial services of about £12 billion. Of this, the surplus from trade in banking services with EU countries accounts for about £1 billion.

EU citizens and corporations held assets to the value of £ 2.6 trillion in UK banks and liabilities of £3.66 trillion with UK banks. These values have increased very rapidly in recent years (Figure 8.1). This trend has progressed as financial market integration has deepened, and the position of London as a world financial centre has strengthened, although it remains to be seen how the current economic downturn will impact on it.

**Figure 8.1: Value of claims and liabilities of EU in the UK**

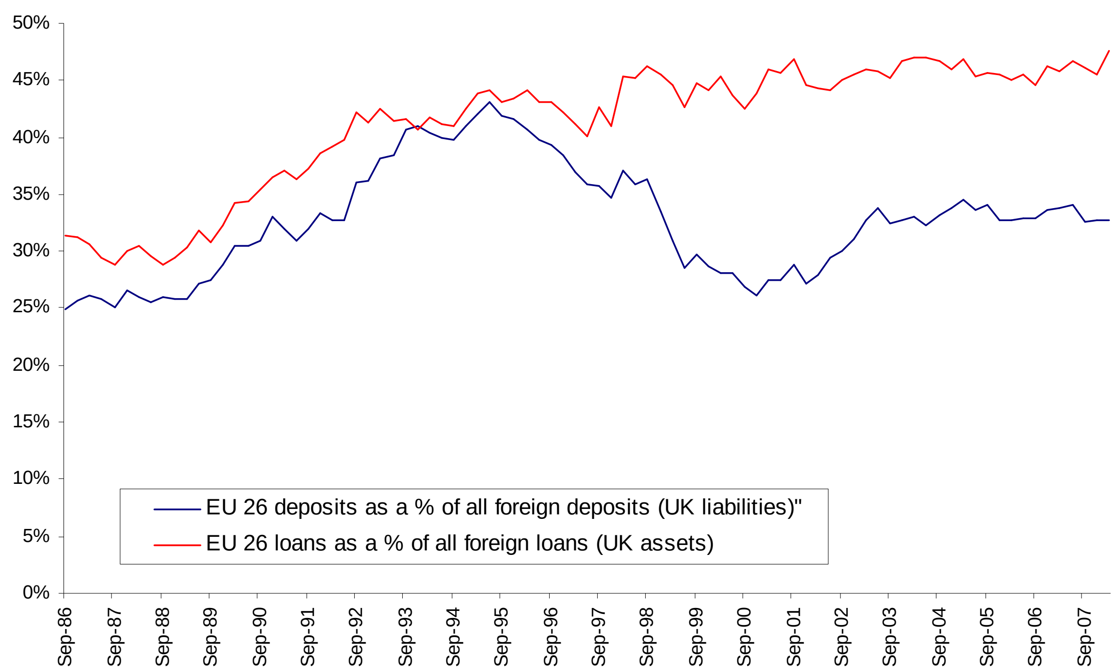



Source: Bank of England, Oxford Economics

EU citizens and corporations held one third of all foreign deposits in the UK, and subscribed 48% of all the loans made to foreigners in the UK. The magnitude of the numbers is not surprising, given the scale of the London Interbank market and its activities (Figure 8.2). Nevertheless, if the UK were not a part of the EU, some of these activities would probably be diverted to other European financial centres. While some financial activities would still be based in London, increasingly divergent regulatory and accounting frameworks, for instance, would mean that many EU banks would be less attracted to do businesses in the UK. Also, many non-EU banks that use London as the gateway to its pan-European operations, would instead conduct some of their activities in other EU countries, for the reasons outlined above.

Nevertheless, it could be assumed that the shift of activities to other EU countries would affect financial markets to a lesser extent than investments in other sectors of the economy (such as FDI). The main reason for this is that capital markets are very globalized, very liquid, and highly mobile.

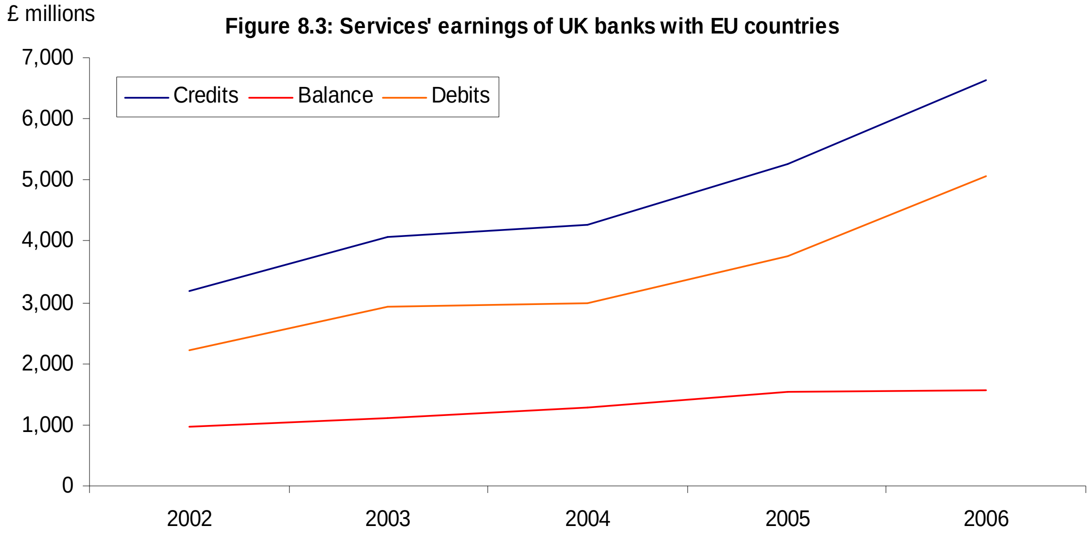
**Figure 8.2: EU loans and deposits as percentage of all foreign assets and liabilities**




Source: Bank of England, Oxford Economics

The scale of the banking activities contributes positively to the UK balance of trade, as indicated in Figure 8.3. The UK had a positive balance in the trade of financial services of more than £12 billion in 2006. If we look only at the service earnings by UK banks (excluding other types of financial intermediation), we can see that the UK has a surplus of about £2 billion per year with EU countries (Figure 8.3).

**Figure 8.3: Services' earnings of UK banks with EU countries**




Source: ONS, Oxford Economics