

Australia should prioritise a free-trade agreement with the European Union to capitalise on [historically optimal relations](#), rather than with the United Kingdom, immediately after a hard Brexit. A hard Brexit would see a sudden exit of the UK from the EU and now seems more likely given [UK Prime Minister Theresa May's line on this](#).

As part of our [submission](#) to a [parliamentary inquiry](#) we examined data on the flow of trade in goods and services between all three regions, separating out the UK from the EU.

The [inquiry](#) is examining Australia's trade and investment relations with the UK post Brexit, in particular the merit and risks of a possible bilateral free-trade agreement.

Australia should be striving to gain an advantage in any trade agreement, this means cooperating with a trade partner so that there is more crossover of exports and imports between the two countries and less competition.

When we looked at the data and when we compared Australia and the EU, there was much more crossover and less competition, than with the UK.

Australian investors exposed

We also compared the data on trade in goods and services to that of Australian investments in the UK and in the EU, and vice versa. We specifically separated out the UK from the EU to get an accurate picture of the post Brexit risks.

We examined two aspects of capital investment. Firstly the exposure of Australian investors who hold stocks and bonds in the the UK and EU financial markets and secondly any investor in the UK and EU who holds stocks and bonds in Australia.

Trade data shows Australia can get more out of a deal with the EU than the UK

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The market volatility created by the hard Brexit will have a significant direct negative bearing on both the Australian financial market and to some extent on Australian portfolios abroad.

Notably, for the past decade the average exposure of Australian portfolios in the EU stocks and bonds markets (minus the UK) is worth nearly double than that in the UK. Overall the UK and EU stocks and bonds portfolios we studied jointly account for approximately more than one-fifth of all asset holdings in Australian financial markets.

Our analysis also highlights the importance of London as a gateway for the UK and EU funds destined for the Australian financial market. The future positioning of London post-Brexit can have deeper long-term implications for patterns of financial flows, and ultimately for Australia's financial solidity.

Given the political uncertainty of [post-Brexit negotiations between the UK and EU](#), Australia's [economic diplomacy](#) should be mindful of sequencing trade and investment negotiations in ways that minimise financial exposure and maximise trade competitiveness with the various European partners.

Likelihood of a hard Brexit

No formal Australian trade negotiations with the UK can be pursued until the conclusion of its withdrawal process from the EU. Only then the UK will become a separate customs entity and so being entitled to negotiate international trade agreements.

Considering the present political climate and [technical difficulties](#), it appears [unlikely that the UK and EU will finalise an agreement before the two-year term](#) set by Article 50 of the EU Treaty. This is also even unlikely to happen before the advance of the [Australia-EU free trade agreement](#).

Without a timely agreement, the UK and EU will revert by default to the multilateral [rules of the World Trade Organisation](#).

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For Australia's trade and investment relationship with the UK, this reset would be an improvement from the present subordination to the European single market. However, it's uncertain whether this regulatory levelling would necessarily improve Australia's economic outcomes.

Nonetheless, pundits in both hemispheres are calling for a [quick bilateral deal](#) to counter the uncertainties of the Brexit process. Yet, there is no clear evidence of economic gains to be reaped from a new bilateral free trade agreement immediately after the Brexit process concludes.

In fact, as established by the [2010 Australian Government's Productivity Commission Report](#), bilateral and regional free trade agreements "can significantly increase trade flows between partner countries, although some of this increase is typically offset by trade diversion from other countries".

It's crucial to ensure that any future preferential trade and investment arrangements with the UK and EU will be negotiated in Australia's economic interests with a rigorous and transparent evidence-based approach.

Australia should avoid multilateral options and hasty blanket deals with the UK. Instead, Australia's end game should be at separate bilateral levels in carefully targeted sectors with both the UK and EU, in order to achieve more favourable trading terms than the UK can score with the EU and vice versa.

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