National Institute of Economic and Social Research

Press Release

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The Economic Impact of Leaving the EU

- A vote to leave the EU would represent a significant shock to the UK economy
- In the short run, our analysis suggests it would lower GDP growth to 1.9 per cent in 2017, compared with a growth rate of 2.7 per cent in a world in which the UK voted to remain.
- In the longer run, our analysis suggests that it would lower GDP by between 1.5 per cent and 7.8 per cent in 2030, also compared with a world in which the UK voted to remain.
- Sterling would also depreciate in the longer-run, to close to parity with the euro by 2030.
- By 2030, consumption would fall by between 2.4 per cent and 9.2 per cent compared to a world in which the UK remained in the EU. This translates into declines in annual consumption per capita of between £500 and £2,000 (at 2012 prices) by 2030.

A decision to leave the EU would represent a significant shock to the UK economy. This shock would be likely to manifest itself through a number of channels, some of which might be expected to be relatively short-lived, predominantly affecting the near-term outlook. Others, such as the reductions in trade and foreign direct investment (FDI), would represent more permanent structural changes to the UK economy, and so would have important long-run implications.

Our analysis considers both, and builds them together into one coherent framework to generate a plausible view of what a vote to leave the EU may mean for the UK economy.

In the short run, the current heightened levels of uncertainty are likely to persist, if not intensify, as the UK establishes its place outside the EU. Financial markets are already pricing in a period of currency volatility around the referendum. It would also seem reasonable to expect an increase in credit premia across the economy, raising the cost of borrowing for the government, businesses and households.

The world that emerges is one in which sterling depreciates immediately, by around 20 per cent, against a basket of currencies. This drives inflationary pressure, causing CPI to jump by between 2-4 percentage points more than our Remain-based forecast in 2017. Meanwhile, GDP growth is around 0.8 percentage point lower next year compared with the counterfactual.

As negotiations conclude, the short-run influences dissipate. In their place come long-run reductions in trade and FDI, as well as a potential impact on productivity. We phase these in starting in 2017.

Leaving the EU works to reduce the UK's access to EU export markets, acting to reduce demand for UK exports. Leaving the EU is also expected to reduce FDI inflows to the UK. We calibrate the size of the UK's loss in EU export market share and the loss in FDI inflows using estimates from academic research. In addition, we assume a 5 per cent increase in tariffs for exports into the EU. We also take potential reductions in the UK's net contributions to the EU into account. Finally, we also allow for the reductions in openness to have a negative impact on productivity in one of our scenarios, with the size of the shock calibrated to be in line with the academic research.

We consider four scenarios, with varying degrees of market access to the EU: Norway (EEA membership), Switzerland (bilateral agreements), WTO (no free trade agreement with the EU) and WTO+ (no free trade agreement with the EU, and a -5per cent productivity shock).

In all scenarios, the reduction in demand for UK exports leads to both declines in export prices and to a long-run and persistent depreciation of sterling to around parity with the euro. While the fall in sterling does allow export demand to rebound somewhat, this is still outweighed by the loss of access to EU markets, and exports fall by between 10 per cent and 29 per cent compared with a world in which the UK remained in the EU.

The weaker pound would also lead to higher import prices, feeding through into higher prices faced by households. Lower prices for our exports, coupled with higher import prices, leads to a persistent deterioration in the terms of trade. The UK benefits less from trade after leaving the EU than it would if it had remained, reducing long-run prosperity. By 2030, consumption is projected to fall by between 2.4 per cent and 9.2 per cent compared with a world in which the UK remained in the EU. This would translate into declines in annual consumption per capita of between £500 and £2,000 (at 2012 prices) by 2030.

In terms of labour markets, our analysis shows that the UK's flexible labour markets would ensure that unemployment would not be perceptibly higher by 2030, but real wages would bear the brunt of the adjustment. By 2030, we estimate that real consumer wages would be between 2.2 per cent and 7.0 per cent lower outside the EU than they would be remaining in the EU.

The Review also includes NIESR's baseline forecast for the UK remaining in the EU – see separate press release.

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Notes:
The complete analysis is published in the National Institute Economic Review no. 236 May 2016.

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