National Institute of Economic and Social Research

ECONOMIC IMPACT OF THE WITHDRAWAL AGREEMENT

Written Evidence to Treasury Committee ahead of the Oral Evidence Session: "The UK's economic relationship with the European Union" held on 3rd December 2018

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Treasury Committee Written Evidence:

Economic Impact of the Withdrawal Agreement

Summary

The UK is set to leave the European Union at the end of March 2019. The process of leaving was triggered by the result of the Advisory Referendum held on 23 June 2016, which led to invocation of Article 50 on 29 March 2017. The Withdrawal Agreement agreed with the EU on 25 November 2018 gives a concrete basis for understanding the impact on the UK economy from EU Exit. It is not at all certain that the current Withdrawal Agreement is the one that will be implemented on Exit and there are a number of other scenarios that may transpire. It therefore is quite sensible to consider a number of alternate scenarios in order to evaluate the consequences of one form of Exit as opposed to another but also to help formulate policies that may militate against some of the more extreme impacts arising from Exit.

The scenarios presented by the Institute, and also by HMG and the Bank of England, are not specific forecasts of the state of the economy at some point in the future, but are statements that allow us to compare different long run outcomes (steady-state equilibria) under the various forms of Exit in which the extent of frictions on trade in goods and services, the scale of foreign direct investment and net migration differ. Even though there are examples of one or two industrial sectors that may benefit marginally from Exit, the consistent result from these analyses is that national income will be lower than it would otherwise be under the current trade and service agreements that the UK observes as an EU member. The central case we find, with which there is a high degree of consensus, is that the implication of the proposed Withdrawal Agreement when compared to the hypothetical case in which the UK stays in the EU is a loss of some 3% of income per head.

An economic analysis or forecast of the short and long-term impact of the Government's proposed Withdrawal Agreement and the joint Political Declaration.

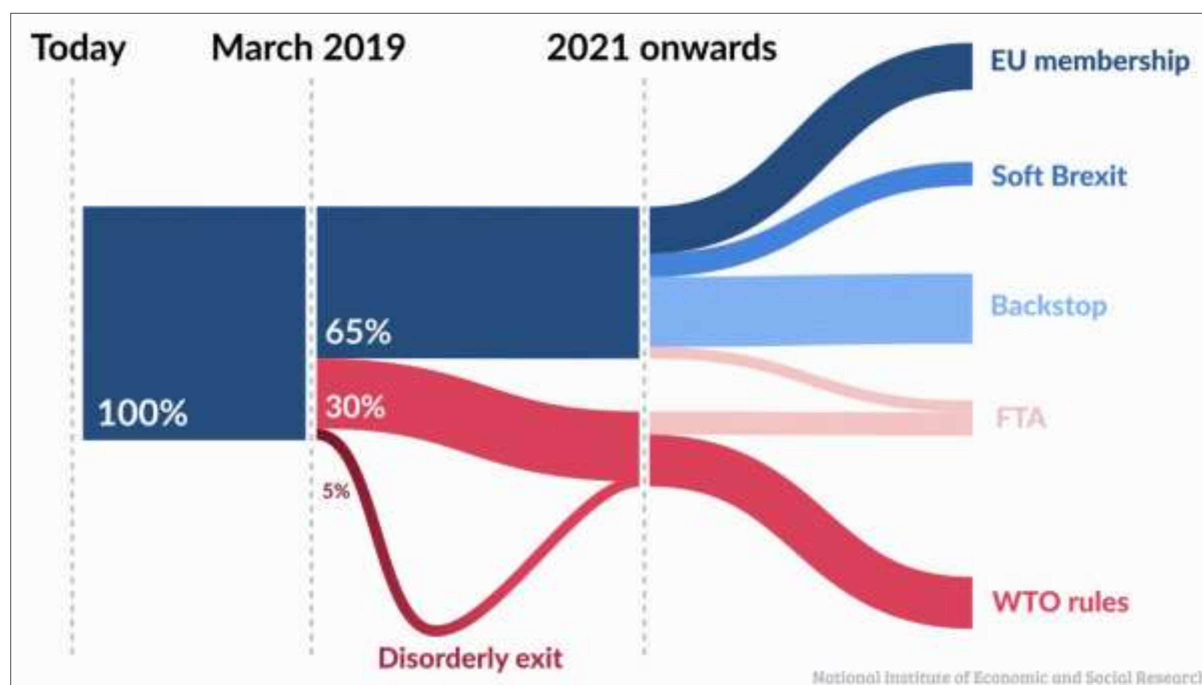
The impact of any EU Exit deal can be broken down into two key components: first, the economic impact of the changes in the trading relationships between the UK, EU and other countries brought about by the deal: second, the economic impact of how the deal affects uncertainty and confidence. The main focus of the Institute's analysis is on how the government's proposed Exit deal is likely to affect the economy, leaving aside the effect it might have on uncertainty. Our assessment is that trade with the EU, especially in services, will be more costly after Exit in terms of tariff and non-tariff barriers. This increase in costs is likely to have an adverse effect on living standards in the UK. Our central estimate is that if the government's proposed EU Exit deal is implemented, then GDP in the longer term will be around 4 per cent lower than it would have been had the UK stayed in the EU. This is roughly equivalent to losing the annual output of Wales or the output of the financial services industry in London. This is equivalent to a loss of 3 per cent in GDP per head, worth around £1,000 per annum on average to people in the UK. If the UK were to stay in a customs union with the EU, or if the Irish backstop position was to be invoked, there would still be a hit to GDP per capita of 2 per cent. In addition to the economic impact of the changes in the UK's trading relationships brought about by the deal, is the effect it has on uncertainty and confidence. Even if the deal is implemented, there will continue to be uncertainty about the precise shape of the future relationship beyond the transition period ending on 31 December 2020 and that is likely to have a material impact on living standards.

Recent estimates, based on the UK's performance relative to other similar economies, suggest that EU Exit uncertainty has already reduced the level of UK GDP by about 2 per cent relative to what it would have been if the UK had planned to stay in the EU. This uncertainty is a consequence of the 2016 referendum result. We are not able to quantify explicitly the effect of the deal on uncertainty and confidence but to the extent that it does not provide clarity about the UK's future trading relationships then business investment and economic activity in the UK is likely to continue to be lower than it would have been had the UK stayed in the EU, so that the estimates in the summary table below may be an underestimate of the economic cost of the Exit. The estimates presented represent the Institute's considered view of the economic impact of the government's proposed EU Exit deal, but they are themselves uncertain as there is no historical precedent of a country leaving a major trading block such as the EU.

It should be stressed that uncertainty about the impact of leaving the EU is not the same as the uncertainty that typically surrounds forecasts. In particular, forecasts are produced by making judgements about the effects of many possible events, and are known to be subject to wide margins of error often represented by forecasts represented as fan charts that show the probability of different possible outcomes at different times. Long-term forecasts are especially uncertain. By contrast, the current exercise aims to compare different scenarios on a consistent basis, holding constant many of the factors that affect the development of the economy, and varying only the economic relationship between the EU and UK. This conditional calculation is much more precise than trying to forecast unconditionally. Similarly, we are more confident about the directional effect of different trading arrangements with the EU than we are about the outlook for the economy. This is because we know that the terms on which the UK will trade with the EU after EU Exit in the different scenarios will not be as favourable to the UK as they are now. Over time, if the UK was to leave the Irish backstop and the EU customs union, this worsening of the terms with which the UK trades with the EU may be partially mitigated by improved trade arrangements elsewhere as the UK makes new trade deals with other countries. But we do not think that better trade relations with distant economies can make up for less access to the EU market. Our key finding is that if the government's proposed EU Exit deal is implemented so that the UK leaves the EU customs union and Single Market in 2021, then by 2030 GDP will be around 4 per cent lower than it would have been had the UK stayed in the EU. This finding is largely because higher impediments to services trade make it less attractive to sell services from the UK and discourages investment in the UK and ultimately means that UK workers are less productive than they would have been if the UK had stayed in the EU.

The Figure below illustrates the uncertainty that is faced by the country as a result of the different trading relationships in which the country may ultimately find itself. It is based in recent betting odds. Approximately there seems to be 35% probability of moving to WTO rules rather than some form of agreement with the EU. With that possibility there is a possibility of a disorderly Exit. The post-2012 possibilities can be ranked approximate terms of welfare from the best case of maintaining EU membership to leaving under WTO rules.

Figure 1: Illustrating Exit Paths



An economic analysis or forecast of the short and long-term impact of the UK leaving the EU without a deal and moving to WTO rules with or without a transition period.

There are two forms of no deal Exit. We have modelled an orderly Exit. We contrast our results with those obtained for an orderly No-deal scenario under which the UK reverts to trade under WTO rules after 30 March 2019. For the long run impact on trade the published literature suggests that moving from full membership in the EU Customs Union and Single Market to a trade relationship under WTO terms would reduce UK-EU trade in goods by between some 50 and 65 per cent in the long run. Services trade would fall by 40 to 65 per cent, according to the extant literature. Our no-deal scenario assumes a reduction of some 50 per cent in total UK-EU trade.

For the short run adjustment we assume that half of the impact in UK-EU trade takes place in the second quarter of 2019 as some goods and services can no longer be traded and others face severe barriers at the border. Trade then adjusts over the course of ten years to reach the long-run trade relationship under WTO rules with bilateral trade 56 per cent lower than under the status quo. We additionally assume that in the event of such an Exit inward FDI falls by some 20% or more, labour productivity is some 1.5% lower and net migration is around 50% of the Remain scenario. In this case, if a no deal Exit can be managed in an orderly manner then GDP in the longer term will be around 5.5 per cent lower than it would have been had the UK stayed in the EU.

We have not modelled a disorderly no-deal as we think a Sudden Stop in activity lies beyond the realm of the sliding scale approach to calibrating Exit. At the extremes we have to make some *ad hoc* assumptions about the scenario in which the country may find itself. The disruption to normality may have consequences that stretch outside of basic GDP calculation if, for example, food and medicines became unavailable for some time. There would also in the event of such a scenario be a sequence of policy reactions, as well as some pre-planning, that might mitigate some of the short run consequences. So such an extreme scenario in which policy does not act to offset aspects

of the impact is best left or thought of as a systemic stress test, which is precisely what the Bank of England analysis has done.

An analysis of the UK economy had the UK voted to remain in the 2016 EU referendum.

The economic performance of the UK economy since the Advisory Referendum on 23 June 2016 has been relatively lacklustre and there is evidence from a wide range of indicators that it has been worse than it would have been had the Referendum not taken place. This appears to reflect two key factors: the sudden depreciation of the sterling exchange rate immediately after the referendum which affected import prices, and the effect of EU Exit-related uncertainty on business investment decisions. Surveys of UK companies, indicates that by Autumn 2018, more than half of businesses reported EU Exit as among the top sources of uncertainty they faced and this seems to have been associated with a 3 per cent reduction in investment per year.

A likely consequence of these developments is that UK economic growth has been weaker than it would otherwise have been since the Referendum, and UK inflation has been higher. While UK economic growth had been among the highest in the G7 prior to the referendum, it subsequently dipped below the growth rate of other advanced economies. On the basis of similar evidence some economists have used synthetic control techniques to estimate that by the second quarter of 2018 the level of UK GDP was 2 per cent lower than it would otherwise have been. And the result is explained by the effects of heightened uncertainty and downgrades of expected future output growth.

Analogously UK CPI inflation had been towards the bottom of the pack of other countries prior to the referendum, it subsequently rose above that in other countries as the effect of sterling's depreciation passed through to import and consumer prices. One of the effects of higher prices is that household real incomes and consumer spending are also likely to be weaker than they would have been had the referendum not taken place. It has been estimated that UK household income was some 2-4 per cent lower than it would otherwise have been as a consequence of the referendum. It is possible that, should the UK decide not to leave the EU after all, some of these negative effects of the EU referendum would unwind. We therefore consider a Stay scenario that reverses some of these effects. We assume that business investment rebounds from 2019 onwards, growing by 4 per cent per annum for two years before reverting to its long-run growth rate of 1–2 per cent. The sterling-US dollar exchange rate appreciates to $1.40 by 2020 while growth in trade steadies. Labour productivity growth picks up to just above 1.5 per cent per year. It is this scenario that provides a benchmark for the various forms of Exit.

Any analysis or commentary on any economic analysis or forecasts provided by HM Government or its associated public bodies.

The Table below compares the assessment of the Institute's independently produced assessment to that of HMG and the Bank of England, as well another independent study produced by UK in a Changing Europe. It is clear that the losses in GDP relative to something near to the status quo increase were more distant relationships with the EU to be established. The official models have used both a top down approach from macroeconomic models of aggregate data and also an industry-by-industry sectoral model that builds the aggregate result from the bottom up. The

Institute has interpreted the various scenarios and calibrated them into a numerical statement of impact on trade in goods and services, FDI, migration and labour productivity the key drivers of any change in activity and allowed the model to work out the impact on overall activity as all relative prices and quantities adjust to shocks. The consistent signal from these analyses which were produced independently from each other is remarkable.

Table 1: Comparison of EU Exit Deal impact studies

		Close relationship	**FTA**	**Orderly no-deal**
Long run				
NIESR	% GDP	-2.8%	-3.9%	-5.5%
	% GDP per capita	-1.9%	-3.0%	-3.7%
UK in a Changing Europe	% GDP	n/a	n/a	n/a
	% GDP per capita	-5.5%		-8.7%
HM Government	% GDP	-2.1% to -3.9%	-4.9% to -6.7%	-7.7% to -9.3%
	% GDP per capita	-2.1% to -2.7%	-4.9% to -5.4%	-7.6% to -8.1%
Medium run (2023)				
NIESR	% GDP	-2.6%	-2.0%	-3.2%
Bank of England	% GDP	-1.25% to -3.75%		-7.75%

Notes: 'Close relationship' encompasses comparable scenarios with stronger regulatory convergence compared to a free trade agreement but characterised by non-tariff barriers in particular to services trade. This includes NIESR's 'Deal + Backstop' scenario and the scenario by HM Government called 'White Paper w/ 50% NTB sensitivity'.

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