MEF Briefing Note: Forecasting Brexit

- The benefits of joining the EEC/EU can be called into question, especially when looked at in GDP per capita terms.
- Many of the short-term forecasts in the immediate aftermath of the Brexit Referendum were overly pessimistic, and have not been borne out in the subsequent economic data.
- Leaked government documents suggest there is also considerable pessimism in the Civil Service.
- Research by the Centre for Business Research suggests that the impact of Brexit may be smaller than some forecasters have predicted.
- Currently, worst-case estimates of the impact of Brexit appear to be less than the cumulative estimated output loss resulting from the 2007-09 financial crisis.

Exiting the EU will undoubtedly have both an economic and political cost for Britain. Calculating the scale of the cost, and indeed any potential benefits arising from Brexit, is heavily dependent of the policy assumptions adopted.

Forecasting how a four-decade institutional arrangement will untangle is fraught with difficulties; this task is made even more problematic when it is understood that, ultimately, some form of economic and political interaction will persist between Britain and the EU – geography alone dictates that. There may be severance but there will be continuity.

Predicting how such an entrenched political-economic construct will unravel is made more difficult both by the fragility of economic data and assessing what policy options may be adopted by the respective parties to accommodate future economic and trade events. In the context of widely perceived past failures of economic forecasters, such as anticipating the 2007-09 financial crisis or the immediate impact of the Brexit vote, all economic forecasts are going to be regarded with some scepticism unless the underlying assumptions are clearly articulated.

Notably, model assumptions require data that is not yet available, as the government has yet to formalise a strategy on what the tariffs on goods will be, potential changes

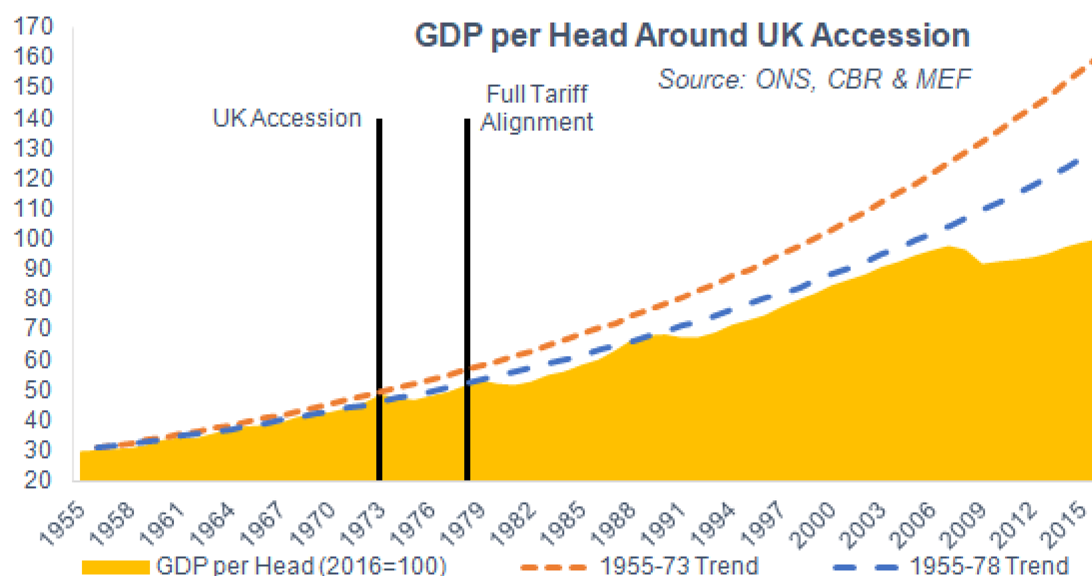
in non-tariff barriers and the likely scale of loss in trade resulting from closer future economic integration. However, given the current integration of the EU in the global trading system, notably the WTO (which most recently signed the WTO Trade Facilitation Agreement in 2017, reducing administrative costs), ensures that adverse conditionality cannot be imposed on Britain by the EU compared to other Non-EU trading partners.

This paper examines the various published assessments made with regard to the economic impact of Brexit. It also summarises the research paper *"How the Economics Profession got it wrong on Brexit"*, Centre for Business Research, University of Cambridge Working Paper No. 493, by Ken Coutts, Graham Gudgin and Jordan Buchanan, January, 2018.

The Base Assumption: the impact of EEC/EU Accession

It is a widely held assumption that Britain secured significant economic benefits from its membership of the EEC and as it evolved into the EU. It is obviously difficult to develop a counterfactual scenario of what may or may not have happened had the Britain not joined or the 1975 referendum had produced a no vote.

It is however the case that measured in GDP per capita terms, the rate of British economic growth has slowed since accession in 1973.

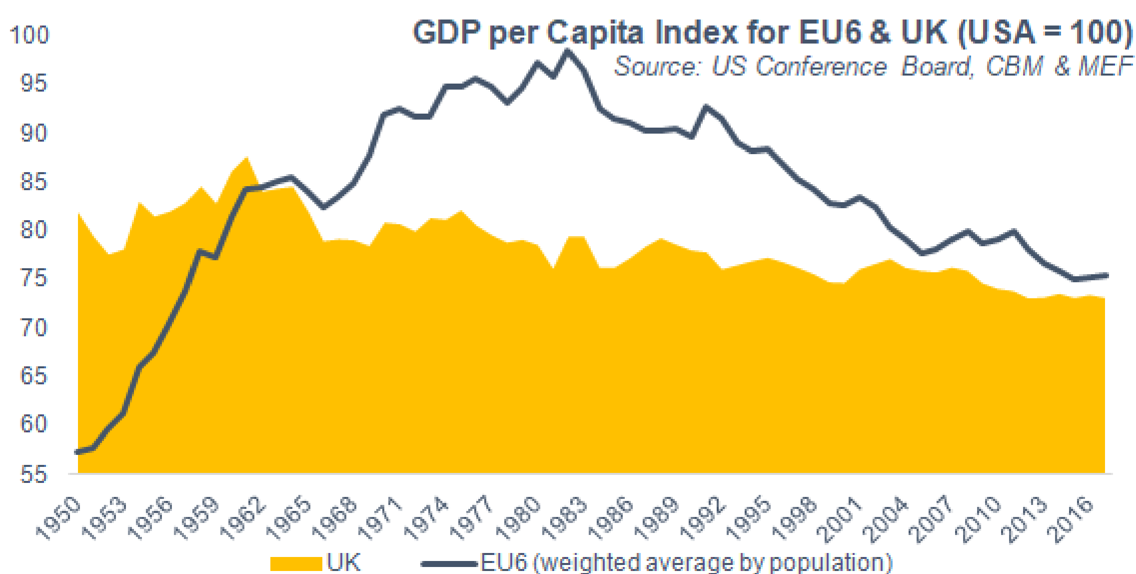


As can be seen from the chart above, if the UK had continued the trend growth from 1955-73 then GDP per capita would be at much higher levels than it is now. Indeed,

even if the trend growth from 1955-78 had been continued, then per capita GDP levels would be higher.

Compared to the EU6 (the original six members of the EU) expansion up until the 1970s was faster than in the UK, and slowed soon after the UK's accession, meaning that before the UK's accession, growth was slower than the EU6, but after the accession it was faster – an argument often used in favour of the EEC – although this relative improvement was more down to a slowing of growth in the EU6 rather than increased growth in the UK.

This relative improvement throws doubt on the idea that the slowdown was due to other external factors, such as the rapidly increasing oil price during the 1970s. These factors would have affected all countries, and indeed, when compared to the USA, growth in the EU6 is faster than in the UK until the mid-1970s, and then slows. Meanwhile, growth in the UK remains broadly in line with the USA.



It can also be argued that many of the policies which most benefitted growth were independent of the UK joining the EEC, such as liberalisation in trade under GATT and subsequently the WTO, as well as under the Thatcher government.

This is not to say that membership has not had a beneficial impact, and indeed as a political economic construct the EU membership can been seen to have been wide ranging, but measured economically in GDP per capita terms the assumption has yet to be proven. However, equally so, many of the modern constructs of the EU only

came into place in the 1990s, such as the Single Market (and subsequent increase in membership) so comparisons with the point of UK entry in 1973 need to be taken with caution.

Forecasts on the Effects of Brexit

A wide range of forecasts were made around the Brexit referendum covering the short-term impact of Brexit as well as the longer-term effects of the UK's departure from the EU. These forecasts cover a wide range of scenarios, with the consensus being that the worst option for the UK is to trade under WTO rules after Brexit.

Summary of Forecasts								
Source:	**Forecast Date**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
ONS	**Outturn**	**1.9**	**1.8**	**x**	**x**	**x**	**x**	**x**
OBR	Nov-16	2.1	1.4	1.7	2.1	2.1	2.0	x
	Mar-17	1.8	2.0	1.6	1.7	1.9	2.0	x
	Nov-17	1.8	1.5	1.4	1.3	1.3	1.5	1.6
HM Treasury	May-16	3.6-6% lower than base level by 2018						
Bank of England	Aug-16	1.8	0.8	1.8	x	x	x	x
	Feb-18	x	x	1.7	1.8	1.7	1.7	x
IMF	Oct-16	1.8	1.1	1.7	1.8	1.9	1.9	x
	Jan-18	x	1.7	1.5	1.6	1.7	1.7	1.7
OECD	Jan-18	x	1.5	1.2	1.1	x	x	x

HM Treasury Model

HM Treasury forecast that the effect of a vote to leave the EU would be that GDP was around 3.6% lower after two years than if the UK had remained a member of the EU. Recent data do not support this forecast's accuracy. If GDP was indeed 1% lower in 2017 due to Brexit, that would have led to growth of 2.8% in 2017 if the UK had chosen to remain in the EU, which is higher than any annual growth figure since 2014, when growth was 3.1%. In the longer term, HM Treasury calculates that EU trade (in goods and services) will fall by 43%, meaning a fall in total trade of 24%, and that GDP will be 7.2% lower by 2030 than if the UK had remained a member of the EU.

The model used to calculate the impact on trade has some flaws, in that data from many developing countries is included, which increases the variance in the data as many developing countries do little trade with the UK. The model also considers the

whole EU rather than specifically at the UK; the UK and Malta are the only two EU countries which export more to non-EU countries than EU countries, so the average effect on an EU country does not apply to the UK in the same way – in fact it is considerably less. HMT also used the results of other papers which showed a positive relationship between trade and productivity, meaning that lower trade would lead to lower levels of productivity. The use of this result then exacerbated the impact of the HMT's predicted fall in trade on the UK economy. However, this relationship mostly holds for developing countries, and is not found in similar studies based on advanced economies.

Bank of England

The Bank of England's short-term forecasts were also overly pessimistic, with pre-referendum forecasts actually being more accurate – this could suggest that the decision to leave the EU has had little effect on the UK economy.

OECD Model

The OECD predicted a more modest reduction to growth of 0.5% in 2017 and 2018, although now these could be seen to also be pessimistic. Their longer term forecast estimates the GDP in 2030 will be around 5.1% lower as a consequence of Brexit. As with HM Treasury's analysis, the OECD underestimated the gains from the depreciation of Sterling. In terms of trade, the OECD calculates that the UK's "trade openness" will fall by 10-20% as a result of Brexit, and that this will have a negative impact on both trade and productivity.

Centre for Economic Performance

The CEP uses two models, a static and a dynamic to calculate the effects of Brexit. The static model calculates that the welfare loss, at current values of consumption, is 2.66% in the most pessimistic scenario studied; reversion to WTO rules. This loss comes from rises in tariffs paid, the additional costs associated with non-tariff barriers, and the loss of future lower trade costs from no longer being a member of the Single Market.

In the dynamic model, more complex variables are considered, including reductions in the choice of goods and services, weaker competition, effects on global supply

chains, falls in FDI, increased barriers to the diffusion of knowledge between countries and lower R&D. Using a similar style model to that used by HM Treasury and the OECD, they calculate a loss of potential GDP of between 6.3-9.4% in the scenario where the UK leaves the EU and joins EFTA. There are several critical assumptions behind this; CEP assume that the UK will not gain trade from outside of the EU after Brexit, and they also make the same assumptions about loss of trade from the EU as HM Treasury, i.e. not taking into account the lower than average exposure to other EU countries in terms of trade which the UK has. They also assume that the loss of trade will be accompanied by a fall in productivity. Therefore, although these are less exaggerated than the HM Treasury forecasts, these forecasts could be seen as pessimistic.

European Social Research Institute (Dublin)

This study looked at the impact of WTO tariffs on trade, and found some significant variation in impacts across the EU, for example a 5% reduction with Finland, but a 43% reduction with Bulgaria. These resulted in an overall loss in trade of 12-45% (median 22%) to the EU, but a fall of 17-56% (median 30%) from the EU to the UK. This does not take into account the depreciation in Sterling, which could considerably offset these effects.

The variations in forecasts are demonstrated when these results are compared to a second ESRI paper, specifically looking at Northern Ireland-Ireland trade. This calculates a loss of trade of 3% between the UK and Ireland, while the first paper calculates it will be 28%. The reasons for the difference are due to the use of different data sources and different assumptions about the elasticity of trade.

World Bank/UNCTAD

The results of this study, which also looks at the impact of trade, find that in the short run, a “no deal” scenario will cause a fall in exports to the EU of 2%, since they judge demand from the EU to be fairly rigid, particularly for goods which face higher tariffs, such as transport equipment, food, apparel, and plastics. This figure is for the effect of tariffs alone, and does not include the effect of any non-tariff barriers.

Cambridge Econometrics/Mayor of London

MIDLANDS ECONOMIC FORUM

This well publicised, paper looks at five scenarios, ranging from no deal to remaining a member of the EU (the “baseline”). This gives a reduction in GVA from the baseline ranging from -1% to -3% by 2030. However, an important point is that, when relative population falls are taken into account, the effect on living standards is relatively small, even from some of the more severe scenarios. Indeed, in the specific case for London, all of the Brexit scenarios result in higher GVA per capita than the baseline, albeit based on large population reductions.

SNP Government Report

This highly politicised report uses similar methods to the HM Treasury model, but produces larger losses from Brexit. It states that GDP will be 2.7% lower under EEA, 6.1% lower under an FTA and 8.5% lower under WTO rules by 2030. It also assumes that the UK will lose half of its exports to the EU.

Rumoured Government Brexit Assessment

With the Prime Minister not due to reveal her Brexit strategy for some weeks, there is much speculation as to the potential economic impact. Although the Prime Minister continues to categorically reiterate that Brexit means leaving both the single market and customs union, what form the future British-EU interaction will take has yet to be articulated. It is therefore difficult, if not premature, to forecast future impacts, although leaked government papers, whose status is not clear, indicate that within the civil service there may be considerable pessimism. Over a 15-year period, a No Deal, worst case scenario the impact is quantified as compressing potential growth by 8% nationally, and by 13% in the WM and 8.5% in the EM.

Rumoured Government Brexit Assessment

assumed forecast impact on economic growth over 15 years compared to current forecasts

Region	Single market	Free trade	No deal
East Midlands	-1.80%	-5%	-8.50%
West Midlands	-2.50%	-8%	-13%
United Kingdom	-2%	-5%	-8%

source:BBC

Moreover, given the means by which these forecasts have been placed in public domain, it is not clear if these forecasts are the cumulative or annual impact assessment, or if indeed they are nominal or real impacts. If they are assumed to be cumulative, then over the forecast 15-year period, the annual average impact appears to have been estimated at less than 1%, even with the most pessimistic of outcomes. Whilst none of these is a favourable outcome, and Brexit is unequivocally not without costs, an accommodative policy response could conceivably offset the impact of Brexit, by realising new opportunities that may become available.

Rumoured Government Brexit Assessment

assumed forecast impact on annual economic growth over 15 years compared to current forecasts (%)

Region	Single market	Free trade	No deal
East Midlands	-0.12%	-0.33%	-0.57%
West Midlands	-0.17%	-0.53%	-0.87%
United Kingdom	-0.13%	-0.33%	-0.53%

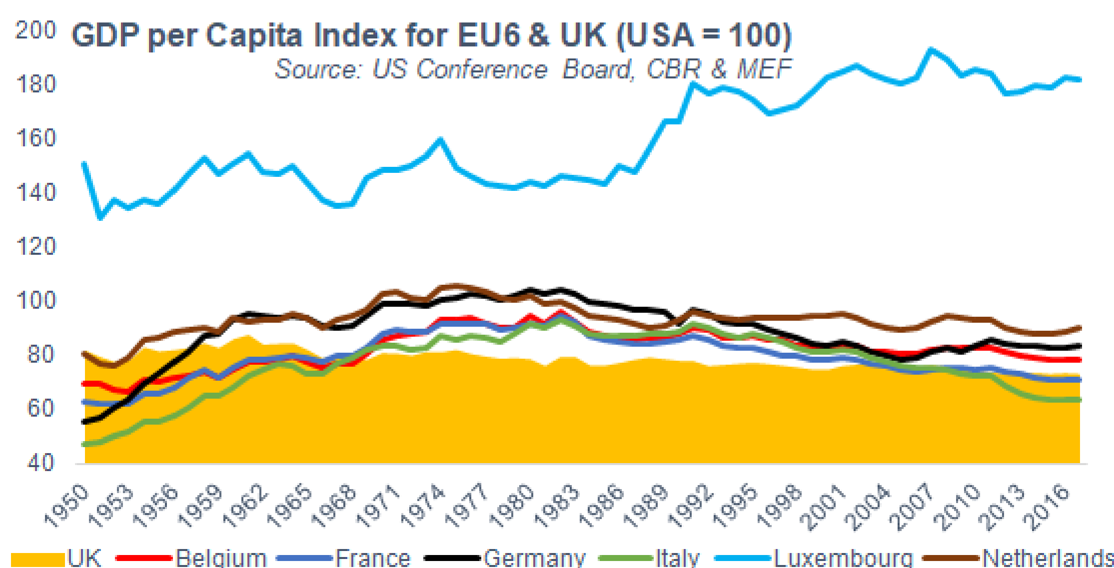
source: BBC & WMEF

Nevertheless, these figures are substantially greater than those for London (1% hit remaining in the single market, 2% with a free trade deal and 3.5% under WTO rules). As the Government have not released the detailed papers to the public it is not possible to critique the methodology as we do not know how the results were arrived at. Although most academic analysis suggests that the regions which voted most strongly for Brexit are likely to be hardest hit, this is largely driven by the size of the manufacturing sector (which trades considerably more heavily than the services sector).

It is noticeable that the worst-case scenario is substantially less that the estimated cumulative impact of the 2007-09 financial crisis, which has been calculated an equivalent to a loss of a fifth of GDP. It had been previously forecast that by 2022, GDP would be approximately 27% higher than 2007, whereas as current forecasts suggest by 2022 it may only be 8% higher than 2007.

Centre for Business Research (University of Cambridge)

Research by the Centre for Business Research, suggests that the ultimate impact of Brexit may prove less profound than many current pessimistic forecasts indicate. In part this is as a result that any economic analysis is based on behavioural assumptions that may or may not prove correct. One such assumption is that there was a marked improvement in British economic performance once it became a member of the then EEC and now EU, as stated above. Measured in GDP per capita terms as proportion of US GDP per capita, there does not appear to have been a noticeable transformation of British performance. Indeed, in terms of the original 6-member states, measured in per capita GDP there seems to be a marked deterioration in performance. There is also considerable variation within the EU6 data, with Luxembourg clearly as the best performer.



This study finds that any negative impacts from uncertainty surrounding the Brexit negotiations will be offset by the fall in Sterling in the short run. Assuming a 2-year transition followed by an FTA with the EU, as well as current monetary and fiscal policy remaining as planned, it is predicted that in the longer run, GDP is 2% below the baseline, mostly stemming from lower migration meaning fewer jobs and consequently lower output. This lower population means that, although UK GDP will be lower, in terms of per capita income, by 2030 there will be no effects of Brexit. The report also finds that there will be a 10% loss of EU trade, although this will slowly be replaced by other markets.

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