The Impact of Brexit on the UK Economy

Ken Coutts  Graham Gudgin

Centre For Business Research, Judge Business School, University of Cambridge

Prof. Neil Gibson  Ulster University

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OUTLINE

• The Economic Context. The Long View
  • Growth has faltered long before the EU referendum
  • Joining the EU does not obviously affect economic growth
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• Why Do Nearly All Economists project Negative Consequences for Brexit
  • Two Treasury reports & similar from OECD & IMF plus a range of commercial assessments
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• Our Forecasts for the UK economy beyond Brexit
  • Assumptions are necessary
  • Economic growth not much affected until after 2020
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• Which Sectors are most at Risk?
The Economic Context. The Long View

- Growth has faltered long before the EU referendum
- Joining the EU does not obviously affect economic growth
Post-war Growth Trend Has Broken Down

A Staggering Loss of national Income

GDP per Head £000s 2013 prices

- Brexit
- 2.5% pa Trend
- pre_referendum

Forecast
Credit Super-Cycles at a Low Ebb

Number of Housing Loans p.a.
per 1000 Population

- Brexit
- Pre-Referendum
- Actual

Forecast
Membership of the EU has Not been Obviously Good for the UK Economy

GDP per Head £000s 2013 prices

GDP per Person

2.75% per annum Trend
Percent of UK Exports going to EU28

EU trade share rises in line with HMT estimate from 1973-90

But notice that this continues
The pre-accession trend

So is the increase due to UK membership of EU?
NAFTA Also Did Not Help Canada

GDP per head $000 2014 prices

- GDP per Head
- Canada
- 2.6% pa Trend
Economies Grow at the USA rate: Joining FTAs makes Little Difference

GDP per Head (USA=100)

- UK/USA
- EU28/USA
- Canada/USA
Why Do Nearly All Economists project Negative Consequences for Brexit

• Where do people get their confident predictions from?

• Some politicians have a ‘gut feeling’ (e.g. Owen Smith writing in the Guardian)

• Many have been influenced by a swathe of reports from “experts from organisations with Acronyms”

• Two Treasury reports & similar from OECD & IMF
Treasury Forecasts on Brexit

• The Immediate Economic Impact of Leaving the EU (May 2016)
  • Statistical work on relationship between Uncertainty and spending by consumers and companies
  • An assumption that uncertainty would be 50% of 2009 level

• The Long-Term Impact of EU membership and the Alternatives (April 2016)
  • ‘Gravity model’ used to estimate impact of EU membership on trade and Foreign Direct investment (FDI)
  • Assumption that all gains from membership will be lost
  • A large part of Treasury impact is additional productivity reductions due to trade losses
Gravity Models at the Heart of Official Estimates of Impact of Brexit

The basic gravity model equation is:

\[
\text{Trade} = \frac{( \text{GDP}_{\text{source}} \times \text{GDP}_{\text{market}} )}{\text{Distance}}
\]

Where:

- **Trade** is the volume of trade in current prices between a pair of countries
- **GDP** is the product of the GDPs of the two countries adjusted for inflation
- **DISTANCE** is the distance between the two countries

Other influences on trade flows can be added:
- Common language or history
- Contiguous borders
- Membership of FTA or Monetary Union

The equation is ‘estimated’ from data on trade between 120 countries over a 65 year period.
Trade and ‘Gravity’ in 2015

13,934 ‘trade-pairs’
EU Trade-pairs have above average levels of Trade
% Rise in Trade due to EU Membership

- Average EU Impact
- Impact on UK Alone
Different Samples of Trade Give a Range of Estimates for EU Impact
Treasury Estimates of Impact of Brexit

Trade

• 76% gain in trade with EU due to membership of EU assumed to be fully reversible, giving a loss of trade with EU of 43%.
• No trade diversion i.e. no gain of trade with 3rd parties after leaving the EU
• Giving a total loss of trade (to EU and non-EU destinations) of 24%

FDI

• Loss of 22% of FDI (measured in money)

Productivity

• Productivity (per capita GDP) impact due to loss of trade at 25% of trade loss.
• Extra small productivity loss of 4% of FDI loss

GDP

• Overall loss of GDP is 7.5% after 15 years for reversion to WTO rules
Our Forecasts for the UK economy beyond Brexit

- Assumptions are necessary
- Economic growth not much affected until after 2020
Key Assumptions

• No reduction in net new business investment 2017-19

• Assume no free trade agreement as ‘worst case’.

• Loss of 10% of EU trade from 2020 with slow replacement in non-EU markets

• Retaliatory UK tariffs lead to reduction in imports from EU

• Interest rates allowed to remain relatively low and public spending higher

• Net migration from EU falls to zero
Forecasts for Real GDP (% per annum)

-5.0 -4.0 -3.0 -2.0 -1.0 0.0 1.0 2.0 3.0 4.0 5.0

Brexit
Pre_Referendum
Actual
HMT Brexit
Unemployment Expected to Rise but by Less than otherwise predicted

Unemployment Rate (%)

- Brexit
- Pre-Referendum
- ACTUAL
- HMT Brexit
Current Account BoP (% of GDP)
Public Sector Debt Initially Higher but later is Lower

![Graph showing Public Sector Debt (% of GDP) over time with different series: Brexit, Pre-referendum, Series3, HMT Brexit.](image)
Which Sectors are most at Risk?

- Agriculture: High tariffs, less immigrant labour
- Food Processing: High tariffs, less immigrant labour
- City of London Financial Services: Loss of access to Eurozone
- For Most Other Sectors: lower value of Sterling offsets higher tariffs
Conclusions

• There is still much uncertainty affecting forecasts

• Particularly on whether businesses will put investment on hold and whether the UK can secure free trade agreements with the EU, USA etc. Also wage growth difficult to forecast

• Some things are reasonably sure.

• Sterling has fallen by around 12%, and interest rates are likely to be kept low and austerity relaxed in public spending.

• The short-term is aided by an upswing phase in the credit cycle. Beyond 2020 a cyclical downswing may make conditions more difficult.
Conclusions

• The Brexit scenario is just about manageable if accompanied by fiscal reflation and accommodating monetary policy.

• GDP & Employment can be supported but at the cost of high inflation

• Particular uncertainties over trade in agricultural, food and drink products due to potentially high EU tariffs and migration controls, and over financial services

• Most other sectors including motor vehicles should be OK at the current exchange rate
Public Sector Deficit Falls Further under Brexit

Government Financial Deficit % of GDP
Ratio of Mean House Price to Disposable Income

Ratio of House price to Average Income

- Actual
- Pre_Referendum
- Brexit
- HMT Brexit