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"No Deal" Fear-checker

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"A no-deal Brexit could knock 10% off UK GDP"

The claim

According to the latest Whitehall analysis, the UK economy could be between 6.3% and 10.7% smaller in a no-deal scenario, compared to remaining in the EU. These figures refer to the level of GDP around 15 years after the UK's new relationship with the EU comes into effect. Another study by the Bank of England included scenarios where GDP could be more than 10% lower than otherwise within only a few years.

The detail

The Whitehall analysis is an update of the briefing leaked in January 2018. It attempts to model the economic impact of four scenarios for the UK's long-term relationship with the EU:

1. The policy ambition set out in the July 2018 White Paper, where the UK leaves both the Single Market and the Customs Union but manages to maintain 'frictionless trade' with the EU;
2. A hypothetical Free Trade Agreement (FTA), similar to the EU-Canada deal, where the UK leaves both the Single Market and the Customs Union, eliminating tariffs but with additional non-tariff costs including customs checks and regulatory barriers;
3. A European Economic Area (EEA)-type scenario, similar to Norway, where the UK leaves the Customs Union and remains in the Single Market, meaning there are no tariffs or regulatory barriers, but standard customs checks still apply;
4. A 'no-deal' scenario, based on Whitehall's assessment of average non-tariff barriers (NTBs) between countries trading on non-preferential World Trade Organisation (WTO) terms, and assuming the current level of Most Favoured Nation (MFN) tariffs applied by the EU.

All scenarios produce negative results compared to the status quo of keeping the existing arrangements, but 'no-deal' is by far the worst. The central estimate is that the level of UK GDP would be 7.7% smaller than otherwise in about 15 years (within a range of -6.3% to -9.0%), assuming no change in migration, or 9.3% lower (within a range of -8.0% to -10.7%) if net inflows of EEA workers fall to zero.

The Bank of England assessed two no-deal scenarios over a shorter horizon of five years:

1. A 'disruptive' scenario, where tariffs and NTBs are introduced suddenly (by both sides) and no new trade deals are implemented for at least five years. However, the UK is able to replicate all the deals it has with non-EU countries by virtue of its past EU membership, and also assumed to recognise EU product standards unilaterally, mitigating some of the negative impact;
2. A 'disorderly' scenario, where the UK loses all the trade arrangements that it now has with non-EU countries as an EU member, there are much longer customs delays, and there is a collapse in investor confidence in UK assets.

In these scenarios, GDP is between 4¾% and 7¾% lower by end-2023, relative to the November 2018 Inflation Report projection, and between 7¾% and 10½% lower than the May 2016 trend (that is, before the June 2016 referendum). What's more, the bulk of the damage is done in 2019 and 2020.

Assessment

These two official studies do different things. Let's deal quickly with the Bank's work first. The Bank analysis is designed to assess the potential risks to monetary and financial stability over the next few years. As such, the Bank has deliberately chosen some extreme assumptions to produce 'worst case' numbers for purposes such as stress testing the banking system. This is a worthwhile exercise, but these numbers are not meant to be interpreted as the Bank's view of what is actually likely to happen in the event of 'no deal'. In the words of the Bank itself, '*this analysis includes scenarios not forecasts*'.

This is just as well, because the results are pretty implausible (including in the view of many economists who are not known to be fans of Brexit, such as Paul Krugman and Andrew Sentance). In particular, the 'disorderly' scenario includes a bigger negative effect on UK GDP and asset prices than the global financial crisis, partly because the Bank is assumed to raise interest rates to 5½% to defend the pound. This brings to mind the 'severe shock' scenario in the (now infamous) 2016 Treasury assessment of the immediate impact of a vote to leave the EU, which suggested that GDP would be 6% lower within two years.

Moving on, the latest Whitehall study looks at the long-term impact of different potential arrangements and does not consider any short-term or transitional effects. Like the Bank study, it is a serious piece of work, but also needs to be interpreted with care.

For a start, the Whitehall numbers are estimates of how much lower the level of GDP might be in around 15 years, relative to a rosy view of what could happen if we remain in the EU. Even if correct, the UK economy would still be a lot larger (and incomes higher) than it is now. For example, taking a conservative estimate that annual growth would average 1.5% in the baseline, GDP would rise by around 25% over a 15-year period. This increase would therefore still be around 20%, even if Brexit lowers growth by a cumulative 5%. That's crucial, because many commentators have misread the latest Whitehall analysis as predicting an outright recession, with falling GDP, job losses, budget cuts, and so on.

What's more, any such results are obviously dependent on the assumptions made. The Whitehall report focuses on the impact on trade. As it says, again obviously, '*higher barriers to UK-EU trade would be expected to result in greater economic costs*'. If more frictions in trade with the EU were the only consequence of Brexit then almost all would agree that the economic impact would be negative.

However, the 'no deal' scenario scores so badly because it assumes that there will be a very large increase in UK-EU trade barriers, and that this will lead to a collapse in UK-EU trade, swamping any benefits. In particular, it is assumed that new NTBs would cost as much as 15% of the value of goods (18% for services), and that the volume of trade with the EU would be more than a third lower.

It is also worth noting that the analysis assumes that any increase in trade barriers now (and the costs associated with them) would be permanent. This ignores the prospect that processes and checks could be simplified in future, let alone the possibility that leaving without a deal in 2019 could be an alternative route towards a comprehensive FTA a few years later.

In contrast, the benefits of independent trade and regulatory policies are assumed to be tiny: a potential boost to trade volumes of just 6% from reducing barriers to trade with faster growing economies in the rest of the world, and a paltry long-term GDP gain of just 0.1% from regulatory optimisation at home.

Finally, the most negative numbers for the hit to GDP rely on a big and harmful reduction in net migration from the EU (not offset by increased migration from the rest of the world). That's a possible result of Brexit, of course, but isn't inevitable, as it would depend on policy choices still to be made by this and future governments. It certainly seems odd for politicians to cite this as an argument against Brexit.

Conclusion

In summary, the Whitehall analysis combines relatively high estimates of the potential long-term costs of 'no deal' Brexit with relatively low estimates of the potential benefits. The Bank of England analysis is intentionally (albeit justifiably) designed to provide 'worst case' scenarios for the near-term impact. Different assumptions could therefore lead to very different conclusions, meaning that neither study comes even close to proving that Brexit would leave the UK economy X% smaller or £Ybn worse off.

Julian Jessop, Chief Economist & Head of the IEA Brexit Unit