Response to the Treasury and Bank of England assessments

of the effects of various Brexit options

Evidence to the House of Commons Treasury Committee

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By Roger Bootle, Chairman of Capital Economics [1]

Introduction

1. The situation that now confronts us over Brexit is without precedent. In making a rational choice we need to make use of whatever material we can muster from a wide variety of sources, including material from previous episodes which, however imperfectly, seem to resemble this one at least in some respects, and then to come to a judgment. But, in the end, this issue is riddled with uncertainty. Accordingly, we need to be on our guard against anything that smacks of a pretence to certainty. In such judgments there may well be much pretence, but there can be no certainty.

2. There are two major issues on which we need to make a judgment:
   (i) The effect on the UK over the long-term of trading with the EU on different terms from now (as addressed by the Treasury's document, "EU Exit: Long-term economic analysis");
   (ii) The immediate, short-term effects of switching to a new regime, (as addressed by the Bank of England's document, "EU withdrawal scenarios and monetary and financial stability").

I begin this note by making some points that bear on both these questions before going on to make some specific points that relate to each of these two issues individually.

Economic models

3. In making such judgments, it is natural to have resort to economic models. This is what the Treasury has done with this exercise, and previously with regard to producing in 2016 two documents about the short- and long-term consequences of a vote to leave the EU. (More on this below.) There is a place for economic models in judgments of this sort, and indeed I make reference below to the results of a different model from the one used by the Treasury.

4. **But it is vital to appreciate that models do not offer an escape from the uncertainty referred to above. The fact that the models are complex, difficult to understand, mathematical and come up with precise answers can easily lead their users to attribute more worth to the "answers" that they provide than they deserve. Such models do not have embodied in them any intrinsic wisdom just because they are models. And what is spewed out from them is not the objective "truth". Forecasts or outcome assessments derived from models are only as good as the structure of the models themselves and the assumptions fed into them.**

5. That is why I regard it as more important to concentrate on underlying economic structures and assumptions. This applies as much to tables and charts derived from the models. **It is easy to produce an impressive–looking forecast or impact assessment document, with or without equations, replete with umpteen tables and charts, purporting to show the shape of various alternative futures that nonetheless amounts to nonsense on stilts.**

6. It is customary to structure economic models on the basis of a view of how the economy works and then to test the model against the data. If the model works tolerably well, this will establish plausible numbers to be attached to the various parameters in the model. Then, with regard to the future, you can feed into this model some change, such as UK withdrawal from the EU, and come up with predictions of what consequences this change will bring.

7. But what if the model was mis-specified in the first place? And what if the data on which the model was tested apply to a country or countries with different characteristics from the one featuring in

the present case? And what if, even if these countries are not noticeably different, the world has changed so much that the relationships tested in the model have changed, and/or the magnitudes to be attached to the various parameters have altered dramatically? The apparent precision in the model's results then risks leading you in precisely the wrong direction.

8. It is difficult to review the model that the Treasury has used with regard to these matters because it has steadfastly refused to be open about the model or the assumptions fed into it, despite repeated calls for it to do so. This mirrors the situation with regard to the model used to prepare the two documents produced before the referendum in 2016, referred to above. But, doubtless influenced by that model's catastrophic error in forecasting dire economic consequences from the Brexit vote, the Treasury has abandoned that one in preference for something else, the GTAP model developed at Purdue University in Indiana.

Flexibility and Substitution

9. We have to be particularly careful with models that were specified, or whose parameters were estimated, some while ago. The world has become more globalised, more competitive and better informed. This has important consequences for the ability to cope with shocks and to withstand adverse supply-side developments. Many things in the world are mechanistic and absolute. But the world of economics is not. It is flexible and responds to incentive.

10. **The greatest of all the qualities of economic systems is the power of substitution. What globalisation and the digital communications revolution have done is to enhance the power of substitution in the economy. Accordingly, supply shocks have less power to cause damage. There are more alternatives, these are readily obtainable, we now have the information systems to enable us to find out about them and we have the delivery systems to enable us to access them.**

11. This enhanced power of substitution is to be seen in many macro variables across the world. In particular, it is the leading factor behind the persistence of very low inflation at higher and higher levels of economic activity and lower and lower rates of unemployment. In this country, the Governor of the Bank of England, Mark Carney, fell foul of its power when he persistently under-estimated how far unemployment could fall without triggering an upsurge of wage inflation, leading to a need for higher interest rates.

12. The power to withstand a supply shock such as a no-deal Brexit is all the greater given that this will not be an out-of-the-blue shock. There is no doubt that it would have been better to have had more notice but if we do leave without a deal with the EU, this will be known within the next several weeks. This means that businesses will have 2-3 months to make preparations, which may include stockpiling of key inputs, the possibility of sourcing goods from non-EU countries if EU supplies become difficult and the possibility of re-routing shipments away from the Dover-Calais route, which is likely to be the most disturbed by initial disruption.

Past forecasting failures

13. It is not unusual for the economic consensus about major events to be horrendously wrong. In fact, quite the opposite. There have been several major episodes in our history that bear serious reflection.

    (i) In 1931, virtually the whole establishment, including the Treasury, was determined that the UK should stay on the Gold Standard and forecast calamity if we left. In the event, we were forced out but, far from calamity, we experienced the fastest period of sustained economic growth in our history.

    (ii) In 1992, we were experiencing great difficulty within the European Exchange Rate Mechanism (ERM). Virtually the whole economic establishment, including the Treasury, asserted that we had to stay in the system or we would face economic calamity. In particular, inflation and interest rates would rise, with the result that the economy would weaken and unemployment would increase. After we were forced out of the ERM on September 16th 1992, in fact interest rates were cut, inflation subsided and the economy recovered.

(iii) At the end of the ’90s, virtually the whole of the economic establishment, although this time not including the Treasury, was convinced that Britain should join the euro. Indeed, they forecast dire economic consequences if we did not, especially for our foreign-owned car manufacturers and for the City of London. They were particularly concerned that being outside the common currency area would lead to increased transactions costs, risks and uncertainties that would deter businesses from locating in the UK. In the event, since the formation of the euro in 1999, the French and German economies have grown by 32%, the Italian economy by 9% and the UK economy by 44%. Evidently, the transactions costs, risks and uncertainties involved in having your own currency were much less significant, and/or the benefits greater, than the economic establishment thought they were. (Read “frictions” and non-tariff barriers today.)

The economic effects of the Brexit vote

14. A fourth major example of gross establishment forecasting error was the Treasury’s forecast of the effect of a vote to leave the EU, made just before the referendum in 2016.

15. It is not possible to produce a hard and fast estimate of the impact of the Brexit vote on the British economy. This is because of the well-known absence of a counter-factual. Some people have tried to estimate the effects of the vote by noting that the UK’s growth rate fell from the top of the G7 to somewhere near the bottom and quantifying the difference. This is completely unsatisfactory. It was inevitable that the UK was going to fall from the top ranking in the G7.

16. Nevertheless, it is likely that the Brexit vote did have a negative effect on investment in the UK, by both domestic and foreign companies, because of increased uncertainty. It is unlikely, however, that this effect was very large, because, quite apart from anything else, investment has not collapsed.

17. What we do know incontrovertibly, however, is that since the Brexit vote the UK economy has grown by 3.2%. This is in complete contrast to the scenarios outlined by HM Treasury in the forecast document that it released in advance of the referendum. It suggested that a Brexit vote would constitute a shock that would lead to 4 quarters of declining output, thereby amounting to a formal recession. An alternative scenario was presented, namely a severe shock. Under this scenario UK GDP would fall by a total of 2% up to Q2 2018. The Treasury envisaged a fall in house prices of 10% in the "shock" scenario and 18% in the "severe shock" scenario and a rise in unemployment of 520,000 and 820,000 respectively compared to what would have happened in the base case. In the event, house prices have continued to increase and unemployment has fallen by 260,000.

The number of voices saying the same thing

18. Superficially, it appears to add strength to a particular forecast of the future if umpteen forecasters and associated bodies take the same view. In practice, this is much less impressive and significant than it may seem. Most of the main forecasting bodies use similar, if not the same, forecasting models, often estimated over countries unlike the UK and/or over periods before the digital era.

19. Moreover, the people engaging in such forecasting exercises are often from the same stable, with a similar mind-set and attitude. On the whole, they have next to no non-official or non-academic experience and little or no experience of business. The fact that they all tend to come out with a similar view is an example of group-think.

20. The Treasury view of the immediate economic consequence of the Brexit vote that has proved to be so catastrophically wrong was shared by umpteen institutions, including the World Bank, the IMF and the OECD. It bears repeating that the outturn has been completely different and that the Treasury's prognostications, and those of all these other bodies, have been proved catastrophically wrong.

The economic advantages of Brexit and the Treasury's modelling

21. Apart from saving our annual net contribution, amounting to about £10bn per annum, and the ability to control unskilled immigration, which in net terms costs indigenous taxpayers money, the major economic advantages of Brexit derive from three sources:

    (i) The ability to negotiate trade deals, and/or to set lower tariffs unilaterally than are imposed by the EU;

    (ii) The ability to set different regulatory standards from those prevailing in the EU;

    (iii) The ability to avoid further integrationist measures in the EU which would impose costs on the UK and/or prevent our position in the EU from being weakened as the countries of the euro-zone integrated further and set policies for the EU not necessarily in accordance with our interests.

22. **The third possible source of advantage is excluded by assumption since the methodology is the time-honoured one of "other things equal". But in this instance, other things will almost certainly not be equal.**

23. On the value of making FTAs with other countries, the Treasury document comes up with the remarkable conclusion that such FTAs with most of the rest of the world would raise our GDP by only 0.2%. Yet in 2012, the EU concluded that the impact of the EU concluding trade deals with this group would be of the order of 1.9% of GDP, roughly ten times the size of the Treasury's estimated effect for the UK. Yet, if anything, you might expect the effect on the UK's GDP to be proportionately larger. Meanwhile, the Treasury assumes that if we conclude a standard trade deal with the EU that will be worth nearly 3% of GDP.

24. It seems that the Treasury has managed to get a small impact from FTAs by making three strange assumptions:

    (i) Putting the assumed global coverage of FTAs at a half or less;

(ii) Non-tariff barriers are only partly abolished (by about a half);

(iii) Only 25% of all this would go ahead as “policy under development”.

25. Meanwhile, in the Treasury’s study the gains from introducing a different regulatory framework are nugatory. Not only that, but on casual inspection they seem to be almost the same as the gains to be secured from this source by implementing Mrs May’s Agreement. Given that the latter relies on a good deal of regulatory alignment, this seems scarcely credible.

26. The Treasury’s conclusions also rest on the assumption that the costs of increased border “frictions” on UK/EU trade would be substantial. Yet, when it comes to estimating the effect of “frictions” on trade, economists do not have much hard data and their theoretical models are not much use. But there are a number of indicative bits of information:

(i) Evidence from various ports that shipments from outside the EU face minimal delays because of digital clearance before transit with only about 3% of cargoes being physically inspected at the port;

(ii) The evidence from certain businesses that trading with the rest of the world causes them little extra difficulty or cost compared to trading with the EU;

(iii) Most importantly, the fact that countries all round the world export successfully into the Single Market without being members. Moreover, the rate of increase of their exports into the Single Market is in general higher than the rate of increase of exports from Single Market members to each other. (See the work of Michael Burrage [2]).

(iv) The absence of other single markets. If the benefits of Single Market membership were so great why are other countries not clamouring to form single markets of their own? Some have formed customs unions and more have formed free trade zones (such as NAFTA) but none has formed, or is trying to form, a single market.

(v) The persistence of poor performance of certain countries, e.g. Italy, within the Single Market. The gains from the Single Market, whatever they are, have evidently not been large enough to offset other structural issues.

27. The EU’s tariff barriers, which we would face in the event of a “no-deal” Brexit, are relatively minor. The average EU tariff on manufactured goods is 3%. Yet the pound has fallen by over 13% since the beginning of 2016. It is true that the tariff rate on cars is 10%. But UK-based car manufacturers should have benefitted enough from the weaker pound to be able to absorb any hits to the post-tariff price if they find that they cannot raise their prices in EU markets by the full amount of the tariff.

Trading under WTO rules

28. It has been alleged that trading under WTO rules would be a leap into the dark. But the UK already does the overwhelming majority of its trading outside the EU under WTO rules. In other words, trading with the EU under WTO rules would be more accurately described as a leap into the familiar.

Overseas investment into the UK

29. Inward investment into the UK will depend, to a large extent, on the policy regime that the UK enacts. If we follow a regime of low or no tariffs (whether achieved through Free Trade Agreements (FTAs) or unilateral tariff reductions), low corporate and personal taxes and a less restrictive regulatory regime than the one imposed by the EU, then there is every prospect that inward investment into the UK will be strong.

Complex supply chains

30. It is alleged that under a “no-deal Brexit” whether “orderly” or “disorderly”, businesses that make use of complex supply chains would be severely hit. The underlying assumption is that the Single Market and the Customs Union are vital to the operation of such supply chains. Yet there are complex supply chains in operation all around the world, in East Asia, North and South America

and globally, with goods crossing currency, legal, tariff and customs barriers. Why should this picture not apply to the UK after Brexit?

The forecast by Economists for Free Trade (EFT)

31. But in fact not every forecaster takes the same view as the Treasury. The Economists for Free Trade (EFT) forecast is radically different from the Treasury's. It includes a substantial addition to the UK's GDP, of 7% over 15 years, deriving from a combination of effects from reduced tariffs, deregulation, increased competition leading to increased efficiency, reduced contributions to the EU and limits to unskilled migration. (I am a member of EFT.)

32. The model used to produce these results is the Liverpool model operated by Professor Patrick Minford of Cardiff University. In contrast to the model employed by the Treasury, full details are available. Incidentally, Professor Minford says that he can get results very similar to his Liverpool/EFT ones using the same model as the Treasury, simply by feeding in different assumptions.

The Bank of England's view of the short-term

33. The Bank of England's forecasts are not directly politically influenced in the way that the Treasury's may be. But they may be similarly influenced indirectly. Moreover, the Bank's officials and forecasters are part of the same stable referred to above.

34. Moreover, given its role, the Bank will be naturally inclined towards giving significant weight to the risks of a major upset from a change to the status quo, or something like it. It would be extremely surprising if any central bank produced a forecast or scenario analysis and an accompanying commentary which effectively said something like: "major shock coming, but don't worry, we think it will all be alright on the night", even if, in the end, it is alright on the night.

35. The Bank's estimates of the loss of GDP in a worst case scenario seem much too large. An analysis of the effects of "disruption" needs to take account of the point I made above about substitution. The Bank seems to have been ultra-gloomy about this.

36. The Bank seems to be sure that the pound would fall a long way. In its worst case scenario it falls by 25%. But it is impossible to be sure how the pound would react to any sort of Brexit outcome. If the UK leaves without a deal then, in contrast to some widely voiced fears, I doubt that the pound would fall far. The reason is quite simply that the pound has already fallen a long way and currently stands at a very competitive level, in contrast to the position at the beginning of 2016, when the pound was very uncompetitive. Over and above this, if the UK were to leave without a deal this would hardly come as a complete shock. This outcome must already be largely discounted in the markets.

37. Indeed, in complete contrast to the certainty expressed by the Bank of England about the pound, I believe that there is considerable doubt – even about the direction. If disruption is much less serious than generally expected then the pound could rise. Moreover, the most important worry in foreign exchange and capital markets is not Brexit - hard, soft or otherwise - but the prospect of a Labour Government under Jeremy Corbyn. If, once Brexit is accomplished, support for the Government were to rise, and support for Labour to fall, then I believe that there is substantial scope for the pound to *rise* on the exchanges.

38. Despite Mark Carney's recent remarks on the issue, I think it is highly unlikely that the Bank of England would raise interest rates in the wake of a disorderly Brexit, let alone increase them to the 5.5% that appears in the Bank's "worst case" scenario. Instead, it is likely to reduce interest rates and give liquidity support to the markets. This would be good practice. Any boost to inflation, whether from supply shortages or a weaker pound, is likely to be short-lived. As in previous such episodes, the Bank should "look through" short-term spikes in the inflation rate.

Conclusion

39. The latest Treasury document on the economic consequences of our Brexit options represents a new episode of Project Fear. It steadfastly under-estimates or even ignores various benefits from Brexit while positively over-playing the benefits of the Single Market and the Customs Union. In particular, it downplays potential gains from increased competition resulting from lower tariffs on imports from the rest of the world and from fashioning a new regulatory regime suitable for the UK.

40. Meanwhile, the Bank substantially exaggerates the likely blow to output from the supply shock of a "no-deal" Brexit. It has apparently not heeded the lessons of the modern economy. Nowadays supply shocks do not have the serious effects that they may once have done. The economy has become more flexible and substitution is quicker and more substantial.

41. Nowhere in these documents is there anything that reflects the fact that the EU has been a comparative economic failure in relation to other parts of the world. That is because it has chosen the wrong policies, largely for political reasons. There is every prospect that this tendency will continue.

42. The upshot is that, just as after the referendum vote in 2016, if we experience a "no-deal" Brexit, the Treasury's forecasts of the economy's performance are likely to be proved to be much too pessimistic. Indeed, provided that we follow the right policies, the UK economy can *benefit* considerably from Brexit relative to what would have happened if we had stayed in the EU.

Roger Bootle

Friday 30th November.

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[1] These notes represent Roger Bootle's personal views and should not be attributed to Capital Economics.

[2] M. Burrage (2014) *Where's the Insider Advantage?* (London: Civitas), M. Burrage (2016) *Myth and Paradox: How the Trade Benefits of EU Membership Have Been Mis-Sold* (London: Civitas), and M. Burrage (2017) *It's quite OK to Walk Away: A Review of the UK's Brexit Options with the Help of Seven International Databases* (London: Civitas).