How the Treasury, Bank and Civil Service have let us down

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Soon after graduate school I joined the Treasury as an economic adviser and worked alongside economists from the Bank and the rest of the Civil Service. We were proud to be bringing economics into the public service. Many years later in 1992 I served on the Treasury's Panel of Outside Forecasters ('The 6 Wise Men') to help guide monetary policy in the aftermath of 'Black Wednesday' when we were driven out of the EU 'Exchange Rate Mechanism. The Treasury chief economist then was Alan, now Sir Alan, Budd, and the Bank's was Mervyn, now Lord, King.

I am appalled that our equivalents today in the government have spent their time issuing anti-Brexit propaganda - still hoping to reverse the referendum decision - instead of dutifully planning post-Brexit policy, so necessary with Brexit only weeks away.

THE WHITEHALL PROPAGANDA WAR AGAINST BREXIT

A few weeks ago, we had the latest Treasury and 'Cross-Whitehall' report, arguing that any Brexit at all, including the government's proposed deal, would be worse than Remaining. Then the Bank weighed in with a 'Brexit crisis scenario', an implied forecast of how bad No Deal would be, concealed as a 'stress test' of whether the economy could survive it - it could! Latterly, the Bank has reiterated its forecast that No Deal would be bad, causing a likely recession, and using it as an excuse for delaying raising interest rates.

These interventions are designed to undermine our efforts to persuade the EU to modify the Government's proposed deal by strengthening popular and MP concerns over No Deal. They aim also to persuade Parliament to back amendments delaying Article 50 and seeking another referendum. The sought-for prize in both cases is the status quo, ultimately Remain. It should be unthinkable for our Civil Service to play politics and conspire against the people's 2016 decision so nakedly, as demonstrated in Brussels last week by the civil service's chief negotiator.

This deceitfulness is bad enough but worse is that their propaganda efforts would lead to terrible economics. My message to Brits is: unlike these self-styled experts, you got this issue right. Yes, you were right to ask for your democracy back, and yes, this is also good for the British economy, contrary to all that Project Fear.

Let us remind ourselves about what Brexit means for economic policy:

- Free trade with the non-EU world, bringing down prices, boosting competition, and increasing productivity
- Setting our own regulations across the economy, to ensure the best approach to new technology, energy, and financial services - all areas central to our future growth prospects. This is in contrast to the EU's highly interventionist, bureaucratic, protectionist approach.
- Ensuring that unskilled immigration is no longer subsidised by the taxpayer at great cost to lower-income communities (£3500 pa for each unskilled worker) and that it stops depressing wages to the detriment of UK unskilled workers, whom businesses then have no incentive to train
- Ending paying large amounts into the EU budget

Taken together, we calculate these policies will add about 0.5% a year to our growth rate over the next decade and a half, cumulatively adding 7% to GDP by 2035.

As part of the EU, we have been unable to adopt these policies because we have lost democratic control. Reasserting it through Brexit means we can move into a post-Brexit world of better policies that will promote UK prosperity.

THE TREASURY's ABSURD ANTI-BREXIT ASSUMPTIONS

How has the Treasury managed to argue precisely the opposite; that post-Brexit our economy will decline by 7% or more of GDP? Answer: by making absurd assumptions.

No Gains from Free Trade with the Non-EU World

First, the Treasury alleges that free trade with non-EU countries brings in trivial gains because we would reduce our own trade barriers by only a little and other countries similarly would do little to reduce theirs.

Aside from this refuting the most widely agreed principle in economics, we have practical evidence from Australia to disprove this claim. Australia too had high protection against the rest of the world but thirty years ago they did remove it and did strike free trade deals with all and sundry. Their government now estimates that free trade boosted Australian GDP by over 5%. If Australia can do it, so can we.

In fact, if we assume we get rid of the current EU protection of about 20% on both food and manufactures, the gain to UK GDP is 4%. – calculated by using the same World Trade Model now used by the Treasury. Moreover, we have further calculated that virtually all this gain could be obtained by agreeing just one key free trade agreement – ie, with the US. This is because the huge US economy can supply virtually all of our current imports and almost all at the lowest world price.

‘War at the Border’ with the EU

Second, the Treasury assumes that we would become engaged in a sort of ‘border war’ with the EU. The Treasury alleges the EU would increase inspections and slow traffic down, that they would query whether our exports comply with their standards. And, vice versa, we would do the same to them. The Treasury assumes that such actions would be the equivalent of imposing 25% tariffs each way.

This is fantasy. Besides being against our own and their own interests, these actions are illegal under WTO Rules. This does not just mean that there could be legal action in WTO Appellate Bodies. More to the point, injured businesses in the thousands would take the offending port authorities to EU and UK courts that enforce acceptable and legal commercial practice - as defined by WTO law.

Practically speaking, such actions would represent economic suicide to European port operators. Not surprisingly these authorities, including Calais, have declared roundly they will not take any such illegal actions and inspection regimes will remain the same as they are today. And HMRC has declared a policy of prioritising flow over checks – ie, waving through imports and worrying about any customs aspects subsequently.

No Gains from Post-Brexit Tariffs

Under No Deal initially there probably would be tariffs both ways. Until a free trade deal is agreed, each side would be forced by WTO rules either to impose tariffs on all countries, or to abolish them entirely for all. For political reasons, the UK is not likely to abolish tariffs universally in the short term.

Importantly, the Treasury has failed to acknowledge that tariffs would favour the UK - we would receive £13 billion in tariff revenue from EU exporters versus the EU Commission receiving £5 billion from EU importers (thus, a net loss to the EU).

As soon as we have agreed trade deals with non-EU countries - especially soon with the US - our home market would be dominated by lower world prices. EU exporters would not be able to ‘pass on’ the increased costs of any UK import tariffs because UK consumers would not pay the higher EU price. Similarly, EU importers could not ‘pass back’ to our exporters the EU tariffs they are paying, as UK producers would switch to selling at home. In practice, our export sales to the EU would not suffer because EU prices are raised by EU protection to the same levels as UK export prices plus these tariffs.

This means that, under No Deal, we gain at the EU’s expense. This should encourage the EU to do a free trade deal with us after Brexit - which we of course would welcome.

So in short the Treasury has it all wrong on trade.

No Gains from UK- Based Regulations

The Treasury attributes virtually no gains to us retrieving control of our economic regulations, contrary to all the evidence of damage from EU regulations. How ridiculous is that? Our own UK government saying it could not do a better job of regulation than a foreign power with an expressed aim of reducing our competitiveness!

A Mad Immigration Policy, Keeping Out Skilled Workers

To cap it all, the Treasury assumes we will pursue a self-harming immigration policy of stopping skilled immigration, which all agree we need. Again, a bad own goal.

To sum up, our own Treasury and civil service see no benefits from free trade with the rest of the world while lamenting the loss of free trade with the EU, imagines standard trade procedures as practiced all over the world will be impossible with our EU neighbours, believes we are incapable of implementing better home regulation, and thinks we will adopt an irrational immigration policy. If this is truly what they believe, we will need another civil service post-Brexit.

THE BANK's TALK OF RECESSION FROM NO DEAL

Turn now from these crazy long term Treasury estimates to the short term threats of recession made by the Bank, backed by regular remarks from the Chancellor Philip Hammond.

As we saw during the referendum campaign, the Bank has form in predicting '*Brexarmageddon*'. Then, the short term forecast was that the uncertainty triggered by only a Leave vote would destroy consumer and investor confidence and so kill off spending, creating a recession.

Instead we have seen the UK economy continue growing fairly steadily, reaching extreme lows in unemployment and record employment. Wages are now growing faster than prices. Also the economy has absorbed a large devaluation that has had a tonic effect in improving our balance of payments. It did this with a minimal effect on inflation. Nothing here to worry about at all.

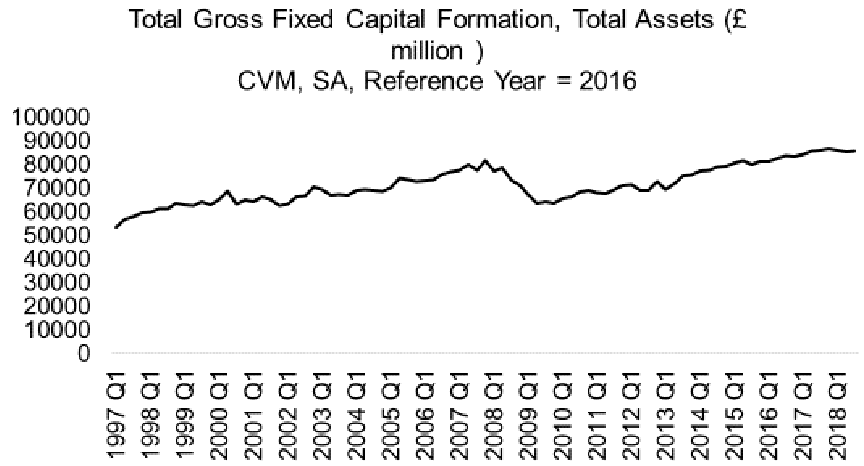
For their latest scary Brexit No Deal scenario, the Bank has again invoked a crisis based on uncertainty and plunging confidence - heavily focused on what happens with the Dover-Calais ferry route.

But No Deal - as we have explained - will not disturb the border, as that would be illegal and there are alternative ferry routes available. As for shortages of vital foods, medicines, or vital components, they depend on the same story, now discredited by the EU port authorities who are worried about losing market share to competing ports.

With border procedures changing, there will be some short run hiccups, as some firms may fail to adapt quickly. But firms will soon learn, and will get extra support and credit to tide them over.

Has investment been hit? I show below the chart of UK total business investment up to the most recent available figures.

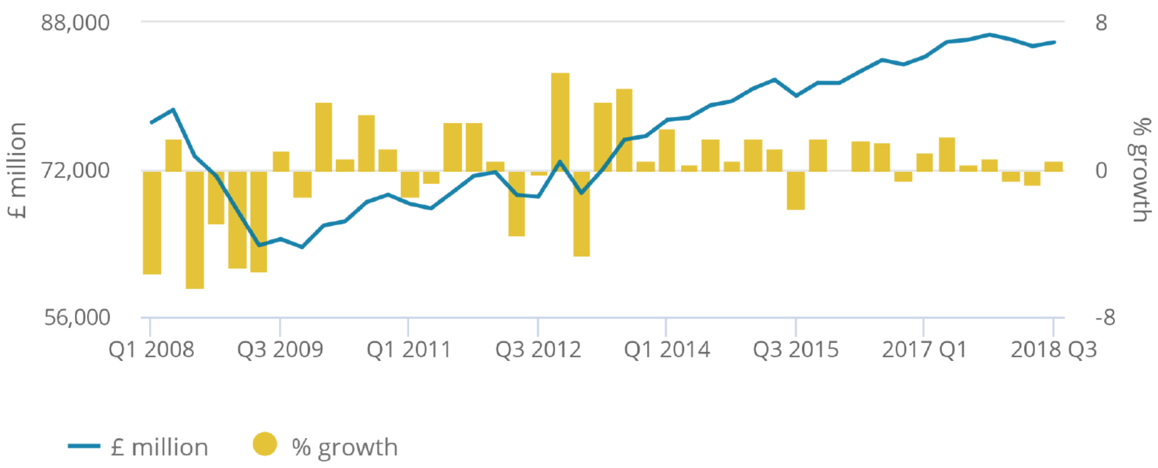
UK total business Investment



What the chart shows – following the Financial Crisis - is the usual irregular behaviour of most economic series around a rather smoothly moving upward trend. It is true that the latest data points to a weak and declining growth of investment as shown below in more detail from the latest ONS release. This is not surprising, given the long deferral of positive Brexit prospects due to the Government's failure to provide a clear route to Brexit and to explain its benefits.

Figure 4: Quarterly levels and quarter-on-quarter growth of gross fixed capital formation, chained volume measure, seasonally adjusted.

Quarter 1 (Jan to Mar) 2008 to Quarter 3 (July to Sept) 2018, 2016, UK



Therefore, it is likely that some investment is being delayed until Brexit has happened; but it then will be implemented. This is the essential point about investment; that it is delayed, not lost.

One can see from these two charts that, although investment growth is weak, its contribution to the economy is fluctuating around a stable trend. Meanwhile we can see that the economy is fully employed so that demand growth overall is continuing to create jobs; growth is fluctuating as the latest GDP figures show, but this is quite normal. The fourth quarter was slower after an unusually strong third quarter – and subsequent revisions often are higher. So from the point of view of demand, the weak investment is not preventing full employment, with an economy well at the limits of productive capacity.

Of course, EU countries would love to have our results – Germany's just announced Q4 GDP growth is half of ours, while Italy has been in recession for six months

NEGATIVE FORECASTS REFLECT POOR UNDERSTANDING OF BREXIT ECONOMICS AND PEOPLE'S EXPECTATIONS

The truth is that 'uncertainty' as a factor is much overdone by commentators. Change is a continuous feature of any economy. The 'uncertainty' argument depends on a belief that rational market participants will somehow not be able to cope with future change thereby freezing their activities.

In reality, businesses need to make money quickly as markets are constantly changing; households need to pay bills over the foreseeable future, and having a job is the best guarantee of being able to do so. So the 'here and now' situation, especially with employment, dominates their actions. As for future shocks, there are many; and predicting them a fool's game. Of course, we can insure the obvious things.

So it is the UK's flexible labour market that has kept the economy fully employed, full of short term confidence therefore, and growing steadily - Brexit has made little difference. It is a good lesson in the importance of market flexibility.

Whatever the short run effects of Brexit uncertainty, they soon will give way to post-Brexit reality. It is here that official forecasts fail most seriously because they do not factor in the gains explained above. The economy, particularly investment, will respond to the prospects of these gains. That is how rational expectations of the future stimulate entrepreneurs to take advantage of unfolding new opportunities. Officials do not understand this process and, consequently, do not include such effects in their forecasts. Add in some uncertainty nonsense and out pop their doom and gloom forecasts – particularly if such forecasts support a biased perspective.

What we need now is for Brexit to occur and usher in the new opportunities from free trade and better regulation.

CONCLUSION

We see here an astonishing catalogue of bad economics coming from a determination to reverse the people's referendum decision. This from our own Ministers and Civil Service who are supposed to support policies the people have voted for. Our civil servants must now get behind Brexit and reflect its opportunities in their forecasts.

It is time that the Bank and the Treasury stopped making arbitrary assumptions that our flexible firms and households will suddenly behave like headless chickens. Instead they should assume rational expectations, by now a widely supported assumption in economic forecasting.

My advice to the British people is: make it known to MPs that you will not stand for their bad economics, stick to your previous thinking, ignore the ongoing Project Fear as you got it right and these 'servants' of yours got it all wrong.