# ANNEX: Economic analysis of UK government's proposals for EU exit
## Supplementary note
**18 March 2019**

### Purpose and wider context

A paper published by the Welsh Government on 4 December[1] reviewed the results of the economic analysis provided by the UK Government on the longer run economic consequences of the UK leaving the European Union. The UK Government's conclusions were compared with those of independent analysts. The paper also included a brief summary of some key conclusions about possible shorter run effects of a "no-deal" scenario as set out by the Office for Budget Responsibility (OBR) and the Bank of England.

This note updates that analysis, drawing on material released more recently, and with a particular focus on the shorter run economic effects of a no-deal Brexit.

This note does not consider the direct impacts on specific sectors and businesses that may arise from new tariff and non-tariff barriers or from exposure to imports that result from the UK Government's policy on tariffs in the event of a no-deal Brexit announced on 13 March 2019[2]. Neither does the note consider geographical differences in impacts across Wales.

While differences in the presence of sectors with high levels of exports to the EU can provide some indication of variation in effects, analysis has indicated that often the particular circumstances facing individual business and the characteristics of the business can be more important than the sector to which they belong[3]. Furthermore, outcomes will be also influenced by: supply chain effects; impacts on imported inputs; foreign direct investment; and, by the potentially large macroeconomic consequences. However, especially adverse effects are most likely in places where affected businesses represent a very large share of local employment and where the local economy is less resilient.

The Welsh Government has based its assessment of the likely economic effects of a no-deal Brexit on a range of evidence rather than a single Welsh model. This reflects the close integration of the economy in Wales with the rest of the UK; the limited data currently available on intra-UK trade flows; and, the major methodological challenges associated with macroeconomic modelling, particularly in this context.

Whilst quantification of the size of an impact is difficult, the direction of impact can be predicted with some reasonable certainty based on established empirical economic relationships. The evidence suggests that economies becoming less open tends to result in lower trade and foreign direct investment which in turn tends to reduce productivity.

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[1] https://beta.gov.wales/economic-analysis-uk-governments-proposals-eu-exit

[2] An assessment of the impact of new trade barriers on sectors and businesses was undertaken for the Welsh Government by Cardiff University and is available here: https://gov.wales/topics/businessandeconomy/economic-action-plan/eu-transition-and-economic-prospects-for-large-and-medium-sized-firms-in-wales/?lang=en. Work is underway to assess the impact of the UK Government's recently announced policy on tariffs in the event of a no-deal Brexit.

[3] See analysis referenced at footnote 2.

Weakening productivity tends in turn to lead to a lower real exchange rate which then passes through into higher prices for consumers. Tax changes, such as tariffs, also tend to be passed through to higher consumer prices further reducing economic welfare.

**Long term effects**

The broad conclusions about the longer run economic effects of leaving the EU without a deal, and trading on World Trade Organisation (WTO) terms, remain unchanged from those described in the paper published in December.

In summary, there is a strong consensus amongst independent mainstream economists that a reduction in access and openness to the EU single market will reduce the UK economy's productive capacity and its rate of growth, with the extent of the economic losses being broadly proportional to the degree of access the UK retains to the EU single market[4].

This analysis indicates that a no-deal Brexit that leads to a longer term arrangement whereby the UK trades with the EU under WTO rules could result in economic output (GDP) in the UK being up to around 10% lower than it otherwise would have been.

The UK Government's own analysis is broadly consistent with these results[5]. This estimates that the UK economy would be 6-9% smaller in the long term in a no-deal scenario (after around 15 years) than it otherwise would have been. The analysis suggests that would be some variation across the UK, although the variation is limited and the UK Government notes that the modelling should be seen as indicative of orders of magnitude rather than providing reliable point estimates. With these caveats, the impact on Wales is estimated to be broadly similar to that on the UK as whole – the recent UK Government publication on the *Implications for Business and Trade of a No Deal Exit on 29 March 2019*[6] refers for example to a negative impact on the economy in Wales of 8.1 per cent. The publication emphasises that this analysis does not account for any short term disruptions, which would be likely to have additional short and long run economic impacts in an immediate no deal scenario.

Analysis indicates that the negative economic effects of a no-deal exit, as described above, could be offset by unilateral tariff reduction, although any such offsetting effects would be relatively small. The UK Government's modelling suggested that maximum tariff reduction (to zero for all goods) might increase UK GDP by a little under one per cent. Of course, such a scenario would create both winners and losers with a high level of economic dislocation over the short to medium term.
Since the UK Government's analysis has been published, the UK Government has now published its initial proposals for tariffs in the event of a no-deal Brexit. Whilst it is proposed that many tariffs are reduced or set to zero, some new tariffs have been introduced for trade with the EU in areas that would previously have been exempt.

It is challenging to estimate the overall economic effects of the proposed tariffs but is likely to mean that any offsetting effects on growth from tariff reductions are likely to be smaller the UK Government's original estimate of a little under one per cent.

[4] See for example:
https://www.instituteforgovernment.org.uk/sites/default/files/publications/2018%20IfG%20%20Brexit%20impact%20%5Bfinal%20for%20web%5D.pdf
[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/760484/28_November_EU_Exit_-_Long-term_economic_analysis__1_.pdf
[6] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/781768/Implications_for_Business_and_Trade_of_a_No_Deal_Exit_on_29_March_2019.pdf

**Short term effects**

Should the UK leave the EU without a deal there is a wide range of potential scenarios - all with strongly adverse economic implications for both the UK and Wales. These adverse affects will come on top of the reduction in economic growth – of around 2% – that the OBR and others have attributed to the referendum result to date. However, the strength and nature of future effects will depend heavily on the specific circumstances that apply in the period after leaving. It is therefore not sensible to seek to produce a single numerical forecast for Wales.

Key factors will be the length of the period that people expect to elapse before there are further changes to the UK's trading relationships with the EU and other trading partners, expectations about what those changes might be, and the implications of any political uncertainty. These factors would be expected to have major but unpredictable implications for business investment decisions and consumer behaviour. A deep and protracted recession is one plausible outcome.

The nature and scale of any impacts will also depend heavily on any macroeconomic measures taken by the UK Government and the Bank of England to prepare for and mitigate negative effects, and on the ways in which new trade barriers (such as customs checks) are imposed in practice. Moreover, Brexit is taking place against a backdrop of slowing global economic growth. The level of preparedness of businesses and infrastructure (such as ports, excise and customs systems and transport operations) will be important in determining how the economy adjusts to new barriers. This combination of factors means that although scenario modelling can give some estimates of orders of magnitude, precise predictions in these areas is impossible.

Both the Office for Budget Responsibility (OBR) and the Bank of England have considered the potential short to medium term economic effects on the UK of a no-deal Brexit.

In its assessment of the impact of the short term effects of such an exit, published in autumn 2018[7], the OBR stressed the lack of any relevant precedent while explicitly noting that: "the 'Three-Day Week' introduced in early 1974 was associated with a fall in output of a little under 3 per cent that quarter, so it may be reasonable to expect very large short to medium term negative effects from 'no-deal'".

In the most recent Economic and Fiscal Outlook, published on March 13 2019[8], the OBR again noted that "an abrupt, disorderly exit could have a severe short-term impact on the economy" but did not quantify this impact. (It also reduced its expected GDP growth rate for 2019 to 1.2 per cent (from 1.6 per cent), or 0.6 per cent per head, in part reflecting Brexit uncertainty. This forecast, which - on a per head basis - is less than a third of the long run trend rate of growth, is still predicated on the assumption of an orderly transition. An orderly transition of course remains the policy of the UK Government, and the OBR is mandated to base its forecasts on government policy.)

The Governor of the Bank of England, addressing the House of Lords Economic Affairs Select Committee on 5 March[9], noted that preparedness measures that had been put in place had reduced the Bank's estimates of the shorter run (around two to three year)

[7] https://obr.uk/forecasts-in-depth/the-economy-forecast/brexit-analysis/
[8] https://cdn.obr.uk/March-2019_EFO_Web-Accessible.pdf
[9] http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/economic-affairs-committee/Gov-BoE-2019/oral/97544.html

economic costs associated with its more adverse scenarios for a no-deal exit. These now lay in the range 5 per cent to 6.5 per cent in terms of lower GDP (in comparison to what would have been expected had the UK continued to grow in line with expectations prior to the referendum).

The Governor cautioned on the uncertainty and “false precision” inherent in such quantified estimates. However, for illustrative purposes, the scale of the impact estimated by the Bank of England under these adverse scenarios would, in very broad terms, be comparable to that of the recession of 2008-9.

Evidence on the close integration of the economy in Wales with the rest of the UK, and previous experience, indicate that an impact of a broadly similar order of magnitude could be expected in Wales. (While the greater exposure of Welsh exports to EU markets might be expected to imply that impacts would be somewhat greater in Wales it is difficult to make an evidence-based assessment of such differential effects for the reasons described above.)

If the impact of an adverse scenario were of this magnitude, experience of the last recession suggests that it might result in a reduction in employment in Wales of around three percent, with some of this reduction reflected in higher unemployment and the remainder in higher inactivity. This would be equivalent to around 40-50 thousand fewer people in work.

There would of course be a range of other adverse consequences, including lower real wages and incomes, reduced job creation, lower business investment[10] and lower business formation. The last two factors would in turn have longer run implications for future productivity growth.

The sudden introduction of new trade barriers would of course affect some sectors more than others, with particularly strong effects on agriculture and food, especially over the shorter term.

As noted above, analysis undertaken by Cardiff University for the Welsh Government has also described how new trade barriers could affect other sectors. The research highlighted particular risks for sectors such as aerospace, automotive and the process and chemical sectors. However, the authors concluded the heterogeneity of responses of firms within sectors means that firm characteristics rather than sectors is the more appropriate perspective for considering potential Brexit related impacts.

[10] There is no official data on business investment in Wales so it is not possible to produce estimates of the scale of this particular effect.