Society of Business Economists

Brexit following Article 50

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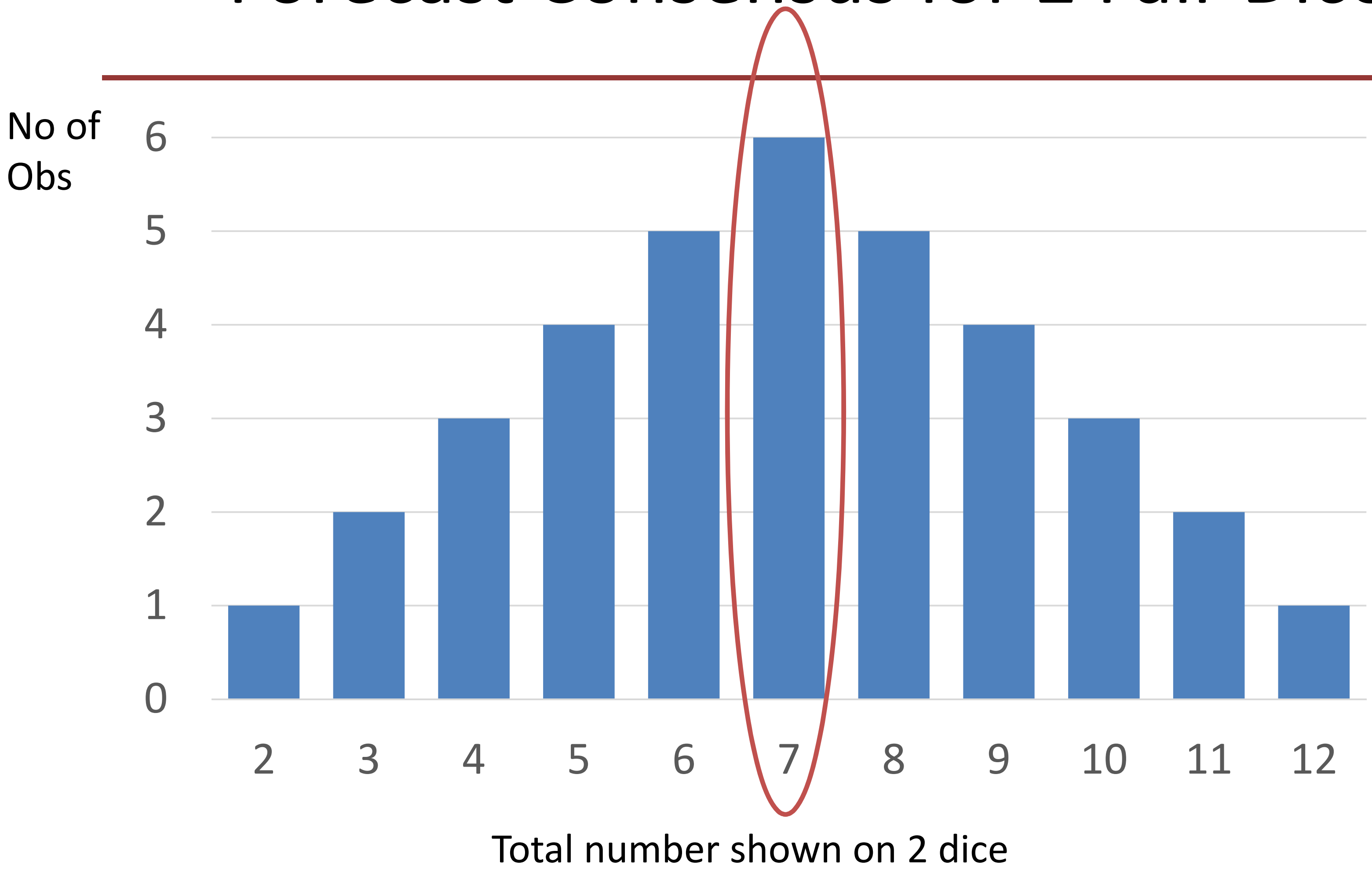
Jagjit S. Chadha
Director
NIESR

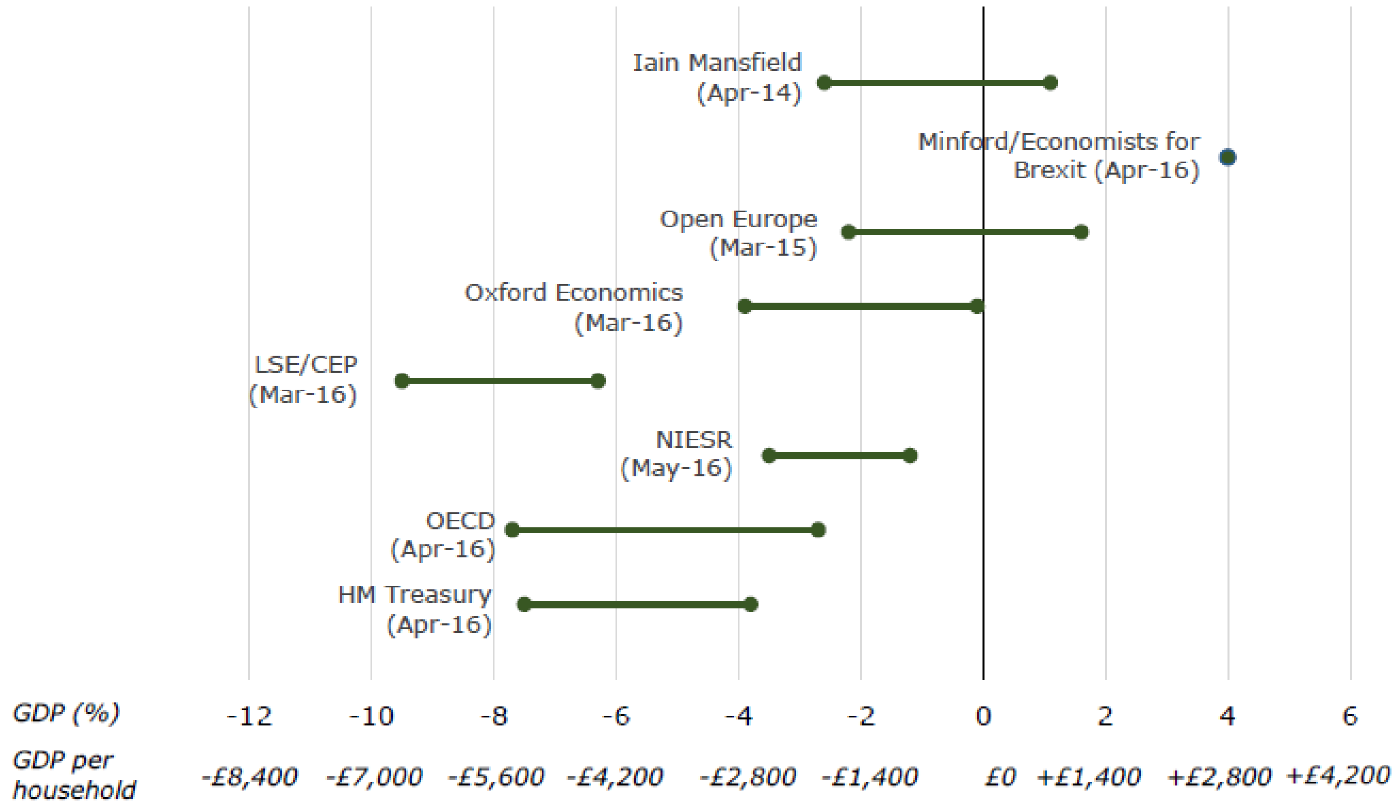
Forecast Consensus for 2 Fair Dice



- Consensus forecast of ***7*** has a large forecast error but is quite rational

How do we use forecasts?

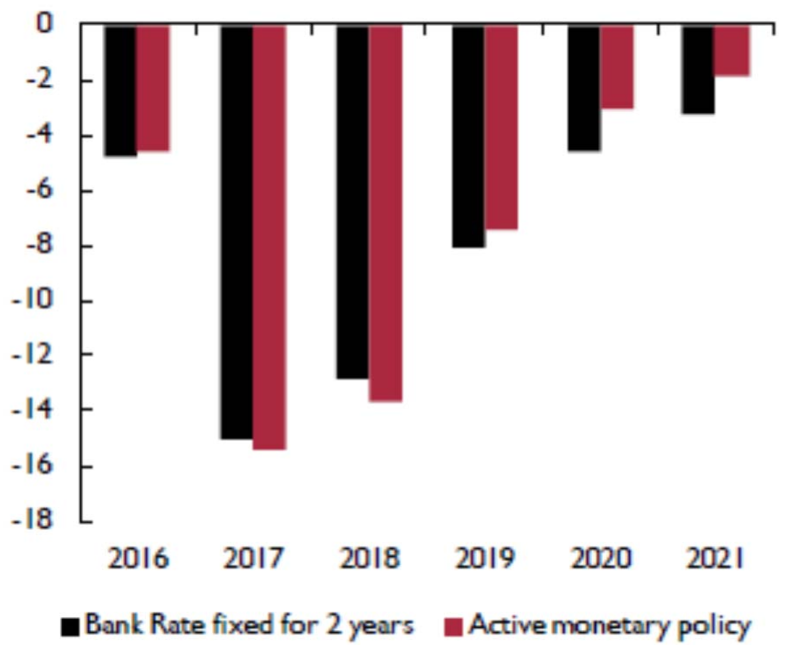
Figure 1: recent estimates of the long-term impact of leaving the EU on UK GDP



National Institute of Economic and Social Research

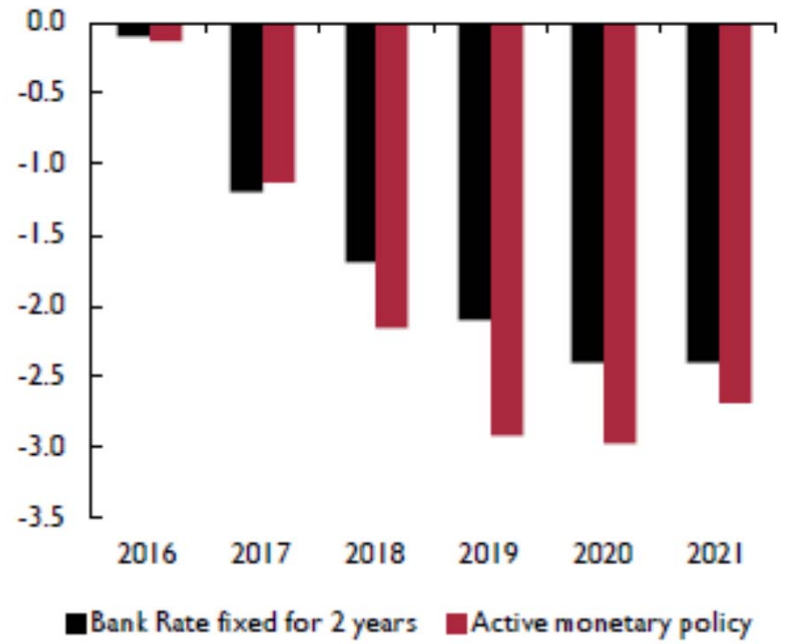
A vote to leave: private sector investment, at trough, around 15% below baseline

Private sector investment (per cent difference from baseline)



Source: NiGEM simulations.

Household consumption (per cent difference from baseline)

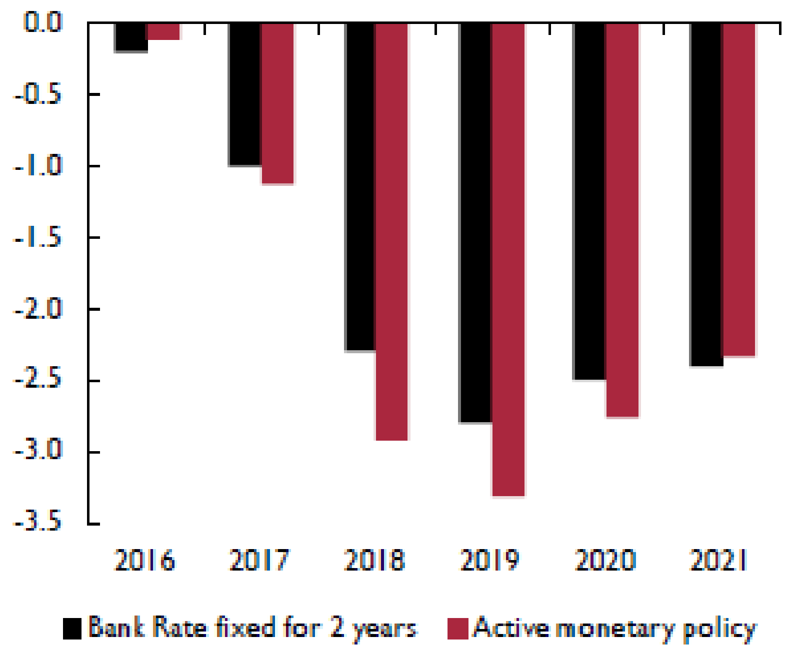


Source: NiGEM simulations.

Note: active policy suggests a tightening of interest rates from 2017. It refers to an endogenous response by the MPC, represented by a Taylor Rule (using the parameters published for the Bank's model COMPASS).

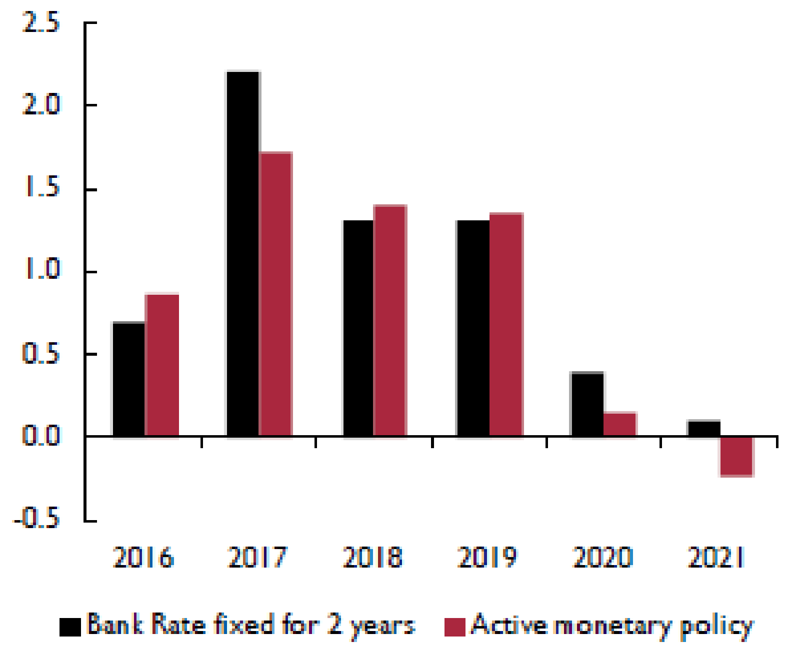
A vote to leave: GDP negatively affected by the shock of a vote to leave; inflation spikes (relative to counterfactual)

GDP level (per cent difference from baseline)



Source: NiGEM simulations.

Inflation rate (percentage points difference from baseline)



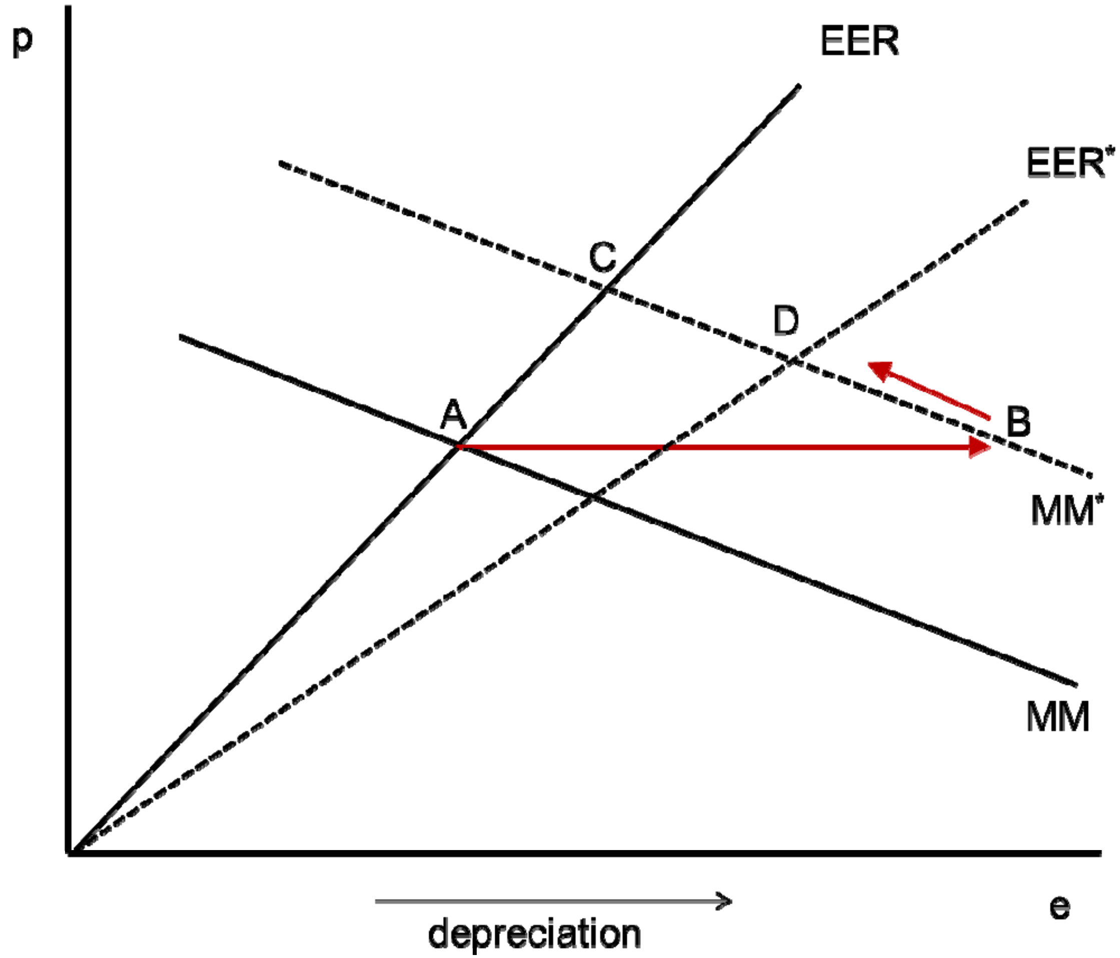
Source: NiGEM simulations.

Note: active policy suggests a tightening of interest rates from 2017. It refers to an endogenous response by the MPC, represented by a Taylor Rule (using the parameters published for the Bank's model COMPASS).

Summary of short-term economic performance following a vote to leave scenario

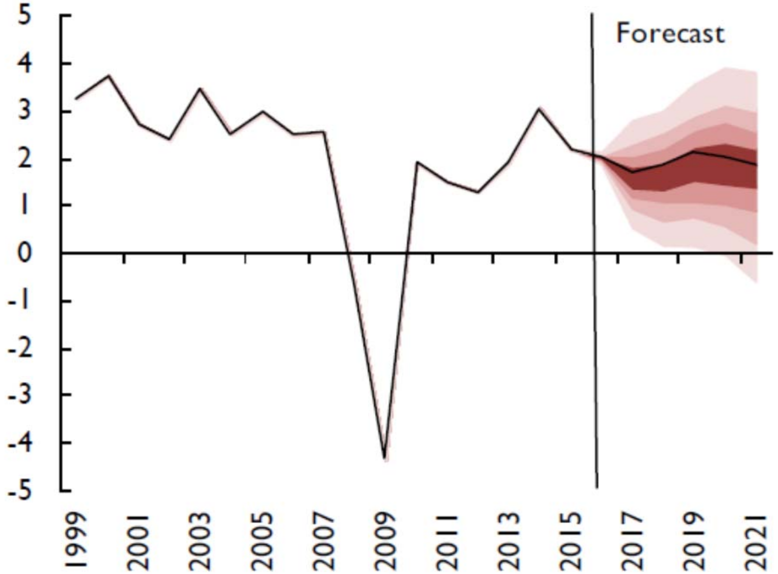
- Heightened risk and uncertainty
  - sterling to depreciate by around 20 per cent
  - Intense bout of inflationary pressure
- Tightening of monetary and financial conditions
  - Fall in investment, relative to counterfactual remain scenario
  - Weigh on household incomes and wealth
- GDP will be 0.7-1% lower than remain counterfactual in 2017
- Even as the short-term effects dissipate, the transition to the longer-run part from the shock of leaving the EU weighs on the economy

Exchange Rate: Shock Absorber



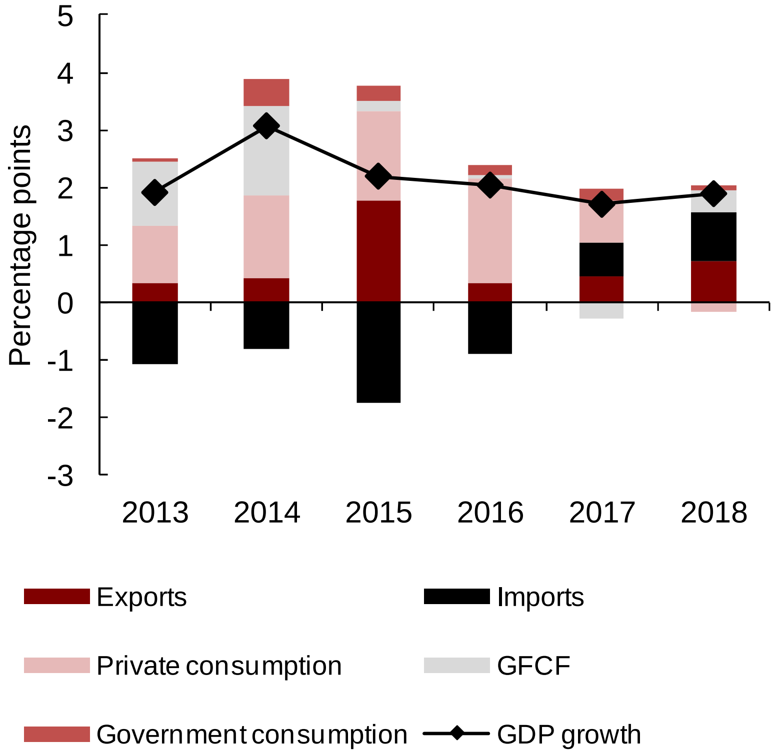
UK GDP growth 1.7% in 2017, 1.9% in 2018

GDP growth fan chart (per cent per annum)



Source: NiGEM database, NIESR forecast and NiGEM stochastic simulations.
Notes: Each bound represents a cumulative decile of the probability distribution around the February 2017 forecast.

Contributions to GDP growth



Source: NiGEM database; NIESR forecast
Note: GFCF is gross fixed capital formation

Long Run Impact: Headline Results

% decrease	Switzerland	WTO	WTO+
GDP	1.9 – 2.3%	2.7 - 3.7%	7.8%
Real wages	3.1 – 3.8%	4.6 – 6.3%	7.0%
Consumption	2.8 – 3.5%	4.0 – 5.4%	9.2%

- All results are % declines compared to the 2030 baseline of remaining in the EU
- Switzerland and WTO focus on trade and FDI effects
- WTO+ adds a 5% productivity drop to WTO-optimistic

Finance: the British dilemma

Table 1. UK financial sector by residency (2014)

	£bn	per cent of GDP
UK banks	3,631	200
Foreign banks	3,374	186
Finance companies and SPVs	480	26
Pension funds	1,430	79
Insurance	1,830	101
Unit, investment trusts and ETFs	880	48
Hedge funds & private equity	760	42
	12,385	682

Source: Table B1 Bank Stats and Burrows and Low (2015).

Armstrong, 2016, NIESR

Four features of UK finance

1. Passporting and the presence of overseas firms
   - More than half largest global institutions EU HQs
2. Financial sector balance sheet = 680% GDP
   - Residency basis & ex derivatives
   - Banks account for 380%
3. Multi-currency area
   - Less than half bank sector assets in sterling
4. Foreign direct investment (related to passporting)
   - 40% is related to financial services

Financial infrastructure post Brexit

1. UK probably treated 'equivalent' in regulation terms
   - o But, a regulatory 'sword of Damocles'
2. Direct membership of TARGET2 extends to EEA
   - o UK banks require an EU home country sub
   - o Would non-EEA banks require EEA home country?
3. MoU between BoE and ECB for currency swaps
   - o Would this be in interests or even credible?
4. No ECJ to enforce non-discrimination
   - o Non-cooperative behaviour in event of cross-border failure?

Trade impacts of leaving the single market, new FTAs

Table A1. Reductions in UK trade with other EU members from leaving the single market

	Goods	Services	Total
Single market → WTO with EU	58%	61%	59%
Single market → FTA with EU	35%	61%	45%

Table A2. Increases in UK trade with BRIICS or Anglo-Americans from new FTAs

	Goods	Services	Total
WTO → FTA with BRIICS	26%	0%	19%
WTO → FTA with Anglos	26%	0%	12%

Table A3. Changes in total UK trade from trade policy changes

	Goods	Services	Total
Single market → WTO with EU	32%	26%	30%
Single market → EU FTA	20%	26%	22%
WTO → BRIICS FTAs	3.2%	0%	2.2%
WTO → Anglos FTAs	3.0%	0%	2.6%

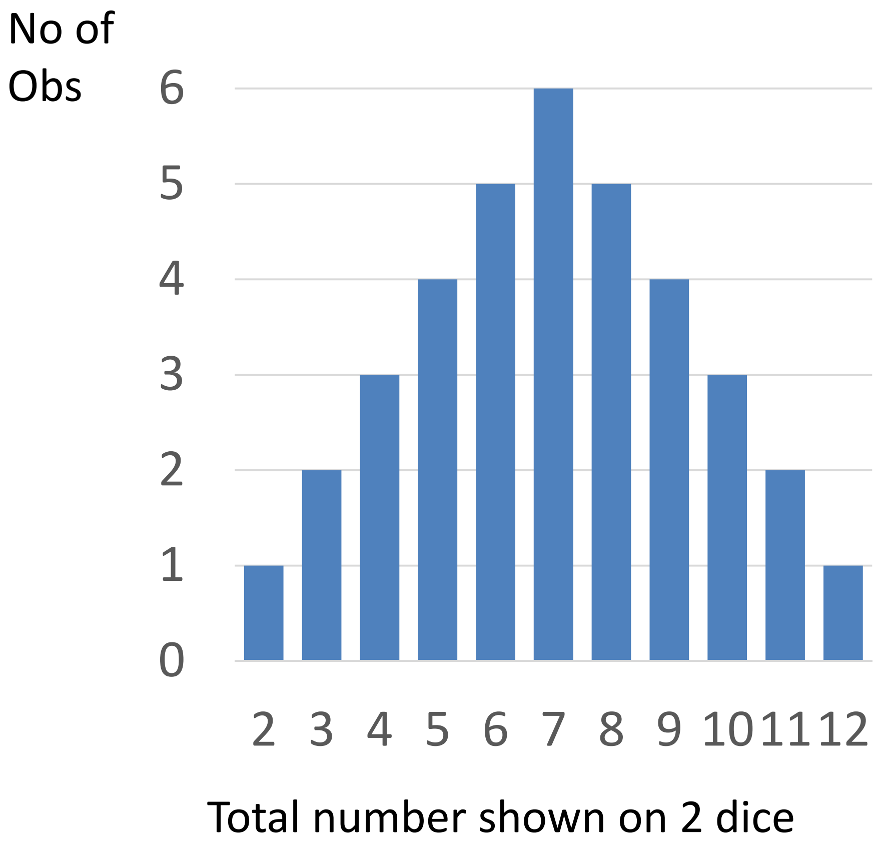
- Trade increases from FTAs with all the BRIICS or all the Anglo-American countries about 1/10 the size of the losses from leaving single market
- Gains from FTAs based on average FTA currently in existence

Risks to the long-run Brexit forecast

- Upside: might reduce losses in WTO cases
  - Deregulation, gains estimated by Open Europe at £12.8 bn annually
  - Migration, if 'optimal' migration policy were achieved

- Downside: might further increase losses
  - Productivity, may be large
  - Scotland, Northern Ireland – debt?
  - Migration – skill shortages, skill mismatches
  - Policy log-jam

Forecast Complexity



- Costly trade is like a tax on production and may shift the distribution
- Increases in uncertainty are like more dice with mean zero,
- Skews imply more dice with mean of greater than or less than 7
- May act against a central projection by formulating policy i.e. dice with numbers a function of the expected error – “feedback”

Will new trade deals soften the blow of Brexit?

Macroeconomic impacts of leaving the single market, new FTAs

Table A4. Long-run impact of changes in UK trading arrangements, % deviations from baseline

	GDP	Cons	Exch. rate
WTO with EU	–2.3%	–3.5%	–15.0%
EU FTA	–2.1%	–2.9%	–11.5%
WTO with EU + Anglos FTAs	–2.3%	–3.5%	–14.9%
WTO with EU + BRIICS FTAs	–2.2%	–3.4%	–13.8%

- FTAs with Anglos have no perceptible impact
- FTAs with BRIICs reduce the GDP and consumption declines by 0.1 of a percentage point.