THE MACRO-ECONOMIC
IMPACT OF BREXIT:
USING THE CBR MACRO-
ECONOMIC MODEL OF THE UK
ECONOMY (UKMOD)

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Abstract. This working paper uses the new CBR macro-economic model of the UK economy to investigate possible futures following the referendum decision to leave the EU. The paper briefly explains why we felt the necessity to build a new model and describes some of its key features. Since Brexit is a unique event with no precedent it is not possible to do a normal forecast in which a few assumptions are made about a limited range of exogenous variables. The best that can be done is to construct scenarios and two are presented here. The difficult part is to decide what scale of adjustment is needed to reflect the likely realities of Brexit. Gravity model analysis by HM Treasury of the potential impact of various outcomes for trade outside the EU is examined and found wanting. The gravity model approach is replicated but with data only from the UK’s main trade partners and not from a large number of emerging economies with which the UK does little trade. The results suggest that the approach is unstable but the impact, if anything, of EU membership on UK trade is much less than suggested by the Treasury.

In addition the actual experience of UK export performance is examined for a long period including both pre- and post- accession years. This augments the gravity model results in suggesting a more limited impact of EU membership. While we include a scenario based on Treasury assumptions, a more realistic, although in our view still pessimistic, scenario assumes a much lower level of the trade loss than that of the Treasury. The results are presented through comparing these scenarios with a pre-referendum forecast. In the milder Brexit scenario there is a 2% loss of GDP by 2025 but little loss of per capita GDP, and also less unemployment but more inflation. In the more severe, Treasury-based scenario the loss of GDP is nearer 5% (2% for per capita GDP), inflation is higher and the gain in unemployment is less.

JEL Classification: E12; E17; E27; E37; E47; E66; F17

Keywords: Brexit; H M Treasury; macroeconomic policy; fiscal and monetary policy; macroeconomic forecasts; macroeconomic models.

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Introduction

The result of the referendum on membership of the European Union in June 2016 generated a large shock to the UK economy. Although the detailed nature of the new arrangements for trade and migration are not yet known, we have taken the Prime Minister’s much satirised comment that ‘Brexit means Brexit’ as an indication that the government means to deliver an exit from the EU which returns control of migration to the UK even if this means leaving the single market, and removing the UK from the jurisdiction of the European Court of Justice.

The UK was already a semi-detached member of the EU, outside both the Euro single currency area and the Shengen area of passport-free movement of people, and as a result the likely impact of leaving the EU will be less of a shock than might otherwise have been the case. Even so, leaving will involve one of the largest changes in the institutional arrangements for the UK economy since joining the EU in 1973. It is not of course the only large shock over this period. The accession of the Eastern European A10 states between 2004 and 2013 represented a large shock, albeit one not immediately recognised, in setting up the large-scale immigration flows in the UK which became one of the two strongest factors behind the ‘leave’ vote in the referendum.

In this paper we use the CBR macro-economic model of the UK economy to estimate the potential impact of what has come to be known as ‘Brexit’. From the outset we need to say that no normal forecast is possible. The CBR model is an econometric model which uses a large set of equations to forecast future trends, each equation based on data covering the last few decades of UK economic behaviour. Because this period has been almost wholly one in which the UK has been a member of the EU, the equations contain little or no direct information about how the UK would fare outside the EU. Put simply, leaving the EU is a unique event; no country has ever done this. The best we can do is to construct a series of scenarios based on assumptions about future trading arrangements, migration controls and about the short-term uncertainties which could affect business investment in the run-up to the likely leaving date of 2019.
The estimates of the impact of Brexit will depend partly on the nature of the model and we will say a little about this. Mostly the estimates will reflect the assumptions entered into the model. Much was written and said during the referendum campaign about such assumptions, much of it highly controversial. Most detailed were the two major reports from H.M. Treasury, one on the long-term impact and the other on the more immediate consequences of a vote to leave. Although the analysis in these Treasury reports was inevitably coloured by the Government’s stated opposition to leaving the EU, the two reports, together involving 280 pages of analysis, offered a comprehensive literature review and were based on best practice in that literature. We thus review the Treasury’s methodology leading to their conclusion that a complete break with the EU single Market would lead to a loss in GDP of 7.2% by 2030. Since the Treasury analysis strangely says little directly about the UK’s trade record within the EU we also examine this in detail to see whether this supports the more indirect methods used by the Treasury in assessing the impact of EU membership on the volume of trade.

The CBR Macro-Economic Model

The main burden of this paper involves assessing what assumptions should be entered into our CBR macro-economic model and then using these assumptions to generate forecasts for two scenarios over the period 2017-25. These issues are dealt with below, but first we describe some of the relevant context of the UK economy and the way in which the CBR model approaches key issues.

Something has gone badly wrong with long-term economic growth in the UK where a relatively consistent growth trend of close to 2.5% per annum has comprehensively broken down (Chart 1). Similarly dramatic breaks of trend can be observed for the USA and the EU although in the latter case the slowdown began rather earlier in 2000 coinciding with the introduction of the Euro. These breaks of trend are related to the so-called ‘productivity puzzle’ for which economists have no agreed explanation. Alongside the failure of existing forecasting models to predict the 2008 economic crisis this break of trend provides another reason for developing a new model which can predict and help to account for these bewildering trends. Our general view is that the slowdown in growth is due to
credit conditions in a post-crisis world with a badly impaired banking system. Perverse government austerity programmes in major economies have exacerbated the situation but the main cause is financial.

Chart 1 Real GDP per Head (£000, 2013 prices)

Note: The forecast to the right of the vertical line is our baseline Brexit scenario described below.
Consumption, Borrowing and Credit Super-Cycles

One key feature of the model is the important role of credit in generating business cycles. The consumption function shown in Table 1 has conventional features in

\[
\text{Table 1 Consumption Function}
\]

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>t-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>17653</td>
<td>1.7</td>
</tr>
<tr>
<td>CV(-1)</td>
<td>-0.39</td>
<td>-8.6</td>
</tr>
<tr>
<td>YD(-1)/CP(-1)</td>
<td>0.31</td>
<td>7.5</td>
</tr>
<tr>
<td>FASN(-1)/(CP(-1))</td>
<td>0.011</td>
<td>2.9</td>
</tr>
<tr>
<td>DEBT_ST(-1)/CP(-1)</td>
<td>-0.18</td>
<td>-3.0</td>
</tr>
<tr>
<td><strong>NEW HOUSING LOANS</strong>(-1)/CP(-1)</td>
<td>0.33</td>
<td>9.3</td>
</tr>
<tr>
<td>D(YD/CP)</td>
<td>0.29</td>
<td>5.3</td>
</tr>
<tr>
<td>D(FTSE/CP)</td>
<td>1191</td>
<td>5.4</td>
</tr>
<tr>
<td>DLOG(HPI)</td>
<td>64129</td>
<td>5.0</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.96</td>
<td></td>
</tr>
<tr>
<td>F-statistic</td>
<td>43.8</td>
<td></td>
</tr>
<tr>
<td>Durbin-Watson</td>
<td>2.2</td>
<td></td>
</tr>
</tbody>
</table>

Note: CV is consumption in constant prices, YD is disposable income, CP is the consumption deflator, FASN is financial assets, DEBT_ST is short term household debt; FTSE is the stock exchange all-share index and HPI is the house price index. All variables in current prices unless otherwise stated.

that consumption depends on disposable income and wealth. Importantly, consumption also depends on annual borrowing for house purchase. These loans are taken out to purchase houses (excluding re-mortgaging) but around 75% of the loans are for the purchase of existing rather than new dwellings and these are thus loans which end up largely as bank deposits of those selling houses (often inherited
property). The evidence of the equation above is that a proportion of these deposits are used to finance consumption.

This in turn is important because of the volatility of mortgage credit. The number of housing loans has fluctuated in large 20-year cycles, termed super-cycles by Mario Borio of the Bank for International Settlements. The extended period with a very low volume of loans since 2008 is unprecedented in the post-war economic history of the UK and is largely responsible for the sluggish growth of GDP over this period. This is the way in which a badly impaired banking system prevents a normal recovery from a deep recession. Our estimate is that the potential demand for loans is currently at historically high levels due to very low mortgage interest rates, but the number of loans is low due to banks’ restrictions on the supply of loans.

**Chart 2 Credit Super-cycles**

Source of data: Council of mortgage lenders. Data is estimated for the period before 1974.

The importance for this in assessing the impact of Brexit lies in the context it sets for economic growth. Credit is currently on the upswing of the latest super-cycle, leading to reasonably rapid rates of household spending. This upswing, helped by government schemes to stimulate house purchase for first-time buyers, allowed the previous Chancellor, George Osborne, to pursue a policy of mild public sector austerity without doing much harm to the growth of aggregate GDP. A continuing
upswing for the next five years would provide a favourable context for the disruptive process of leaving the EU. Beyond the early years of the next decade we had expected before the referendum that the credit cycle would turn down, as demand for loans became the main constraint on loan volumes with demand depressed by high debt levels and falling real wages. Chart 2 shows that the cycle is now expected to flatten but not fall. This is chiefly due to the lower level of mortgage debt and somewhat lower interest rates in our baseline Brexit scenario.

Assumptions on Brexit

The difficulty in generating any forecast for the future of the UK economy is in knowing what to assume about both future trade arrangements and the short-term impact of uncertainty about these arrangements. As we have stated, the best that is possible is to generate scenarios based on assumptions about these things. This is not to say that there is little on which to base assumptions. A plethora of reports were produced during the referendum campaign to assess what the impact might be of a vote to leave the EU and several months on from the referendum some consequences have also begun to emerge.

Short-term Impact of Brexit

These reports published during the referendum campaign generally produced separate estimates for both the short-term impact of uncertainty and the long-term
impact of changed trading arrangements. A summary of short-term impacts from non-government sources is shown in Table 2. The government’s own estimates are shown in Table 3. The estimates vary depending on what is assumed about the nature of the likely eventual relationship sought with the EU. In general the largest estimates of losses of GDP stem from an expectation that the UK will leave the single market and fall back on WTO rules. Something of a consensus emerges from these studies with an expectation that uncertainty will reduce GDP (relative to a pre-referendum baseline) by around 1% after one year, 2-4% after 2 years, 3-4% after three years and 4-6% after 5 years. The Treasury’s estimates are at the high end of this spectrum with a view that GDP would be reduced by between 3.5% and 6%.

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Table 2  HMT Summary of Studies of Short-term Impact of Brexit on GDP

<table>
<thead>
<tr>
<th>Source</th>
<th>Effect on level of GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PwC/CBI⁴</td>
<td>-3.1 to -5.5 (over 5 years)</td>
</tr>
<tr>
<td>Citi⁵</td>
<td>-4.0 (over 3 years)</td>
</tr>
<tr>
<td>Credit Suisse⁶</td>
<td>-1.0 to -2.0 (over 2 years)</td>
</tr>
<tr>
<td>Deutsche Bank⁷</td>
<td>-3.0 (over 3 years)</td>
</tr>
<tr>
<td>HSBC⁸</td>
<td>-1.0 to -1.5 (over 1 year)</td>
</tr>
<tr>
<td>JP Morgan⁹</td>
<td>-1.0 (over 1 year)</td>
</tr>
<tr>
<td>Morgan Stanley⁰</td>
<td>-1.5 to -2.5 (over 2 years)</td>
</tr>
<tr>
<td>Nomura¹¹</td>
<td>-4.0 (over 1 year)</td>
</tr>
<tr>
<td>Société Générale¹²</td>
<td>-4.0 to -8.0 (over 5 years)</td>
</tr>
</tbody>
</table>

Table 3 H M Treasury Estimates of the Short-term Impact of Brexit

<table>
<thead>
<tr>
<th></th>
<th>Shock scenario</th>
<th>Severe shock scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-3.6%</td>
<td>-6.0%</td>
</tr>
<tr>
<td>CPI inflation rate (percentage points)</td>
<td>+2.3%</td>
<td>+2.7%</td>
</tr>
<tr>
<td>Unemployment rate (percentage points)</td>
<td>+1.6%</td>
<td>+2.4%</td>
</tr>
<tr>
<td>Unemployment (level)</td>
<td>+520,000</td>
<td>+820,000</td>
</tr>
<tr>
<td>Average real wages</td>
<td>-2.8%</td>
<td>-4.0%</td>
</tr>
<tr>
<td>House prices</td>
<td>-10%</td>
<td>-18%</td>
</tr>
<tr>
<td>Sterling exchange rate index</td>
<td>-12%</td>
<td>-15%</td>
</tr>
<tr>
<td>Public sector net borrowing (£ billion)</td>
<td>+£24 billion</td>
<td>+£39 billion</td>
</tr>
</tbody>
</table>

* Peak impact over two years. Unemployment level rounded to the nearest 10,000.  


The Treasury summarised its own view in the following words, “The analysis shows that the economy would fall into recession with four quarters of negative growth. After two years, GDP would be around 3.6% lower.... the fall in the value of the pound would be around 12%, and unemployment would increase by around 500,000, with all regions experiencing a rise in the number of people out of work. The exchange-rate-driven increase in the price of imports would lead to a material increase in prices, with the CPI inflation rate higher by 2.3 percentage points after a year”.

The mechanism underlying the Treasury assessment is that firms and households would begin adjusting to the expected new relationship with the EU, and business investment would be damaged by uncertainty. Financial markets would react immediately with a 10-14% fall in the sterling exchange rate. Consumer spending would be reduced because higher inflation occasioned by a lower exchange rate would lead to lower real wages. Exports would be higher and imports lower but the overall impact would be sharply negative. Some econometric work was done to assess the relationship between measures of uncertainty and key macro-economic variables. However the actual judgement on uncertainty impacts is arbitrary with
the assumption of a 1 to 1.5 standard deviation rise in uncertainty. A similar assumption is used to obtain the financial markets effect resulting in a 1-2 percentage point rise in market interest rates and equity risk premia.

Writing five months after the referendum result, only one of the Treasury’s expectations has been clearly realised. This is the fall in the value of sterling. A 12% fall in the effective exchange rate matches the HMT ‘severe shock’ scenario. There was, however, little movement on interest rates, at least until the US Presidential election result in November 2016 when anticipated higher infrastructure spending and higher expected inflation quickly drove bond yields upwards. The Treasury expectation that equity risk premia would rise, leading to lower equity prices, has proved wrong. The sterling depreciation instead led to higher UK equity prices as FTSE 100 corporate earnings from abroad became worth more in sterling. Preliminary data also suggest little or no fall in consumption, house prices or house building. GDP in the third quarter of 2016 was well above Treasury expectations.

Our own expectation has been that there would be little direct impact of Brexit on consumer spending or investment in housing. Since, as we argue below, the long-term impact of Brexit is expected to be well below Treasury estimates, even if the UK ends up with no free trade agreement or other privileged access to the EU single market, our expectation of any transitional losses to investment would be relatively small. Uncertainty effects are harder to assess. It seems reasonable to expect that at least some domestic firms will delay investment until they are clearer about future trade arrangements; foreign direct investment will be reduced partly for the same reasons and also because some firms wish to locate within the EU. The initial evidence to date has been mixed. Several strategically important firms have announced major investments. Others, particularly in financial services are said to be at least exploring the possibility of relocating some activities into the continuing EU. These announcements have no doubt influenced the OBR in the November 2016 forecasts released in conjunction with the Chancellor’s Autumn Statement. Their forecast of GDP growth of 1.4% in 2017 is a long way from the Treasury’s four quarters of negative growth³.
We have made two arbitrary assumptions on short-term impacts to drive our Brexit scenarios. We propose two scenarios. A severe scenario broadly matches Treasury expectations even though we view these as unrealistic. A mild scenario assumes a significant but milder reduction in business investment. In the mild scenario net new business investment is arbitrarily reduced by close to 3% below the pre-referendum baseline in each of the years 2017-19, after which uncertainty reduces and some recovery of investment occurs. This amounts to around 15% of net new business investment. In the severe scenario the reduction is closer to 15%, equivalent to three-quarters of net business investment. The sterling effective exchange rate is assumed to depreciate immediately by 10%, although some of the depreciation into 2017 was already projected in our pre-referendum baseline forecast. The impact on consumer spending, household investment and exports and imports are all indirect consequences of the above assumptions without any more direct impacts.

**Long-term Impact of Brexit**

It is widely accepted that the long-term impact of Brexit depends on the trade arrangements agreed for the UK after leaving the EU. Several forecasters have made separate estimates for the UK joining the European Economic Area (EEA), negotiating a new free-trade agreement with the EU, or most drastically having no agreement and falling back on World Trade Organisation (WTO) rules. In this
### Table 4  IFS Summary of Assessments of 2030 Economic Impact of Brexit

<table>
<thead>
<tr>
<th>Organisation</th>
<th>Scenario</th>
<th>Estimate (% GDP)</th>
<th>Range</th>
<th>Impacts modelled</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEP (2016a)</td>
<td>Dynamic</td>
<td>−7.9</td>
<td>(−6.3 to −9.5)</td>
<td>Budget, trade, productivity</td>
</tr>
<tr>
<td></td>
<td>EEA/FTA</td>
<td>−1.3</td>
<td>N/A</td>
<td>Trade only</td>
</tr>
<tr>
<td></td>
<td>Static EEA</td>
<td>−2.6</td>
<td>N/A</td>
<td>Trade only</td>
</tr>
<tr>
<td>HM Treasury</td>
<td>EEA</td>
<td>−3.8</td>
<td>(−3.4 to −4.3)</td>
<td>Budget, trade, FDI, productivity</td>
</tr>
<tr>
<td></td>
<td>FTA</td>
<td>−6.2</td>
<td>(−4.6 to −7.8)</td>
<td>Budget, trade, FDI, productivity</td>
</tr>
<tr>
<td></td>
<td>WTO</td>
<td>−7.5</td>
<td>(−5.4 to −9.5)</td>
<td>Budget, trade, FDI, productivity</td>
</tr>
<tr>
<td>OECD</td>
<td>WTO/ FTA</td>
<td>−5.1</td>
<td>(−2.7 to −7.7)</td>
<td>Budget, trade, FDI, productivity, migration, regulation</td>
</tr>
<tr>
<td>NIESR</td>
<td>EEA</td>
<td>−1.8</td>
<td>(−1.5 to −2.1)</td>
<td>Budget, trade, FDI</td>
</tr>
<tr>
<td></td>
<td>FTA</td>
<td>−2.1</td>
<td>(−1.9 to −2.3)</td>
<td>Budget, trade, FDI</td>
</tr>
<tr>
<td></td>
<td>WTO</td>
<td>−3.2</td>
<td>(−2.7 to −3.7)</td>
<td>Budget, trade, FDI</td>
</tr>
<tr>
<td></td>
<td>WTO+</td>
<td>−7.8</td>
<td>N/A</td>
<td>Adds productivity</td>
</tr>
<tr>
<td>PwC/CBI</td>
<td>FTA</td>
<td>−1.2</td>
<td>N/A</td>
<td>Budget, trade, FDI</td>
</tr>
<tr>
<td></td>
<td>WTO</td>
<td>−3.5</td>
<td>N/A</td>
<td>Budget, trade, FDI</td>
</tr>
<tr>
<td>Oxford</td>
<td>FTA&lt;sup&gt;a&lt;/sup&gt;</td>
<td>−2.0</td>
<td>(−0.1 to −3.9)</td>
<td>Budget, trade, FDI, migration, regulation</td>
</tr>
<tr>
<td>Economics</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Open Europe</td>
<td>FTA</td>
<td>−0.8 to +0.6</td>
<td>(−2.2 to 1.6)</td>
<td>Budget, trade, migration, regulation</td>
</tr>
<tr>
<td>Economists for Brexit</td>
<td>WTO</td>
<td>+4.0</td>
<td>N/A</td>
<td>Budget, trade&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

<sup>a</sup> FTA with moderate policy scenario used as central estimate; range includes ‘liberal customs union’ (−0.1) to ‘populist MFN scenario’ (−3.9).

<sup>b</sup> Regulation impacts assessed separately.

Note: Estimates are for impact on GDP in 2030.

Source: Estimates from organisations above. Authors’ assessment of impacts modelled.

*Source: Institute of Fiscal Studies (2016) Brexit and the UK’s Public Finances. Table 3.1 Page 18.*
paper we focus on the last of these three as the putative worst-case scenario. Other scenarios should not be as bad for the UK. The Institute for Fiscal studies (IFS) usefully summarised the range of estimates for fourteen years after the referendum (Table 4). Several major forecasters (Treasury, OECD, NIESR and the LSE’s Centre For Economic Policy (CEP) broadly agree that leaving the single market and falling back on WTO rules would lead to GDP being more than 7% lower by 2030 than it would otherwise have been. PwC, Oxford Economics and Open Europe have lower impacts for the scenarios they consider, but the main reason seems to be that they exclude the productivity effects included in the Treasury, OECD, NIESR and CES studies. The one clear outlier is that of the Economists for Brexit led by the free-market economists Patrick Minford and Gerard Lyons. The main reason for the positive impact of Brexit in their study appears to be their assumption that all exports and imports behave like oil and other commodities. Commodities can always be sold in world markets at prevailing world prices, and hence being shut out of any particular market makes little difference. This seems to us an assumption which, although true for some exports and more imports, is not representative of most exports.

**How Does the Treasury estimate its Long-term Impact?**

In this paper we focus on the Treasury’s assessment of the long-term impact of Brexit as a representative example. The Treasury examines three possible cases (EEA, FTA and WTO rules) and we take only the last of these as an example of a worst-case scenario. The Treasury report made estimates of three macro-economic variables and then inserted these estimates into the NIESR’s NiGEM model to calculate overall impacts on GDP and GDP per head. The three variables are:

- Trade (exports and imports)
- Foreign Direct Investment (FDI)
- Productivity (GDP per head)
The Treasury’s estimates for WTO rules

The Treasury’s estimates are summarised in the Box below. These estimates are for a case in which the UK leaves the EU without joining the European Economic Area or concluding a new free-trade agreement. The estimated loss of trade with the EU in this option is very large at 43%, and is based on coefficients from econometric work which the Treasury regard as being in line with academic studies. The same work leads the Treasury to conclude that these losses would not be offset by any gains in trade with non-EU countries.

Box 1 Summary of Treasury Estimates of 2030 Impacts of Brexit with WTO Rules

| Trade                  | 76% gain in trade with EU due to membership of EU assumed to be fully reversible, giving a loss of trade with EU of 43% (=76/176) |
|                       | No trade diversion i.e. no loss of trade with 3rd parties due to membership |
|                       | Giving a total loss of trade (to EU and non-EU destinations) of 24% |
| FDI                   | Loss of 22% of FDI (measured in money) |
| Productivity          | Productivity (per capita GDP) impact due to loss of trade at 25% of trade loss. |
|                       | Extra small productivity loss of 4% of FDI loss |
|                       | Overall loss of GDP is 7.5% after 15 years (table 3.D) |
| Migration             | No impact of any reduction in migration |

Source HM Treasury (April 2016) annex A
The gains from membership of the EU, relative to no FTA are assumed to be fully reversible, hence it is imperative to understand how these gains are estimated. The EU6 share of UK goods exports at accession in 1973 was 25% and a 76% increase in trade due to EU membership, without any change in non-EU trade would take that share up to 35% (=1.76*25/125). By the next wave of accessions to the EU in 1986 the actual UK share had risen to 37.7%, roughly in line with the Treasury calculation. However the EU6 share peaked at the end of the 1980s at just over 40% and has subsequently fallen back to 30% by 2015. Hence, by 2015 the overall increase in UK goods exports to the EU6 was only half of the Treasury estimate. How, then did the Treasury arrive at the high estimate of 76%?

**The Gravity Model Approach**

The most common approach to estimating the impact of free trade areas, customs unions or monetary unions, over the last decade and more, has been “gravity” modelling. The Treasury report describes this as ‘best practice’ and uses this approach to derive its own estimate of the UK gain in trade in goods and services from membership of the EU. The approach is analogous Newtonian physics where the attraction between planetary bodies is directly proportional to their masses and inversely proportional to the distance between them. In trade analysis the volume of trade in any period between a pair of countries is assumed to be proportional to the product of the size of their economies, and inversely proportional to some measure of the distance between them. Other factors such as common language or currency can also be taken into account. In the Treasury version below, the product of the populations of the trade partners is also taken into account to give some weight to productivity (GDP per head) as well as GDP per se.
\[
\ln(T_{ijt}) = \alpha_{ij} + \gamma_t + \alpha_1 \ln(Y_{it} \times Y_{jt}) + \alpha_2 \ln(POP_{it} \times POP_{jt}) + \varepsilon_{ijt} \\
= \alpha_{ij} + \gamma_t + \alpha X_{ijt} + \varepsilon_{ijt}
\]

Where:

- \( T_{ijt} \) denotes trade flows between country i and country j at time t
- \( Y_{it} \) and \( Y_{jt} \) are the GDP of countries i and j at time t
- \( POP_{it} \) and \( POP_{jt} \) are the population of countries i and j at time t
- \( \gamma_t \) is a set of time dummies
- \( \alpha_{ij} \) is the country-pair fixed effect

In practice the influence of all time-invariant factors, including distance, are usually wrapped up in the fixed effects for each pair of countries, \( \alpha_{ij} \). The impact of membership is simply measured via dummy variables indicating which countries are members of the EU or associated free trade areas:

\[
\ln(T_{ijt}) = \alpha_{ij} + \alpha X_{ijt} + \beta_1 EU1_{ijt} + \beta_2 EU2_{ijt} + \beta_3 EEA_{ijt} + \beta_4 FTA_{ijt} + \varepsilon_{ijt}
\]

Where:

- \( EU1 \) is a dummy variable which equals 1 if only one country is a member of the euro area at time t and zero otherwise
- \( EU2 \) is a dummy variable which equals 1 if both the origin and destination countries are members of the euro area at time t and zero otherwise
- \( EEA \) is a dummy variable which equals 1 if both the origin country is a member of the European Free Trade Area.
- \( FTA \) is a dummy variable which equals 1 if both the origin country is a member of a FTA with the EU
The Treasury report gives limited information about the nature of their analysis but it appears to involve trade for 118 countries over the period 1981-2009. With (118 x 117 =) 13,806 country pairs over 28 years this gives over 380,000 individual observations. The coefficients on the EU dummy variables are essentially cross-sectional, being approximately an average of EU members’ deviations from the trade predicted by general world relationship between trade and GDP etc. The issue of trade diversion, i.e. loss of third party trade from countries which are EU members, is determined from the dummy EU1 where only of a country pair is an EU member. With 118 countries in all, the number of such country pairs will be very large and the impact is estimated as an average over all of these countries, many of which will be small developing nations.

The Treasury is thus relying on cross-sectional averages across a range of countries at different dates, rather than on the direct experience of the UK itself. Indeed, the Treasury analysis provides virtually no information directly about UK trade with the EU. We will return to this issue below, but will first complete a description of the Treasury approach to estimating the overall impact of Brexit.

**Service sector trade**

A similar approach is used to estimate the impact of EU membership on trade in services. Once again the data includes a large range of countries over the period 1981-2009. Once again the method finds a positive impact of EU membership, albeit smaller than for goods, and no evidence of trade diversion.

**The Impact on FDI**

The Treasury also uses a gravity model to assess the extent to which EU membership increases the flow of foreign direct investment between country pairs. The data in this case covers 40 countries over the period 2000-14. Although the Treasury do not say so, the data is in the form of financial flows. It thus includes financing flows and mergers and acquisitions alongside physical investment...
projects such as new green-field sites or extensions to existing sites. The Treasury do admit that the data is troublesome due to profit shifting for tax reasons. In fact the data can be very difficult, with annual FDI inflows into Luxemburg in recent years averaging 320% of GDP and flows into Ireland and the Netherlands averaging 25% of GDP. Our own estimates for the UK are that under a quarter of FDI flows measured in money terms relate to new physical investment projects. The issue then is: even if EU membership increases FDI flows in money it is difficult to assess what impact this will have on an individual economy. The impact of new physical investment is likely to be very different from acquisitions or profit-shifting.

The estimation period used in this analysis i.e. 2000-14 means that the results are dominated by countries which joined the EU in these years. These were of course largely Eastern-European post-Soviet bloc countries with very low labour costs. The impact of EU membership was generally very large, as restrictions on inward investment from the EU were removed and EU-based companies were able to take advantage of the low cost of labour. The analysis estimates that EU membership increased FDI flows by 22% with no diversion from other countries, but it is difficult to know what this implies for physical FDI flows into the UK and hence for UK economic development.

**Impact on Productivity**

The Treasury Report summarises a few academic reports linking expansion in trade and FDI to increases in economy-wide or firm productivity. Some of the trade studies are based on a gravity model methodology. Once again the relationships emerging from these studies are based on cross sections of up to 200 countries. Most of these countries are necessarily small emerging economies. In some cases trade increases as economies emerge from behind high tariff walls allowing multi-national companies to operate. In these circumstances it is unsurprising that aggregate productivity rises, but it is not obvious that these results can be applied to a well-developed open economy like the UK leaving a single market and customs union with generally low tariffs.
An average elasticity of 0.25 is drawn by the Treasury from this literature. Even if this were applicable, any impact depends on the size of the trade losses based on gravity model studies which, in our view, are unreliable. Two established practitioners of this approach recently published a 'mea culpa' in which they discovered that their earlier results were extremely sensitive to equation specification. They concluded that it is “currently beyond our ability to estimate the effect of currency unions on trade with much confidence”8. This paper referred to trade and currency unions but it seems likely that the conclusions apply to similar studies of trade and customs unions.

The Treasury also cite a number of firm-level studies. It is well known that foreign-owned firms generally have higher productivity than domestic companies - much of this is because the former are more likely to be exposed to greater competition and to be involved in international trade and foreign direct investment. The ‘most comprehensive of these studies in the view of the Treasury is the study by Melitz and Trifler showing that productivity in Canadian manufacturing grew by 14% from 1988-96 following Canada’s joining the US-Canada FTA in 1989 and the full NAFTA in 1993. What the Treasury did not say was that part of the effect was due to an 18% loss of jobs in low productivity plants in Canada. Nor did they apparently know that the impact on the Canadian economy as a whole was entirely the opposite. Per capita GDP fell sharply in 1990 and has never regained the 2.5% per annum growth trend established over the previous four decades and more (Chart 3). What seems to have happened was that opening Canada to greater competition raised productivity in a range of surviving manufacturing firms but displaced a significant amount of labour in low productivity sectors that was never re-employed at pre-NAFTA levels of productivity. This may be a general process since most countries joining the EU at various dates between 1970 and 1996 had a similar experience. This includes the UK joining in 1973.
The Treasury also conduct a production function analysis to estimate a link between FDI and ‘technology’. They find a small elasticity of 0.04. However, given our misgivings about the earlier link between FDI and trade openness it is not obvious that this is very informative.

**Summary on Treasury Views on the Impact of Brexit**

The Treasury estimate of a 43% loss of trade with the EU in the event of reverting to WTO rules translates into a 24% loss in total trade. They also estimate no diversion in trade with non-EU countries to offset these losses. Both of these conclusions appear implausible, especially since EU external tariffs average only 2% although additional costs of customs documentation will add to this. Non-tariff barriers can be high but these are unlikely to be relevant to UK exporters since most of these will be already compliant with most EU regulation, at least in the short term. Issues like passporting for financial services may also add to the cost of trade, although it is not yet clear whether EU equivalence rules will make this less of an issue.

Most importantly, our view is that the gravity model technique is controversial and, as applied by the Treasury, is flawed. The Treasury conclusion that EU membership doubles the amount of goods trade appears not to apply to the UK where the EU share of trade is declining rapidly. In estimating the impact of EU
membership on UK trade the Treasury analysis relies on the coefficients of a dummy variable for EU membership. In principle this might be reasonable, but the value of the coefficient obviously depends on the underlying equation. In the Treasury analysis this equation is estimated over a very large number of countries many of which are involved in minimal levels of trade with the UK. The estimate is also an average across EU members and is estimated over the long period spanning almost three decades. In the annex to this paper we estimate a gravity model for goods trade with the UK’s main trade partners. This includes 28 countries accounting for 92% of UK exports to the EU and 81% of total UK exports of goods. Our analysis also focuses on the last three years (2013-15) to draw conclusions about the current influences on trade. This analysis generates a much smaller coefficient for EU membership than does the Treasury analysis (see annex B).

The Treasury approach also assumes that the EU coefficient captures the beneficial impact of the Single Market on trade between EU members, but this must be wrong. A major additional factor is the growth of demand for imports within the EU compared with elsewhere. The fact that the EU, and especially Eurozone, economies have grown so slowly over recent decades has meant that exports to EU countries have grown less rapidly than exports to other destinations. This will affect all exporters but especially those which undertake most trade with EU countries, and hence mainly the EU countries themselves.

In our view a better way of estimating the direct impact of the Single Market per se is to include a dummy variable for third country exports to EU member states. This should pick up the impact of slow growth in EU markets and the common external tariff but not the benefits of membership of the single market, since these third countries are not members of the EU. As expected the coefficient on this dummy variable is negative, indicating that third countries export fewer goods to the EU, ceteris paribus, than to other countries. An estimate for the benefits of the single market is obtained by subtracting this coefficient from that of the EU2 dummy variable. This is 30% smaller than that estimated by the Treasury.

Even this is not the end of the story. The Treasury have used an impact for membership of the Single Market which is an average over all member states. The evidence of our analysis indicates that the UK experience is very different from the
other member states. It turns out that UK exports to EU partners are much lower than predicted by our equation with the single exception of exports to Ireland. This may also be the case in the Treasury analysis but their report makes no comment on residuals.

Since the loss of trade turns out to be much lower in our analysis than in that of the Treasury, their assumption that a loss of trade will reduce productivity becomes less important. In any case it is not obvious that a productivity link of this magnitude based on evidence dominated by emerging economies is appropriate for the Brexit situation. Nor is the evidence cited on FDI impressive, although there is likely to be some loss of physical FDI.

Another issue ignored in the Treasury analysis is the importance of exchange rates. The 12% depreciation of sterling that occurred immediately after the referendum will do much to offset EU tariffs on EU exports. Our estimate is, for instance, that a 15% depreciation of sterling relative to the euro is sufficient to offset the impact of a 10% EU external tariff on motor vehicles, including the higher costs of intermediate imports to this sector. For most engineering firms, tariffs of close to 2% are small in relation to a sterling depreciation of this magnitude.

Our preferred gravity model equation also indicates that membership of the EU leads to reduced exports to non-EU markets. We do not need to go as far as the ‘Economists for Brexit’ in assuming that all exports lost in EU markets can be sold in non-EU markets. But it defies logic to move to the opposite extreme and accept the Treasury estimate that no trade will be diverted. Some UK exports (e.g. milk powder) are commodities that can be sold on world markets as the Economists for Brexit suggest. For other exports it may take longer, in some cases much longer, to build additional export sales.

In summary, we regard much of the Treasury evidence on the likely impact of Brexit on trade, FDI and productivity to be flawed and not directly relevant to the likely impact on UK trade from leaving the EU. Our attempt to replicate the gravity model analysis, reported in annex B, generated very different conclusions to those of the Treasury. It was a serious weakness of the Treasury report that almost no evidence of the record of UK trade with the EU was included in the
analysis. Before outlining this analysis we examine the direct evidence on UK trade.

**Direct Evidence on UK Exports to the EU**

A different approach to analysing the impact of the UK joining the EU, in order to get a sense of what might happen when the UK leaves, is to examine time series data. This approach compares the pre-accession trends in economic behaviour with post-accession behaviour. Two variables are of key interest. First is trade; we will examine the EU share of UK exports of goods and services. Instead of looking at the EU membership at any particular date we examine a constant set of the current 28 members throughout a period from 1950-2015. Second is productivity. If membership of the EU is beneficial for productivity, this should show up in the UK’s productivity record. The difficulty comes in allowing for factors other than EU membership, especially since the UK’s accession date of 1973 was in many ways a turning point in post-war economic history, especially in Western Europe.

**Data Sources**

For data on trade we have used the IMF’s Direction of Trade (DOT) series of annual goods exports by country from 1948\(^{13}\). This provides data for our 1950-2015 period for all of the current member states that have been independent states throughout the period. Data is thus missing prior to 1990 for the Baltic States, formerly part of the Soviet Union and Slovenia and Croatia which were part of the former Yugoslavia. Even without these five states, the data covers 98% of the exports of the current EU. However for completeness we have estimated UK exports to these five states for the period prior to 1990\(^{14}\).

ONS data on total UK exports of goods and services are available back to 1950. The IMF DOT data provides data for exports to the EU28 but only for goods. For services, ONS provide data only from 1999. For earlier years we have assumed that the EU28 share of UK services exports expanded at the same rate as the share for goods. The sum of exports of goods and services at current prices is deflated by
the same UK export price deflator whether these exports are to the EU or to other countries.

Productivity is measured as per capita GDP. Data for GDP and population has been obtained for the EU28 countries from the Conference Board database. GDP is measured in $1990 at purchasing power parity. Data is converted into sterling using the average dollar-sterling exchange rate for each year. Missing data for the Baltic and former Yugoslav States prior to 1990 is estimated in the same way as for trade.

**Trends in UK Exports to the EU28**

We examine exports to all current EU member states from 1950 to 2015 irrespective of whether the states were EU members at any particular dates or even whether they were independent states. This avoids the problem of an EU membership which changes over time. If membership of the EU promotes trade then we might expect to see growing exports to the EU28 not only after the UK joined in 1973, but also as other countries joined in subsequent years and as countries left the Soviet orbit after the fall of the Iron Curtain in 1989.

Total exports to the EU28 countries grew surprisingly rapidly through most of the post-war period (Chart 4). The 6% per annum pre-accession growth trend was
maintained right up until the end of the 20th century, despite the sharp slowdown in the growth of the European economies\textsuperscript{15}. UK exports to the rest of the world grew more slowly than exports to the EU28 in the pre-accession period at just over 3% per annum or around half the rate of exports to the EU28 (Chart 5). This reflected the more rapid growth of the European economies recovering from the enormous damage of World War II and catching up with the USA, representing the best practice frontier for technological efficiency. The growth of UK exports to non-EU28 countries clearly slowed down after UK accession in contradiction to the
Treasury finding that no trade diversion took place\textsuperscript{16}. From the millennium, UK exports to non-EU countries have grown rapidly, and much more rapidly than to the EU. It is a little known fact that Commonwealth markets have grown faster than EU markets since the UK’s historic switch from the former to the latter in 1973.

**Chart 6  EU28 Share of UK Exports (%)**

![Chart 6 EU28 Share of UK Exports (%)](chart6.png)

These trends mean that the EU28 share of UK exports rose steadily over the post-WWII period with no obvious acceleration in the trend after accession to the EU in 1973. After peaking at the end of the 1980s the EU share first flattened and since the formation of the Eurozone has fallen sharply. The share is now 43% and is only a little above the 40% share at accession.

It is not possible to discern the precise role of EU membership from the above trends. Part of the changes in trend are due to changes in economic growth in markets for imports. The fact that European growth rates fell sharply just as the UK joined the then EEC makes it difficult to interpret raw data on trade. More informative is a measure of import penetration, i.e. the volume of exports divided by the GDP of the import market.
The penetration of EU and non-EU markets by UK exports is shown in Chart 7. UK penetration of EU28 markets was on a slowly growing trend from the late 1950s, but the trend accelerated markedly from the early 1990s coincident with the formation of the EU single market in 1992 and the fall of the Iron Curtain in 1989.

The path of UK penetration of non-EU markets was quite different. Penetration fell steadily until the late 1970s and then stabilised with UK exports equivalent to around 1% of Non-EU GDP.

We can take the penetration of non-EU markets as a benchmark of what might have happened in Europe without UK accession to the EU. UK export penetration of EU28 markets is shown relative to penetration of non-EU markets in Chart 8. Penetration of EU28 was already growing faster than penetration of non-EU markets prior to 1973. This probably reflected reductions in global tariffs under the various GATT rounds, allowing the natural geography of trade to re-assert itself.

After UK accession, UK penetration of EU28 markets was generally above this rising trend with a peak of 30% above trend in the recession years of 1991/2. However the average, for the 15 years after EU tariffs were fully removed in 1978, was only 10% above trend. Since 1999, the trend has been flat with no further widening of the gap in import penetration between EU and non-EU markets. By this time UK export penetration of EU markets was seven times higher than for non-EU markets, but in 2015 it was 40% below the extended pre-accession trend.
The influence of the UK membership of the EU single Market is difficult to discern among these shifting trends. On the one hand UK penetration of EU markets is seven times higher than for non-EU markets, but most large EU markets are less than 1000 miles from London. Non-EU markets are generally 5 to 10 times further away. If UK exports to the EU fell by 43% as suggested by the Treasury’s gravity model analysis, then import penetration would fall to 4% of GDP, or 4 times higher than penetration of non-EU markets. This would take the UK back to close to the pre-accession level.

The key question is whether it is reasonable to assume that UK exports to the EU could fall by as much as this, especially when average tariffs are so low. One further piece of evidence that can shed some light on this conundrum is the trend of US penetration of EU markets. US penetration of EU28 markets rose sharply after 1973 despite the USA not being a member of the EU (Chart 9). Indeed the level of penetration of EU markets by US exports rose by 250-300% above the pre-1973 level. The increase was much the same as for the UK. US penetration of non-EU markets also rose after 1973 and by similar amounts. The greatest rise for non-EU markets appears to coincide with the USA signing FTAs with Canada and Mexico under NAFTA in 1989 and 1993.
UK penetration of EU markets remains 4 to 5 times higher than US penetration of the same markets. Some of this advantage may be due to the single market, but distances are much shorter for the UK and it seems unlikely that all of the advantage is due to membership of the single market.

**Summary on Trade Assumptions**

It seems that much of the large increase in UK trade with the EU has been a continuation of previous trends and that large increases have also occurred for exports into the EU from non-member states such as the USA. The share of the EU as a market for UK exports has been falling fast in the present century and will soon be below the level of 1973. Another factor is the sterling-euro real exchange rate which is now about a third lower than was the (Deutschmark) rate in 1973 (Chart 10). With low tariffs and a low exchange rate it seems implausible that Brexit would result in the large decline in markets calculated by the Treasury.

In the model scenario described below, we will model the Treasury assumption on trade losses due to Brexit. However, our main Brexit scenario will use a much smaller reduction in exports. We have arbitrarily assumed a loss of 10% of EU markets, i.e. around one sixth of that calculated by the Treasury, although our view...
is that even this may be a larger loss than may actually materialise. We also assume that these market losses are offset by gains in non-EU markets over a 20 year period. Again this assumption may be overly pessimistic.

**Chart 10  Real Exchange Rate: Sterling v Euro/Deutschmark**

**Chart 11  Per capita GDP (@ppp) USA = 100**
We make no assumptions in the model about Brexit-induced reductions in productivity although the model equations will generate indirect changes in productivity. We should note that if the trade losses are lower than assumed by the Treasury then the associated productivity losses would also be lower. Our expectation is that there will no marked productivity effect at all. Chart 11 shows that per capita GDP has remained close to 72% of the US level throughout the post-war period. It is not obvious that membership of the EU since 1973 has made any sustained difference. Even starker is the evidence that per capita GDP in the EU28 has remained at close to 50% of the US level since the early 1970s. Per capita GDP in the original EU6 states reached 80% of the US level in the 1980s but has since fallen to 65% while levels in the new A10 members have risen from initially very low levels since their accession. The evidence appears to be that the accession of new members has led to a redistribution of GDP from older members, but has not raised productivity in the union as a whole.

Assumptions For the Scenarios

The assumptions used in the Brexit scenarios are shown in Box 2 below. The key assumptions have already been outlined. Business investment is assumed to fall by 4% in 2017 in the baseline Brexit scenario and by over 15% in the severe Brexit scenario. These declines are largely due to uncertainty and diminish from 2019 once the UK leaves the UK, even though all of the long-term arrangements may not be fully settled.

The scenarios here assume no free-trade agreement and instead that UK trade with the EU occurs within WTO rules. Demand for UK exports within the remaining EU is assumed to fall by 10% in the baseline Brexit scenario and by 40% in the severe Brexit scenario based on Treasury estimates. Offsetting growth in export sales to non-EU economies is assumed to be slow with full replacement of markets occurring only after 20 years. These assumptions are viewed as pessimistic rather than realistic, and are presented as worst-case scenarios.

It is assumed (again pessimistically and for illustrative purposes) that the UK imposes tariffs against at least some imports, leading to a fall in import volumes. These falls are similar to the reductions in exports in spite of the fact that many UK
imports are food and commodities. In practice a degree of diversion of imports may occur. For instance new world wines displace French, Italian, Spanish and other EU wines.

We have assumed substantial losses in net FDI flows into the UK. These are flows of physical investment with direct effects on employment, rather than the financial flows in the Treasury analysis. The numbers are essentially arbitrary but are based on the belief that a significant proportion of FDI enters the UK as a base for accessing an EU-wide market, and will be less attracted to a UK location once the UK leaves the EU.

The sterling effective exchange rate has been adjusted so that the average value in 2017 is 12% below the pre-referendum level. No further adjustment is made and the exchange rate after 2017 is determined by the exchange rate equation in the model.
<table>
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<th>Box 2</th>
<th>Assumptions</th>
<th>Reduction</th>
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| **Capital investment by businesses** | • 15% reduction in net new business investment  
• Tapered from 20120  
• Bounce-back in investment from 2018  
• Severe scenario=75% fall | -15% 2017-20  
-7% 2021  
-3.5% 2022  
-15% 2017-19 |
| **Exports** | • 10% loss in EU markets from 2019  
• exports helped by lower £  
• Replaced by non-EU markets over 20 years  
• Severe trade Loss Scenario = 40% | Exports fall by little initially but 2% lower by 2025  
Exports reduced by 10% from 2019 |
| **Imports** | • Assumes UK tariffs imposed on imports from EU with partial diversion of imports to non-EU sources  
• Impact on imports reduced to 0 by 2040 | Imports fall by:  
2.% in 2019  
4% from 2020 Reaching 0% by 2040 |
| **FDI** | • Permanent losses in annual FDI | -33% in 2017, -20% in 2018, 10% in 2019 |
| **Effective Exchange Rate** | • Effective rate 12% lower in 2017 than the pre-referendum level | -12% in 2017, -12% in 2018, -14% in 2019, -18% in 2020 |
| **Fiscal and Monetary Policy** | • Government spending as in Autumn statement plans  
• with accommodating monetary policy | Spending 6% p.a. higher by 2021  
Bank rate allows CPI to rise to 4% by 2018 |
| **Migration** | • Zero net migration from EU after 2019 | Net migration falls to 190,000 pa |
Fiscal policy is taken directly from government plans announced in the 2016 Autumn Statement. In these plans capital spending rises faster than in pre-referendum plans, adding 3% to overall government spending on goods and services. Monetary policy is accommodating of higher inflation and the bank rate is assumed to be kept one percentage point lower through to 2019.

Finally, controls on migration from the EU are assumed to be imposed in mid-2019, leading to net migration falling to around 165,000 from 2020. This does not of course imply no migration to or from the EU, merely that inflows and outflows are balanced.

**Scenario Results**

As outlined above we generate two scenarios. Our baseline Brexit scenario uses the main assumptions in the Box above. The other more severe ‘HMT Brexit’ scenario uses the Treasury’s calculated impact on trade and short-term uncertainty impacts which are much higher than those in the baseline Brexit scenario. These assumptions are entered into the CBR UKMOD model with no further adjustments. The following sections calculate an estimated impact of Brexit as the difference between the Brexit scenarios and our pre-referendum forecasts run last June and with none of the adjustments listed in the Box. We emphasise again that we regard these scenarios as pessimistic but illustrative of what could happen. In practice, we expect a free-trade agreement to emerge between the UK and EU. Since this a continuation of the status quo it should be easier to negotiate than a completely new FTA such as the Canada/EU agreement. Political differences may however mean that this takes a long time to emerge, although it seems likely that transitional arrangements based on free-trade will be put in place.
The short-term impact of uncertainty reduces the growth of GDP in 2017 to 1.2% but the lower exchange rate raises this to 1.4%, or 0.3% lower than in the pre-referendum forecast (Chart 12). The difference in 2018 is even less. The more severe HMT Brexit scenario generates slower growth of only 0.4% in 2017 and 1.1% in 2018.

One important aspect of these scenarios is that uncertainty leads to a postponement rather than cancellation of investment. Once uncertainty diminishes, normal capital-output ratios are restored. This means a bounce-back in GDP with growth of 2.6% in 2019 or 1.2% above the pre-referendum forecast. A similar bounce-back occurs in the HMT Brexit scenario, but a year later.

The assumed loss of trade from 2019 leads to a more severe downturn with GDP growth at 0.6% for 2021 in both scenarios. We have assumed that government consumption accelerates to 2% per annum after 2021 and government investment to 4% per annum. This provides some offsetting stimulus; growth picks up but only to around 1.2% per annum, as by this stage the credit super-cycle is beginning to turn down, making growth harder to achieve without a major policy stimulus.
The overall impact in the baseline Brexit scenario is that GDP is largely unchanged up to 2020 as the lower exchange and interest rates offset the negative impact of uncertainty. After 2020 the loss of trade results in GDP ending in 2025 some 1.5% below the pre-referendum forecast. Part of this reduction in GDP comes from lower migration and fewer jobs. As a result there is less of a fall in per capita GDP which ends up in 2025 at much the same as in the pre-referendum forecast. The HMT Brexit scenario has a greater loss, at 6% of GDP in 2025. This is close to the Treasury’s 7% for 2030. Once again the fall in per capita GDP by 2025 is less in this scenario at 4%. Unlike the NiGEM model, our CBR model predicts a negative impact of migration on productivity measured as per capita GDP. This is to be expected when the majority of recent immigrants from the EU come to work initially in minimum wage jobs.

**Consumer Price Inflation**

The one indisputable result of the Brexit referendum has been a large fall in sterling relative to most other currencies, although in our view this brings forward a depreciation that would eventually have occurred, albeit more slowly. The long-term result of this depreciation is expected to be a welcome reduction in the large balance of payments deficit to a manageable level. The more immediate impact is to increase the price of imported goods and services leading to a general rise in consumer price inflation.
We had expected inflation to pick up towards 3% in 2018 even in the pre-referendum forecasts although much depended on the relative paths of UK and US interest rates in influencing the sterling exchange rate. The 12% depreciation since the referendum brings forward this rise in inflation (Chart 13). A further depreciation resulting from trade losses on leaving the EU in 2019 is projected to cause further inflation with price rises at over 4% for three successive years from 2019. Inflation could be reduced by higher interest rates, but we assume that the Bank of England ‘looks through’ this bout of high inflation just as it did after the 20% depreciation in 2008. The bank rate is assumed to rise only slowly, eventually reaching 3% by 2020. At this point inflation begins to fall although it does not reach the 2% target by 2025.

We have assumed even lower interest rates in the severe Brexit scenario to offset the harsher assumptions about investment uncertainty and trade.
Real wages

High inflation resulting the sterling depreciation can undermine the real value of wages, leading in turn to lower consumption and hence lower GDP. Much depends on whether wages rise in response to higher inflation. Average earnings have risen by less than 2% per annum in most years since the economic crisis of 2008 and there is a widespread view among economists that there is a relatively stable 2% per annum wage norm among employers. Average weekly wages did break this ceiling in 2015 and 2016 but not by much.

Our equations for earnings suggest that earnings will rise by more than 2% as employment rates reach a peak in 2017 and especially as migration reduces from 2019. The UK labour market has become very dependent on foreign-born labour with the increase in foreign-born workers being equivalent to over 80% of additional employment since 2004. Immigration restrictions will provide the biggest shock to wage bargaining for over a decade. Even so, we expect real wages to be broadly flat for the next decade. Nominal wages will keep pace with rising consumer prices but no more. Real wages in 2025 are expected to be only very slightly above the level in 2004 at the accession of the EU10 member states to the EU. It is only later that we expect lower migration to be associated with steady rises in real wages.

Unemployment

The unemployment rate is projected to keep falling into 2017 but to begin rising from 2018. Our pre-referendum forecast had unemployment rising back to almost 7% of the labour force by 2025 due to continuing public sector austerity, a downturn in the credit cycle and higher interest rates. The lower interest rates of the baseline Brexit scenario stimulate more employment growth (Chart 14). Unemployment rises but by much less than previously expected. Lower interest rates prevent a downturn in the credit cycle and have a positive impact on company cash-flows. The harsher conditions of the severe Brexit scenario have an intermediate impact on unemployment, but even lower interest rates prevent unemployment rates from reaching 7%.
Public Sector Finances

Public expenditure on goods and services rises 0.75% per annum faster than in our pre-referendum forecast. With GDP growth generally slower, public sector revenues are initially lower but improve into the next decade as economic growth picks up and with savings on contributions to the EU. The OBR figures we use for public spending assume that the EU savings are spent on other things and these are built into the spending assumptions above. The same spending assumptions are used in both Brexit scenarios, but tax revenues are lower in the severe scenario due to lower growth in GDP.
In our pre-referendum forecast we had not expected the government’s fiscal deficit to hit the Chancellor’s target of budget balance by 2019-20, but instead to flatline at around 2.5% of GDP (Chart 15). The Brexit scenarios, not surprisingly, have initially higher deficits. The deficit in the baseline Brexit scenario remains below 3% of GDP which is low enough keep aggregate debt on a downward path from 2017, helped by higher price inflation (Chart 16). Even in the severe scenario the deficit does not rise above 4% until 2025, allowing the debt ratio to fall for most of the period. The initial rise in Government debt under the Brexit scenarios is due to the official classification of additional Bank of England lending to commercial banks as part of the Bank’s August 2016 measures.
Balance of Payments

The UK has managed to finance unprecedentedly large current account deficits for a number of years. Indeed deficits have been the norm almost every year since 1980. The capital inflows supporting this deficit are likely to be lower in the uncertain conditions of the run-up and immediate aftermath of Brexit. This is probably the main reason for the large depreciation of sterling following the referendum.

A slow improvement in the current account had been expected in the pre-referendum forecasts, but the improvement is faster in the Brexit forecasts due to the lower level of the sterling exchange rate (Chart 17). Part of this improvement is due to the trade balance, but importantly we also project an improvement in the net earnings on UK foreign investment.
**Chart 17   Current Account Balance of payments (% of GDP)**

![Chart 17](image)

### Unbalanced Housing Markets

Housing markets play an important role in economic cycles in the UK. The market has been unbalanced for many years, and the ratio of house prices to household disposable incomes is close to double the pre-crisis average. We had expected this ratio to become even more extreme, but in the Brexit scenarios, lower demand for housing due to reduced migration causes the ratio to decline from 2019 (Chart 18). The number of dwellings needed to house migrants with net migration running at 330,000 per annum is close to the 150,000 dwellings actually built each year. The provision of housing for migrants through the buy-to-let market pushes up prices and crowds out other potential buyers. With lower net migration after 2019 this pressure is expected to recede.
Chart 18  Mean House Price (% of Mean Household Disposable Income)
Conclusions

A model based largely on equations reflecting past relationships between macro-economic variables has little to go on in attempting to project a long-term future outside the EU. Nor is there much on which to base a judgement about how much of investment and consumption might be delayed or cancelled due to inevitable uncertainty about the future. Our two scenarios about possible futures leading up to and following Brexit are based on a series of assumptions not only about what form trade arrangements might take, but importantly, what impact these changes will have on the wider economy. We do not feel that it is possible to rely strongly on the gravity model approach to estimating the impact of EU membership on trade. The method can be unstable and the Treasury’s reliance on this approach is inappropriate. The Treasury rely on average impacts across all EU members and on equations estimated across over a hundred countries most of them involved in little trade with the UK. Our attempt to replicate the Treasury analysis with a gravity model using data solely from the UK’s main trade partners demonstrates that even when an average impact of EU membership on trade can be estimated the UK’s dependence on the EU is much weaker than the average. The Treasury failed to recognise this and its conclusion must be regarded as flawed. A time-series approach is better but still leaves a wide range of possibilities.

One of our two scenarios examines the Treasury’s assumptions even though we feel that these have little basis in reality. More probable but still pessimistic is our baseline Brexit scenario. This scenario is arbitrary but does build in things we already know including the depreciation of sterling and the government’s expenditure plans. In this baseline scenario the loss of GDP peaks at less than 2% in the next decade, after leaving the EU, before beginning to recover. Postponed investment, loss of EU trade and lower migration all play a role, but an accommodating monetary policy and a depreciated currency help to manage the shock, as they should. In per capita terms there is never any loss and in the longer term a substantial gain as lower cumulative migration exerts an influence. Even under these somewhat pessimistic assumptions about (temporary) uncertainty and trade losses, the path of GDP is projected to be only a little lower than it might have been in the absence of a Leave vote. Inflation is higher but unemployment lower as migration is restrained.
The economic outlook is grey rather than black, but this would, in our view, have been the case with or without Brexit. The deeper reality is the continuation of slow growth in output and productivity that have marked the UK and other western economies since the banking crisis. Slow growth of bank credit in a context of already high debt levels, and exacerbated by public sector austerity prevent aggregate demand growing at much more than a snail’s pace.
Annex A. The CBR Model of the UK macro-economy

The CBR model has been developed and refined over the last five years. It was originally developed in response to the failure of academic and commercial economic forecasters to foresee or understand the economic crisis of 2008-9 or to recognise the dangers in the preceding accumulation of debt by the household and financial sectors. The ‘business as usual’ response of much of the forecasting industry leaves much to be desired and the nature of the main public sector models in the UK is, in our view, unfit for several aspects of policy analysis.

The OBR model, which took over from the Treasury model in 2010, when the Office for Budget Responsibility was set up as an independent body to place official economic forecasting, at arm’s length from Government, has particular problems. In an attempt to make a predominantly demand-side system into a supply-side model, the OBR model gives precedence to its projections of productive capacity. This capacity is projected purely by assumption. The key assumption relates to labour productivity which is exogenous and usually presumed to grow at close to 2% per annum despite the fact that there has been virtually no increase in UK productivity since 2007. In the OBR’s world, next year will always be better. The other, less important assumption is on the growth of labour supply, and the OBR adopts official ONS projections with their arbitrary assumptions about future migration flows. To make the demand system consistent with supply the OBR assume that actual output will move to achieve full-capacity operation within 3 or 4 years. At times like the present where the economy is already operating at close to full capacity, the forecast for GDP is almost exactly just the track of productive capacity. In the latest OBR Economic and Fiscal Outlook, released in November 2016, the forecast for growth in real GDP is 2.1% per annum from 2019. In such a system there can be no Keynesian multiplier and as a result OBR forecasts have been consistently over-optimistic about tax revenues and hence the Government’s ability to achieve fiscal balance17.

The forecasting model of the Bank of England (in line with other Central Banks) is a new Keynesian general equilibrium system, with rigorous but unrealistic micro-economic foundations. This has a poor forecasting record leading to unfortunate embarrassments for the Governor of the Bank of England. These include the
debacle in 2013 when Mark Carney attempted to introduce a ‘forward guidance’ regime to guide financial markets as to the probable future path for interest rates. The Bank’s unemployment forecasts which underpinned the regime proved hopelessly pessimistic and the regime had to be quietly side-lined.

A general equilibrium model is also used by the Revenue and Customs (HMRC) side of the Treasury. Our dealings with HMRC over the transfer of responsibility for corporation tax to Northern Ireland showed that use of this model defied common sense to an extant verging on the bizarre. The model predicted that changes in corporation tax would lead to rapid adjustments in the capital stock of businesses with no medium or long-term impact on FDI flows. In reality low corporation tax rates continue to attract investment year after year as the experience of the Republic of Ireland has demonstrated for more than half a century. The decisions of successive Chancellors of the Exchequer to reduce UK corporation tax rates from 30% down to 17% since 2007 suggest that the advice of their own modellers has been comprehensively ignored.

**The CBR Macro-Economic Model (UKMOD)**

The CBR model is described in CBR Working Paper 472 at [www.cbr.cam.ac.uk/publications/working-papers](http://www.cbr.cam.ac.uk/publications/working-papers). In brief the model consists of a series of econometric equations and identities describing how important macroeconomic indicators are related to one another in both the long-term and short-term. All equations consist of statistically significant relationships estimated from UK data over recent decades. A Keynesian view of the economic world influences the relationships selected for inclusion in these equations, but ultimately it is the data that determines what precisely is included in each equation and with what weights. There is no overt attempt to insert profit-maximising or other optimising behaviour into the model except in as far as it is implicit in the equations for such things as company investment or private-sector employment. Nor is the model precise about the formation of expectations. Since it is assumed that most expectations are based on the recent history of the economy these become subsumed within econometric equations.
Importantly, there is no explicit NAIRU (non-accelerating inflation rate of unemployment). Instead the estimated equations prevent employment rates rising above historic peaks via higher inflation and rising interest rates. We estimate equations for various key aggregate price terms based on past behaviour. In practice these show that price inflation reflects changes in wage and import costs. Wage inflation in return reflects price inflation and the employment rate. Interest rates also influence inflation with a two year lag (mainly via their influence on the sterling exchange rate) but there is no strong tendency in the data in recent decades for inflation to accelerate when unemployment is below some critical rate as assumed in many forecasting models. Forecasts and simulations generated with UKMOD indicate that rises in wage inflation associated with low unemployment (or high employment rates) can be contained with relatively small increases in short-term interest rates.

The forecasts generated by the model are conditional on a number of exogenous variables chiefly reflecting government fiscal policy and economic conditions outside the UK. Key exogenous variables are:

- World trade (weighted by UK markets)
- Government fiscal policy plans (tax rates and nominal spending plans)
- Short-term interest rate (used as a policy variable to target consumer price inflation)
- Interest rates in USA
- Global price of oil and other raw materials.
The model is based on the post-Keynesian approach of Wynne Godley described in Monetary Economics by Godley and Lavoie 19:

- 4 sector approach: households, companies, government and foreign (importantly Godley-Lavoie also has a separate monetary/banking sector which is not yet developed in this model)
- Stock-flow consistent with a tendency for ratios of assets to incomes not to diverge too far from long-term averages
- Consumer spending depends on borrowing as well as income, assets and liabilities
- Mark-up pricing (i.e. consumer prices rise with wage and other costs of production)
- Wages determined as attempts to gain a traditional share of value-added but constrained by changes in the employment rate.

In its present form the model does not have a banking sector, although lending to households is modelled. Household borrowing is semi-exogenous determined by an equation reflecting past experience in the demand for housing loans but with a partial adjustment mechanism to move from the current situation in which bank lending is constrained by impaired balance sheets back towards a relatively unconstrained position.
Annex B. Some Experiments with Gravity Models

In the academic literature, there has been an explosion of papers in the past two decades on empirical estimates of trade relationships, using the workhorse of the gravity model. The basic hypothesis is that trade between any country pair is proportional to the products of the GDPs of the two countries and is inversely related to some measure of distance between the country pair – hence the analogy with the Newtonian theory of gravitation. This approach underpinned the Treasury’s estimates of the impact of Brexit. The method used residuals from a basic gravity equation to measure the impact of EU membership on trade flows. The gravity model approach is used by the Treasury to establish a crucial elasticity for the impact of EU membership on the size of trade between EU member countries in the years when both country pairs have been members. The other elasticity, for country pairs where one country is an EU member, but the other is not, is interpreted as indicating whether there is a trade diversion effect for the country which joins the EU. Given the Treasury’s methodology of using the size and significance of these two factors in estimating the overall loss to UK trade of leaving the EU, the econometric procedure bears a great deal of weight in the Treasury’s overall assessment.

The Treasury equation was not described in detail but appeared to be based on data from around 114 countries and 30 years, providing about 390,000 observations in all. A feature of this large country sample used by the Treasury is that the vast majority of the sample consists of non-OECD countries. Much of the cross-section variation is likely to reflect the large differences in GDP per capita and trade between emerging economies and mature industrial economies. This is important since the measure of the EU impact depends on the underlying gravity equation. An average relationship between trade, GDP and distance obtained from such a large range of countries, most of which do little trade with the UK or the EU, may not be the best basis for estimating the impact of EU membership on trade flows. Glick and Rose (2016) show that in the context of membership of the European Monetary Union (EMU) the number of countries included in the sample makes a large difference to the results obtained from a gravity model²⁰.
To investigate further the properties of the gravity modelling adopted by HM Treasury, we have focussed on a smaller number of trade partners, responsible for the majority of UK trade. Since we wish to examine the cross-country variation in trade and GDP for countries with more similar living standards, we have used a sample of 28 mainly OECD countries accounting for 81% of UK exports and 92 of exports to EU countries\textsuperscript{21}. We have also confined the sample to the three most recent years of data, 2013-15\textsuperscript{22}. This provides sufficient degrees of freedom, and focusses attention on the current impact of EU membership rather than on a historic average. This is important because the measured impact of EU membership does not only capture the gains to trade from an absence of tariffs and customs formalities and low non-tariff barriers. It also includes the impact of slow growth in EU markets for imports. This slow growth affects all exporters to the EU but has a larger impact on countries with large exports to the EU and hence predominantly EU members themselves. The slow growth of EU markets since the formation of the Euro in 1999 means that samples from recent periods will be affected more than earlier samples.

In order to estimate the impact of the single market per se, independently of any growth effects, we use the following reasoning. The dummy variable indicating that both countries are EU members (EU2) is assumed to include the impact of both single market benefits and slow growth losses. Slow growth in EU markets will affect exports of non-EU countries into EU markets as well as exports from EU countries themselves, and is measured by the dummy variable for non-EU exports into EU markets (EU1\_DEST)\textsuperscript{23}. The coefficient on the latter dummy can then be subtracted from the coefficient on the EU2 dummy to measure the direct benefit of membership of the single market. Finally, the dummy for EU exports to non-EU markets (EU1\_ORIGIN) measures the impact of EU membership on EU exports to non-EU markets. In other words it measures any displacement of exports due to EU membership.

Data is readily available for exports from country \(i\) to country \(j\) from the IMF Direction of Trade statistics for a large number of countries and for long time periods. Similarly, data on GDP and population by country is easily available\textsuperscript{24}. 

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The general specification used by the Treasury is the following:

\[ \ln T_{ijt} = \alpha_{ij} + \gamma_t + \ln GDP_{it} GDP_{jt} + \ln POP_{it} POP_{jt} + EU1_{origin_t} + EU1_{dest_t} + EU2_t + \epsilon_{ijt} \]

where:
- \( \ln T_{ijt} \) is the log of exports from country \( i \) to country \( j \) at time \( t \).
- \( \ln GDP_{it} \) is the log of GDP of country \( i \) at time \( t \).
- \( \ln POP_{it} \) is the log of GDP of country \( i \) at time \( t \).
- \( EU1 \) is a dummy taking the value 1 if one country is a member of the EU and the other is not at time \( t \). \( EU1\_ORIGIN \) indicates EU exports to non-EU markets and \( EU1\_DEST \) indicates EU imports from non-EU countries.
- \( EU2 \) is a dummy taking the value 1 if the country pair are both members of the EU at time \( t \).
- \( \alpha_{ij} \) is a \((i*(j-1))\) set of dummies (country fixed effects) taking the value 1 for observations corresponding to country pair \( i \) and \( j \) and zero otherwise.
- \( \gamma_t \) is a set of time dummies, taking the value 1 for observations on \( T_{ijt} \) for time period \( t \) and zero otherwise.
- \( \epsilon_{ijt} \) is an independent set of errors, uncorrelated over time and country, with constant variance.

For our basic equation the sample consists of 27 countries with observations from 2013 to 2015 inclusive, giving a sample of 2106 observations. There are 702 fixed effects \( \alpha_{ij} \) coefficients, 3 \( \gamma_t \) dummies and 5 initial regressors, making a total of 710 regression coefficients to estimate. The fixed effects and time dummies make a perfectly co-linear set, so one of the dummies must arbitrarily be dropped. We choose to drop one of the time dummies in the full estimation.

To get a sense of the role of the EU dummies, we have experimented with a number of specifications of the above equation and the inclusion of additional dummy variables. The first specification treats the combined cross-section and time series as a single regression with a common intercept (i.e. a dummy variable taking the value 1 for all observations). The second adds three time dummies and drops the constant to avoid collinearity. The third adds the full set of 701 fixed effects with one country dummy dropped (USA:Sweden) to avoid a singular
matrix. The fourth includes a set of dummies which have statistically significant coefficients, but omits all other dummies. We summarise the results in the tables below.

Equation 1 shows a strong positive relationship between trade-pairs and the product of the two GDP countries, with a negative relationship between trade pairs and the population product. If the coefficients had been approximately equal and opposite, one could argue that the trade pattern was related to productivity as measured by GDP per capita. Population appears to act as a measure of living standards in the regressions.

**Equation 1**

Dependent Variable: LTRADE  
Method: Panel Least Squares  
Date: 01/03/17  Time: 11:36  
Sample: 2013 2015  
Periods included: 3  
Cross-sections included: 702  
Total panel (balanced) observations: 2106

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R-squared: 0.678551  
Adjusted R-squared: 0.677633  
S.E. of regression: 1.004199  
Sum squared resid: 2116.665  
Log likelihood: -2993.604  
F-statistic: 738.4694  
Prob(F-statistic): 0.000000
The distance variable is negative and highly significant as expected. The EU2 dummy, which is interpreted by the Treasury as a measure of trade creation, is small and insignificant. However the EU1_DEST dummy, measuring the impact on non-EU exporters of slow growth of EU markets and the common external tariff, is negative and significant. If we subtract this from the EU2 coefficient we get an implied direct Single Market effect of 0.43. This indicates that the single market per se raises trade between EU member countries by 52% (=exp(1)^0.42). We interpret this as saying that while membership of the single market increases trade between EU member states, the slow growth of EU markets over recent years diminishes the level of trade by a similar amount. The EU1_ORIGIN dummy, interpreted as measuring trade diversion, is negative and statistically different from zero. These coefficients thus differ from the Treasury analysis. The single market effect is around half that observed by the Treasury, and there is a significant diversion effect not observed by the Treasury.

For the UK there is an additional factor. The residuals from this equation are strongly negative for UK exports to all EU countries except Ireland. The average residual is around -0.8, indicating that for UK exports to the EU, membership of the EU is insufficient to offset the negative growth effect. This is in line with what we observed from the time series data in the main text, namely that since the Eurozone was formed in 1999 the EU share of UK exports has declined rapidly.
Equation 2 replaces the common intercept with the three time dummies, but does not change the character of the first result.

Equation 3 adds the full set of 702 country fixed effect dummies less one. To avoid perfect co-linearity, one of the time dummies is also arbitrarily dropped. Although there are 2106 observations in the sample and 710 coefficients to be estimated, the effective number of degrees of freedom of the regression is low. This is borne out
by the large number of country dummies which are statistically insignificant as are several of the variables of main economic interest.

**Equation 3 Fixed Effects**

Dependent Variable: LTRADE  
Method: Panel Least Squares  
Date: 01/03/17   Time: 10:48  
Sample: 2013 2015  
Periods included: 3  
Cross-sections included: 702  
Total panel (balanced) observations: 2106

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Effects specification  
Fixed Effects (701 Country Dummies)

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Bear in mind that if there were only one time series observation, the fixed effect dummies alone would be sufficient to give perfect correlation of the observations.
A sufficiently large number of time series observations would be required to improve the standard errors of the regression coefficients. These would need to extend the sample back in time, but this would provide a less up to date estimate of the impact of EU membership on trade.

The coefficients on the EU dummies are no longer plausible and coefficients on the population and distance variables are no longer statistically significant. This confirms the conclusion of Glick and Rose that gravity models with fixed effects can be unstable.

Our response to this instability is not to add more observations stretching further back in time but to restrict the number of fixed effects. We do this by including only country dummies with statistically significant residual values. Some residuals form a pattern and we have created composite dummies to allow for these. One example is the dummy RMS which includes Australia, Canada and Russia and reflects the fact that major raw material exporters tend not to export much to each other. Another is SCAND indicating that Scandinavian countries tend to trade more with each other than might be expected on the basis of their GDP, populations, distances apart and EU membership. Other composite dummies are added for common language groups, i.e. ENGLISH, CHINESE and GERMAN. Dummies are also included for free-trade areas other than the EU. These include NAFTA2 for trade between the USA and Canada and NAFTA1 for trade between other countries and either the USA or Canada. Exports from either Norway or Switzerland to EU countries (NOR_EU, SWI_EU) non-EU countries (NOR_OTHER, SWI_OTHER) also have dummies. We have also included dummies for Swiss imports from either the EU or elsewhere (SWI_EU_DEST, SWI_OTHER_DEST). Trade with the Netherlands and Belgium also has dummies (NETH, BELG) to capture the effects of entrepôt trade through Rotterdam and Antwerp. A further dummy BELNETH captures the fact that trade between the Netherlands and Belgium is much lower than suggested by an equation with separate dummies for these two countries separately.

Equation 4 is our preferred equation. The EU2 dummy for trade between EU members is replaced by EU2_XGBR and GBR_EU_ORIGIN. EU2_XGBR is a dummy for EU trade partners excluding the UK, since the UK appears to have a
different pattern of trade with EU members than do the other EU countries included within our sample. GBR_EU_ORIGIN is a dummy for UK exports to EU countries.

The coefficients for GDP, population and distance are much the same as in equations 1 and 2. The implied coefficient for the impact of the single market is somewhat larger at 0.55 than in equations 1 or 2, as expected now that the UK is excluded. A coefficient of 0.55 indicates that goods trade is increased by 73% through common membership of the EU Single Market, although this is reduced by 30% due to slow growth in EU markets. There is also a further 19% reduction in trade due to diversion of trade between EU and non-EU countries. For the UK the implications are very different. The significant negative coefficient of -0.62 on the UK_EU_ORIGIN variable indicates that UK exports to the EU are 46% lower than would be otherwise predicted by equation 4. The bottom line appears to be that UK exports to the EU receive no boost from the UK’s membership of the Union, while exports to third countries are diminished.
Equation 4  Selected Fixed Effects

Dependent Variable: LTRADE
Method: Panel Least Squares
Date: 12/31/16   Time: 08:54
Sample: 2013 2015
Periods included: 3
Cross-sections included: 702
Total panel (balanced) observations: 2106

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R-squared          0.812686  Mean dependent var 21.95937
Adjusted R-squared 0.809978  S.D. dependent var 1.768660
S.E. of regression  0.770986  Akaike info criterion 2.332317
Sum squared resid   1233.419  Schwarz criterion 2.415521
Log likelihood     -2424.929  Hannan-Quinn criter. 2.362788
Durbin-Watson stat  0.085215
The Treasury treat the coefficients they estimate from their gravity model as reversible. If membership of the EU increases goods trade by 110% then leaving the EU will lead to a loss of trade of 52% (=110/210). We would not make the same argument based on equation 4. Leaving the EU without a replacement agreement based on free trade or some equivalent could lead to the loss of some export trade. We view this as likely even though the average tariff is only 3% and most UK goods exporters are likely to be already compliant with EU regulations affecting non-tariff barriers for goods. If the existing 12% post-referendum reduction in the sterling effective exchange rate is maintained, higher tariff on exports to the EU are unlikely to result in any loss of company profits except for some agricultural products such as meat and dairy products. The importance of agricultural exports to the UK from Ireland, France, Denmark and the Netherlands make it likely that some agreement on agricultural produce is agreed even if only as a transitional measure.

Annex Conclusion

We have experimented with a smaller data sample than that used in the Treasury analysis albeit a sample accounting for 81% of UK goods exports and 92% of exports to the EU. We deliberately did not include a large number of emerging market economies as in the Treasury analysis, arguing that much of the cross-section variation in the data would reflect the very large differences in productivity levels between the emerging market countries and the advanced industrial countries. We have generated four equations all of which generate smaller coefficients for the EU impact than does the Treasury’s analysis. Attempts to include fixed effects lead us to agree with Glick and Rose that the results are sensitive to the specification adopted.

We place limited weight on the regression results themselves, except to illustrate that one can generate trade creation and diversion dummies that are completely different from the results obtained by the Treasury. Our overall conclusion is that gravity modelling, while a useful technique for the analysis of trade patterns, may not be an appropriate method of inference for establishing the economic impact of joining or leaving a customs union. The method is too fragile to bear the weight of interpretation of key regression coefficients used by the Treasury without strong
supporting evidence based on direct time series observation of UK trade flows. Even when plausible estimates for the impact of EU single market rules can be made, as in our preferred equation 4, the negative residuals observed for UK exports to the EU suggest that average impacts derived from gravity models do not apply to the UK. The general conclusion is that the results of gravity model applications suggest a negligible advantage to the UK of being a member of the EU. Even if this is currently the case it is still difficult to assess what will be the impact of the UK leaving the EU. The UK may have weaker links with EU markets than suggested by gravity model equations but the process of withdrawal could still be disruptive.
Notes


4 HM Treasury (April 2016) op cit.

5 There is something odd about a gravity model applied to trade in that the amount of trade between two countries is not constrained by the size of the smaller economy. Hence the size of the term \( \ln(Y_i \cdot Y_j) \) can be the same for trade between say Luxemburg and the USA as between two medium sized countries even though in the former case the size of the Luxemburg economy imposes an upper limit on the level of trade.

6 In the annex B to this paper we investigate some of the properties of the Treasury’s gravity model, using a reduced data set focussing on the UK’s main trade partners. The coefficient estimates are found to be sensitive to the alternative specifications.

7 We have used data from FDI Intelligence, an FT subsidiary, on employment in FDI projects to estimate the money value of physical projects. The Treasury do undertake some sensitivity analysis but in our view this will not solve the problem.

8 Glick R and Rose A K (September 2015) Currency Unions and Trade. A Post-EMU Mea Culpa. NBER Working Paper 21535. In a revised version of this paper published in March 2016 Glick and Rose repeat the point that different econometric methodologies deliver different results. In particular different samples of countries deliver widely variant results. However in this paper they adopt a preferred form of equation which generates a positive impact for membership of the EMU. See Rose and Glick (March 2016) Currency Unions and Trade. A Post-EMU Re-assessment. Haas School of Business, University of California, Berkeley.
Over the last decade the volume of UK exports to the EU has grown by only 4% due to stagnation in many Eurozone markets, while exports to non-EU markets have grown by 42%. The Treasury forecast of a future loss of 43% of the EU market equates with a fall in the EU share from the current level also of 43%, down to 32% by 2030. This level was last seen (for the same 27 countries) in the early 1960s. If the falling share of EU markets for UK exports experienced over the last decade were to continue, the EU share would in any case fall to around 30% even if the UK stayed fully within the UK.

Within our sample Norway and Switzerland have access to the single market without being members of the EU itself. As a result separate dummy variables are included for both countries.

This estimate is derived from our preferred equation with a limited number of specific country dummy variables. We argue in the annex that the Treasury approach which includes a full set of fixed effects is unstable and likely to generate unreliable estimates.

This implies that all exports are standard commodities for which there is a world price at which all exporters can sell their goods.

A convenient source for accessing this database is at www.stats.ukdataservice.ac.uk

For the Baltic States we assume that exports grew at the same rate as in Poland, and for Croatia and Slovenia at the same rate as the former Yugoslavia.

GDP at purchasing power parity in the EU28 countries grew at an annual average rate of 4.7% in the period 1950-79 but only at 2.4% over the subsequent 1980-1999 period, falling to 1.1% after the Eurozone was established in 1999.

Growth in UK exports to Non-EU28 countries was 3.3% per annum prior to 1976 but only 1.5% per annum in the following 13 years. New Zealand was the most obvious market affected by UK accession to the EU. NZ exports to the UK fell sharply and UK exports to NZ fell by three-quarters between 1974 and 1984 and have remained low ever since.
In a Keynesian demand-based system a reduction in government spending would normally result in slower growth in GDP. In the OBR model medium-term GDP is determined independently of demand and the link between austerity and slower growth is broken.

These are ECM equations estimated as single regressions, rather than as a system.


See footnote 10.

This included 23 of the 35 OECD members plus two of the five OECD ‘key partners’, India and China, and also Russia, Hong Kong and Singapore.

This gives a sample of 27*26*3=2106 observations. Note that Belgium and Luxemburg are counted as a single observation.

This EU1_DEST dummy also includes the impact of the EU Common External Tariff and non-tariff barriers.

A convenient source is available at: www.ukdataservice.ac.uk. Data on GDP and population by country is available at Conference Board Total Economy Database, http://www.conference-board.org/data/economydatabase/