House of Commons

Treasury Committee

The UK's economic relationship with the European Union: The Government's and Bank of England's Withdrawal Agreement analyses

Twenty-Fifth Report of Session 2017–19

Report, together with formal minutes relating to the report

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The Treasury Committee

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Evidence relating to this report is published on the inquiry publications page of the Committee's website.

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1 Introduction

1. During the passage of the European Union (Withdrawal) Act 2018, Parliament secured a "meaningful vote" on the withdrawal agreement. Appearing in front of the Treasury Committee on 6 December 2017, the Chancellor agreed that "the maximum amount of analysis [should be placed] in the public domain" when the deal was being put before Parliament.[1] On 27 June 2018, the Chair of the Committee wrote separately to the Chancellor, the Governor of the Bank of England and the Chief Executive of the Financial Conduct Authority to set out the Committee's expectations for the analysis that each organisation should produce.[2] Replies were received from each agreeing to produce this work to enable the Committee to scrutinise their analysis ahead of the "meaningful vote".[3] The Chair wrote again on 10 and 11 October setting out more detail about the Committee's expectations, although at this point the timetable remained uncertain.[4]

2. After the EU Summit on 17–18 November, the timetable for the "meaningful vote" became clearer. The Treasury Committee issued a call for evidence from economists, firms, trade bodies, regulators, experts and other interested parties to present their own economic analysis of the withdrawal deal and to comment on the analysis produced by the Government and the Bank of England.[5]

3. After informal discussions with the Committee staff, the Bank of England changed the publication timetable for its regular Financial Stability Report to enable it to meet its commitment to the Treasury Committee.[6] It subsequently agreed to send its response to the Treasury Committee on 28 November to give the Committee members more time to digest it and to enable all Parliamentarians to see the work ahead of the Prime Minister's appearance before the Liaison Committee on 29 November.[7] The FCA sent its response on 29 November.

4. The analysis committed to by the Chancellor was published by the Government as a Command Paper on 28 November alongside several other documents about the future relationship.[8]

The inquiry

5. The Committee took evidence on the UK's future economic relationship with the EU (Economic Analysis ahead of the "meaningful vote") over three days as follows:

1 *Oral evidence taken on 6 December 2017*, HC (2017–19) 600, Q305

2 *"Treasury, BoE, FCA asked to publish Brexit impact analysis ahead of vote"*, Treasury Committee press release, 3 July 2018

3 *Letter from Chancellor to Chair of the Treasury Committee (23 August 2018)*, *Letter from Governor of the Bank of England to Chair of the Treasury Committee (12 July 2018)*, *Letter from Chief Executive of the FCA to Chair of the Treasury Committee (10 July 2018)*

4 *Letter from Chair of the Treasury Committee to Chancellor (10 October 2018), Letter from Chair of the Treasury Committee to Governor of the Bank of England (11 October 2018), Letter from Chair of the Treasury Committee to Chief Executive of the FCA (11 October 2018)*

5 *"Committee to take evidence on the economic impact of the Withdrawal Agreement"*, Treasury Committee press release, 26 November 2018

6 *"Change of publication date for the Financial Stability Report and Bank of England stress testing results"*, Bank of England press release, 20 November 2018

7 *"Change of publication time for the Financial Stability Report"*, Bank of England press release, 27 November 2018

8 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742

3 December 2018:

Economists

Roger Bootle, Chairman, Capital Economics; Professor Jagjit Chadha, Director, National Institute of Economic and Social Research; and Dr Gemma Tetlow, Institute for Government.

Financial Conduct Authority

Andrew Bailey, Chief Executive, Financial Conduct Authority.

4 December 2018:

Bank of England

Dr Mark Carney, Governor, Bank of England; Ben Broadbent, Deputy Governor for Monetary Policy, Bank of England; Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England; Sam Woods, Deputy Governor for Prudential Regulation, Bank of England and Chief Executive Officer, Prudential Regulation Authority.

Government Officials

Sir Tom Scholar, Permanent Secretary, HM Treasury; Clare Lombardelli, Director General, Chief Economic Adviser, HM Treasury; Sam Beckett, Director General, EU Exit and Analysis at the Department for Business, Energy and Industrial Strategy; Susannah Storey, Acting Director General at the Department for Exiting the European Union.

5 December:

Economist

Dr Andrew Sentance

Specialist Adviser to the Treasury Committee

Professor Sir Stephen Nickell

Treasury Ministers

Rt Hon. Philip Hammond MP, Chancellor of the Exchequer;

Government Officials Clare Lombardelli, Director General, Chief Economic Adviser, HM Treasury; and Susannah Storey, Acting Director General at the Department for Exiting the European Union.

The analysis produced for the Treasury Committee

6. In her letter to the Chancellor of 27 June,[9] the Chair set out what the Committee expected to see in the Government analysis, including:

9 *Letter from Chair of the Treasury Committee to Chancellor (27 June)*

(ii) Short-term analysis

The short-term analysis should describe the path for the economy and the public finances in the five years following March 2019, assuming:

(a) an agreement is reached before March 2019 on the Withdrawal Agreement and the framework for the future relationship, and

(b) a 'no deal' scenario, relative to a 'status quo' baseline. The economic component of the short-term analysis should describe the path for GDP, GDP per capita, labour productivity, household incomes, employment, exports, imports, the trade-weighted exchange rate, and any other indicators deemed by the Treasury to be relevant. The fiscal component of the short-term analysis should describe the path for public sector net borrowing, net debt, revenues, expenditure, and any other indicators deemed by the Treasury to be relevant, relative to the baseline.

7. In his 23 August reply, the Chancellor confirmed the Committee would be receiving the evidence it requested:

> I would like to reiterate a previous commitment the government has made: once we have agreed a deal with the EU the government will provide Parliament with the appropriate analysis of that deal ahead of the vote on the final deal[10]

8. When asked in oral evidence why the Treasury had not included a short-term analysis as requested the Chancellor said:

> My understanding is that the Bank of England has provided you with the analysis that you need to look at the short-term scenario. We do not have the capability to do that.[11]

9. However, when asked for sectoral detail from the Bank's analysis, the Governor said:

> That is not within our responsibilities. The determination of the nature of any trading relationship or partnership with Europe versus someone else is, I am afraid, the responsibility of the Government and it has to take into account sectoral determinations, both for shorter-term impacts and longer-term prospects.

When pushed to simplify he said, "It is not our job".[12]

10. **After an extensive exchange of letters and with discussion at various oral evidence sessions, the Committee expresses its disappointment that the Treasury did not provide all evidence that the Committee requested. The Treasury did not produce short-term analysis of any scenarios. The Committee is also disappointed that the Treasury modelled scenarios that have been rejected by the EU (i.e. Chequers) yet did not model scenarios that are considered probable and have the potential to be persistent over the medium to long term (i.e. the Backstop). And while the Office for**

10 *Letter from Chancellor to Chair of the Treasury Committee (23 August 2018)*
11 Q1252
12 Q1051

Budget Responsibility now undertakes this sort of short-term analysis for the Budget and other fiscal events, the OBR can only forecast based on stated Government policy; the political declaration is only a statement of intent. Therefore, there is no short-term analysis of the deal upon which Parliament will vote.

11. **Notwithstanding this objection, the Committee is grateful that all institutions responded to the request in good time to enable the challenging programme of scrutiny and to allow a report to be produced ahead of the "meaningful vote".**

2 The Government's EU exit scenarios

12. The scenarios modelled by the Government[13] included:

- A "modelled White Paper" scenario which represents the policy position set out by the Government in the July 2018 White Paper on *The future relationship between the United Kingdom and the European Union*;

- A "modelled White Paper with 50 per cent Non-Tariff Barrier (NTB) sensitivity" scenario, in which NTBs are assumed to be higher than in the main White Paper scenario;[14]

- A hypothetical Free Trade Agreement (FTA) (known as the "modelled average FTA"), with zero tariffs, reflecting average FTA non-tariff costs such as being outside the Customs Union and standard customs arrangements with the EU, regulatory barriers and other costs. The Institute for Government likens this to the Canada model;[15]

- An EEA-only scenario (without membership of the Customs Union), which reflects being outside of the Customs Union and as such primarily reflects the costs of standard customs arrangements with the EU. Zero tariffs are applied. The IFG analysis likens this to the Norway model;[16] and

- A No Deal scenario based on an assessment of average non-tariff barriers between countries trading on non-preferential World Trade Organization terms and applying EU applied Most Favoured Nation (MFN) tariffs.

The Government's international trade model and the difference between absolute and relative scenario forecasting

13. The Government's EU exit long-term economic analysis emphasises that it "is not an economic forecast for the UK economy", since "it only considers the potential economic impacts that are specific to EU exit". As a result, "the estimates show the relative impacts of difference trading arrangements… and do not estimate the absolute increase or decrease in economic output compared to today… in all scenarios the economy would be expected to grow".[17] In evidence to the Committee, Sir Tom Scholar, Permanent Secretary at HM Treasury, emphasised that "we have not tried to model any policy response, whether macro, micro, further development in the industrial strategy or the regions and devolved nations… because the purpose of the analysis is to separate out just the effects of trade barriers".[18]

13 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 4

14 In the White Paper Sensitivity scenario, NTBs (excluding costs due to customs checks) are set halfway between those in the main White Paper scenario and those in the FTA scenario.

15 Institute for Government, *UK-EU economic partnership*, November 2018

16 Institute for Government, *UK-EU economic partnership*, November 2018

17 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 3

18 Q1165

14. Witnesses to this inquiry emphasised the difference between forecasting economic growth in absolute terms and modelling the relative differences between different scenarios, as the Government analysis does. Professor Sir Stephen Nickell, specialist advisor to the Committee, said there are fewer uncertainties involved in relative scenario modelling:

> By saying what would happen with this assumption relative to that assumption, you can ignore all the exogenous shocks that will undoubtedly hit the economy over the next 15 years… For example, you can say that, aside from the shocks implicit here, if the economy or the outside world runs smoothly for the next years… in the end you are better off under any of these scenarios. On the other hand, if the world economy is hit by a gigantic recession at the end of the 2020s, you could easily be worse off under all scenarios. Under the assumption that shocks from outside in some sense hit all the different scenarios equally, you can afford to ignore them in this kind of analysis.[19]

15. The National Institute of Economic and Social Research (NIESR's) made a similar point in written evidence:

> The current exercise aims to compare different scenarios on a consistent basis, holding constant many of the factors that affect the development of the economy, and varying only the economic relationship between the EU and UK. This conditional calculation is much more precise than trying to forecast unconditionally.[20]

16. The scenarios are modelled using a Computable General Equilibrium (CGE) model called GETRADE, developed from the GTAP model coordinated by the Center for Global Trade Analysis at Purdue University.[21] The Government's analysis says that CGE models "can allow for a large number of countries, and for a large number of sectors in each country", estimating "a long-term equilibrium where supply and demand in all markets is in balance, and there is full employment of capital and labour".[22] Clare Lombardelli, Chief Economic Advisor at HM Treasury, outlined some of the pros and cons of CGE modelling. In particular, it has a high degree of sectoral detail, but does not model the path taken by the economy in the short and medium term, unemployment, and the process by which jobs and capital are redeployed in adjustment to a new trading relationship:

> It is worth bearing in mind that this is an analysis of the long-term impact over 15 years. That provides time in which businesses, consumers and household would adjust their behaviour. It does not make any assumption about the speed with which that adjustment would happen, but it assumes a 15-year framework.
>
> [CGE] is the standard tool that is used for trade analysis of this kind. It has some pros and cons. One of the advantages is that it allows you to think about… how businesses and households adjust to those changes in trade

19 Q1217
20 EU0043
21 Purdue University, *Global Trade Analysis Project*
22 HM Government, *EU Exit, Long-term economic analysis, Technical reference paper*, November 2018, p 28

> prices, in a way other analysis does not allow you to do. In that sense, it can give you a picture of the economy after this change has happened and what it would look like.
>
> The downside of it is that, as you say, it does not pick up the short-term impacts that may happen and the transition through those, and any issues where those short-term impacts have long-run effects, which might be the case. There are pros of using this kind of model, but that is one of the limitations of it… It is worth bearing in mind that this sort of model makes no assumptions about unemployment.[23]

Ms Lombardelli acknowledged that CGE modelled is not "necessarily the best-understood technique", but added that "the test of the best model is not necessarily how well understood it is; it is how well it does at answering the question".[24]

17. The Chancellor acknowledged that the Government analysis only covered long-term impacts, and not the transition to that end state:

> This piece of work is answering the question, "In any one of these given scenarios, what will be the long-term effect on our economy?" It is not, "How will the economy adjust to that long-term effect?", but, "What will be the long-term effect?"[25]

18. **CGE models are widely employed in economic analysis of international trade. The Government's model has the advantage of analysing decisions about trade at a significant level of sectoral detail. It also analyses the economy in the long term only, assuming there is full employment of capital and labour. As such, it does not show how the economy will transition to the new trading relationship, the path taken by inflation and unemployment, and whether the transition could result in increased structural unemployment.**

The Government's findings and choice of scenarios

19. The diagram below based on Institute for Government analysis illustrates the differences between the scenarios:

23 Q1108–1109
24 Q1187
25 Q1255

Figure 1: Institute for Government Analysis of UK-EU future economic partnership[26]

		Access to the Single Market		Requirements		Influence over EU rules and regulations	EU Trade Policy	
Type of Arrangement	Example	Goods	Services	Financial Contribution	EU Rules and Legal System		Scope to negotiate free trade negotiations	Free movement of people
Membership of the EU	UK (current model)	✓	✓	✓	✓	✓	✗	✓
European Economic Area (EEA)	Norway	✓	✓	✓	✓	EEA members have right to be consulted on laws and regulations but limited channels for formal influence.	Can conclude bilateral free trade agreements with non-EU countries. Can negotiate free trade agreements as part of EFTA.	✓
Chequers	Bespoke	✓	Lose current level of access to EU market. Seek enhanced equivalence on financial services and mutual recognition of professional qualifications.	Would have to meet outstanding obligations. Could choose to contribute to some programmes but does not have to go through EU Budget.	Continue to update UK rules in line with EU law for goods stated in common rulebook. Would not fall under jurisdiction of ECJ, but ECJ would have final say on interpretation of EU law.	Where the UK commits to a common rulebook, it may seek participation in relevant EU agencies and technical committees, although would have no formal voting rights.	Can conclude bilateral free trade agreements with non-EU member states. Trade policy inhibited by common rulebook as standards will need to remain consistent with EU.	✗
Free Trade Agreement (FTA)	Canada	Phases out around 98% of duties and tariffs. Some quotas on produce, but most removed. Alt. arrangements for NI – possibly backstop.	Increase firms' access to EU market in services, but not substantially.	✗	✗	✗	✓	✗
World Trade Organisation (WTO) (No Deal)		The UK would access EU markets as a third country.	The UK would access EU markets as a third country.	✗	✗	✗	✓	✗

20. Professor Jagjit Chadha of NIESR told the Committee that the analysis "is broadly in line with the Institute's own independent analysis of the impact of leaving the European Union"[27] which also show that the UK is worse off under both a "no deal" scenario and a "FTA" compared to remaining in the EU.[28] He observed the results are driven by the extent to which "there are frictions imposed on what are broadly called the four freedoms of being in the European Union: goods, services, capital and labour".[29] Dr Gemma Tetlow of the Institute for Government (IfG) also agreed that the Government's analysis was in line with the "vast majority of economic modelling".[30]

26 Institute for Government, Analysis of the Draft Political Declaration setting out the framework for the future relationship between the United Kingdom and the European Union, with Treasury Committee staff summaries

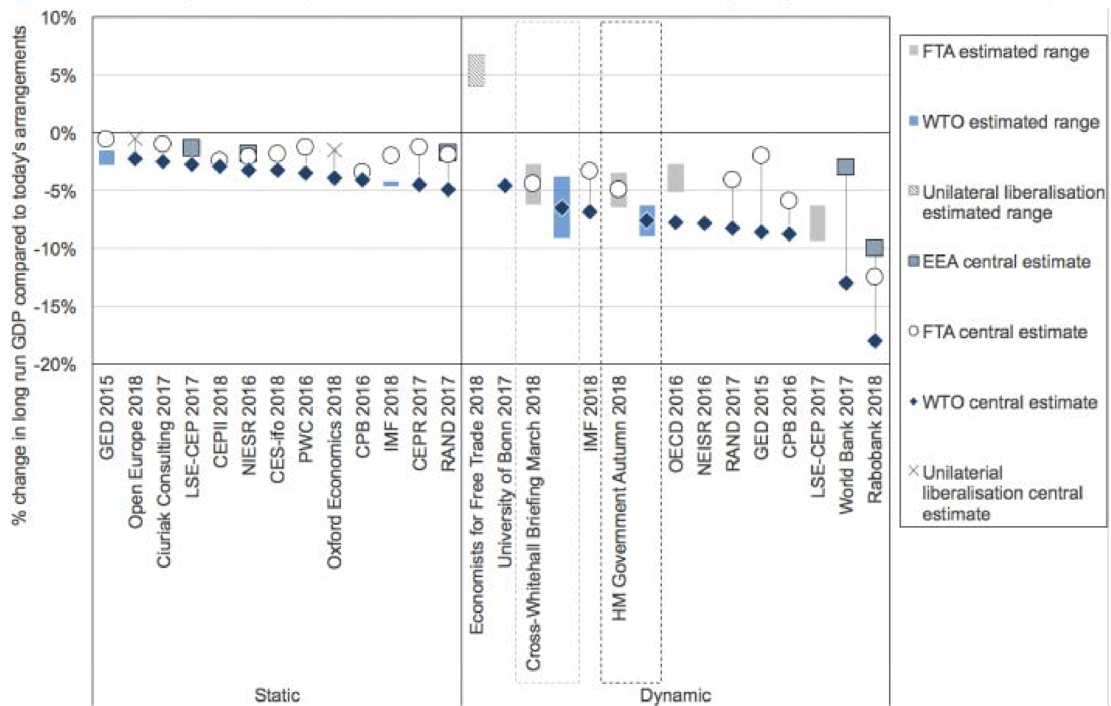
27 Q 867

28 NIESR (EUN 0043)

29 Q867

30 Q867

Figure 2: Extract from Government EU Exit Analysis: Summary of total impacts on GDP from external trade modelling compared to Government analysis (Figure 5.1)



White paper model

21. In the Government analysis, the White Paper scenario gives the outcome that GDP is 0.6 per cent lower relative to remaining in the EU,[31] the most positive outcome for GDP among all the scenarios. However, the Government analysis also includes an additional variant of the White Paper scenario that assumes additional non-tariff barriers. Whereas the White Paper scenario gives a more positive outcome for GDP than the EEA-only scenario, the White Paper scenario with additional non-tariff barriers gives a worse outcome.[32]

22. The Committee received considerable evidence that the White Paper scenario was an exceptionally optimistic scenario for what the Government could achieve in its negotiations. Professor Nickell thought “the White Paper is the very best deal you could conceivably get if you had lots of terrific negotiators who did a fantastic job”.[33] Dr Tetlow also indicated that the White Paper with additional non-tariff barriers was likely to be the more realistic option. She told the Committee that the white paper with “sensitivity analyses throughout the report, is maybe more what you want to have in mind”.[34]

31 This figure assumes no change to migration arrangements.
32 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 7
33 Q1215
34 Q873

23. In his evidence to the Committee, the Chancellor indicated that the White Paper was an "aspiration" for the Government rather than a central scenario:

> Of course, the Government will negotiate in the expectation of achieving a solution that is close to the White Paper aspiration, but we recognise that in a negotiated final text we will not achieve everything that we set out to achieve, so it is right that we look at a range.[35]

24. Some economists also found it puzzling that the White Paper scenario gave a better outcome for GDP than the EEA-only scenario. Dr Tetlow said it was "surprising" but not "implausible" that the UK fared better under the White Paper scenario whereby there were "no customs barriers to goods but you are outside the single market for services" than the EEA-only scenario given that "no customs barriers to goods but you are outside the single market for services".[36] Dr Andrew Sentance, an independent economist, told the Committee:

> If I had to put a hierarchy of what is likely to produce the least negative economic impacts I would say that EEA, which would keep us in the Single Market and keep us in a very close relationship to Europe in many other respects, would probably be the least damaging, both in the short and longer term. Then some sort of bespoke deal like the Chequers White Paper might be the second-least damaging, with more of a free trade agreement scenario, and then a WTO rules scenario being the most damaging, or No Deal.[37]

25. **The White Paper scenario represents the most optimistic and generous reading of the Political Declaration, insofar as it is consistent with it at all. It certainly does not represent the central or most likely outcome under the Political Declaration, and therefore cannot be used to inform Parliament's meaningful vote on the Withdrawal Agreement.**

26. **Parliament may prefer to draw from the range of the scenarios in the Government analysis, additionally informed by external analysis and comment, in order to assess the economic impact of the Withdrawal Agreement.**

No Deal

27. The No Deal model in the Government's analysis is based on an assessment of what would occur if the UK moved towards trading with the EU on WTO terms. The No Deal Scenario gives the worst outcome relative to remaining in the EU out of all the scenarios. The Government's analysis indicated that GDP would fall by 7.7 per cent relative to remaining in the EU, assuming no change to migration arrangements. This is mainly driven by increases in non-tariff barriers but there are also customs costs and tariffs.[38]

35 Q1247
36 Q873
37 Q1206
38 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 10

28. Although the IFG analysis of models shows that most economists' models give the most negative outcome to a No Deal situation compared to remain, the Government's analysis is notably on the pessimistic side.[39] In what it calls an orderly No Deal scenario, NIESR estimates that GDP will be 5.5 per cent lower than it would otherwise be if the UK remained in the EU.[40] However, Open Europe told the Committee:

> In summary, we can see no relationship between the cold numbers of our economic analysis, which are in line with other comparable studies, and the rhetoric of those who argue that Brexit will make a dramatic difference to Britain's growth trajectory in either a negative or positive direction. Leaving on WTO terms is not Open Europe's preferred option but in narrowly economic terms it would not, according to this model, be an unreasonable path for the UK to take, if a negotiated exit was unavailable.[41]

29. The short-run impact of No Deal scenario is explored later on in the report.

Free Trade Agreement

30. The Government's Free Trade Agreement scenario gives a more negative outcome for GDP relative to remaining in the EU compared to both the Government's White Paper and EEA-only scenarios. The Government's analysis indicates that GDP under the FTA scenario would be 4.9 per cent lower[42] than remaining in the EU in the long term.[43] This broadly agrees with NIESR's analysis which shows a reduction of 3.9 per cent of GDP under the FTA scenario relative to remaining in the EU.[44]

31. Clare Lombardelli from the Treasury explained to the Committee why there would be higher frictions and subsequently lower output outcomes in the FTA scenario compared to both the EEA and White Paper scenarios:

> The other thing worth being aware of is that a free trade agreement is different from being in a customs union and a single market. In a customs union and a single market, economies integrate to a much higher degree. For example, you do not have tariffs at all; you do not have to consider them. You have a common external border, so you are not interested in things like rules of origin costs. You have a lot of alignment on non-tariff barriers, particularly on goods but also some on services. You are slightly comparing apples and pears, if you are comparing a free trade agreement with being in a customs union and a single market, because of this degree of economic integration. You see that when you look at the evidence on how European countries in particular have integrated.[45]

39 NIESR (EUN 0043), Andrew Sentence (EUN 0045)

40 National Institute for Economic and Social Research, *The Economic Effects of the Government's Proposed Brexit Deal*, 26 November 2018, p 1

41 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/the-uks-economic-relationship-with-the-european-union/written/93314.html

42 This figure assumes no change to migration arrangements.

43 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 7

44 NIESR (EUN 0043)

45 Q1161

EEA-only scenario

32. The Government's EEA-only scenario shows a drop of 1.4 per cent of GDP relative to remain,[46] arising out of customs costs.[47] It gives the most positive outcome for GDP other than the White Paper scenario. Under the EEA-only there are no non-tariff barriers because EEA countries are in the Single Market and have regulatory alignment, but some customs costs because they are not in the Customs Union and can negotiate their own trade deals.

33. Sir Tom argued that though the EEA would look "very similar indeed to the Government's proposal", "it would have important differences relating to the nature of the legal agreement, sovereignty, rule-taking".[48] Susannah Storey, Acting Director-General of the Department for Exiting the European Union, also pointed out that "EEA would not end free movement of people".[49]

34. Sir Tom Scholar told the Committee that if the Government were to model an EEA scenario within a customs union, it would look very much like the baseline in which the UK remains in the EU.[50]

The Backstop

35. During the course of the inquiry, the Committee observed that the Government had not done any analysis of the Backstop position agreed to in the Withdrawal Statement.

36. The Backstop comes into place if "a future agreement to supersede the Protocol cannot be finalised by December 2020" and the Government has not extended the transition period. However, the transition period can only be extended by one or two years.[51][52] It establishes a customs territory between Great Britain and the EU Customs Union, while Northern Ireland remains in the EU Customs Union.[53]

37. Susannah Storey from the Department for Exiting the European Union gave the following reasons for the Government not modelling the Backstop:

> It is not the preferred policy position and it is not a long-term scenario. Also, in analytical terms, when you look at articles 6 to 8 of the protocol, it is clear that some of the details still need to be set by the joint committee and in subsequent negotiations.[54]

38. Professor Nickell though that "in principle" you could model the Backstop but the Government "might feel embarrassed by modelling 15 years of Backstop".[55] He said that the Backstop involved being "not in the single market" but "there are potential differences

46 This figure assumes no change to migration arrangements.
47 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 49
48 Q1166
49 Q1170
50 Q1181
51 HM Government, *Explainer for the agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union*, para 122
52 *Withdrawal Agreement*, November 2018, Article 132
53 Attorney General's Office, *Legal Effect of the Protocol on Ireland/Northern Ireland*, 13 November 2018
54 Q1095
55 Q1212

in standards, regulations and so on so there would be non-tariff barriers of a highly uncertain size". He thought that in principle the outcome would be something between the White Paper and FTA scenarios.[56]

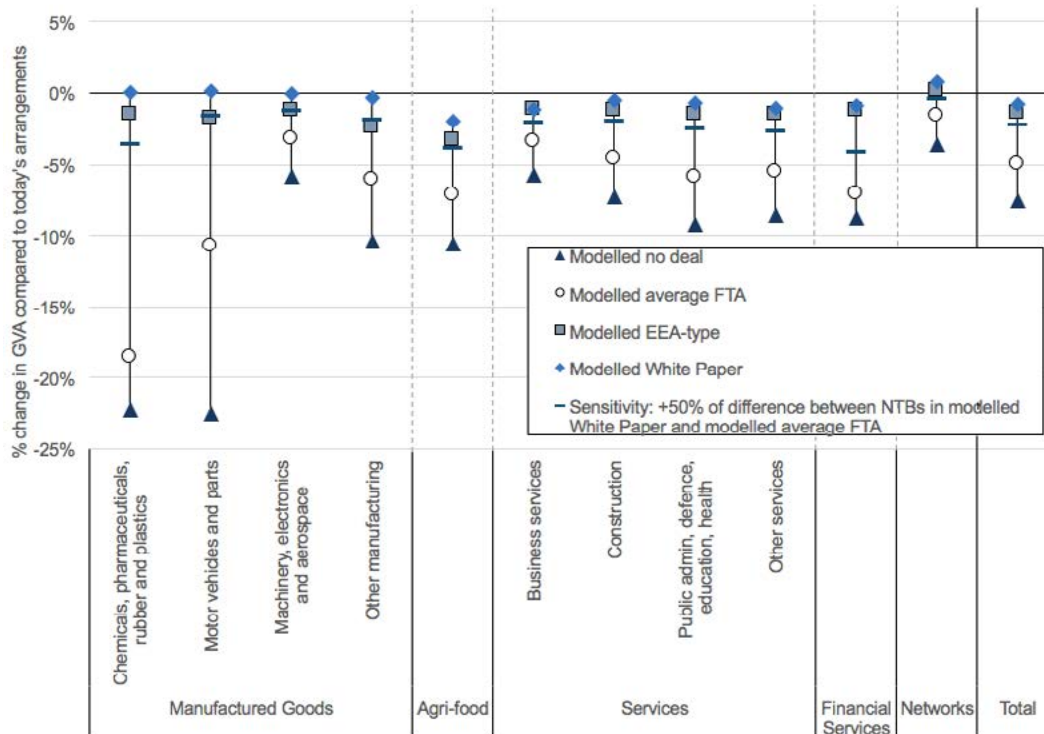
39. The Governor of the Bank of England had told the Committee previously that "on average for a trade deal from start to finish, it is something in the order of four years. The implementation period tends to be a little more than half of that time".[57]

40. **Trade agreements can take four years to agree, and previous EU negotiations, have taken longer. The CETA deal took over eight. Therefore, the Committee believes it is feasible that the UK could enter the Backstop, despite it being neither the UK's nor the EU's preferred position. And it believes that the Government should have modelled the Backstop, making some broad-brush assumptions.**

Sectoral and regional analysis

41. The Government analysis gives a chart which illustrates what happens to sectors in the long run.

Figure 3: Extract from Government EU Exit Analysis: Summary of trade only impacts on UK sectors, compared to today's arrangements (Figure 4.5)



Central estimates only.[157]

This does not include migration or regulatory flexibility effects.

Other sectoral modelling suggests economic output in the agriculture sector could increase in a no deal scenario with EU MFN tariffs, although this is at the expense of consumers who face higher costs (see box on Agri-food additional modelling).

The benefits of new trade deals with countries outside of the EU are captured.

Sectoral GVA excludes tariff revenue.

56 Q1212

57 Oral evidence taken on 20 November 2018, HC (2017–19) 596, Q 312

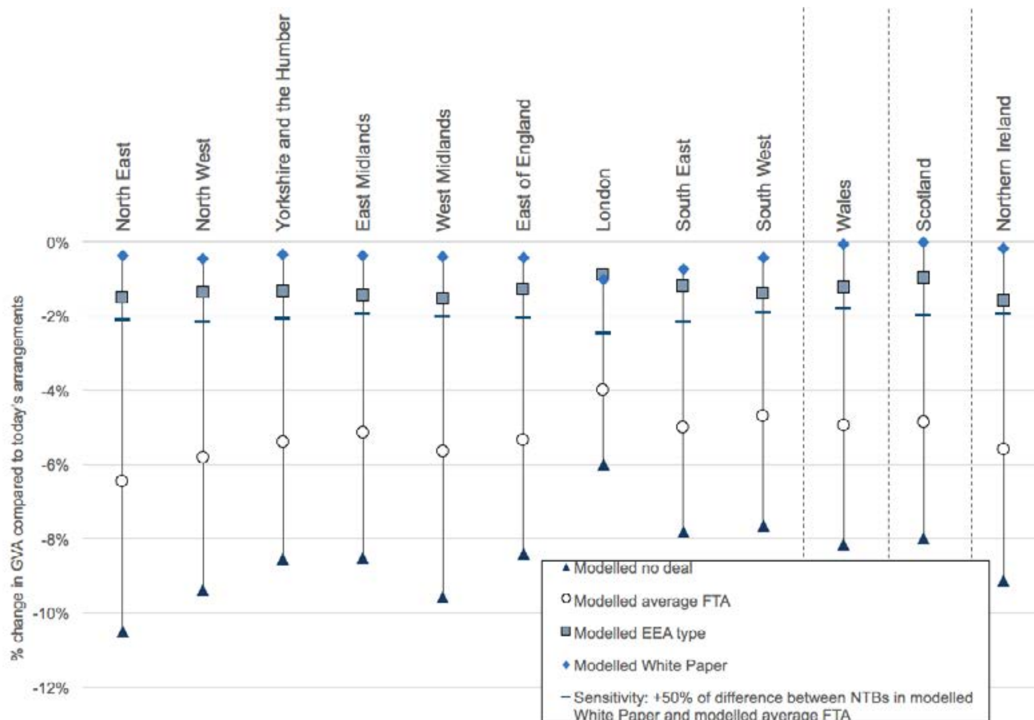
42. It shows that all sectors have lower levels of output in the long run as a result of leaving the EU under the FTA and No Deal scenarios but chemicals, pharmaceuticals, rubber and plastics, and motor vehicles and parts sectors are the hardest hit.

43. Professor Chadha told the Committee that NIESR's analysis showed very similar results to the Government's:

> The extent to which a particular industry has strong import or export competition from the European Union—they are the ones that will be damaged the most.[58]

44. The Government's analysis finds that all regions are worse off under each scenario. In a No Deal scenario, the North East, North West, West Midlands and Northern Ireland would suffer the highest loss of output.

Figure 4: Extract from Government EU Exit Analysis: Summary of trade policy impacts on UK nations and English regions compared to today's arrangements. (Figure 4.6)



Central estimates only.[167]
The benefits of new trade deals with countries outside of the EU are captured in these estimates.
This does not include migration and regulatory flexibility effects.

45. City REDI submitted evidence arguing that Brexit will widen regional inequalities:

> Brexit is likely to exacerbate the UK's current interregional inequalities, which are already very high by international standards. Moreover, this conclusion holds largely irrespective of the eventual form of Brexit. The reason is that the UK's economically weaker regions, especially in the

58 Q917

> Midlands and the North of England, are more exposed to Brexit trade-related risks because they tend to be much more dependent on EU markets for their prosperity than the UK's richer regions.[59]

46. As explained above, the Government analysis models the economy in the long term once it has fully adjusted to new trading arrangements and labour and capital are fully employed. The Committee was directed to the Bank of England for short-term analysis, but was told by the Governor:

> Sectoral analysis is not our job. I am sure the Treasury will be very informative on these issues. The general sectoral impact depends on the nature of the deal and if there is a deal.[60]

47. Dr Tetlow also pointed to analysis from the Institute for Fiscal Studies showing:

> That in some of the particularly industrial areas of the country, some of the people who might be most affected are relatively low-skilled older men with quite firm specific skills at the moment. You might be more worried about that group of people becoming unemployed and leading to the structural unemployment questions that you were talking about and that we saw post-deindustrialisation in the 1980s.[61]

48. Professor Chadha indicated to the Committee that leaving the EU could lead to long-term unemployment, similar to that of de-industrialisation if those who lost jobs could not find jobs elsewhere.

> I could hark back to the de-industrial episode of the 1980s that I touched upon moments ago, I would argue that there are still regions in the UK that have not fully recovered from that process. So we are talking about things that will take a generation or so to solve.[62]

49. The Chancellor also cited the 1980s as a precedent:

> I would suspect there will be quite a prolonged period of adjustment. If I could use an analogy[…] it would be rather like the adjustment after 1980 when, over a period of time, nearly a decade, our economy made a significant adjustment away from certain patterns of industrial and commercial activity to a different set of commercial and industrial activities.[63]

50. **The Government has provided long-term regional and sectoral analysis of a number of EU exit scenarios. However, the Committee notes that it did not include analysis of the Backstop nor did the Committee receive short-term regional and sectoral analysis showing where losses and gains in jobs are most likely to be located as the economy adjusts to a new trading relationship.**

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59 University of Birmingham, *City REDI Blog*, 6 December 2018
60 Q1053
61 Q919; IFS, *Green Budget 2018*, 5 October 2018, Chapter 10
62 Q918
63 Q1332

51. **It is worth emphasising that the Treasury analysis makes no allowance for any other dynamic, domestic policy responses, such as policies developed under the Industrial Strategy, that could affect the impacts of the EU Exit scenarios on regional and sectoral growth.**

3 Key assumptions in modelling the economic impact of withdrawing from the European Union

Tariffs

52. In the majority of scenarios, the Government's EU exit long-term economic analysis assumes that there are no tariffs (defined as "import taxes… only levied on goods"[64]) on UK-EU trade in either direction. In the No Deal scenario, it is assumed that each party charges tariffs at the existing EU Most Favoured Nation rate. In Ad Valorem Equivalents (AVEs), these are as high as 20 per cent in the Agri-food sector and 8–9 per cent in the Motor Vehicles sector. These tariffs subtract 1.4 per cent from UK GDP compared to the other scenarios.[65]

53. The analysis also includes an additional No Deal scenario in which the UK unilaterally reduces its tariffs to zero on imports from both the EU and the Rest of the World (but still faces export tariffs). In this case, GDP is 0.8 per cent higher than in the main No Deal scenario.

54. Roger Bootle, Chairman of Capital Economics, told the Committee that "it is quite plausible that the effect would be much better than that, but… the best result for the UK would be to achieve widespread, deep and meaningful free trade agreements around the world". However, Professor Jagjit Chadha, Director of NIESR, told the Committee that "a reduction in tariffs to completely free trade would severely impact on import-competing industries in the UK" and "it is not clear than all prices would adjust downwards".[66]

Non-tariff barriers

55. The Government analysis defines non-tariff barriers (NTBs) as:

> All barriers to trade that are not tariffs. Examples include customs controls, differences between national regulatory regimes, and restrictions on the international movement of people insofar as this constitutes a barrier to trade. NTBs only capture barriers to trade, not barriers to investment or policy measures affecting domestic productivity unless they also constitute barriers to trade. Some organisations use a narrower definition, referring to NTBs as a subset of obstacles to trade brought about by policies with a protectionist or discriminatory intent.[67]

56. NTBs cause GDP to be 0.9, 1.5, 2.3, 5.1 and 6.5 per cent lower than the baseline in which the UK stays in the EU in the White Paper, EEA, White Paper Sensitivity, FTA and No Deal scenarios respectively. In each scenario, NTBs are by far the largest contributor to the overall impact on GDP.[68]

64 HM Government, *EU Exit: Long-Term Economic Analysis Technical Reference Paper*, p 4
65 HM Government, *EU Exit: Long-Term Economic Analysis Technical Reference Paper*, p 9
66 Qq896–897
67 HM Government, *EU Exit: Long-Term Economic Analysis Technical Reference Paper*, p 10
68 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 10

57. Professor Nickell, Specialist Advisor to the Committee, emphasised the importance of the Government analysis's assumptions about NTBs, and explained to the Committee how they had been derived using an econometric gravity modelling approach:

> Non-tariff barriers drive this whole thing, basically[…] It is not just a number plucked from the heavens. What you do is analyse trade. You take 120 countries and analyse trade between those countries over a period of time. You look at the countries that trade with each other under WTO rules, the countries that trade with each other on free trade agreements and the countries in the EU that trade with each other on much deeper than free trade agreements… controlling for distance and size.
>
> You then say, "Look, the average trade between the EU countries, controlling for distance and size, is much higher than between free trade agreement countries, which is then somewhat higher than trade between WTO countries". You then say, "Okay, anything about these differences in average trade that we cannot explain by tariffs and customs is explained by non-tariff barriers"[…] That is quite a scientific activity, not arbitrary guesswork.[69]

58. In addition to these top-down estimates of total NTBs (which encompass costs due to customs compliance), the HMRC provided alternative bottom-up estimates of the additional costs of customs compliance that may be incurred outside the EU's Customs Union. These were used in the construction of the EEA and White Paper scenarios.[70]

59. Some analysts have estimated that the rise in NTBs that would result from exiting the EU would be lower than in the Government analysis. According to Dr Tetlow, the Economists for Free Trade model "assumed that there would be no increase in trade barriers between the UK and the EU, even if the UK were to leave with no deal … [and] assumed that there would be a very big reduction in non-tariff barriers and tariffs with other countries by our adopting completely unilateral free trade—in fact, the complete removal of all non-tariff barriers with the rest of the world."[71] Roger Bootle, a member of Economists for Free Trade said that:

> [The increase in non-tariff barriers under WTO or FTA] is just about plausible, but it is very much at one end. If I were asked to give a central fair estimate of how large that increase would be, I do not think this would be it. I would not say it is completely beyond the realms of possibility … Non-tariff barriers are very difficult to model and very difficult to measure.[72]

60. Professor Nickell told the Committee that he found the Government's method more reliable for analysing NTBs:

> The Economists for Free Trade use a different and, in my view, less reliable framework for analysing these things … For example, when they do a WTO argument, they assume that non-tariff barriers between the UK and the EU do not go up by very much… Patrick Minford argues that, when you switch

69 Q1231
70 *Letter from Chief Executive Officer of HMRC to Chair of the Treasury Committee (4 June 2018)*
71 Q908
72 Q885

> to WTO rules, because we are already completely in alignment, nothing will happen so there will be [no] non-tariff barriers. That has superficial plausibility, but arguably depends to some extent on the good nature of the French not wishing to discover whether our goods obey the regulations. Also, after a certain time, regulatory alignment would unalign, so you could not rely on it in the long term. That kind of assumption is probably not very plausible.[73]

61. The Chancellor told the Committee that "there is no doubt that moving from a single market even to the most ambitious FTA, for example, would introduce significant non-tariff barriers."[74]

Brexit opportunities

Free Trade Deals

62. The Government's modelling assumes that by the end of the 15-year period the UK would have successfully pursued trade negotiations with the United States, Australia, New Zealand, Malaysia, Brunei, China, India, Mercosur (Brazil, Argentina, Paraguay and Uruguay) and the Gulf-Cooperation Council (UAE, Saudi Arabia, Oman, Qatar, Kuwait and Bahrain).[75]

63. Despite assuming that such a large number of trade deals are agreed, the Treasury's analysis only shows an increase of less than 0.3 per cent in GDP in 15 years' time as a result of new trade deals.[76]

64. Roger Bootle told the Committee this was a very pessimistic aspect of the Government's analysis:

> On free trade agreements, in particular, it is a very negative set of assumptions, where the benefits to the UK of being able to sign free trade agreements with other countries come down to just 0.2 per cent of GDP, which is out of line with its own assessment of the benefit of a free trade agreement with the EU and out of line with other people's assessments of what happened with Australia. It just looks very odd.[77]

65. In a paper brought to the attention of the Committee, Economists for Free Trade strongly criticised the Government's assumptions about the potential benefits from global FTAs. On their calculations, the Government had included only 6.25 per cent of the potential for reduction in non-tariff barriers with non-EU trading partners.[78]

66. Professor Chadha explained to the Committee why the impacts of new trade deals were so small in the Government model:

> What tends to determine bilateral trade is the size of income in a country and its geography or distance from another part of the world. Brussels is

73 Q1234
74 Q1307
75 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 22
76 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 7
77 Q869
78 Economists for Free Trade, Overview of Published Treasury Brexit Forecasts, 4 December 2018

> around 200 miles from London. The BRICs are each several thousand miles away from London and, depending on the formulation of the equation you write down, that means that they are going to have to be much larger than Europe in order to get the same level of trade. That is the essential reason why you don't get the compensating increase in exports and imports from the rest of the world that you would lose on leaving the European Union. So we are starting from the position that they are, in size, smaller than the European Union, and even if they are growing more quickly at the moment, it is still going to take some 10 to 20 years for them to grow to the levels of the EU if that divergence remains.[79]

67. Professor Nickell gave a further reason why the impacts of new trade deals were so small in the Government model:

> Trade between the EU and the UK has much higher average tariffs than UK/rest-of-the-world trade because there is much more agriculture and cars, and much less services in UK/EU relative to the UK/rest of the world. That means there are much lower tariffs so, when you strike a free trade agreement, you get much less bang for your buck than you would if you went from WTO to a free trade agreement in the EU. The other one is because there are more services, and non-tariff barrier reductions in services have a much lower impact on trade than non-tariff barrier reductions on goods.[80]

68. The Government analysis admits that it excludes future developments in some important trends in global trade. These include "the increasing importance of services trade", "the rise of global value chains" and "demographics and economic development", in particular the rising numbers of middle income households in emerging markets.[81] Clare Lombardelli, Chief Economic Advisor at HM Treasury, explained their exclusion:

> The reason it does not cover them is that it is incredibly hard to specify what the impact of those would be as inputs to this sort of analysis. You are right that those things are likely to be changing, but estimating exactly how they are changing, which you would need to do in order to put them into this analysis, is not something we can do on a robust basis.
>
> […]
>
> I can tell you that these are the standard tools used in economics for trade analysis. Those tools have stood up very well to the test of the evidence on what actually happens with trade and how trade has evolved over time. To an extent, you would have to believe something was very different about the future to how it has been in the past, for you to think this analysis could not tell you something useful.[82]

69. By assuming no continuation in the trend in economic development, the Government analysis may under-estimate the benefits of the assumed Free Trade Agreements with countries such as China. Roger Bootle told the Committee:

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79 Q900

80 Q1233

81 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 31

82 Qq1135–1136

> The European share [of UK trade] has been falling quite markedly over recent decades, and I suspect that would continue anyway, even if we stayed in the EU. That is to do with the fact that the EU has been growing more slowly than the rest of the world.[83]

Regulatory flexibility

70. The Government analysis states "there is significant uncertainty around the potential impacts of regulatory flexibility. External studies[84] make a wide range of estimates, ranging from a negative or zero net impact, to a benefit of 1.3 per cent of GDP."[85] Within that range the Government chose to include a 0.1 per cent benefit to GDP to model the additional regulatory flexibility the UK will have once it leaves the EU.[86]

71. The Government explained that it did not include a larger figure, such as that provided by Open Europe who suggest the benefits to GDP from regulatory flexibility could be between 0.7 and 1.3 per cent of GDP,[87] because:

> The lower end of these gains assumes the repeal or scaling back of a range of EU-derived regulations including across social, employment, environment and renewables targets. Such changes would therefore not be consistent with UK Government policy to maintain or enhance standards and to continue to meet existing international commitments. The higher end of the range relies additionally on removing further regulatory requirements, including on climate change, energy performance of buildings, restrictions on GM crops, data protection, product standards, and health and safety.[88]

72. Other studies included within the Treasury analysis at the lower end of the range state that "weakening social, employment and environmental regulation to some degree, even if it were politically possible, would make little economic difference."[89]

Migration

73. The Government analysis states:

> Free movement of people will end as the UK leaves the EU. Future migration arrangements will be determined in the UK's national interest, and will be set out in a White Paper, in line with the Government's overall policy to reduce net migration to sustainable levels.[90]

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83 Q900

84 Oxford Economics, OECD, Open Europe, Centre for European Reform, LSE

85 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 23

86 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 24

87 Open Europe, 'What if...? The Consequences, challenges & opportunities facing Britain outside EU', March 2015, HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 24

88 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 24

89 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 24, LSE Centre for Economic Performance, *"The consequences of Brexit for UK trade and living standards"*, March 2016

90 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 11

74. In terms of assumptions of migration, the Government analysis gives "two illustrative variants for long-term migration arrangements, … reflecting the range of policy options". These are represented as "no change to migration arrangements" and "zero net inflows of EEA workers". The Government analysis notes "these scenarios illustrate a very wide range of impacts and are not intended to indicate any future migration arrangements."[91]

75. The table below illustrates that no change to migration arrangements gives a more positive outcome than zero net inflows of EEA workers for GDP and GDP per capita under every scenario.

Table 1: Extract from Government EU analysis: Summary of total GDP impacts (considering trade, migration, regulatory flexibility effects) compared to today's arrangements, for the illustrative no change to migration arrangements and zero net inflows of EEA workers scenarios.

Compared to today's arrangements (per cent change)		Modelled no deal	Modelled average FTA	Modelled EEA-type	Modelled White Paper	Modelled White Paper with 50 per cent NTB sensitivity
No change to migration arrangements	GDP	-7.7 (-9 to -6.3)	-4.9 (-6.4 to -3.4)	-1.4 (-2.4 to -0.9)	-0.6 (-1.3 to -0.1)	-2.1
	GDP per capita	-7.6 (-8.9 to -6.2)	-4.9 (-6.4 to -3.4)	-1.4 (-2.3 to -0.9)	-0.6 (-1.3 to -0.1)	-2.1
Zero net inflows of EEA workers	GDP	-9.3 (-10.7 to -8)	-6.7 (-8.1 to -5.1)	N/A	-2.5 (-3.1 to -1.9)	-3.9
	GDP per capita	-8.1 (-9.5 to -6.8)	-5.4 (-6.9 to -3.9)	N/A	-1.2 (-1.9 to -0.7)	-2.7

Source: Table E.4, Government Long-term Economic Analysis, figures in brackets are ranges.

76. Dr Tetlow observed that "it is not just total GDP that gets worse, but GDP per capita" under zero net inflows of EEA workers.[92] Professor Chadha noted:

> The critical question is the extent to which there is a structural shortfall of labour supply to meet firms' demands in the UK whatever they might be. In the recent past, that has been met—both in high-skilled and low-skilled workers—by migration from the European Union.[93]

77. He noted that since the referendum there had been a swap; "migration from the EU has fallen by almost as much as migration from outside the EU has increased."[94]

91 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 65
92 Q950
93 Q956
94 Q956

78. Professor Nickell described immigration as an "add-on" to the model and said "the problem with immigration is that we do not know what the policy is going to be, so what can you say about it? I suspect not very much".[95]

Productivity

79. The impact of changes in trade on the overall size of the economy are mediated by assumptions about the relationship between trade and productivity. The Government analysis models several channels by which greater trade can raise productivity:

> For example, trade allows countries to specialise more in their areas of comparative advantage and allows businesses to sell their goods and services to a larger market. To serve a larger market, firms scale up their workforce and production, increasing overall demand in the economy. Trade can increase productivity, a key driver of economic growth, by exposing firms to competition, best practice, new technologies and through investment.[96]

80. Professor Chadha told the Committee that the Government had included more channels by which productivity could influence trade than NIESR had in their own EU exit analysis:

> The Government's analysis of further-away deals is slightly more damaging to the economy than that of the institute, because we have taken a more small-c conservative view of the impact on productivity. One of the important spill-overs from introducing frictions to trade is that it might impact on productivity enhancement in the economy. Trade encourages firms to move as close as possible to the productive possibility frontier. It encourages specialisation and learning by doing … We take that as a risk rather than a central case, which is why our overall view of how bad things are is not quite as bad as the Government's.[97]

Nonetheless, Professor Chadha said that "we have taken a cautious view of the impact of trade on productivity, but the literature is probably a bit stronger than the Institute's view".[98]

Investment

Domestic investment

81. The Government's *EU Exit Long-term economic analysis* does not specifically discuss changes to domestic investment in any of its core scenarios. However, it does provide a separate sensitivity analysis.

82. In each of the Treasury's modelled scenarios, GDP is lower as a result of changes to business investment:

95 Qq1231, 1243
96 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p 12
97 Q871
98 Q913

Table 2: Summary of investment sensitivities results on GDP compared to today's arrangements.

	Modelled No Deal	Modelled average FTA	Modelled EEA-type	Modelled White Paper	Modelled White Paper with 50 per cent additional NTB
Change to UK GDP central estimate: Business investment model extension	-2.3 percentage points	-1.2 percentage points	-0.2 percentage points	-0.1 percentage points	-0.5 percentage points

Source: Table 4.16, Government Long-term Economic Analysis

83. In the Bank of England's short-term analysis both of its "Economic Partnership" models find that investment will increase, but that it doesn't fully recover to the pre-referendum trend:

> Investment, which has been subdued by uncertainty, recovers somewhat following the agreement, though it remains below the May 2016 trend.[99]

In a No Deal scenario, the Bank states "weak current and future income growth, higher uncertainty and tighter financial conditions all weigh on consumer spending and business investment."[100]

Foreign Direct Investment

84. The Government's analysis does not assume any change in Foreign Direct Investment (FDI) in any of its scenarios.

85. Clare Lombardelli from the Treasury told the Committee that FDI was excluded from the Government's analysis because the way in which FDI responds to changes in the openness of an economy to trade is not as well understood as the way trade responds to such openness.[101]

86. NIESR did include FDI in its analysis and referenced various academic studies that had attempted to estimate changes in FDI relative to the level of trade agreements in place. NIESR stated:

> While the [Political Declaration] commits to "ambitious, comprehensive and balanced arrangements" also on investment, any barriers for UK-based companies to access the EU market would make the UK a less attractive investment destination. This is because EU membership enables UK producers to be integrated in EU supply chains. In addition, the opportunity

99 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, p 44, Table 3.1.2

100 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, p 51, Section 3.2.4

101 Q1172

to serve the EU market has in the past contributed to non-EU companies choosing the UK as an investment destination, alongside other factors, such as language and the legal and tax system.[102]

87. NIESR summarised its conclusions as follows:

Table 3: Impact of trade agreements on FDI

Agreement with EU on terms comparable with	Percentage reduction in FDI compared to stay scenario
Norway	8 - 11
Switzerland	11 - 23
FTA	20 - 27
WTO	24

Source: Table 5. National Institute for Economic and Social Research Analysis, The Economic Effects of the Government's Proposed Brexit Deal, 2018

88. The Committee asked the Governor of the Bank of England what conclusions could be drawn from the fact that the UK was the second most popular destination for FDI in the first half of 2018.[103] The Governor responded by stating that:

> The UK is a very attractive destination for foreign direct investment for a variety of reasons, and has been for quite some time […] It is geographically obviously on the edge of the EU but fully integrated into the European Union. It has the rule of law. It has highly skilled people. [However] Depending on the form of Brexit we take, one of those things changes. At least in the short term, that makes it a less attractive destination for foreign direct investment.[104]

102 NIESR, *The Economic Effects of the Government's Proposed Brexit Deal*, 26 November 2018, p 15
103 United Nations Conference on Trade and Development, *Investment Trends Monitor*, October 2018
104 Q1072

4 The short-term impact of EU exit (Bank of England scenarios)

89. The Bank of England provided the Committee with macroeconomic analysis of six scenarios for the five-year period from the start of 2019 to the end of 2023: a close economic partnership; a less close economic partnership; a prepared transition to WTO; an unprepared transition to WTO; a "disruptive" no transition and no deal; and a "disorderly" no transition and no deal.[105]

No transition and no deal scenarios

90. The Bank's "disruptive" and "disorderly" no transition and no deal scenarios assume that there will be significant disruption to the UK economy after a no deal Brexit, even more so in the latter case, resulting in a recession and rises in inflation and unemployment. The Bank describes these as "worst case macroeconomic scenarios" produced to inform the Financial Policy Committee's (FPC's) focus "on outcomes that would have the greatest potential impact on financial stability".[106]

91. Key assumptions in the scenarios include:

- the EU and UK apply tariffs and customs checks on one another's goods trade, the EU imposes regulatory checks on goods, and services trade reverts to WTO terms;
- the UK losses access to existing trade agreements between the EU and third countries in the disorderly scenario only;
- there are "some delays" at the border in the disruptive scenario and "severe disruption" in the disorderly scenario;
- the value of sterling falls 15 per cent and 25 per cent in the disruptive and disorderly scenarios respectively;
- monetary policy responds "mechanically", rising to 1.8 per cent and 5.5 per cent in the disruptive and disorderly scenarios respectively; and
- the fiscal response is limited to the automatic stabilisers.[107]

92. Key results in the scenarios include:

- GDP falls 3 per cent and 8 per cent, peak to trough, in the disruptive and disorderly scenarios respectively;
- inflation rises to 4.25 per cent and 6.5 per cent respectively;[108]

105 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, Tables 3.1.1–3.1.2, Table 3.2.1, Table A.1

106 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, p 47, Section 3.2

107 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, pp 47–48, Table 3.2.1

108 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, p 53, Table 3.2.3

- the price of food rises by up to 10 per cent;[109]
- the unemployment rate rises to 5.75 per cent and 7.5 per cent respectively; and
- house prices fall 14 per cent and 30 per cent, peak to trough, respectively.[110]

93. These analyses have been referred to, in some quarters, as forecasts.[111] However, the Bank has been careful to describe them as "worst case scenarios". The Governor explained to the Committee what the Bank meant by this and the FPC's purpose in looking at worst-case scenarios:

> A scenario, first off, is not what we think is the most likely thing to happen, so it is not our central expectation. It is a depiction of what could happen to the economy, based on a series of clearly identified assumptions, which are laid out. […]
>
> Now, this is particularly relevant for the Financial Policy Committee, as you can appreciate, because [it] is concerned with less likely, tail risk scenarios. By design, it will look at a series of worst-case assumptions, because the position we need to be in… is to have a financial system… that can withstand a highly unlikely but worst-case set of events … .,what you should take away from the worst-case Brexit scenarios is that the UK banking system has the capital, the liquidity… and the overall resilience to withstand that and be part of the solution, not part of the problem.[112]

94. In terms of the likelihood of these scenarios, the Governor commented "tail risk is tail risk, so there is a low probability that all of these events would happen at the same time."[113]

95. The Bank's purpose in producing these scenarios was supported by Professor Chadha, Director of NIESR, who said it is "an extreme test of the system, in the same way you might want to test a bridge under extreme circumstances".[114] The Chancellor described the analysis as a "reasonable worst case".[115]

96. However, some witnesses to the inquiry felt that the disorderly scenario, in particular, was nonetheless implausible. Dr Andrew Sentance, a former member of the Monetary Policy Committee, said it included "some very extreme assumptions" and that the "Bank appeared to be throwing in the kitchen sink to create the most negative scenario possible"[116] (a description the Governor was content to adopt[117]). Roger Bootle, Chairman of Capital Economics, called it "thoroughly implausible".[118] Each argued in particular that the prospect of Bank rate rising to 5.5 per cent is remote:

109 Q1029
110 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, p 53, Table 3.2.3
111 For example *https://www.thesun.co.uk/news/brexit/7853101/mark-carney-says-doom-gloom-uk-economy-no-deal-brexit/*
112 Q1012
113 Q1043
114 Q874
115 Q1270
116 Q1190
117 Q1045
118 Q875

> If you look at how the MPC has behaved over the last decade or so that seems implausible, even though the Bank had a scenario where inflation was going up to about 6.5 per cent. That is not much higher than a couple of the peaks that we have already had in 2008–09 and 2011–12… and yet the Bank did not respond by putting up interest rates dramatically in that scenario.[119]

Dr Sentance was also concerned that the Bank had faced difficulties in communicating the difference between a scenario and a central forecast.[120]

97. The Governor told the Committee that Bank rate was set "mechanically" in the scenarios, based on an equation that balanced deviations of inflation from target and output from potential.[121] He has also told the Committee that Bank rate could be higher or lower following a no deal Brexit:

> That depends on the balance of demand and supply, and the exchange rate, as the committee has made clear. We could see either scenario. […]
>
> There are scenarios where [Bank rate could be lowered] but, to be clear, those are scenarios where the hit to demand for the level of activity is greater than the impact on the supply capacity of the economy. Both of those are going down, so it depends on your definition of net stimulus.[122]

98. The Bank also provided the Committee with scenarios in which the UK moves to WTO terms after a transition period, and there is no significant near-term disruption.[123] In this case, GDP is 5.25 per cent lower at the end of 2023 than in the May 2016 baseline.[124]

99. The Chancellor told the Committee:

> There has been a great deal of work going on. I can tell the Committee that, just yesterday, HMRC wrote to the 145,000 traders who currently trade only with the EU and who therefore do not necessarily have any experience of export documentation or procedures.

100. **The Committee finds it hard to fathom why the traders who currently trade only with the EU were not written to long before this time. And it is of the view that these and other preparations should have started sooner.**

Economic partnership scenarios

101. The Bank provided the Committee with two "economic partnership" scenarios in which the UK secures a trade agreement with the EU based on the Political Declaration

119 Q1190
120 Q1204
121 Q1045
122 Oral evidence taken on 20 November 2018, HC (2017–19) 596, Q307
123 Q1016
124 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, Chart A.1, pp 71–72

following a smooth transition period. According to the Bank, "close" and "less close" scenarios "form the top and bottom of a range of possible characteristics of the economic partnership".[125]

102. Key assumptions in the scenarios include:

- there are no customs checks or new regulatory barriers on goods in the close scenario, but there are customs checks and regulatory checks for new product lines in the less close scenario;
- the access of financial services to EU markets falls by a half and three quarters in the close and less close scenarios respectively;
- uncertainty falls to average by the end of 2019 and 2021 in the close and less close scenarios respectivelys; and
- Sterling appreciates 5 per cent and 2 per cent in the in the close and less close scenarios respectively.[126]

103. Under the close economic partnership scenario, economic growth accelerates a little around 2020 and 2021, closing the gap a little with the May 2016 pre-referendum forecast baseline. At the end of 2023, GDP stands 1.25 per cent below the baseline. Under the less close scenario, there is a dip in growth after the UK exits the implementation period in 2021, and GDP stands 3.75 per cent below the baseline at the end of 2023. The unemployment rate stands at a little above and a little below 4 per cent at the end of 2023 in each scenario respectively.[127]

104. The Chancellor pointed to the pick-up in growth around 2020 and 2021 in the close economic partnership scenario as evidence of a possible "deal dividend".[128] The Governor told that Committee that a portion of this pick-up was due to a fall in uncertainty allowing a release of pent-up investment:

> [Investment] is in the order of 28 per cent cumulative growth over the five-year horizon. You get an acceleration of investment with a fall in uncertainty and retention of access to the market … .
>
> … We do feel that there is some pent-up investment. I will give you a number that I am confident in, as the counterfactual. Investment is now running at about 16 per cent below what had been projected pre-referendum, but that is understandable. There is uncertainty about the arrangements, so people have held back despite the strength of the global economy and other factors.[129]

105. Roger Bootle was less certain that investment was lower than it would have been had the UK voted Remain in 2016. He told the Committee:

125 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, p 40, Section 3.1
126 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, p 43, Table 3.1.1
127 Bank of England, *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*, November 2018, p 46, Charts 3.1.1 3.1.2
128 Q1295
129 Q1067–1068

> It is, of course, impossible to tell what investment or GDP would have been without the referendum vote, because we lack the counter-factual—that is a problem that besets all of economics. By contrast we do know, or sort of know, what happened to GDP, which is that it grew rather than falling into a recession the way the Treasury forecast.[130]

130 Q894

5 Fiscal implications of EU withdrawal

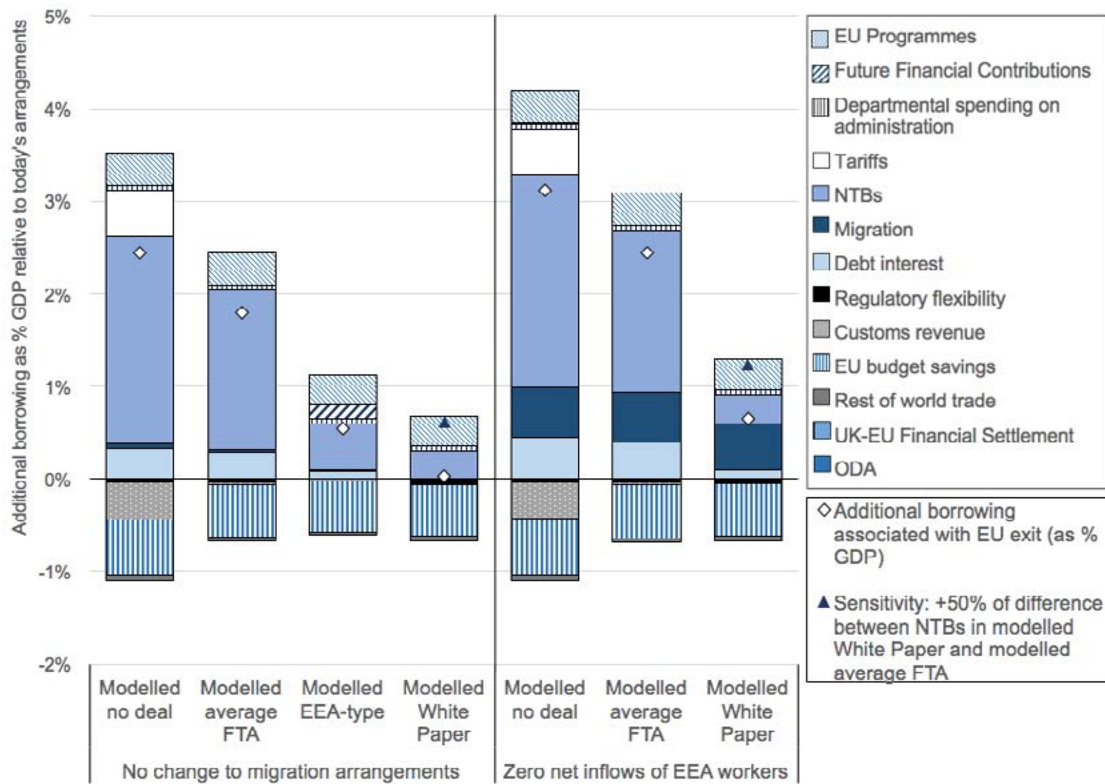
106. The Government's EU Exit Long-term economic analysis sets out the potential debt to GDP ratio in each of its scenarios in 15 years' time. In each scenario, debt to GDP is higher than it would otherwise have been. See table and chart below:

Table 4: Summary of impact on public sector net borrowing compared to today's arrangements (No change to immigration)

Additional borrowing associated with EU exit	Modelled no deal scenario	Modelled average FTA scenario	Modelled EEA-type scenario	Modelled White Paper scenario
As a percentage of GDP	+2.4	+1.8	+0.5	+0.0
In £ billions	+£95 billion	+£72 billion	+£22 billion	£1.3 billion

Source: Table 4.13a Government EU Exit: Long-term economic analysis

Figure 5: Extract from Government EU Exit Analysis: Impact on public sector net borrowing compared to today's arrangements, per cent of GDP in 2035–36 (Figure 4.9)



The EEA-type scenario has not been modelled with zero net inflows of EEA workers, as EEA membership requires free movement of people. In the modelled EEA-type scenario there are future financial contributions based on Norway's existing precedent. There are no future financial contributions assumed in the other modelled scenarios. The July White Paper set out that the UK will make an appropriate financial contribution where the UK participates in EU programmes or agencies, and this is open to negotiations.

The cost of the financial settlement and ODA in 2035-36 are small and not visible in the chart. The Technical Reference Paper includes a detailed breakdown of the fiscal results.

107. As with the changes to GDP over the analysis period, the majority of the difference is caused by the introduction of non-tariff barriers (NTBs). This impact is partly reduced by the net total of reductions in UK payments to the EU. The reductions in financial contributions and new discretionary contributions to the programmes the Government wishes to take part in are analysed separately.[131]

108. Only the modelled EEA scenario includes continued contributions to the EU. However, all scenarios include identical sums of money being paid to the EU for continued participation in EU programmes.[132] It therefore appears that the Government assumes that under an EEA scenario it would have to pay the same amount for discretionary access to EU programmes as in other scenarios in addition to its contributions to the EU budget.

109. Whilst not listed in table 4.13a of the Government's analysis, the White Paper 50 per cent Non-Tariff Barrier scenario would result in higher debt to GDP than both the EEA scenario and the central White Paper scenario.[133]

110. The Government assumes no fiscal response in any of its scenarios. Therefore, were the Government to make discretionary changes to Government spending in response to worse economic performance are not included in this analysis. Were discretionary policies to be included in response to worse economic performance—similar to the reductions in VAT or the Car Scrappage Scheme introduced after the 2008 financial crisis—such policies would increase debt to GDP further.

111. When the Committee raised the potential policy responses to a No-Deal scenario with the Chancellor he stated it was inevitable that fiscal response would be needed:

> It is implausible that in a No-Deal scenario the Government would not do anything. Of course we would do something. The kind of impacts that are being suggested by the Bank of England publication would elicit a fiscal policy response, and, of course, our fiscal rules are set in cyclically adjusted terms. The automatic stabilisers would operate, and over and above the automatic stabilisers, as I have just described, we have some discretionary fiscal fire power. I would remind the Committee—I think I have said this before—that what we are talking about is carrying out additional borrowing in order to support the economy in the short term.[134]

112. The Bank of England has made very clear that the nature of the shock that we are now talking about in the case of a No-Deal exit might make it very difficult for the Bank to be able to provide monetary policy support to the economy, because we would expect—I think the Bank have said this—the transmission mechanism to be through the exchange rate. We would expect to see inflation rise sharply in response to a reduction in the sterling exchange rate, and the Bank's normal monetary policy response to that would have to be to tighten monetary policy, not loosen it. I suspect that in that scenario the Bank of England would be looking firmly at the Treasury to respond through a fiscal policy response.[135]As discussed earlier in the report, the Government analysis does not include any short-term scenarios. The Bank of England has produced short-term scenarios, but

131 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p72, Figure 4.9
132 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p72, Figure 4.9
133 HM Government, *EU Exit, Long-term economic analysis*, November 2018, Cm 9742, p72, Figure 4.9
134 Q1298
135 Q1300

the Bank of England analysis does not consider the impact of its scenarios on debt to GDP. Therefore, the Committee has not seen any short-term analysis of what may happen to the public finances under different scenarios.

113. The 2.4 per cent increase in the debt to GDP ratio in the Treasury's No Deal scenario is significantly less than that incurred in the Financial Crisis, when it increased from 35 per cent in 2007–08 to 64 per cent in 2009–10.[136] When the Committee asked the Chancellor why this was the case, he said:

> It is widely accepted that the fiscal impact of a financially induced recession is usually more significant and more enduring than a demand [driven recession].[137]

114. **The Committee notes that the Government's economic analysis does not include any fiscal policies that would be required in response in any scenario. The Chancellor told the Committee it would be implausible for the Government not to respond in a No Deal scenario with automatic stabilisers and additional discretionary fiscal fire power. The debt-to-GDP figures in the Government's No Deal scenario therefore cannot be quantified.**

136 Office for Budget Responsibility, *Public finances databank*, 29 October 2018
137 Q1305

6 The impact on financial services

The impact of different withdrawal scenarios on the UK financial services industry

115. The Government's EU Exit Long-term economic analysis states that the financial services sector will contribute less Gross Value Added (GVA) in each of its modelled scenarios compared to remaining in the EU.

Table 5: Government's summary of trade-only impacts on financial services activity compared to today's arrangements

				Modelled White Paper	
Compared to today's arrangements (per cent in GVA)	**Modelled no deal**	**Modelled average FTA**	**Modelled EEA-type**	**Modelled *White Paper***	**Modelled White Paper with 50 per cent Non-Tariff Barrier sensitivity**
Financial Services	-9 (-11 to -6)	-7 (-9 to -4)	-1 (-2 to -0.8)	-0.8 (-3 to -0.2)	-4

Source: Table 4.6 of Government's EU Exit long-term economic analysis, figures in brackets are ranges.

116. Under the White Paper scenario, the financial services sector would lose its ability to sell financial services across the EEA via the EEA's financial services passporting arrangements. Without such passporting, the financial services industry would be unable to sell services such as lending, deposit taking, insurance, investment services, credit cards and asset management as it currently does.

117. Alternative access to the EU financial services market for companies outside of the EU can be achieved in a limited number of areas through a system of regulatory equivalence. However, the Government's White Paper states:

> These regimes are not sufficient to deal with a third country whose financial markets are as deeply interconnected with the EU's as those of the UK are.[138]

Instead the Government's White Paper states that "the existing autonomous frameworks for equivalence would need to be expanded, to reflect the fact that equivalence as it exists today is not sufficient in scope for the breadth of the interconnectedness of UK-EU financial services provision. […] The UK recognises, however, that this arrangement cannot replicate the EU's passporting regime."[139]

138 Department for Exiting the European Union, *The future relationship between the United Kingdom and the European Union*, 12 July 2018, p 29, para 62

139 Department for Exiting the European Union, *The future relationship between the United Kingdom and the European Union*, 12 July 2018, p 30, para 65

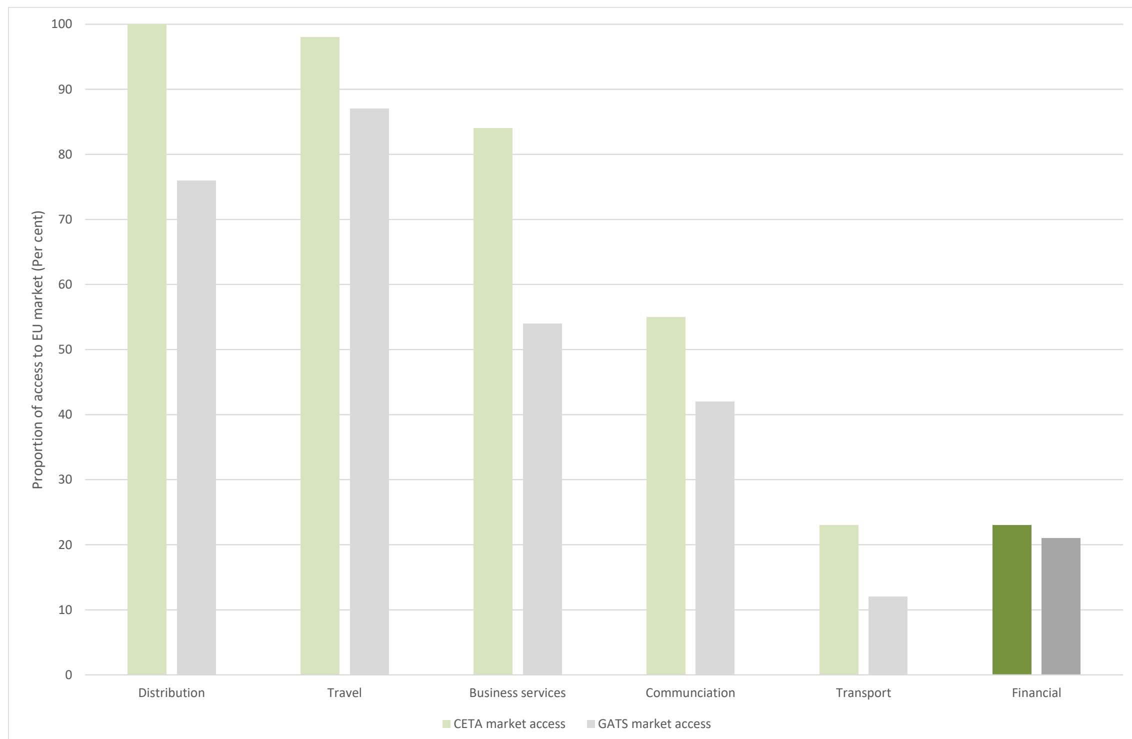
118. When asked why the Government's analysis suggested financial services would be better off without EEA passporting, Clare Lombardelli from the Treasury told the Committee the level of financial services trade is closely linked to the levels of goods trade, so the higher level of goods trade under the White Paper scenario compared to the EEA scenario leads to higher levels of financial services trade despite the loss of passporting.[140]

119. NIESR's report *The Economic Effects of the Government's Proposed Brexit Deal* states that:

> The extent of service sector liberalisation under GATS is low. The number of sectors that the EU is prepared to open to non-EU countries is small and as a result of that the arrangements that are likely to be negotiated for services trade are likely to be less ambitious than the trade in goods. [...] The sections in the Political Declaration that cover the service sector are imprecise and therefore open to interpretation, but there is no doubt that the scope of any agreement on services trade is set to fall well short of current arrangements.[141]

120. NIESR's analysis estimates that UK financial services access to the EU under a Free Trade Agreement or under WTO rules would be reduced by approximately 80 per cent, as shown in the chart below:

Figure 6: Extract from National Institute for Economic and Social Research, "The Economic Effects of the Government's Proposed Brexit Deal", Market access under CETA and GATS (Figure 7)



Source: NIESR, Magntorn, Winters

140 Q1325
141 NIESR, *The Economic Effects of the Government's Proposed Brexit Deal*, 26 November 2018, p 14

121. Dr Gemma Tetlow, from the Institute for Government, noted to the Committee that the insurance and long-term savings industry has raised concerns that the Government's approach of not seeking a continuation of passporting poses quite considerable risks.[142]

122. In contrast, Roger Bootle of Capital Economics told the committee that the ingenuity of the financial industry would mitigate most of the losses to access:

> The City of London has throughout its whole history been used to finding workarounds. It is immensely flexible. I suspect that the amount of business and jobs that will be lost directly to the continent—that may be what you mean by "access"—will be comparatively minor.[143]

Equivalence

123. The Committee examined the prospect of the UK and the EU recognising each other's regulatory frameworks for financial services as equivalent. Granting this equivalence would, amongst other things, make certain services and products provided by UK firms acceptable for regulatory purposes in the EU, and vice versa. The Political Declaration commits the UK and the EU to "start assessing equivalence with respect to each other … as soon as possible after the United Kingdom's withdrawal from the Union, endeavouring to conclude these assessments before the end of June 2020".[144]

124. Andrew Bailey, Chief Executive of the Financial Conduct Authority, told the Committee that there is substantial scope for improving the current EU equivalence regime:

> First, there is the scope of it, and how it operates in terms of scope and consistency, because it is a regime in Europe that, in my experience, has grown up step by step. Different bits of legislation have different equivalence provisions. Some of it reflects the passage of time and some of it reflects a sector. It doesn't look very consistent.
>
> […]
>
> The second thing is the process. It doesn't look very transparent. There is the charge that—it is true—the European Union can take it away at almost no notice. That is true and does not look very good. […]
>
> I do not think it is a system we would feel comfortable with, in terms of being able to give particularly firms a clear sense of, "Look, this is how it works. This is how you should interpret it," and also to say to third-country authorities, "This is how the system works."[145]

142 Q962

143 Q963

144 Department for Exiting the European Union, *Political declaration setting out the framework for the future relationship between the European Union and the United Kingdom*, 25 November 2018, pp 8–9

145 Q1008

The Chancellor also acknowledged the shortcomings of the existing equivalence regime, saying:

> We have always been clear that the current equivalence regime would be inadequate to deal with the scale of the UK/EU financial services relationship. […].
>
> The scope of the current EU equivalence regime is not wide enough. The methodology for applying it is too uncertain for multi-trillion-dollar commercial business to be able to be done on it.[146]

125. But the Chancellor also stated his belief that the EU recognises the problems with the current equivalence regime, and that both sides will work together to bring about the necessary improvements:

> I am confident from the discussions we have had that our partners in the European Union understand this. They have a red line, and we have deliberately and ostentatiously respected their red line. That is that the equivalence decision must always be an unencumbered sovereign decision made either by the EU or by the UK. […]
>
> What we need is a set of operational rules that means that those decisions are not suddenly applied in an arbitrary way. In other words, the regime has to be one within which commercial firms could reasonably operate. That means a certain period of notice if an equivalence decision is going to be withdrawn. Crucially, for our own macroprudential regime, it means that there has to be a high level of co-operation between regulators and supervisors in the EU and the UK. […]
>
> It has taken us a while to get there, but I think we now have a wide coalition on the European side, understanding that this is in all our interests. […] There is clearly a way forward on financial services co-operation that does work for both parties.[147]

Rule taking

126. During the implementation period, the UK would no longer have a vote in the European Supervisory Authorities, and it would no longer be part of the EU legislative process. As such, it could no longer directly vote upon legislative or regulatory actions that would impact upon the United Kingdom's financial sector. Yet, in the implementation period, it would have to implement such actions. This is sometimes described as being a "rule taker".

127. The FCA appeared comfortable with the risk of being a rule taker in the implementation period. Its impact assessment noted that "leaving the EU creates a number of risks for us regardless of the form of exit. The implementation period helps address these at the cost of a lower ability to influence regulation during that period, for example due to the removal of our voting rights in the [European Supervisory Authorities]."[148] This view was

146 Q1329
147 Q1329
148 Financial Conduct Authority, *EU Withdrawal Impact Assessment*, November 2018, p 6

confirmed by Sam Woods, Deputy Governor for Prudential Regulation at the Bank of England, who told us that "the net benefit of the implementation period in giving the country more time to get ready outweighs the rule-taker risk."[149]

128. However, there was concern about an extended or permanent period of rule taking. Andrew Bailey, told the Committee that "I do worry a lot about rule-taker risk, because I think in a world where we are outside it will be difficult if we are a pure rule taker with no influence."[150] However, he also said that:

> This is much more speculative, but we talk a lot about being a rule taker—I am guilty of this—and we are worried about the rule-taker issue. I think some people on the continent also ask whether there is a risk that it could work the other way around: that the UK becomes, in a sense, a rule maker in wholesale markets. That would put the question the other way round, particularly for those who wish to compete.[151]

129. The risks were also emphasised by the Governor, who explained them as follows:

> […] we have a huge financial sector in the UK. It is 10 times the size of GDP. It is the most sophisticated, complex and interconnected financial sector in the world. […] we would be uncomfortable not having some flexibility to ensure that it is appropriately regulated and supervised. We would not be comfortable […] outsourcing supervision of this incredibly complex and incredibly important financial sector. As everyone knows, part of the reason that the Bank of England is structured like this, has a financial stability remit and has to release its analysis of risk to Parliament when Parliament demands is that, in living memory, that sector brought the country to its knees.[152]

130. On the potential adoption of a "Norway model" for the UK's relations with the EU, Andrew Bailey noted that

> […] what I would say about the current Norway model is that in our world it is a rule taker model; they are members of the EEA and they are at the ESMA table, but they do not have a vote. In many ways, it is a pure rule-taker model. People will say—I get that there are many views on this—"Ah, but it would be different with the UK in that role, because we have big markets." Well, maybe, but we cannot give you any assurance on that.[153]

131. When pushed on the distinction between voting and non-voting members, in terms of influence and persuasion, Mr Bailey replied:

> I would say that at the moment, as I observe it, it is very important. There are three non-voting members: Norway, Iceland and Liechtenstein[…]. They are all there, and they do speak from time to time, but you obviously

149 Q1025
150 Q984
151 Q982
152 Q1025
153 Q984

> see the difference. Some of us have votes and others have not, and it does make a difference. But I reiterate that what I cannot tell you is how it would work with a big financial market in that role.[154]

132. After noting that voting frequency at ESMA "has been quite often", when asked whether voting was a meaningful thing, Andrew Bailey replied "Yes, it is" and added: "By the way, there are actual votes and then there are processes that lead to outcomes that might be consensual, but there has been an opinion-forming process, so it is not just the votes in that respect."[155]

133. The Chancellor appeared to take a more sanguine view of the rule-taker risk:

> I just want to put the rule-taking question in context. Let us take financial services. Over the years, the UK has been hugely influential in shaping the EU's financial services regulatory environment. We have not liked every single piece of EU financial services regulation, but we have been hugely influential.
>
> In my judgment, and the judgment of everybody I have spoken to on both sides of the table, we have not achieved that influence because of our voting power, because we do not have voting power. We have achieved that influence because of our expertise, our willingness to do the work and the excellence of the people we have deployed to work on these things. The UK has been able to influence through skill, knowledge, expertise and critical mass.
>
> […] We should not for one moment simply assume that we will no longer seek to influence. I have said before, and I am happy to say again here, that, once we have left the European Union, I imagine that we will have a very large and very active embassy in Brussels that will spend a great deal of time and effort seeking to make input to the debates that are going on within the European Union. […][156]

When pressed on whether the influence the UK has would change when it is not "round the table", the Chancellor replied:

> It will be a different kind of influence, but we also have to recognise that in a QMV [Qualified Majority Voting] environment we do not have a veto. I believe we have been influential because of the quality of our analysis. Even now, in discussions that go on all the time with European Union partners and the Commission, by far the most powerful argument is always a piece of calm, rational analysis that points out to them something that perhaps they have not quite identified themselves, especially if we are able to show an unintended and negative consequence that they would feel that they had not necessarily seen.[157]

154 Q985
155 Q987
156 Q1326
157 Q1327

No Deal preparations

134. In the event of No Deal, the FCA provides the following description of what would happen:

> For financial services, this would mean an abrupt end to UK firms' access to the single market. The single rulebook and provisions on regulatory cooperation would cease to apply in the UK. Instead, the UK would default to a 'third country' relationship with the EU. In this case, the terms of market access would largely be decided by the national laws of each member state and the EU rules on third countries. This would limit firms' ability to undertake cross border business without having to physically establish themselves in the relevant jurisdiction or meet additional local authorisation requirements.[158]

135. Sir Jon Cunliffe, Deputy Governor of the Bank of England, provided the following description of the cross-border financial services trade risks a No Deal would present, alongside mitigating strategies the UK has been able to adopt:

> The other area is whether there is cross-border trade between us and the EU in financial services where, if there were no permissions and equivalence and if passporting was lost, there could be difficulties. The FPC has been preparing and publishing a checklist of those issues for over a year now and we have isolated the largest issues. They were around cleared and uncleared derivatives, insurance contracts and data. […]
>
> On insurance contracts, the problem has been mitigated over the period by a number of UK insurance companies that sell into Europe and European companies sell that into the UK having set up UK or European entities and transferred those contracts. In the UK, the risk is taken away by the ability that Parliament has now given us to have a temporary permissions regime, so that European insurance companies can operate in the UK. On the European side, we believe there is still a risk. It has gone down but, from memory, about 9 million policyholders in the EU may not be able to depend on their UK insurance companies, because companies will not have the permissions to do what they need to do to pay claims.
>
> On the derivatives side, for derivatives that are not cleared, at the moment we have about £28 trillion notional of uncleared derivatives, of which about £13 trillion will exist after 29 March next year. That number is growing. We think the contracts will be safe after Brexit, but the ability to perform the so-called lifecycle events that firms use to manage their financial stability risks will be a doubt in a number of jurisdictions. There is no answer. The firms cannot move those contracts and, from the perspective of the FPC, there is a risk there that, were we to see a market stress in the event of Brexit, some risk-mitigation mechanisms that are normally available to companies will not be available to them.

158 Financial Conduct Authority, *EU Withdrawal Impact Assessment*, November 2018, p 6

> The last one I will mention is cleared derivatives, where we are about £60 trillion notional with £40 trillion maturing after Brexit. That number of those maturing after Brexit is growing, as we have discussed in front of the Committee before. On the UK side, Parliament has given us temporary permission regimes that can deal with it. On the EU side, there is a recognition now that there will have to be temporary permission for UK clearing houses to operate in Europe. We have had some more details since I last spoke to the Committee about what is required but, as the Financial Stability Report made clear last week, the clearing houses need a bit more definition of the conditionality, scope and timescale. Those are the risks.[159]

136. The economic analysis around a No Deal scenario has been described previously in this Report. The Governor provided us with the following reassurance on the ability of the financial sector to withstand such a scenario:

> We have made sure that the one thing you do not have to worry about is whether the banks have enough capital and liquidity, and are managing their risks. They are going to buffer this issue, if there is an issue. They are going to buffer it; they are not going to amplify it. […]
>
> We are already sleeping soundly at night, because the core of the financial sector is in the position that it needs to be in for the tough scenario. If it moves to an easier scenario, a fortiori, we are okay.[160]

159 Q1040
160 Q1043

Conclusions

Introduction

1. After an extensive exchange of letters and with discussion at various oral evidence sessions, the Committee expresses its disappointment that the Treasury did not provide all evidence that the Committee requested. The Treasury did not produce short-term analysis of any scenarios. The Committee is also disappointed that the Treasury modelled scenarios that have been rejected by the EU (i.e. Chequers) yet did not model scenarios that are considered probable and have the potential to be persistent over the medium to long term (i.e. the Backstop). And while the Office for Budget Responsibility now undertakes this sort of short-term analysis for the Budget and other fiscal events, the OBR can only forecast based on stated Government policy; the political declaration is only a statement of intent. Therefore, there is no short-term analysis of the deal upon which Parliament will vote. (Paragraph 10)

2. Notwithstanding this objection, the Committee is grateful that all institutions responded to the request in good time to enable the challenging programme of scrutiny and to allow a report to be produced ahead of the "meaningful vote". (Paragraph 11)

The Government's EU exit scenarios

3. CGE models are widely employed in economic analysis of international trade. The Government's model has the advantage of analysing decisions about trade at a significant level of sectoral detail. It also analyses the economy in the long term only, assuming there is full employment of capital and labour. As such, it does not show how the economy will transition to the new trading relationship, the path taken by inflation and unemployment, and whether the transition could result in increased structural unemployment. (Paragraph 18)

4. The White Paper scenario represents the most optimistic and generous reading of the Political Declaration, insofar as it is consistent with it at all. It certainly does not represent the central or most likely outcome under the Political Declaration, and therefore cannot be used to inform Parliament's meaningful vote on the Withdrawal Agreement. (Paragraph 25)

5. Parliament may prefer to draw from the range of the scenarios in the Government analysis, additionally informed by external analysis and comment, in order to assess the economic impact of the Withdrawal Agreement. (Paragraph 26)

6. Trade agreements can take four years to agree, and previous EU negotiations, have taken longer. The CETA deal took over eight. Therefore, the Committee believes it is feasible that the UK could enter the Backstop, despite it being neither the UK's nor the EU's preferred position. And it believes that the Government should have modelled the Backstop, making some broad-brush assumptions. (Paragraph 40)

7. The Government has provided long-term regional and sectoral analysis of a number of EU exit scenarios. However, the Committee notes that it did not include analysis

of the Backstop nor did the Committee receive short-term regional and sectoral analysis showing where losses and gains in jobs are most likely to be located as the economy adjusts to a new trading relationship. (Paragraph 50)

8. It is worth emphasising that the Treasury analysis makes no allowance for any other dynamic, domestic policy responses, such as policies developed under the Industrial Strategy, that could affect the impacts of the EU Exit scenarios on regional and sectoral growth. (Paragraph 51)

Key assumptions in modelling the economic impact of withdrawing from the European Union

9. The Committee finds it hard to fathom why the traders who currently trade only with the EU were not written to long before this time. And it is of the view that these and other preparations should have started sooner. (Paragraph 100)

Fiscal implications of EU withdrawal

10. The Committee notes that the Government's economic analysis does not include any fiscal policies that would be required in response in any scenario. The Chancellor told the Committee it would be implausible for the Government not to respond in a No Deal scenario with automatic stabilisers and additional discretionary fiscal fire power. The debt-to-GDP figures in the Government's No Deal scenario therefore cannot be quantified. (Paragraph 114)

Formal minutes

Monday 10 December 2018

Members present:

Nicky Morgan, in the Chair

Rushanara Ali	Alison McGovern
Mr Steve Baker	Catherine McKinnell
Colin Clark	Stewart Hosie
Mr Simon Clarke	Wes Streeting
Charlie Elphicke	

Draft Report (*The UK's economic relationship with the European Union: The Government and Bank of England's Withdrawal Agreement analyses*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 136 read and agreed to.

Resolved, That the Report be the Twenty-Fifth Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

[Adjourned till Tuesday 11 December at 9.00 a.m.

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Monday 3 December 2018

Professor Jagjit Chadha, Director, National Institute of Economic and Social Research, **Roger Bootle**, Chairman, Capital Economics, **Dr Gemma Tetlow**, Chief Economist, Institute for Government	Q866–972
Andrew Bailey, Chief Executive, Financial Conduct Authority	Q973–1010

Tuesday 4 December 2018

Dr Mark Carney, Governor, Bank of England, **Ben Broadbent**, Deputy Governor for Monetary Policy, Bank of England, **Sir Jon Cunliffe**, Deputy Governor for Financial Stability, Bank of England, **Sam Woods**, Deputy Governor for Prudential Regulation, Bank of England and Chief Executive Officer, Prudential Regulation Authority	Q1011–1082
Sir Tom Scholar, Permanent Secretary, HM Treasury, **Clare Lombardelli**, Director General, Chief Economic Adviser, HM Treasury, **Sam Beckett**, Director General, EU Exit and Analysis at the Department for Business, Energy and Industrial Strategy, **Susannah Storey**, Acting Director General at the Department for Exiting the European Union	Q1083–1188

Tuesday 5 December 2018

Dr Andrew Sentance CBE, Independent Business Economist	Q1189–1211
Professor Sir Stephen Nickell, Specialist Adviser to the Treasury Committee	Q1212–1244

Tuesday 5 December 2018

The Rt Hon Philip Hammond MP, Chancellor of the Exchequer; **Clare Lombardelli**, Director General, Chief Economic Adviser, HM Treasury; and **Susannah Storey**, Acting Director General at the Department for Exiting the European Union	Q1245–1339

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

EUN numbers are generated by the evidence processing system and so may not be complete.

1 ADS Group (EUN0041)

2 Andrew Sentance (EUN0045)

3 Bank of England (EUN0038)

4 Capital Economics (EUN0042)

5 Dr Gerard Lyons (EUN0053)

6 Dr Graham Gudgin (EUN0056)

7 Durham University Business School (EUN0049)

8 Economists for Free Trade (EUN0057)

9 Financial Conduct Authority (EUN0039)

10 HM Treasury (EUN0050)

11 Institute for Government (EUN0046)

12 Michael Burrage (EUN0054)

13 National Institute of Economic and Social Research (EUN0043)

14 Open Europe (EUN0048)

15 Paul Mortimer-Lee (EUN0040)

16 Professor Patrick Minford (EUN0055)

17 Professor Tim Congdon (EUN0047)

18 UK Trade Policy Observatory (EUN0044)

List of Reports from the Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website. The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

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First Report	Appointment of Sir Dave Ramsden as Deputy Governor for Markets and Banking at the Bank of England	HC 472
Second Report	Appointment of Professor Silvana Tenreyro to the Bank of England Monetary Policy Committee	HC 471
Third Report	The Solvency II Directive and its impact on the UK Insurance Industry	HC 324 (HC 863)
Fourth Report	Transitional arrangements for exiting the European Union	HC 473 (HC 850)
Fifth Report	Autumn Budget 2017	HC 600 (HC 757)
Sixth Report	Appointment of Elisabeth Stheeman to the Financial Policy Committee	HC 758
Seventh Report	Student Loans	HC 478 (HC 995)
Eighth Report	Appointment of Charles Randell as Chair of the Financial Conduct Authority and the Payment Systems Regulator	HC 838
Ninth Report	Childcare	HC 757 (HC 1196)
Tenth Report	Re-appointment of Alex Brazier to the Financial Policy Committee	HC 936
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Fourteenth Report	Re-appointment for Gertjan Vlieghe to the Monetary Policy Committee	HC 1056
Fifteenth Report	Women in finance	HC 477 (HC 1567)
Sixteenth Report	Appointment of Bradley Fried as Chair of Court, Bank of England	HC 1319
Seventeenth Report	Appointment of Professor Jonathan Haskel to the Monetary Policy Committee	HC 1318
Eighteenth Report	Appointment of Andy King to the Budget Responsibility Committee of the OBR	HC 1340

Nineteenth Report	Household finances: income, saving and debt	HC 565 (HC 1627)
Twentieth Report	Appointment of Jill May to the Prudential Regulation Committee	HC 1511
Twenty-first Report	Appointment of Professor Julia Black to the Prudential Regulation Committee	HC 1512
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Twenty-third Report	Re-appointment of Sir Jon Cunliffe as Deputy Governor for Financial Stability at the Bank of England	HC 1626
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First Special Report	Transitional arrangements for exiting the European Union: Government Response to the Treasury Committee's Fourth Report	HC 850
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Third Special Report	Autumn Budget 2017: Government and Office for Budget Responsibility responses to the Treasury Committee's Fifth Report	HC 757
Fourth Special Report	Student Loans: Government and Office for National Statistics responses to the Committee's Seventh Report	HC 995
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Sixth Special Report	Women in finance: Government Response to the Committee's Fifteenth Report	HC 1567
Seventh Special Report	Household finances: income, saving and debt: Government Response to the Committee's Nineteenth Report	HC 1627