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29 March 2021

Dear Rachel,

Thank you for your letter of the 5 March concerning our latest assessment of the economic impact of the UK's recently concluded Trade and Cooperation Agreement (TCA) with the EU.

Before addressing your specific request, let me briefly summarise the findings of the key pieces of analysis that the OBR has conducted on the economic and fiscal implications of EU exit since the conclusion of the referendum in June 2016. I will then come on to our current assessment of the TCA and what further analysis we are in a position to provide in future.

Major pieces of OBR analysis of the economic and fiscal implications of EU exit

In keeping with our mandate to produce regular medium-term economic and fiscal forecasts based on current government policy and to analyse the risks surrounding those forecasts, the OBR has produced a range of analysis concerning the economic and fiscal implications of the UK's departure from the EU. Given the limited resources at our disposal, this work draws heavily upon academic research and analysis by other institutions, including the *EU exit: Long-term analysis* produced by HM Government in November 2018. The key outputs and findings of our analysis include:

- Our **November 2016** forecast incorporated initial estimates of the effect that the vote to leave the EU would have on the economy and public finances. We incorporated a series of broad-brush assumptions about the economic and fiscal impact of Brexit that would be consistent with a variety of future trading relationships with the EU, given the absence of a meaningful basis upon which to predict the precise outcome of the negotiations. The most important assumptions were initial downward revisions to our trend productivity growth and net migration forecasts, which combined to reduce cumulative potential output growth over the 5-year forecast period by 2.4 percentage points.

- Our **November 2017** forecast set out our initial 'top-down' approach to forecasting post-Brexit financial flows between the UK and EU budgets. In the absence of firm policy detail, we assumed that the net fiscal savings of around £14 billion a year associated with these flows would be recycled into domestic spending in the UK.

- Our **March 2018** forecast included an initial 'bottom up' estimate of the UK's financial settlement ('divorce bill') with the EU. We estimated that the size of the settlement would amount to around £40 billion over the next 50 years.

- Our **October 2018** Discussion paper on *Brexit and the OBR's forecasts* explained how we expected to approach the task of making forecasts and projections in the pre- and post-Brexit environment. We also discussed how we would approach incorporating some associated policy decisions, including those related to migration, third-country trade agreements, regulatory changes, and tax and spending policies.

- Our **July 2019** *Fiscal risks report* included a stress test which explored the economic and fiscal implications of a 'no deal, no transition' outcome to the EU exit negotiations. The stress test was based on an IMF 'no deal' scenario and included a recession where GDP fell by about 2 per cent followed by a recovery that left potential output about 1 per cent lower than our previous forecast by the end of the scenario period.

- Our **March 2020** forecast incorporated estimates of the effect that trading under the terms of a 'typical' free trade agreement would have on productivity in the long run. We assumed that this channel would reduce long-run productivity by 4 per cent relative to remaining in the EU, with around one-third of this effectively already seen in the data due to post-referendum uncertainty weighing on business investment. We also assumed that the new migration regime would reduce output at the forecast horizon by 0.3 per cent.

- Our **November 2020** forecast included an alternative 'no deal' scenario that explored the economic and fiscal implications of the UK's trading relationship with the EU defaulting to World Trade Organization (WTO) terms. The scenario assumed that the impact would leave output 1½ per cent lower than our central forecast after five years, rising to 2 per cent in the long run.

- Our **March 2021** forecast included an assessment of the Trade and Cooperation Agreement, as well as estimates of the economic and fiscal impact of its first two months of operation. We forecast that the associated short-term disruption would temporarily reduce GDP by 0.5 per cent at the start of 2021. Our estimate of the impact of the TCA on long-run productivity was unchanged from the 4 per cent reduction incorporated into our March 2020 forecast, as we judged that the content of the TCA was broadly in line with the assumption of a 'typical' FTA that underpinned that earlier estimate.

Impact of the UK-EU Trade and Cooperation Agreement on our forecasts

Turning to our current assessment of the economic impact of the TCA, I should stress at the outset that it is not within the OBR's mandate or resources to discern and separately estimate the impact of the TCA and related policies on all the elements of our forecasts on an ongoing basis. Responsibility for the production of policy impact assessments of this nature lies with the Government. Its November 2018 *EU Exit: Long-term analysis* offers an example of this kind of comprehensive and detailed assessment of alternative future trading arrangements against a counterfactual of remaining an EU member state.

Our forecasts are instead produced in an iterative manner, incorporating policy and other developments as they materialise. When we update these forecasts, we aim to be as transparent as possible in explaining how and why we think the outlook has changed since our previous forecast, including where this relates to the changing nature of our economic relationship with the EU. As set out above, we have incorporated developments, decisions and data concerning the new EU trading and other arrangements as they have materialised over the past four years. So while we can identify these factors and explain their impact on our forecasts as they arise, it is not possible for us to provide a regular, comprehensive and detailed assessment of the collective impact of all EU exit-related decisions taken since the referendum or conclusion of the TCA.

Furthermore, the coincidence of the economic and fiscal shock associated with coronavirus at the same time as the end of the Brexit transition period also means that it will, in practice, be very difficult to isolate the contribution of the TCA to changes in the medium-term economic and fiscal outlook. These shocks have occurred on top of uncertainty about the underlying trend rate of growth in the economy following the post-financial crisis stagnation in productivity. Unpicking these different effects is likely only to be possible with the benefit of hindsight, will be challenging to undertake and will require substantially greater time and resources than are available to the OBR. Furthermore, disentangling these effects is not necessary to deliver our core mandate of producing regular economic and fiscal forecasts.

Moreover, it is explicitly outside the scope of the OBR's mandate to provide assessments of the sectoral, regional, or per household impact of government policy decisions, except where it is necessary to meet our core responsibility to produce medium-term economic and fiscal forecasts and assess the risks surrounding those forecasts. That said, we have, on several occasions, used the sectoral and regional analysis produced by the Government and independent organisations, to inform our key macroeconomic and fiscal forecast judgements. We will continue to do so where that is appropriate.

Taking these legal and practical constraints into consideration, our latest economic and fiscal forecast published earlier this month reflects the following impacts of the new UK-EU arrangements in the short and long run.

In the near term, our forecast assumes that the trade disruption associated with the implementation of the TCA will temporarily reduce GDP by 0.5 per cent in the first quarter of this year. Box 2.2 of our March 2021 *Economic and fiscal outlook (EFO)* sets this analysis out in more detail. We also assume the disruption will generate some cost pressures for UK importers, adding around a quarter of a percentage point to CPI inflation by the end of 2021. We will need to revisit these judgements in light of the latest UK-EU trade data and the Government's recent announcement to further delay the imposition of new checks and procedures on UK imports from the EU.

Over the longer run, our latest forecast incorporates the following assumptions regarding the impact of the new trading arrangements:

- We assume that the TCA will reduce **long-run productivity** by 4 per cent relative to remaining in the EU, unchanged from our March 2020 assessment. This largely reflects our view that the increase in non-tariff barriers on UK-EU trade acts as an additional impediment to the exploitation of comparative advantage. In order to generate this figure, we looked at a range of external estimates of the effect of leaving the EU under the terms of a typical free trade agreement (see Box 2.1 of our March 2020 *EFO* for more information). Our latest assessment is that the TCA looks broadly similar to the 'typical' FTA that was assumed in those studies and reflected in our forecasts since March 2020. We estimate that around two-fifths of the 4 per cent impact has effectively already occurred as a result of uncertainty since the referendum weighing on investment and capital deepening (see Box 2.2 of our March 2021 *EFO* for more information).

- We assume that both **exports and imports** will be around 15 per cent lower in the long run than if they UK had remained in the EU. The size of this adjustment is calibrated to match the average estimate of a number of external studies that considered the impact of leaving the EU on the volume of UK-EU trade (see our November 2016 *EFO* for more information). With similar impacts on export and import growth, the downward revisions to gross trade flows are broadly neutral in their effect on the current account over the medium term.

- We assume that the TCA will not have any material impact on **unemployment** over the medium term, Instead, the labour market impact of leaving the EU will be felt via weaker average earnings as a result of lower productivity.

- Our forecasts assume that the Bank of England will adjust monetary policy in order to keep CPI **inflation** at target in the medium term, so we have not made any adjustments here.

- We have not adjusted our forecasts to reflect the impact of **new trade deals with non-EU countries.** This is because most of these largely replicate deals that the UK already had as a member of the EU and in any case they are likely to have only a very small and gradual impact on GDP (see our 2018 *Discussion paper* for more detail). By way of illustration, the

Government's own economic impact assessment of one of the most important of the agreements concluded to date, the UK-Japan Comprehensive Economic Partnership, was that this agreement would increase the UK's GDP by 0.07 per cent over the next 15 years (see the Government's October 2020 *UK-Japan CEPA: final impact assessment).*

While not part of the TCA, since March 2020, our forecasts have also assumed that the Government's new post-Brexit migration regime will reduce net migration to the UK. We assume that these changes will reduce the future size of the population and also result in a small reduction in the labour market participation rate (due to the population effect being concentrated among those of working age). The combined effect is to reduce total employment by 0.4 per cent at the March 2020 *EFO* forecast horizon. We also assume a small increase in productivity via a 'batting average' effect as some low wage – and, therefore, lower productivity – workers will no longer be able to enter the country, thereby raising average productivity relative to the current regime. As we set out in our most recent *EFO*, net migration is also likely to have been significantly disrupted by the coronavirus pandemic. Some recent analysis suggests that there may have been significant net emigration from the UK over the past year, leaving the total population and workforce materially smaller.[1] As discussed above, this is likely to make discerning the contribution of EU exit to future trends in net migration and participation of EU migrants in the UK labour force very difficult.

Regarding our fiscal forecast, the main impact of the TCA will be the indirect effects associated with the economic developments set out above, although these will also be difficult to disentangle from the more dramatic shock to the public finances associated with the coronavirus pandemic. Our spending forecasts continue to incorporate the impact of the previously agreed 'divorce bill' as set out in more detail in our March 2018 *EFO*. They also capture the fiscal costs of EU replacement programmes, including the UK Infrastructure Bank announced last month. Our revenue forecasts incorporate the tariff revenue collected on both EU and non-EU trade based on the UK Global Tariff introduced on 1 January 2021. Annex A of our November 2020 *EFO* sets out more detail on the fiscal implications of the UK's new customs regime for both EU and non-EU trade.

Plans for further analysis of the Trade and Cooperation Agreement

Significant uncertainty remains both around some of the outstanding elements of our future economic relationship with the EU (e.g. with respect to financial services) as well as the response of firms and households to the new trading arrangements. We will continue to update our forecast assumptions as existing arrangements are revised, new agreements are reached, and new data emerges, in our *Economic and fiscal outlooks* and other publications.

In our next forecast, we will take account of any specific UK-EU agreements that have been concluded concerning trade in financial services and the insights from data on UK-EU trade flows since

[1] For example, see: ONS, *Exploring how the UK population and workforce are changing in the pandemic*, March 2021.

January 1. We will also incorporate the Government's recent decision to further delay the full implementation of controls and checks on EU imports until January 2022. And we will need to take stock of the impact of the pandemic and the more restrictive migration regime on the current stock and future flows of foreign-born workers in the UK.

Thank you again for your letter. I hope this response provides you with a useful overview of the analysis we have provided, and will continue to provide, on the economic and fiscal impact of the UK's departure from the EU, consistent with our legal mandate and resources.

Yours sincerely,

Richard Hughes
Chairman