

Treasury Committee

Oral evidence: The UK's economic relationship with the European Union, HC 473

Wednesday 5 December 2018

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Members present: Nicky Morgan (Chair); Rushanara Ali; Steve Baker; Colin Clark; Mr Simon Clarke; Charlie Elphicke; Stewart Hosie; Alison McGovern; Catherine McKinnell; Wes Streeting.

Questions 1245 - 1339

Witnesses

I: 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.

Examination of witnesses

Witnesses: The Rt Hon Philip Hammond MP, Clare Lombardelli and Susannah Storey.

Q1245 **Chair:** Thank you for being here. Your 90 minutes start now.

Mr Philip Hammond: You might like to have a word with the Speaker about that, madam Chairman.

Q1246 **Chair:** For the benefit of the tape, perhaps you could all introduce yourselves again. Chancellor.

Mr Philip Hammond: Thank you. I am the Chancellor and I have with me Clare Lombardelli, who is the chief economist at the Treasury, who has been working on the economic analysis, and Susannah Storey, who is director general at DExEU, which is the Department with overall responsibility for co-ordinating this cross-government work that has been done on the economic model.

Madam Chairman, before we start, could I take this opportunity to give the Committee a piece of information about the spring statement? As you know, we are required to give the OBR at least 10 weeks' notice of the requirement for a forecast, so I have today given the OBR 10 weeks' notice in order that we will be able to have a spring statement no earlier than 26 February—so when the House comes back from the February recess. The spring statement will be sometime between the end of the February recess and the end of March. I will give the Committee more information in due course, but I thought you would like to know that the OBR has been given that warning today.

Q1247 **Chair:** Thank you. First, it is very nice to see Susannah and Clare back before the Committee so soon. Obviously, that notice triggers, and we will look forward to seeing you back before the Committee when the spring statement takes place.

Time is short today. This is the final oral evidence session in our inquiry on the withdrawal agreement and the political declaration before the House of Commons before MPs get to vote on it next Tuesday evening.

Chancellor, on 27 June I wrote to you setting out a formal request for the Government's analysis. On 23 August you wrote to me "to reiterate a previous commitment" the Government had made, and you said, "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."

The Government analysis published last week has no specific analysis of the political declaration, no analysis of the backstop and no short-term analysis. Why not?

Mr Philip Hammond: I do not agree with that assessment. The deal that we have negotiated with the European Union in terms of the trade



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arrangements, which is at the centre of this economic analysis, provides for a range of outcomes. The only logical and sensible way to approach a modelling exercise around this kind of scenario is to model a range of outcomes. That is what we have done. At one end of the range is the White Paper, which clearly sets out the Government's preferred embodiment of what has been agreed in the partnership—in the framework agreement. At the other end of that range is a sensitivity that represents only 50% of the reductions in non-tariff barriers between the White Paper scenario and the free trade agreement scenario being achieved, so I think a broad range of outcomes.

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.

Q1248 Chair: But you would accept that the deal that Parliament—the House of Commons—is going to be voting on next Tuesday night, as in the draft withdrawal agreement and the 26-page political declaration, is not Chequers.

Mr Philip Hammond: It allows for the White Paper that the Government have published following Chequers. It would accommodate that outcome, but, of course, as we have recognised in the document, not everybody in the European Union accepts all of our aspirations in the White Paper, so there will be further negotiation required.

Q1249 Chair: Would you accept that there is no specific analysis in the Government's analysis of the future political declaration, nor analysis of a spectrum of outcomes that could be achieved under that political declaration?

Mr Philip Hammond: The two points that are modelled as the White Paper outcome and the White Paper variation, with a 50% reduction in non-tariff barriers achieved, represent, in our view, a reasonable range of possible outcomes from the political declaration, which defines quite a number of important parameters of the future arrangement but does not define every detail.

Q1250 Chair: Okay, but do you accept that the backstop is a critical part of the withdrawal agreement? I think we can agree it is a politically contentious part of the withdrawal agreement. There is no economic analysis of the backstop.

Mr Philip Hammond: The exercise that the Treasury, DExEU, DIT and the other Departments have undertaken is a long-term economic analysis looking at the steady state, the equilibrium state, at approximately 15 years out from the trigger event. The backstop, were it ever to be used, is clearly expressed to be a temporary arrangement. Therefore, it cannot be reflected in a long-term analysis.

Q1251 Chair: Also, you would accept, therefore, that there is no short-term



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analysis in the Government's economic analysis.

Mr Philip Hammond: Absolutely. The Government's economic analysis is using a long-term, computable general equilibrium model, which shows what the steady state of the economy will be after it has adjusted to a shock. The Bank of England has produced, as you know, short-term analysis, and the Bank is much better equipped to do that than the Treasury; it does it as part of its routine work for both the MPC and the FPC. The OBR also does short-term modelling work. The Treasury looks at the long-term, and the models that we have available in Government are long-term models.

Q1252 **Chair:** On 27 June I wrote to you—and the letter you wrote back to me replied to it—and said that the Committee wanted, "(i) the long-term, steady-state economic and fiscal impact of the choices facing Parliament, and (ii) the short-to-medium-term path for the economy and the public finances towards that state."

Would you agree that you have complied with point (i) of that letter but not point (ii)—the short-to-medium-term path for the economy and the public finances?

Mr Philip Hammond: 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.

Q1253 **Chair:** No, we were told that yesterday, and we have understood from evidence this morning as to why that is the case. What we also heard yesterday from witnesses was that it was the Cabinet that signed off on the scenarios that are included in the Government's economic analysis. Is that correct?

Mr Philip Hammond: Yes. The Cabinet was given a document that showed the scenarios to be modelled and the key assumptions that would be used in the modelling. The Cabinet agreed that that represented an appropriate range of scenarios and that the assumptions were appropriate.

Q1254 **Chair:** Was the Cabinet given the letter that this Committee has written to you when we asked for the scenarios and the type of analysis that we asked for? Did it understand the gap between the two, basically?

Mr Philip Hammond: I am not sure that the Cabinet was given the letter. The Cabinet was given a document produced by the cross-Whitehall group proposing the scenarios and the assumptions.

Q1255 **Chair:** Finally from me, a Treasury official confirmed to this Committee yesterday that the Government analysis uses a model that cannot tell us anything about unemployment and the adjustment costs of redeploying jobs and capital across regions and sectors.

We, as politicians, know that how our regions and sectors react over the next few months is going to be extremely important for the prosperity of



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our constituents. Would you agree, therefore, that what has been published by the Government offers a very partial picture of the economic impact of Brexit?

Mr Philip Hammond: No, not at all. It is right, of course, that, because one core assumption of the model is full employment, it cannot show the unemployment impact, but it is not trying to show the short-term adjustment path. It is trying to show the long-term equilibrium effect on the economy.

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?" It shows, for each of the scenarios, how different the economy would look, all other things being equal, at 15 years out.

The Bank of England's work addresses a different question because its modelling has a five-year time horizon. It looks at the question of how the economy will transmit the shock and how the adjustments in the economy will be made over that five-year period through changes in patterns of employment, patterns of activity, inflation, currency adjustments and so on.

Chair: I will return to that, but I am going to bring in Rushanara.

Q1256 **Rushanara Ali:** Good afternoon. Chancellor, you have said that the UK will be worse off "in pure economic terms" under all Brexit outcomes. You have also stated in the past that people did not vote to be poorer, which many people will agree with. Can you reconcile these two positions?

Mr Philip Hammond: Yes. The analysis clearly shows that leaving the European Union under any scenario that we are modelling has a cost—an economic cost. In the case of the White Paper proposal, that cost is very small at 15 years out, but it is still a cost, so the point is rightly made.

My own judgment is that we need a way forward that heals our country. We have a deeply fractured country, with opinion heavily polarised and trust in the political system correspondingly damaged. I would suggest to the Committee that divided countries are not successful countries. I have thought long and hard about this because you know where I started from in this debate two and a half years ago.

I have come to the conclusion that the future success of our country depends on us executing the instruction of the British people in the referendum, leaving the European Union, but doing so in a way that minimises the impact on our economy and maximises the opportunity that we have in the future so that we can come together as a nation and work together to exploit those opportunities in the future. Any solution that left the country divided, left a large segment of the population feeling betrayed, in my view, would have a negative political and societal



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impact that would far outweigh the very small economic impact that the White Paper scenario is showing here.

Q1257 Rushanara Ali: No one could disagree with the need to unite the country and heal the divisions, but would it not be an underestimation to say that the impact would be minimal, given some of the projections, whether they are the Treasury's or the Bank of England's and others, that we are going to be worse off, in your own words, even in the best possible scenario? Yet the Prime Minister said last week that the Government's analysis does not show that we will be poorer in the future than we are today.

If we want to bring the country together, we need to be straight with the public about what the consequences are, but there does not seem to be agreement between the position that you have taken and some of the findings that are coming through in the various assessments, including the Treasury's, and what gets said, including in the Prime Minister's comments.

So how do you expect the country to come together when, in certain regions, people are going to be worse off? The lack of a short-term Treasury assessment means that we cannot reassure our constituents. My constituency will be very heavily hit by uncertainties around passporting rules, service sector issues and what the future relationship will hold for financial services and others in relation to goods and trade.

How on earth, in real terms, are we going to make sure the country is brought together when people are going to be poorer as a result of the EU withdrawal agreement or other scenarios in the scenario of being in a no-deal situation?

Mr Philip Hammond: First, there is no difference between what the Prime Minister said at the Liaison Committee and what I have just said—and have said many times before. Almost certainly—and these are not economic forecasts; these are scenarios—on any reasonable forecast of the economy's growth pattern, in all these scenarios people will be better off in 15 years' time because economic growth will resume, and there will be economic growth throughout this period. People will not be poorer.

It will be true to say that the economy will be of a smaller size overall; how much depends on which scenario, but the economy will be of a smaller size. That is not the same as saying people will be poorer, and, with respect to Mr Hosie's question at PMQs, it is not the same as saying that economic growth will be lower. It does not say anything about economic growth. It says something about the baseline from which measurement of growth over a period of time is made.

Q1258 Rushanara Ali: With respect, you are talking about 15 years, but in the next 15 years people are going to face major challenges. For anybody thinking about what their future holds, the short term and the medium term is of grave concern to a lot of people in the country.



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Mr Philip Hammond: You rightly commissioned some short-term analysis from the Bank of England in order to look at what the path of adjustment would be and what the impact of that would be over the short term. That is a perfectly legitimate thing to do. What it shows, of course, is that, of the five scenarios modelled, the White Paper scenario is by far the most benign, both in the short term and the long term, which is why we believe this is the right way forward for the country.

Q1259 **Rushanara Ali:** What happens if that “right way” in your view is not supported by Parliament next week?

Mr Philip Hammond: If Parliament does not agree to go forward with the negotiated proposal, clearly, we are in uncharted territory, but the important thing is that, when Parliament makes that decision, it and all Members of Parliament are fully aware of the implications of adopting any of the other scenarios as a way forward. That will have consequences both in the short term and the long term for our economy, and it is important that people understand that.

Q1260 **Rushanara Ali:** Do you think it is right that Parliament should be placed with that kind of choice, being put between a rock and a hard place, which is something that many have warned about right from the beginning, and the narrative, “It is either this deal or no deal”? Is that a responsible way to run the country, Chancellor?

Mr Philip Hammond: I do not think Parliament is being placed in that position. Parliament may choose to put itself in that position, but manifestly—

Q1261 **Rushanara Ali:** That has certainly been the rhetoric.

Mr Philip Hammond: Let me—

Q1262 **Rushanara Ali:** Including the Prime Minister’s rhetoric.

Mr Philip Hammond: Let me—

Chair: Let the Chancellor answer.

Mr Philip Hammond: Let me recall the sequence of events. Parliament has voted to ensure that we will leave the European Union on 29 March. We have legislated for that. Now Parliament has to decide what arrangement we will put in place before 29 March to manage the transition and the longer-term end state.

The Government have negotiated a deal and proposed it to Parliament. If Parliament does not choose to adopt that deal, Parliament will have to form a view, I guess, on which of the other scenarios it likes the look of.

Q1263 **Rushanara Ali:** Do you have a preference?

Mr Philip Hammond: Yes; I do have a preference—for the White Paper.

Rushanara Ali: If that got voted down, do you have a preference?



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Chair: We are going to move on, because one scenario that could unfold, of course, is a no-deal situation, about which I know Steve wants to ask.

Q1264 **Mr Baker:** I am very keen to ask about no deal, Chancellor, but can I pick up on some of the things you have just said? These CGE models are about comparative policy analysis, are they not? They are about comparing—

Mr Philip Hammond: Yes.

Q1265 **Mr Baker:** Thank you. For example, Open Europe have just written to us and pointed to PwC research saying that UK GDP could be over 10% higher across the same period to 2030 if we exploited advances in artificial intelligence. These CGE models do not include things like that, do they?

Mr Philip Hammond: This modelling is not intended to represent a forecast of the growth of the economy. The speed with which the economy adopts advanced technology, including artificial intelligence, in any of these scenarios will affect our GDP 15 years out. I would guess—and I defer to my chief economist—that, in any scenario, the quicker the economy adopts technologies such as AI, the faster our growth and the larger our GDP will be at the 15-year horizon.

This analysis is attempting to give us a sense of the ranking order of the different outcomes in terms of the impact on the size of our economy at 15 years, because there is no reason to imagine that the ability of the economy to adopt new technology would be greater or less depending on which of these scenarios we adopt.

Q1266 **Mr Baker:** I want to put to you something from Open Europe. I think you have acknowledged before that the assumptions that go into these models are extremely important, and Open Europe have slightly different assumptions. But they have written to us saying: “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 a positive direction.” Do you recognise that analysis from Open Europe, which is based on subtly different assumptions?

Mr Philip Hammond: It depends what you mean by “dramatic.” In one of the modelled scenarios here, GDP is 9.3% lower 15 years out compared with today’s arrangements. That, to me, represents a needless loss of consumption in the economy.

Q1267 **Mr Baker:** But Open Europe—I just want to make the point and move on—are saying that in a no-deal Brexit the hit to GDP growth could be 2.2% by 2030, mitigated to 0.5% if we took unilateral action, which is why they are saying it is really neither here nor there.



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Mr Philip Hammond: I am not sure I agree with that number. You said GDP growth. Did you mean cumulative GDP?

Q1268 **Mr Baker:** Forgive me. It says: "The economic impact for no-deal Brexit where tariffs are raised on our trade with the EU could result in a hit to GDP growth of 2.2% by 2030. This material but small effect could be reduced to a 0.5% hit if the UK took unilateral action." That is by 2030. This is why Open Europe are saying, because their assumptions differ somewhat—and I do not mean to particularly labour the assumptions this afternoon, because I want to ask you about the Bank of England scenarios, by just asking you—

Mr Philip Hammond: Let me ask Clare to make a comment on that.

Q1269 **Mr Steve Baker:** The selection of assumptions can give quite significantly different views.

Mr Philip Hammond: Of course it can. Before I ask Clare to answer that, of course it can, and the assumptions must not be thought of as things that are just plucked out of thin air; they are based in most cases on extensive literature or on evidence that we have available to us. Clare.

Clare Lombardelli: As we discussed yesterday, the assumptions that we have taken are all set out here and, as the Chancellor says, are based in the literature. My understanding of the Open Europe assumptions is that they differ particularly in two areas. One is around regulation, where, as we discussed yesterday, I think they take more aggressive assumptions; and we know where regulation makes a difference is around labour market regulation, product safety and environmental regulations. The Government have already said they do not seek to be reducing regulation in those areas.

The other area where they make a big difference is around the question of unilateral tariff liberalisation, where we have shown what happens if you were to do that. Of course, you can unilaterally reduce your tariffs. What you cannot do is control how much other people will reduce their non-tariff barriers. So, with regard to some of the assumptions around whether or not in the EU they would, for example, actually check our goods—those sorts of things—we have taken a different assumption.

Mr Baker: Thank you. I would love to spend an hour on this particular subject, but I have four minutes.

Chair: You have four minutes.

Q1270 **Mr Steve Baker:** Chancellor, just thinking about the Bank's two scenarios, I think it is fair to say they were very clear with us yesterday that the purpose of this analysis was scenario planning, not forecasts. To paraphrase, but I use some of their words, it said that they are highly unlikely scenarios to enable them to sleep soundly in their beds knowing that the financial system is robust to whatever may happen.

Do you think the Bank was adequately clear with you about the purpose



of its scenarios to ensure security of the financial system?

Mr Philip Hammond: We certainly understand that these are the Bank's stress-testing scenarios, where the Bank necessarily looks at a reasonable worst case. Indeed, in the Government's own civil contingencies planning work, "reasonable worst case" is the benchmark that we use. We look to plan to be able to manage the reasonable worst-case outcome, and these scenarios from the Bank represent the Bank's assessment of reasonable worst case. Of course, the good news is that even in the worst reasonable worst case, because of the strengthening of our financial institutions and our financial systems, the stress test shows that the financial system would be resilient even to that reasonable worst case. That is the good news.

Q1271 **Mr Baker:** Thank you, Chancellor. The Bank also told us about its reports from its network of agents. It said that "the corporate sector is in general not yet well equipped to cope with a 'no-deal' Brexit." It cast doubt on the readiness of port and transport infrastructure. Could you tell us a little about how domestic preparedness has accelerated since Chequers, where the Cabinet took a decision to put in place that acceleration?

Mr Philip Hammond: Yes. 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.

The Department for Transport is engaged in actions and negotiations even as I sit here around trying to improve resilience at the channel ports, so there is a great deal of work going on. I think what the Bank of England's agents' reports show, and it is not the only insight that we have into this, is that, while Government can plan from their side, there are two things that are to different but considerable extents beyond our control.

We cannot control the extent to which European Union counterparts engage with us, and the level of engagement we have had on, for example, border management planning is patchy. Some is better than others; sometimes it stops and then starts again. There are, I think it is probably fair to say, differences of view in some cases between national authorities and Brussels about how much engagement and what form of engagement.

The other area that we, of course, do not control is the planning that private businesses are carrying out, in particular the investment that private businesses are making, because any change in processes, procedures or business model requires some level of investment in training, software and equipment.

Chair: We are going to move to Charlie, who will follow up.

Q1272 **Charlie Elphicke:** Chancellor, in October last year I asked you how you



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thought that Britain would be better off as a result of Brexit. You said at that time: "We will have the freedom to make our own decisions. I hope we will exercise that freedom in a way that maximises the interests of the British people, protects our jobs, our businesses and our prosperity for the future."

Considering how the Prime Minister's deal would leave us as a rule taker and that the backstop could stop us from ever leaving, how can you support the deal on offer?

Mr Philip Hammond: We could spend a lot of time in this Committee rehearsing the backstop point. I think it has been well rehearsed in the Chamber and again just recently. I do not accept the characterisation of the backstop as something that could endure forever.

If I may, I will make a general observation as someone who has had quite a lot of engagement with the EU over the last few years. I think there is a general tendency by politicians in the UK to underestimate the extent to which the EU is a highly bureaucratic and legalistic organisation. It might be tempting for us to think that the EU makes casual commitments in 26-page documents and will not pay any regard to them.

My observation is that that is not the way the EU works. Because it is an organisation composed of 28—soon to be 27—members, because it is built on a basis that is highly legalistic and law-driven, I believe that the EU does demonstrate, and through the negotiation has demonstrated, that it treats the commitments and obligations that it makes very seriously. It does not make them casually. We will go into the negotiation of the legal text on the basis that the EU will faithfully interpret what has been agreed in this text, and I have no doubt that it will do so.

Q1273 **Charlie Elphicke:** They could use their best endeavours for years to come. Is not the reality, though, that modelling the White Paper, which has been rejected, is a fantasy, and the backstop is reality, and if the backstop is enduring will that be good for the UK?

Mr Philip Hammond: I do not think the backstop is a good place to be at all, and I have said before that we should use every effort to make sure we never get into it. I am quite sure that we will succeed in doing that. I do not think we will go into backstop, but, if we did go into backstop, it cannot be a permanent arrangement.

The Attorney General said very clearly to the House on Monday—and it has always been my view—that there are sufficiently large numbers of people inside the European Union whose interests would be critically damaged by the UK being in the backstop, with all the access that provides, that they would take action at the European Court of Justice to strike down the backstop as something that could not endure under article 50. It can operate as a temporary arrangement under article 50, but article 50 does not have the scope to provide for an enduring arrangement.



Q1274 **Charlie Elphicke:** Nevertheless, if it was down to you, would you prefer to see the backstop time limited?

Mr Philip Hammond: Obviously, if it were on offer to us to have a backstop time limited, that would be attractive, but it is not on offer. The backstop provides the ultimate insurance that the EU has always been clear, since December 2017, it would require in any negotiated agreement that, whatever the future outcomes, there are arrangements for an open border in Ireland—not just a declaration that we will keep the border open or that we will never build border infrastructure, but a practical, working model that shows how we would give effect to that in terms of trading goods across the border.

Q1275 **Charlie Elphicke:** Now it is four months away and you are just saying that a whole load of letters got sent out yesterday. Can you explain why the Government did not engage much sooner with business?

Mr Philip Hammond: Government have engaged with business, but we have had to take a series of decisions about the balance between helping business to be properly prepared and creating more uncertainty that would be damaging to the economy. Clearly, we have wanted to give a message of reassurance to business, but at the same time it is necessary to ensure that businesses that might need to take actions in the unlikely event of a no-deal exit are aware of what actions they would need to take and have a reasonable period of time in which to do so.

Q1276 **Charlie Elphicke:** Chancellor, everyone knows how important the port of Dover, which I represent, is to UK trade, and the channel ports make up a third of the UK's entire trade in goods. There is always a chance that we might end up leaving the EU with no deal. Why has so little been done to prepare Dover and the channel ports for no deal so far?

Mr Philip Hammond: I do not agree that "so little" has been done. You will know better than most that the significant things that would need to be done at Dover in the longer term if we were to end up having a WTO-type trading arrangement with the European Union would involve some very significant infrastructure works that could not be done in a matter of months; they would take years to complete.

Q1277 **Charlie Elphicke:** Two years.

Mr Philip Hammond: I would suggest, to be very frank with you, that the planning system might struggle to approve such significant infrastructure changes in two years, never mind getting them built. I think it would take quite a lot longer to deliver the kind of major infrastructure changes that might be needed if we were going to be looking at a long-term, WTO-type trading relationship. But we have sought to engage with the big port operators on measures that they can take—software adjustments that they would need to make. HMRC is in discussion with all of them and has been for some time.

Q1278 **Charlie Elphicke:** Two thirds of my constituents in Dover and Deal voted



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to leave the European Union, and this was despite blood-curdling “project fear” claims in 2016 of mass unemployment and a recession. Why should they believe Treasury forecasts now?

Mr Philip Hammond: I do not want to add to any blood-curdling claims, but I would say to them that we are not there yet, and, if traffic volumes were reduced through the port of Dover as a result of restrictive operation of customs processes on both sides of the channel, that clearly would have impacts.

More generally—I have said it to the Committee before and I say it again today—the forecasts that were made in 2016 were not based on robust assumptions. The assumptions were transparent, but they did not come to pass. The assumptions that were made were immediate serving of an article 50 notice, no monetary policy response and no fiscal policy response. That was not what happened. This exercise is different. This exercise is ranking scenarios over the longer term and is fundamentally a more robust exercise.

Q1279 **Catherine McKinnell:** Chancellor, yesterday the Government officials told the Committee—and you have confirmed this again this afternoon—that they have not undertaken the short-term analysis because the Bank was to do that.

Mr Philip Hammond: Yes.

Q1280 **Catherine McKinnell:** The Bank told the Committee that it had not carried out regional analysis in the short term because that is not within its remit. We have had an explanation that that is the job of the OBR, but the OBR has not been tasked with undertaking that, so there is no short-term regional analysis. Would you agree that the absence of such analysis is deeply problematic?

Mr Philip Hammond: There are good reasons why there is not a short-term regional analysis in here, which I am sure Clare explained to yesterday but could do so again.

Q1281 **Catherine McKinnell:** No. I do not want to repeat that because we do not have much time. I want to know if you think it is problematic.

Mr Philip Hammond: Let me just go to the OBR. The OBR answers to Parliament, and the question of whether or not the OBR should be tasked with something is a question for Parliament.

Chair: Catherine is asking a different question.

Q1282 **Catherine McKinnell:** No, Chancellor, I really do not want to go round the houses on who should be doing what and where, because it is the Government putting this forward and asking us to vote for it. There is no regional analysis on the impact in the short term. Do you not agree that that is problematic when Members from up and down the country—from the north-east—are being asked to vote on an agreement when we do not actually know what the short-term and medium-term impact is going



to be on our constituents?

Mr Philip Hammond: Yes. Let's take a no-deal Brexit. It is very difficult to model how the shock to the economy would be transmitted, because, of course, it depends on many millions of individual decisions.

Q1283 **Catherine McKinnell:** Chancellor, I am not talking about no deal. I am talking about the deal that the Government are asking us to vote for next week and what the short-term to medium-term impact will be.

I will give a very concrete example, because the analysis shows clearly that certain sectors and certain groups of people will be impacted. We have heard evidence that those particularly exposed to leaving the EU "tend to be older men with skills specific to their occupation who, history suggests, may struggle to find equally well-paid work if their current employment were to disappear." Do you not share the same concern for that group of people?

Mr Philip Hammond: Yes, I do, and I think we can say something clearly from this analysis. We can say that an outcome that has a lower negative impact on trade with the EU will have less likelihood of those negative outcomes, and we can say that regions that have greater exposure to trade with the EU are more vulnerable if we see a scenario that has a larger negative trade outcome.

Although there is not modelled numeric analysis, I think the ranking is clear. For a region that has a high level of goods export exposure to the European Union, the modelled White Paper outcome will clearly be the best outcome in terms of protecting jobs and regional GVA, and the no-deal modelled outcome will clearly be the worst outcome. For a region that has less exposure to goods exports but a high exposure to financial services exports, the ranking may be slightly different.

Q1284 **Catherine McKinnell:** In terms of the projections for full employment within 15 years, presumably—

Mr Philip Hammond: It is not a projection; it is an assumption.

Q1285 **Catherine McKinnell:** I am sorry—the scenario planning. Are you expecting, and is there some evidence within the assumptions, that there will be movement of labour, and so regions that will be more affected by whatever Brexit scenario will expect people to get on their bikes, in the words of Lord Tebbit?

Mr Philip Hammond: Do you mean geographical movement?

Q1286 **Catherine McKinnell:** Yes, and just move elsewhere to find employment. Are we moving back to that?

Mr Philip Hammond: As to how the economy adjusts, the model assumes full employment. It assumes that the impact on the labour market will be felt through wage levels rather than through employment levels. That is just an assumption. Clearly, over time, the market will respond to a shock to the economy by reallocating resources—capital and



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labour—not necessarily across regions, but across industries and sectors as the new circumstances impose themselves on the economy.

Q1287 **Catherine McKinnell:** That is in the 15-year projection that you are talking about. What about the short to medium term?

Mr Philip Hammond: In the short to medium term—and this is the Bank of England's remit, but—

Q1288 **Catherine McKinnell:** They say it is not their remit. It has to be somebody's remit because the Government are asking us to vote for it.

Mr Philip Hammond: The Bank of England is looking at what happens in the short term.

Q1289 **Catherine McKinnell:** I can quote from Dr Carney: "It's not our job." He said that yesterday.

Mr Philip Hammond: You are talking about the regional analysis.

Q1290 **Catherine McKinnell:** Yes, and that is what I am asking about.

Mr Philip Hammond: But looking at a macro level at what will happen in the short term is very much—

Q1291 **Catherine McKinnell:** No, I am asking about the regional analysis.

Mr Philip Hammond: Clare, do you have anything you want to say about this, because I can—

Clare Lombardelli: Talk about it at length.

Mr Philip Hammond: I can talk about it at length, but I am not sure I am taking us forward.

Clare Lombardelli: I take your point. The Bank analysis did give a sense of which sectors would be the most hit and under which scenarios those would happen. The way we have approached this for the longer-term analysis is basically to map that on to give the regional picture. You can do a similar thing to have a look at what will happen in the short term—those sectors that are most exposed and will be most hit. Obviously, the regions with the higher concentration in those sectors will—

Q1292 **Catherine McKinnell:** The only information we are getting is that there will be an impact, it will be bigger on regions such as the north-east, and it will be bigger in sectors that employ those who are most exposed to the impact of Brexit. Does it not concern you that you are pursuing a policy that you know will make certain regions that are exposed—and they are exposed for very good reasons because we have had situations like this before—less able to recover from the impact of a deliberately pursued Government policy that will impact those regions?

Mr Philip Hammond: No, not at all. The policy that I am pursuing will absolutely minimise the impact on those regions.



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Q1293 **Catherine McKinnell:** It is just "less worse." You are not pursuing a policy that is going to aid growth in those regions, support jobs and create investment. You are actively minimising damage.

Mr Philip Hammond: There are lots of things that will aid growth and raise wages, and we are pursuing them: the promotion of technology across the economy; the support for R&D; and the investment in infrastructure. All these things will drive economic growth.

As I said before, this scenario modelling looks at one set of impacts on the economy and what the effect of them will be over a period of time. There will be many other things going on in the economy, some of them positive, some of them negative, some of them Government-inspired and some of them exogenous in a way that we cannot control, but the way in which the impacts on the economy are felt will depend on decisions made by individual firms.

Let me give an example. A car plant is established in a region of the country and it finds that it can no longer effectively export cars to the European Union because it is facing a high tariff. It is quite likely that the response to that situation will not be to close the car plant but to redirect the production to the UK market, which will now be protected, effectively, by higher tariffs on cars. So, there will be a change in the pattern of business. The UK economy will become less open.

Q1294 **Catherine McKinnell:** That is a bit of a gamble, though.

Mr Philip Hammond: It is not a gamble; it is an observation about the way economies work in the short term. The question, I think, that should be exercising us is: what then happens at the point where that capital installation has reached the end of its life and the owners have to decide whether to reinvest in the UK or whether to replace that life-expired capital somewhere else in order to serve the needs of the European Union market?

The effects will be felt differently in different sectors and different industries, and indeed different firms. In some cases, they may be very quick; trading businesses may simply stop their trading activity. In businesses with large capital stock, such as the chemicals industry or the car industry, for example, it is likely to take longer for the employment effects to be felt, I would guess.

Chair: Thank you. I am sure we will return to the issue about tariffs being imposed in a moment, but now we are going to bring in Alison.

Q1295 **Alison McGovern:** Thank you, Chair. Chancellor, in each scenario of your Government's analysis the debt-to-GDP ratio increases. Given that Government borrowing is higher in each scenario compared with the situation today under the current arrangements, does that mean that the "deal dividend" that you have spoken of does not really exist?



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Mr Philip Hammond: No, not at all. I have talked about a deal dividend and I describe two parts to it.

The first part is simply the release of the fiscal buffers that we are currently holding—£15.4 billion of borrowing capacity between the current forecast and the fiscal rules-imposed cap in 2021, which would not be needed if we had certainty about the future of our economy—if this uncertainty were removed.

Secondly, there is the expectation that the creation of certainty would itself be an economic stimulus. In the Bank of England's report, there is clearly a "deal dividend" effect where the Bank of England has described it as recovering some of the lost output from the May 2016 trend.

Q1296 **Alison McGovern:** Can we just come back to the bit that you are responsible for rather than the Bank's work? On the fiscal buffers, why is that not in the model? Why is that not in the Government's analysis?

Mr Philip Hammond: Our model is a long-term model, so the release of the fiscal buffer in increased borrowing in 2020-2021 is not going to be reflected in this modelling.

Q1297 **Alison McGovern:** Do you think that the Bank should have included that in their work then?

Mr Philip Hammond: The Bank effectively—I am sorry, you are talking about the release; you are talking about the additional borrowing. Do you want to answer that, Clare—the additional borrowing?

Clare Lombardelli: The Bank, I understand, have not taken a judgment on fiscal policy, and we would not expect them to; they have just shown what would happen.

Q1298 **Alison McGovern:** Okay. The Government's analysis also "has not sought to consider the potential impact of future domestic policy responses that the UK Government and devolved administrations may implement, including in a no deal scenario."

In a no-deal scenario, it is not that plausible that the Government would not do anything. So, do you think that the analysis you have provided us with is quite unrealistic?

Mr Philip Hammond: No, because it is long-term analysis. I agree with you that 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



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support the economy in the short term. The Government's analysis shows us that we would have to unwind that borrowing and pay it back, reducing the deficit over the medium term against the backdrop of an economy that was smaller than it would otherwise have been.

Q1299 Alison McGovern: Sure, but we are trying to produce a report, Chancellor, that is supposed to aid our colleagues in their decision about how to vote. You have just explained that the deal dividend that you have talked about does not refer to the analysis that you have given us, on which we are supposed to report. It refers to an immediate release of the fiscal buffers.

Mr Philip Hammond: Yes.

Q1300 Alison McGovern: If people are voting on this, over the period of the analysis that you have provided, it is not really relevant.

Then we come to the work of the Bank over the short term. The Bank frequently tell us that, in the aftermath of the Brexit referendum, the situation was not as bad as forecast because they also took action on interest rates and QE, but that action is never really acknowledged by the public or in fact many of our colleagues.

Are we not just going round the houses here and repeating all the same mistakes, producing analysis about situations that, for the reasons that my colleague Catherine McKinnell just explained pretty well, do not accurately describe the economic choices in front of us?

Mr Philip Hammond: On that last point—the monetary policy action taken in June 2016—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.

Q1301 Alison McGovern: Sure, but you are basically making my point for me, Chancellor, because you are describing a situation that none of these reports with which we have been provided in order to advise our colleagues describes, so we have been put in a slightly invidious position, don't you think, as a Committee?

Mr Philip Hammond: No, I do not think so, but I do think you have to do a bit of synthesis, if I may say so, because you have a long-term report, which is a robust piece of work, and a short-term set of scenarios from the Bank of England. What probably our colleagues in Parliament



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will be looking for is some kind of overview from the Committee of what taking the two together suggests to Parliament.

Alison McGovern: I will ask a couple of questions to conclude, but what the two together tell us—

Chair: One more.

Q1302 **Alison McGovern:** It is not very much, to be honest. This might be a question of—

Mr Philip Hammond: I do not agree. If the question is which of the five scenarios is best for the country—

Alison McGovern: Chancellor, that is not the question.

Mr Philip Hammond: I think the answer is pretty clear.

Q1303 **Alison McGovern:** This is probably not a question for you; it is just a technical one. In the Government's no-deal scenario, debt to GDP increases by 3.8 points, but during the financial crisis debt to GDP increased rapidly from 35% to 64% within two years. Could you talk us through why there is such a difference from a technical point of view?

Clare Lombardelli: What you are talking about there again is a short-term effect of what happened after the financial crisis. We experienced a rise very quickly; what happened in that situation was very rapid, because you had a combination of effects going on. This is a longer-term picture and it does not make assumptions about the economic cycle in the same way; it just assumes that is a smooth movement to this new position, which is basically reflecting that a smaller economy has a smaller tax base, and so on and so forth.

Q1304 **Alison McGovern:** But, as the Chancellor just said, the automatic stabilisers would kick in and that is not accounted for in the analysis.

Mr Philip Hammond: I am touched that you do not think I could answer this question, but Clare—

Chair: We are just noting that Clare gets all the hard questions.

Mr Philip Hammond: Clare will correct me if I am wrong, but—

Q1305 **Alison McGovern:** I just know that you believe in a gender balance in giving evidence.

Mr Philip Hammond: My understanding is that it is widely accepted that the fiscal impact of a financially induced recession is usually more significant and more enduring than a demand—

Clare Lombardelli: Historically, that has been the case. To answer the question you are asking, we would have had to project a short-term cyclical response, and this sort of analysis simply does not do that.

Alison McGovern: Basically, over 15 years, we assume it away.



Chair: We are going to move on.

Q1306 **Colin Clark:** Hello, Chancellor. We have been given an Armageddon on non-tariff barriers, even though the EU and the UK could sign a free trade agreement. Why would it be so severe considering the UK and the EU economies are already integrated and closely aligned?

Mr Philip Hammond: So, let me—

Q1307 **Colin Clark:** Do you agree that non-tariff barriers would be so bad?

Mr Philip Hammond: Yes, I do. Non-tariff barriers are what matters. The benefits of having zero customs tariffs are that they are useful, and in certain sectors such as agriculture and finished vehicles they can be very important, but for the majority of the economy tariff considerations pale into insignificance compared with non-tariff barriers.

What is important here is that we are currently not in a free trade arrangement; we are in a single market. As soon as we move away from being in a single market, we introduce the bureaucracy of goods moving from one market to another with procedures, documentation, checks and controls—compliance with regulations. It is those things that add cost. How much cost will depend on how much alignment we have in future. It will depend on what we are able to negotiate.

Fortunately, the political declaration makes clear that the level of regulatory control required will be proportionate to the UK's degree of regulatory alignment. We have it in our hands, if you like, to reduce that impact by having a greater level of regulatory alignment, which is where the White Paper suggests we should be in relation to goods, but there is no doubt that moving from a single market even to the most ambitious FTA, for example, would introduce significant non-tariff barriers.

Q1308 **Colin Clark:** Would I be right in saying that we already do have a certain amount of paperwork? There are already Eurostat declarations. My companies used to import from Europe and from outside the EU, so there already is a lot of import and export declaration paperwork. Why do you think the non-tariff barriers are explosively larger than they already are?

Mr Philip Hammond: Rather than me pontificating on this, I would refer you back to the letter that Jon Thompson, the chief executive of HMRC, wrote to your Chair back on 4 June that sets out precisely the decomposition of this additional cost, which he estimates could be between £17 billion and £20 billion a year. The Committee already has that analysis.

Q1309 **Chair:** I am sorry, Colin, to interrupt, but we had this discussion—I was going to mention it—with Susannah and Clare yesterday. I do not know whether you have had a chance to think further overnight about the Intrastat and VAT declarations. When you talk about non-tariff barriers in the analysis, is it based on what was in that HMRC letter?



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Clare Lombardelli: They would be part of the non-tariff barrier. The analysis here is consistent with that, but there will be additional non-tariff barriers that come from, for example, misalignment of regulation over time that is included in our analysis.

Q1310 **Colin Clark:** We can move on, but, just on that, Chancellor, the analysis was based on other countries trading on FTA and WTO terms. I am still trying to hone down to this. Surely, in UK trading with Europe, considering our years and regulatory equivalence, trade barriers should be less between us and the EU than they would be between a third country and the EU.

Mr Philip Hammond: I understand why you are asking the question. The European Union position is and has consistently been in these negotiations that we can have a reduction in trade frictions if we commit through treaty to alignment, but merely choosing to align de facto will not be enough to avoid the introduction of all the structures. In other words, if there is a possibility of us being misaligned in regulatory terms, for example, in goods, there will be a goods regulatory structure in place. The only way we can avoid that is if we choose in the negotiation to accept that we will be aligned in goods regulation.

Q1311 **Colin Clark:** Moving on, the Government analysis finds that unilateral free trade, in which the UK imposes no tariffs on imports from around the world, would increase GDP by 0.8%. Why have the Government not adopted a unilateral free trade policy after Brexit?

Mr Philip Hammond: It is an option and it is something that we have been looking at, but, of course, the big problem with it would be for many of our colleagues that it would immediately remove the leverage to secure free trade agreements with third countries. The concept of free trade agreements with third countries would dissipate instantly as soon as we unilaterally removed all our tariffs. We would have nothing to trade.

Q1312 **Colin Clark:** Can I specifically drill down into a subject that came up yesterday? A subject that the general public and we would all be particularly interested in is the price of food. We heard yesterday that potentially it could go up. There is other analysis that would suggest that we import half of our food, and for each of the EU countries from which we import there is a substitute country—I have a list of them here. It is things like tropical fruit, cereals, dairy products and beverages.

If we have no EU external tariff and there is no UK tariff on things that we do not produce ourselves, remembering that I am from the agricultural community, why would food not necessarily be cheaper and therefore the food basket could actually go down and not up?

Mr Philip Hammond: There are quite a number of reasons. Obviously, one can paint different scenarios, but for many foodstuffs the cost of the raw commodity is a relatively small percentage of the finished price to the consumer. Transport costs can be very high. Obviously, products



coming by truck from Europe, ro-ro'd through Dover, are very efficiently delivered compared with products that might need to be air freighted from more distant locations.

The single most important point to bear in mind here is probably the expected transmission mechanism for this shock to the economy. It is likely to come through the exchange rate, and, as we experienced in the autumn of 2016, that is likely to mean that the sterling denominated cost of those imported commodities rises. That, in itself, will be a significant driver of inflation in the UK, and I think the Bank's analysis shows that.

Q1313 Colin Clark: That would suggest that if we did not have external tariff barriers—one of the White Paper scenarios—the price of food could actually come down. You just mentioned the potential issues of leaving the EU.

Mr Philip Hammond: If sterling depreciated in, let's say, a no-deal scenario—let's assume sterling depreciated—the impact of that sterling depreciation will feed through into the sterling cost of all imports. Food is a very significant import, so we would expect there to be an inflation effect from sterling depreciation.

Q1314 Colin Clark: Chancellor, can I draw you back to a slightly different subject? It was a question that somebody asked you earlier about WTO preparation or no-deal preparation. If we had started preparation in 2016, could we have been ready by March 2019? If we had set out in 2016 saying that we would operate from WTO—I am thinking about certification, regulation and industry having time to prepare for it—could we have been ready by March 2019?

Mr Philip Hammond: That is a hypothetical question because it requires me to guess how private sector firms would have reacted and responded. I am not sure, given the political debate that has been going on for the last two and a half years, whether private sector firms would necessarily have gone out in 2016 and said, "I will now start investing for one particular outcome scenario."

My engagement with firms—and I have had a huge amount of engagement with firms over the last two and a half years—suggests that what they have done is entirely rational. They have set out carefully prepared plans in many cases. They are looking at critical paths and investing the minimum required to protect their interests at each stage. There would be some things that had a one-year lead time, which they will have done last spring on a contingent basis to make sure they were ready for a worst-case scenario in March 2019. There will be other things that did not need doing until, let's say, the end of this year, and they will have deferred doing them. Nobody wants to make nugatory expenditure if they can possibly avoid it.

Q1315 Stewart Hosie: I want to pick up something from earlier. On the model scenarios—every one of them—GDP and GDP per head is lower in 15



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years than would otherwise be the case. It must be the case, therefore, that modelled GDP growth is lower than otherwise it would have been to get to these numbers.

Mr Philip Hammond: The run rate of growth is not determined by the baseline that you start from. If you look at the Bank of England analysis, that shows us what happens in the short term. In the medium to longer term the economy will grow. We are confident about that. The HMG analysis is showing what the compound effect will be at the end of 15 years—how much smaller our economy will be than it otherwise would have been.

Q1316 **Stewart Hosie:** That is the compound effect of a lower rate of growth than would otherwise be the case; otherwise GDP would have been the same.

Clare Lombardelli: It does not quite work like that. As part of this analysis, we have not done a forecast for GDP. What we have done is looked at what having a trade difference between two models would do to GDP, if you like. You are seeing a difference in the GDP. You just get that difference, but you do not actually get a level for GDP through this sort of analysis. The question we are answering is, "What will be the impact of changing the trade relationships?" The impact of that change is a change in GDP.

Q1317 **Stewart Hosie:** I do not mean to labour this point, but there are many components to GDP growth, trade being one of them. Clearly, if we have a number that is smaller than it otherwise would have been, the growth rate for the number over 15 years is clearly small.

Clare Lombardelli: All else being equal, yes. As we have said, it is not a forecast. It just shows you how that one component of GDP changes.

Q1318 **Stewart Hosie:** I am very clear that this is a scenario and it is modelled. I just wanted to be clear that that was the case.

Chancellor, if the EU signs new trade deals with third countries while the UK is in a customs backstop with the EU, the UK would have to offer the same tariff schedule as the rest of the EU to that third country. As I understand it, that is the situation.

Mr Philip Hammond: Yes.

Q1319 **Stewart Hosie:** Would that third country have to offer tariff-free access to the UK?

Mr Philip Hammond: I am going to have to check the detail in this rather large tome and come back to you on that. I will write to the Committee.

Q1320 **Stewart Hosie:** We have a UK backstop provisionally, depending on what Parliament does next week, but we do not know and you do not know whether or not, if we fall in and have to use that backstop, third countries would have to offer the UK the same consideration that we



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might be required to offer them. It is quite a fundamental question.

Mr Philip Hammond: I do not want to give the Committee a wrong answer. I want to check, and I will write later.

Q1321 **Stewart Hosie:** That would be helpful, if that could be done.

Mr Philip Hammond: I will make sure it is as soon as we leave the room.

Chair: They are drafting now, no doubt.

Q1322 **Stewart Hosie:** Despite a series of potentially optimistic assumptions, the Government's analysis shows almost no increase in GDP under 0.25% for new trade deals compared with today's arrangements. Is that the correct number?

Mr Philip Hammond: Yes. I think it goes back to the point I made earlier. Free trade agreements are good. I am a free trader and I am all in favour of free trade agreements, but the benefits of a free trade agreement with a distant rest-of-the-world country nowhere compare with the value that we get from the single market arrangement that we currently have with the European Union. We would expect there to be worthwhile benefits from being able to do free trade agreements with third countries, but, as the analysis clearly shows, they would not compensate for the impact to GDP of losing trade access to the European Union.

The Government's whole focus throughout this process has been to try to maximise our continued access to EU markets while retaining the ability to enter into third country trade agreements.

Q1323 **Stewart Hosie:** I agree that entering into those third country trade agreements is good, but the benefit in economic terms is marginal and does not really compensate for what we could potentially lose.

Mr Philip Hammond: The benefit is worth while, but I would not want to pay a price in terms of existing trade access.

Q1324 **Stewart Hosie:** In terms of paying a price, or making it stack up to some extent, can we just confirm that in order for that very modest advantage to be gained—if it is gained at all—we would have to conclude successful trade deals with the United States, Australia, New Zealand, Malaysia, Brunei, China, India, Brazil, Argentina, Paraguay, Uruguay and the Gulf Cooperation Council of the UAE—Saudi Arabia, Oman, Qatar, Kuwait and Bahrain?

Is it credible to achieve successful outcomes with all these countries in pretty quick order?

Mr Philip Hammond: This is a 15-year type horizon, as we have said before, so I think it is. Several of the countries that you have mentioned there in Latin America are members of Mercosur, so we would work with them as a group. Several of the other countries are members of the



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Trans-Pacific Partnership. These would not necessarily be negotiated as individual bilateral trade deals. They might be multilateral trade deals.

Susannah Storey: What we have tried to show is an ambitious set of assumptions, and it is obviously over the long term.

Stewart Hosie: I think it is helpful to know that this is an ambitious set of assumptions. Perhaps for my own part I will therefore err on the more cautious numbers in the modelling.

Q1325 **Wes Streeting:** Good afternoon. Chancellor, I want to begin by asking why it is that the Government analysis forecasts a bigger reduction in financial services under the EEA than under the White Paper.

Clare Lombardelli: Your question is about the EEA and the White Paper. With regard to the impact of financial services, it has a very similar impact overall on the economy for the EEA and the White Paper. It is -1% versus 0.8%, despite the fact that the non-tariff barriers on financial services are quite different.

If you look at page 43, you can see the financial services non-tariff barriers. This shows quite a difference between the White Paper and the EEA. That reflects passporting and other things, and the fact that under the White Paper there are greater barriers to financial services' trade.

The reason that that then does not translate to quite as big a change in the overall macroeconomy is because the way the model interacts is that it looks at how all the sectors interact. A lot of financial services are sold alongside goods. If you think about cars, they are sold with car purchase schemes and the like. When you factor those two effects in together, what you are seeing is the fact that there are barriers to goods trade in the EEA because you are outside the customs union. That is what is driving that difference, in effect.

Q1326 **Wes Streeting:** That is very helpful to understand. It seemed a surprising conclusion, but since you have put it in that context it makes much more sense.

One of the issues we have been looking at particularly this week, but it has been a running theme, is how comfortable the UK should be with our country being a rule taker under any future arrangement. I think the Governor was quite clear yesterday about some of the risks associated with this. Mr Bailey reached broadly the same conclusion, but perhaps with slightly less clarity than the Governor.

In the Government's view, what is the priority for financial services for passporting rights to the EU or restricted access to EU markets, but the ability to set our own rules?

Mr Philip Hammond: We have been very clear that we are not pursuing full passporting rights, because full passporting rights will not be available once we are no longer members of the European Union and part of the single market. There is a balance to be struck. That is one of the drivers



of the architecture of the White Paper, where we are proposing a close alignment of regulation in goods, where the regulation is stable and predictable, and where manufacturers of goods are not at all concerned about alignment with EU regulation in goods.

In services, we have prioritised the ability to have a looser relationship, which, yes, means less access than we might otherwise have sought but does avoid being caught in a rule-taking trap.

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 will continue to contribute to all of these debates that go on in the European Union. 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. The European Union decisions will still be very important to the UK, but we will be seeking to influence them through analysis and hard work rather than through the exercise of voting power.

Q1327 Wes Streeting: I absolutely accept what you have said about the expertise that we would bring, and the size of our financial services sector would earn us a hearing automatically as well as the expertise, but that is not the same as the influence we currently enjoy being round the table and setting the rules, not just abiding by them. Would you accept that?

Mr Philip Hammond: It will be a different kind of influence, but we also have to recognise that in a QMV 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.



Q1328 Wes Streeting: I am conscious of the time. I think we have to be clear with the public at this stage. One of the things I have struggled with listening to your answers this afternoon with other colleagues—and this follows on from Mr Hosie's question and Alison McGovern's questions—is that you set out very clearly the context for your decision making and your conduct as Chancellor. It is effectively a political calculation. You have placed great emphasis and importance on simply abiding by the result of the referendum, leaving the European Union and trying to do the best to mitigate harm and risk in the process.

Looking at the outcome of the deal and the way you have conducted yourself as Chancellor during this process, I do not think anyone would doubt both your intention and the fact that to a large extent you have done your very best to achieve that.

However, that is not the same as leaving the European Union for a brighter future that my constituents voted for, who voted leave. People who voted leave now feel that what they are hearing from Government is mitigation of risk and minimising damage. That is borne out by the numbers, and in fact I think you have confirmed that this afternoon.

My remain-voting constituents, which is just under half of my constituents, are pretty upset because what they see is loss of economic potential and our country being less well off than we might otherwise have been. They do not hear a vision for a brighter future outside the European Union. They just see the UK making compromises economically to achieve a political objective.

Is it not the case that when we vote next week, whatever happens with that vote and the immediate aftermath, what we have been doing for the last two years is an exercise in risk mitigation and damage avoidance, not actually beating a path to a future that will make our country more prosperous and secure than we currently are as members of the European Union? Should we not be up front with the public about that now?

Chair: A brief answer, please, because time is short, and I know you want to get away.

Mr Philip Hammond: What getting to a brighter future now entails—and we are where we are—is putting this debate behind us. We have to move on as a nation. What would be catastrophic for us is to fail to move on and remain mired in this debate for months or years longer. We have to resolve this so that we can go back to rolling out the latest technologies, to supporting our businesses, to grow and focus on upskilling and all the other things that we need to do.

If the only proposal on the table was a no-deal exit, which would cost us nearly 10% of our GDP according to this modelling, I would take a different view, but politics is about judgment. When there is a deal on the table that has very, very modest cost to the economy, which will allow us to put this behind us and move on as a nation both economically and politically, and which avoids large swathes of half of your constituents



feeling betrayed but allows all of us to accept that in a rather British way we have made a compromise solution and we have moved on, I judge that, even narrowly economically, that will be in the best interest of our country. If we move forward from here with half the nation feeling that it has been betrayed, I do not believe that is an auspicious basis for us to be an economically successful country in the future.

Chair: This is our final question, and Mr Simon Clarke may have a view on that.

Q1329 **Mr Simon Clarke:** I do rather take issue with that, Chancellor, on the basis that you cannot split the difference between two essentially binary outcomes, it seems to me. You either leave and make a success of it, or you remain and make a success of it. Therefore, I would take the view that that is positing a false choice.

To take the Attorney General's legal advice as published today, paragraph 16 relates to the Northern Ireland protocol and backstop: "...in international law the Protocol would endure indefinitely until a superseding agreement took its place, in whole or in part, as set out therein. Further, the Withdrawal Agreement cannot provide a legal means of compelling the EU to conclude such an agreement."

It is very clear that if the backstop were activated—we can take different views about whether or not that would in fact be likely—it might very well endure indefinitely. To me, this exacerbates the risks.

Do you share the concerns that Andrew Bailey from the FCA put forward on Monday regarding the existing EU equivalence regime, particularly in relation to its scope, consistency and transparency?

Mr Philip Hammond: First of all, I am afraid I do not share your view of how politics works. I think there are very few examples where success has been achieved by looking at the two extreme possible options and selecting one of them—and certainly not in our country. We tend to do things by coming to some kind of compromise. It is nothing personal, but I am afraid I am rather suspicious of politicians telling the public that they have only the choice of two extreme options and that there is not a way to find a compromise solution.

On the question that you have asked about the EU equivalence regime, I made a speech about this six or eight months ago. 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. We have spent a lot of time and energy promoting that view and explaining it in Europe. The political declaration shows that we have got that message across.

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. 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



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decision must always be an unencumbered sovereign decision made either by the EU or by the UK. That is the architecture we are proposing.

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. Both sides will find that essential for macroprudential stability.

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. We can only get anything agreed if it works for both sides. It has to be in the interests of both parties, and there is clearly a way forward on financial services co-operation that does work for both parties.

Q1330 Mr Simon Clarke: To go back to your earlier point, Chancellor—and this is nothing personal—I am suspicious of politicians who stand on their manifesto saying one thing and then end up doing another in a way that does not meet the expectations of the public.

Can you confirm that, if the deal is rejected next week, it remains stated Government policy and the Treasury will be planning on the basis that we will leave on 29 March of next year, come what may?

Mr Philip Hammond: That is the legislated position. As I have already said, the Government have an extensive contingency planning operation in place that is preparing for the contingency of no deal, but, for the record, I think that would be a terrible outcome for the UK economy.

Q1331 Mr Simon Clarke: In that scenario and notwithstanding the fact that you personally would have grave reservations about it—and we can read into that what your course of action might be were that scenario to arise—what measures would the Treasury look to put in place to try to mitigate that impact, if mitigation is indeed the right term?

Mr Philip Hammond: You mean if we found that we were in a no-deal scenario, over and above the obvious things.

Mr Simon Clarke: Yes, indeed.

Mr Philip Hammond: We are already spending £4.2 billion on no-deal planning.

Q1332 Mr Simon Clarke: We are looking now towards the dynamic policy choices.

Mr Philip Hammond: In the short term, as I have already described, there will be a need for a fiscal policy response to support the economy through what will be a period of turbulence. The Bank of England MPC may not have as much flexibility to offer a monetary policy response as it



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would like because of the nature of the transmission mechanism and the possibility that we are going to see a significant inflationary pressure. It will fall to fiscal policy to carry, I suspect, much of the short-term burden.

Over the medium to longer term—and bear in mind that our debt-to-GDP ratio is already unsatisfactorily high, so our fiscal capacity is limited—the UK economy will have to adjust to the new reality. Many industries that depend on trade with the European Union will either have to significantly lower their costs to overcome the frictional costs of being in a no-deal trading arrangement or will have to look for other markets, or probably more likely capital and labour will have to shift into other areas of activity.

I would suspect there will be quite a prolonged period of adjustment. If I could use an analogy—and you are probably too young—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.

Q1333 Mr Simon Clarke: I have one final question. Within that one option would obviously be free port status for significant parts of the country, which would effectively have the effect of removing some of those costs facing businesses. Is that something that you would look at in that scenario?

Mr Philip Hammond: We are open to all ideas. As you know, free port is one of the things that the Treasury has looked at. We did have a free port in Liverpool and it did not prove successful.

Q1334 Mr Simon Clarke: Without the same diversions as we might have in this case.

Mr Philip Hammond: We would look at all sorts of models. In a genuine no-deal scenario, where there was no premium to us as a country in remaining aligned in any areas, then we would be able to look across the spectrum at options. We would act according to what was in the UK's best interest.

Q1335 Chair: Thank you, Chancellor. I have one final question. You started this afternoon's session by talking about the instruction you had given to the OBR to prepare for the spring statement. We have asked it before, but the OBR has been unable to model anything significant on Brexit for some years now because it says that it can only model what is agreed Government policy.

Are you confident that by 26 February at the earliest, or certainly by the end of March, the OBR will have a settled Government policy on Brexit to model? Presumably, that means a withdrawal agreement that has been agreed by Parliament and a settled political declaration, or at least firm progress towards a political declaration, so that it can model it, or are we going to see yet again from the OBR that it is unable to model Brexit on



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the economic and fiscal outlook because it does not know what Government policy is?

Mr Philip Hammond: I hope that the OBR will be presented with a clear decision by Parliament to endorse this deal and, therefore, that the withdrawal agreement and the political declaration will be known. I suspect that the OBR will continue to say at that point that, because, as I have already explained, there are a range of outcomes of the final negotiation that are entirely compatible with the political declaration, it cannot fully model the outcome, although it may be able to be clearer than it has been.

Q1336 **Chair:** Is that not an unsatisfactory political situation? It is bad enough that MPs, as you have heard around the table today, are feeling that they are going into next week's votes without having everything that they possibly could have, but to have a spring statement where, yet again, a key part of this Government's policy cannot be modelled so that not only Members of Parliament but members of the public cannot know what the short or medium-term economic and fiscal outlook is for this country has to be unacceptable.

Mr Philip Hammond: Yes; this is not unique to Brexit. The OBR takes a very cautious approach with anything that is novel.

Q1337 **Chair:** Brexit is a pretty unprecedented and rather enormous consequence for this country.

Mr Philip Hammond: It is, but I am just explaining to the Committee that it is not unprecedented in the sense that the OBR does respond to Government policy initiatives by saying that it cannot model them until the outcomes are clear. We regularly have to live with policy initiatives that the OBR will not give us credit for until it sees the outcomes clearly demonstrated.

I agree that it would be preferable for the OBR to be able, as quickly as possible, to give us as much clarity as possible.

Clare Lombardelli: The only thing I would add is that the OBR has explained to you in a letter, and also published quite a long paper, about the information it feels it would need to be able to make a judgment. It will face the same challenge. To really understand this, you need to know the specifics of the trading relationship, and of course that will be subject to forthcoming negotiations. As the Chancellor has suggested, I think what it says in the spring will be quite far from what the final say it has is.

Q1338 **Chair:** If it cannot do it—this is my final question—would the Treasury either consider filling the gap that the OBR is unable to or commission an independent economic body, perhaps NIESR, for example, to fill that gap?



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Mr Philip Hammond: I do not think it cannot do it because it does not want to do the work. I think it is because you would be speculating. You would have to make such significant assumptions at this stage that it would not be a sensible or useful thing to do, I suspect.

Clare Lombardelli: The issue is less that it cannot do it but that it cannot be done until that specificity is there. I suspect NIESR would say the same, which is that it depends on the detail, which would not be available at that time.

Q1339 **Chair:** I think the reason the OBR cannot do it is because of its statutory remit, is it not? Exactly as Clare has set out, it would find it difficult because of the remit it has been given by Parliament, but other forecasters and economists may feel that they would be able to do it. Would it be something that the Treasury would look at—commissioning other work—making it clear that it is work from another body and obviously not from the OBR or from the Treasury itself?

Mr Philip Hammond: I do not know that the Treasury would commission such work, but I can be confident that external bodies will be running models and making forecasts.

Chair: The Treasury Select Committee might have to do it for you. Chancellor, thank you very much indeed for your evidence this afternoon. We are very grateful for your time. Thank you.