

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; Colin Clark; Charlie Elphicke; Stewart Hosie; Alison McGovern; Catherine McKinnell; John Mann.

Questions 1189 - 1244

Witnesses

I: Dr Andrew Sentance CBE, Independent Business Economist.

II: Professor Sir Stephen Nickell, Specialist Adviser to the Treasury Committee.

Written evidence from witnesses:

– [Dr Andrew Sentance](#)

Examination of witness

Witness: Dr Andrew Sentance.

Q1189 Chair: Good morning. Dr Sentance, thank you very much indeed, first for sending in evidence and then agreeing to appear before us, I know at very short notice. We are really grateful to you. This is the next session in our inquiry into the draft withdrawal agreement and political declaration before the House of Commons at the moment. I am going to ask you to introduce yourself and then I know Charlie is going to start with some questions.

Dr Sentance: My name is Andrew Sentance. I describe myself these days as an independent business economist. I have recently retired from PwC where I worked for seven years. Before then, I was a member of the Bank of England's Monetary Policy Committee and have had various other roles as an economist in the business world.

Chair: This is not your first appearance before the Treasury Select Committee, by any stretch of the imagination.

Dr Sentance: I am always pleased to help you out.

Q1190 Charlie Elphicke: Dr Sentance, thank you very much for coming this morning. It is greatly appreciated. As you know, part of the reason you are here today is your reaction to the publication by the Bank of England last week, a publication this Committee invited the Bank to make. Can you tell us about your reaction and why you reacted in such a way?

Dr Sentance: It seems that the Bank published a forecast or a scenario with some very extreme assumptions, reflecting their view of a no-deal scenario. I have been involved in scenario-planning exercises in business and, when you do scenarios, you do not try to find the most extreme assumptions that you can take; you try to create a plausible and internally consistent scenario. Looking at it in more detail, they assume that the disruption created by a no-deal scenario would be very long-lasting, which seems extreme to me.

Secondly, they have put in assumptions about the response of policymakers, particularly that the Monetary Policy Committee would actually raise interest rates to about 5.5%. If you look at how the MPC has behaved over the last decade or so that seems implausible, even though the Bank had a scenario where inflation was going up to about 6.5%. That is not much higher than a couple of the peaks that we have already had in 2008-09 and 2011-12, which were over 5%, and yet the Bank did not respond by putting up interest rates dramatically in that scenario. That added to the degree of stress in a way that was not really plausible. I described in my memorandum—and I saw you put the point to Mark Carney—that the Bank appeared to be throwing in the kitchen sink to create the most negative scenario possible.



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I have two concerns about that. One is that, by its own terms, it looks extreme but, secondly, when the Bank produces forecasts and scenarios, people interpret them in a wide range of different ways, because the Bank has a number of different roles and it produces other types of forecasts. The way that this came across in the media and the way it was presented following the Treasury forecast were not clear that this was an extreme view, even in the Bank's own terms, so the communication of it was less than ideal as well.

Q1191 Charlie Elphicke: Yesterday, when I asked the Governor questions, I picked up that the word "substitution" was nowhere to be found. I asked him whether he had taken into account substitution and business adaptation, and he said that was all taken into account. Do you feel that business adaptation has been taken into account in that analysis?

Dr Sentance: Looking at it in its own terms, we did our own work when I was at PwC, jointly with the CBI, and you can get quite significant short-term effects from Brexit, particularly if there is no properly agreed deal. We then found that, as time passed, some of the uncertainty dissipated and the economy adapted. I have been studying the British economy for the last 30-plus years and I have been struck by how adaptable the British economy is to changing circumstances. It does look as if they perhaps did not allow enough adaptation and adjustment in the scenarios they were looking at.

Q1192 Charlie Elphicke: I think it was yesterday that Mervyn King, the former Governor of the Bank of England, wrote an article on Bloomberg that was critical of Brexit and how it has been handled in general. It broadly said that a no deal would be just fine. What do you think of that? Have you looked at that and do you have any reaction to that?

Dr Sentance: I take a slightly different view on Brexit than Mervyn. I am not enthusiastic about Brexit and think we would be better off if we were not Brexiting, and I think a no-deal scenario could be quite disruptive. There are two types of effect you need to think about. One is short-term disruption. You would think that might last a quarter or two but not persist for a number of years. You are then in a world closer to what we would call a WTO scenario, in the work that we did at PwC. Yes, you have less good access to the markets, particularly in Europe, in the short term, but over a period of time some of that access can be restored and the economy can adjust.

Mervyn King was making another point, with which I have some sympathy, that the Bank has recently not been careful enough in trying to distance its comments from the Government and the political system. It has commented a lot on Brexit in various different ways. I was always conscious when I was on the Monetary Policy Committee that the independence of the Bank meant that we should try to keep our distance from the political debate, particularly when issues are highly politically charged. The Bank has appeared to get drawn into the political debate,



in a way that might have been avoided, which was another strand of Mervyn King's criticism.

Q1193 **Charlie Elphicke:** I am not sure if the Governor of the Bank of England was referring to your period or Mervyn King's period yesterday, but he said it was a "simpler time". Did you live in a simpler time?

Dr Sentance: I joined the committee in 2006 and left in 2011. There was a rather big event that happened then called the global financial crisis, so I am not sure it was a simpler time when we were dealing with the global financial crisis. I saw Mark Carney's comments in front of the Committee on that point, and he seemed to be saying that the Bank is now paying more attention to financial regulation issues and the financial stability part of its brief, whereas in the past it mainly focused on inflation. Financial stability has always been an important part of the brief of the Bank of England. Indeed, some of the dramatic actions that were taken in the time when I was on the MPC were to shore up the financial system and to stop it getting into an even worse position, so that the damage to the economy would be limited. I am not sure I agree that things were simpler, at least when I was on the committee, between 2006 and 2011.

Q1194 **Charlie Elphicke:** The Governor used to make speeches in which he talked about Brexit being—he used a French-Canadian phrase—taking one step back to jump forwards. I understand that to mean short-term disruption but the possibility of long-term gains. Have you analysed that and looked at how that short-term/long-term thing works?

Dr Sentance: I find it difficult to believe that, ultimately, even if you look 10 or 15 years ahead, we are going to be better off with Brexit. From the analysis in the PwC/CBI report that I referred to, even if we strike trade agreements with the European Union and some other countries, by about 2030, the hit to GDP is relatively small, about 1% or so, but we did not find that things would actually be better than they would have been if we were in the EU.

Now, there are some economists who take a more optimistic view, but you have to recognise that we have good access to the European markets at the moment, and we actually have quite good access to a wide range of other markets. We do a lot of trade with the United States and it is not clear that new trade agreements will boost that a great deal, because the trade that we do is based on longstanding, historical business relationships that have existed between the US and the UK for many decades. I find it hard to see that we would actually be better off in the long term.

We found that the main hit to GDP came in a three-to-five-year time horizon after Brexit and what has transpired is consistent with that. If you do back-of-the-envelope calculations to compare the trends that people were identifying around 2016, you will come up with a loss of GDP of around 2% to 3% around 2020, in the current short-term forecasts



and the performance of the UK economy. They are in the ball park that we were talking about in our report and in many other reports.

Q1195 **Colin Clark:** It is good to see you this morning. Can I bring you to some of your evidence where you speak about investment? We asked the Governor and Deputy Governor about pent-up investment in the economy and people holding back because of the Brexit decision. They both agreed that it has been dampened for two years. Can you expand on that and explain what sort of impact it could have if investment is released?

Dr Sentance: I was monitoring this through my role as senior economic adviser at PwC, because we have access to a lot of business clients. They come in for dinners and for discussions about the state of the economy. We have not seen big dramatic cuts in investment or delays to investment projects but, at the margin, many businesses have just become a bit more cautious about pressing the button on those projects that hinge on or may shape their business in the 2020s, because they are not sure what the regulatory and trade climate is going to be like. You can see in the investment figures that we have had since 2016 that business investment was growing by about 5% per annum from 2011 through to about 2015-16, and has hardly grown at all since then. That is consistent with the idea that investment uncertainty has put a brake on business investment plans, not in a dramatic way but at the margin companies have delayed projects by one or two years, or maybe even longer.

Q1196 **Colin Clark:** As companies get more clarity, is there any way of estimating part of the balance sheet? If people are making money, it is not that they are not making a profit; they are putting it somewhere else on their balance sheet. Is there a way of estimating the quantum of what has been built up and what the result is when they invest? If they have been holding back, a company has to fix capital eventually. It cannot hold back building factories forever.

Dr Sentance: There is an argument that, if the UK looks a less attractive place for international investment after Brexit, there could be some loss to other destinations, particularly within Europe. The firms that would have been investing in the UK may be investing elsewhere, which is a loss to UK investment. It depends on the nature of the deal, so the more advantageous the deal is in our access to European and other markets, the less likely that effect will be. That drives some of the differences that we had in our two scenarios, between a free trade agreement world and a WTO rules world.

It is also worth making the point that investment is part of the organic way in which the economy adjusts and evolves over time. There will be other new opportunities and drivers for investment to do with technology and the move to the low-carbon economy that are not necessarily going to be disrupted by Brexit. I would have expected that, over five to 10 years, the negative investment uncertainty impacts that we are seeing



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now will fade away, assuming we have reasonable access to European and other markets around the world.

Q1197 Colin Clark: I will finish with one last question. You have skirted over foreign direct investment. In the first half of 2018, UK was the second-biggest destination for foreign direct investment after China, in front of the US, Spain, Holland and many other countries. Why would that be? What is industry doing or thinking, or is this pent-up investment that was in the system anyway?

Dr Sentance: The UK has always been an attractive place for foreign direct investment. Historically, we have always been one of the top places.

Q1198 Colin Clark: Will that change?

Dr Sentance: It very much depends on the nature of the deal we have and the way in which things go with Brexit. A crucial thing for a lot of the investment that comes here is our access to European markets. Maintaining good access to European markets is important for that future foreign direct investment.

Q1199 John Mann: I am not sure you have been portrayed in the media too accurately. You are a strong remainder in your analysis. Are you too optimistic about the different scenarios? Your criticism of the Bank does not quite fit into where you are coming from when you were on the MPC. I look at your evidence to this Committee on the first three occasions that you appeared. To take the first occasion and the first thing you said to the Treasury Committee as an external on the MPC, you were eulogising how there would be growth in business investment. That was in March 2008. There were some problems in how strong business investment was and has been since. Is there not a danger that you are overconfident about business investment finding its way into this country?

Dr Sentance: That was a very different time. I joined the MPC in October 2006 and I appeared before the Committee on a few occasions before 2008. I would have had a hearing with the Committee on my appointment, for example, and external members tended to come along once or twice a year to the inflation report briefings. At that time, certainly in 2006, the world economy was growing strongly and that is generally supportive of healthy business investment growth in the UK. That was the case in 2006 and 2007 but, of course, the world changed as we moved into 2008 when we had Lehman Brothers and all the problems in the banking system. One of the things that swung the economy around that time was the impact of those banking problems on investment. Investment is one of the more sensitive and volatile components of demand.

Q1200 John Mann: But you were bullish in March 2008, November 2008 and November 2009, when you were in front of the Committee. You were certainly not an outlier; you were bullish.



Dr Sentance: You will have to quote it back.

Q1201 **John Mann:** You were very supportive of the Government. To quote you, the first thing you said, in March 2008, was that the “economy remains attractive to ... investment”. That was in March 2008.

Dr Sentance: That was a reasonable assessment of the relative position of the UK economy being an attractive location for businesses to invest in. We have benefited in the UK from decades of supply-side reforms and trying to keep our tax system competitive. All those fundamental things are not necessarily going to be adversely affected by Brexit. Without having the opportunity to look at the context of those remarks in more detail, I cannot say much more.

Q1202 **John Mann:** To summarise your position, you are confident on investment regardless of what we do. In your view, investment would be stronger if we remain in the EU.

Dr Sentance: I do not think I was saying that. I was saying we have seen a period of particular investment uncertainty and that has been one of the negatives already impacting the economy. Assuming that we get a reasonable deal that gives us access to European markets and may enable us to strike trade agreements with other countries around the world, it should be supportive of a recovery in investment. If that deal is not so good, the closer we get to a no-deal scenario in which we are reliant on WTO rules makes it more difficult climate for investment. Even in that scenario, over a period of time, it is hard to believe that policymakers would just sit there, not do anything and say, “Oh, we are dependent on WTO rules. We cannot change the world”. You would envisage them striving to improve our access to European markets and to markets around the world. Over a period of time it would help to mitigate the short-term impacts we have recently seen to investment.

Q1203 **Alison McGovern:** I have a brief question, if I may, Dr Sentance. Your evidence to us and the coverage of your views seem to define the difference between you and Mark Carney as what you think it would be appropriate to do in these circumstances. He said to us they had looked at the worst-case scenario; you are saying to us that is fine, but how useful or helpful is it to look at a worse-case scenario when, actually, it is probably something that no one would allow to happen? Is that correct? That is essentially the difference between you.

Dr Sentance: Yes. There are many mitigating factors. We saw in the global financial crisis that, when things get very bad, Governments are prepared to do things that they might not have contemplated before. Central banks are prepared to do things they might not have contemplated before. When I joined the MPC in 2006, I did not envisage that we would end up cutting interest rates down to 0.5% and injecting so much quantitative easing into the economy, but policymakers do respond.

Alison McGovern: Stuff happens.



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Dr Sentance: That is part of the process by which the world evolves and we deal with the big shocks we face. They did not seem to have factored any of that into the analysis. It is almost as if we just sat back and accepted the worst of all possible worlds. In the particular area where the Bank has a remit, which is on monetary policy, I find it hard to see the MPC jacking up interest rates in the way their scenario suggested. In addition to the Brexit shock, they have overlaid quite a negative domestic demand shock by tightening monetary policy.

Q1204 **Alison McGovern:** Dr Sentance, this is my last question. The reason why you are here and we are all here is so that we can produce a report to advise our colleagues. From what you have said today, it sounds as though, if you were to give that advice to Members of Parliament now, you might say that of course terrible things can happen if politics proceed on a course that is damaging for the economy, but even if that happens, we will not be without tools to respond.

Dr Sentance: That is a valid point of view. The other thing that is potentially confusing is in the Bank's broader remit, because the Bank has a number of responsibilities and its projections where in the context of a financial stability report and stress testing. Yesterday Mark Carney acknowledged that he had thrown in the kitchen sink.

Alison McGovern: He sort of said that was the point.

Chair: I think he said that was a good thing.

Dr Sentance: The difficulty with that from a communication point of view is that the people who read those forecasts and see them reported in the press do not make that type of distinction. They might view it as closer to the Bank's central forecast, rather than an extreme forecast. Managing communications is a difficult art for the Bank, and this is one of a number of examples where they had some difficulties in recent years.

Chair: You have just used the word "forecast".

Dr Sentance: I am sorry; I should say "scenario".

Chair: We should all try, around these tables, to get the right words and to reflect what the Bank has said, even if communication and media coverage can be something else.

Dr Sentance: Technically speaking, it is a forecast conditioned on a set of assumptions. That is how you generate a scenario. It is probably more helpful to describe it as a scenario, but the process of developing this scenario is not that different from developing a forecast.

Q1205 **Stewart Hosie:** I have one brief question to take you back to Charlie Elphicke's question about substitution. The Bank of England assessment cites some academic research on tariffs, suggesting that investment would, under certain circumstances, be redeployed domestically. That evidence suggests it would be less efficient and would give the result of



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reducing aggregate productivity. Does that sound like a valid assessment to make in the case of high tariffs, with capital being redeployed but less efficiently than it would otherwise be?

Dr Sentance: That is a valid assessment because, if you look at the investment that is attracted to the UK because of our trade position, particularly with Europe, a lot of it is in high-productivity, high-value-added industries, both in manufacturing and services. One of the worries about Brexit is that, if we do not get good enough access to European and other markets, we may lose some of that high-value-added, high-productivity activity.

Q1206 **Chair:** I have probably three questions that may lead on to other things. The first was to pick up on the evidence that you sent. One of the things that you might have picked up from the questions that we raised yesterday with Treasury officials is that the Chequers proposal has been modelled, not the deal that is before Parliament at the moment. You picked that up in your second comment on the recent forecast. This is about the Government presenting “a scenario in which the loss of GDP can be reduced to 0.6% by embracing the White Paper/Chequers policy proposals”. You said that “Aside from the fact that this deal is already off the table, this is an implausibly optimistic scenario”. Those are quite strong words. Could you add to them?

Dr Sentance: My comments on that scenario were on the way it is positioned relative to what I think is also a benign story, which is staying in the European Economic Area. If I had to put a hierarchy of what is likely to produce the least negative economic impacts I would say that EEA, which would keep us in the single market and keep us in a very close relationship to Europe in many other respects, would probably be the least damaging, both in the short and longer term. Then some sort of bespoke deal like the Chequers White Paper might be the second-least damaging, with more of a free trade agreement scenario, and then a WTO rules scenario being the most damaging, or no deal.

I was a bit surprised that it seemed to give a very benign assessment of the Chequers White Paper approach, which has a couple of problems. One is that a lot of that approach is not necessarily going to find its way into the final deal. Secondly, they may have taken some rather optimistic assumptions relative to the EEA scenario, for example.

Q1207 **Chair:** That is helpful. You picked up on the EEA point, because you said that the UK Government believe they can “do better” economically in its White Paper deal than through EEA membership. You have just covered that, so you would rank them differently from the way the Government have done.

Dr Sentance: Yes, I would. That jumped out at me as being slightly counterintuitive.

Q1208 **Chair:** The other point I want to ask you is that your own analysis, looking more broadly, said, “The main downside risk to UK growth



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prospects is not Brexit in isolation, but a new wave of global protectionism". While we have you here, could you expand on that?

Dr Sentance: Yes, let me expand on that. One of the things that has struck me through my career—and it was very striking when I was a member of the MPC—is how the really big shocks that hit the UK economy are international shocks. We saw this in the global financial crisis: it was a global financial crisis; it was not just domestically driven from here in the UK. If you look at all the major recessions we have had since the Second World War, in the mid-1970s, early 1980s, early 1980s and the 2008-09 recession, they have all been associated with a downturn in many other countries.

One of the interesting points about where we are now is that, even though Brexit is having some negative impacts on the UK economy, the world economy has been performing quite strongly and that has helped to keep up our growth rate. The things that I would worry about as being big potential future shocks to the UK are things that are international in nature. When you hear some of the statements that Donald Trump is making and the way he is conducting US policy at the moment, one of the worries you have is that we go back into a more protectionist world, which was very damaging to the world economy in the 1930s. If we start moving in that direction, it would probably have more significant negative impacts on the UK than Brexit in isolation. The two could interact together and create an even worse combination, and maybe that is something that should have featured in the Bank's stress test analysis, in some way, but it seemed to look at a no-deal Brexit in isolation, not necessarily in conjunction with other factors.

Q1209 Chair: That is a common theme in both analyses. The Government were quite open yesterday about the fact that they have not factored in any other domestic policy responses. We touched on industrial strategy, for example, and looking at regional growth. I do not want to put words into your mouth, but you would say that there are things not included in both analyses. They are very much focusing on the trading relationship with the EU.

Dr Sentance: The things that will move the dials in the UK economy over the next five to 10 years are if we see Brexit interacting with other things that are happening across the international economy that are not positive and hit us negatively. That is probably a better encapsulation of the worst-case scenario, rather than just looking at Brexit in isolation.

Chair: On that thoroughly depressing note, do any colleagues have any other questions?

Q1210 Charlie Elphicke: You mentioned independence. The timing was raised in the Committee. We invited the reports, but it was raised in the Committee that the timing of the Treasury's report and the Bank of England's report being issued on the same day was unfortunate and not great from an independence point of view. What do you think?



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Dr Sentance: I agree. I looked for explanations about why these two things were coming together on the same day and I do not think the Bank put out a very clear explanation or maybe the Government did not, but it may be a failure of co-ordination. The Government have a stake in the Bank of England being seen to be independent and credible in its monetary policy response. When I was on the MPC there was a lot of concern to make sure the Bank was seen to be acting properly and independently, and not being too drawn into political debate. It seemed that the coincidence of those things coming on the same day did not help perceptions of independence and credibility.

Chair: Mr Elphicke knows very well the reason why those two things were published on the same day, because he was in the room yesterday when it was discussed.

Charlie Elphicke: I was simply asking. Can I ask a wider question?

Chair: The reason, Dr Sentance, to clarify the explanation, is that they were published on the same day at the request of this Committee, so staff and Committee members would have time both to read them and to be briefed before the evidence sessions started this week. This was covered in evidence given yesterday and I am sorry that you are being asked a question that has already been covered and explained by me, as Chair of the Committee, but I understand why you would want to cover it before you were aware of that situation.

Dr Sentance: At the time it happened, what was going on was perhaps not clear enough to independent commentators like me.

Chair: The Committee could certainly have made it clear. Even to the House the fact that these documents had been published at the request of the Committee was a mystery, as I explained in an exchange with the Speaker of the House last Wednesday. Do you have one more?

Q1211 **Charlie Elphicke:** What is your general view of how well the independence of the Bank has continued to be protected and what are your views on what the Committee can do to support that?

Dr Sentance: I have some concerns when I compare where the Bank is and is perceived to be now that its independence does not seem to stand as strong as perhaps it had in its first 10 to 15 years as an independent central bank. A number of things have happened and contributed to that. The appointment process of the Governor was rather unfortunate. The Bank of England Act laid down that there should be a single eight-year term and he was appointed for five years, and then the term was extended twice. The whole point of having a single eight-year term is to avoid extensions and discussions between the Governor and the Government about his future appointment.

In other ways, the Bank has been drawn into policy discussions, particularly on Brexit, where it has been seen not to be acting as



independently as it has in the past. The other thing may just be something I am preoccupied with. The Bank's stance on monetary policy seems to have been to avoid raising interest rates at all, in a way that is not quite appropriate for an independent central bank. I would have preferred to see the Bank operating a more robust and independent monetary policy, but not all economists agree with me on that one.

Chair: Thank you. We are straying into territory outside of the immediate remit of the Committee. Dr Sentence, thank you very much indeed for coming this morning to give evidence. We are very grateful to you for your time and for the written evidence and oral evidence as well, so thank you very much.

Examination of witness

Witness: Professor Sir Stephen Nickell.

Q1212 **Chair:** Professor Nickell, thank you very much indeed for being here this morning and thank you for your work in being a special adviser to the Committee on this inquiry. You will have heard the various evidence sessions that we have been through in the last couple of days. I have a series of questions and I am sure colleagues will have as well, particularly following the Treasury officials' evidence session yesterday. We also have the Chancellor coming before us this afternoon. I would like to explore your professional opinion on the Government's economic analysis, the things that have been modelled and the things that have not. We will start with something Mr Elphicke has asked questions about, which is whether the Government could have modelled the backstop scenario.

Professor Nickell: In principle, somebody could have modelled it. The problem for the Treasury officials, as you heard at some length yesterday, is that the Treasury now has a capacity for doing long-run modelling and not short-run modelling. In the light of that, there is a problem with modelling the backstop using a long-run model, because the backstop is not supposed to be a long-run entity. In principle you could do it, but they might feel embarrassed by modelling 15 years of backstop, so I can see why they would have that difficulty.

There is another problem, which is that you have no customs costs and tariffs in the backstop, but you are not in the single market, but there are potential differences in standards, regulations and so on, so there would be non-tariff barriers of a highly uncertain size. Even if it was for the long run, you would have to say the outcome would be something between the White Paper, say, and something to the left of an FTA. That would not be satisfactory and it is difficult to get a handle on precisely what kind of non-tariff barriers would exist in a backstop, particularly if it



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went on for a long time. I can see where they are coming from. If it was a short-run model, in principle you could model the backstop and you would just have to say, "The outcome is somewhere between here and here".

Chair: If it had been modelled, you think it would sit somewhere between an FTA and the White Paper.

Professor Nickell: Yes, it would, except the FTA has some customs and migration things, so you would remove those from the FTA.

Q1213 **Chair:** Were you surprised to hear that the Government Economic Service does not have a short-run capability?

Professor Nickell: It has outsourced it to the OBR basically, so it does not surprise me that much. Given the OBR produces the regular forecasts, I guess they felt it would not be sensible to maintain that capacity at the Treasury unused.

Q1214 **Chair:** There are two things that Parliament is being asked to approve. There is the draft withdrawal agreement, but also the 26-page political declaration. In your view, which of the scenarios the Government have looked at is consistent with the political declaration?

Professor Nickell: As I understand it, the political declaration is not consistent with the EEA, because it states that free movement shall no longer apply and EEA has free movement of workers. The Treasury report persistently says "free movement of people", but I think EEA is free movement of workers, so it is inconsistent with that. Do you want me to go on to the consequences?

Q1215 **Chair:** Could the Government have modelled other scenarios that are consistent with the political declaration? You will have heard the question that I and others put yesterday to the Treasury officials, which was that what has been modelled is not what was asked for and is not what is on the table before Members of Parliament. The answer came back that the political declaration has a spectrum of outcomes underneath it and it would not have been possible to model all of them. Do you agree? Are there scenarios that could have been modelled using the political declaration?

Professor Nickell: My instinct about that is to say that we modelled the so-called White Paper. Given the political declaration, the White Paper is the very best deal you could conceivably get if you had lots of terrific negotiators who did a fantastic job. Consistent with the political declaration, the other extreme is what you might call a bog-standard free trade agreement. In some sense, I feel that, if the negotiation goes really badly, that would be the lower bound. If it goes really well, the White Paper would be the upper bound, but the outcome is going to be somewhere between those two. I would put it slightly closer to the White Paper than the other side, because we start from a position of regulatory alignment, which is a good place to start from. In some sense, where we



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end up will be a matter of how the negotiation turns out. I assume that is why the Treasury included another scenario, which is the White Paper plus some extra non-tariff barriers.

Q1216 Chair: What is your view of that to the Committee? Do you think that is still unrealistic? Was it right for the Treasury to put in a scenario with sensitivities?

Professor Nickell: I do not know. In some sense it is up to you. You can do that. As a Committee, you can decide. Basically, there are lots of scenarios and assumptions. In some sense, each individual has to decide which they think is the most plausible. My judgment is that, by and large, given any set of assumptions, the outcomes that they forecast are quite plausible. The key is which assumptions you take and, in some sense, that is a personal decision.

Q1217 Chair: I want to come on to the assumptions in a moment, which we will do. Just sticking with the Treasury's choice of models, we have also received evidence that the Government's analysis about the relative impact of leaving the EU under different regimes is more certain than general economic forecasts. Do you agree with that?

Professor Nickell: Definitely. By saying what would happen with this assumption relative to that assumption, you can ignore all the exogenous shocks that will undoubtedly hit the economy over the next 15 years, under the assumption that these shocks would affect both scenarios in the same way. For example, you can say that, aside from the shocks implicit here, if the economy or the outside world runs smoothly for the next years at a background of 1.4% growth, say, in the end you are better off under any of these scenarios. On the other hand, if the world economy is hit by a gigantic recession at the end of the 2020s, you could easily be worse off under all scenarios. Under the assumption that shocks from outside in some sense hit all the different scenarios equally, you can afford to ignore them in this kind of analysis.

Chair: Do any other Committee members have anything to ask specifically on the models, before we go on to the underlying assumptions?

Q1218 Charlie Elphicke: One concern I keep raising with Treasury officials and the Chancellor is that they do not publish the assumptions. In the weeks leading up to publishing their modelling and conclusions, I said, "You talk about CGE modelling and all this, but what are the assumptions? Can you publish them, so that we can all have a look and a say, and assess whether the model is fair, biased or otherwise?" Would you agree, as an economist, that it would be helpful to have the assumptions and understand things better?

Professor Nickell: I am unclear as to what level of assumption. They publish assumptions about the size of non-tariff barriers under the WTO, an FTA and so on. They publish those assumptions. What other



assumptions are you looking for? Do you mean the structure of the model?

Q1219 **Charlie Elphicke:** Yes, I mean the structure of the model, because we are just being presented with a black box and told, "This is the black box and the Treasury knows best". Is that good enough?

Professor Nickell: It is true that they have produced this technical document, which has quite a lot of equations in it, which gives you some insight into the black box. To be quite honest, I do not know whether the Treasury has published the manual describing the CGE model they use. When I was at the OBR, we had a big model of the economy and that was published for anyone to see. You are right that they should publish the manual of the model, and I am quite surprised that they have not, if they have not. Mind you, I am not sure that the person in the street would get much out of it anyway.

Q1220 **Charlie Elphicke:** My point is the Treasury has had the Treasury view for so long that there has been, in fact, a phrase in the English language, "the Treasury view", over the last century. This Committee and parliamentarians need to hold the Government to account, so the more people who look at and model these things, the more information and evidence we have. Would you agree that evidence is important for political decision-making?

Professor Nickell: I could hardly disagree.

Chair: That was a nice short answer. Thank you.

Charlie Elphicke: Can I ask about the whole backstop-modelling issue?

Chair: I did ask that at question number 1, Charlie, but you are very welcome to come in.

Q1221 **Charlie Elphicke:** I am troubled that we are being asked to make a decision and we got evidence yesterday from Treasury officials that they have not modelled the backstop at all.

Professor Nickell: I thought I explained that the reason they have not modelled the backstop is that a long-run equilibrium is not appropriate for the notion of backstop, since it is not going to last for 15 years—touch wood. They do not have the facility to do short-term modelling. Of course, the Bank of England has such a facility, but my understanding is that the Treasury does not have that facility. The OBR has that facility.

Q1222 **Charlie Elphicke:** I have two follow-up questions. The first is that the NIESR says that it has modelled the backstop.

Professor Nickell: It has a facility for short-run modelling.

Q1223 **Charlie Elphicke:** That makes sense. The other issue is from our point of view as parliamentarians. We read the history books and see that countries such as Norway have been in temporary arrangements for 20



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or 30 years, so would it not be prudent—prudential in an accounting sense—to model it being a long-term scenario with long-term effects?

Professor Nickell: It may be. The fact is that, given the existing scenarios, you can say, roughly speaking, where the backstop scenario would be. It would be somewhere between the White Paper and a somewhat adjusted FTA, but precisely where would be very hard to judge. Even the Treasury would find it hard to judge.

Q1224 **Charlie Elphicke:** The backstop would be worse than the White Paper, effectively.

Professor Nickell: Almost certainly, yes.

Q1225 **Charlie Elphicke:** It would be without the potential upsides of trade deals in an FTA.

Professor Nickell: I am not sure what the thing about trade deals and the backstop is.

Charlie Elphicke: In the backstop, we are in a customs union, and the view seems to be that we cannot do trade deals.

Chair: There are trade deals and what you are in the customs union for. We had a debate yesterday on whether you can do trade deals in relation to services, but not in relation to goods, which is what you are in the backstop for, which is why it is uncertain. Everyone is looking at me. I do not have the answers; I am not the Government. John, you had some questions.

Q1226 **John Mann:** I recall, in the late 1970s and early 1980s, there was a wonderful Warwick University piece of software, which had three models built into it into which you could put your assumptions. It was incredibly useful. I used it for union wage negotiators across the country. They used to say, "Spend all this money on this; spend all this money on that". I used to feed it in and say, "Inflation has gone up, so you had better negotiate a higher pay rise. Let us see what happens when you do that". It was a useful tool for people thinking through some of the arguments to be put against why X and Y should be done. I have asked Warwick and tried to track it down. It does not seem to continue doing it. Are you aware of whether there is an idiots' guide for us or even a more sophisticated one for informed politicians?

Professor Nickell: You would probably have to pay for it. There are various commercial organisations who will do almost anything, if you give them the money. Warwick used to have a Macroeconomic Modelling Bureau, but that was abandoned. That was funded by the ESRC.

Q1227 **John Mann:** Are you aware of a parallel anywhere?

Professor Nickell: I am sorry; I am not.

John Mann: We are probably in error as a Committee. Six months ago, we should have investigated this.



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Q1228 **Chair:** Did the Treasury not mention the University of Indiana model yesterday? There is a University of Indiana model.

Professor Nickell: The CGE model comes out of the University of Indiana, and I assume that it would have published a manual for this model.

John Mann: It is probably a bit late for us. I am looking at our brilliant staff here.

Professor Nickell: But it would have been tweaked. Everybody who takes these models tweaks them.

Q1229 **John Mann:** I do not know whether my other two questions are on the model or the assumptions, and they kind of collide. One of the things with the labour market and assumptions on immigration is that some of the industries in my area are on the cutting edge on this. I have two in particular, in terms of options going forward. One is fruit-picking, where robotic fruit-picking is quite possible. Robotics is a field I have done a lot of work in historically, so I can see exactly how it would work. The other is warehousing, where again there are advantages from artificial intelligence linked to robotics. There is a coherent argument that labour shortages would simply bring forward technological advances, and those are good at it will thrive and those who are not will lose their market share. The industries would be able and forced very quickly to adapt in the way that parts of manufacturing in this country had to do in the 1980s, when they computerised almost overnight.

In your judgment, is that built into the model sufficiently? Immigration or access to labour is certainly a factor, but there is a big question about whether, if there is a shortage of ready unskilled labour, there would be investment in AI/robotics to replicate that faster than is going to happen anyway, because people do not have a choice. Is that too complex a hypothetical for the model or is it built in, in some way?

Professor Nickell: It would be possible to put that into a slightly more sophisticated model. I am not quite sure whether the model they use has different types of labour. You are basically saying capital replaces unskilled labour. The fact is that, in the modelling done, there are only two scenarios for migration. They are as we are now and zero net migration from the EEA. That was done explicitly because, as I understand it, we do not have a policy for migration subsequent to Brexit, although we do have the MAC recommendations. They would, if they were followed, lead to a cut in unskilled migration, which would particularly focus on the EU, because most of the unskilled migration is currently from the EU. The rules governing non-EU migration are such as to discourage unskilled migration.

Q1230 **John Mann:** That seems to be a weakness in modelling that could exacerbate potential problems. Can I throw in another weakness in the other direction, which could minimise or understate the problem? It is



about the manufacturing industry and its ability to relocate. That may or may not be economically rational, and people could argue about that, but clearly the capacity to take a car company and shift it in a short period of time is dramatically easier now, anywhere in Europe including us as part of Europe in that definition, than it was even 10 years ago. How much is that modelled in, as an ultra-cautious response that we will simply shift because that is the cautious thing to do and we can? I am using car plants, but there are other bigger examples and many much smaller ones. They can take an operation and simply shift it, because these days that is much easier to do. The danger is that that is potentially understated by the modelling.

Professor Nickell: I find it hard to say whether it is understated. It is true that, in these kinds of models that are done for different sectors, capital shrinks and rises depending on profitability and so on. That is all encapsulated into the long run of these models. If you make the assumption that there are non-tariff barriers particularly affecting the motorcar industry, you will notice from this thing that the car industry shrinks more relative to other industries. To a certain extent, that is in. Whether the parameters of the model are accurate and capture all the effects in which you are interested I could not possibly say. They may overstate these things. The parameters of these models are based on empirical evidence gathered over long periods of times and, therefore, reflect history to some extent. They may not completely capture changes that have occurred recently.

John Mann: Thank you. That unhelpful answer is actually very helpful to us, in the sense of shedding light.

Q1231 **Chair:** Building on that, what assumptions that the Government's analysis has made do the most to drive the differences between the scenarios? We have talked about migration, where you can see the numbers changing depending on which migration scenario you use. Are there any others?

Professor Nickell: Non-tariff barriers drive this whole thing, basically. Migration is just an add-on for certain scenarios and not others, and it is kind of obvious, but the non-tariff barriers drive everything. The difference between the White Paper and the WTO, leaving aside the tariffs, which is obvious, is the huge difference in non-tariff barriers between the two. I will just say how they work that out. It is not just a number plucked from the heavens. What you do is analyse trade. You take 120 countries and analyse trade between those countries over a period of time. You look at the countries that trade with each other under WTO rules, the countries that trade with each other on free trade agreements and the countries in the EU that trade with each other on much deeper than free trade agreements. You then work out the average trade you get, taking account of distance and size, as we heard yesterday. You look at the average trade between the WTO countries, the free trade agreement countries and EU countries, controlling for distance and size.



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You then say, "Look, the average trade between the EU countries, controlling for distance and size, is much higher than between free trade agreement countries, which is then somewhat higher than trade between WTO countries". You then say, "Okay, anything about these differences in average trade that we cannot explain by tariffs and customs is explained by non-tariff barriers". Then they back out the non-tariff barriers from the amounts of trade they observe in these different scenarios, and that is how you get these big differences in non-tariff barriers. That is quite a scientific activity, not arbitrary guesswork.

Q1232 Chair: We touched on this yesterday in the session with the officials. From memory, Mr Baker in particular was asking about some detailed VAT declarations and that sort of thing. Understanding the assumptions being made about what to treat as non-tariff barriers is important in understanding how the scenarios have been arrived at.

Professor Nickell: Yes, but deriving these numbers is not bottom-up. It is done by backing it up from the actual observed trade. Anything you cannot explain by tariffs and customs must be non-tariff barriers.

Q1233 Chair: I have a couple of final questions and I know Alison has a couple of questions as well. Overall, as an adviser to the Committee on this particular inquiry, do you consider the Government's scenarios to be plausible?

Professor Nickell: Broadly speaking, yes. They are within the bounds one might expect. One thing that I noticed in the evidence is the effect of free trade agreements between the UK and the rest of the world. If you recall that was something like 0.2%. People asked about that and Roger Bootle said it was because they obviously do not have enough free trade agreements, but the fact is they have free trade agreements with everybody they can think of in their assumptions, so that is not the answer. It was then said yesterday that it is because of all these free trade agreements with countries that are a long way away. In some sense that explains the trade. The fact is that these rest-of-the-world free trade agreement countries add up to 27% of UK trade, which is quite a lot.

I thought of a back-of-the-envelope calculation here. You are going from WTO to free trade in these agreements. You are going from WTO to free trade for the EU, which is 50% of trade. Look at the two columns in your picture and you get a difference of about 2.5% of GDP. If you do the same for 27% of trade you get half that, 1.25% of GDP, which is a lot bigger than 0.2%.

Anyway, I found the answer. The answer, first, is that EU/UK trade has much higher average tariffs than UK/rest-of-the-world trade because there is much more agriculture and cars, and much less services in UK/EU relative to the UK/rest of the world. That means there are much lower tariffs so, when you strike a free trade agreement, you get much less bang for your buck than you would if you went from WTO to a free



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trade agreement in the EU. The other one is because there are more services, and non-tariff barrier reductions in services have a much lower impact on trade than non-tariff barrier reductions on goods. That is apparently just a fact, which I can believe. The consequence of that explains why these effects are much smaller.

Q1234 Chair: That is very helpful. Finally, you might have seen the Institute for Government produced a helpful chart that set out the long-term impact of Brexit on GDP, relative to remaining in the EU. It went through all the different economic analyses, perhaps not all of them but the whole scenario. The one that is out of kilter with everybody else's is the Economists for Free Trade's. What assessment have you made of the Economists for Free Trade's analysis, if you have made an assessment? Is it something you have looked at?

Professor Nickell: The Economists for Free Trade use a different and, in my view, less reliable framework for analysing these things. They also tend to make different assumptions. For example, when they do a WTO argument, they assume that non-tariff barriers between the UK and the EU do not go up by very much. This is what I think of as the Minford argument. Patrick Minford argues that, when you switch to WTO rules, because we are already completely in alignment, nothing will happen so there will be non-tariff barriers. That has superficial plausibility, but arguably depends to some extent on the good nature of the French not wishing to discover whether our goods obey the regulations. Also, after a certain time, regulatory alignment would unalign, so you could not rely on it in the long term. That kind of assumption is probably not very plausible.

Q1235 Alison McGovern: Thank you, Sir Stephen. It has been helpful listening to you this morning and for all your work on our behalf. I have one question. Often we think about trade between the UK and the EU or the UK and the rest of the world, but the regions of the UK are quite different in how they trade with other parts of the world, whether the EU or not the EU. Does it make sense to think about the impact of Brexit in that way? The disaggregate impact will be more significant than the aggregate. That is my sense from what I have heard from witnesses.

Professor Nickell: This kind of long-run model is disaggregated by sectors. It has vehicles, chemicals, financial services, et cetera. There is some useful information here. What you basically learn from this is that the chemicals and vehicles sectors take the biggest hits, relative to the other sectors. Then they look at the regions. The way they do the regions is simply to back them out of the sectors, because we know how the sectors differ across regions. Cars are much more important here than they are, and financial services here than they are there. Once you have the sectors, you can look at regional impacts and, as you rightly say, they are very important. They can say what the regional impacts will be, but they cannot talk about how to get there. Do people move from one region to another? How does that all work? The transition process is completely unmodelled.



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Q1236 **Alison McGovern:** It is partly because that is a big political question. Whether the people of the north-east all want to move to London is a bigger question than the economics can tell us.

Professor Nickell: A lot of them do now.

Q1237 **Alison McGovern:** Exactly, and not all of them are thrilled about it. With that in mind, I want to come to unemployment. From a modelling point of view, economists are a little at sea about unemployment at the moment.

Professor Nickell: Do you think so? I thought we understood it pretty well.

Q1238 **Alison McGovern:** The Bank does not quite understand why we have got to near full employment but wages are not going up.

Professor Nickell: That is true.

Q1239 **Alison McGovern:** What consideration should our report take of the place of unemployment in these models?

Professor Nickell: The fact is there is no unemployment in the Government model. It is fundamentally a full-employment model. What they investigate is what happens if you change this, change that, and what will happen to all the sectors of the economy, assuming everybody is employed. That tells you nothing about unemployment. The Bank models have unemployment as a very important feature of the consequences of the shock. The consequences of the shock mean you get a swift fall in GDP and a swift rise in unemployment associated with that, just like we had in 2008.

Q1240 **Alison McGovern:** To pursue this a little, this is the difference between the short-term and the long-term models. The long-term model, which is an across-government analysis, has basically assumed that, after 15 years, any immediate problems with unemployment have resolved themselves and there is no longer an impact. Would not everything that we know about unemployment, as a result of the recessions or shocks in the 1970s and 1980s, say that that is an unfortunate assumption, given the impact, especially on regional economies, of short-run unemployment?

Professor Nickell: What you are basically saying is that, if you have a severe shock to Sunderland or somewhere, it could last a long time and we have many examples of that across the country. It is unfortunate but true that, in their model, they have nothing to say on that question.

Q1241 **Alison McGovern:** What about wages?

Professor Nickell: They do have something to say on what happens to wages. The way I think about it is, as a first pass, you expect real wages to adjust with GDP per capita, but that is not quite what happens in this model. Actually, real wages fall by more than GDP per capita, and the reason is that profits per capita fall by less than GDP per capita. In other



words, what implicitly emerges in this activity is a slight reduction in the share of wages and a slight increase in the share of profits.

Q1242 **Alison McGovern:** It exacerbates the problem that we already have.

Professor Nickell: To that extent it does. Why does that happen? My instinct is that it is probably because these trade barriers tend to reduce competition and reductions in competition are good for profits.

Alison McGovern: Did we want to cover anything further on immigration? Is there anything else we need to ask on immigration in the models?

Q1243 **Chair:** I was going to ask a general question at the end, which is whether there is anything else that you feel you want to bring to the Committee's attention. Alison is right; it could be on immigration. We had quite a good Q&A with John, but is there anything else that you feel we should be aware of before we prepare our report to MPs?

Professor Nickell: We have more or less covered everything that I had down here. The problem with immigration is that we do not know what the policy is going to be, so what can you say about it? I suspect not very much.

Q1244 **Chair:** It is quite hard to make assumptions, because even the Migration Advisory Committee has a recommendation to Government. It does not necessarily mean Government are going to follow what has been recommended.

Professor Nickell: Exactly so. You could say the MAC says what you should do and pursue the consequences of that, but that is not Government policy.

Chair: Thank you, Professor Nickell. I know you have been working behind the scenes, with Treasury officials as well and are here today to give evidence. We are very grateful to you for the time you have put into this to enable us to prepare, hopefully, a useful report for our fellow MPs.

Professor Nickell: Thank you very much. I am happy to be here. I have not been here for two years.

Chair: I am sure you missed it, as all former witnesses do. We are going to finish the conversation there. Thank you.