# Assessing the implications for business of a "BREXIT" scenario

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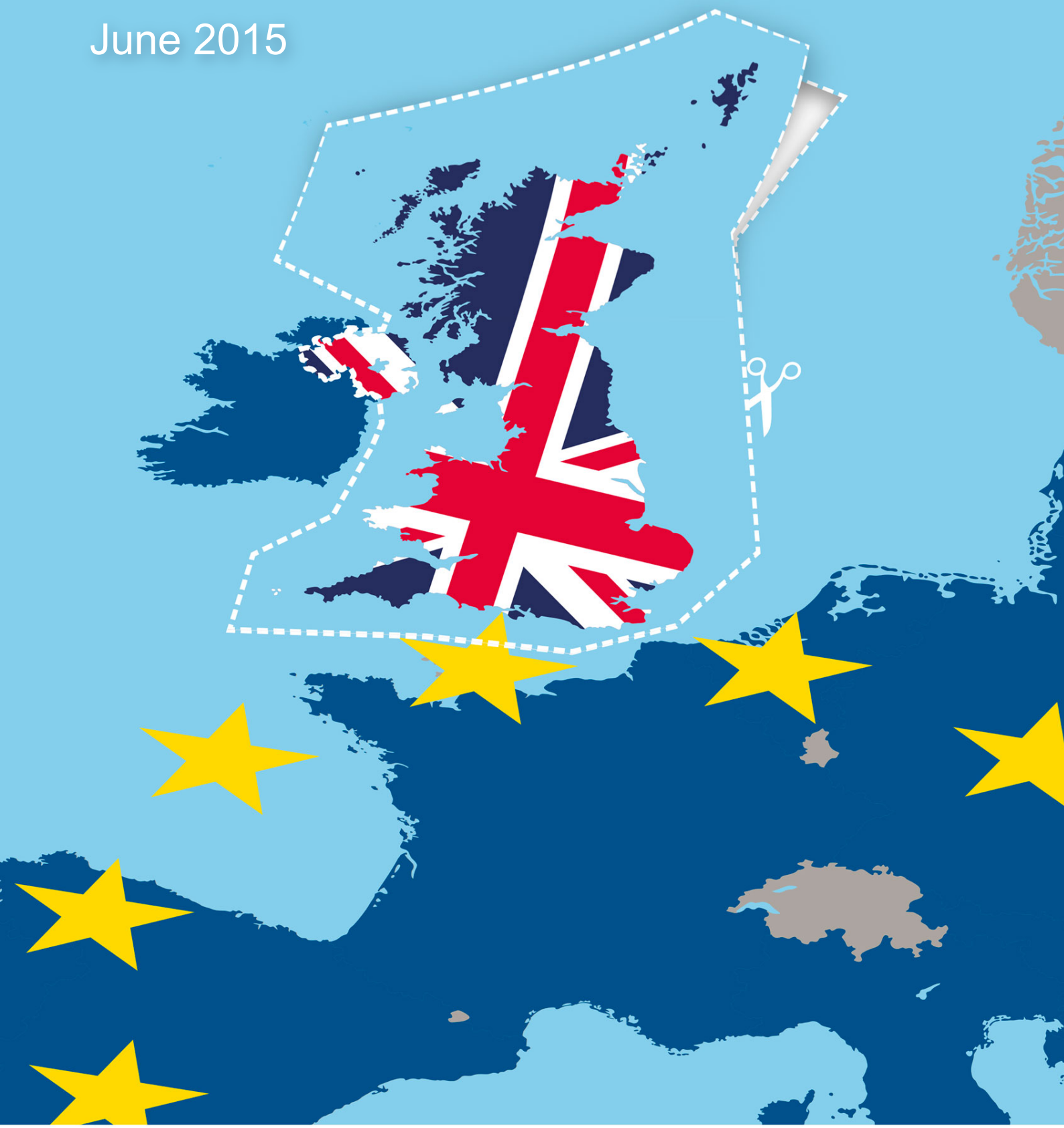

OXFORD ECONOMICS

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# 1 Executive Summary

**The implications for business of a BREXIT scenario**

The new Conservative government is committed to holding a binding referendum on European Union membership by 2017, while seeking before then to negotiate "a better deal" for the United Kingdom within the 28 member bloc. A UK withdrawal, a scenario dubbed "BREXIT" would have wide-scale implications for businesses and investment decisions across the board. Part of the single market since 1973, the union's third largest economy currently attracts half of all its overseas investment from the EU, and a similar percentage of the nation's goods and services are exported to other member states.

In order to prepare for a possible break with the EU after 2017, business leaders, economists, investors, and strategists need to assess its potential economic implications. Analysing BREXIT is extremely complicated because of the range of ways it might occur, and because the ways in which the economy is affected are so complex—via trade, investment, labour markets, and consumer and corporate confidence to name but a few.

To fill this information gap, Oxford Economics is **seeking funding to support a quantitative research study** which will include the results of an intensive and impartial modelling exercise using our global economic model, with full analysis and data sets for a series of potential scenarios. The study will represent a comprehensive and fully independent assessment of the implications for economic activity in the UK and the rest of the world.

Any post-withdrawal settlement could vary substantively in terms of how it affects UK-EU trading and investment relationships. To account for this, we propose to run a number of scenarios framed around the most likely options including:

- **The Norway option:** leaving the EU but becoming a member of the European Economic Area (EEA);
- **The Swiss option:** where the new settlement is the product of continued bi-lateral negotiation;
- **The Turkey option:** where the UK would enter into a customs union with the EU, similar to the current arrangement adopted by Turkey; and
- **Complete withdrawal:** involving a complete repatriation of powers, with the UK-EU's trading relationship determined according to the WTO's Most Favoured Nation (MFN) criterion.

Outputs will include a report, databases, and a conference in London. The final results will detail BREXIT's impact on activity across a range of metrics including GDP growth, trade volumes, inflation, household spending, and employment. The analysis will provide insights into BREXIT's impact on the UK property market, implications for UK and global asset prices, how it would affect London's status as an international financial centre (and which rival hubs stand to gain from this), and how the impacts would vary across different industries and regions of the UK.

To ensure that our approach meets the standards or best practice we will consult with a group of expert advisors whose expertise cover all aspects of the complicated subject. Although the full team has yet to be finalised, the objective will be to assemble a group whose expertise cover the full range of effects that will result from this type of scenario.

The analysis will cover:

- How trading patterns for both goods and services would be affected accounting for the impact of both tariff and Non-Tariff Barriers (NTBs);
- The potential impact on capital flows, including, but not restricted to, the effect on Foreign Direct Investment (FDI);
- The effect on inward and outward migration and how this will affect the availability of both skilled and unskilled labour;
- Implications for business costs and consumer prices due to changes in trading patterns and tariffs imposed on specific products; and

- How the Government could opt to use its new-found freedom in certain areas to reform the business regulatory environment.

We plan to publish the results of our research in September 2015. Subscribers to this study will benefit from the following:

- Bespoke access to our final report which will detail the results of our modelling.
- Access to an online databank which will contain the quantitative results from the scenario for 46 economies covering a wide range of core macroeconomic variables such as GDP, consumer spending, inflation, international trade flows and financial asset prices.
- An invitation to a launch event in London, to mark the publication of the final report, where a panel of experts will debate the pros and cons of EU membership.
- For subscribers not able to attend the launch event, we will hold a series of webinars hosted by a senior member of the project team.

# 2 Introduction

This proposal sets out the approach that Oxford Economics would pursue in quantifying the implications of BREXIT for the UK and global economy. The remainder of the document is set out as follows:

- Section 3 sets out the approach we would adopt for this study;
- Section 4 sets out the deliverables you would receive as part of the study;
- Section 5 provides background information about Oxford Economics.

If you have are interested in subscribing to this multi-client project please contact:

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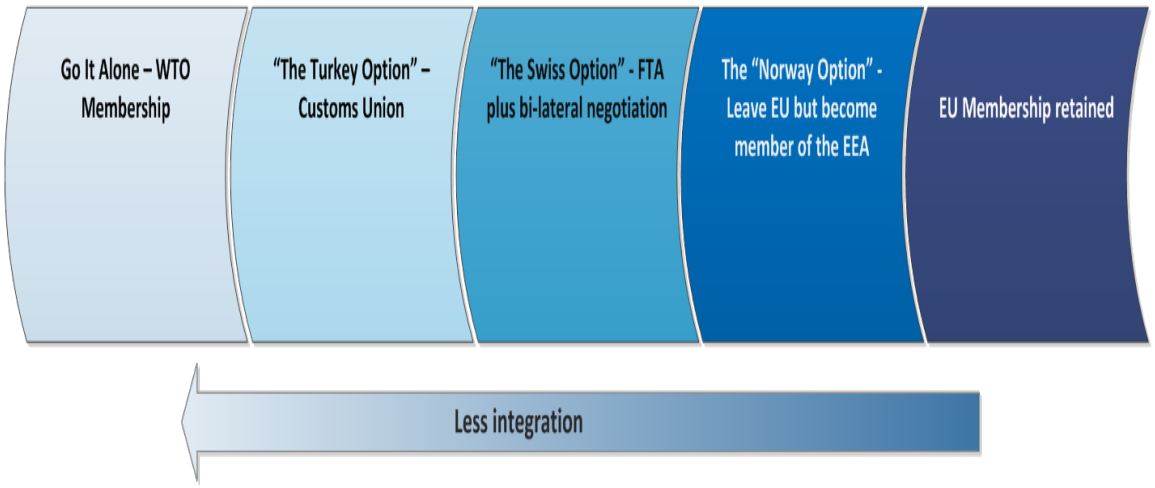
# 3 Project Approach

## 3.1 Different post-withdrawal outcomes

One of the key sources of uncertainty, when trying to model the impact of a BREXIT event, is that there are numerous options with regards to the counterfactual of how trading, regulatory, fiscal and investment conditions would evolve post-withdrawal. Typically, these have been defined in terms of arrangements adopted by other European non-EU member states as summarized in Figure 3.1:

**Figure 3.1: Post-withdrawal options for the UK-EU bi-lateral relations**




- **The "Norway Option"**: this would involve becoming a member of the European Economic Area (EEA), therefore retaining full access to the single market. The UK would no longer be bound by the CAP or regional policy but would have to abide by EU product harmonization laws and employment regulation. Fiscal contributions would be reduced to some specific programmes (e.g. research and cohesion funds).
- **The "Swiss Option":** this would involve negotiation of bi-lateral agreements with the EU (Switzerland currently has over 100) member states. This option is the hardest to define with precision, since the outcome is dependent on the extent and success of such negotiation. The most probable method of calibration would be to assume that the UK eventually ends in a similar position to the current status quo in Switzerland.
- **The "Turkey Option":** entering a customs union would preserve access to the single market. In a customs union, the UK would no longer be bound by the EU's social and employment regulation or programmes such as the CAP. However, it would still be bound by technical regulation of products, competition and Intellectual Property (IP) law.
- **The "Complete Withdrawal Option":** this would represent complete withdrawal with a full repatriation of powers back to the UK. Without agreement of a separate Free Trade Agreement (FTA), UK goods exports would be subject to the EU's Common External Tariff (CET) and it would be free to negotiate new trade deals with other members of the WTO.

Given the alternative options that exist, it is little wonder that the past literature has reached such divergent conclusions regarding the implications of withdrawal for the UK economy. We propose to overcome this issue by running a range of scenarios underpinned by different assumptions regarding the characteristics of the post-withdrawal settlement.

## 3.2 Channels of impact

This section summarises the various channels of impact through which BREXIT would impact upon UK and global economic activity. The channels are sub-divided into a number of different categories:

### 3.2.1 Impact on trade in goods

- Full withdrawal would potentially lead to the implementation of tariffs on UK goods exports to the EU under the existing Common External Tariff (CET). Equally the UK government would now have the authority to impose tariffs on EU goods imports.
- There may also be an impact on the UK's trading relationship with countries where the EU has already agreed a preferential trade deal (these include Korea, Chile, Turkey, South Africa and Mexico).
- Unless it joined the EEA, the UK would have the freedom to negotiate new agreements bi-laterally with non-EU trading partners.
- Goods trade is also affected by a variety of non-tariff barriers. Longer-term the impact of withdrawal is that these will increase (compared to the baseline case), premised on the assumption that there is continued harmonisation of the single market.

### 3.2.2 Impact on trade in services

- Services trade is currently subject to a range of restrictions even within the EU (the single market is not complete), in the form of NTBs. It is likely that these barriers will grow over time, post-withdrawal, as the regulatory environment (for example in terms of product standards) diverges further. This reflects the fact the UK will not be bound by continued efforts by the EU to complete the single market.
- Certain elements of services trade likely to be directly impacted by regulation. For instance:
    - **Financial services** – the ECB is currently trying to regulate to ensure that Euro-denominated transaction clearing occurs in the Eurozone (if the UK left it could not appeal this in the European Court of Justice).
    - **Travel** – restrictions on movement of labour will hit tourism, transport and hospitality trade with the EU.
    - **Consulting** – government procurement contracts are typically restricted to companies based in EU-member states.

### 3.2.3 Impact on movement of labour

- Dependent on the type of withdrawal, it could be that the UK regains full control over its borders. Such an outcome would have implications for net migration flows, with any government likely to introduce controls at the border, and equally that restrictions would be imposed by the EU on the entry of UK immigrants.
- In addition, it is possible that withdrawal could affect the residency status of both EU migrants within the UK and UK migrants living in EU countries abroad.

### 3.2.4 Impact on regulatory environment

- Depending on the nature of the new settlement, the government would have scope to reform existing regulations affecting areas such as:
  - Health and safety
  - Employment law (Working Time Directive, Temporary Agency Workers Regulations)
  - Product specifications
  - The environment and energy
  - Financial sector
  - Consumer protection
- Such reforms will have implications for both businesses and other stakeholders within society such as households.

### 3.2.5 Impact on fiscal policy

- Dependent on the terms of the withdrawal settlement, the UK's fiscal responsibility to the EU is likely to change as measured by the size of its annual net contribution. Since the UK is set to continue to be a net contributor, the overall fiscal impact of BREXIT, other things equal, is likely to be positive.
- The overall impact on fiscal policy will depend on how the Government decides to use the surplus funds. For example, they could opt to boost expenditure elsewhere to help compensate groups (such as farmers) and regions that have lost out, cut taxes or simply use the extra fiscal space to reduce government borrowing.

### 3.2.6 Impact on consumer prices

- Agricultural prices likely to fall if the UK no longer has to comply with the CAP, and is able to import freely from other countries.
- To the extent that producers decided to pass costs on, the imposition of tariffs on EU imports (and those from countries with which the EU has negotiated an FTA) would push up import prices. Equally, the UK would have the option to reduce the CET on a variety of products.

### 3.2.7 Impact on Foreign Direct Investment

- Empirical evidence suggests that there is a positive relationship between market size and inflows of FDI. This seems to be verified by both econometric evidence tracking actual flows of FDI by country and survey evidence when firms are asked about factors which most influence their investment decisions. Given this, any loss of access to the single market has the potential to diminish FDI flows into the UK.
- There is the potential for both "stock" (firms shifting existing operational facilities out of the UK to a base elsewhere in the single market) and "flow" (future flows of FDI that would have gone to the UK diverted to elsewhere in the single market) effects.
- The impact is likely to vary significantly by sector. Factors that could affect this include the capital intensity of production (firms typically find it easier to re-locate machinery as opposed to labour) and the extent to which the sector sells its output internationally.
- Finally, we will also consider the extent to which associated regulatory reforms could influence flows of FDI. For example, the extent that the UK opts to introduce a more

"business-friendly" environment will affect the attractiveness of the UK as a location for FDI.

### 3.2.8 Impact on the status of the City of London

- Related to a number of the effects outlined above will be the potential impact on the City of London's status as an international financial hub and conversely the other centres that could benefit, were this to diminish.
- In order to assess how London's status as a financial sector would be affected in this scenario, we will survey the available literature (this covers both reports addressing this question and related submissions from firms in the financial sector) and seek guidance from our expert advisors (see Section 3.4 below).

## 3.3 Modelling approach

Our approach will be to combine alternative modelling techniques, although the core work will be run on our bespoke global macro model. The global model is uniquely suited to being able to answer questions relevant to this piece of work. Country models are linked, among other channels, through trade and investment flows which are clearly of paramount importance in this context.

In order to quantify and model the impact of changes in NTBs we will identify indicators that measure trade restrictiveness (a number of alternative measures are produced by organisations such as the OECD and the World Bank) and calculate the size of the barrier in tariff-equivalent terms using econometric techniques. The static first round effects of a change in NTBs (in terms of how it affects the allocation of resources across sectors) will then be modelled using the CGE model of the General Trade Analysis Project (GTAP) centre at Purdue University. Outputs from this model will then be used as inputs into our global model which will help capture dynamic effects of changing trade patterns (via channels such as economies of scale, competition, technology transfer and innovation).

The model's international framework will also enable us to assess the broader implications of what would be a truly "global" shock. Some of the feedback channels to the rest of the world that will be quantified via the global model include:

- The impact from the re-allocation of capital flows (including FDI) that might be diverted away from the UK as a result of BREXIT;
- Reduced activity including via multiplier effects that would result from a reduction in trade flows; and
- Reverse impacts on labour markets and the supply side capacity of economies abroad as a result of the changes in net migration patterns into the UK.

In terms of the modelling time horizon, we believe that a 10-year forecast period would be appropriate (post-withdrawal) for this type of scenario. Whilst some of the impacts discussed above will feed through immediately, others (particularly those affecting the supply side capacity of the economy) are likely to feed in more gradually.

## 3.4 Expert guidance

In order to ensure that we employ best-practice in our methodological approach we intend to consult a group of expert academic advisors. The aim will be to assemble a panel with a range of expertise covering all relevant issues for this scenario. Although the final group of advisors has yet to be determined the following will form part of the project team:

- Professor John Muellbauer: Professor Muellbauer is a fellow of Nuffield College at the University of Oxford. He is an applied macroeconomist specializing in macroeconomic modelling and forecasting and areas such as the link between the financial sector and the real economy and regional housing and labour markets. He has also written extensively on the relative merits to the UK economy of joining the Euro.
- Chris Allsopp: Chris is a fellow of New College at the University of Oxford and Director of the Oxford Energy Institute and has also served as a member of the Monetary Policy Committee (MPC) of the Bank of England. Much of his recent work has focused on the design and evaluation of monetary and fiscal policy frameworks. He has also investigated the implications for fiscal policy in the UK of becoming part of European Monetary Union.
- Andrea Boltho: Andrea is an emeritus fellow of Magdalene College at the University of Oxford, specializing in applied macroeconomics and economic policy. He has written extensively on international trade and economics of Europe. He has also published, together with Barry Eichengreen, on the economic impact of European integration.

# 4 Deliverables

The key outputs from this project will include:

- A main report summarising the key results and conclusions from our analysis including an executive summary and a methodological appendix;
- A databank including the results across all scenarios for core macroeconomic variables for the 46 economies covered by the global model[1]. This will enable subscribers to view the impact of BREXIT on variables including:
    - Real GDP and its expenditure components (household consumption, investment etc.)
    - Consumer prices and other measures of inflation
    - International trade flows and the current account position
    - Labour market metrics such as employment and earnings.
    - Financial asset prices (exchange rates; interest rates; 10-year sovereign bond yields; stock market indicies etc.)
- A launch event in London to mark the publication of the final report. The event will include a panel debate between a group of experts discussing the pros and cons of EU membership.
- For clients not based in the UK, we will hold a series of webinars hosted by a senior member of the project team to discuss the key findings from our analysis;

The fee for joining the research programme is £9,500.

[1] **Developed economies**: US, Japan, Eurozone, Germany, France, Italy, UK, Canada, Austria, Australia, Spain, Denmark, Finland, Norway, Netherlands, Belgium, Portugal, Ireland, Sweden, Austria, Switzerland

**Emerging markets:** China, Taiwan, South Korea, Hong Kong, Thailand, Malaysia, Philippines, Indonesia, Singapore, Mexico, Brazil, Argentina, Chile, Poland, Czech Rep., Hungary, Russia, Bulgaria, Croatia, Slovakia, Romania, South Africa, Turkey, India, UAE

# 5 About Oxford Economics

Oxford Economics was founded in 1981 as a commercial venture with Oxford University's business college to provide economic advice and forecasts to international organisations. Since then, we have become one of the world's foremost independent global economic firms, producing forecasts, analysis, and data on over 200 countries and regions, 100 industries, and 3,000 sub-regions and cities. Our team includes over 120 professional economists, industry analysts, and management experts.

Oxford Economics specialises in global quantitative analysis and business and public-policy advice. The firm offers a sophisticated portfolio of forecasting services, consisting of regular reports, databases, and models on countries, cities, and industries. Oxford Economics is renowned for its evidence-based consulting and thought leadership services, including economic impact studies, scenario analysis, business modelling, risk assessment, market sizing, executive surveys, white papers, and public-sector analysis. The firm is distinguished by the quality of its quantitative analysis, calibre of its staff, and close links with Oxford University. We offer the world's only integrated Global Economic and Industry Model.

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- **Multinational firms**, such as Apple, GE, Shell, Coca-Cola, Airbus, IBM, Rolls- Royce, BP, BAT, Daimler, Akzo Nobel, Mittal Steel, Petrobras, Honda, Boeing, Renault, Ford, Rio Tinto, Air Products, Owens Corning, Carrefour, and Siemens.
- **Financial institutions**, including Citi, Credit Suisse, Commerzbank, Goldman Sachs, American Express, Lloyds TSB Bank, Macquarie Bank, State Street Global Advisors, Mastercard, BNY Mellon, BNP Paribas, Nomura, Barclays, and TD Bank.
- **Real estate, real estate finance and infrastructure**, including Aareal, AEW, Allianz, CBRE, DTZ, Invesco, GIC, Cushman and Wakefield, Patrizia, Pradera, Jones Lang LaSalle, and Bouwfonds.
- **Professional service firms**, such as Booz Allen, AT Kearney, LEK Consulting, McKinsey and Company, Deloitte, PwC, Accenture, KPMG, and E&Y.
- **Academic institutions**, including Oxford University, Brown University, UCLA, NYU, LSE, ITESM, Aichi University, and University of Melbourne.

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