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## A note rebutting the recent Cambridge Econometrics assessment of Brexit on the UK and London economies: Commissioned by London Mayor Khan

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# Cardiff Economics Working Papers



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# **A note rebutting the recent Cambridge Econometrics assessment of Brexit on the UK and London economies- commissioned by London Mayor Khan**

Patrick Minford

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This study for the London Mayor by Cambridge Econometrics purports to find large negative long term effects on UK GDP from Brexit, with similarly large negative effects on the London economy.

However, this study can be strongly criticised in various respects. First, the model is limited to a purely demand side analysis, inadequate for examining long term trade effects. Second, it makes implausibly damaging assumptions about trade barriers both against the EU and the rest of the world. Third, the 'effects' it asserts to be happening cannot be found in statistical analysis of the UK data since Brexit. Overall, its claims about the damage of Brexit are quite unwarranted, while the Brexit agenda of wide-ranging free trade being pursued by ongoing negotiation promises to bring substantial benefits according to Trade models that fit the facts of long term world trade behaviour.

This report was commissioned by London Mayor Khan and is available at <https://www.camecon.com/what/our-work/londons-economy-after-brexits-impact-and-implications>. The report finds that Brexit will have had severely negative effects on the UK economy by 2035, amounting to a 10.1% decline in UK GDP (compared with no Brexit) and corollary negative effects on UK employment and the London economy.

It uses the Cambridge Econometrics ESME model. This model is driven by demand which then feeds into output and employment via production relationships; these are then distributed across sectors by input-output relationships. Net immigration and home labour supply then determine unemployment. ESME covers European and all other countries and regions with similar model set-ups, linked by trade. It has a detailed energy sector in which prices of energy affect the emission of carbon in production.

The effects of Brexit come through assumed new trade barriers of the UK vs the EU and the non-EU. These affect trade and in turn are assumed to affect investment through confidence factors. In Appendix E are set out the assumptions of the Brexit effect on trade

costs due to changes in tariff and non-tariff barriers. The report says that these are based on the 'pessimistic' assumptions of Dhingra et al at LSE (2016, Centre for Economic Performance Brexit Analysis no. 2). They involve permanent rises in both export and import costs, depending on sector, of up to nearly 10% on EU trade, together with rises on non-EU trade of up to nearly 11% on imports and nearly 10% on exports. . In addition, they assume non-tariff barriers rise due to Brexit on both imports and exports by up to 55%.

The Brexit effects then work by reducing trade both with the EU and the non-EU. The resulting fall in imports reduces business confidence and so investment (para 5.2).

The falls in exports and investment reduce demand and so output and employment. There is a further loss of employment from the lower capital stock, lowering labour productivity; this in turn feeds back into lower demand.

## **A rebuttal of these Brexit claims**

The first point to be made about this model is that it is not based on optimising choices by households and firms, so that their supply-side choices on labour supply and innovation are not in the model. Nor is the effect of the economy's factor endowments (skilled and unskilled labour, and the supply of land) taken account of as one would expect in a model of trade and comparative advantage. Because of this absence there are no market clearing equations setting the prices of traded and nontrade goods and services. Effectively prices are fixed and demand governs everything.

This first point underlines a total difference in ESME modelling compared with that done in CGE models of long term trade, such as our work in Cardiff- see Minford, Dong and Xu (2021) for our world trade model set-up, on the basis of which we find Brexit has strong positive effects on the UK economy by bringing in free trade with the rest of the world.

The second point is that even within the ESME framework the assumptions about trade barriers are at odds with the aims of Brexit, which were:

a) to maintain no tariffs on EU trade and create a frictionless border in which the new trade regulations would be seamlessly administered so that these latter would not become non-tariff barriers.

b) to reduce the previous EU trade barriers against non-EU countries through new Free Trade Agreements.

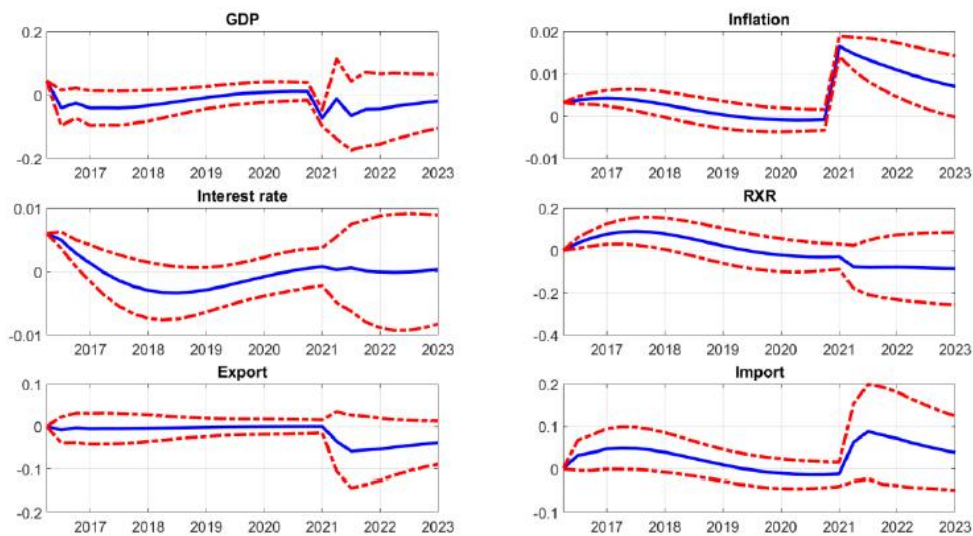
This study in fact assumes there will be permanent new barriers vs the EU and even new barriers vs the non-EU. It might be reasonable to assume some temporary increases on a. as the new systems take time to bed down. But on b. it is hard to see any justification as such EU FTAs with non-EU countries as there were have been rolled over while new FTAs designed to reduce EU barriers (estimated widely at around 20%- see Minford et al, 2015, chapter 4) have begun to be negotiated- with Australia, New Zealand, and the rest of Asia via the CHTPP, and several US states, already, and others such as with India, in progress.

Instead of the above assumptions, which are in line with current government policy, the Cambridge model team uses grossly faulty ones, in direct contradiction of policy, to trigger a large decline in exports and imports that in turn also destroy business confidence and so investment. Their assumptions are that we will create large tariff barriers (up to nearly 10%) and also non-tariff barriers (up to 55%) versus both the EU and the rest of the world. This is the exact opposite of what Brexit is both aiming to do and succeeding in doing. So the Cambridge calculations are based on totally false assumptions, specifically designed to give damaging Brexit effects. The true ones, where EU trade barriers are completely avoided and barriers against the rest of the world come down, are shown in our Cardiff models of trade and the economy ([https://carbsecon.com/wp/E2023\\_19.pdf](https://carbsecon.com/wp/E2023_19.pdf)) to boost GDP in the long term by around 6% due to freer trade and more competition.

The ESME model naturally finds negative effects from its trade barrier assumptions. But these assumptions are absurd, especially as permanent for the long term.

Minford, Dong and Xu (2021) comment on the 'gravity' trade models widely used by others such as LSE to evaluate Brexit effects. These models also embody strong demand effects of trade barriers and downplay their long run effects on competition and supply such as occur in our own 'classical' trade model noted above. Yet this paper has shown that these models are rejected when tested for their match with the long term behaviour of the trade data across the world.

A final point in rebuttal of this study is probably in practice the most powerful. If it was correct, these large negative Brexit effects should be observed with statistical significance in the UK data. But they cannot be found. Minford and Zhu (2023) looked for them in a structural VAR (a vector autoregression in which variables are related to their joint past) of UK macro data and found the following effects of the Brexit events, shown in Figure 2 taken from their paper:



**Figure 2: Effects of Brexit when inserted into the structural VAR (blue= estimated effect; red=95% confidence bands)**

It can be seen that the estimated effects are both small, disappear over time, and are well within the 95% confidence bands, so that they cannot be confidently said to be non-zero after their initial impact. If the ESME estimates were correct, we should not see this.

## Conclusions

This study for the London Mayor by Cambridge Econometrics purports to find large negative long term effects on UK GDP from Brexit, with similarly large negative effects on the London economy.

However, this study can be strongly criticised in various respects. First, the model is limited to a purely demand side analysis, inadequate for examining long term trade effects. Second, it makes implausibly damaging assumptions about trade barriers both against the EU and the rest of the world. Third, the 'effects' it asserts to be happening cannot be found in statistical analysis of the UK data since Brexit. Overall, its claims about the damage of Brexit are quite unwarranted, while the Brexit agenda of wide-ranging free trade being pursued by ongoing negotiation promises to bring substantial benefits according to Trade models that fit the facts of long term world trade behaviour.

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