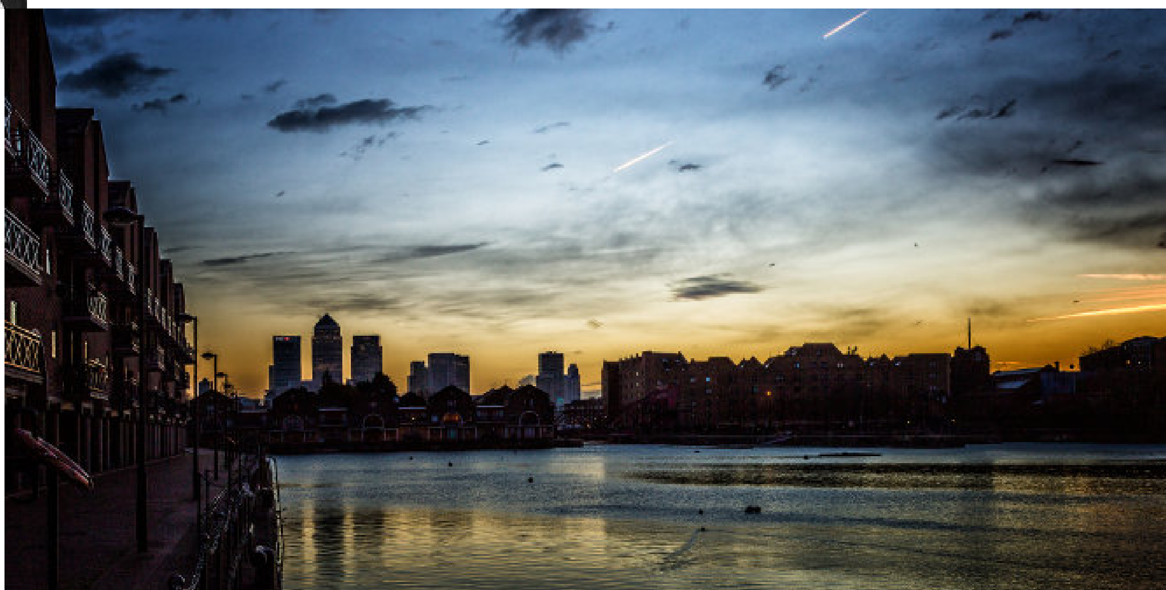
How can Brexit be an economic success when the economics establishment is united in predicting a disaster?

The Economists for Free Trade group has argued that contrary to the predictions of many economists, Brexit could provide gains to the UK economy of around £135 billion. **Kent Matthews** *argues that the differences between Economists for Free Trade and other economists stem from distinct theoretical assumptions about how trade functions, and that the only way to resolve this debate is with careful empirical testing of each model.*



Sunrise on Canary Wharf, Credit: Davide D'Amico (CC BY-SA 2.0)

Distinguished economists (let's call them Economists for Remain) challenge the argument made by Economists for Free Trade that leaving the EU will be positive for the UK economy. In particular, even under the best case assumptions, exit from the EU, according to these economists, will lead to a loss of trade, a loss of investment and a loss of welfare to the UK. In contrast, Economists for Free Trade estimate a gain in trade, a gain in investment and a gain in welfare to the tune of £135 billion. Economists are notorious for disagreeing with each other, but such diametrically opposing views deserve some explanation.

The economists in favour of remaining in the EU make the point that a hard Brexit, meaning leaving the Customs Union and the Single Market, will damage UK exports to the EU and also weaken Foreign Direct Investment (FDI), leading to a rise in unemployment and a fall in long-run GDP. They base their reasoning on the 'gravity model' of trade which assumes that a country has the greatest trade with geographically closer countries. Hence reducing trade with the EU will not be made up by increasing trade with the rest of the world that is further away. This sort of reasoning has a Keynesian flavour to it – a reverse Says Law, which is that demand creates its own supply. In contrast, Economists for Free Trade use the 'Classical model' based on comparative advantage, where the marginal reduction in exports to the EU is assumed to be sold to the non-EU at world prices. In this world, Says law operates as in Classical thinking – 'supply creates its own demand'.

A hard Brexit means that the UK will face the Common External Tariff (CET) that all countries face exporting to the EU. This in turn will lead to a fall in demand and there will be no seamless production space between the UK and the EU. The result will be a fall in FDI and domestic investment, which reduces productive potential and lowers full capacity GDP. But what about the Brexit devaluation of sterling? Surely this must mitigate some of the damage of the CET? Not quite say the economists in favour of remain. First, the biggest barrier to trade is non-tariff barriers (NTBs), and second, exporters to the rest of the EU will notice that while their selling prices have fallen in euro terms, the cost of their imported intermediate inputs from the rest of the EU will have risen by the extent of the devaluation. The competitive advantage of the devaluation is lost because of the deep integration of UK manufacturing into the rest of the EU supply chain.

One might make the point that the UK is currently in the Single Marker and therefore meets all current non-tariff barriers. These non-tariff barriers are basically common quality standards and of course the EU can create new ones that raise costs for UK exports (they also raise costs to themselves by doing that but let's ignore that possibility). But any exporter to a country must meet the quality standards expected from that country and that will be true for trade with the rest of the world as for the EU. So let's look at the second issue which is the effect of the devaluation on competitiveness. The selling price of exported goods will be made up of the unit cost of imported intermediate products and the cost of domestic factors of production. Because the sterling devaluation will raise the price of imports and therefore domestic prices, these will feed into the cost of domestic factors of production and so the gains from the devaluation will be marginal, according to these economists. UK exporters to the EU will face the full force of protective tariffs.

At this point we can discern the first major difference between the two camps. Economists for Free Trade interpret hard Brexit to mean a commitment to free trade and the removal of all tariff barriers to imports, and the abolition of the Common Agricultural Policy (CAP). Second, Economists for Free Trade assume a bonfire of EU red tape and a more balanced approach to regulation. The latter is expected to generate investment and improve productivity, but the former reduces the price of food which feeds into the general price level which in turn will moderate any effect the devaluation has on domestic costs.

So there will be a significant competitive gain. The effect of lower food prices will also increase the real income of households but particularly at the low end of the income distribution – tackling poverty at a stroke and improving welfare. The removal of the CAP will reduce the margin of cultivation in agriculture, as production becomes uneconomic, and reduces the demand for unskilled EU labour. This will also have the benefit of eliminating the taxpayer subsidy to unskilled EU immigrants in the form of health and welfare state benefits. The net effect of all this is to increase real GDP by about £135 billion or 7 per cent of GDP.

The Minford Research Team at Cardiff use a calibrated model to estimate that the adoption of free trade and the abolition of CAP will increase GDP by 4%. A further 2% comes from the removal of EU regulations that hinder innovation and productivity. A further 0.2% comes from the removal of the taxpayer subsidy to unskilled EU migrants, and a further 0.8% gained from the saving of the net contribution to the EU.

Of course these numbers come from the numerical exercise of a Classical type of economic model and critics might want to examine the structure and parameters of every behavioural equation contained therein. Nobody would deny that free trade is superior to protection. It is what I was taught as an undergraduate at LSE. But in the context of Brexit, in essence we have two views of the world – 'gravity' versus 'Classical', and two scenarios; free trade and all its regulations within the protective wall of the EU, or free trade outside the EU facing EU tariffs and with regulations determined by the UK government.

Perhaps the Cardiff team have overestimated the parameters that drive the benefits and underestimated the parameters that drive the costs. But in the end this is an empirical matter rather than a theoretical one. The debate should be based on empirical testing of the different models (views of the world). The economics profession and the policy maker would value such a debate.

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Note: This article gives the views of the author, not the position of EUROPP – European Politics and Policy or the London School of Economics.

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