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BRIEFING

Dealing with no deal

Understanding the policy implications of leaving the EU without a formal agreement

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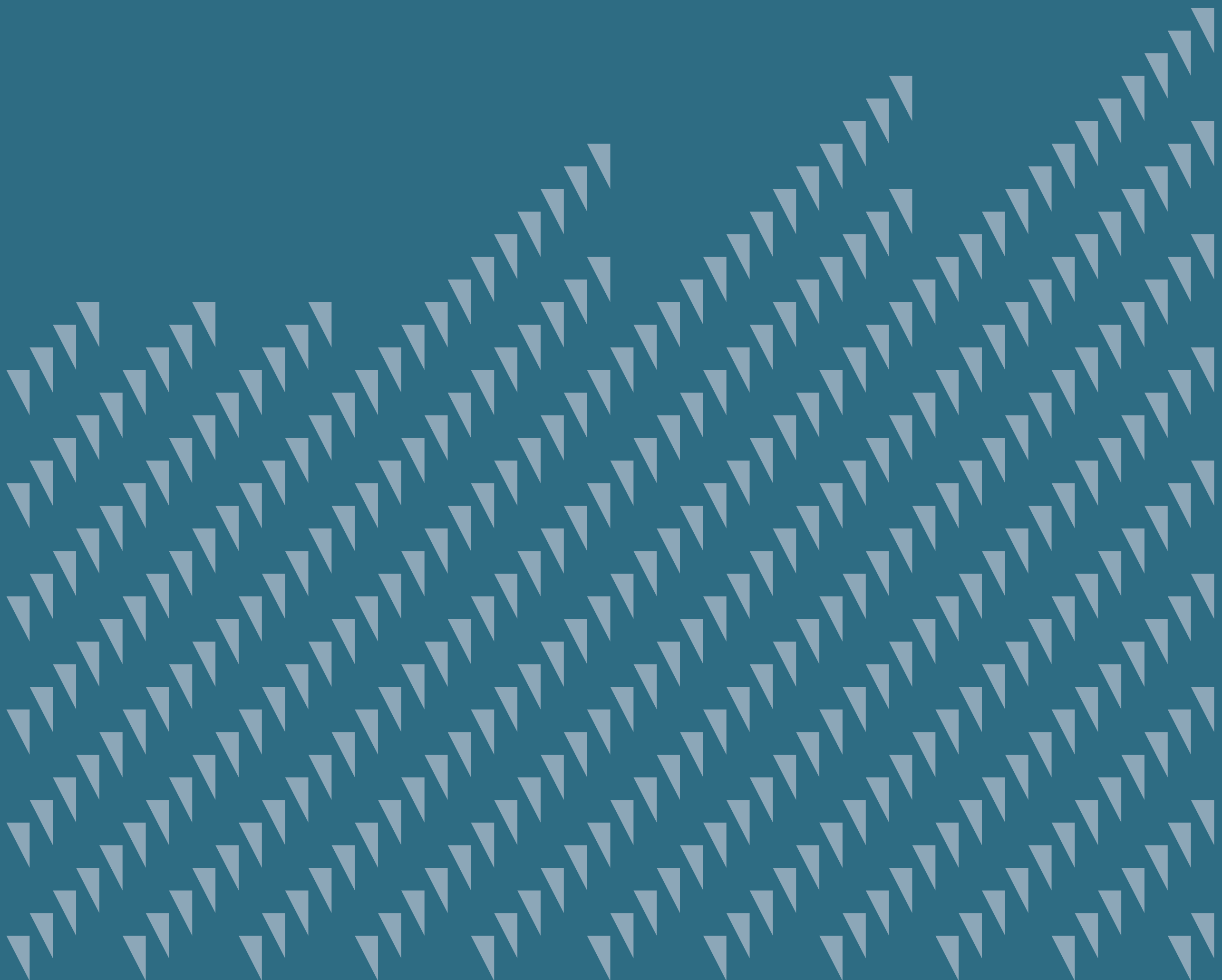

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Summary

This report focuses on the economic policy response to a 'no deal' Brexit, the likelihood of which has risen significantly in recent months. It does so by focusing on the nature of the economic shock such an exit would represent and how policy makers could in practice respond.

Many studies of a 'no deal' Brexit outcome prioritise estimating the size of the shock from 'no deal', with a lack of focus on how policy should respond. This is at least partly because the debate has, understandably, concentrated on the structural changes to the economy (the permanent hit to the supply side of our economy) associated with 'no deal', with policy makers keen to point out there is not much they can do about it.

This report goes further, by providing a framework for thinking about the nature, not just the uncertain size, of a 'no deal' shock. Understanding the ways in which 'no deal' plays out is crucial to recognising the important role that policy should play in reducing (but far from eliminating) economic damage in its aftermath. This report also provides a discussion of the separate elements of a 'no deal' shock and the types of responses that are desirable for each element. It illustrates too, specific policies that could be pursued. In so doing it recognises that in the face of any economic shock the job of policy makers is to address the root causes of that shock (to reduce uncertainty in the short term and any lasting effect on potential output), and to support the economy in the here and now

'No deal' would of course affect our economy in many ways, but from the perspective of national policy makers there are three distinct elements. First, a reduction in overall demand in the economy, not least as households and firms cut back on spending in the face of significant uncertainty in the near-term and a reduction in earnings in the long-term. Second, a temporary but very significant supply shock given an abrupt increase in barriers to trade as we move overnight to trade on WTO terms with our biggest trading partner. And third, the permanent supply shock that comes to the size and structure of our economy once 'no deal' is replaced with a permanent relationship with the EU: one much less open than the status quo today but more open that seen in the immediate aftermath of a 'no deal' exit.

While there is less that policy can do to reduce this last long-term impact, policy makers should be focusing on all three elements in their response. Negotiating a final trading relationship with the EU will reduce the size of the permanent supply hit, while clarifying and moving to that relationship as soon as possible following 'no deal' would reduce the size and duration of the temporary supply shock. Given the choices about trading relationships have been well rehearsed, this paper focuses on other elements of the policy response.

To the extent that the impact on demand is larger than that on supply, traditional macroeconomic stabilisation policy has a crucial role to play. This should take the form of looser monetary policy from the Bank of England and fiscal policy stimulus measures from government combining to reduce the short-term impact of the shock. However, the balance between these two policy approaches will need to be far from traditional. Constraints on monetary policy (it can currently provide around a quarter of the demand support required for an average recession) mean that fiscal policy will need to take a proportionally much larger share of the load than was the case during the financial crisis.

Wider government policy action will need to be focused on the underlying nature of the shocks. This will involve helping firms bridge genuinely temporary supply disruptions (largely with cash flow support) and then facilitate, rather than fight against, a transition for firms and workers to a less open economy in the medium term.

To illuminate the importance – and scale - of such a policy response, we illustrate a package of policies tailored to the specific circumstances of 'no deal'. On the demand side these include increases to welfare payments, a temporary cut to VAT and increased capital spending. On the supply side we distinguish between a temporary provision of loans or other cash flow support to firms affected by the trade disruptions ('Emergency Supply Support'), and longer term measures to aid the redeployment of labour and capital to productive industries ('Transitional Supply Support'). There are lessons for how to implement such policies from both our financial crisis experience and the experience of other countries facing substantial supply shocks – we illustrate these by reflecting on the Swedish experience in the 1990s.

While there would be much discussion of the exact quantum of these interventions, the central issue is that they will need to be much more significant than many assume, or than we are used to – principally because it will need to do much of the work previously undertaken by monetary policy. The package above would add £60 billion to government borrowing in its first year.

Crucially the background to that package would be significant deterioration in the public finances – we estimate borrowing rising by around £50 billion on the basis of the Bank of England's scenarios for a 'no deal' scenario (before the extra borrowing for a stimulus package). This is larger and more permanent than the estimates set out previously by the Office for Budget Responsibility (OBR), reflecting the fact that its estimates are based on the permanent supply hit to the economy being a relatively small part of the overall impact of 'no deal'.

Taking the permanent nature of much of the underlying deterioration in the public finances alongside the sheer scale of the policy intervention required, it is clear that the fiscal stimulus needs to be temporary – with an eventual fiscal consolidation being

required. In our illustrative scenario it would need to be of the order of £35 billion to avoid debt being on a permanently rising trajectory.

Taken together, this paper argues that the economic policy response to 'no deal' will need to be much bigger than is currently appreciated. We show what such a package might look like and argue that it is possible, given the current fiscal context, but we are clear that it can only ameliorate the significant negative shock that 'no deal' entails.

Given evidence of a heightened perceived risk of a 'no deal' Brexit, it is important to think about the policy response

This briefing focuses on the economic policy response to the UK leaving the EU without a transition arrangement or formal agreement on the new trading relationship – what is commonly referred to as 'no deal'.

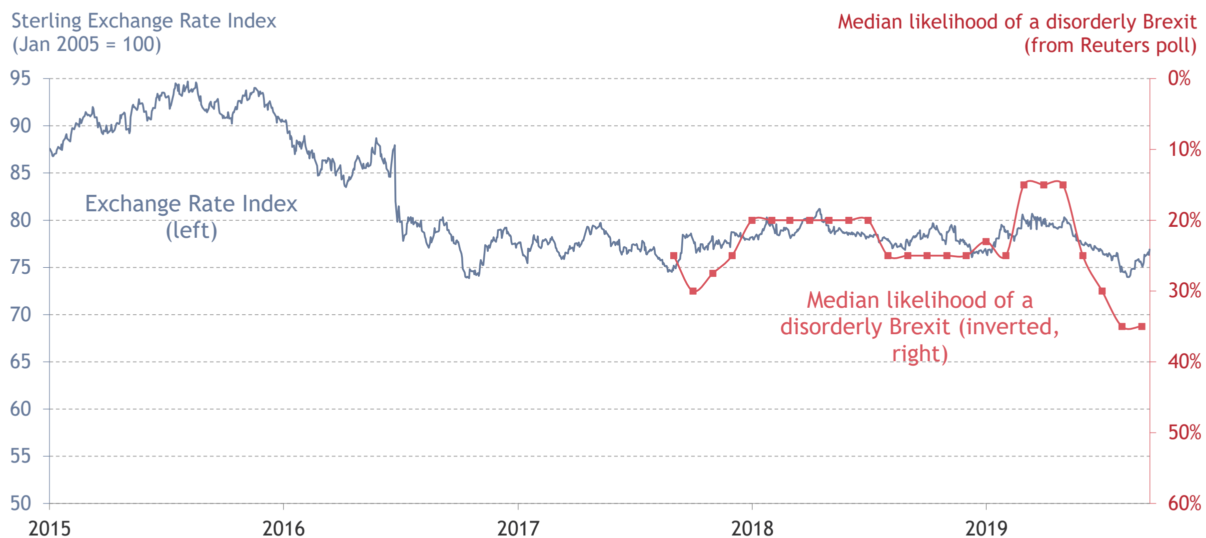
Legislation recently enacted by Parliament appears to have significantly lowered the likelihood of leaving on 31 October without a deal, but stated government policy does not reflect that fact and nor does it rule out leaving without a deal at a later date. Indeed, if we step back from recent events, we can see that the overall risk of a 'no deal' has increased over the course of 2019. And it is already having an effect on the economy. Figure 1 shows the typical weight put on 'no deal' by respondents to Reuters' monthly poll of UK economists. That poll shows that the perceived risk has more than doubled since March (with the weight on 'no deal' increasing from 15 per cent to 35 per cent).

In this note we do not try to anticipate the precise potential for or timing of 'no deal'. Instead we aim to inform discussions of what a policy response to 'no deal' should look like were it to occur. Likewise, we focus not on the potential scale of the 'no deal' economic impact,[1] but on how 'no deal' would affect the economy in the short-to-medium term and what that means for the appropriate macroeconomic policy response.

1 There has been plenty of attention paid to the economic impact from 'no deal'. A number of studies have estimated the depth of the economic contraction immediately following a 'no deal' exit as well as the longer-term reduction in potential GDP growth from trading with the EU and rest of the world on WTO terms. See, for example: Bank of England, EU withdrawal scenarios and monetary and financial stability, November 2018; HM Government, EU Exit: Long-term economic analysis, November 2018; IMF, World Economic Outlook: Scenario Box 1. No Deal Brexit, April 2019; National Institute for Economic and Social Research, Update: Modelling the short- and long-run impact of Brexit, May 2010. Given that this plausible range of estimates already exits, we do not seek to add to the literature on the size of any economic impact.

FIGURE 1: **The risk of 'no deal' has increased in recent months and has led to a further depreciation in sterling**

Movements in sterling and survey evidence on the risk of a 'no deal'



NOTES: Survey data from Reuters' poll of economists on the likelihood of a 'disorderly' Brexit.
SOURCE: RF analysis of Reuters Polls; Bank of England

'No deal' would have implications for both the demand side and the supply side of the UK economy

In the face a downturn, good macroeconomic policy would provide significant support to tackle any shortfall in aggregate demand relative to supply, protecting employment and minimising falls in living standards.[2] But, as in any crisis, it is important to tackle not just the demand shortfall but the underlying drivers of the shock. Ten years ago, that meant stabilising the financial system; in the case of 'no deal' it would involve both addressing temporary disruptions to supply and recognising permanent ones that require structural economic adjustment as our trading relationship with the EU and the rest of the world changes.[3]

Brexit clearly involves choosing a permanently less open trading relationship with the EU, with ambiguous effects with regard to other parts of the world. In the end, this represents a permanent supply shock - the longer-term capacity of the UK economy would be reduced, relative to what it would otherwise would have been.

In the case of 'no deal' however, that supply shock is not only brought forward (by the lack of a transition period) but also made temporarily larger (because it means trading on WTO terms until any future relationship is negotiated). This temporary supply shock

2 For a thorough theoretical discussion of the issue, see J Chadha, Monetary and fiscal options in the event of a 'No-Deal Brexit', NIESR, July 2019.

3 For a discussion of the macroeconomic policy framework for the UK, see: J Smith, J Leslie, C Pacitti and F Rahman, Recession Ready? Assessing the UK's macroeconomic framework, Resolution, September 2019.

represents a sudden increase in barriers to trade, and associated disruption to the flow of goods, services, people, and capital between the UK and the EU.

Choices about the nature of the eventual relationship, or length of time between 'no deal' taking place and that permanent relationship being agreed and coming into effect, materially affect the size of these supply effects. A key policy priority in the aftermath of 'no deal' would be to return to the negotiation table and come to a rapid and comprehensive agreement on the new trading relationship with the UK. These issues have been well-covered by ongoing debates about trade-offs between openness and sovereignty, and are not the focus of this note.

Instead we focus on what wider economic policy should do in the face of 'no deal'. Many argue that the supply shock nature of 'no deal' means there is little macroeconomic policy can do to cushion its impact on the economy. We reject this view. While the supply side of the economy will be affected, the impact on demand will likely be larger in the near-term. Moreover, much of the immediate impact on supply is likely to be the result of temporary disruption and uncertainty about the nature of the UK's future trading relationship with the EU and rest of the world. There is a strong macroeconomic case for significant policy intervention measures to both support the demand side and help firms and households cope with the temporary disruption to the supply side of the economy. The case for doing this is reinforced by the increased vulnerability of those on lower incomes to a downturn and the relatively forgiving financing conditions for governments at present.[4]

Instead of inaction, this note makes the case for a comprehensive and credible macroeconomic policy response to 'no deal', including elements that mitigate the acute disruption to the supply side of the economy, stimulate demand on the part of firms and households temporarily, and facilitate longer-term adjustment to the UK's new terms of trade with the EU and rest of the world. This should be done with an eye to minimising concerns about the institutional framework for macroeconomic policymaking, not least by recognising that a permanent reduction in supply capacity would require a fiscal consolidation in time. Indeed reinforcing rather than undermining the credibility for the UK's economic framework is important to minimising that permanent supply shock.

Because the macroeconomic policy response will depend on the underlying drivers of the slowdown as well as its overall size, it is important to understand the different ways in which a 'no deal' can affect the behaviour of firms and households. Box 1 sets out the various ways in which 'no deal' is likely to impact on the economy. But, at a high level, it

4 That vulnerability is discussed in more detail in C Pacitti & J Smith, A problem shared? What can we learn from past recessions about the impact of the next across the income distribution? Resolution Foundation, August 2019.

is helpful to distinguish three distinct aspects to the economic impact of leaving the EU with a deal:

- First, tighter financial conditions, a spike in inflation, and heightened uncertainty about the nature of the UK's new trading relationship with the EU and the rest of the world is likely to lead households and businesses to cut spending, **reducing overall demand in the economy.**
- Second, the abrupt imposition of or increase in barriers to the cross-border flows of goods, services, people, and capital between the UK and the EU, for which firms and households are only partly prepared, will **temporarily very significantly disrupt the supply side of the economy**; and
- Third, changes to the structure and reduction in the overall openness and trade-intensity of the UK economy from the eventual final new trade relationship with the EU will likely lead to a (smaller) **permanent reduction in supply capacity and potential growth**.

BOX 1: The macroeconomic impact of 'no deal'

In this box we set out a number of ways in which 'no deal' would affect the supply and demand sides of the economy. It is helpful to separate the supply effects into those which are short-term and largely temporary in nature, and those which are more long term.

We start with ways in which 'no deal' might affect the supply side of the UK economy:

- **Supply chain disruption**, leading to cash-flow problems, a shortage of key inputs to production, or a sharp increase in inventories (immediate but largely temporary effect)

In the very short term there will be questions about the extent to which the UK trade infrastructure – such as customs checks at the border – are prepared for a sudden change in trading arrangements. Given this, there is a risk of disruption to goods and services crossing borders. That said, the extent of these disruptions will depend on the state of readiness of infrastructure, the preparedness of firms, and the approach taken by the authorities to enforcement of cross-border trade restrictions. So it is difficult to assess how important they are likely to be. These disruptions will create cash-flow and inventory shortages/surpluses for businesses involved in such trade. Some of that may be offset by

redirecting goods into the domestic market. But much of this will be temporary as all forms of the possible future relationship with the EU will allow continued trade, just at potentially higher cost.

- **Industrial change** (long-term and permanent effect)

Because the composition of the goods and services produced in the UK will need to shift away from those it has been exporting to the EU, capital and labour will need to reallocate too. This will take time and resources, reducing the overall supply capacity of the economy as factors are redeployed between sectors. And to the extent that the new uses are less efficient than the old ones, that capacity will grow more slowly in future too.

- **Changes to migration** (medium-term and permanent effect)

Net migration is an important contributor to the supply side of the economy. Following a 'no deal' there is likely to be uncertainty about the new migration regime that will be adopted in the UK as this will be a key aspect of the further negotiation. While important, changes in migration are not a major source of uncertainty for the balance of supply and demand. This is because migration tends to affect both the demand and supply side of the economy to a similar degree as migrants tend to increase overall employment levels but also raise consumption. EU migrants do, however make a net positive contribution the public finances, given that they are disproportionately of working age and employed.[5]

- **Reduced openness/ lower productivity growth** (long-term and permanent effect)

More open economies tend to be more productive. This is because increases in trade lead to: more specialisation in production, economies of scale, and greater transfer of technology and ideas. Competition is also more intense for products traded across countries, increasing the incentives for firms innovate and produce more efficiently.

'No deal' would affect the **demand side** through the following channels:

- **Increased barriers to exporting into EU markets**, (immediate effect, at least some of which will prove permanent)

Most obviously, increased trade barriers will make it more difficult for the UK firms to sell into EU markets. In the short term, these barriers may reflect disruptions to supply chains mentioned above. But part of this will reflect the new trading relationship with the EU which will lead to new tariffs being applied to UK exports, but also new non-tariff barriers such as customs checks and differences in product standards.[6]

5 Migration Advisory Committee, EEA Migrants: Final Report, September 2018.
6 Imports into the UK face the Government's announced temporary tariff regime – which sees 87 per cent of imports exempt

- **Increases in household saving** (immediate effect and largely temporary effect)

If 'no deal' leads households to become more uncertain about the future - for example, because a lack of clarity about the future trading relationship with the EU leads to worries about job prospects - this will reduce household spending in the short term (increasing saving). Once there is clarity about the overall effect of 'no deal', households are likely to run down some of the extra savings. A concern in this context, however, is that lower-income households have already seen their share of 'essential' consumption – items like food, fuel and transport – increase since the financial crisis and have not fallen back since. This raises the question of the extent to which consumption can be cut further.[7]

- **Investment postponed or cancelled** (immediate and largely temporary effect)

An increase in uncertainty leads businesses to postpone investment plans. This is because spending of this kind is often costly to reverse, creating an incentive to wait and see if it looks likely to be profitable. Again, once the uncertainty has subsided, firms may choose to resume their investment plans, although some may no longer be profitable given the new trading relationship with the EU (see industrial change above).

- **Tighter credit conditions** (short-term and largely temporary effect)

The cost of borrowing for families and businesses tends to rise when economic prospects deteriorate reflecting a rise in the compensation required for the risk that the lending might not be repaid. When prospects improve, the cost of borrowing is likely to improve but the volume of credit will reflect the lower rate of return on UK assets.

- **Boost to exports from a fall in sterling** (medium-term and permanent effect)

As shown above, movements in the pound respond to news about the UK's future economic trading relationships and economic prospects. These movements in sterling will tend to reduce the price of UK exports (when they are converted into foreign currency prices abroad). This makes UK exports more competitive, providing a boost. To the extent that the change in sterling is a reassessment of the UK economy, this effect will be permanent.

- **Falls in financial wealth** reduce spending (medium-term and permanent effect)

Following 'no deal' the weaker economy and higher uncertainty will put downward pressure on asset prices

from tariffs for a year, before reverting to the current EU 'most-favoured nation' rates (of around 4 per cent, on average). See: HM Government, Temporary tariff regime for no deal Brexit published, 13 March 2019, revised on 29 March.

7 For a discussion, see: C Pacitti & J Smith, A problem shared? What can we learn from past recessions about the impact of the next across the income distribution? Resolution Foundation, August 2019.

such as government bonds, equities and housing. This will reduce overall wealth, leading to a cut in spending, especially among wealthier households.

- **Real-income squeezed by higher inflation** (medium-term and permanent effect)

When the pound falls, that increases the price of imported goods, pushing up inflation. This leads to a fall in the inflation-adjusted value of household incomes. While sterling remains at this lower level, the effect will be permanent.

Long-term adjustment to the new trading relationship with the EU (medium-term and permanent effect)

In the longer term a less open, less productive economy will be one in which incomes, asset values, and living standards will grow more slowly. Households anticipate that they will be poorer in future, reducing spending in the near term.

Estimates suggest the economic impact of 'no deal' could be considerable in both the near and long-term

Table 1 summaries the overall the impact of 'no deal' as quantified in scenarios produced by the Bank of England in November 2018 and the OBR, along with a summary of the assumptions that underlie them.[8] It is worth keeping in mind that these scenarios are not attempts to predict what is actually going to happen, but instead try to isolate the impact of a 'no deal' based on informed guesses about what might happen. The range of estimates illustrates the uncertainty, but these scenarios are nonetheless useful for thinking through the appropriate policy response, particularly for understanding the overall size of the effect.

8 See: OBR, Fiscal Risks Report, July 2019; and Bank of England, EU withdrawal scenarios and monetary and financial stability, November 2018. The OBR's scenario is based on 'Scenario A' taken from Box 1.1 in the IMF's World Economic Outlook, April 2019.

TABLE 1: **Assumptions underlying prominent estimates for the short-term impact of 'no deal'**

	No Deal EU Exit Scenarios		
	OBR (IMF)	BoE	
		Disruptive	Disorderly
Impact:			
Peak GDP loss by 2023 Q4	4.0%	4.8%	9.1%
Rise in unemployment rate	1.1ppts	2.0ppts	3.6ppts
Margin of spare capacity	2.3%	2.0%[a]	4.0%[a]
Exchange rate	-10%	-15%	-25%
Interest rates	-0.5ppts	+1ppt	+4.75ppts
Peak inflation	2.4%	4.3%	6.5%
Key assumptions:			
Trading relationship with EU	WTO terms	WTO terms	WTO terms
Channels incorporated:			
Supply-chain disruption	×	✓	✓
Industrial change	✓	✓	✓
Migration	✓	✓	✓
Lower productivity	×	✓	✓
Increased barriers to exports	✓	✓	✓
Lower consumer confidence	✓	✓	✓
Investment postponed	✓	✓	✓
Tighter credit	×	✓	✓
Real-income squeeze	✓	✓	✓
Boost to exports from sterling	✓	✓	✓
Falls in asset prices	✓	✓	✓
Long-term adjustment	✓	✓	✓
Monetary policy loosening	✓[b]	×	×
Fiscal policy loosening:			
Automatic stabilisers	✓	✓	✓
Discretionary stimulus	×	×	×
Macropru loosening	×	✓	✓

NOTES: Peak GDP loss relative to baseline is calculated to 2023 Q4. (a) the Bank of England did not provide an output gap estimate so we have made an assumption based on the unemployment rate provided with the scenario and to maintain consistency with the underlying narrative;[9] (b) cut of 50bps in the Bank of England policy rate.

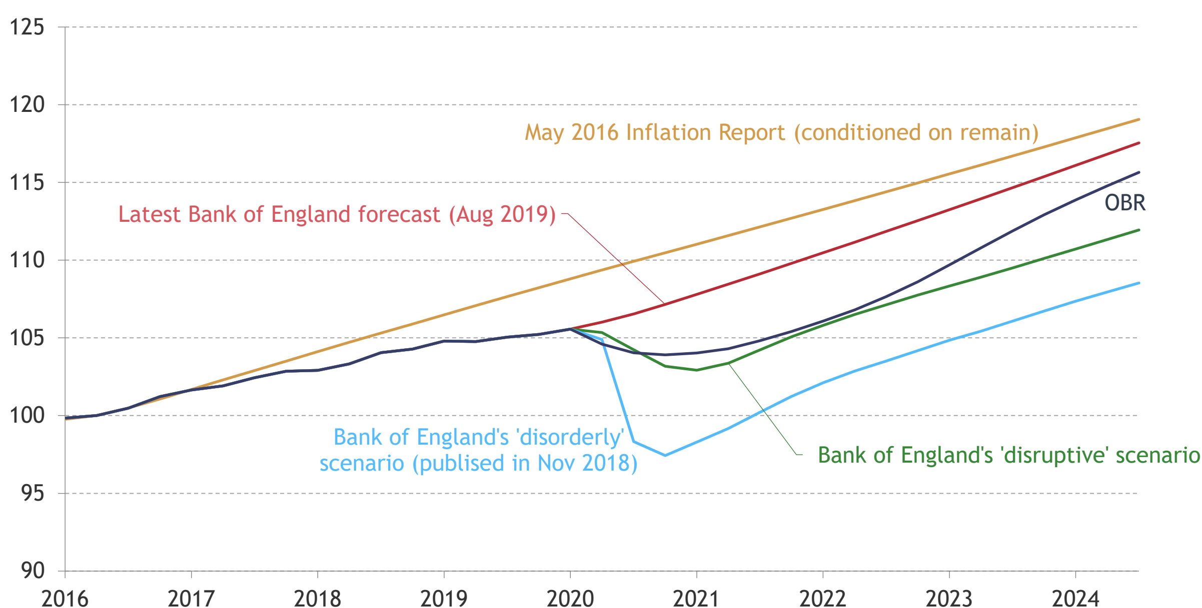
SOURCE: RF analysis of Bank of England and OBR

9 The Bank of England make it clear that an output gap does open up in their scenarios, albeit by less the overall impact on GDP, reflecting the supply effects, noting that '…the margin of domestic slack widens by much less than the fall in output', see Bank of England, EU withdrawal scenarios and monetary and financial stability, November 2018.

The overall effect on GDP is summarised in Figure 2. For the Bank of England we include both their 'disruptive' and 'disorderly' scenarios from their November 2018 report to the Treasury Select Committee. The 'disorderly' scenario is essentially a worst-case scenario, designed to help the Bank of England's Financial Policy Committee identify risks to the financial system. Here it simply helps to illustrate the wide range of potential impacts. The 'disruptive' scenario also includes a number of features which lead to a severe economic impact, alongside some measures which reduce the impact (such as the UK being able to retain trade deals acquired by virtue of EU membership). By contrast, the OBR's scenario is less severe, and crucially less permanent, because it excludes some aspects of potential impacts on the supply side.

FIGURE 2: **Bank of England and OBR analysis points to a substantial hit to GDP in 'no deal'**

Level of real GDP (2016 Q2 = 100)



NOTES: Scenarios are shown as deviations from the August 2019 Inflation Report forecast.
SOURCE: RF analysis of Bank of England and OBR

There are three key points worth reinforcing about these scenarios:

First, while there is obviously a lot of uncertainty about the overall size of the impact of 'no deal', all these scenarios include a significant impact on both the demand and supply side of the economy.

Second, while much of the policy discussion of the impact of 'no deal' has focused on the long-term impact on the structure of the UK economy,[10] all three scenarios assume

10 For example, the Governor of the Bank of England has, on a number of occasions, said that 'the monetary policy response to Brexit will 'not be automatic and could be in either direction', meaning interest rate could either rise or fall. See, for example: M Carney, Opening Remarks by the Governor at the August Inflation Report press conference, 1 August 2019. That said, at an

that the impact on demand will be larger than the impact on supply in the near-term. This is because the factors that weigh on demand (like greater uncertainty, tighter financial conditions, higher inflation, and worries about future income growth) play out more quickly than the factors that gradually reduce long-run productivity (like lower investment, lower competition, and less intensive exchange of ideas and innovations).[11]

Third, in all scenarios some of the impact on the supply potential of the economy is temporary, due to lack of public and private preparation for 'no deal'. As capacity at the border expands, firms familiarise themselves with new trading regulations, and firms build up larger inventories of key imports.

While there is little macroeconomic policy can do to prevent the longer-term effects of Brexit, monetary and fiscal policy should respond decisively to the short-term impacts of 'no deal'

Policy can do little to address the longer-term impact of less openness and trade-intensity on the supply capacity of the economy. Here the most important policy action the government can take is to agree a clear and comprehensive new trading relationship with the EU as rapidly as possible following 'no deal'. Policy can, however, exacerbate the negative consequences for the UK economy if it combines with 'no deal' to lead to a loss of confidence in the UK's wider macroeconomic policy framework. In that case, prolonged uncertainty, financial market volatility, and increases in financing costs would be likely to lead to a worse long-term outcome.

But policy can do much to address the short-term impact on demand, help overcome elements of the short-term supply disruption, and facilitate the transition to the UK's new trading arrangements. Monetary policy and fiscal policy can both support demand, while it is the fiscal authorities that will have to provide the lead in addressing the temporary disruption to the supply side and help firms and individuals adjust to the changing structure of the UK economy.

Below we discuss the type of considerations that should be taken into account in responding to 'no deal', illustrating how these might work against the backdrop of the Bank of England's 'disruptive' scenario. This scenario is useful because it incorporates significant supply effects which help illustrate the importance of taking these into account. That said, much of the prescription below would apply given a variety of impacts on supply and demand.

appearance at the Treasury Select Committee on 26 June, Governor Mark Carney stated that in a no-deal Brexit, 'it is more likely we would provide some stimulus' and 'we have said we would do what we could in the event of a no-deal scenario but there is no guarantee on that'.

11 For a discussion of how expectations of future supply-side developments are likely affect demand in the near term, see: P Beaudry & F Portier, 'News-Driven Business Cycles: Insights and Challenges', Journal of Economic Literature, vol. 52, pages 993–1074, December 2014.

Monetary policy would rapidly reach its limits in the aftermath of ‘no deal’

Monetary policy would play a key role in supporting the economy after ‘no deal’, with the Bank of England’s Monetary Policy Committee (MPC) helping to cushion the economy in a face of a fall in demand. There is little that monetary policy could do to support the economy in the face of a permanently lower path for supply – but in the initial phase of any ‘no deal’ shock the impact on demand is likely to be larger than the impact on supply, meaning there is scope for MPC to loosen policy.

The fall in value of sterling will be an important way in which the economy adjusts to ‘no deal’. This will tend to increase the cost of imported goods, pushing up prices across the economy (even those goods which aren’t directly imported include some element of imported cost in their supply chain). While inflation above the MPC’s 2 per cent target would point to the need to tighten monetary policy, there is leeway under the MPC’s remit to balance above-target inflation against weakness in the economy.[12] In this case, with inflation temporarily above target as the higher cost of imported goods gradually feeds through, there is a strong case for ‘looking through’ the initial effects of the fall in sterling. This is consistent with the MPC’s behaviour following a 15 per cent deprecation in 2016 (see Figure 1).

As discussed in our recent assessment of the macroeconomic policy framework, cutting the MPC’s policy rate to zero would deliver a small stimulus of around 0.5 per cent of GDP.[13] This would leave an output gap of nearly 2 per cent of GDP opening up in our illustrative scenario – with a clear need to stimulate the economy further.

We would expect the MPC to also restart quantitative easing (QE). This is worth doing but, because QE works by reducing longer-term interest rates, there are reasons for thinking a further expansion would be unlikely to get much traction. As Figure 3 shows, rates are already at historically low levels.[14] That said, the Bank of England’s ‘disruptive’ scenario incorporates a small rise in longer-term interest rates reflecting increased uncertainty and a rise in the risk premium demanded by investors for holding UK assets. As a result, we incorporate an expansion in QE (of around £120 billion) that offsets this increase and delivers a further 0.5 per cent of stimulus to GDP.

12 See: Monetary policy remit: Budget 2018, HM Treasury, October 2018, available at: https://www.gov.uk/government/publications/monetary-policy-remit-budget-2018.

13 The Bank of England’s ‘disruptive’ scenario embodies a small rise in interest in the near term reflecting a mechanical but unrealistic response of policy to an increase in inflation. The 0.5 per cent impact of cutting the policy rate includes the reversal of this increase in rates in the scenario. Overall, this does little to change our assessment of the overall monetary policy capacity materially.

14 See J Gagnon, J Leslie, F Rahman & J Smith, ‘Quantitative (displ)easing?: Does QE work and how should it be used next time?,, Resolution Foundation, September 2019

FIGURE 3: **The low levels of longer-term interest rates suggest little scope for QE**

10-year gilt yields

NOTES: 10 year gilt yields are a combined series of spliced consul yield (corrected for Goschen's conversion issues) 1850-1945, medium dated stocks 1945 - 1960 and 10 year government bond yields from 1960 onwards.

SOURCE: RF analysis of Bank of England; OECD.

As noted above, maintaining confidence in the authorities' handling of the situation is important in order to avoid exacerbating falls in confidence. The key priority for the Bank of England would be to maintain financial stability, and Box 2 shows that preparations for 'no deal' are advanced in the financial sector. In addition, it is likely that the Bank of England's Financial Policy Committee (FPC) would loosen capital standards on retail banks, complementing the easing in monetary policy and reducing the (small) risk that there is a credit crunch associated with 'no deal'.

BOX 2: **Ensuring financial stability in 'no deal'**

The financial sector is likely to be affected significantly during 'no deal'; the general deterioration in the economic outlook as well as sector-specific factors could have major ramifications for the UK's financial stability. This box looks at the two most important issues which, if not addressed, could lead to a much larger deterioration in the economic outlook.

Issue 1: Banking crisis

Falls in GDP would trigger losses for banks as households and firms default on loans. And disruption in financial markets would lead to further losses

from falling asset prices. As a result, banks might see unusually large withdrawals. This could leave them short of cash to meet their day-to-day needs.

This scenario would only lead to a banking crisis if either the banking sector had inadequate capital to absorb losses or had a shortage of liquidity to meet funding requirements. Since the financial crisis, there have been significant efforts to improve the capital and liquidity positions of banks. In the latest round of stress tests, the Bank of England estimated that the major UK banks all had enough loss absorbing capacity to cope with a severe 'no deal' scenario. Banks have also substantially raised their holdings of liquid assets since the financial crisis, and the Bank of England is much better positioned to be able to provide liquidity to banks if necessary. Taken together these significantly reduce the risk of a banking crisis resulting from 'no deal'.

However, there are two outstanding concerns. First, the post-crisis regulatory framework for banks has yet to be tested in a recession. It is possible that banks will not want to call on their capital buffers, and so will choose instead to restrict lending; this could exacerbate the macroeconomic shock. Second, while the public stress tests cover the largest seven UK banks, it is less clear if some of the smaller 'challenger' banks are as well capitalised and in a position to continue to provide credit to the economy through a downturn. While unlikely to be large enough to trigger a widespread banking crisis, these smaller banks can have material market share for some products – for example 55 per cent of net mortgage lending in 2016 was from banks not included in the main Bank of England stress testing exercise.

Issue 2: Disruption in cross-border financial services

The economic consequences of 'no deal' could be worse if financial services provided by EU financial institutions to UK households and firms were disrupted. This disruption would be caused by new regulatory barriers which would apply automatically as the UK left the EU (absent mitigating actions by regulators and governments), affecting the availability of financial services to the economy and increasing volatility in financial markets.

These risks have been largely mitigated by a combination of restructuring by cross-border financial firms (to ensure their continued access to EU and UK markets) and contingency arrangements by regulators/governments. For example, EU banks have either set up UK-based subsidiaries or will rely on the UK's plan to temporarily recognise EU branches to continue to serve UK clients.

There remain a number of challenges in ensuring no disruption of cross-border services. First, some areas

of responsibility fall to national governments/regulators rather than EU-wide bodies. This means that contingency provisions are not uniformly in place across countries for provision of services to the EU from UK-based firms. Second, the EU is yet to make arrangements in some areas that could affect cross-border services. For example, the UK government has approved measures to allow the transfer of personal data from the EU, but there is no reciprocal arrangement. While reports suggest firms have responded to this with alternative arrangements, there remain operational risks. Finally, some of the contingency measures are non-permanent. For example, the three major UK-based central counterparties will be recognised by the EU regulator in the case of 'no deal'. But this arrangement is not permanent and does not guarantee that services will not be disrupted in the future.

The two primary risks discussed above are not an exhaustive list of the financial stability challenges. For example, falls in asset prices (particularly for financial assets) would impact insurance firms which could have ramifications for customers. And more generally, there is the potential for currently unidentified risks to manifest; significant focus has been on the risk of a banking crisis, because 2008-09 is still fresh in people's minds, but other areas of the financial sector could also disrupt the real economy. However, given the resources invested by the Bank of England, Financial Conduct Authority, and EU regulators in preparing for 'no deal', it is clear that steps have been taken to mitigate the most significant risks. This reduces the risk of major financial firms failing or substantial disruptions in the provision of financial services to households and businesses. But it is still likely that 'no deal' will be accompanied by significant volatility in financial markets.

Fiscal policy would become the main tool for supporting demand in the aftermath of 'no deal'

With monetary policy quickly running up against the constraint of the lower bound on interest rates, fiscal policy needs to play a more immediate and significant role in stabilising output following 'no deal'. In the aftermath of the 2008 financial crisis, two-thirds of the overall support from macroeconomic policy came from loosening monetary policy.[15] However with monetary policy only able to provide – at best – support of around 1 per cent of GDP, fiscal policy will have to take a much more central role in response to

15 See, J Smith, 'Failing to plan = planning to fail: The risk of recessions and the importance of macroeconomic policy in limiting the damage they cause', July 2019.

'no deal'. With the automatic fiscal stabilisers also likely to be weaker today than in 2008, more of this support will likely need to come from discretionary changes in tax, spending, and other fiscal policy instruments.

Allowing fiscal policy the scope to act would likely require a suspension of the current fiscal rules. While the current 2 per cent structural deficit target does allow for the operation of the automatic stabilisers, the around £20 billion of headroom that the Government had against its 2020-21 borrowing and debt target at the time of the March 2019 Spring Statement is unlikely to be sufficient to accommodate the level of support required in the near-term. That's particularly true given that the combination of economic and fiscal developments since March and the £13.4 billion increase in spending announced for 2020-21 in the Spending Round earlier this month is likely to have already exhausted most, if not all, of this headroom.[16] This should not be a constraint on the fiscal policy response – indeed circumstances like 'no deal' and the significant negative shock for the UK economy it entails is exactly why the Charter for Budget Responsibility has an escape clause so that government does not have to meet its fiscal rules in those circumstances.[17]

In looking to stimulate economic activity, fiscal policy should rely on measures which are temporary in nature, targeted on the problems facing the economy, timely in their response as well as having the maximum possible impact on the economy. However there are inevitable tensions between these objectives, which require compromises at the margin. For example, VAT reductions can be enacted quickly but deliver benefits to all consumers and not only those with the highest propensity to consume. By contrast, capital investment has the highest multiplier effect on the economy but can take several years to implement. Finally, while discretionary fiscal policy needs to act quickly, comprehensively, and at a scale that responds to the severity of the shock and limitations on other stabilisation tools, the effectiveness of any fiscal stimulus package would be enhanced if it is accompanied by a credible plan for returning to the public finances to a sustainable position once the economy has recovered.

In order to provide a baseline for our analysis of the policy response, below we start by looking at the fiscal implications of 'no deal' and discusses the possible scale and components of a comprehensive, multi-year fiscal stimulus and adjustment package designed to support the economy in its aftermath.

16 See, A Corlett, D Tomlinson, M Whittaker & T Bell, 'Rounding up: Putting the 2019 Spending Round into context', September 2019.
17 The fiscal framework allows for the fiscal rules to be suspended in the face of a 'significant negative shock'. See: Charter for Budget Responsibility: Autumn 2016 update, HM Treasury, 2017.

'No deal' would have adverse consequences for the public finances

We estimate the impact of 'no deal' on the public finances before discretionary policy action is taken by running the Bank of England's 'disruptive' macroeconomic scenario through a model based on the OBR's fiscal 'ready-reckoners'. These provide a simple, mechanical mapping of economic developments onto the fiscal position - to estimate the fiscal implications of 'no deal'.[18] The results are then compared against a baseline counterfactual drawn from the OBR's most recent (March 2019) Economic and Fiscal Outlook.[19]

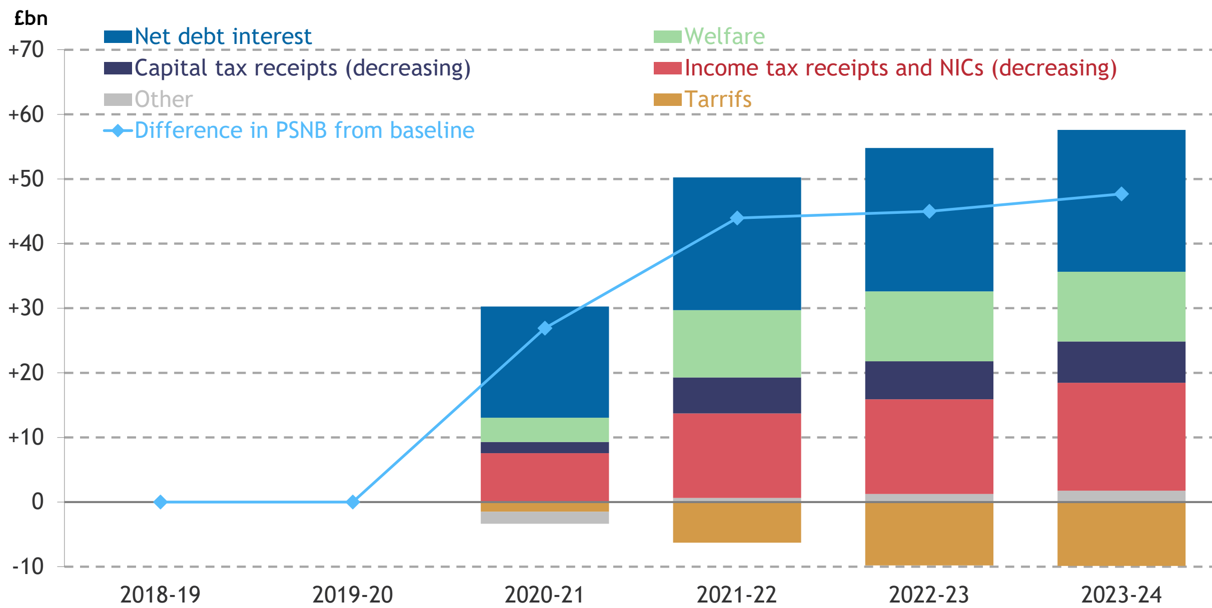
The results of this modelling suggest that 'no deal' would have significant adverse consequences for the public finances - adding around £50 billion to borrowing in 2023-24 and causing debt to rise as a share of GDP in every year from 2020-21. As shown in Figure 4, this net fiscal impact is the result of modest direct benefits and significant indirect costs. Specifically, the around £50 billion (or roughly 2 per cent of GDP) net increase in borrowing by 2023-24 is attributable to the combination of two factors.

- First, there is a £10 billion direct benefit to the public finances from the tariff revenue collected on EU and non-EU imports. As in the OBR's post-Referendum forecasts, we assume that any savings on our net contribution to the EU are recycled into spending on domestic replacement programme and therefore generate no net benefit to borrowing over the next few years.[20]
- Second, there is around £60 billion of indirect costs to the public finances in 2023-24 as a result of the adverse effect of 'no deal' on the economy. This includes: a roughly £20 billion reduction in income tax and National Insurance Contributions as a result of lower earnings growth and employment; an £11 billion increase in welfare spending due to the 20 per cent increase in unemployment in the baseline and 2.4 per cent higher inflation in 2020-21 which feeds through to inflation-linked benefits; and around £20 billion in debt interest costs due to a combination of an increase in the debt-to-GDP ratio of 15 percentage points and a 0.5 percentage point increase in debt-servicing costs, and higher inflation which pushes up the cost of index-linked gilts.

18 For the purposes of this exercise we assume that the UK leaves the EU at the start of 2020.
19 To maintain consistency with the OBR's latest published forecasts in March 2019, the baseline has not been updated either for the outcome of the 2019 Spending Round or forthcoming changes in the statistical treatment of student loans.
20 As the 2019 Spending Round concluded on 4 September 2019 has already increase resource spending by £13.8 billion per year relative to the OBR's March 2019 EFO forecast, one could argue that the Government has already spent any potential savings on the UK's £13 billion annual net contribution to the EU.

FIGURE 4: **Higher spending and lower tax receipts add £50 billion to borrowing following 'no deal'**

Sources of difference in PSNB (based on the Bank of England's 'disruptive' scenario) compared to the March 2019 OBR projection



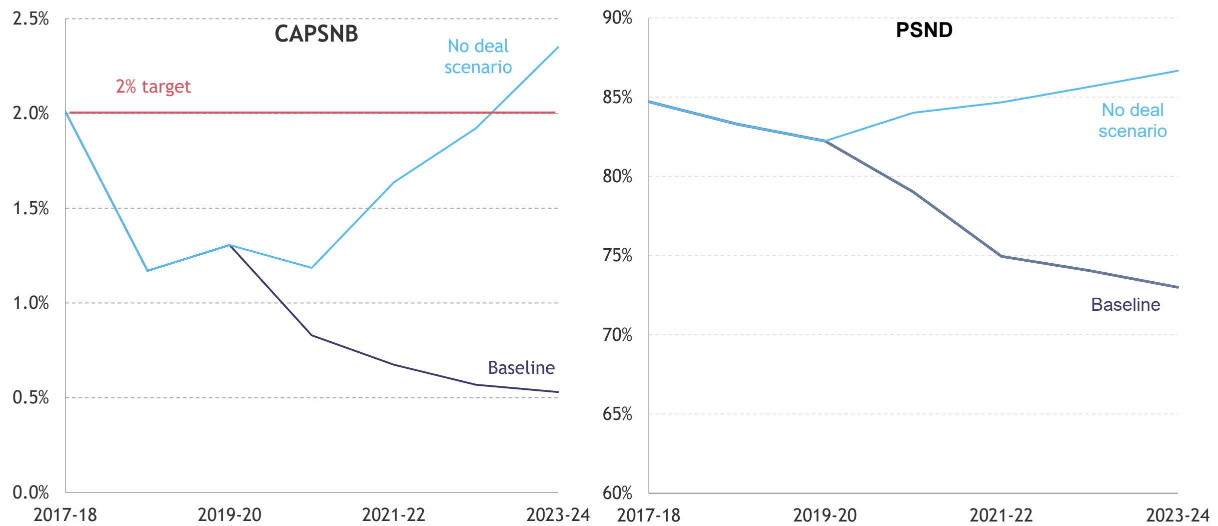
NOTES: "Other" includes a combination of increases in borrowing resulting from reductions in receipts from council tax, excise duty, business rates, interest receipts and the retained cost of collection of EU customs duties, offset by reductions in borrowing from increases in VAT receipts and reductions in costs relating to public sector pensions.

SOURCE: RF analysis of Bank of England; OBR

As shown in Figure 5, relative to the March 2019 projection, the sharper reduction in demand than supply in the aftermath of 'no deal' means that the government does not immediately breach its 2 per cent structural borrowing target. But, as mentioned above, if the baseline was updated, the limited headroom under the fiscal targets has probably already been breached and certainly would be following a 'no deal'. Debt begins rising as a share of GDP from 2020-21 and reaches around 88 per cent of GDP by the end of the forecast, due to a combination of the rise in borrowing and smaller and slower-growing economy than in the baseline.

FIGURE 5: **Both fiscal rules are set to be broken following 'no deal'**

Impact of no deal on the cyclically-adjusted PSNB and PSND (based on the Bank of England's 'disruptive' scenario)



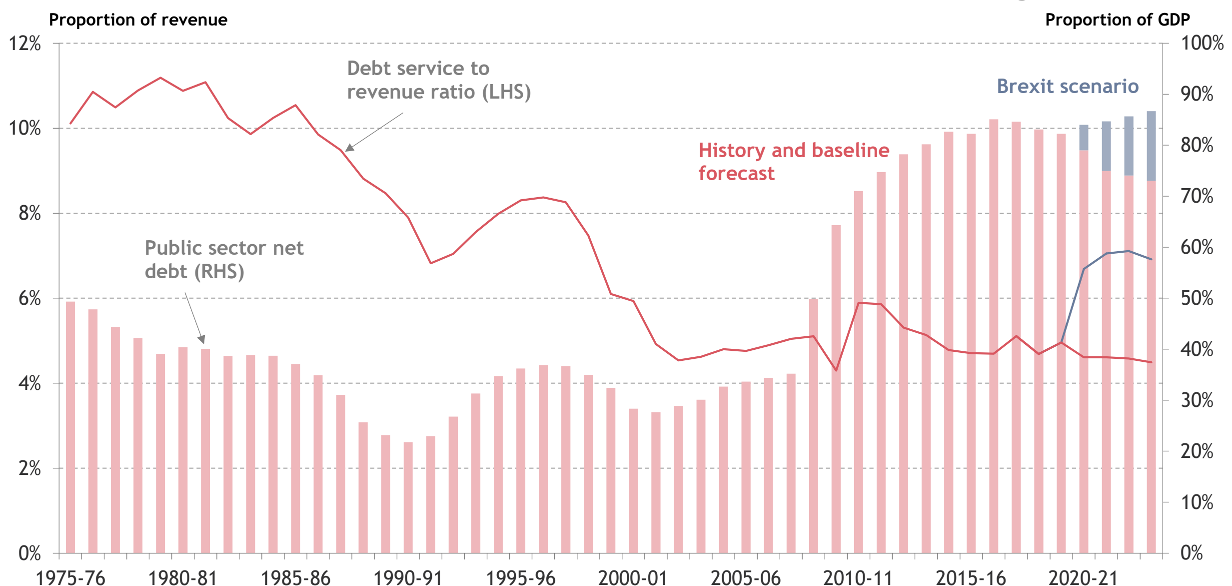
NOTES: Baseline PSND includes the unwinding of the Bank of England's Term Funding Scheme (TFS), as set out in OBR Fiscal Risks Report 2019, Table 10.13. No deal scenarios assume the TFS would not unwind and so include an additional £51bn in PSND in 2020/21 and £121bn from 2021/22 onwards, as compared to the baseline.

SOURCE: RF analysis of Bank of England; OBR

While 'no deal' would entail a significant negative shock to the public finances, fiscal policy does have significant room for temporary discretionary action. At 1.3 per cent of GDP in 2019-20, the starting level of borrowing is below its pre-crisis levels and rises by only around 2 per cent of GDP as a consequence of 'no deal'. While debt in 2019-20 is more than twice its pre-crisis level, historically-low interest rates mean that debt interest costs remain below the levels recorded in the late 1990s, even after taking account of the effects of 'no deal', as shown in Figure 6.

FIGURE 6: **Debt levels remain elevated compared to the past, but debt servicing costs are low**

Public sector debt servicing costs as a proportion of tax receipts (left axis) and public sector net debt as a proportion of GDP (right axis)



NOTES: Historic data up to 2017-18 with forecasts for subsequent years. 'No deal' Brexit is assumed to take place in 2020-21. Baseline PSND includes the unwinding of the TFS, as set out in OBR Fiscal Risks Report 2019, Table 10.13. No deal scenarios assume the TFS would not unwind and so include an additional £51bn to PSND in 2020/21 and £121bn from 2021/22 onwards, as compared to the baseline.

SOURCE: RF analysis of OBR, various and Bank of England, EU withdrawal scenarios and monetary and financial stability

A comprehensive fiscal policy package to support demand and supply while restoring sustainability

This section considers the potential size, composition, and profile of an illustrative discretionary fiscal policy package designed to support both the supply and demand side of the UK economy in the near term, while also restoring fiscal sustainability in the longer term. The illustrative fiscal package, summarised in Table 2, is comprised of four elements:

1. A £75 billion demand stimulus package of tax cuts and spending increases designed to support consumption, protect the most vulnerable, and sustain investment. The size of the demand stimulus package is calibrated to fill the 1 per cent of GDP output gap left after the monetary policy loosening described above, and is assumed to have an overall average fiscal multiplier of 0.5.
2. £20 billion of 'Emergency Supply Support' to help firms to maintain or rebuild working capital, build up inventories, and reconfigure supply chains during the period of temporary disruption of trade with the EU. This cash flow support is provided through a combination of grace periods on small business taxes to HMRC and one-year government-guaranteed emergency loans. The latter are

assumed to have an expected default rate of around 30 per cent which would increase borrowing by around £5 billion in 2020-21.[21]

3. £100 billion of ‘Transitional Supply Support’ to individuals and firms to facilitate reskilling, retooling, and relocation of labour and capital from less competitive to more competitive sectors. These are also primarily assumed to take the form of government-guaranteed loans also with a four-year maturity and an expected default rate of 30 per cent – resulting in a £30 billion net cost to the taxpayer over the forecast period. The package also includes a provision for training schemes calibrated to provide places for half of the peak increase in unemployment – costing around £3 billion.

4. An illustrative fiscal consolidation of around £35 billion in 2022-23, designed to reduce borrowing to the 1.2 per cent of GDP level which stabilises the debt-to-GDP ratio by the final year of the forecast.

TABLE 2: **Impact of Fiscal Policy Package on public sector net borrowing**

PSNB £bn	2019-20	2020-21	2021-22	2022-23	2023-24	4 Year Total
Baseline forecast (March 2019)[a]	**29**	**21**	**18**	**14**	**13**	**96**
No Deal Brexit (pre-stimulus package)	**29**	**48**	**62**	**59**	**61**	**260**
Net Impact of stimulus package, of which:		**60**	**40**	**15**	**5**	**120**
Demand Stimulus[b]		40	30	5	5	75
Emergency Supply Support[c]		5	0	0	0	5
Transitional Supply Support[c]		15	10	5	0	35
Illustrative fiscal Consolidation[d]					**-35**	**-35**
No Deal Brexit (Post-Measures)	**30**	**110**	**105**	**75**	**35**	**345**

NOTES: (b) the demand stimulus package includes a VAT cut, an 8 per cent uprating for benefits, and boosted capital investment, (c) emergency supply support targets short term supply shocks while transitional supply support aims to help the economy adjust to the long-run economic position, and (d) the mechanical estimate of the fiscal consolidation required to keep the debt-GDP ratio constant in 2023-24. Totals may not sum due to rounding.

SOURCE: (a) OBR, Economic and fiscal outlook, March 2019

Demand stimulus package

The £40 billion demand stimulus package (in 2020-21) is designed to fill the remainder of the output gap left by monetary policy and balance the need for any support to be timely, targeted, and temporary. Specifically this means that the package is aiming to provide stimulus equal to around 1 per cent of GDP. The stimulus package has three main parts.

21 We have assumed the Government’s package will address half of the temporary supply shock. In addition, the fiscal multiplier for the measures is assumed to be 0.5, in line with the OBR’s fiscal multiplier for government borrowing.

The first and largest element is a two-year 2.5 percentage point reduction in VAT from 20 per cent to 17.5 per cent costing around £30 billion over the next two years. While the VAT cut is less well targeted and benefits all consumers rather than those with the highest propensity to consume, it has the great advantage of being both fast-acting and temporary.

The second element is an 8 per cent increase in working-age benefits costing around £10 billion. Absent action, the large rise in inflation (peaking at 4.3 per cent) resulting from the rapid devaluation in sterling would significantly reduce real incomes. This would also be true in the short term for those relying on benefit income given lags in uprating.[22] The rise in benefit payments aims to mitigate this issue as well as providing a generalised support to demand.

Raising benefit payments would be a more effective part of a stimulus package than cuts in tax rates (either corporate or income tax/National Insurance) for a number of reasons. First, evidence suggests that fiscal multipliers (the impact of increased net government spending) are twice as high for welfare payments than for taxes on income.[23] Second, raising benefit payments provides more targeted support for poorer households who may be more affected by a recession and tend to have lower savings.[24] Indeed, as Figure 7 shows, 69 per cent of the boost in incomes from this increase in benefits goes to the bottom half of the income distribution. And third, history has shown that it is easier to reverse real increases in welfare spending by freezing payments than it is to raise taxes on incomes. Being able to reverse the stimulus package is important to maintain long-term fiscal sustainability.

The third and final element of the demand stimulus package is £12 billion in additional capital expenditure (in 2020-21), roughly twice the amount that the Labour government brought forward following the 2008 financial crisis.

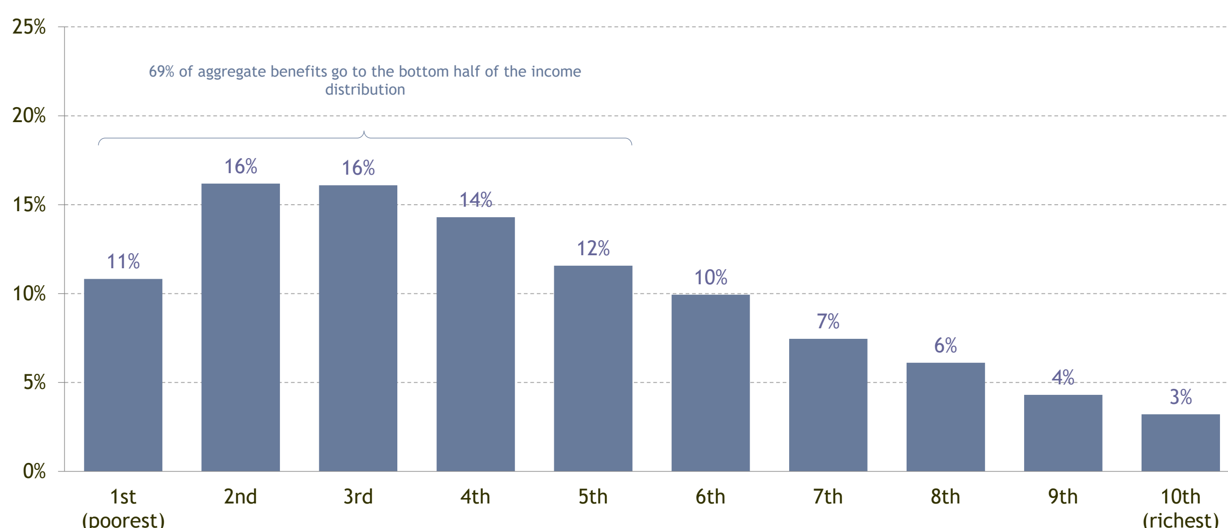
Spending on this scale would be challenging given time lags. The government could give itself the best chance of achieving it by focusing on speeding up existing public sector investment and directly stepping in to replace stalled private sector construction (rather than simply trying to incentivise the private sector to continue, as in the financial crisis), alongside making provision for the additional infrastructure needed to alleviate UK/EU transport bottle-necks and strengthening the UK's trade connections outside the EU. This would reinforce the Emergency and Transitional Supply Support packages, outlined

22 Benefits are generally uprated each April in line with CPI inflation in the previous September.
23 See OBR, 'Economic and Fiscal Outlook', July 2015.
24 See C Pacitti & J Smith, A problem shared?: What can we learn from past recessions about the impact of the next across the income distribution?, Resolution Foundation, August 2019.

below. As capital projects take several years to plan and deliver, various elements of the package should be carried over to future years but withdrawn slowly. The appropriate pace of unwinding the fiscal stimulus is discussed further below.

FIGURE 7: **Boosts to welfare spending help those at the bottom of the income distribution most**

Proportion of aggregate change in income flowing to households by income decile: 2020-21



NOTES: Income is measured after housing costs.
SOURCE: RF analysis using the IPPR tax-benefit model.

Emergency Supply Support

As discussed above, a no deal Brexit is likely to generate a number of temporary disruptions to the flow of goods, services, people, and capital.[25] No published economic scenario has included an estimate of the size of this temporary supply shock. However, based on the immediate negative shock to employment and investment in the 'disruptive' scenario, we have assumed the temporary element of the supply shock to be around 1 per cent of GDP in 2020-21.

In order to minimise the temporary impact on the supply side of the economy, there are a number of steps that could be taken. These include emergency financial support to avoid cash flow pressures turning into permanent losses of productive capacity. Such 'Emergency Supply Support' would aim to help firms temporarily affected to maintain or rebuild working capital, build up inventories, reconfigure supply chains, and retain workers during the period of temporary disruption of trade with the EU. We assume that

25 We have assumed the Government's package will address half of the temporary supply shock as it fiscal policy will be unsuited to address all temporary issues. In addition, the fiscal multiplier for the measures is assumed to be 0.5, in line with the fiscal multiplier for government spending.

part of this support takes the form of £20 billion in government-guaranteed loans of up to one year (2020-21) to help viable firms cope with temporary disruptions to their supplies of inputs, capital, or labour, or to their ability to access established export markets. As it did in the financial crisis, HMRC could also extend grace periods for the payment of VAT and employer National Insurance Contributions (NICs).

As the VAT and NICs grace period would simply be an adjustment to the timing of payment, the impact on accrual-base public sector net borrowing would be limited to the expected default rate on the guaranteed short-term loans. This is estimated to be around £5 billion in 2020-21, based on an assumed 30 per cent default rate on a total loan portfolio of £20 billion.[26] The size of the loan portfolio is assumed to equal the total size of the temporary element of the supply shock in 2020-21.

The loans would carry a rate of interest equal to the interest rate on a one year Treasury bill, plus a premium to compensate for some of the estimated credit risk of the borrower and administration cost by the bank. They would be guaranteed by the government but administered by private banks with experience of small business lending. Firms that receive these short-term loans should have to:

- demonstrate that they have an ongoing trading relationship with a counterparty in the EU or rest of the world which has been disrupted by Brexit;
- that the disruption is expected to be temporary and last no longer than one year;
- that the proceeds of the loan will be used to deal with the cost of that temporary disruption by, for example, building up working capital, stockpiles of inputs or exports, source alternative suppliers domestically or abroad;
- pledge collateral to be claimed by the government in the event of default; and
- commit to not reducing their workforce during the period for which they are in receipt of the loan.

Transitional Supply Support

In addition to temporarily supporting supply, the government can play a key role in smoothing the process of transitioning to a new underlying economic structure that will be required by the permanent supply shock.

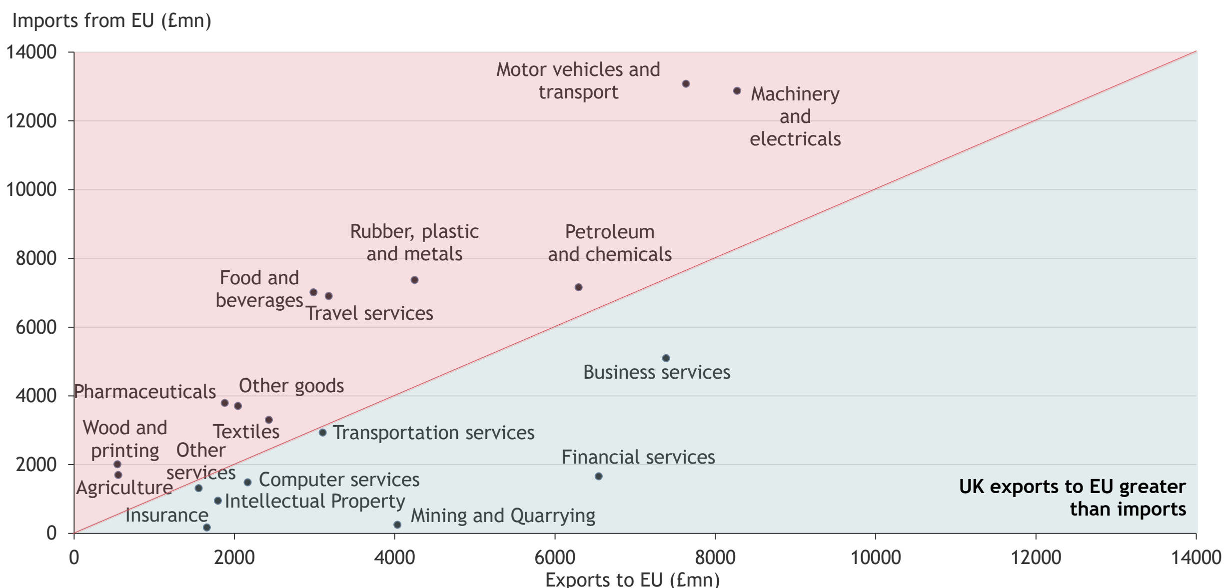
The extent to which the structure of the economy will change depends on the new trading relationship with the EU. But to the extent that that there are permanently higher barriers to trade with the EU, the UK economy must transition away from producing

26 This is twice the current average default rate on small business loans.

goods and services for the EU export market, and move towards production of goods and services either for domestic consumption or the rest of the world. Figure 8, provides a simple high-level analysis of the type of sectors that might shrink (those in the bottom, blue triangle), compared with those that might expand (top, red triangle) in a 'no deal' environment. Such a transition is fundamentally about the movement of labour and capital between sectors and geographies. There are a number of reasons why categories in which there are large imports from the EU may be affected, however – not least if they involve complex cross-border supply chains. Such supply chains are common in complex manufacturing, such as car production.

FIGURE 8: **A product analysis of imports and exports to the EU**

Relative value of imports and exports to and from the EU



NOTES: "Other goods" includes services and arts, electricity, gas and steam, water and waste, tobacco and furniture. "Other services" includes cultural and recreational services, government services, construction, maintenance and repair and manufacturing services.

SOURCE: RF analysis of ONS

To support this structural transformation of the economy, £100 billion in 'Transitional Supply Support', also in the form of government-guaranteed loans, would be available for four years and be designed to help firms and individuals adjust to the UK's new trading relationships. It would be front-loaded, and taper to zero by 2023-24 when the UK's future trading relationships have been established and firms would be expected to return to operating on a full commercial basis. This presumes that the UK government, EU, and other countries quickly resume and conclude negotiations on their future trading relationship following the UK's departure from the EU on 31 October 2019. In the absence

of such clarity about the future terms of trade, it would be unclear whether many firms' restructuring plans and individuals' retaining programmes are appropriate and worth investing in.

The £100 billion government-guaranteed loan program is somewhat smaller than the size of the Bank of England's £127 billion Term Funding Scheme, and about 10 per cent of the total stock of business lending. These medium-term government-guaranteed loans would carry a rate of interest equal to the interest rate on a gilt of similar maturity, plus a premium to compensate for estimated credit risk of the borrower and the cost of administering the loan by a bank. They would also be conditional on the firm offering both collateral in the event of default and equity investment equal to proportion of the loans towards the proposed transition (be that from their own resources or other investors). In addition to these conditions, firms that receive these medium-term loans could have to demonstrate that:

- the disruption to their operations from Brexit and the planned permanent UK/ EU trading relationship is expected to be permanent and therefore require a restructuring of their business;
- there are alternative domestic or international markets which they can profitably sell into once the UK's future trading relationships have been established;
- the proceeds of the loan will be used to pay for the transitional costs inherent to restructuring of the business including the sourcing of new suppliers, purchase or reconfiguration of equipment, market research and sales promotion, payment of legal or other contractual fees, and payment of redundancy or one-off hiring costs; and
- commit to meeting the cost of workforce retraining, including for those workers made redundant as a result of the restructuring.

Transitional support to individuals could also take the form of help with retraining, job-search, and relocation for employment opportunities. This could be important because unemployment rises by around 600,000 under the 'disruptive' scenario. And getting dislocated workers back into employment would be a key part of the policy response, particularly where they are geographically concentrated. In order to do this effectively, policy makers would need target any retraining efforts towards sectors which are more likely to expand (Figure 8), and do so by providing dislocated workers with advice on how to acquire the necessary skills for those sectors. This could be done by expanding significantly the National Retraining Scheme (NRS).[27] The cost of doing so would depend

27 Department for Education, National Retraining Scheme, 20 August 2019.

on the extent of the required retraining, which will ultimately depend on the new relationship with the EU.[28]

With more certainty we can say that any increase in unemployment of this size would require a swift adjustment to Jobcentre Plus (JCP) operations. JCPs around the country are currently focused on delivering the transition to Universal Credit – meaning that they are focused on servicing a much larger client group than in the past. While they would previously be focused on those out of, but looking for work, they now also administer benefits (and in some cases conditionality) for millions of working households. This broadening of JCPs' role sits alongside a reduction in the number of staff by almost a third over the past eight years.[29] With record employment driving down the claimant count, this is understandable. But the situation would change rapidly were we to see a spike in unemployment. More staff would be needed in JCP and the current approach of rolling out Universal Credit and applying conditionality to working households would need to be adjusted to give priority to traditional JCP roles of ensuring swift financial and job search support to those made newly unemployed.

Managing the fiscal risks from loans and guarantees

In both emergency and transitional supply support schemes, an important consideration will be the quality, transparency, and affordability of the loans which will ultimately be guaranteed by the Government. Such lending by commercial banks is likely to be the quickest and most cost-effective means of providing temporary financial support to firms and individuals. Commercial banks have the infrastructure, personnel, expertise, and access to funding needed to issue the loans quickly. Were government to attempt to provide such a large-scale lending program itself, it would likely lose valuable time and potentially face higher loss rates on the loans due to lack of expertise in loan appraisal.

However, a number of countries, including the UK, have made use of loans or guarantees (whose costs are generally not reflected in borrowing) as a way of obscuring the true costs of supporting a given sector or activity. This was the case, for example, with student loans in the UK up until the ONS's recent decision to recognise the interest rate subsidy and expected losses on the loans in borrowing at the time the loan is taken out.

The same principle should be applied to any emergency or transitional supply support, with the interest rate subsidy, forecast default rate and calling of the guarantee recognised in borrowing at the point the loans are issued (as they are in the illustrations above). Estimates of the forecast default and call rate should be made by an independent

28 The illustrative stimulus package in this note provides funding for training for roughly half of the increase in unemployed workers, over the first two years.

29 Our estimate is echoed by the Work and Pensions Select Committee inquiry into JCP, which found that the number of work coaches fell by 35 per cent between 2011-12 and 2015-16. See: Work and Pensions Select Committee, The Future of Jobcentre Plus, November 2016.

body such as the NAO and adjusted on a quarterly basis depending on actual performance of the loans. The OBR should include a forecast of the expected value of these loans in a detailed forecast of the public sector financial balance sheet in each EFO so their impact on overall net worth can be seen. The issuance of the guarantees should be under the exclusive authority of the Treasury and the portfolio of guarantees should be managed by a single agency who should produce a regular report on their performance and risk. This approach would learn the lessons of the Swedish government, described in Box 3, following a proliferation of government guarantees and loans in the aftermath of a severe recession in the 1990s.

BOX 3: **Swedish Model for Management of Loans and Guarantees**

Sweden experienced a financial crisis and severe recession in the early 1990s which resulted in widespread distress among households and firms with a 25 per cent fall in property prices, tenfold increase in non-performing loans, and 5 per cent contraction in GDP between 1990 and 1993. As part of its efforts to restore confidence in the financial system and prevent a spiralling credit crunch recession, the Swedish government took over the two largest domestic banks and issued a blanket guarantee of all deposits and credit in the economy. The impact of the recession on government spending and receipts, and socialisation of financial sector losses, contributed to a more than doubling in government debt from below 40 to 80 per cent of GDP in the first half of the 1990s.[30]

The extensive, albeit successful, use of sovereign guarantees to resolve the financial crisis led the government to develop a more formal institutional framework for issuing and managing both government guarantees and loans.[31] In the aftermath of the crisis, a new law gave the exclusive right to issue loans and guarantees to the Finance Minister who delegated some of this authority to four line ministries with extensive experience with the issuance and management of loans and guarantees (the Housing Board, Development Agency, Export Credit Agency, and Student Loan Agency). All other loans and guarantees are issued and managed by the Swedish Debt Management Office (DMO), an agency of the Ministry of Finance. As in the case with traditional expenditure, the approval of the Parliament is required for the issuance of all loans and guarantees, who also have to approve any subsidy element within the instrument. The DMO is responsible for the pricing of all loans and guarantees

30 Peter Englund, The Swedish Banking Crisis of the 1990s: A Revisit in Light of Recent Experience, June 2015.
31 Sweden Debt Management Office, Central Government Guarantees and Lending in Sweden: An Introduction

which is based upon an analysis of the riskiness of the instrument and creditor, typically using historic default and recovery rates. In the pricing of the loan, the DMO follows a set of principles. These principles are:

- **Cost recovery:** the government is required to charge a fee equal to the expected loss on the instrument plus any administration cost. If the recipient is afforded a lower premium than the expected cost, then this subsidy element must be financed from within the responsible ministry's current budget and approved by the Parliament.
- **Instrument neutrality:** in determining the fees and conditions attached to loans and guarantees, the DMO aims to make the responsible ministry indifferent between offering support via a grant, loan, or guarantee and thereby chose the instrument based on its effectiveness rather than its accounting treatment;
- **Risk accounting:** fee income from guarantees are remitted to the Treasury to help reduce debt but are tracked in a notional account to enable the DMO to avoid building up hypothecated funds held against those liabilities. Fees are included in the cash flow of central government and help reduce debt. However, for each guarantee the income and pay-outs for that guarantee are tracked in a notional account.

The centralisation and risk-based pricing of loans and guarantees by the DMO helped Sweden to bring what was a complex and costly array of financial support to firms and households. In recent years, the default rate on loans and guarantees has been less than 1 per cent. In the meantime, the government earns between 2 and 6 billion Swedish kronor (0.1 per cent of GDP) annually in interest and guarantee fees.[32]

Illustrative fiscal consolidation

While fiscal policy can provide temporary and transitional support to supply and demand, in the long run it needs to adjust to the fact that the post 'no deal' Brexit economy will be smaller and less dynamic than it would otherwise have been. While the UK currently has low borrowing (and borrowing costs), the combination of the fiscal impact of 'no deal' itself and the government's demand and supply support would, if left unchecked, result in debt and debt interest costs rising and potentially ending up on unsustainable paths.

The final element of the fiscal package is therefore an illustrative fiscal consolidation in 2023-24 of around £35 billion, which is the amount of tax rises or spending cuts

32 Sweden Debt Management Office, Central Government Guarantees and Lending: A Risk Analysis, March 2019

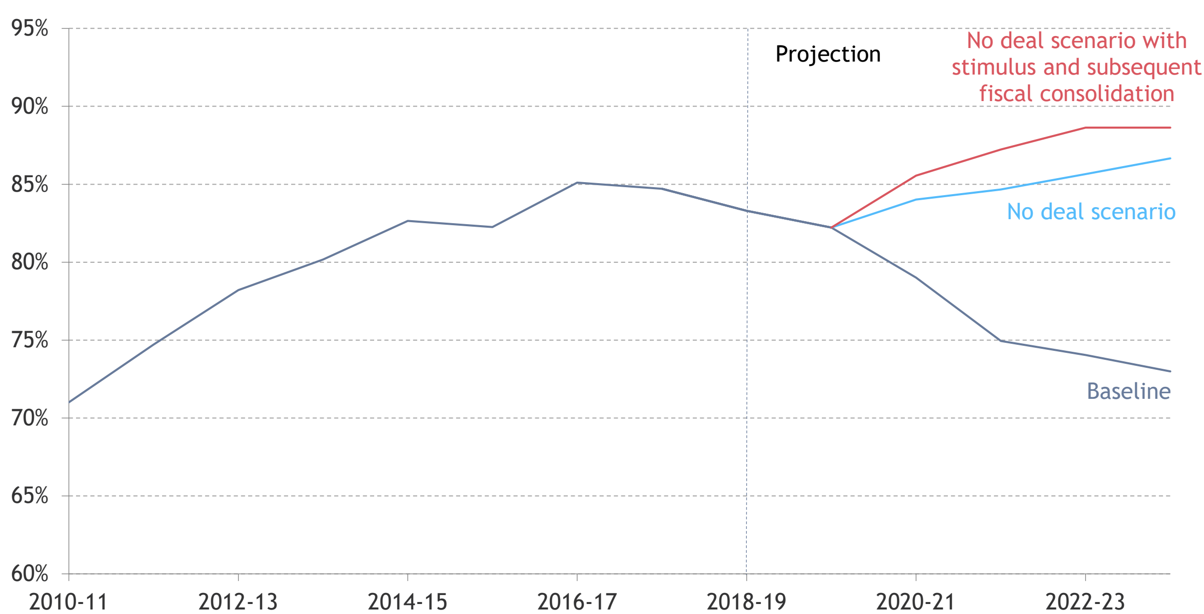
required to stabilise the debt-to-GDP ratio by the final year of the forecast. In practice, a government may choose to spread this adjustment out over a number of years depending on the strength of the economic recovery. We have included all of it in 2023-24 to illustrate the magnitude of adjustment required within the limited time horizon offered by the illustrative forecast.[33]

Summary impact of the overall fiscal package

Figure 9 sets out the effect of taking the fiscal impact of 'no deal' together with all four elements of the fiscal policy response. It shows borrowing rising to almost 5 per cent of GDP at its peak in 2020-21: around half the 9.9 per cent of GDP peak in borrowing following the 2008 financial crisis. Borrowing then falls steadily as the economy recovers, the demand and supply support packages unwind, and fiscal consolidation begins. Debt climbs steadily from 82 per cent of GDP in 2019-20 before stabilising at a new level of 89 per cent of GDP in 2023-24.

FIGURE 9: **Using fiscal policy to support the economy under 'no deal' would lead to a substantial but temporary increase in the deficit**

Public sector net borrowing as a proportion of GDP



NOTES: Baseline includes the unwinding of the TFS, as set out in OBR Fiscal Risks Report 2019, Table 10.13. No deal scenarios assume the TFS would not unwind and so include an additional £51bn in PSND in 2020/21 and £121bn from 2021/22 onwards, as compared to the baseline. The fiscal consolidation is assumed to be applied in 2023-24, in practise the Government would likely want to spread this over multiple years.

SOURCE: RF analysis of Bank of England and OBR

33 This estimate takes into account the increased GDP level from the stimulus package. However the estimate does not incorporate second round effects of higher GDP improving public finances; if included, this would lower the necessary fiscal consolidation as tax receipts would be higher and spending lower than in our forecast.

While this note is focused specifically on a 'no deal' shock, this also illustrates a wider point about macroeconomic policy in the years ahead. Even though this is (by historical standards) a relatively shallow recession, it leads to significant increases in the deficit and debt – because fiscal policy is stepping in where monetary policy would previously have led.

Conclusion

There has been substantial debate around the impact of the UK leaving the EU without a deal, especially as the perceived probability of a 'no deal' scenario has climbed in recent months. The public debate has focused heavily on the size of the overall hit to GDP but has largely ignored important questions around the nature of the economic shock and what the appropriate macroeconomic response would be.

We have argued that a 'no deal' would trigger three distinct economic shocks: a reduction in overall demand; temporary disruption to the supply side of the economy; and a permanent reduction in supply capacity. Irrespective of the – very uncertain – size of the hit to the economy and public finances, our economic policy response should be designed to address these three different economic shocks, and to do so in as timely and effective a way as possible.

Monetary policy should do what it can to boost demand and look through the temporary rise in inflation from the depreciation in sterling. But a significant fiscal stimulus package would be needed too. This would need to be designed to be implemented quickly and to maximise its effect by focussing on the households and businesses most affected. Fiscal policy will also need to recognise that, while the UK is certainly able provide a stimulus package for the economy, the permanent reduction in the supply capacity of the economy will necessitate tighter fiscal policy in future years. Therefore the stimulus package would need to be followed by a moderate fiscal consolidation to stabilise the debt-to-GDP ratio.

The scale of the necessary economic policy response to a 'no deal' Brexit has been understated and would be crucial in reducing the negative impact of such a shock should it take place. But of course it can only reduce not eliminate the short term impact of such a shock, while the eventual scale of the hit to the UK's supply capacity depends on what eventual relationship is agreed with the EU – irrespective of whether a deal is agreed on the terms of our exit from it.

Resolution Foundation

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