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The self-inflicted dangers of the EU referendum

di Martin Wolf

What were they thinking? It is extraordinary to read a succession of official reports arguing, rightly, that a vote to leave the EU would impose long-term damage and a short-term shock. What sort of government would run such a risk, particularly when the economy has barely recovered from the financial crisis of less than a decade ago? The answer is one that has put the needs of short-term party management above its responsibility for the country's welfare. David Cameron, prime minister, might soon be known as the man who left the UK in far-from-splendid isolation.

The Treasury has already argued that leaving the EU might lower real gross domestic product by between 3.4 and 9.5 per cent in the long term. This is broadly in line withestimates from other reputable forecasters. Patrick Minford of Cardiff University, a proponent of leaving, argues that the UK would enjoy a jump of 4 per cent in aggregate economic welfare after leaving the EU and adopting free trade (an unlikely choice). But this result is an outlier. It rests on implausible assumptions, not least on the impact of EU non-tariff barriers on domestic prices.

The Treasury has now followed up with a report on the short-term consequences of a vote to leave. In summarising the results, George Osborne, the chancellor of the exchequer, has stated that the UK would suffer a "do-it-yourself" recession if it decided to leave. One might better call it a "do-it-himself" recession. For it was the government's decision to take this risk.

The new report's main scenario predicts that GDP would be 3.6 per cent lower after two years than if the UK voted to remain, unemployment would be 520,000 higher and the pound would be 12 per cent lower. Under a worse scenario, GDP could be 6 per cent lower, unemployment 820,000 higher and sterling 15 per cent lower. TheInstitute for Fiscal Studies adds that, instead of an improvement of £8bn a year in the fiscal position, as the net contribution to the EU fell, the budget deficit might be between £20bn and £40bn higher in 2019-20 than otherwise, sharply slowing the planned fiscal consolidation.

Indeed, the Treasury argues, plausibly, that the very possibility of a vote to leave is already having an impact on the economy. But an actual vote to do so in June's referendum would crystallise this risk and create significant and immediate effects, via three channels.

The first of these would be the tendency of households and businesses to adjust at once to becoming permanently poorer. This would lead to significant cuts in consumption and investment.

The second effect would come from prolonged uncertainty about how the UK's relations with the EU would work out. It is difficult to exaggerate the scale of this uncertainty. After a vote to leave, the country would not know the complexion of its new government, the UK's desired approach to renegotiation of its relations with the EU, or the response of the other members, let alone any final outcome. The uncertainty could also be long-lasting. Even the formation of a new government and agreement on its new approach might prove difficult. The likely leaders of a new government have also said things in this campaign that must hinder the chances of reaching an amicable settlement with EU partners.

News, comment and analysis on the referendum to decide whether Britain will leave the EU.

The third effect would be the shift in financial conditions. Markets would at once reassess the UK’s economic prospects. Asset prices, including the exchange rate (as the Bank of England has already noted), are likely to adjust downwards immediately. An appreciable increase in the risk premia on UK assets could emerge. Asset price volatility would also increase. The BoE might face a difficult dilemma, since there is likely to be a simultaneous rise in expected inflation and a decline in expected output in the short term.

Official sources have described, in painful and quite plausible detail, how far the referendum unleashed by this government is a risky and dangerous gamble with the health of a fragile post-crisis economy. This is apart from the risks to the future cohesion of the UK and, quite possibly, of the EU, too.

This referendum is, arguably, the most irresponsible act by a British government in my lifetime. To the objection that this is to deny democracy, one can respond that the country was a successful democracy well before it embarked upon such referendums. Furthermore, the right time for a referendum would be when the UK is asked to accept further treaty changes or some other significant alteration in its position in the bloc. Right now one can only hope that the country does not soon learn what it means to divorce in haste and repent at leisure.