

**Economy Committee Response (Post 9 Sept 2014 Meeting)
Dr Gerard Lyons Chief Economic Advisor to the Mayor of London**

1. a) Did Volterra model the impact of any specific EU reforms? b) If yes, which ones were included? If not, what assumptions were used in the modelling, and how did these differ across the four scenarios set out in the report?

Answer: Yes and the focus was on the supply side. Volterra, who carried out the independent forecasts, focused on a definition of reform that is essentially a supply side one. A reformed EU would, for example, offer free trade in services on the basis of passported regulation, rather than wanting to set a universal standard. Volterra took on board that such reforms would equally apply inside the UK, which would not 'gold plate' new regulation and would encourage trade in services across the globe. Volterra's scenario of 'Business as Usual' does not therefore reflect an average of the post war period, but rather a view of the prospects offered to economies that are restricted on the supply side, whatever policies of demand side management is being pursued. The 'Inward Looking' scenario reflects, in Volterra's words, "an attempt at autarky, with reduced trade and would have economic out turns similar to those seen in the inter war period. "Thus, as opposed to trying to quantify a specific reform over a twenty year period, in terms of the EU scenarios outlined, the aim is to give the range of possible macroeconomic outcomes, between reform and unreformed, in or out of the EU, over a couple of economic cycles.

c. What interest rate assumptions were used in the modelling?

Answer: Over a 20 year period, the background is that in all four scenarios real interest rates on long dated government bonds gradually return to 2 per cent. This was to ensure that the scenarios reflected what we were trying to model, namely the economic outcomes around various UK-EU scenarios. This makes sense, particularly also given the expectation of an independent Bank of England, committed to achieving low inflation, throughout the forecast horizon.

2. Will you commission further work to model changes in other indicators, poverty, income and wealth inequality, greenhouse gas emissions, subjective wellbeing, or other economic indicators for your four scenarios?

Answer: We are not currently planning to. One of the main aims behind the report was to gauge the impact on London of the wider EU debate, and the report aimed to provide an overall gauge of both the main macro-economic and also key sector specific issues. In particular, the detailed appendices look both at the forecast scenarios and the impact on the various key sectors of the London economy.

3. How were you able to produce accurate projections from a 'qualitative' assessment? For instance, GDP growth is projected to be 2.75% in scenario two, and 2.5% in scenario three. What is the margin of error in these projections?

Answer: At City Hall we did not have the econometric model to be able to carry out such detailed forecasting analysis. As a result we commissioned such work from a respected outside economic forecaster, with a proven track record and the necessary skills in this area. In terms of the question, such comments are frequently asked of any long-term macro-economic forecast, and thus it is both

important to be both clear and realistic about what are trying to forecast, as outlined in the questions asked above.

There is a very considerable margin of error in any macroeconomic projection, no matter how it is generated, even on a one year ahead forecast. The track record of forecasting, established over decades, shows this clearly. It would be wholly misleading to imagine that so-called quantitative models would not require major qualitative input, when a long term future is being considered in which behaviour and institutional structure may be different from the past. In order to address these recognised issues with economic modelling, the basis of the scenarios is the quantitative technique of fuzzy clustering, set out for example in P Ormerod, B Rosewell and P Phelps, 'Inflation/unemployment regimes and the instability of the Phillips curve', Applied Economics, 45:12, 1519-1531, 2013.

4. Did you consider any other reforms in your future scenarios, other than those advocated in the report?

Answer: Not other than those advocated in the report. The report considered the various reforms and scenarios that were outlined.

Our identified reforms were based on what we felt was within the realms of possibility. As indicated in the answers above, our scenarios looked at the overall reform agenda, and in doing so identified this as key to the economic outcome, as indicated in the various key macroeconomic indicators, such as growth and employment.

5. What is your assessment of the impact of the EU reforms you advocate on levels of poverty, income and inequality in London? What is this assessment based on?

Answer: The scenarios provided economic indicators on some of the key macroeconomic indicators for London. To have taken this further into areas such as levels of poverty, income and inequality would have necessitated further analysis making more detailed assumptions about national economic policy, and possibly making assumptions about what such policies may have been under different governments. Instead, it made more sense to be clear about where the report could add value, particularly in the focus on the different sectors of the London economy, and identifying the key aspects for each of these sectors in terms of the current and possible future relationship with the EU. This was vital for understanding the future issues. Overall, having an understanding of the growth and jobs outlook in each scenario would be an important first step to addressing the issues asked about in this question.

6. Have you considered the potential impact of the opening up of the health services market, which is subject to ongoing negotiations between the EU and United States in relation to the Transatlantic Trade and Investment Partnership? If yes, what is your assessment?

Answer: Our assessment would be that the Government needs to clarify the position of the NHS in TTIP – there are a number of possible downsides particularly in regulatory harmonization and The Investor State Dispute Settlement (ISDS) mechanism. But in a wider context, the service sector is a key opportunity area for the UK and hence the Europe Report highlighted the benefits to the EU and to the UK and London of ensuring the single market in services works properly across the EU.

7. a) What labour market reforms do you believe need to be introduced by the UK and/or EU? Do these include relaxing restrictions on working hours, health and safety regulations, or the right to flexible working arrangements?

Answer: The issue of the labour market is, in the terms of this report, naturally impacted by both national and regional policies. But, in addition, an underlying issue is the need for London to ensure it remains competitive in a changing global economy. So global factors influence how firms will behave in many sectors. Thus a combination of global, regional and national influences matter. Also, as is clear from the current policy focus it is also about recognising that there is a combination of high and low skilled jobs, and thus at national level the importance of the minimum wage and in London the desire to ensure a greater number of firms pay the London living wage.

The UK is also often seen as a model for the rest of the EU in terms of flexibility. For example, the rapid rise in the numbers of self-employed suggest that there is widespread recognition of the need for flexible working arrangements. These were all made clear in the report and at a national level where policy can be set according to the needs of national business. It is worth pointing out that governments would then be freer to adjust policy far faster to reflect demands of the electorate and business.

b) How would you quantify the potential negative impacts of these reforms, for instance on wellbeing?

Answer: It is hard to define wellbeing, but it is likely to include issues outside the remit of this report. But in terms of this report, and the relationship between the UK and EU and the impact on London, it will include growth, jobs and living standards. The question appears to assume reforms will be negative, but that is far from clear. London needs to position itself in a changing world economy and the report suggests that within the EU, or outside the EU, a reform agenda is important to achieving stronger economic growth, and by implication more jobs and income. Wellbeing and quality of life issues will likely be impacted by other factors, as now, such as housing, transport and travel and low crime. Indeed the report highlights that London benefits from many such factors. From an economic perspective, expanding the choices available to individuals, and increasing their real incomes can help improve well-being.

8. What input did the Mayor have on the choice of the four future scenarios used in the report?

Answer: This was an economic report and so was carried out by myself, the Mayor's chief economic advisor. The Mayor was keen for the report to address all the key areas of relevance to the economic and financial outlook for London. He was thus supportive of the approach the report took, but he did not interfere or intervene in the report. It is important to see this as a report to the Mayor, and the Mayor gave his response to the report in the speech that he gave on the day the report was released, at Bloomberg. Thus, in terms of this specific question, the Mayor was not the person who chose the four scenarios; these were chosen by myself - and then we discussed them with Volterra - as they followed naturally from the various meetings and discussions that took place with businesses, economists, and other experts as part of the compilation of this report. Naturally, before an outside consultancy was commissioned to carry out the economic scenarios I checked with The Mayor that he was supportive of this approach and that he was aware of the four scenarios we were asking Volterra to model.

It is important to stress that this was an independent report carried out by the Chief Economic Advisor to the Mayor, and moreover, to reinforce the full independence of the report the four scenarios on which the economic forecasts were based were conducted by an outside, world class

and independent economic consultancy. Their forecasts, along with the sector focus, were reflected in the detailed analysis in both the 107 page report and the 129 appendix that accompanied it.

Gerard Lyons
19th October, 2014