



CPB Netherlands Bureau for Economic
Policy Analysis

*Brexit Affects
the Netherlands
more than many
EU Countries*

*Free Trade
Agreement
UK/EU
lowers Costs*

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Brexit Costs for the Netherlands Arise from Reduced Trade

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Summary

A Brexit will have a relatively severe effect on the economy of the Netherlands, because the Dutch economy is more connected to the economy of the United Kingdom (UK) via trade than to that of the European Union (EU) as a whole. By 2030, the costs for the Netherlands could run up to 1.2% of GDP, or 10 billion euros. And, if we also assume innovation is trade-induced as recent examples in the literature have shown, then the Brexit-related costs of 10 billion euros could increase with another 65%.

If the majority of voters in the UK would choose to leave the EU, we assume the actual withdrawal of the UK from the EU will take two years to complete. Next to that, the UK may enter a renegotiation process for various trade agreements that will likely last a number of years. This will involve some uncertainty about the ultimate relationship between the EU and the UK, which will also affect the business community. The economic damage caused by that uncertainty will be the greatest in the short term and can already be seen in the run up to the UK referendum.

After a possible Brexit, the UK would become less attractive to foreign investors as a gateway to the EU. The EU may profit from that situation when those foreign investments are shifted from the UK to other countries within the EU. However, the more substantial losses for the UK and the EU will occur in the long term, as a result of economic adjustments caused by the increase in trade costs and the non-tariff barriers to trade (NTBs) between the UK and the EU. NTBs result from differences in technical specifications or environmental standards that traded products must meet before they are allowed to be sold within the EU.

The GDP losses in the Netherlands induced by a Brexit are sector-specific. Sectors such as 'other transport' and 'transport equipment' hardly will be affected, because they are connected more closely to the EU than to the UK. However, this does not apply to other sectors, such as 'chemicals, plastics and rubber', 'electronic equipment', 'motor vehicles and parts', 'food processing industry' and 'metals and minerals' (together 12% of Dutch GDP). These sectors could suffer production losses of around 5% – losses that could be reduced with 40% under a new free trade agreement.

Following a possible Brexit, the UK will have various options with respect to trade agreements with the EU. On the one hand, there will be the fallback option of the standard WTO regulations. According to such regulations, the UK will face the higher, external EU tariffs. If the UK, in addition, would decide to implement standards and regulations that deviate from those of the EU, this will create non-tariff barriers to trade.

On the other hand, it is possible to enter into a new free trade agreement that would result in a substantial reduction in trade costs. Such an agreement would circumvent trade tariffs and would set standards and regulations that would apply to both the UK and the EU. It would not be able to completely restore the current full access to the internal market, however. Should the EU and the UK reach a free trade agreement, the economic consequences of a

Brexit for the Netherlands would be reduced by 20%, because one of the important elements of such an agreement would be that NTBs will increase by only 6%, instead of the 13% under WTO regulations. The other element of a free trade agreement would be the absence of trade tariffs for goods traded between the EU and the UK.

A new free trade agreement poses a dilemma for the EU. On the one hand, the EU wants to avoid the Brexit setting a precedent, or encouraging Member States to pick and choose from the different benefits and costs of EU membership. It would therefore want to increase the costs of the withdrawal as much as possible. On the other hand, this would then also lead to higher costs for the EU itself. A new trade agreement could reduce those costs for the EU—but also for the withdrawing country.

Furthermore, the Brexit-related costs are relatively low for countries in eastern and southern Europe, as they are less connected with the UK. Those countries, therefore, would benefit less from a new free trade agreement than countries such as the Netherlands, Ireland and Belgium. For this reason, it is conceivable that countries with a large economic interest in a new free trade agreement with the UK will not be able to muster the support of all EU Member States.

1 Introduction

On 23 June 2016, the UK will hold a referendum about whether or not the country should withdraw from the EU: the Brexit. Should the referendum result in victory for the ‘leave’ camp, we expect it will take at least two years before the UK will be able to fully withdraw from the EU. Next to that, negotiations will begin about the future collaboration between the UK and the EU, and trade agreements will be reached. We expect such negotiations to last several years¹.

A Brexit would influence the EU economy in various ways (see text box 1), particularly with respect to trade. Economic consequences may be even larger if other EU Member States were to follow the UK example of exiting the EU, thus endangering the whole EU project.

Studies on the impact of a possible Brexit show that the highest costs are related to trade, particularly in the long term². A number of studies also include other effects, in addition to those on trade (see text box 1) as well as differing post-Brexit scenarios (see Chapter 2), which means that the sum of Brexit-related costs presented in those studies are not fully comparable. The calculated costs for 2030 vary between 1.5% and 9.5% of GDP¹.

¹ In an interview in the *Financial Times* of 25 May 2016, Director-General Azevêdo of the WTO warns that any renegotiations of trade agreements would be a long and complex process for the UK ([link](#)).

² See the OECD study by Kierzenkowski et al., 2016; HM Treasury, 2016; NIESR study by Armstrong & Portes, 2016; LSE/CEP study by Dhingra et al., 2016; PwC, 2016, Oxford Economics, 2016.

Text box 1: Brexit will impact the UK and EU economies through various channels

Trade

UK Costs would depend on the type of trade agreement that is chosen after the Brexit. The increasing differences in regulations between the UK and the EU would have a negative impact on trade. The UK will also no longer be included in existing EU trade agreements with third parties (e.g. TTIP).

EU The EU will also face higher trade costs, although these will be lower than for the UK. Without the UK, the EU will be a less attractive partner for entering into trade agreements with non-EU countries.

Direct foreign investments

UK The UK will become a less attractive gateway to the EU. However, the UK may become cheaper for foreign investors due to less regulation.

EU Other countries could take over the UK position as gateway to Europe. Simplification of regulations in the UK would make the EU relatively less attractive as a location for corporate headquarters.

Financial services

UK Because of its existing clustering/agglomeration, the UK is likely to maintain its strong competitive position. It would, however, become more difficult to service European markets from the UK, which would lead certain financial service providers to relocate their company.

EU Financial centres in the EU may benefit from this, but relocation to elsewhere within the EU would lead to higher costs for financial services. Thus, there is also the risk of them relocating to somewhere outside the EU.

Uncertainty

UK A Brexit would take several years to complete, with uncertainty about the time of completion, making the business community apprehensive towards investing. That uncertainty will be the greatest in the short term, and can already be seen in the run-up to the referendum.

EU Uncertainty is also bad for business in the EU. The greatest risk is that of political contagion of the '*proof of concept*' of withdrawal from the EU.

Immigration

UK UK immigration policy will likely become more restrictive, with possibly negative consequences for attracting new talent, which in turn could diminish the competitive position of London, in particular.

EU There is a risk of political contagion in this area, as well, with EU countries also demanding a more restrictive immigration policy.

Liberalisation and regulation

UK After a Brexit, the UK would no longer have to conform to EU standards, except for their exports to the EU. The UK no longer would be able to influence EU regulation.

EU The EU would lose an influential promoter of liberalisation and deregulation. The balance of power within the EU may shift towards other countries that are less supportive in this area, causing deregulation to become more difficult.

Budget

UK The UK would no longer have to make net payments to the EU budget (nearly 8400 million pounds sterling in 2014, see Begg (2016)).

EU The EU loses a net contributor to the EU budget, a gap that would need to be closed through slightly higher contributions from other Member States or through reduced spending. In addition, the EU would also lose a supporter of stringent budgetary regulation.

International influence

UK For managing its own economic and foreign interests, the UK would lose the advantage of being able to exert influence on and through the EU.

EU The EU would lose leverage in foreign politics as well as in military respect with the loss of a powerful European nation, although it may be able to act with greater coherence.

Source: based on Irwin, 2015.

Only few studies have focused on the quantification of Brexit-related economic effects on the EU. For example, Schoof et al. (2015) calculated an effect of 0.1% to 0.4% in GDP losses for the EU in 2030. A number of studies explain the negative effects for the EU without quantifying these effects.³ In addition, there are some country-specific studies on the impact of a Brexit, such as for Ireland (Barrett et al., 2015) and Germany (Schoof et al., 2015). The German study indicates that a Brexit, at best, may reduce German GDP growth in 2030 by 0.1–0.3% and, at worst, by 2.0%. Particularly affected would be the German automotive industry.

All those studies consider that, in the long term, the highest costs will be related to trade, because of the damage EU countries will experience due to the sectoral adjustments to increasing trade costs. Costs in other areas (text box 1) are less important for the EU and the Netherlands. This policy brief, therefore investigates the macroeconomic long-term consequences of a Brexit for Europe, and particularly for the Netherlands; looking at alternative trade agreements that, following a Brexit, could be reached between the UK and the EU. The consequences of a Brexit for the UK itself are also included.

2 After the Brexit: WTO or FTA

In case of a Brexit, the free access that the UK currently has to the internal EU market for goods, services and people would cease after two years. The UK would also no longer be part of trade agreements between the EU and other countries. Trade from and to the UK would only need to comply with the regulations of the World Trade Organization (WTO). However, the UK and the EU could decide to make certain agreements about UK access to the internal EU market. In addition, the UK could also enter into new trade agreements with other non-EU countries.

There are a number of conceivable scenarios for organising varying degrees of UK access to the internal EU market. Options that would provide the highest levels of access (EEA and customs union) are probably unacceptable to the 'leave camp', because this would continue EU interference in the UK. This leaves two possible scenarios: a free trade agreement (FTA) or the standard fallback option under which the UK stays a member of the WTO and makes no additional arrangements.

European Economic Area (EEA)

A number of European non-EU countries have entered into an agreement with the EU, in which access to the internal market is organised to varying degrees. Countries that are a member of the European Economic Area (EEA), such as Norway, Iceland and Liechtenstein, thus have free movement of persons, goods, services and capital within the EU. In exchange, these countries make substantial contributions to the EU budget and they have to comply

³ See Bond et al., 2016; Fitch, 2016; Dabrowski; Irwin (2015).

with European standards and regulations, without being able to influence future modifications.

However, joining the EEA is probably out of the question for those in favour of a Brexit. Brexit supporters want no more contributions to the EU budget and no EU interference in UK regulations. They want the UK to have control over migration, and they do not accept any treaty that would regulate the free movement of people between the UK and the EU.

Customs union or bilateral trade agreements

Switzerland and Turkey have a more limited agreement with the EU. Turkey has a customs union with the EU that allows free movement of goods and uniform trade politics.

There are 10 agreements between Switzerland and the EU (among which Schengen) that provide Switzerland with access to the internal EU market in certain economic sectors. In addition, it has over 200 trade agreements. All these agreements have closely connected Switzerland to EU legislation, but do not allow it to participate in European decision-making. Switzerland also contributes to the EU budget. This situation is not an option in the eyes of the supporters of the UK 'leave' camp, for reasons comparable to those under the EEA.

The Turkish option would not be to the UK's advantage. Agricultural products and services are outside the internal market, and Turkey must comply with EU legislation without having a say in the rules and regulations. Turkey also has to conform to EU policy with regard to trade agreements; it cannot enter into its own trade agreements with third parties. Brexit supporters in fact want the UK no longer to be obligated to follow EU standards and regulations and for the UK to determine its own trade politics. This, therefore, excludes the Turkish model as an option.

This leaves only two plausible scenarios.

World Trade Organization (WTO)

If, after the Brexit, the UK makes no other arrangements, it would fall under the regulations of the WTO. As there is no precedent for this type of situation, it is unclear whether continuation of the UK membership of WTO would be automatic. It remains to be seen whether agreements with other, non-EU countries – that the UK entered into as a member of the EU – will hold. In case they do not, this will make things much harder for the UK, as it would need to start long and complex negotiations with the WTO and come to new agreements with 58 non-EU countries⁴.

For our study, we assumed that the UK will be able to continue its WTO membership and that trade agreements with other non-EU countries remain valid. It will, however, be faced with external EU tariffs. We assumed that these would come to 3% across the board, comparable with EU tariffs for other countries. These trade tariffs would reduce the amount of trade between the UK and the EU. The UK would not have to comply with EU standards

⁴ See the interview with Director-General Azevêdo of the WTO in the *Financial Times* of 26 May 2016. ([link](#))

and regulations, but this will also cause non-tariff trade barriers, leading to an approximately 13% increase in the trade costs for goods and services.⁵

Free Trade Agreement (FTA)

The UK could enter into a free trade agreement with the EU, thus circumventing any tariff barriers. Such an agreement would set standards and regulations that would apply to both the UK and the EU. However, this agreement would not necessarily include full access for certain services (e.g. financial services).

For our calculations, we assumed that the UK and the EU would not impose trade tariffs on each other. An FTA would only determine some of the standards and regulations, and allow the UK to deviate from EU regulations. Therefore, we assume that certain trade barriers would be created but that these would not be immediately obvious. This could concern differences in technical specifications or environmental standards with which traded products must comply. We assume that trade costs for these goods, as well as for services such as tourism and financial products, would increase on average by 6%.⁶

3 High costs for the Netherlands

The two possible scenarios as options following a Brexit (FTA and WTO) would both lead to GDP losses (absolute and in percentages), which are country-specific and scenario-specific. The bold circles/bars in Figure 1 show the consequences without accounting for trade-induced innovations. The more uncertain, additional costs are presented by the shaded circles/bars “with trade-induced innovation”. The latter GDP losses are substantially larger, while they concern also the costs resulting from less innovation and smaller productivity increases due to a reduction in trade.⁷ Although this mechanism seems plausible, can be understood intuitively and is also indicated in the empirical literature, the size of its’ impact is unclear (text box 2).

A comparison of Brexit-related GDP-losses of both scenarios shows the WTO scenario to generate the highest numbers for all parties involved. This is due to the fact that, in this scenario, the costs of the Brexit come to 3% and the non-tariff trade barriers to 13%.

For Europe (excluding the UK), the Brexit-related GDP losses in both scenarios are relatively lower than for the Netherlands, because other than the Dutch economy, the European economy is relatively less linked through trade with that of the UK (see Figure 3 for the distribution of costs across European countries).

⁵ See Rojas-Romagosa (2016) en Egger et al. (2015)

⁶ These last 6% are based on ‘iceberg costs’ which model all trade restrictions. They are comparable to those in the OECD and HTM studies.

⁷ This mechanism concerns all bilateral trade flows, not only those related to the UK.

Text box 2 Does trade lead to an increase in innovation and productivity?

In addition to the direct impact of trade on the economy, there are also indirect, dynamic effects. Under this theory, an important effect is that of trade leading to more innovation and therefore higher productivity levels. The reason for this is that increased competition induces innovation and increases the significance of more innovative companies. The prospect of higher financial yields on main international markets may stimulate the accumulation of capital and innovation. Furthermore, trade may also indirectly lead to innovation through knowledge transfers and learning effects.

Quantifying these dynamic effects has proven difficult, for two reasons. In the first place, it is difficult to capture the link between trade, knowledge transfer and innovation as one specific mechanism; the relationship is much more complex. Therefore, it is not easy to include in trade models. In the second place, empirical studies quantifying the effect are proven to be faced with a number of econometric problems. See Rodriguez and Rodrik (2001) for a critical overview.

Over the last years, however, new studies have emerged with new methods and results. Feyrer (2011) analysed changes in transport technology and the closure of the Suez Canal. He concluded that trade elasticity on income can be 0.5, while estimating that productivity increases in goods will be between 0.15 and 0.25. Melitz and Trefler (2012) found that trade-induced productivity increases in companies occur as trade increases the return on innovation. Implicitly, they found a trade–productivity elasticity of 0.6 for the production sector (see Rojas-Romagosa, 2016).

Recent literature explained part of the complex relationship between trade and productivity, but as yet there have been only few studies on the subject, and the estimated elasticities cannot automatically be applied to all goods or sectors. Therefore, we conclude there are compelling examples indicating that more trade will lead to more innovation and therefore will increase productivity, but the degree of generalisation for trade–productivity elasticity must be considered with some reservation. The exact value of this elasticity certainly is not robust and would justify further investigation. For the sensitivity analysis, we therefore used a conservative estimation of 0.1, which also brings our GDP losses of the UK in line with estimates by the OECD (Kierzenkowski et al., 2016) and HM Treasury (2016).

Source: Annex A.3 in Rojas-Romagosa (2016).

However, the Netherlands will experience relatively higher Brexit-induced GDP losses. In the WTO scenario, these are calculated for 2030 at 1.2% of GDP (Figure 1, upper right). This equals 10 billion euros or 575 euros per person (Figure 1, upper left).⁸ When we also account for the potential impact of trade-induced innovation, the costs for the Netherlands, in the WTO scenario, will increase to 2% of GDP or around 1000 euros per person.

In the FTA scenario, the costs for the Netherlands are lower and drop to a GDP loss of 0.9% (Figure 1, on the lower left), which equals 8 billion euros or 450 euros per person (Figure 1, on the lower right). Taking innovation through trade into account decreases these costs from a 2% GDP loss to 1.5%.

⁸ The percentage of GDP loss for the Netherlands in 2030 and 2040 is of the same order of magnitude.

Table 1 GDP losses, according to CPB, compared with those in four other Brexit studies (in %) for the UK in 2030, under two scenarios

	OECD	PWC		LSE		HTM		CPB	
	WTO/FTA	FTA	WTO	FTA	WTO	FTA	WTO	FTA	WTO
Central estimate	5.1	1.2	3.5	1.0	2.3	6.2	7.5	3.4	4.1
Range	2.7–7.7			1.0–9.5		4.6–7.8	5.4–9.5	2.0–5.9	2.7–8.7

Sources: Kierzenkowski, 2016, PWC, 2016, Dhingra et al., 2016, HTM, 2016.

However, for the UK, a Brexit will lead to far higher costs – in particular for the more uncertain share of those costs due to trade-induced innovation losses. The UK is far more dependent on the trade with the EU than vice versa. The UK losses in 2030, under the WTO scenario, would be around 4% of GDP. And, if we assume that innovation would lag behind due to reduced trade levels, these losses may even increase to nearly 9% of GDP. In that case, the UK losses would be similar to those experienced during the 2008–2009 crisis.

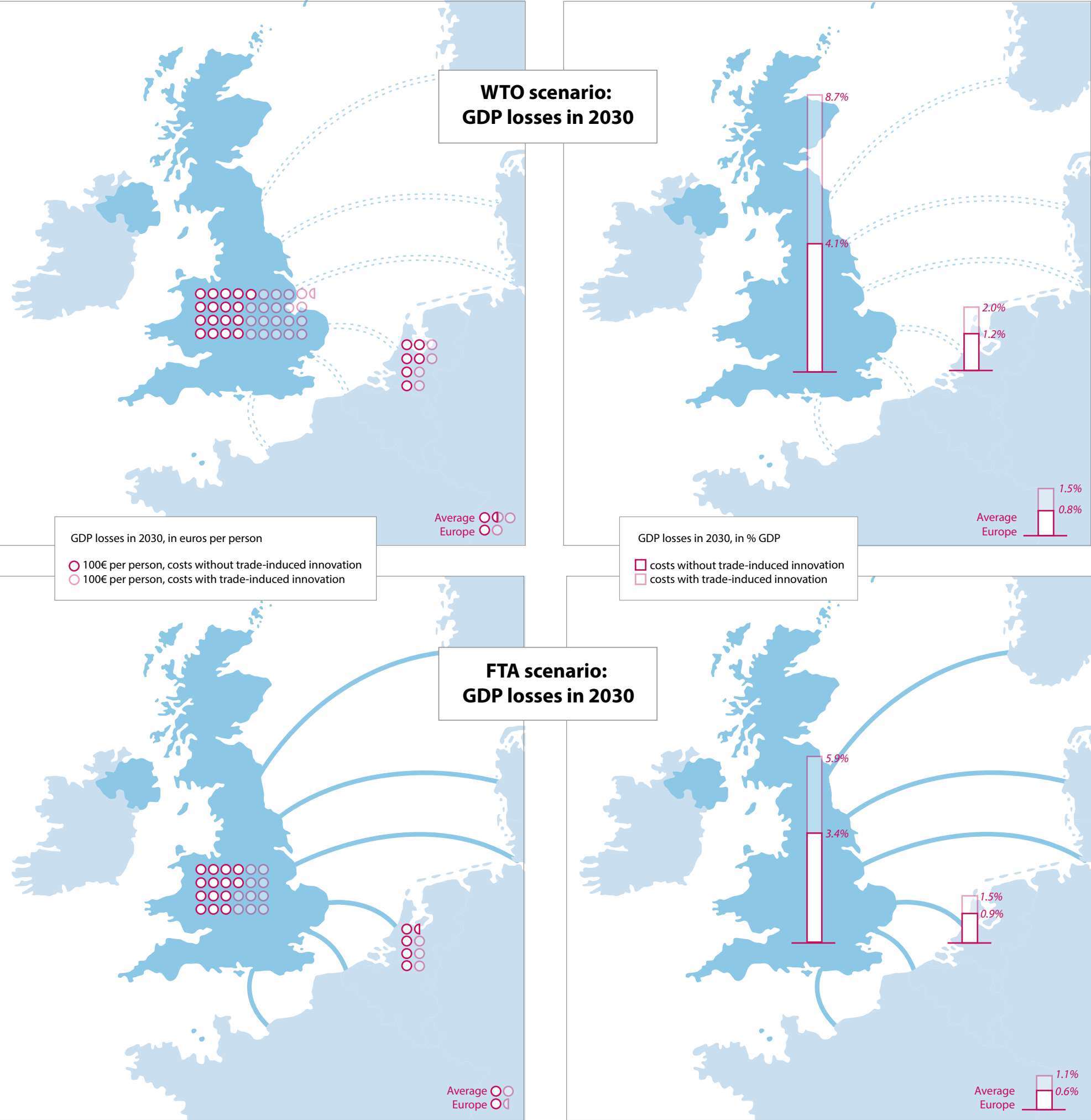
A comparison between the various studies on the economic consequences of a Brexit for the UK itself shows that CPB estimations are of the same order of magnitude as those by the HTM and the OECD and slightly higher than those by PWC and LSE (Table 1).⁹ The PWC estimation of costs under the FTA scenario is slightly lower because PWC does not include any additional losses from less innovation due to less trade.

The difference between the estimations under the WTO scenario (higher tariff barriers) and the FTA scenario (lower tariff barriers) is slightly smaller in the CPB study than in the other studies. This may be explained by the fact that only the CPB study looked at the effects of trade tariff changes on the shift of inputs, such as labour and capital, caused by sector-specific production changes.¹⁰

⁹ The estimated GDP losses by CPB in the WTO scenario and the FTA-scenario shift from the central estimate to the top of the range if the scenarios also account for trade induced innovation. However, the GDP losses shift from the central estimate to the lower end of the range in both scenarios if the trade costs are uniform for all types of goods and another uniformly fixed level of trade costs for all types of services as used in the HTM study, instead of the sector-specific trade costs of Egger et al. (2015). For more details, see Rojas-Romagosa (2016).

¹⁰ This also accounts for shifts in production between sectors (including employment)).

Figure 1. Consequences of a Brexit are relatively large for the Netherlands, particularly under the WTO scenario

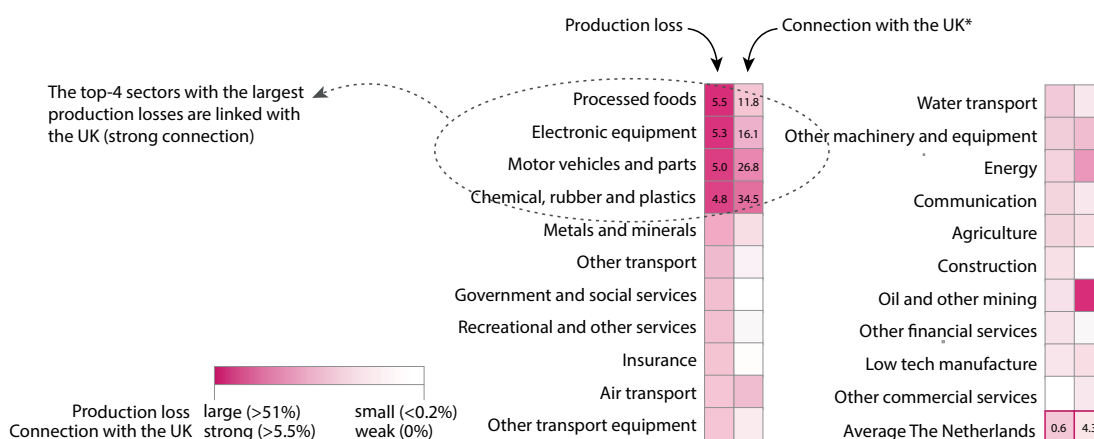


4 Unequal cost distribution across sectors

The macro numbers conceal large losses in certain Dutch sectors (Figure 2), particularly in those most integrated with the UK. Production losses will be around 5% in sectors with a connection with the UK of more than 10%; i.e. ‘chemicals, plastics and rubber’, ‘electronic equipment’, ‘motor vehicles and parts’, and the ‘food processing industry’. Together, these sectors earn 12% of GDP. The ‘metals and minerals’ sector is weakly connected to the UK, but nevertheless would suffer a production loss of 1.6%.¹¹

The services sector (including the public sector) is less interwoven with the UK – with a connection with the UK below 5% – and therefore would experience a relatively lower production loss.¹² The low-tech industry and agriculture seem less sensitive to a Brexit. Calculations show only limited production losses or even a slight increase in production (in the low-tech industry and the sector ‘other financial services’).

Figure 2. Production losses (in %) in 2030 in the Netherlands, versus connection to the UK (in %), under the WTO scenario without innovation due to trade



Note: connection = (sectoral import into, export from and export to the UK) / 2 * (GDP in that sector)¹³.

A Brexit would cause wages to go down as well as a structural decrease in employment of 0.5% (around 40,000 currently employed people).¹⁴ In certain sectors, however, employment would increase, while in others it would decrease. For example, the top 5 production-losing sectors mentioned earlier will also provide less employment: 20,000 jobs (around 3% of the employment in these sectors). However, in a number of other sectors, employment would increase, such as an additional 15,000 jobs in the low-tech industry and in the sector ‘other financial services’.

¹¹ On average, the production losses can be reduced with 40% if the EU can enter into a free trade agreement with the UK.

¹² In an absolute sense, this would result in the largest loss, as this sector contributes over 40% to Dutch GDP. This sector depends on declining tax revenues or is supplier of services to most of the other production-losing sectors.

¹³ It is divided by twice the GDP, because both import and export are included in the numerator. Although this is a specific choice, the interpretation of connection is that a sector is considered more connected to the UK if there is more trade related to this sector between that country and the UK.

¹⁴ This is based on structural, long-term mutations of employment on sectoral level. Not included are changes in employment within these sectors. Changes shown here, therefore, are a fraction of the annual job changes per sector.

5 After Brexit: Policy Perspective on Trade Agreements

When looking at the effects of a Brexit on Europe, the following picture emerges. Countries that will experience the highest GDP losses are Ireland, the Netherlands, Belgium and Luxembourg. There is a relatively large amount of trade between these countries and the UK, and they will be hit the hardest by the trade restrictions that would follow a Brexit (Figure 3). Therefore, these countries would benefit the most from a new FTA, as described in Chapter 2.

The Brexit-related GDP losses are relatively low for countries in Eastern and Southern Europe (Figure 3), as they are less linked through trade with the UK. Therefore, compared with the Netherlands, Ireland or Belgium, these countries would benefit the least from a new free trade agreement. It is conceivable that countries with a large economic interest in such a new agreement with the UK will not be able to muster the support of all EU Member States.

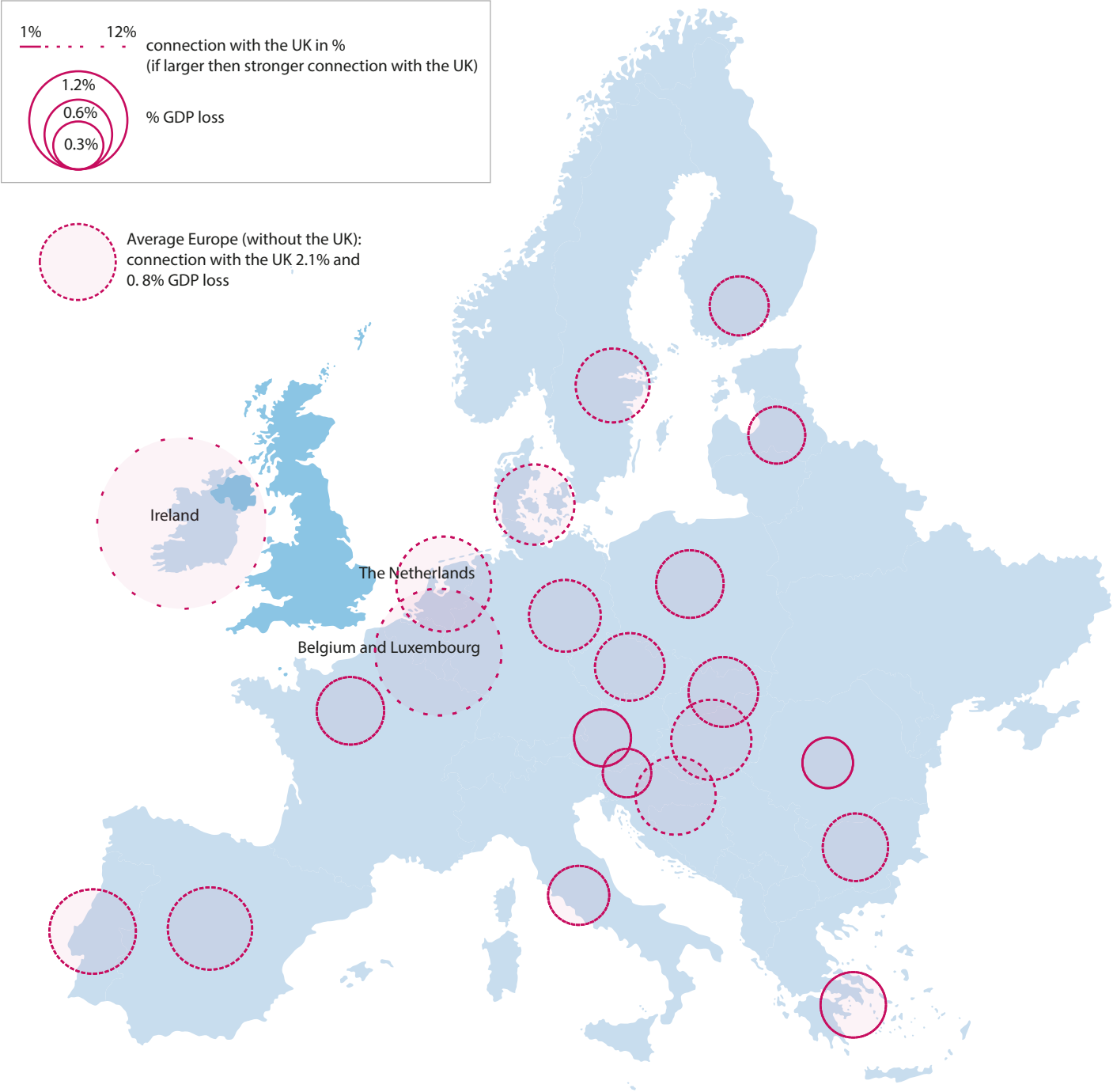
Should there be a Brexit, this would set a risky precedent for the whole EU project. Other countries could decide to follow the UK in reconsidering their EU membership. The likelihood of such a scenario is unclear. On the one hand, there is the Eurobarometer, a biennial survey conducted by the European Commission to gauge the opinions of EU citizens, which shows that a majority of citizens still has a positive image of the EU and is optimistic about its future¹⁵. On the other hand, the call for a referendum similar to the UK referendum is becoming increasingly stronger in various Eurosceptical countries in Scandinavia as well as in Central and Eastern Europe¹⁶.

A new free trade agreement would pose a dilemma for the EU. On the one hand, the EU wants to avoid the Brexit setting a precedent, and therefore the EU could be willing to increase the costs of the withdrawal by as much as possible. But this would then also lead to higher costs for the EU itself. A new trade agreement would reduce those costs again – but this would also benefit the withdrawing country.

¹⁵ EC (2015), Public Opinion in the European Union, Standard Eurobarometer 83, see [link](#).

¹⁶ For example, see the Financial Times ([link](#))

Figure 3. The WTO scenario: GDP loss versus connection with the UK in Europe in 2030



*Connection with the UK = (import from and export to the UK) / (2*GDP)

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