Is Brexit or Covid uncertainty the biggest threat to the UK recovery?

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Vaccine on the horizon or not, it is difficult for business to see at present much beyond the Covid with cases still rising and restrictions tightening in much of the developed world, including the UK. The uncertainties around the timing and availability of any vaccine and the timing of any future packages of government support are also unsettling the markers which have in the past week been oscillating between euphoria and renewed sell-offs.

At the same time , as the occupants of the most senior advisory roles to the Prime Minister, Dominic Cummings and Lee Cain departed No 10 in such a public way last week, the future of the Brexit talks, resuming again in the week of November 16, have come into sharp focus. Has the chance of a deal, however thin, increased? Could there be some further delay in implementation to give firms -and the government- some breathing space and more time to prepare?

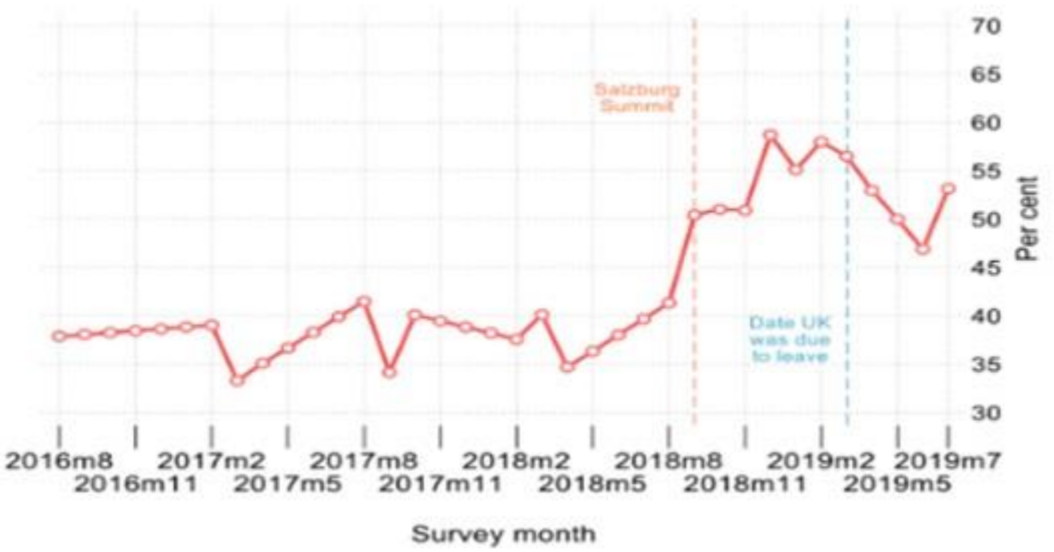
It may be time to reflect about which of the market disruptors has had the most significant impact? In the short term, it is undoubtedly Covid. The near 20% fall in UK GDP in the second quarter was the sharpest on record. The EU and the US have also seen record declines. But they have all been followed by sharp bounce- backs which have also set records such as the UK’s 15.5% rise in Q3. Yes it is true that the monthly improvement has been slowing down recently and we may go into a fall again in November and December. But the forecasts, including from the Bank of England, are for increases again in each of the four quarters of 2021. And if the vaccine news if confirmed, allow for the chance of returning to pre-Covid levels earlier than thought- maybe even by mid next year.

Brexit is different- and Brexit uncertainty has had a longer lasting impact already. The Bank of England, the Centre for European Reform and the NIESR all calculated that by late 2019 the UK economy had lost some 2% to 3% of the growth that it would have had if the vote in June 2016 had been to remain in the EU. And the Brexit impact was weighing on the UK economy -when the Bank of England published its latest forecasts for the UK economy just before Brexit in January this year, it expected GDP to rise by just 0.8% in 2020 followed by no more than 1.5% growth per annum until the end of the current Parliament.

Much of this has been reflecting business insecurity. The economic case for eliminating uncertainty centres precisely around the detrimental impact of uncertainty as firms find it worthwhile postponing investments while waiting for the uncertainty to lift.[i] A study by Nick Bloom and others last year showed that in the three years since the referendum the vote leave decision resulted in investment being some 11% lower than it would otherwise have been and productivity some 2-5% lower [ii]

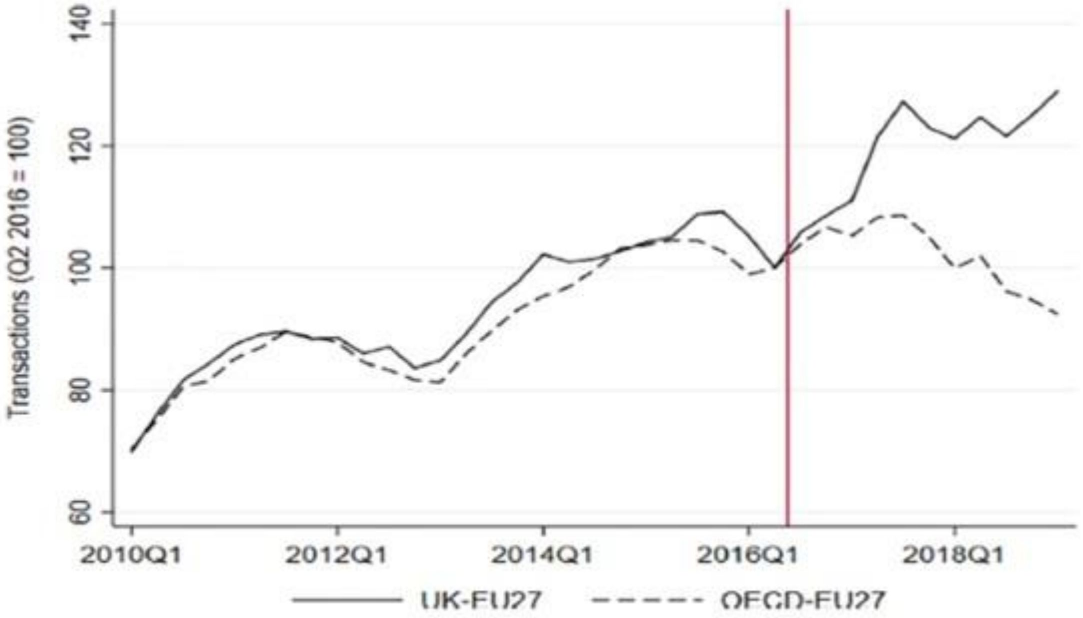
According to the Bank of England, 'the Brexit shock is more long lasting… because there are so many unknowns that are difficult for businesses to quantify'[iii]. This is shown in the chart below of the *Brexit Uncertainty Index*. This is based on data from the Bank of England's *Decision Making Panel*, working with Nick Bloom et al, which tracks the percentage of British companies quoting Brexit as one of their top three sources of uncertainty[iv]. It is clear that the impact of Brexit on uncertainty has been substantial.

Brexit Uncertainty Index (% with Brexit in top 3 sources of uncertainty)- *Source: N Bloom et al , BoE, 2019*



Worryingly EY’s annual UK Attractiveness survey has also shown that in addition to lack of domestic investment, there were increases in investment outflows from the UK to the EU in the two years 2017 and 2018[i]. And an analysis in 2019[ii], demonstrated that concern over Brexit resulted in a 17% increase in outward FDI from the UK to the EU 27 between the referendum vote and early 2019 at a time when FDI from non-EU OECD and non-UK into the EU was actually declining. Over the same period the number of FDI transactions to the UK from the rest of the EU, in other words inward FDI fell by 9%. The authors of the paper consider most, or all, of this to be an attempt to ensure continued EU presence after Brexit displacement with the opening of EU subsidiaries by UK firms. They calculate that the lost investment to the UK over that period could be up to £21.1b. The exodus was more pronounced in the services sector with much of that resulting in increased production in the EU rather than just a name plate activity to ensure continued presence in the Continent post Brexit.

Number of Greenfield and M&A Transactions per quarter since 2010 and change since 2016 Brexit referendum- Source: European Economic Review, 124(2020)



Moreover As Dr Thomas Sampson from the LSE has argued in a recent blog, the negative long term impact of Brexit, if wrongly handled, can easily be twice if not three times larger for the UK economy than Covid 19[i]. So there seems to be considerable agreement that Brexit is a longer term issue and COVID-19 more short term (though still with some long term implications).

Fingers crossed then that the changes at No 10 will indeed herald a new willingness to look again at the evidence and support a deal that better serves the longer-term interests of the UK economy and its businesses.

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[1] Dixit and Pindyck, 1994.

[2] https://blogs.lse.ac.uk/brexit/2019/09/11/the-impact-of-brexit-on-uk-firms-reduced-investments-and-decreased-productivity/

[3] https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2019/brexit-and-uncertainty-insights-from-the-decision-maker-panel.pdf

[4] https://www.bankofengland.co.uk/statistics/research-datasets

[5] EY, 2019. Tipping point. EY attractiveness survey UK.

[6] Voting with their money: Brexit and outward investment by UK firms

[7] Holger Breinlich , Elsa Leromain , Dennis Novy , Thomas Sampson, European Economic Review 124 (2020) 103400

[8] https://blogs.lse.ac.uk/brexit/2020/08/26/a-no-deal-brexit-may-still-be-more-costly-than-covid-19/