Brexit and Investment: Assessment and Prospects

By Professor David Bailey, Professor of Business Economics at Birmingham Business School at University of Birmingham, Visiting Professor at Centre for Brexit Studies and Senior Fellow at UK in a Changing Europe.

Business investment held up reasonably well in the immediate aftermath of the 2016 Referendum (although it was weaker than in other countries and when compared with previous economic expansions in the UK); indeed, there was little evidence of any immediate 'Brexit effect'.

This, though, changed markedly in 2018, with ONS figures showing business investment falling in every quarter of the year. This was the worst performance since the Global Financial Crisis and – outside of recessions – the longest decline on record, prompting Ben Broadbent (Deputy Governor of the Bank of England) to note that this "is remarkable at a time when the economy has been growing."

While preliminary estimates suggest business investment picked up in the first quarter of 2019, business surveys suggest the underlying trend is still negative.[1] Interestingly, firms have been reducing investment while creating jobs, with employment growing quite strongly during 2018.

But as investment today helps to boost productivity in the future, there is concern that declining investment could dent future productivity and growth prospects.

While the UK still does well in terms of attracting foreign direct investment (FDI), evidence from the UK Trade Policy Observatory[2] suggests that since the referendum, inflows of FDI to the UK have seen the longest continuous decline since the beginning of its data series in 2003.

Its analysis suggests that the Brexit vote may have reduced the number of foreign investment projects to the UK by 16-20 per cent. For services FDI, the fall is even greater: investment may be some 25 per cent lower than if the UK had voted to remain in the EU. There has been a decline in investment in high-value-added sectors such as ‘software publishing’, ‘investment management’ and ‘retail banking’, which puts high-skilled jobs at risk.

The most recent evidence suggests a six-year low in FDI projects into the UK.[3]

This fall in FDI is critical as the UK economy relies more on FDI than any other G7 country, with FDI bringing employment opportunities, often in areas of high unemployment, such as the North East. Firms with inward FDI are also more productive than non-FDI firms and this is not limited to those sectors thought of as being ‘high tech’ sectors, but includes large employers in other sectors.[4]

However, approximately half of this productivity difference is accounted for by the fact that MNEs are more prevalent in higher value added sectors. FDI into the UK has driven demand for skilled jobs such as technicians, engineers and IT specialists. UK businesses that were foreign-owned and received investment from overseas employed four million people in 2016 – some 17% of all UK employees. Half of those were employed by EU-owned firms.[5]

Investment has declined even more markedly in certain industries such as automotive (down by 80% since 2016) as assemblers and suppliers postpone investment decisions, awaiting clarification on the form of Brexit and the UK’s future trading relationship with the EU.

With major model replacement decisions looming, this raises the risk of automotive assembly shifting elsewhere if uncertainty continues – and Peugeot has stressed that while it is minded to invest in new Astra model production at Ellesmere Port, it has stated bluntly that No Deal means no investment.[6]

There also seems to be emerging evidence from manufacturing surveys that overseas customers are switching their supply chains away from the UK, in turn impacting on investment intentions.[7]

The long-run effects of Brexit in this regard will largely depend upon the nature of the future UK-EU trading relationship. But what we can say is that 3 years on from the referendum, the short-run impact of

Brexit is negative. Overall, Brexit uncertainty is making the UK a less attractive place for business to invest.

Prospects

As noted, the biggest single deterrent to foreign investment is uncertainty.[8] The more uncertainty that firms attach to their 'net present value calculations', the less likely they are to invest. As Driffield and Karoglou (2018) note, if one looks at past events in terms of magnitude, Brexit may have a short term negative shock on inward investment. Their analysis suggests that it would then take about 4 years for the UK to get back to a new lower long-term trend of inward investment.[9]

Even if Parliament does support a version of the Withdrawal Agreement, the transition period offers only short term clarification on trading on existing terms; longer term, a new trading arrangement needs to be agreed, again raising issues of uncertainty for sectors heavily dependent on FDI like automotive.

Ben Broadbent of the Bank of England has noted that business investment suffers more than it needs to if firms repeatedly expect things to be resolved sooner than they actually are. A repeated series of cliff-edges, each of which firms expect to be decisive but then just gives way to the next cliff, is more damaging for business investment than if it had been clear at the outset that the process will take time.[10]

Note that this doesn't mean that ending uncertainty by going for a No Deal is a sensible option. Business investment plans that have been put on hold given Brexit uncertainty would probably be scrapped altogether should the UK leave without a deal, paving the way for weaker economic growth in the future.

Looking back, it is worth noting that the single event that has had the greatest positive impact on inward investment in the UK in recent history was the creation of the EU Single Market.[11] This was because it became easier for firms to conduct business within their organization across national borders. For example, automotive and engine assemblers like GM, BMW and Ford all import sizeable inflows of components to the UK from their other EU operations and from the broader value chain.

The key point here is that trade is no longer bilateral between countries; rather trade is characterized by fine grained cross-border value chains where the end product incorporates inputs from multiple origins. These value chains need to be ‘frictionless’ in terms of non-tariff barriers (think of regulations and standards) as well as tariffs. Anything which puts these value chain relationships at risk, whether currency risk or higher transactions costs from having to deal with EU and UK regulations separately, reduces the likelihood of further investment.

Three years on from the Referendum, there remains considerable uncertainty over the nature of the UK’s trading relationship with the EU. That uncertainty will continue to act as a drag on investment in the UK. Longer term, how attractive the UK will be depends on the form of the trading relationship that the UK has with the EU.

Professor David Bailey recently contributed to a recent Brexit Scorecard assessing the Impact of Brexit which can be found here.

[1] https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/investment-and-uncertainty-the-value-of-waiting-for-news-speech-by-ben-broadbent.pdf?la=en&hash=99EEF9737299C0917D481C9B526A4F24D4804679

[2] http://blogs.sussex.ac.uk/uktpo/publications/not-backing-britain-fdi-inflows-since-the-brexit-referendum/

[3] https://www.ft.com/content/6416a20a-9805-11e9-8cfb-30c211dcd229

[4] Bailey, David, Nigel Driffield and Erika Kispeter (2019) Brexit, foreign investment and employment: some implications for industrial policy?, Contemporary Social Science, 14(2) 174-188: https://doi.org/10.1080/21582041.2019.1566563

[5] https://theconversation.com/a-no-deal-brexit-could-put-nearly-20-of-british-jobs-at-risk-and-disproportionately-hurt-weaker-regions-112908

[6] https://ukandeu.ac.uk/uk-car-manufacturing-slumps-amidst-brexit-uncertainty/

[7] https://www.accountancydaily.co/brexit-delays-hit-uk-manufacturing-investment

[8] Bailey, D, Driffield, N and Karoglou, M (2017) Inward investment will fall in the UK, post Brexit, *Columbia FDI Perspectives,* Number 204. Available at: https://academiccommons.columbia.edu/catalog/ac:31zcrjdfnq

[9] Driffield, Nigel L. and Karoglou, Michail (2018) Brexit and foreign investment in the UK. Journal of the Royal Statistical Society: Series A (Statistics in Society). doi:10.1111/rssa.12417

[10] https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/investment-and-uncertainty-the-value-of-waiting-for-news-speech-by-ben-broadbent.pdf?la=en&hash=99EEF9737299C0917D481C9B526A4F24D4804679

[11] Driffield, Nigel L. and Karoglou, Michail (2018) Brexit and foreign investment in the UK. Journal of the Royal Statistical Society: Series A (Statistics in Society). doi:10.1111/rssa.12417