Brexit will exacerbate long-term challenges facing the UK economy

Leaving the EU represents the largest change in the UK's relationship with the rest of the world in half a century. The impact won't be a one-off event. Structural changes will take place over the long term, as capital and labour adjust to the new trading arrangements. Household incomes will decrease as a result of a weaker pound and lower investment and trade. But we should not expect changes to the UK's overall services focus and export specialisation. ***Swati Dhingra, Emily Fry, Sophie Hale, and Ningyuan Jia*** *write that understanding the scale and nature of this change, and the extent of progress so far, is crucial for policymakers looking to reset the country's economic strategy.*

#LSEUKEconomy

Immediately after the referendum, sterling depreciated. This brought forward the impact on household incomes of what would otherwise be a slow burn change for the UK economy. A year after the referendum, sterling settled at more than 12 per cent below its previous level, and the higher price of imports led to higher inflation, with the resulting increase in the cost of living, equivalent to £870 per year.

Meanwhile, firms faced increased uncertainty about the terms on which they might be able to access the world's largest integrated marketplace, providing a major headwind to investment. UK business investment fell by 0.1 per cent a quarter on average in the three years post-referendum, compared to growth of 1.7 per cent a quarter on average growth in the previous three years, and ongoing growth in other G7 countries. Firms expect this decline in investment to taper off now that Brexit-related uncertainty has fallen, but the UK's relative investment position remains weak as we emerge from the pandemic.

The driver of investment underperformance has not been the widely expected fall in foreign direct investment (FDI), an important driver of productivity and innovation. UK FDI inflows as a percentage of EU-27 inflows has remained above pre-Brexit levels since the referendum and, despite a decline in the UK's share of global FDI, it remains in line with that in Germany and higher than France.

These impacts materialised before any new trade (or migration) barriers were introduced. Indeed, the Office for Budget Responsibility (OBR) estimates that two fifths of the overall expected impact on productivity materialised before the new trading arrangement with the EU, in the form of the Trade and Cooperation Agreement (TCA), was implemented in January 2021.

The expected relative decline in UK exports to the EU compared with the rest of the world has not materialised

Firms' forward-looking investment decisions responded quickly to the referendum result, but trade flows themselves have proved more resilient than expected, showing little evidence of responding to Brexit before the TCA was implemented. Some argued that sterling's depreciation would make UK exports to the EU more competitive, while others believed that the uncertainty following the referendum would depress trade flows. However, the share of UK exports to and imports from the EU changed little in the period immediately following the referendum. But significant change has taken place since the implementation of the TCA.

However, this major change to trading arrangements occurred during the COVID-19 pandemic, meaning that care is needed to disentangle the impact of these two shocks. COVID-19 affected global trade flows through supply chains and global travel disruptions, causing inflated freight costs and transport delays. In 2020, world trade fell by 8.9 per cent, the steepest fall since the financial crisis, and only the fifth time world trade has fallen on an annual basis since World War Two. Global services trade was disproportionately impacted, falling by more than 20 per cent. That was the context when the TCA entered into force a year into the pandemic. For this reason, our focus is on the relative performance of UK trade with the EU relative to that with the rest of the world, or on the UK's trade performance relative to similar economies during this exceptional period, rather than changes in the level of UK trade with the EU.

On the face of it, UK trade data do not show the response to Brexit that we would have expected. There was a near consensus that leaving the EU would disproportionately hit UK-EU trade, causing an enduring decline in the share of imports from and exports to the EU. The UK has now been trading under the terms of the TCA for 18 months and, although UK imports from the EU have fallen relative to the rest of the world, there is no clear evidence of this occurring for UK exports to the EU. Between December 2020 and January 2021 (when the TCA was implemented), the share of UK goods exports to and imports from the EU fell by 15.7 and 8.1 percentage points, respectively. Although the share of UK goods imports from the EU has remained below its pre-Brexit level, the share of goods exports to the EU recovered in the following month and has remained at the same level since. Services trade shows similar patterns to goods trade: the share of UK services exports to and imports from the EU declined by 0.4 and 2.6 percentage points respectively between 2020 and 2021, but this is in line with the longer-term decline in the share for exports, meaning that, here again, the expected relative decline in EU exports is not clearly observable in the UK data.

On the other hand, although not observable in the UK data, our trading partners' data does suggest that UK goods exports to the EU have fallen by more than those to the rest of the world. EU trade data shows that the UK's share of total EU goods imports fell by more than a quarter between 2020 and 2021, more than double the fall of some large non-EU partners, such as the US. However, EU and UK trade data diverged in 2021 due to measurement changes on both sides; as a result, UK exports to the EU are recorded as 10 per cent higher in the UK's data than EU-recorded imports from the UK. If the share of EU imports coming from the UK is estimated using the UK exports data, this fall would be just 13 per cent, which aligns much closer to the falls seen across non-EU partners.

Although some see the lack of a post-TCA fall in exports with the EU as good news, the UK has experienced a more broad-based loss in competitiveness

The lack of clear evidence of the expected relative decline in UK exports to the EU seems like good news. However, developments should instead lead us to take seriously the signs that Brexit is impacting UK trade openness and competitiveness more broadly. In particular, the fall in UK trade openness since the introduction of the TCA, measured as trade as a share of GDP, has been larger than that experienced by our peers. Between 2019 and 2021, UK trade openness fell by 8 percentage points, significantly more than in countries with similar trade profiles, such as France, which experienced a 2 percentage-point decline.

Furthermore, the UK is the only large European country to experience a decline in openness since 2020, with openness falling 1 percentage point; France, for example, saw openness rise by 4 percentage points. These relative declines in UK openness are driven by goods trade: UK goods exports as a share of GDP fell between 2020 and 2021, despite rising for all EU countries except Ireland. Research using the so-called 'synthetic control' method to estimate a counterfactual for UK trade flows corroborates these findings, indicating that goods exports were 15.7 per cent lower in December 2021 than they would have been in the absence of Brexit. UK openness also fell across services trade between 2020 and 2021, but, whereas the UK was almost unique in experiencing a decline in goods exports as a share of GDP, the Netherlands, Belgium, and Canada saw similar declines in services trade (around 1.0 percentage point of GDP). This is unsurprising, given the lasting impact of the pandemic on international travel, which is key for trade in services.

Data on trade in international goods points to a broader loss in UK competitiveness across several of its most important markets. The UK lost market share in 2021 across three of its largest non-EU goods import markets: the US, Canada, and Japan. Some have attributed this weak performance to unfavourable changes in the composition of global demand. But, although the fall in global demand for transport manufacturing imports has contributed to the fall in the UK share, our analysis shows that the change in the nature of global demand has contributed less than the decline in the UK's competitiveness: changes to sectoral demand explain £6.7 billion of lost annual exports to these markets, but the remaining £11.7 billion comes from the decline in the UK's share across products. Evidence of disruption to UK supply chains is also clear – imports have fallen, and the prices of imports have increased – and this could explain our weak export performance across trading partners, and the limited extent to which UK firms were able to exploit opportunities of the global trade recovery in 2021. It is unclear exactly how persistent these changes in non-EU trade will prove, but these are worrying signs that Brexit may have had a broader impact on the UK's openness and competitiveness than expected.

UK firms orientated to exporting to the EU have implemented coping mechanisms, but longer-term adjustments may see UK-EU trade experience the expected relative decline

Trade relationships are long-term and sticky, suggesting that changes to trade will take time: more than 60 per cent of UK exports are via trade relationships that have existed since the 1960s. There are signs that UK firms are using 'coping strategies' to help ease the short-term adjustment to the new trading relationship with the EU. For example, the number of UK export relationships (measured as the number of country-product export 'varieties') to the EU has fallen by 30 per cent relative to the rest of world following the implementation of the TCA. Some have attributed this to a squeeze on small and medium-sized companies' ability to export, but our new analysis suggests that, given the increased regulatory burdens, UK firms may also be choosing to ship directly to a single EU destination and use EU-based distributers, rather than exporting directly to smaller markets. Consistent with this, exporters are increasingly sending trade to countries linked to the largest UK ports (specifically: France, the Netherlands and Belgium, whose share of EU imports from the UK increased by 7.5 percentage points between 2020 and 2021). Some sectors are particularly affected, such as agriculture and forestry. Here, the number of export relationships from the UK to the EU almost halved relative to non-EU relationships, and the share of trade directed to these three port countries increased by 6 percentage points.

Overall, although we haven't seen the sort of large relative decline in UK-EU exports that was expected, Brexit already is weighing on both UK openness and competitiveness. But it will take many years for the economy to fully adjust, as firms gradually wind down capital invested in EU exports, the labour market adjusts, and changes to the rate of exit and entry of firms across sectors affects the structure of our economy. Modelling the expected long-run impacts of trading with the EU under the TCA can provide evidence on the scale and distributional impacts of these longer-run structural changes.

But Brexit will not transform the nature of the economy

Despite these significant impact on some sectors, the new trading relationship with the EU will not drive a large or swift labour market adjustment when we consider the UK economy as a whole. Our modelling suggests less than 0.5 per cent of the workforce, equivalent to an extra 132,000 people, will move from their current region-sector as a result of Brexit. This reflects that the UK's comparative advantage and the structure of the economy will not be fundamentally transformed by Brexit in the way that some hoped, and others feared. Tradeable professional services, including finance and business services, are set to lose out the most, but our analysis suggests its share of gross output will shrink by just 0.3 percentage points, to 20.2 per cent. Some hoped that Brexit would lead to a revival of manufacturing: the modelling suggests that this will not happen, and that it will decline as share of the economy, but this decline is marginal, at just 0.1 percentage point. This will leave the broad industrial structure of the UK unchanged: the UK will remain a highly services-dominated economy with a smaller manufacturing sector than France. It is more useful to think of Brexit as driving a fall in openness, rather than a big picture sectoral restructuring.

The main impact will be a real wage and productivity hit, exacerbating the long-standing challenges faced by the UK

Brexit is not, therefore, expected to transform the nature of the UK economy, with only minor impacts on its industrial structure, export specialisation and pattern of regional inequalities. Instead, the impact of Brexit is better thought of as a broad-based reduction in workers' pay and productivity.

A less-open UK will mean a poorer and less productive one by the end of the decade, with real wages expected to fall by 1.8 per cent, a loss of £470 per worker a year, and labour productivity by 1.3 per cent, as a result of the long-run changes to trade under the TCA. This would be equivalent to losing more than a quarter of the last decade's productivity growth. And it should be noted that this analysis assesses only the direct impacts of the new trading arrangement and does not account for wider impacts on investment levels or changes to migration policy.

Our analysis finds that, although there is uncertainty over the Brexit impacts that have occurred to date, not least because of the entangled Covid-19 impacts, we should expect the lasting impact of reduced openness to be substantial, and to lead to widespread productivity and real income shocks, much of which has already taken place. Understanding the impact of Brexit is crucial for policy makers looking to renew the UK's economic strategy.

♣♣♣

Notes:

- *ThisThis blog post summarises The Big Brexit, a report of The Economy 2030 Inquiry. The Economy 2030 Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at LSE. It is funded by the Nuffield Foundation.*

  The post represents the views of its author(s), not the position of LSE Business Review or the London School of Economics.

- *Featured image by Dolapo Ayoade on Unsplash*
- *When you leave a comment, you're agreeing to our Comment Policy.*