The real Brexit 'dividend': a decade of economic underperformance and political crisis

Contrary to some predictions, Britain's economy has not crashed in the two years since the EU referendum. But growth has slowed markedly, productivity is down, and investment is on hold. ***Dimitri Zenghelis*** *looks at the effect the prolonged uncertainty about future trade arrangements is having on the economy.*

In September 2016, a few months after the UK referendum vote to leave the European Union, I argued in this blog that it was too soon to judge the impact on the UK economy. At that time, GDP growth was accelerating and I warned it was too early to talk of a Brexit boost. Almost two years on, the time is ripe to revisit the data and make a more informed assessment of the impact of Brexit on the trajectory of the UK economy.

It is important at the outset to distinguish between the impact of the Brexit vote, and the negotiations that have followed, from the impact of Brexit itself, noting that the latter has yet to happen. On first pass, the much-vaunted post-referendum economic crash turned out to be the dog that never barked. UK GDP growth has held up and the economy has not slipped into recession. More people are in work than ever before. According to the latest figures, the UK employment rate stood at 75.6% in Feb-April, the joint highest since comparable records began in 1971. Tabloid headlines vaunting a 'Brexit boom' seem far-fetched, but the resilience of the UK economy has surprised some, especially compared to many dire forecasts made prior to the referendum.

Yet closer examination of the evidence paints a far less rosy picture. It is of course impossible to know how the economy would have fared in the absence of a vote to leave the EU as we have no observable counterfactual. Yet UK growth has slowed markedly since the referendum in 2016, over a period when the rest of the global economy has boomed. The UK has gone from top of the G7 growth league in 2015 to likely bottom in 2018. All else equal, growth in the UK economy should have accelerated and not slowed over this period. World growth increased in 2017 to 3.8 percent, with a notable rebound in global trade which is expected to endure through 2018. At the same time the Bank of England loosened policy, and the Treasury soft-pedalled on fiscal policy. Yet despite this, something seems to be acting as a powerful drag on UK growth and this is consistent with a negative Brexit effect.

The boost to employment ought to be welcome, and such an occurrence is normally associated with a strong economic recovery and a rise in consumption. But looking behind the numbers it is clear that strong employment growth has coincided with weak output growth, such that output per worker has stagnated. Figures published by the ONS earlier this month showed that productivity fell 0.4 per cent in the first quarter of the year and was only 0.9 per cent higher than a year earlier. A lot of the employment turns out to have been part-time and low wage.

Low productivity growth combined with the post-referendum depreciation of the pound, which correspondingly pushed up import costs, have squeezed British real wages and purchasing power. Indeed, according to the OECD, the UK had the weakest wage growth of any G7 country over the past decade. UK real wages contracted by an average annual rate of 0.3 per cent, the worst performance of all 34 OECD countries, with the exception of Greece and Mexico.

The Financial Times estimates that 0.9 per cent of annual national income has been forgone relative to what was possible if the country had voted to stay in the EU. By fortuitous coincidence this equates to £350m a week, precisely the figure emblazoned on the side of the Brexiters campaign bus, touted as the so-called 'Brexit dividend' available for immediate investment in the NHS.

Making labour more productive requires investment, yet total and business investment fell in the latest quarter of the year, and rose only 1.5 per cent over the same period the previous year, the weakest performance of all the G7 economies. Lower investment reduces GDP growth today, but it also cuts capacity for future economic expansion because generating growth is what investment does. The fall in business investment is likely driven by two Brexit-related causes. The first is greater uncertainty surrounding the political and economic environment post-referendum. The second is the average expectation that, whatever form Brexit takes, it will likely involve some reduction in access to markets, capital and skilled labour, making the UK a less attractive place to invest. Both put off investors.

A recent survey of 600 Eurozone corporations by UBS found that over three-quarters of companies headquartered in EU countries plan to move at least some of their investments out of the UK as a result of Brexit. More than one tenth had stated an intention to leave the UK entirely. According to the Society of Motor Manufacturers and Traders, the industry lobby group, investment in Britain's car industry has halved, reflecting uncertainty about the UK's future relationship with Europe. The Bank of England estimates that UK nominal business investment is already at least 3-4ppts below what it would have been without the Brexit vote.

The bottom line is the UK cannot sustain growth in living standards without productivity growth, and productivity growth depends on investment in machines and people. Which brings us to the second question: what are the prospects post-Brexit? This is much harder to answer, not least because we will still don't know what kind of Brexit (if any) will be finally negotiated. Even if we did, economists are notoriously bad at predicting the long run impact of out-of-sample, non-marginal changes to an economy's underlying structure. Will reduced access to cheap labour force productivity enhancing automation? Will removing business burdens allow the UK to shave costs and retain a competitive edge? Will removing technocratic constraints give the UK policy flexibility to support the economy?

On the face of it, tighter controls on immigration may encourage greater capital investment in automation and efforts to enhance the skills of British workers to offset reduced access to cheap foreign labour. This could boost labour productivity and wages. Indeed, staff at the Bank of England have suggested this process may have already begun. However, this seems at odds with ONS findings that companies that import and export heavily tend to have significantly higher than average productivity, suggesting that open borders induce greater efficiency. Moreover, to the extent that a weaker pound has lowered UK real wages relative to other inputs, such as materials, components and finance capital, firms would be expected to shift to less productive labour-intensive activities.

Loosening labour and environmental regulations may look to some like an easy way to cut costs for business, but it is unlikely to build UK competitiveness in the modern economy. UK and global manufacturers will likely choose to set standards which allow access to the far bigger EU market. Moreover, there is a large and growing body of evidence showing that tighter environmental standards induce innovation, attract capital and draw in skilled workers to meet rising global demand for renewables and energy efficiency.

Yet some immediate effects of Brexit can be quantified with greater confidence. Perhaps the most robustly and rigorously tested model in economics is the gravity model. This tells us that trade between two countries is proportional to size, measured by GDP, and inversely proportional to the geographic distance between them. As Theresa May accurately reported before the referendum vote, this is why "we export more to Ireland than we do to China, almost twice as much to Belgium as we do to India, and nearly three times as much to Sweden as we do to Brazil".

Throwing up obstructions to trade with all our closest neighbours will be predictably costly. Trade means greater competition, which encourages British firms to improve efficiency. It also allows the UK to specialise in sectors where it has a comparative advantage, benefiting from economies of scale in supplying large global markets. The effects of lower immigration on GDP and the public finances are also predictable. Immigrants tend to be younger and more economically active than the average citizen, and therefore make net contributions to GDP and the public finances. The government's own numbers show national income would be 8% lower under a no deal scenario, around 5% lower under a UK-EU free trade agreement and 2% lower under a 'soft Brexit' with single market membership over a 15-year period. Indeed, this is based on the implausible assumption that trading outside the EU customs union and single market is going to be frictionless. Other independent economic studies have shown similar or worse impacts.

Most reasonable Brexiters expect some economic transition cost, but they argue either that this is worthwhile to meet other cultural aims, or that it will be limited and temporary (or both). This may be so, but it remains the case that many Leave voters believed they would be at least no worse off after Brexit, which is why Brexiters put so much effort into downplaying the economic impact.

Looking ahead, the prospects are not encouraging. The 'agreement' at Chequers and subsequent ministerial resignations reflect the fact that the time for appeasing Eurosceptic conservatives with vague language, while postponing detailed outlines of a workable Brexit plan, has run out. The resignations reflected the inevitable acceptance that the UK is heading towards some form of 'Brexit In Name Only', whereby the UK is a de facto EU member, paying into the budget and subscribing to the rules, but without representation or influence. One of the few things Remainers and Leavers see eye-to-eye on is that this is deeply unsatisfactory. This makes it an inherently unstable position. Yet the alternatives of No Deal (or even a 'Canada deal') or remaining in the EU are, respectively, too costly—especially as the UK has made no preparations for it—or politically toxic in the absence of a mandate from a new referendum.

This means the coming years are likely to be defined by a continued and profound uncertainty over Britain's future trade and investment climate, with enduring political tension over the destination. Until the terms of Brexit are known, companies will continue to defer investment. Even once terms are agreed, the resulting reallocation of resources to reflect new comparative advantages, trading partners and production patterns, is likely to prove costly and hold back productivity growth. In short, barring a vote to remain in the European Union, Britain faces the prospect of a lost decade of economic underperformance, subdued wage growth and investment and, increasingly, political crisis.

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Note: This post was originally published on the LSE Brexit blog.

About the Author

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