ECO FLASH

N°23-06

15 June 2023

HAS BREXIT TRULY MADE THE UK LESS ATTRACTIVE ECONOMICALLY?

Stéphane Colliac in collaboration with Louis Morillon (intern)

It is generally assumed that Brexit has made the United Kingdom less attractive economically. However, data on the balance of payments and foreign workers reveal that it's not as simple as that.

Granted, as recently as March 2023, one UK company out of four ranked Brexit as one of its top three concerns. While that number had fallen since 2019, it does show that concerns have not disappeared entirely.

Real business investment (both foreign and domestic) in the UK was 0.4% lower in the fourth quarter of 2022 than in the second quarter 2016. However, this decline was not driven by weaker foreign direct investment (FDI) by non-residents in the UK, as this does not show up in the data.

Brexit has had a more notable impact on workforce flows. There have been fewer European worker arrivals since the second quarter of 2016, which the increase in non-European workers since 2021 has not yet fully offset. We estimate that 76,000 fewer foreign workers were employed in the UK than would have been, had the pre-Brexit trend in this category continued.

These comparisons suggest that Brexit did have a negative impact on the UK economy during the post-referendum period of uncertainty. But this period ended once actual Brexit details had been ironed out. Once a stable post-Brexit framework had been established, the UK got a boost, as direct investments and arrivals of foreign workers from countries outside the European Union (EU) made up the ground lost.

UNITED KINGDOM: NET FLOWS OF FDI BY TYPE

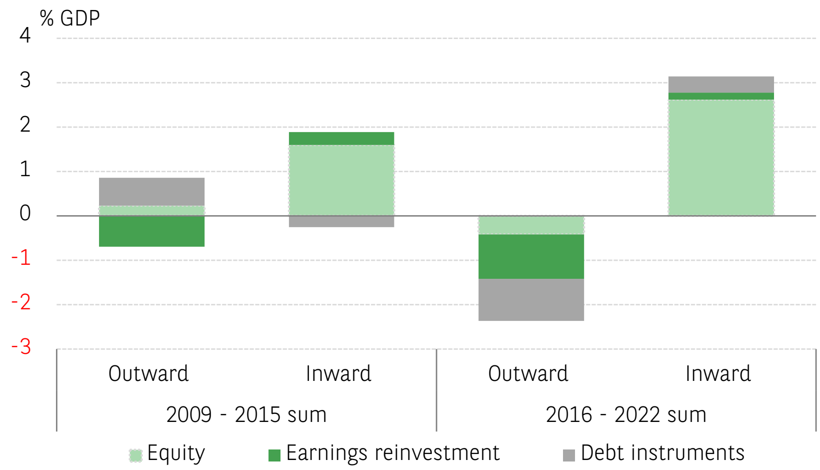

CHART 1

SOURCE: BANK OF ENGLAND, BNP PARIBAS CALCULATIONS

THE UK IS STILL ATTRACTIVE FOR FOREIGN INVESTORS

Back in 2016, one of the main arguments put forth by Brexit opponents was that foreign direct investments (FDI) in the United Kingdom would dry up. Dhingra et *al.*[1] estimated at that time that an exit from the European Union (EU) would lead to a 22% decrease in FDI inflows into the UK in the 10 years after Brexit.

For the moment, balance-of-payments figures have ultimately belied this fear. Adding up FDI flows between 2009 and 2015, on the one hand, and those between 2016 and 2022, on the other, and comparing them to GDP, we find that inflows (i.e., investments in the UK by non-residents) rose from 1.6% of GDP from 2009 to 2015 to 3.1% from 2016 to 2022 *(see Chart 1)* [2]. The same trend is found in FDI capital inflows alone (from 1.6% of GDP between 2009 and 2015 to 2.6% between 2016 and 2022).

In parallel, FDI outflows also rose, from 1.3% of GDP to 2.4%, driven by an increase in intra-group loans by British companies to their foreign subsidiaries. These intra-group loans may have had several causes. One of these would be that British companies have diversified their activities outside the UK, to the Netherlands, France, etc. This could be due directly to Brexit, particularly in the financial sector, as certain activities have been offshored, but without undermining London's status as a financial hub.

1 The impact of Brexit on foreign, Dhingra et al., April 2016.
2 The Brexit vote in 2016 took place against a backdrop of heavy capital flows, but if 2016 is removed from the comparison, there is no meaningful change in the increase in flows between 2009-15 and 2017-22.

The net sum of these shifts in FDI inflows and outflows is a decrease in net flows as a percentage of GDP between two periods under review (*see Chart 2*). However, based on a breakdown in FDI flows, this decrease does not necessarily mean that the UK has become less attractive. Quite the contrary, if we look at FDI capital inflows.

NET FLOWS OF FDI, EUROPEAN COMPARISON

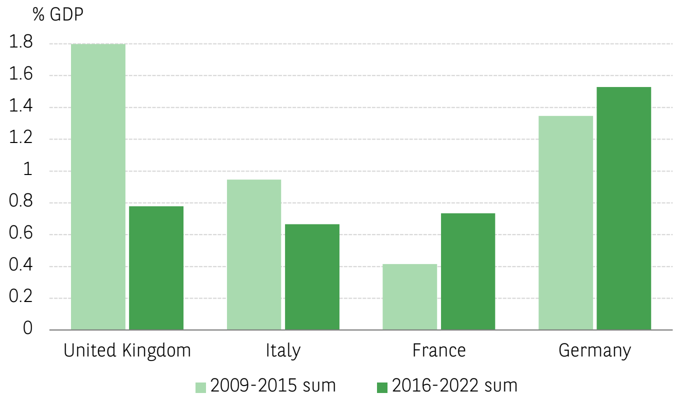

CHART 2 SOURCE: BANK OF ITALY, BDF, BUNDESBANK, BOE, BNP PARIBAS CALCULATIONS

PRODUCTIVE INVESTMENT WAS UNDERMINED BY THE PERIOD OF UNCERTAINTY BETWEEN THE BREXIT VOTE AND ITS IMPLEMENTATION

While the UK economy appears to have remained attractive to non-resident investors, the increase in the number of UK companies' intra-group loans to their foreign subsidiaries may have reduced the resources available to fund investment in the UK. This reduction is at least in part due to the uncertainty that marked the period from the June 2016 referendum to the UK's actual exit from the EU in January 2020.

Since 2016, the Bank of England has produced the Brexit Uncertainty Index (*see Chart 3*)[3]. This index indicates that the June 2016 Brexit vote triggered a surge in uncertainty, peaking in December 2018 during the phase of negotiations, with 58% of respondents then counting Brexit as one of their top three concerns. Uncertainty then pulled back with the January 2020 ratification of the Brexit agreement. Even so, in May 2023 more than one respondent out of four regarded Brexit as one of their three greatest sources of uncertainty.

This uncertainty most likely played a big role in the stagnation of companies' real productive investment in the UK from the third quarter of 2016 to the fourth quarter of 2019. The post-Covid recovery has not yet been enough to return to the prior level. Accordingly, in the first quarter of 2023, real business investment in the UK remained +1.2% below its third quarter 2016 peak. Chart 4 illustrates the situation in the UK compared to its linear trend from 2012 to 2016, to provide a contrafactual viewpoint, and compared to its peers.

UK BREXIT UNCERTAINTY INDEX

CHART 3 SOURCE: BOE, BNP PARIBAS

BUSINESS REAL INVESTMENT, EUROPEAN COMPARISON

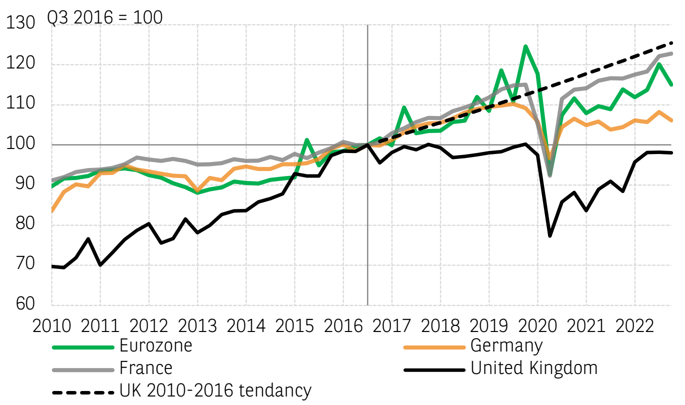

CHART 4 SOURCE: ONS, EUROSTAT, BNP PARIBAS CALCULATIONS

This shows a clear divergence between the UK and Germany or France. This divergence began in the fourth quarter of 2016, when the post-2008 recovery of the UK business investment was stronger than that of its peers (+30.3% between 2010 and 2016 for the UK, vs. +8.8% for France, +16.5% for Germany, and +10.3% for the euro zone). We nonetheless see a relative outperformance of investment by UK companies that coincides with the end of the pre-Brexit transition period, beginning in the first quarter of 2020 (-2.1% between 1Q 2020 and 1Q 2022 for the UK, vs. -7.6% for the euro zone).

LESS ATTRACTIVE FOR EUROPEAN WORKERS

While Brexit does not seem to have lessened the UK's attractiveness to foreign investors, it has reduced the mobility of European workers. The resulting lack of non-qualified workers has not yet been reabsorbed.

3 The Bank of England's Decision Maker Panel expresses the economic expectations of market participants, including Brexit Uncertainty Index, which sums up the replies of more than 10,000 UK companies regarding their concerns over the consequences of Brexit

However, this is now happening, thanks to the arrival of workers from non-EU countries. We estimate that the number of foreign workers employed in the UK in the first quarter of 2023 was 76,000 lower than it would have been if total employment of European and non-European workers had stuck to its pre-Brexit trend. The gap between this trend and the employment of foreign workers widened during the post-Brexit period of uncertainty, then began to level off in 2020. Arrivals of new workers from non-EU countries have risen recently, in particular after the lifting of Covid-19 health restrictions. Since then, these new arrivals have helped offset the absent flows of European workers. Moreover, the latest figures, particularly those of the first quarter of 2023, suggest that the numbers are catching up with the pre-Brexit trend.

Meanwhile, a June 2022 study by the Centre for European Reform[4] found that Brexit had led to a net loss of 330,000 foreign workers compared to a counterfactual, non-Brexit scenario. The study also found that the hardest hit sectors are those that mostly employ non-qualified workers, such as transport (net loss equivalent to 8.7% of the labour force), hotels and catering (6% of the labour force), and retail and wholesale trading (3.2% of the labour force).

The UK labour shortage has been aggravated since the start of the Covid-19 crisis by the broader issue of a declining participation rate, which has underperformed the euro zone's rate – an issue that we reported on in a research note in early March[5]. The number of persons of working age absent from the working population has, in fact, increased by almost 6% since February 2020. While the participation rate had risen by 0.5 percentage points in the euro zone from its pre-Covid level by the fourth quarter of 2022, it had still not returned to its pre-Covid level in the UK, with a rate 0.9 points lower than in the fourth quarter of 2019.

This serious shortage of workers in the UK is weighing on the supply side and is one reason inflation has been so stubborn.

UK: LOSS & GAIN OF WORKERS WITH RESPECT TO PRE-BREXIT TREND

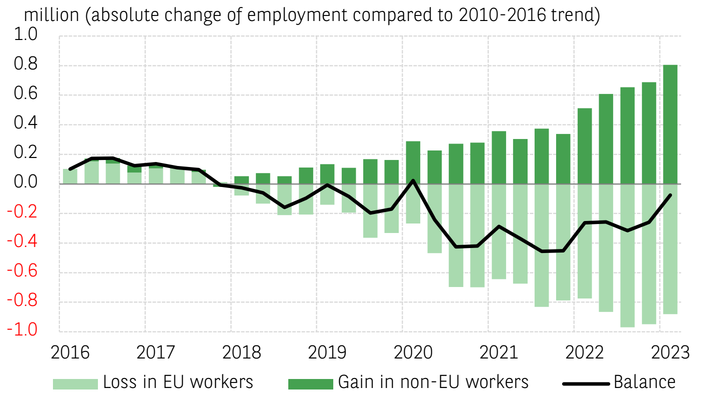

CHART 5

SOURCE: ONS, BNP PARIBAS CALCULATIONS

Stéphane Colliac

stephane.colliac@bnpparibas.com

4 Early impacts of the post-Brexit immigration system on the UK labour market | Centre for European Reform (cer.eu)
5 BNP Paribas Global Markets, UK Economic Outlook, Slide N°3

William De Vijlder Chief Economist	+33 1 55 77 47 31	william.devijlder@bnpparibas.com

OECD ECONOMIES AND STATISTICS

Hélène Baudchon Deputy chief economist, Head - United States	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Stéphane Colliac France, Germany	+33 1 42 98 43 86	stephane.colliac@bnpparibas.com
Guillaume Derrien Eurozone, Southern Europe, Japan, United Kingdom - Global trade	+33 1 55 77 71 89	guillaume.a.derrien@bnpparibas.com
Veary Bou, Tarik Rharrab Statistics		

ECONOMIC PROJECTIONS, RELATIONSHIP WITH THE FRENCH NETWORK

Jean-Luc Proutat Head	+33 1 58 16 73 32	jean-luc.proutat@bnpparibas.com

BANKING ECONOMICS

Laurent Quignon Head	+33 1 42 98 56 54	laurent.quignon@bnpparibas.com
Céline Choulet	+33 1 43 16 95 54	celine.choulet@bnpparibas.com
Thomas Humblot	+33 1 40 14 30 77	thomas.humblot@bnpparibas.com
Marianne Mueller	+33 1 40 14 48 11	marianne.mueller@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

François Faure Head – Argentina, Turkey – Methodology, Modelling	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam – Methodology	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot South Korea, Philippines, Thailand, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
Cynthia Kalasopatan Antoine Ukraine, Central European countries	+33 1 53 31 59 32	cynthia.kalasopatan.antoine@bnpparibas.com
Johanna Melka India, South Asia, Russia, Kazakhstan	+33 1 58 16 05 84	johanna.melka@bnpparibas.com
Lucas Plé Africa (Portuguese & English-speaking countries)	+33 1 40 14 50 18	lucas.ple@bnpparibas.com

CONTACT MEDIA

Mickaelle Fils Marie-Luce	+33 1 42 98 48 59	mickaelle.filsmarie-luce@bnpparibas.com

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Head office: 16 boulevard des Italiens – 75009 Paris France / Phone : +33 (0) 1.42.98.12.34
Internet: www.group.bnpparibas.com - **www.economic-research.bnpparibas.com**

Head of publication : Jean Lemierre / Chief editor: William De Vijlder