Brexit’s effect on the United Kingdom’s Trade, Foreign Direct Investment, and the Value of Sterling

Logan Matusow
April 2019
Abstract

The United Kingdom has been experiencing a period of economic uncertainty and volatility as a result of Brexit, Britain’s impending exit from the European Union. This paper discusses and projects the UK’s economic environment post-Brexit, placing significant emphasis on the country’s trading landscape and level of foreign direct investment (FDI). It discusses how Brexit will affect the price of sterling, along with the greater implications the change in value of the currency will have on the aforementioned economic variables.

Through analysing and critiquing the works of those most qualified to report on and forecast the political and economic fallout resulting from Brexit, this paper will examine whether or not the UK’s action to leave the EU was the right one from a purely economic perspective. The paper begins by exploring the context of the UK economy prior to the referendum and the country’s decision to ultimately leave the EU. The paper then delves into a critical analysis of each economic factor mentioned, using several different quantitative analyses, models, and projections to further predict the economic state of the UK following Brexit. Lastly, the paper discusses the differing ways the nation could exit the EU, providing a recommendation of either a “soft” or “hard” Brexit to maintain the economic interests of the UK.

KEYWORDS: Brexit, European Union, Trade, Foreign Direct Investment, Sterling

Introduction

On June 23rd, 2016, the United Kingdom sent shockwaves around the world when the nation elected to leave the European Union by a margin of 51.9 percent to 48.1 percent (Reenen, “Brexit’s Long-Run Effects” 2016). To understand why the country decided to do so, it is important to provide background of the UK economy and relationship with the EU prior to the referendum. Britain joined the European Union in 1973, not because there was great desire to join the Union but because it seemed as though the only option to significantly increase relations with the then more prosperous Western European countries (Riley, 2016). Given that the UK withheld a long tradition of autonomy as an unconquered nation with its own parliamentary democracy and currency, it stood out from the other European countries. For this reason, there was immediate rejection to the idea of joining the EU. This rejection heightened with the decision of the Blair government to permit full freedom of movement rights to all the 2004 accession states; one of which being the United Kingdom. This resulted in an influx of immigrants from poorer and less developed European countries. This influx of workers intensified during the 2008 economic crisis. As Britain was not in the Eurozone and effectively had control over its own currency allowing the country to deploy financial stabilisers, the country’s economy was able to quickly recover from the crisis. This, in turn, resulted in more immigrants due to better employment opportunities and ultimately made the UK responsible to act as the employment “shock absorber” for worse off European countries (Riley, 2016). With the focus to stabilise and further progress employment of British citizens in the UK in addition to a rejection towards being taken advantage of by struggling European countries, the UK proposed a referendum to leave the EU (Panjwani, 2018).
The United Kingdom’s exit from the EU will have important economic consequences, perhaps none more important than its effects on trade, FDI, and sterling. An in-depth analysis of each economic factor is provided later in the paper. After exploring the effects Brexit will have on the previously introduced economic factors, a discussion of their effects on income is necessary to determine the overall economic impacts Brexit will have on the UK. From there on, a decision regarding whether or not the UK should push for a “soft” or “hard” Brexit can be made.

**Literature Review**

**Brexit Economic Effects Thus Far**

Britain has yet to officially leave the European Union, however, Brexit has already contributed to a very different economic landscape than was seen prior to the June 23rd referendum. As explained by Thomas Sampson in *Brexit: The Economics of International Disintegration*, the rationale behind this change is predominantly based upon a pessimistic outlook on the UK economy. This is due to potential decreases in FDI and trade with EU members, coupled with increases in speculation over the price of sterling as a result of the market’s attempts to evaluate the implications of Brexit on the currency. As shown in Figure 1, there has been a depreciation of 12 percent in the price of sterling vs. the dollar just one year after the decision to leave the EU was made. This devaluation in the GBP has contributed to an increase in inflation from 0.5 percent in June 2016 to 2.6 percent in June 2017. Furthermore, there has been a decline in real wage growth from 1.5 percent to -0.5 percent in the same period. This has all contributed to a slowdown in growth in the UK as GDP was down from 1.7 percent in the year leading up to the referendum to only 1 percent in the first half of 2017. These statistics emphasize how Brexit is already harming the UK economy prior to the country even leaving the EU (Sampson, 2017).
Speculation has truly been the driving force behind the UK’s recent economic downturn, however, recent negative outlooks could be warranted through analysing the potential effects of Brexit on the country’s migration, productivity, and wages. A major reason for Britain’s decision to leave the European Union pertains to the country’s unwillingness to harbor responsibility for immigrants looking for work in their superior job market. According to The economic impact of Brexit-induced reductions in migration, authors Portes and Forte explain how net EU migration into the United Kingdom could decrease anywhere from 90,000 all the way up to 150,000 in a more extreme case by 2020. While Brexit will almost certainly meet the UK’s wishes regarding a decrease in the amount of EU migrants, this decrease in migrants could have negative connotations. For starters, there is strong evidence that migration has a positive impact on productivity. With more workers comes an increase in competition and thus, an increase in productivity in order to effectively compete. Therefore, a decrease in both, skilled and unskilled workers will result in a decrease in competition in the UK labor market, culminating in a loss in productivity. Portes and Forte go on to detail how even though a decrease in migration could hurt Britain’s labor market, it will most likely enhance the wages of British citizens; those who the UK is most concerned about. As has always been the case, the more workers there are, the lower wages are. Given that Britain’s exit from the EU will limit the number of workers from other countries, there will be less laborers available who will demand more money for their employment. To quantify this situation, Portes and Forte conclude that a 1 percentage point decrease in the proportion of migrant workers working in the low-to medium-skilled service sector increases wages by 0.2 percent. Given projections on migration after Brexit, it is estimated
that there will be a wage increase of 0.21 percent by 2020 and 0.51 percent by 2023. While many still maintain a negative perspective on the economic effects of Brexit due to perceived decreases in productivity and growth, decreases in migration can also result in a positive in the form of wage increases and more job availability/less unemployment (Portes, 2017).

**Trade**

A great majority of the market moving speculation that has plagued the United Kingdom economy since the referendum revolves around projected trade following Britain’s planned exit from the European Union. While a significant factor in the post-Brexit trading landscape is the way with which the UK exits (soft or hard), this section focuses on the broader trade implications Brexit entails, leaving the discussion of exit strategies for later in the paper.

Ever since the United Kingdom joined the EU, they have reaped the benefits of a customs union shared amongst EU members which allows for the free trade of goods and services. Similarly, the UK had the privilege of reduction in non-tariff barriers resulting from the EU’s efforts to create a Single Market. These limitations of trade costs promoted trade between EU members and allowed Britain’s trade relationship with the rest of Europe to prosper. However, the UK’s impending exit from the EU will have major ramifications for the country’s trading environment.

While it can be concluded that the United Kingdom’s level of trade will decrease following Brexit, an effective forecasting can aid in determining just how significant this decrease in trade will be on the greater UK economy. To do so, computational general equilibrium trade models simulated by Swati Dhingra can be used. Dhingra considers three channels through which Brexit may affect trade costs: tariffs, nontariff barriers, and future declines in intra-EU trade costs in which the United Kingdom participates only if it remains an EU member. Since it is estimated that intra-EU trade costs have been declining approximately 40 percent faster than between other OCED countries, this cost must be considered. Dhingra also models both, an optimistic scenario where the UK stays in the EU Single Market (Soft Brexit) and a pessimistic scenario where the UK trades with the EU under WTO laws (Hard Brexit). The results of the models (in percentage change in income per capita) are outlined in Figure 2 below and their significance is further examined in the “Findings & Analysis” section of the paper (Dhingra, 2017).
Foreign Direct Investment

Foreign Direct Investment comprises of investments from outside a country to start up new subsidiaries, expand existing establishments, or to acquire local companies. Most countries typically welcome FDI as it raises productivity, increasing output and wages; this is due to foreign firms’ tendency to pay higher wages than domestic firms and bring managerial know how and new technology to make their processes more efficient. FDI is responsible for a significant portion of the United Kingdom’s economy. With an estimated stock value of over £1 trillion, the UK is a major recipient of FDI and is only behind the U.S. and China when it comes to total FDI received.

The one complication with Britain’s FDI, especially with the impending Brexit, is that EU members are accountable for approximately half of the UK’s total FDI. This is a problem as Britain’s exit from the European Union could result in increases in tariffs and non-tariff barriers which will make it more expensive for European firms to do business with the UK. John Van Reenen forecasts that this negative economic impact from decreased FDI could result in a fall in real income by about 3.4 percent and a loss of GDP by approximately £2,200 per household. Whereas EU membership added 2.25 percent to UK GDP primarily through increased inward FDI, Brexit will do the complete opposite. Given that FDI is a major contributor/predictor of GDP, it is worth analysing experts’ forecasts regarding changes in FDI following Brexit and its effects on the greater UK economy (Reenen, “Brexit 2016”).

Sterling

The sterling, or Great British Pound (GBP) as it is commonly referred to as, is the United Kingdom’s currency and its value is a measure of the country’s economic strength and stability. The value of the sterling floats freely against other countries’ currencies and is affected by a plethora of factors. As explained in Understanding the Economic Impact of Brexit, the recent deterioration of the pound since the referendum can be attributed to the negative view of market participants towards the strength of the UK economy. It is therefore a direct reflection of the
view that Brexit will reduce economic growth. Following the announcement of the UK’s exit from the EU, sterling declined roughly 15 percent over a period of 12 months against the USD, marking a 31-year low. With this being said, 2017 signaled a rebound year for the sterling as it gained 9.5 percent against the USD (“How Will England”, 2018). As explained by Gemma Tetlow and Alex Stojanovic in *Understanding the Economic Impact of Brexit*, the changing value of the sterling has different effects on the economy. For instance, a weaker pound raises the price of imports as the pound now buys less of another currency, resulting in higher costs for consumers purchasing imported goods. Similarly, Tetlow and Stojanovic point out how the depreciation of the currency provides an economic boost to UK businesses exporting products as foreign buyers will look upon the goods as cheaper due to the devalued currency. While the UK economy is in unprecedented territory as far as the volatility of its currency and speculative nature of its market economy go, the ongoing updates in Brexit negotiations will continue to have monumental effects on the value of sterling. After describing the differing exit methods the UK can negotiate that follows this section of the paper, an in-depth examination of the potential changes in valuation of the GBP post-Brexit is made (Tetlow, 2018).

“Soft” or “Hard” Brexit

Ever since the British public voted to leave the European Union, a key issue of concern has been how the process of Brexit will be managed and what kind of exit scenarios are available; the two most popular being either a “soft” Brexit or a “hard” Brexit. Proponents of the soft option point to the current deal Norway has with the European Union as the basis for a potential Brexit deal. While Norway is not part of the EU, they are a member of the European Economic Area (EEA). Being a member of the EEA grants countries privileged access to the EU Single Market but also results in certain EU obligations of which the UK would have limited say in. One of these obligations in Norway’s case is the free movement of people; a main objection the UK had to being in the EU. This makes the soft option very difficult, especially when “the EU has demanded that access to the Single Market can only be granted if all its principles, including the free movement of people, are respected” (Liberto, 2019). The soft Brexit option would also result in the UK contributing to the EU budget albeit at a reduced level.

The other option available to the UK in their Brexit negotiations with the EU is the hard exit option. A hard Brexit would result in the UK negotiating free trade deals with the EU and other trading partners under free trade rules established by the World Trade Organization (WTO). Under this scenario, Britain would not have to contribute to the EU budget nor to the Union’s laws, but the country would also no longer have access to the Single Market; at least until a new trade deal is reached with the EU. Similarly, the UK will face a Common External Tariff when trading with EU countries and will no longer benefit from the array of Free Trade Agreements negotiated by the EU on behalf of its members. While many believe that a preferred Brexit deal would allow the UK to pick and choose preferential aspects of the EEA while ensuring the free movement of workers is not included, the EU objects and has been very strict with the rules required to enter their Single Market (Burns, 2016). Whichever path the UK takes towards exiting the European Union will have considerable effects on both, the UK and EU economy. For this reason, the economic impacts of both exit methods are analysed throughout the remainder of the paper.
Findings & Analysis

Without a reasonable timeframe to conduct primary research, this paper will rely solely on secondary resources for data. The data provided by these sources will allow for a comprehensive analysis and projection of the United Kingdom’s economic landscape post-Brexit and will aid in creating a recommendation for the country’s best course of action in exiting the European Union from an economic perspective. This section will begin by examining the different economic implications a “soft” and “hard” Brexit pose, followed by the impact Brexit will have on UK trade, FDI, and sterling through the secondary analysis of primary sources.

A soft Brexit would ensure the least amount of disruption possible to Britain’s trade, supply chain, and businesses as it would likely result in the UK becoming a member of the EEA and maintaining access to the EU Single Market. A hard Brexit, on the other hand, would result in significantly more immediate consequences to the UK economy; this is due to the uncertainty surrounding relations with the EU and the great amount of time needed to negotiate new trade agreements. With this being said, the country would now have unlimited freedom to organize their own trade deals and rules, attaining complete self-determination.

After exiting the EU, the trading and investment landscape of the country could be very different. The UK currently enjoys free trade of goods and services with EU countries. This has resulted in increased trade with EU members, who of which accounted for 45 percent of imports and 53 percent of exports for the country in 2014 alone (Reenen, “Brexit’s Long-Run Effects” 2016). While a soft Brexit could allow for the use of a Single Market with free trade and reduced nontariff barriers, a hard Brexit would reduce trade significantly with EU members due to higher trading costs. Without access to the EU customs union, UK goods will be taxed abroad, increasing the cost of British goods purchased abroad. Similarly, if Britain is denied access to the EU Single Market following Brexit, non-tariff barriers will increase drastically as the price to get UK goods through border controls and rules of origin checks increases. With the potential removal of free trade/free movement of capital comes the likely outcome that EU countries also might find it more expensive to invest in the UK. For example, financial services, Britain’s most FDI reliant industry, is extremely dependent upon EU connections/branches and could suffer significantly as a result of increased movement of capital costs. This would, in turn, reduce GDP and have an inherently negative impact on the UK economy. Whereas a soft Brexit in which the UK remains in the EU Single Market will result in less disruption to Britain’s FDI, a hard Brexit will albeit cause a catastrophe in the country’s economy through marginally increasing costs for potential foreign investors due to the UK having to abide by more expensive WTO laws prior to the negotiating of its own foreign trade agreements. On another note, while Britain will in fact have more freedom to negotiate and create their own trade deals with foreign nations as a result of no longer having to abide by the European Union’s common trade policy, the UK alone has less power and attraction when compared to the entire EU. When the EU negotiates a trade deal, they are providing the other party with access to every country they are comprised of. Because of this, the UK alone has less bargaining power, resulting in less favorable trade agreements.

One point worth noting is that after leaving the EU, Britain will no longer be bound by the Union’s common external tariff on imports. The UK could therefore benefit from this change
by unilaterally removing all tariffs on imports into Britain in order to lower the cost of imported goods. This could provide a much-needed benefit to the UK economy by providing citizens with cheaper imported products and transforming the country into an attractive market to export to. Figure 2 mentioned earlier forecasts this potential economic benefit. According to the chart, the benefits of unilateral liberalization are an increase in income of 0.30 percent in the case of a soft Brexit and 0.32 percent for a hard Brexit. Given that prior estimated change in welfare results in an overall fall in income of 1.28 percent in the optimistic case and 2.69 percent in the pessimistic case, the benefits of unilateral liberalization added with the fiscal savings of Britain’s exit are far from enough to economically rationalize Brexit.

The everchanging landscape of Brexit negotiations coupled with the numerous potential outcomes to the UK’s exit has also resulted in an extremely volatile sterling; one that experienced a sharp selloff after initial reports of Brexit but has been on the rebound ever since. The value of sterling has been resting at around $1.31 in recent months which is a far cry away from the $1.47 it was directly prior to the referendum (Reynolds, 2018). However, it can be said that the sterling is depreciated due to the risk of a disorderly Brexit being factored into the market. Saying this, a shift in negotiations/public optimism towards a soft Brexit will likely increase the value of the currency due to less unknowns pertaining to the United Kingdom’s relationship with the EU and available access to their Single Market. Similarly, if negotiations do not go as planned and a harder exit strategy is taken, a further depreciated sterling will likely result. The greater depreciation of the sterling could only mean worse for the UK economy as the sterling will be able to buy less from foreign countries and consumer prices would increase due to this decrease in purchasing power in the UK.

**Conclusion**

After analyzing the forecasted effects of the United Kingdom’s exit from the European Union on the country’s trade, foreign direct investment, and currency, while also comparing and contrasting the potential exit options available to Britain, it is recommended that the country pursue a soft Brexit. The UK should attempt to negotiate a soft exit in order to ensure the least economic disruption possible. Whereas a hard Brexit will result in a steep decline in the country’s trade, demolish nearly fifty percent of Britain’s FDI, and plummet the value of the sterling, a soft Brexit allows for continued access to the EU Single Market and a maintained relationship with the EU economy. Given that the UK would obviously prefer the economic advantages of an accessible Single Market, the country has been wary about sacrificing rights they hoped to gain through leaving the Union; the topic of the free movement of people comes to mind. As was discussed earlier in the paper, the EU is unwilling to alter its policies regarding members commitments to being in the Single Market. With this being said, it is in the UK’s best interest to be open to the idea of continued free movement of people from the EU. While it was a big point of exit for the UK, after analysing the economic fallout from a hard Brexit, the hit on the UK economy from increased migration pales in comparison to the increased costs of doing business with the country’s primary trading partner. Therefore, it is suggested that the United Kingdom pursue a soft Brexit, keeping an open-mind while negotiating a deal with the EU as the UK truly needs the economic support of the Union much more than the EU needs Britain.
Bibliography


