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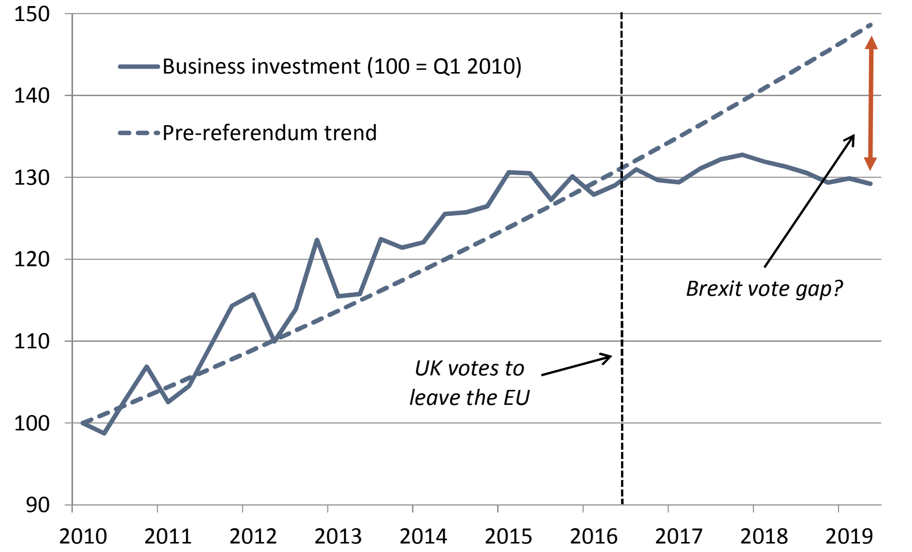
9 August 2019

UK investment stagnation highlights Brexit risks

Business investment has stalled since the June 2016 vote to leave the EU



Quarterly data. Source: ONS, Berenberg

- **Uncertainty hurts:** The persistent threat of a hard Brexit since June 2016 has weighed heavily on the risk appetite of UK businesses. Unsurprisingly, investment has fared badly. Our chart shows that business investment in Q2 2019 was c13% lower than it would have been had the pre-referendum trend (from 2010 onwards) continued. Of course, global factors matter too. As an open economy, the UK is partly at the mercy of the global cycle. With 30% of UK GDP coming from exports, many firms make investment decisions with an eye on global demand. Rising global uncertainties linked to the slowdown in China and the noisy US-China trade negotiations add to businesses' anxiety.
- **A glimpse of the future:** With its light-touch approach to product and labour market regulations, the UK has become the location of choice for companies wanting to serve the entire EU market. Due to a high inflow of foreign capital, the UK has for years consistently enjoyed more investment than its domestic savings would have otherwise allowed. Between 2010 and 2018, UK investment relative to GDP was 17%, while savings were only 13%. Outside of the EU, the UK will lose part of its shine as a place for firms to base their European business. The lower growth in capital inflows from abroad will probably reduce future growth of investment unless domestic savings rise – which seems unlikely.
- **Weak investment hurts growth potential:** During most of the post-Lehman upswing, firms have relied on the UK's flexible labour markets to cheaply expand their workforces to raise productive capacities while shying away from big, risky investments. As a result, UK worker productivity – output per hour – is just 2.3% above the pre-Lehman peak in Q3 2007. To draw a striking comparison, average annual productivity growth from 1980 to 2007 was 2.3%. As rising capital per worker is crucial for productivity growth in the long run, the stagnation in investment since the Brexit vote is cause for serious concern. Without higher investment soon to lift productivity growth, the ongoing slowdown in employment growth as the labour market tightens will constrain potential growth.
- **Near-term outlook depends on Brexit:** The new UK prime minister, Boris Johnson, has picked fights on two fronts – with the EU and with moderate Conservatives. This sets the stage for a noisy UK-EU standoff in the coming weeks, followed by a clash between Johnson, who may try his luck with a hard Brexit, and moderate MPs, who will try to stop him shortly after 3 September, when Parliament returns. Investment will probably remain weak again in Q3. Beyond that, the near-term outlook depends on what happens on 31 October. If there is an orderly Brexit (30% probability), investment will probably rebound sharply. In the case of a hard Brexit on 31 October (30%), investment will probably tank badly. In the case of a further extension (40%), which could still end with a hard Brexit, the stagnation in investment will probably be prolonged.

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