

**Paying Our Way in the World?  
Visible and Invisible Dangers of Brexit**

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**Abstract**

The UK economy has long been associated with a weak balance of payments. This reflects the underlying growth model: demand has been reliant on private household consumption and deficits in goods trade have been offset by surpluses in services trade and foreign investment earnings. The Single Market provided wider markets for the UK, but did not fundamentally alter Britain's structural weaknesses as evidenced by the deficit with the rest of the EU. The Brexit vote took place against the background of Britain running its largest peacetime current account deficit, despite subdued economic activity. Financing Britain's external position represents a key challenge post-Brexit. Post-Brexit models of British political economy partially address this. Proposals for a 'Singapore' type model would accentuate key aspects of the current British model; its proponents see opportunities to pursue further trade agreements, particularly in services trade. Alternative proposals floated in terms of a new industrial strategy for Britain could provide the basis for a reorientation of the British economy towards key export industries and a more interventionist state regime. Any emergent model will critically depend on the nature of the Brexit deal with the EU, not least in terms of the position of the City of London.

This paper sets out the recent evolution of the UK's current account position, particularly in relation to the EU. It then highlights particular areas of potential disruption from Brexit and sketches out scenarios of possible evolution of the Britain's external position in response to this.

Key words: Brexit, Balance of Payments, British Growth Model

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## 1. Introduction

In 2016 the United Kingdom's current account deficit hit a peacetime record of more than 5 per cent of GDP; this was also the largest deficit (relative to GDP) of any G7 economy. It has been claimed that a country's current account enters a danger zone for sustainability around 5 per cent of GDP<sup>1</sup>; indeed, the 5 per cent limit has often been taken as an early warning indicator for crises in emerging economies. There are, of course, key differences between Britain and emerging economies, but Brexit still poses an unprecedented challenge for the British economy. The current account deficit has fallen back since then, although it is now at its highest level since 2016 despite a record fall in sterling since the referendum result.

By definition, such a deficit requires overseas financing, leading Bank of England governor Mark Carney (channelling Blanche DuBois) to comment that Britain is now relying on the 'kindness of strangers' to finance its external deficit (Carney 2017). The potential impact of Brexit on Britain's trading relations and its ability to attract foreign investment are central to the widely forecast negative effects on the British economy. Since the referendum vote some indicators point to international investors shifting away from the UK. Much of the discussion has focused on the direct impact of Brexit on trade, but the effects on the capital account are key too as the UK will either have to continue to attract capital inflows to offset the current account deficit or to engineer a marked improvement in its current account position. The former would require continued international investor confidence in the UK; without a new economic strategy the latter could only be achieved through lower living standards.

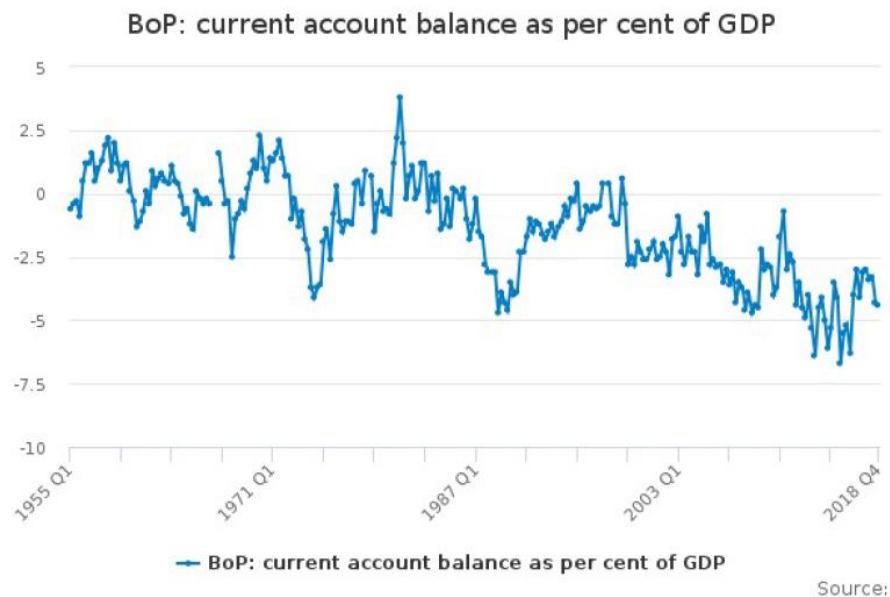
Section two of this paper considers the balance of payments in the context of the UK's growth model, particularly its reliance on periodic private consumption booms. Section three considers trade and current account developments, particularly in relation to the European Union. Section four considers the potential impact of Brexit on Britain's external position and the resulting policy implications. Section five concludes.

## 2. The British Growth Model and the Balance of Payments

The United Kingdom has run a current account deficit almost continuously since the mid-1980s, averaging around 2 per cent of GDP, as figure 1 shows. The UK experienced an extreme version of trends seen in other developed economies with deindustrialization - a decline in manufacturing employment and the share of manufacturing in output that has also been associated with a continued deterioration in the trade balance for manufactures (Coutts and Rowthorn 2004, 2013; Perraton 2015). The UK experienced a particularly marked fall in the balance for manufactures, from high surpluses initially in the post-war period to continuous deficits from the early 1980s. Much of the deindustrialisation had occurred by the early 1990s, but the process has continued since and the manufacturing balance has continued to deteriorate with a strong fall in this balance from the mid-1990s (Coutts *et al.* 2007). The UK has seen its share of world goods trade decline and this was forecast to continue even before Brexit (OBR 2017: 73, OECD 2017). These developments were of particular significance in the context of the Brexit referendum vote; key drivers of the vote to leave were voters living in areas that had experienced deindustrialisation and negative effects of globalisation generally (Becker *et al.* 2017, Rodríguez-Pose 2018). It worth noting here that although the UK has a similar growth model to other Anglo-Saxon economies, British deindustrialisation was exceptional even relative to other comparable Anglo-Saxon economies. The UK has particularly low manufacturing employment (Eurofund 2019). The

US experienced relatively strong growth in manufacturing output and productivity over the great moderation period; notwithstanding structural change and offshoring of production, US manufacturing retains key strengths (Levinson 2017, Schwartz 2009: ch. 5). Ireland has also exhibited strong performance in manufacturing (Hay and Smith 2013, Romalis 2007).

Figure 1: UK Current Account Balance (per cent of GDP)

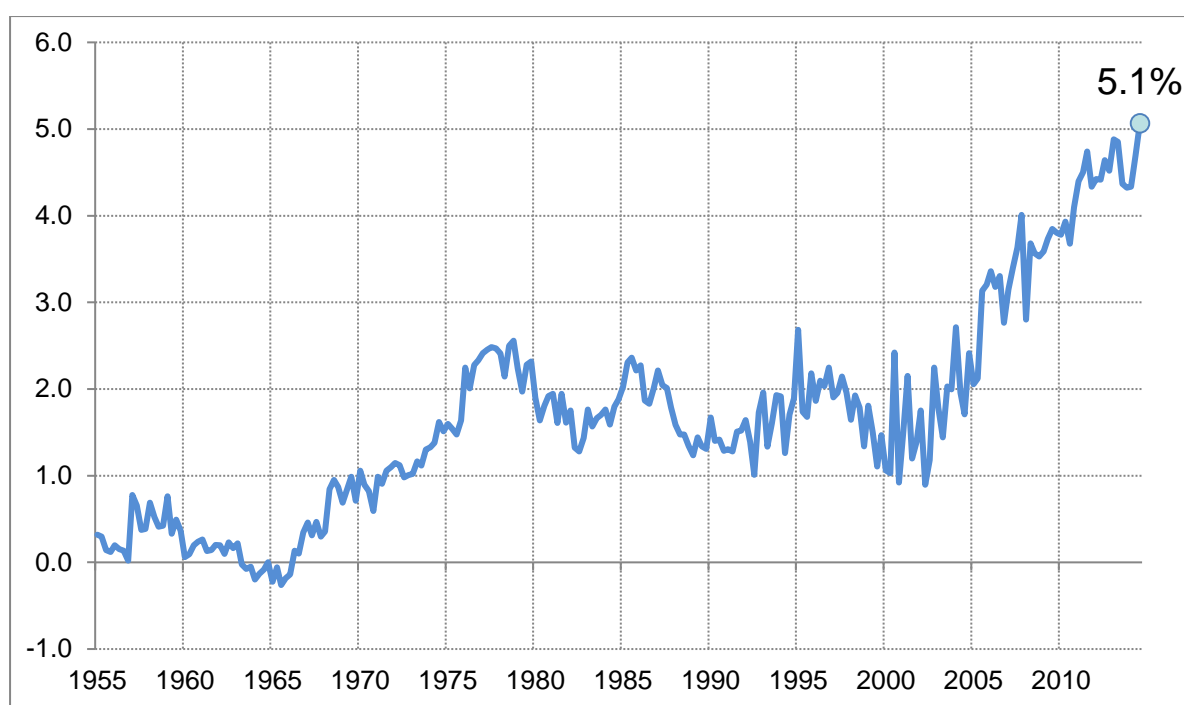


Source:

**Source: ONS**

The long term deterioration of the manufactures balance has been partially offset by improvements in the balance for other goods, notably through the impact of North Sea oil from the 1970s, and a clear improvement in the services trade balance from the mid-1990s as shown in figure 2. Britain has a longstanding advantage in certain tradable services and from the 1980s the balance of services has improved significantly with the growth in net exports of skill- and knowledge-intensive business and financial services so that the UK is now the world's second largest exporter of commercial services. This has primarily been driven by growth in exports of financial and insurance services, particularly in the current century.<sup>2</sup>

Figure 2: Services Balance as Per Cent GDP



From the mid-1980s, though, the continued deterioration in the balance for goods trade has only partially been offset by improvements to the services trade balance. Before 2012 the UK's current account position was also usually supported by net inflows on the primary income balance, the difference between income earned by UK residents on investment abroad and income paid on foreign-held investments in the UK. This item fluctuated, but on average there was a rate of returns differential with the returns on British overseas assets exceeding returns on foreign-held assets held in the UK. There was something of a *rentier* economy element here, deficits on trade being partially offset by net overseas investment earnings despite a weakening net international investment position.

The balance of payments plays a key role in the operation of the British economic model. The 'privatised' or 'house price' Keynesianism underlying the British economic model has led to recurrent consumer spending booms based in part on rising property prices (Crouch 2009, Hay 2009, 2011, Hay and Smith 2013); worsening trade deficits are in part the external counterpart to the falling households savings rates and rising debt associated with these consumption booms. Growth of credit is strongly associated with weakening current account positions. These developments can be traced back to the 1980s with financial liberalisation and rising homeownership, leading to a marked deterioration in Britain's external position (Muellbauer and Murphy 1990). Schematically Anglo-Saxon economies have evolved to this growth model; some other Northern European economies have seen somewhat similar developments from rising homeownership and credit availability, although typically these economies have had stronger current account positions (Baccaro and Pontusson 2016, Schwartz 2009). During the 'great moderation' period before the 2007/08 global financial crisis countries operating house price growth models typically experienced faster growth than the 'repressed rich', those current account surplus countries which relied more on export-led growth (Schwartz 2009: ch. 4). However, although consumption booms can promote short term growth, they are associated with slower longer term growth and credit crunch episodes (e.g. IMF 2017: ch. 2, Kharroubi and Kohlscheen 2017). Household credit boom episodes tend to distort economic activity, channelling resources to low productivity sectors such as construction. The consolidation period

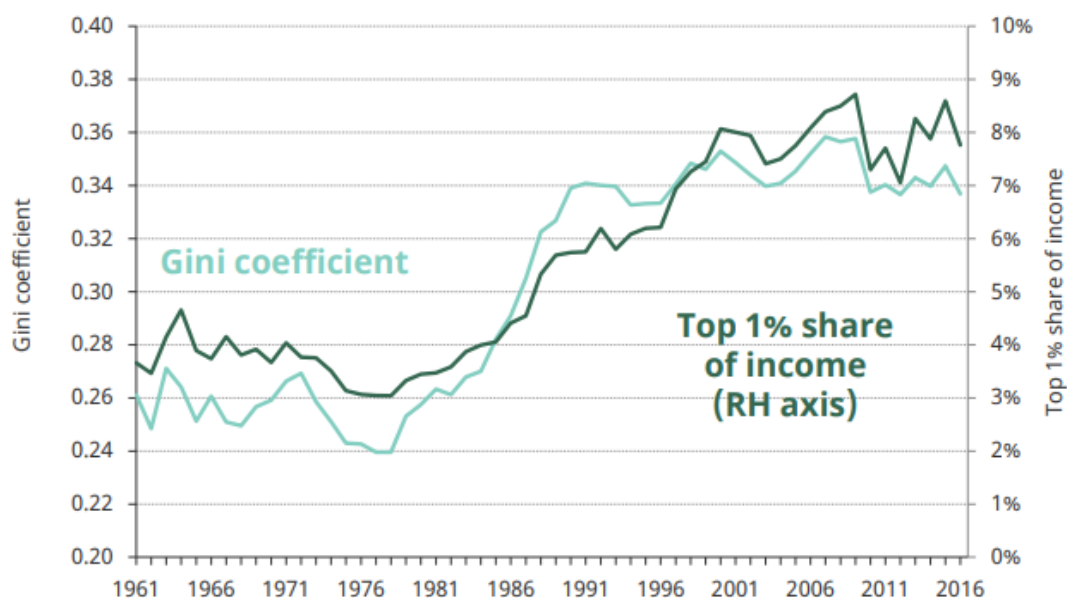
following the end of debt build-up typically leads to financial instability, credit squeezes and subdued economic recovery. Commentators have noted the unsustainable nature of Britain's pre-crisis household consumption boom on various indicators (e.g. Weale 2012).

This Anglo-Saxon growth model is associated with relatively high levels of inequality. In the Britain case inequality rose significantly in the 1980s and early 1990s, during the same period that the consumption-led growth model emerged; overall inequality has largely stabilised since at levels that are high by developed country standards, as figure 3 shows. The position of the top 1 per cent shows more continuous growth, consistent with the experience of Anglo-Saxon economies. The position of the top 10 per cent

The links between inequality and current account positions are not straight-forward, but higher inequality does appear to be associated with a weaker current account position from periodic private consumption booms (Behringer and van Treeck 2015, Kumhof *et al.* 2012). In principle increased inequality could lead to a shortfall in aggregate demand and a current account surplus to the extent that richer households consume less than poorer ones; instead, Anglo-Saxon economies have seen periodic episodes where poorer and middle income households maintained desired consumption levels in the face of squeezed living standards through lower saving and higher borrowing with an associated deterioration in these countries' current account positions.

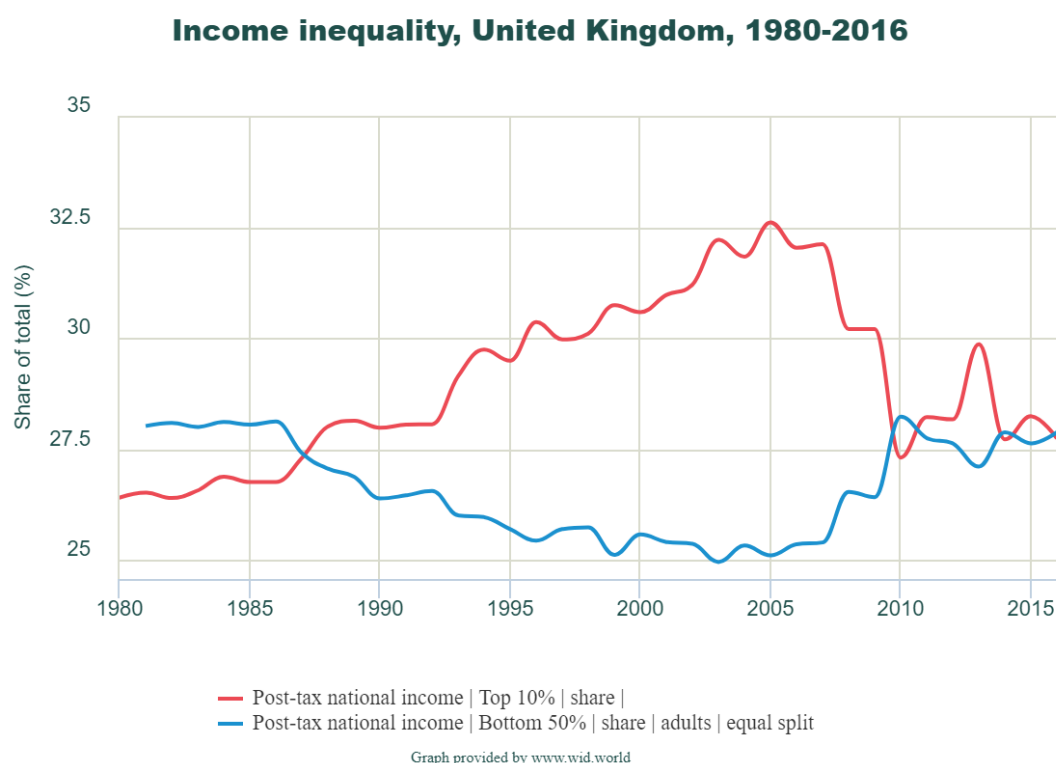
Figure 3 Inequality in the UK

### Long-run inequality: 1961 to 2016-17 (GB)



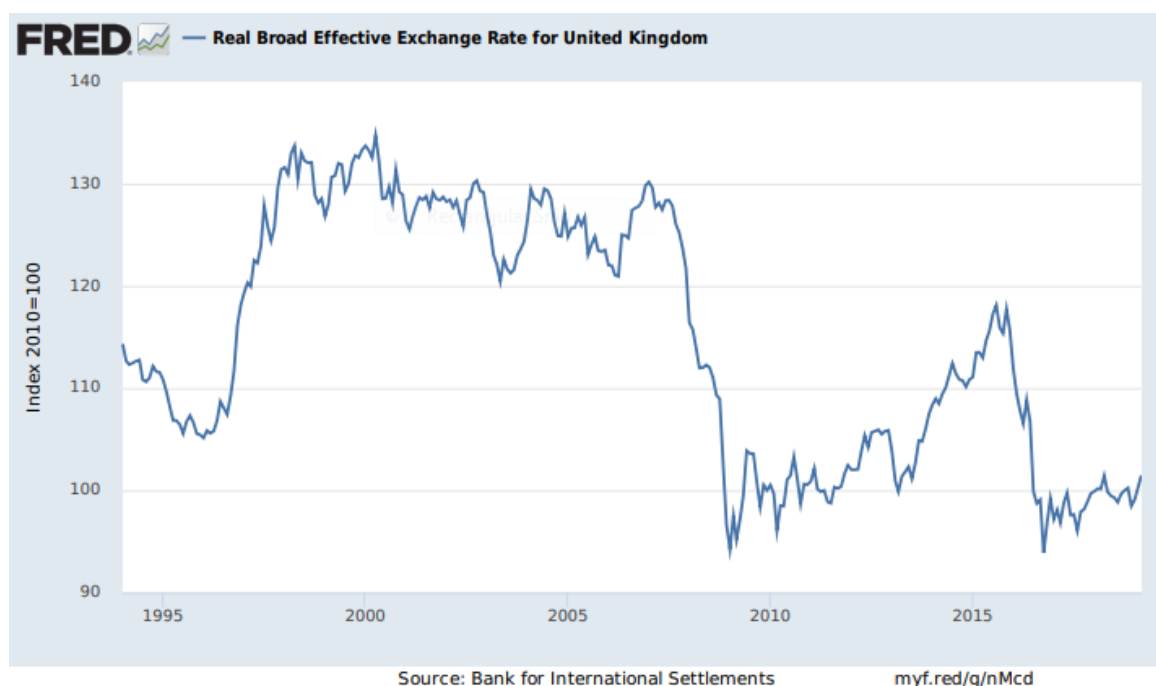
Source: Figures 3.7 and 3.8 of *Living Standards, Poverty and Inequality in the UK: 2018*

Figure 4 UK Income Inequality



The consumption boom in Britain from the mid-1990s would be expected to lead to a real appreciation of the exchange rate and thereby a current account deficit. A domestic consumption boom will act to raise prices of non-tradable goods. The Bank of England, as an inflation-targeting central bank, responded to the rise in domestic demand by tightening monetary policy and thereby strengthening the currency. The real exchange rate appreciated from 1996 by around 20 per cent, particularly relative to European currencies, and remained relatively high until 2007 (see figure 5). This is a highly schematic account, though; the strong real appreciation of sterling from 1996 cannot be explained entirely in terms of the monetary policy response and sterling appeared over-valued on some estimates (Alvaro and Arestis 2007, Cobham 2006, Wadhvani 1999). The Bank of England had no target for sterling, effectively regarding it as a macroeconomic shock absorber, and arguably has neglected the impact of its appreciation on tradable industries including manufacturing (cf. Alvaro and Arestis 2007, Cobham 2006). The United Kingdom also benefited from terms of trade improvements, partly reflecting growing imports from low cost emerging economies. These developments helped underpin what the then Bank of England governor Mervyn King termed the ‘non-inflationary continuous expansion’ era before the financial crisis by dampening inflationary pressures from expansion.

Figure 5: UK Real Exchange Rate



A current account deficit must by definition have its counterpart in net borrowing by sectors within the UK economy. Although the fiscal deficit has been widely noted, the weakening of household balances - both in the run up to the financial crisis and during the post-crisis recovery – is key here. Partially offsetting this, the corporate sector has been in surplus for much of the period since 2003, reflecting subdued investment even before the financial crisis. This aggregate position though obscures key developments within this sector – whilst non-financial corporations have usually been in overall surplus, financial corporations overall have been net borrowers. Thompson (2013) sets out in detail the accumulated debts of this sector and its substantial overall contribution to the UK’s total debt position. Since the onset of the financial crisis there has been little private sector debt consolidation in the UK and much of this is accounted for by the non-financial corporate sector. Most recently, the household, corporate and public sectors have all been in deficit, for which there is little if any precedent (OBR 2019: ch. 3).

Since 2007 sterling has depreciated, but the current account deficit has also risen. This real depreciation has been a key channel through which living standards have been squeezed with real household incomes having flat-lined since the mid-2000s. In particular, the current account deficit has risen sharply from 2011 at a time when, although economic activity was recovering, it was not particularly strong – unemployment has fallen, but underemployment persists and spare capacity remains (Bell and Blanchflower 2018). By comparison, the only occasions in the post-war period when the UK had a comparable current account deficit were during the mid-1970s oil crisis and in the late 1980s at the height of the Lawson boom. The deterioration in the current account during previous episodes was primarily driven by a worsening trade balance. By contrast, much of the rise in Britain’s current account deficit since 2011 has been driven by a marked deterioration in the primary income balance; around 80 per cent of the increase in the deficit was due to a fall in net income on direct investment (ONS 2016). As noted above, previously Britain had generally enjoyed a positive rate of return differential which gave it a positive balance on primary income even with a net international investment position that was low or negative. This appears to have been

reversed since 2011; indeed, the most recent revised figures indicate that the primary income balance is weaker than previously estimated. Further, much of this was driven by transactions with the EU, with a fall in returns on UK FDI in the EU (although this may partly be cyclical). Since the referendum UK companies appear to have increased their FDI in the EU27, whilst conversely flows into the UK from the rest of the EU appear to have declined (Breinlich *et al.* 2019). This also appears to be a service sector effect, possibly reflecting greater fears over barriers to service trade after Brexit.

This is part of a more general shift; historically movements in the UK's current account were largely driven by developments in the trade balance. The trade deficit remains a key component of the current account and typically accounts for the majority of the deficit. However, during this century the majority of *changes* in the UK current account were accounted for by changes in the primary income balance (Bénétrix *et al.* 2015, Forbes 2016, Forbes *et al.* 2017). In general financial globalisation processes before the crisis led to growth of cross-border financial flows amongst developed economies. Whilst most developed countries also saw rises in their external assets and liabilities over that period, the figures for the UK are exceptional so that both UK foreign assets and liabilities now exceed 500 per cent of GDP, having risen from around 150 per cent in 1997; These figures have fallen slightly from their peaks with the decline in cross-border financial flows since the global financial crisis (Forbes 2014; Bank of England 2015). More than half of British external assets and liabilities are accounted for by financial institutions and with the growth of financial globalisation and the position of the UK's financial system within this the primary income balance is subject to volatility. The rate of return differential is volatile and not fully understood. The United States, for example, has long had a rate of return differential on overseas assets enabling it to have a positive primary income balance despite an apparent net negative external wealth position; Schwartz (2009) identifies this as central to the ability of the US to sustain consumption-led growth. However, the US benefits from the 'exorbitant privilege' of the dollar's role as a world reserve currency ensuring demand for low return Treasury securities. In part the UK's position reflects the portfolio mix of UK overseas assets – the UK has a positive net asset position in foreign direct investment (FDI), which would be expected to have relatively high returns, but it also reflects differences in the nature of the UK banking system's foreign asset and liability profile. In particular, the UK has run a persistent positive returns differential on FDI whereas the yield differentials for equity were typically negative (Bordon *et al.* 2016, Key *et al.* 2016). Key *et al.* (2016) found evidence of a positive returns differential across various assets, which may be related to institutional features of the UK economy. The recent weakening of the primary income balance may reflect relatively short term factors, but it cannot simply be assumed that Britain's past positive rates of return differential will persist indefinitely or that the income inflows will return to earlier levels.

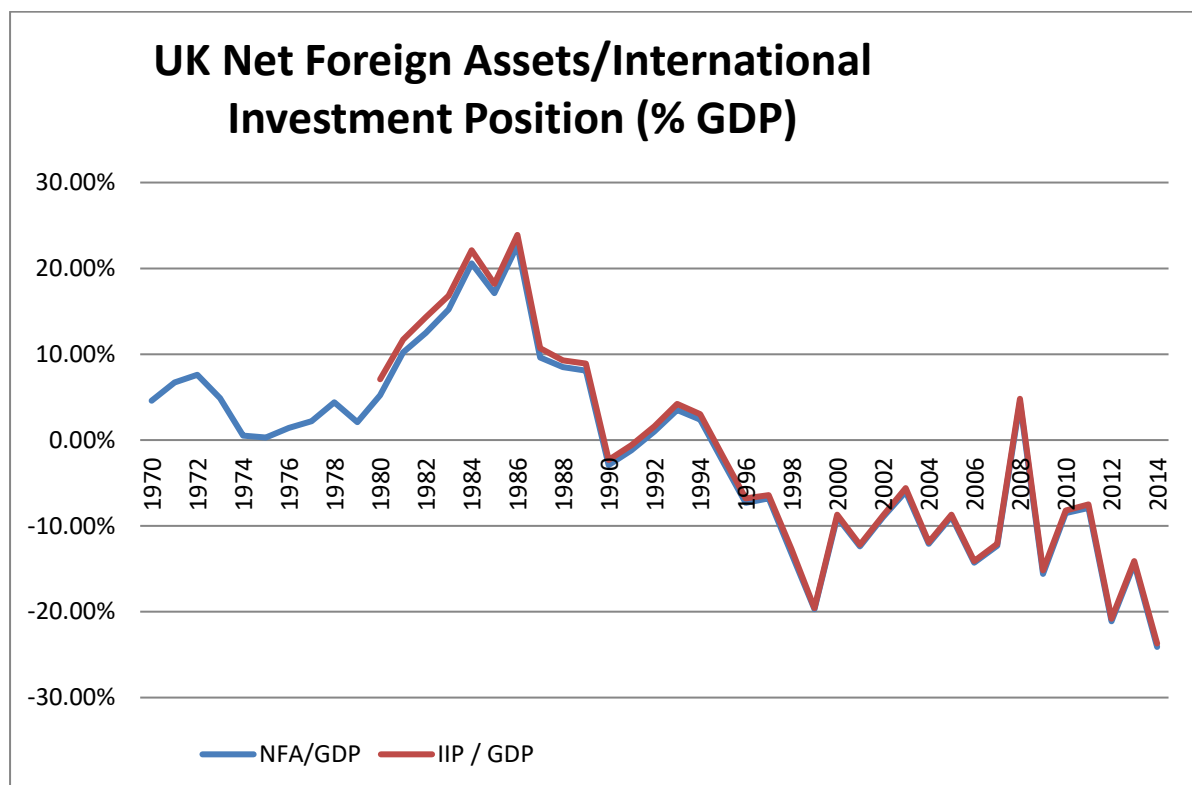
There are major caveats to the reliability of these figures. In particular, Tørsløv *et al.* (2018) estimate that once transfer pricing activities are properly accounted for the UK was estimated to have run a small trade surplus in 2015. This accounting also would raise the profit share in the UK national income by 2.5 percentage points.

The UK's increased current account deficit since 2012 has largely been financed by FDI inflows, with EU investors accounting for a majority of these flows whilst British companies have divested from the rest of the EU over this period (ONS 2016). The resulting decline in net FDI is likely to weaken the UK's positive returns differential given the typically positive returns differential on FDI. Thus, the UK has continued to be able to attract inward investment flows from overseas (mostly European) companies, although these flows are still relatively low – as a percentage of GDP these flows are now only around half



the average levels of inflows since 1988 (Bank of England 2015). Most recently, portfolio investment has helped finance the deficit, combined with continued disinvestment by UK investors in overseas equities and debt securities. The persistent current account deficit has led to a deteriorating net asset position in absolute terms. As figure 6 shows, the UK's net international investment position worsened during the 1960s and 1970s, but improved substantially in the 1980s peaking in the mid-1980s. During the 2000s the net international investment position remained broadly stable relative to GDP even with continuous current account deficits; since 2012 the net international position has deteriorated, although this partly reflects valuation effects. Further, there are considerable margins of error in estimating external wealth in relation to valuation of the total assets and liabilities which may have understated the UK's net position (Kuenzel 2012, Whitaker and Khan 2010). UK external assets and liabilities both exceed £10 trillion and the difference between the two figures is relatively small. Nevertheless the most recent estimates shown in figure 5, and based on wider surveys than hitherto, have revised downwards earlier measures of Britain's net international investment position point to a greater fall since 2007 despite the positive valuation effects of sterling depreciation. These revisions also point to continued worsening of relative returns on assets.

Figure 6 UK Net International Investment Position



The UK is approaching Brexit with a large current account deficit despite subdued economic activity and sterling depreciation. A weak trade position was compounded by a negative primary income balance from 2011. Britain has continued to attract FDI inflows to finance this deficit, mostly from EU companies, but its net international investment position appears to have weakened. Previously the UK had been able to earn a net positive return on overseas assets despite an apparently negative net international investment position, which partially offset a weak external trade position, but this is weakened by a fall in the net FDI position. The IMF, amongst others, regards this deficit as excessive (IMF, 2018); in the absence of significant trade response to falls in sterling any improvement in the current account is likely to be achieved through further reductions in living standards and/or tighter fiscal policy.<sup>3</sup>

### **3. The European Union and the UK's External Position**

Britain's trade and financial relations with the rest of the EU are central to its overall external position. A clear deficit on goods trade is partially offset by a surplus on services trade; nevertheless, the services trade surplus with the EU is small and Britain's positive services balance is largely driven by non-EU trade. Britain has a small trade surplus with the rest of the world (chiefly with the US) – its overall external deficit is largely driven by trade with the EU and with emerging economies. The position of China is particularly noteworthy here; China accounts for the majority of the deficit of the UK's goods trade deficit with Asian emerging economies.

As with the overall picture, in the current decade the primary income account position has shifted to a deficit. The EU accounts for around 45 per cent of British exports of goods and services, a share that has fallen from around 55 per cent at the start of the century. Imports from the EU account for around 54 per cent of UK imports; a figure that has been broadly stable this century. These figures understate the role of the EU in British trade given the preferential trading arrangements with over 50 further countries. With relatively slow growth in the Eurozone and the broader shifts in global patterns of economic activity, a relative fall in the EU's share of British exports is a predictable development; the EU remains Britain's largest trading partner. The EU accounts for a similar share of foreign investment; FDI in the EU accounts for around 41 per cent of the UK total, with the EU accounting for 43 per cent of total inward FDI in the UK. These shares have fallen from around half earlier in this century.

Two key developments have operated here. The UK's (apparent) growing trade deficit has been driven by rising deficits with the EU and China; imports from the EU account for around half for UK's imports, whilst exports to the EU have fallen proportionately. Most of the UK trade, both exports and imports, is in intermediates (Giametti 2019, Mulabdic *et al.* 2017). This reflects integration of UK manufacturing into European production networks. The goods trade deficit has been partially offset by rising surpluses on services trade; whilst the UK does run a surplus in services trade with the rest of the EU, the rise in the services trade surplus has largely been driven by exports to the rest of the world.

The presumed impact of trade and investment relations with the EU, and hence the expected losses from any post-Brexit disruption to them, is widely predicted to extend beyond their direct contributions to economic activity. Trade integration through the European Single Market is presumed to have pro-competitive effects raising productivity and lowering price

mark-ups. FDI is also expected to stimulate competition and promote the transfer of best practice technology.

These relations should be seen in context. Although completion of the Single Market programme acted to raise trade levels within the EU, British goods exports rose less rapidly than those of other major European economies and the UK's share of the EU market has fallen. Much of this can be explained by the relatively high exchange rate before 2007, but it also reflects weaknesses in key industries (Barrell *et al.* 2006, Buisan and Sebastia-Barriel 2006). Similarly, whilst the Single Market has led to increased sales within the EU for European companies, British firms appear to be an exception to this. Since the formation of the Single Market, Mayer *et al.* (2017) found that British firms' sales to other EU markets have remained stable at relatively low levels as a share of total sales, in contrast to other European firms who have expanded their sales to the rest of the EU; over the same period, British firms' sales to countries outside the EU have risen sharply as a proportion of their sales. Amongst the largest firms these trends have been even more pronounced with sales to other European countries falling as a proportion of total sales of UK companies whilst large French and German firms saw risings shares of sales to the rest of the EU. Major British firms have also been particularly active in offshoring production to low wage economies (Marin *et al.* 2015). This is all consistent with FDI developments as British firms divested from Europe.

(It may be noted, though, that these developments pose potential challenges for continental European companies (Perraton forthcoming). These companies remain oriented towards slow-growing European markets and concentrated in legacy industries. Advanced industrialized countries have seen a fall in their share of leading global companies from the mid-1990s with the rise of emerging economies, but this has been particularly marked in Europe relative to the US (McKinsey Global Institute 2018)).

The UK retains some key areas of advantage in advanced manufacturing, but overall it has continued to lose market share in high technology manufactures. The entry of China and other emerging economies into global markets were associated with lower export shares for most major developed economies, including the UK. There are further indicators of structural weaknesses. The relative technology intensity of exports is significantly associated with changes in export share and Britain's falling relative technology intensity since the mid-1990s partly explains the decline in Britain's share of world export markets over this period. There is some evidence that this has pushed British exports into relatively price/cost sensitive product ranges. In addition to adverse exchange rate movements, UK exports continue to suffer from longstanding weaknesses in non-price competitiveness. Benkovskis and Wörz (2014) provide a detailed recent analysis of disaggregated data indicating the importance of non-price competitiveness for goods trade. The UK's loss of export share was largely driven by price factors from the mid-1990s, reflecting sterling appreciation; however, from the 2000s non-price competitiveness explains an increasing proportion of the continued fall in the UK's share of global markets and accounts for the majority of the fall since the financial crisis. Further, the growth of export market share of major emerging economies – notably China and India – is increasingly due to improvements in non-price competitiveness rather than simply low wage costs. In general, the limited effect of the Single Market is not surprising; the programme was more extensive in eliminating barriers to cross-border trade in manufactures than for services, frequently across goods in which the UK does not have a strong comparative advantage. The Single Market did liberalise trade and investment relations in services within the EU, but liberalising measures under the services directive remain far less thoroughgoing than for

manufactures. Further, as noted, British companies have been relatively oriented towards rest of the world markets.

Over the longer term, growth must be consistent with balance of payments equilibrium; the UK patterns of specialisation are biased towards exports with relatively low income elasticities of demand whilst the UK tends to have relatively high demand for imports. This implies a relatively low long run growth rate consistent with balance of payments equilibrium (cf. Garcimartín *et al.* 2012); in the short term, faster growth may be possible, but this tends to be followed by a period of subdued growth. Current account imbalances reflect underlying macroeconomic conditions and therefore it cannot simply be assumed that these could be improved by reorienting trade from countries with which Britain has bilateral deficits in the EU towards countries with which Britain currently runs a surplus. The UK has consistently run a surplus on services trade with emerging Asia economies, this has fallen some way short of offsetting the deficits in goods trade with these economies. Overall the EU is central to Britain's trade and the evolution of its external position.

#### **4. The Potential Impact of Brexit**

Before the referendum official analysis predicted a range of negative developments in the immediate aftermath of a Brexit vote (HM Treasury 2016a), and independent forecasters made similar predictions. In the event, although the fall in sterling was broadly in line with expectations and inflation rose from higher import prices, the British economy did not experience a recession and unemployment continued to fall (see further Coutts *et al.* 2018). Asset prices did not fall and there was no major increase in the premium on lending to UK businesses and households. Foreign demand for UK gilts has been strong since the referendum result and the UK has continued to attract FDI inflows. Other indicators did indicate a switch away from investment in the UK for some assets; the ONS noted in September 2017 that 'There was also disinvestment by foreign investors in UK equity capital of £1.5 billion, the largest disinvestment since records began in 1987.'<sup>4</sup>

Growth since the referendum result, though, has almost entirely been driven by consumer expenditure as household savings rates fell to record lows and there was a marked expansion in personal credit with household debt-to-income ratios rising to levels close to their pre-financial crisis peaks; further much of the post-referendum rise in household borrowing has been driven by rising unsecured debt. In 2018 household savings fell into negative territory. Thus, activity has been maintained through a resumption of the debt-fuelled household consumption growth model, but this cannot be maintained indefinitely in the face of erosion of real incomes by the inflationary effects of sterling depreciation. Corporate investment remains subdued. The fall in sterling has only had a limited impact on net exports, with exporting firms increasing their margins. Thus, the UK has operated a version of the Anglo-Saxon model noted in the comparative political economy literature; growth has been sustained through rising consumer expenditure (indeed the resilience of consumer expenditure was a key reason why pre-referendum results of a recession did not materialize). Although trends in inequality are mixed, as noted above, median incomes have stagnated since the financial crisis; in particular waged income has stagnated. The fall in household savings and rise in borrowing appears to have exhibited clear patterns of inequality, with these developments being concentrated amongst lower and middle income households.

The UK continues to run a substantial current account deficit; the fall in sterling since the referendum vote has had a limited impact on reducing the trade deficit, but through squeezing living standards and hence consumer expenditure on imports, rather than through a lasting increase in trading capacity. Sterling depreciation episodes since 2007 have only had a limited impact on raising exports. The earlier fall from 2011 only led to limited improvements in export performance as many companies used a lower pound to raise their margins rather than expand overseas sales (SPERI 2014). The depreciation of sterling following the referendum vote has had some effect on expanding export volume, but again producers have raised margins.<sup>5</sup> This will not necessarily lead to higher investment in export industries – if the fall in sterling is in anticipation of Brexit then this presumably reflects higher expected costs of trading; alternatively, the fall may, at least in part, be a temporary response to short run developments. It is not surprising that exporters have raised margins – profitability in the tradable sectors has been persistently lower than in non-tradable sectors, in part from the earlier period of real appreciation of sterling (cf. Broadbent 2017). As noted above, the deterioration of the UK’s trading position partly reflects weaknesses in non-price competitiveness and, as such, cannot simply be offset by sterling depreciation but would require further investment in tradable industries.

Consensus forecasts indicate that the expected negative impact of Brexit over the longer term is primarily expected to operate through reduced trade and FDI inflows. There is clearly considerable uncertainty over this, not least over the nature of the final arrangements after leaving the EU. Current projections are that post-Brexit arrangements will lead to Britain leaving the Single Market, with the British government’s preferred outcome to be to negotiate a specific free trade agreement with the EU preserving tariff-free access and at least some aspects of the current preferential trading arrangement. The complexity of such trade negotiations effectively precludes concluding a final deal before Britain leaves the EU, though. Treasury forecasts before referendum predicted that GDP would be around 3-10 per cent lower over a decade against a baseline, depending on the nature of the final settlement (HM Treasury 2016b). Most forecasts made similar loss projections, some estimating that a ‘hard’ Brexit (i.e. defaulting to trading on WTO rules) in particular would lead to even higher losses (e.g. Ebell and Warren 2016, Emmerson *et al.* 2016, Kierzenkowski *et al.* 2016, OECD 2017, Van Reenen 2016). These studies also predict that Brexit would lower immigration, although not by the levels projected by the government,<sup>6</sup> with a further negative impact on output and productivity. More recent studies indicate similar potential losses to potential output from various Brexit options, with an outright recession forecast in the event of a disorderly ‘no deal’ Brexit (Bank of England 2018; IMF 2019: ch. 1).

Although key estimates point to a negative impact on trade and foreign investment flows, these are clearly subject to margins of error. Gudgin *et al.* (2017) and Coutts *et al.* (2018), in particular, argue that the Treasury study and similar independent estimates are likely to overstate the impact of Brexit. Consensus estimates are based on the now standard gravity model of trade and FDI, estimating the additional stimulus to trade and FDI that EU membership provides beyond the ‘natural’ levels predicted by the gravity model (and other controls). The gravity estimates of the impact of EU membership are based on average effects across a large number of economies; Gudgin *et al.* (2017) note that this is an average effect and re-estimate a gravity model for a more representative sample and report a lower expected impact of Brexit on trade. Estimates from gravity models are sensitive to the sample countries, the time period chosen and the conditioning variables used. The UK’s trade with the rest of EU is relatively low by EU member standards and this is consistent with evidence already noted that the Single Market has had a relatively limited impact on the British economy. These studies also query the assumed impact of Brexit on productivity

in the estimates from the Treasury and others; in particular, the estimated impact of lower trade and FDI on productivity is based on an average effect across a wide range of economies; a narrower focus on developed country evidence suggests smaller effects of changes in trade and FDI on productivity.<sup>7</sup> In practice, much of the UK FDI flows are in the form of mergers and acquisitions rather than new capital investment; although FDI through M&A could raise productivity through transfer of improved techniques, it is likely that this form of FDI would have a lower impact on productivity than new net investment in the capital stock. Gudgin *et al.* (2017) estimate that supportive macroeconomic policy and a lower pound could largely offset the negative impact on exports; if investment is being held back by uncertainty over the Brexit deal then once this is finalised it may recover. Nevertheless, estimates of the impact of Brexit following a broadly similar methodology to these studies also point to significant potential losses (Cambridge Econometrics 2018).

Beyond the details of any future trading arrangements with the EU, there is no clear post-Brexit economic model. Visions of a 'global Britain' or a 'Singapore-style' model of a free trading nation with low taxes and regulation negotiating bespoke trade deals (and/or pursuing a global services trade deal) are largely a continuation of the existing model. Defaulting to WTO rules would lead to further erosion of the manufacturing sector, through the elimination of remaining tariffs; assumptions that adjustment to this would be smooth are belied by historical experience. The UK already has some of the lowest product and labour market regulations, and lowest corporate tax rates, amongst developed economies; the OECD (2017) identifies low skill provision and infrastructure weaknesses, rather than regulation, as central to the UK's post-crisis stagnation in productivity. It is worth noting that an earlier text from now leading pro-Brexit politicians set out proposals to shift the UK to a less regulated, smaller government economy without evidently regarding EU membership as providing any major obstacles to achieving this (Kwarteng *et al.* 2012).

More generally, this does not address the issues noted here. The challenge of balance of payments adjustment post-Brexit is to provide mechanisms for the UK to improve its current account position over the medium term and finance continued deficits over the short term. Visions of a 'global Britain' echo successive UK governments' policy assumptions that the UK can be expected to gain significantly from increased services trade with high income elasticity of demand for commercial services and on-going negotiations to reduce barriers to services trade both regionally and globally; trade restrictions are held to lead to services trade being significantly below potential levels. The issue here is whether the combination of global growth and possible services trade liberalisation could generate the expansion in UK commercial services trade that could compensate for a deteriorating goods balance. Services trade growth of such magnitude appears unlikely.

Barattieri (2014) notes that economies with a comparative advantage in services tend to run current account deficits and those with a comparative advantage in manufactures tend to run surpluses. Further analysis indicates that global services trade liberalisation could reduce the UK's current account deficit by around 0.7 per cent of GDP (Joy *et al.*, 2018). This may partly be explained by the much greater degree of liberalisation of goods trade than for services trade. In principle this implies greater potential growth for services trade. Developments in digital technology offer the potential for lowering costs of cross-border trade in services. Quantifying the degree of policy barriers to trade in services is complex, but estimates indicate that such barriers to services trade remain substantially higher than for trade in manufactures (Borchert *et al.* 2014); barriers to global manufactures trade have fallen significantly from the 1990s whilst services trade barriers appear little changed over the same period (Miroudot *et al.* 2013). As such, there is much greater potential for liberalisation of services trade both globally and specifically in Europe), although barriers to

services trade do not appear high enough to explain most of the current account deficit in economies like the UK (Boz *et al.*, 2018). The Single Market has promoted integration amongst services markets within the EU (Mustilli and Pelkmans 2013), although integration has gone significantly further with trade in goods and the European Commission has regularly noted the limited development of a single market in services. Successive British governments have pushed for deepening of the Single Market to promote services trade within the EU; Brexit, by contrast, threatens to undermine Britain's position in the EU market for services assuming that it would entail leaving the Single Market. Rest of the world services exporters face significantly higher barriers than EU members (Benz & Gonzales 2019). Estimates indicate that withdrawal from the Single Market itself could cost the UK services sector up to 2 per cent of GDP (CEBR 2017, Emmerson *et al.* 2016). The political economy here is unlikely to be helpful to a post-Brexit UK. The British government itself has ambitious, if somewhat vague objectives, for negotiating further trading arrangements, including in services. Global negotiations for liberalisation through the WTO are effectively stuck, though; the EU is currently party to negotiations of 23 WTO members for a Trade in Services Agreement (TiSA), countries that together account for 70 per cent of world services trade. However, TiSA negotiations were formally initiated in 2013 and progress has been limited and the EU currently notes that 'Negotiations are now on hold and are expected to resume when the political context allows. There is no formally set deadline for ending the negotiations'. The position of the City of London faces competitive challenges, although it is likely that the City would still be able to retain much of its business post-Brexit, given the longstanding advantages London has in its time-zone (SPERI 2017). There would be limited incentives for the EU-27 to negotiate a bespoke trade agreement that largely preserved the UK's access to EU services markets. The complexities of trade negotiations militate against concluding agreements for liberalising services trade agreements with non-EU countries. British services exports beyond the traditional markets of Europe and North America remain relatively small. India apart, the UK has relatively low services exports to the major emerging economies. There is a particular issue here that services trade frequently requires mobility of labour given the nature of the product and the requirement for interaction between suppliers and consumers; the tradable services industry has also been a key employer of foreign labour. Recent European integration has arguably played a key role here in providing a supply of migrant labour for both the highest end of the services (cf. Coulter 2018). Any post-Brexit arrangements designed to limit migration into the UK would therefore be unlikely to undermine expansion of services trade and the negotiation of trade deals.

Broader global trends may also have become less favourable here. Before the financial crisis the continuation of globalisation processes was largely assumed; since then, although services trade has been more resilient than trade in goods there has been a downturn in global trade since the crisis. There has been clear retrenchment of financial globalisation since the crisis; although this primarily reflects a decline in international capital flows, particularly cross-border banking, this may also impact on commercial services trade more generally (Credit Suisse Research Institute 2017, Forbes 2014, McKinsey 2016). Developed economies are currently dominant in commercial services trade; growth in emerging market economies may erode developed countries' competitive advantage here. The assumption of continued strong growth in global services trade, and with it demand for UK exports, may not hold. This of course is in the context of rising global protectionism.

The importance of value chains and the potential disruption through Brexit has been widely noted also potentially leads to disruption of supply chains in the UK. As noted majority of the UK's trade in goods and services with the EU is in intermediates, reflecting integration

with European supply chains, and these exports and imports have grown during the current century. Reportedly 63 per cent of supply chain managers in the EU27 with UK suppliers are planning to move some of their supply chains from the UK and around 40 per cent of British companies are looking to move away from EU suppliers.<sup>8</sup> For most key. Although widely acknowledged, standard modelling of trade flows – including that underlying key forecasts of the effects of Brexit – remain based around models of final goods trade. Explicit modelling of supply chains does point to similar losses from other studies, although this is dependent on the degree of substitutability of imported inputs with alternative supplies (Giammetti 2019). This could potentially ameliorate the effects. Importantly here full modelling of the effects of disruption indicate that in absolute terms potential losses could be of similar size for the EU27 for the UK, with concentrations in particular economies and industries.

It should be noted that the impacts here will critically depend on a small number of firms. Around half of the UK's outward FDI stock is accounted for by 25 multinational companies, with 25 overseas multinationals accounting for a third of the inward investment stock in the UK (ONS 2016). The majority of the fall in FDI earnings that led to the deterioration of the current account position since 2011 was due to the top 5 per cent of multinationals. Similarly the top 1 per cent of UK exporting companies account for around a quarter of total British exports and the top 5 per cent account for more than half (Marin *et al.* 2015). As already noted British companies are relatively oriented to non-EU markets and suppliers; the medium term effects of Brexit will depend on the strategic decisions of a small number of major companies.

## 5. Conclusions

When the UK belatedly acceded to the EEC, British industry had been held back in the post-war period by its orientation towards traditional, slow growing imperial markets at a time when Europe had experienced *les trentes glorieuses*, with a particularly strong rise in trade (Owen 1999). The Brexit process is being undertaken at a time when the UK is running a large current account deficit, despite subdued economic activity and sterling depreciation since the referendum result. Productivity growth and living standards have stagnated. A weak external balance position is a corollary of the British growth model that has emerged from the 1980s – periodic private consumption booms leading to a deterioration of the current account and a financial sector that has accumulated high past debts. Underlying this is an economy characterised by high inequality and latterly stagnating real wages. Deindustrialisation left the UK with a relatively weak manufacturing sector; this was only partially offset by a sustained improvement in the services trade balance. The rise in inequality to high levels from the 1980s reflected a combination of structural changes and policy choices; deindustrialisation and the rise of the financial services sector have raised inequality, both personal and regional. The current account was previously supported by surpluses on the primary income balance reflecting a favourable rate of returns differential on British overseas assets, but this may have been eroded as Britain's net international investment position has weakened. Balance of payments disequilibrium is one key manifestation of the problems of sustainability of the UK model; Brexit is likely to aggravate this. A key mechanism for adjustment since the financial crisis has been the depreciation of sterling; this has only had a limited effect on stimulating exports, but has been significant in squeezing living standards. Any continued current account deficit requires funding. Although the UK has continued to attract inward investment since the Brexit vote to offset the deficit, these inflows may not continue at current levels and there



are already indicators of a shift away from the UK in FDI. The most recent figures indicate a marked disinvestment in equity capital. Quantitative easing by the ECB has indirectly created net demand for UK securities by Euro zone investors from 2014,<sup>9</sup> but this presumably would fall as the programme is tapered. Over the medium term, although Britain's has been able to attract FDI inflows to cover current account deficits, this may weaken as Brexit makes the UK a substantially less attractive location for overseas companies.

Overall Brexit poses major challenges to Britain's external balance. Whatever the final settlement, trade is particularly vulnerable in key areas – Britain's strong position in commercial services trade, not least with the EU, is likely to be undermined. The UK is thus likely to continue to run a current account deficit. The UK has been able to attract inward investment as an EU member with access to the Single Market; leaving the Single Market is likely to undermine this. Britain's weak external position reflects weaknesses in its underlying economic model; Brexit is likely to worsen this. A fall in sterling is unlikely to be sufficient to boost net exports sufficiently. This vulnerability goes beyond trade. The UK will either need to attract inflows on the capital account to offset the current account deficit or adjust through a further depreciation of sterling. Further, current account developments crucially reflect changes in the primary income balance as well as goods and services – if the UK relative returns differential has fallen and foreign investors respond to Brexit by increasing the risk premium required on investment in the UK then this would erode further any positive rates of return differential.

It is unlikely that Brexit will lead to a sudden stop balance of payments crisis of the type seen in emerging economies in the 1990s. There remains strong demand for UK gilts and as yet no indicators of a rise in the risk premium, whilst outstanding UK government debt is relatively long-dated; there is some limited evidence of rising costs for private debt. There are a few precise precedents for a policy change in a developed economy of this magnitude. A post-Brexit settlement that largely preserved market access could lead to relatively small losses. One that leads to significant disruption of financial services trade and production networks could potentially lead to losses comparable to a major recession. Whilst past precedents of major adjustment to balance of payments disequilibrium amongst developed economies are limited, they do point to much of this occurring through pressure on living standards and/or further fiscal austerity.

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<sup>1</sup> Clarida *et al.* (2007) cite studies indicating that a threshold in the 4-5 per cent range also holds for developed economies, although their own estimates suggest that for the US at least such a deficit is likely to be sustainable.

<sup>2</sup> Even here the data is subject to margins of error – both the UK and US report surpluses in services trade with each other which cannot simply be explained by reporting differences and there are significant discrepancies in services trade figures between the UK and several EU economies including the Irish Republic. See ONS, Asymmetries in trade data - diving deeper into UK bilateral trade data:  
<https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/articles/asymmetriesintradedatadivingdeeperintoukbilateraltradedata/2018-01-29>

<sup>3</sup> An expansion by current account surplus countries could also operate to rebalance payments positions.

<sup>4</sup>  
<https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/balanceofpayments/apriltojune2017>

<sup>5</sup> See the ONS analysis at:

<https://www.ons.gov.uk/economy/inflationandpriceindices/articles/theimpactofsterlingdevaluationonpricesandturnoverinthemanufacturingsector/2017-09-15>

<sup>6</sup> The OBR also predicts that the government will be unable to reduce immigration to its target levels.

<sup>7</sup> This is supported by broader surveys of the evidence: 'the evidence on the effects of trade and FDI on productivity are decidedly mixed and nonrobust' (Wolff 2014: 366).

<sup>8</sup> Chris Giles, 'UK-EU supply chains begin to break amid Brexit trade fears', *Financial Times*, November 6, 2017.

<sup>9</sup> See ECB figures for purchases by investors in the Eurozone:

<https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170711.en.html>