THE
ECONOMY 2030
INQUIRY
SHAPING A DECADE OF CHANGE

Trading places

Brexit and the path to longer-term improvements in living standards

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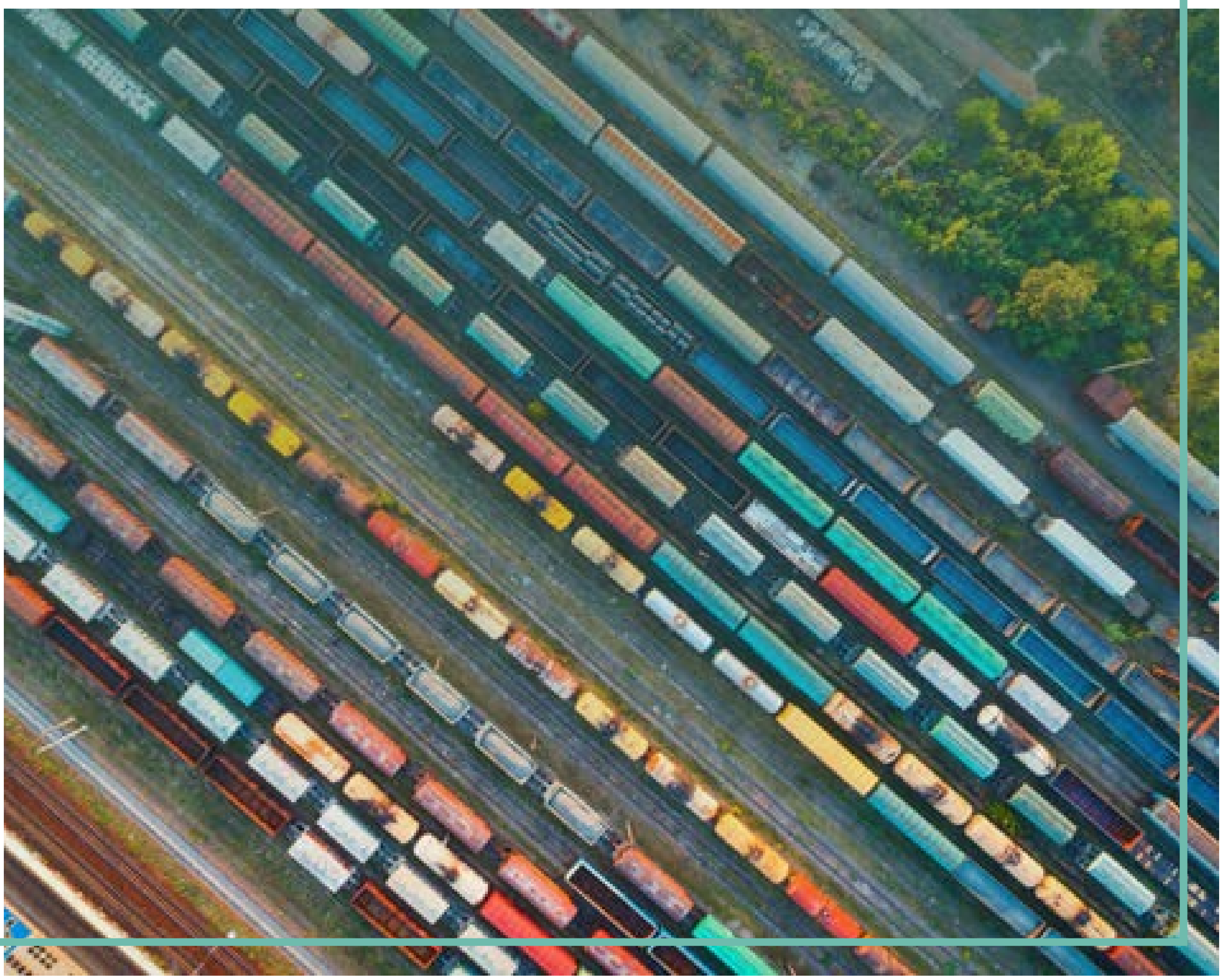

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The Economy 2030 Inquiry

The Economy 2030 Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics, funded by the Nuffield Foundation. The Inquiry's subject matter is the nature, scale, and context for the economic change facing the UK during the 2020s. Its goal is not just to describe the change that Covid-19, Brexit, the Net Zero transition and technology will bring, but to help the country and its policy makers better understand and navigate it against a backdrop of low productivity and high inequality. To achieve these aims the Inquiry is leading a two-year national conversation on the future of the UK economy, bridging rigorous research, public involvement and concrete proposals. The work of the Inquiry will be brought together in a final report in 2023 that will set out a renewed economic strategy for the UK to enable the country to successfully navigate the decade ahead, with proposals to drive strong, sustainable and equitable growth, and significant improvements to people's living standards and well-being.

The Nuffield Foundation

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Summary

Exit from the EU has catapulted the UK into the most significant debate on the future of international trade in half a century. But that political and policy debate is currently preoccupied with individual trade deals that the UK can now pursue. Largely ignored are the big questions that such a fundamental shift in openness of the UK economy poses for the shape of our economy, the nature of jobs for millions and our prosperity. So, as well as focussing on potential new trade deals, we need to step back to consider the fundamental goals of a new economic policy agenda and to examine the wider changes brought about by Brexit which, along with net zero and the fallout from Covid-19, mean that the 2020s will be a decisive decade for the UK economy. How those changes can be managed, and how the UK's economic strategy should be reshaped in their light, is the motivation for The Economy 2030 Inquiry to which this paper is a contribution.[1]

History shows us that major shifts in the level and nature of openness have big direct impacts on people, places and firms, but they are also intertwined with the overall economic strategy of the country, reshaping it whether intentionally or not. In this paper we present evidence that the direct impacts of leaving the EU have started to materialise, but the accompanying more fundamental implications for the UK's economy have not. This means that now is the time to ask the most important questions Brexit brings: how open the UK should be; whether to maintain the existing economic strategy, or change it; and how the UK should position itself in a world trading system dominated by three major trading blocs. In asking these questions we focus on openness to trade and investment, we will return to the issue of migration policy in a future paper.

The past: previous shifts in UK openness drove large direct effects and reshaped the UK's economic strategy

The last big debate about UK openness – leading to the UK joining the EU – led to marked changes to the size and nature of trade flows and to a new political and economic context that shaped the country's economic strategy.

Joining the EU increased both the overall level of UK trade and the share of trade with the EU and contributed to the increased specialisation of the UK in exporting services over goods. The UK's share of total Economic Communities (EC) trade, the predecessor of the EU, increased by 3 percentage points between 1972 and 1990 and the pace of average annual trade growth with the EU outpaced non-EU trade growth between 1973 and 1990 by around 4 percentage points. Some of this came at the expense of trade

1 *The Economy 2030 Inquiry* is a two-year project, which is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics (LSE), funded by the Nuffield Foundation, to explore the nature of economic change that the UK is living through, and start a national conversation about what this means for people, places and firms.

with the Commonwealth – with countries such as New Zealand, who had been sending around 50 per cent of their exports to the UK in the 1960s – being forced to redesign their economic strategies.

But the past also shows us, that in addition to these direct impacts, such large-scale changes to openness also leads to shifts in the country's overall economic strategy. Increased competition and flows of foreign investment were encouraged to increase firm innovation and productivity – particularly in UK manufacturing that had been flagging relative to overseas competitors.

Increased openness also allowed the UK to specialise in high-value tradeable services – in line with its comparative advantage. This led to relatively large increases in services exports as a share of GDP, which grew by 9 percentage points between 1972 and 2019, compared to growth of 5 percentage points on average for the rest of the OECD. Measured in value-added terms, nearly £7 in every £10 of UK exports (68.5 per cent) was services. This is well above the OECD average of just over half.

The UK became one of the most attractive Foreign Direct Investment (FDI) destinations, given access to the EU market and government focus on removing restrictions to capital flows and creating a stable investment environment. The UK attracted 6 per cent of total FDI inflows between 1990 and 2019, outstripping its share of global GDP. In addition, both inflows as a share of capital formation and FDI stock as a share of GDP were above the EU and developed countries' average.

On the face of it the strategy of driving faster productivity growth through increased competition, specialisation in services and FDI inflows was successful as the UK's relative economic performance improved. The productivity gap with France and Germany, which had been widening up to 1975, stopped growing as the UK kept pace with Europe over the following decade and even closed some of the gap with the US. There was then a sustained period of two decades in which the UK caught up to its peers.

But while the disruptive effects of this transition were widespread across the country, the new opportunities from expansion of tradeable services and FDI were concentrated in London and the South of England. Regional inequality increased markedly between 1975 and 1990: the variance in household incomes across regions and nations of the UK increased by around 9 percentage points. Moreover, the shift in employment from manufacturing to services was associated with a shift in the nature of job opportunities with lower skilled workers losing out on 'wage premiums' for manufacturing jobs.

The present: the direct Brexit impact is already evident but the longer-term economic implications remain ahead of us

Brexit represents one of the most significant shifts to international trade and investment policy across the world. It is also highly unusual in that Brexit will increase barriers to trade with the UK's largest trading partner. Given history shows that we should expect both significant direct impacts, as well as disruption to the UK's current economic strategy, are such effects already evident?

The data so far suggest that the direct impacts from the changes to the UK's closest trading relationship have already been substantial.

It is clear that investment, prices and real wages have all been affected. Financial and currency markets were the first to respond after the referendum. In its aftermath, sterling depreciated by around 10 per cent on a trade weighted basis leading to higher prices and falling real wages. The depreciation is estimated to have increased prices faced by consumers by 2.9 per cent, equivalent to an £870 increase in the cost of living per year for the average household. For firms, the referendum increased uncertainty, providing an unwelcome headwind to investment. Even by December 2020 the prospect of a 'no deal' Brexit had not been ruled out, with just 59 per cent of businesses saying that they were at least somewhat prepared for that eventuality. This increased uncertainty weighed on investment, which has slowed with average quarterly investment growth in the three years post-referendum falling to -0.1 per cent, compared to 1.7 per cent in the three years pre-referendum.

And early data for 2021 suggest that the implementation of the Trade and Cooperation Agreement (TCA) with the EU has prompted changes to trade flows. Goods and services trade with the EU have fallen by between 10 and 20 per cent relative to non-EU trade this year, a clear break with the close past relationship between such trade flows. But UK firms are starting to report fewer challenges to exporting attributed mainly to the end of the EU transition period, indicating they may have started to adapt to the new arrangement. Taken together it appears that direct effects of Brexit on trade flows are materialising, although the impacts have been compounded by the impact of Covid-19 on global trade flows.

Looking ahead, however, the longer-term implications of Brexit for the UK's economic strategy will take time to become clear.

The future: to make a success of Brexit policy makers must respond to reality of a less open economy and recognise the realities of the global trading system

The policy debate is fixated on the nuts and bolts of the individual trade deals that may be possible after Brexit. But such a debate misses the more important issues. Focusing on individual deals presupposes the UK is on a path towards becoming more open, without asking the fundamental question: how open should the economy be? In turn, any decision on how to approach openness must be informed by the question of whether to maintain the existing economic strategy, or change it? Here it is crucial that any change in strategy be grounded in the realities of the world trading system. For this reason, we must also ask what is the UK's place in the world trading system; as geopolitical tensions escalate among the world's trading superpowers, where does 'Global Britain' fit in? The answers to these three fundamental questions about where the UK is heading will govern what policy makers should do today.

How open should the UK economy be?

It is clear that policy makers are focussed on striking bilateral trade agreements as quickly as possible. The Government is ambitious in this regard – signalling that it is aiming for trade agreements covering 80 per cent of UK trade by the end of the 2022. The first phase involved frantically negotiating agreements which rollover those the UK benefited from as part of EU membership. In this respect there has been success with over 60 per cent of trade now covered by existing trade deals.

Much has also been made of new deals that may be in the offing. This is at least in part because such deals are popular with the UK public. According to Government surveys around three quarters of the public supports the UK pursuing free trade agreements, with only 8 per cent against. A trade deal with the US is often held up as one of the major opportunities of leaving the EU. The US made up 16 per cent of UK trade in 2019, by far the largest trading partner outside of the EU (the next largest partner is China with 6 per cent of UK trade in 2019). So, it can be no surprise that no time has been lost in launching negotiations with the US. Unfortunately, however, the current US administration has taken a decision not to pursue new trade agreements and paused negotiations with the UK indefinitely. In response, the Government's new priority appears to be attempting to capture the trade opportunities created by the growing middle class in the Asia-Pacific region. In this context, there has been a lot of debate about the implications of trade deals with Australia and New Zealand, particularly for farming. This will, however, do little to offset the substantial loss of EU market access, particularly in the short run. This is because trade with Asia and Australasia is smaller (just 22 per cent of UK trade in 2019, a quarter of which was with China, less than half the trade the UK does with the EU).

The current trade strategy does not show clear signs of prioritising services liberalisation, despite the highly specialised nature of the UK economy in exporting services. A service orientated trade strategy would instead prioritise reopening deals with our largest export markets for services (in the continued absence of a US deal). However, delivering deep services liberalisation remains highly challenging. Even the EU's most ambitious free trade agreements on services to date have managed very little liberalisation of current barriers to trade relative to the liberalisation within the Single Market. According to Government analysis, using the OECD Services Trade Restrictiveness Index (STRI), the UK's deal with Canada reduced a tiny fraction, significantly less than 1 per cent, of the barriers to services liberalised within the EU. As a result, negotiations would be slow as they require difficult trade-offs, for example on the freedom of movement of people. This is incompatible with rapidly delivering deals to reach the Government aim of covering 80 per cent of trade with trade agreements.

All this adds up to a limited scope for increasing openness beyond the EU given the limited availability of willing partners. The reality, then, is that leaving the EU will ultimately make the UK less open. The priority moving forward must be recognising that the economic strategy and international positioning of the UK must be revaluated in this context.

What does reduced openness mean for the UK's economic strategy?

EU membership has been a cornerstone of the UK's economic strategy and a key challenge for this decade is deciding what replaces that. A less open economy means that the strategy of driving increases in productivity and prosperity through EU competition and FDI inflows will no longer be available to the same extent. Despite the significant direct impacts already seen, the Government position has been to downplay the scale of trade policy change implied by Brexit, and therefore the impact that might have for the UK's economic strategy. This is in marked contrast to the Prime Minister's argument that the UK's new migration regime post-Brexit will be a key driver of change to our economic model, with an end to the availability of lower-paid migrant labour forcing firms to invest and driving "a high wage, high skill, high productivity" economy.

It is true there are relatively few signs of a fundamental shift in the structure or drivers of productivity of the UK economy as yet. For example, although there is evidence the referendum caused a reduction in inward FDI transactions to the UK, and increased outward FDI transactions into the EU, overall inflows have not yet fallen anywhere near as far as feared yet (around 20 per cent).

But such a significant shift in the degree and nature of openness will matter for the shape of the UK economy in the longer term. Trade policy has differential effects across jobs, industries, and regions. For example, the Government's own analysis of EU exit indicates that Brexit will lead to larger relative declines in output and an associated movement of jobs out of sectors including chemicals, motor vehicles, agri-food and financial services. The chemical sector, for example, is expected to be almost 20 per cent smaller in GVA terms than within the EU.

In time policy makers will need to decide how to respond to these pressures for change. This will include knowing whether we are aiming to maintain the status quo amid less openness – for example with more support for sectors adversely affected – or choose to embrace some refashioning of our economic strategy to reflect this new reality. There are early signs of areas where politicians are keener to embrace change, although not always with a desire to raise productivity. This is important because productivity growth is the ultimate driver of the higher wage economy the Prime Minister wants to see. Sectorally, political preferences have shifted from wishing to build on the UK's comparative advantage in tradable services to a desire for manufacturing to play a greater role in the UK economy. Insofar as that involves fewer service exports and more manufacturing for a domestic market, it may go with the grain of Brexit's impact as well as the cross-party consensus in favour of rebalancing regional economic activity, albeit at the price of lower productivity in aggregate. For the past four decades active support for FDI and foreign ownership of UK firms has been an explicit part of the UK's economic strategy, supporting higher productivity via capital and better management. That support appears to be becoming more ambiguous, with the Government undertaking consultations on the handling of mergers, indicating a desire to take a more interventionist approach. Again, this would go with the grain of the impact of Brexit.

Of course, a new strategy would ideally be about more than embracing some elements of change that, however desirable, are likely to push down on productivity. Indeed, it should explicitly aim to scale up alternative productivity drivers, to mitigate the impacts of reduced openness on competition and diffusion of overseas innovation through investment. There are signs the Government believes this could come from regulatory reform, where the objective is to give UK firms competitive advantages via a more flexible and agile regime. There is scope for a different approach now the UK has left the EU, although it is not clear that substantial gains in this area are possible if the focus is simply on having less regulation. The UK is already ranked as having the lowest level of product market regulation among OECD countries. Indeed, rather than a smaller role for the state, the indicators are that the Government favours a more active, interventionist role. The establishment of the UK Infrastructure Bank, which has seen the UK take an equity stake in a number of start-up businesses across a variety of sectors, suggests that there is an intention to proactively promote private sector investment and innovation. This requires institutional infrastructure to ascertain and monitor the productivity benefits from the use of public monies and is likely to be successful when there are clear objectives to the overall economic strategy that the government intervention is seeking to achieve. How an approach that favours more regulatory nimbleness and state activism will be institutionalised to maximise any benefits and avoid capture by particular private interests remains to be seen.

What is the UK's place in the world?

It is important to recognise that the UK will not be setting its policy in isolation, rather it must set its post-Brexit course in the emerging new era of global geopolitics. The UK is leaving the EU during an era of trade defined by the actions of three highly connected but increasingly competitive superpowers – the EU, the US and China – which together make up almost 60 per cent of world GDP. China's successful export-led growth model has made it the largest source of imports to both the EU and the US. The three global powers are also deeply economically connected through cross-border supply chains and the ownership of debt. Almost 20 per cent of the foreign content of US exports comes from China. And China holds over $1 trillion of US debt, making it the second largest foreign owner of such debt after Japan. This shows how interconnected these global powers have become.

However, current trading relations between the three are tense and complex. The US introduced a number of retaliatory tariffs on Chinese and EU goods in 2018 and 2019 respectively, put in place in response to claimed violations of WTO intellectual property and subsidy rules, many of which have not been revoked by the Biden administration. Both responded with their own retaliatory tariffs against the US. The EU also implemented or sought to introduce a range of policies, including changes to rules on digital localisation and a new digital tax, that were seen as aggressive new trade barriers for large US tech firms, despite being designed to address data privacy and tax avoidance issues.

The UK's position, in the past, was to a large extent governed by collective agreement of the EU, including where and when to use retaliatory tariffs and where and when to deescalate tensions. Now the UK must decide its position independently, accounting for the fact these three global trade superpowers account for almost 70 per cent of UK trade. The UK may want to minimise any further disruption to trade with any of its major partners as it adjusts to the change in openness with the EU, but the UK risks being caught up in rising US-China tensions.

The Government seems to be aiming to align politically with the US, at the expense of China and the EU. This is demonstrated by stepping up collaboration on security, for example UK membership of AUSUK that aligns the UK with the US (and Australia) against China. The UK is also ramping up bilateral action against China, due to rising concerns about Chinese involvement in critical national infrastructure, including banning Chinese firms from delivering 5G networks and nuclear power services. The EU-UK relationship remains strained following the Brexit negotiations, with unresolved issues around the Northern Ireland protocol a continuing source of tension.

However, the extent to which this approach is compatible with a trade strategy that appears to prioritise liberalising with and promoting Asia-Pacific trade is questionable. The current US administration does not present an opportunity for liberalisation of trade. However, China requesting to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which the UK has already applied to join, could force the UK to directly confront this conflict. Alternative strategies open to the UK all come with strategic trade-offs. Continued alignment with the EU, in the absence of a US deal being available, might be most valuable from a trade perspective – but runs directly counter to the Government's objectives of securing trade and regulatory freedoms. Alternatively, the UK could tread the path commonly adopted by smaller very open economies: avoiding global tensions, remaining open to all and hoping to be the beneficiary of rising tensions and barriers to trade between the three main actors. Some economic models would suggest such a position would be economically advantageous, but operationalising it would likely involve sacrificing international influence and activism in a way that UK governments have historically been reluctant to do.

Starting to tackle the three big questions we pose above makes it clear in broad terms what the Government must do. First, policy makers must shift their focus away from individual trade deals and instead recognise the underlying reality that the UK will be a less open economy. Second, they must decide what the new economic strategy should be. And third, consider how to make this consistent with the global situation. In short, what is needed is a post-Brexit trade policy informed by an economic strategy.

The Economy 2030 Inquiry will deliver just that. But doing so with any specificity requires that we seek to further unpick the relationship between openness and the structure of the UK economy – including the impact of changes to the regime for migration. Over the next two years the Inquiry will investigate the nature of the economy today and the change to come and explore what this means for people, places and firms across the UK. We will also consider how the availability of trade deals with countries around the world could fit into a coherent strategy for generating lasting improvements in living standards. Most importantly, such evidence must inform wider thinking on how the UK economy will change given wider sources of economic change such as the pandemic and net zero, and how we can successfully shape the decisive decade ahead.

Introduction: Brexit and the UK's economic future

The Brexit debate has become stuck in the wrong place. The referendum has pushed the UK's relationship with the rest of the world to front of mind for the first time in half a century. But the political and policy debate has become mired in the nuts and bolts of individual trade deals, overlooking the major structural adjustments that will change the context in which the UK's economic strategy is set. Leaving the EU will of course change the size and nature of trade flows, but because EU membership was inextricably linked with many aspects of the country's overall economic strategy. Leaving will reshape our economy way beyond its impact on trade – changing the nature of work and affecting prosperity. So, while individual deals are the means by which our relationship with the rest of the world takes shape, we need to step back to consider the fundamental changes brought about by Brexit. Along with the transition to net zero, and shifts brought about by the Covid-19 pandemic, Brexit will drive change for our economy during the 2020s. These changes provide the context to The Economy 2030 Inquiry, set up to consider how we reshape the UK's economic strategy in light of them.

To inform the debate on these key issues, we start by presenting evidence on how past integration with the EU had changed the economy, and the broader impacts on the UK's economic strategy. We then analyse how the situation has changed since the referendum before turning a discussion of the big issues that matter for the future of the country and so should dominate the debate.

The past: previous shifts in UK openness drove large direct effects and shaped the UK's economic strategy

Joining the EU represented a change in the extent and nature of openness of the UK economy, and shows us that these shifts not only create substantial direct impacts, they can shape the country's economic strategy. Understanding the experience of the past is vital to informing the big debate about the future of openness.

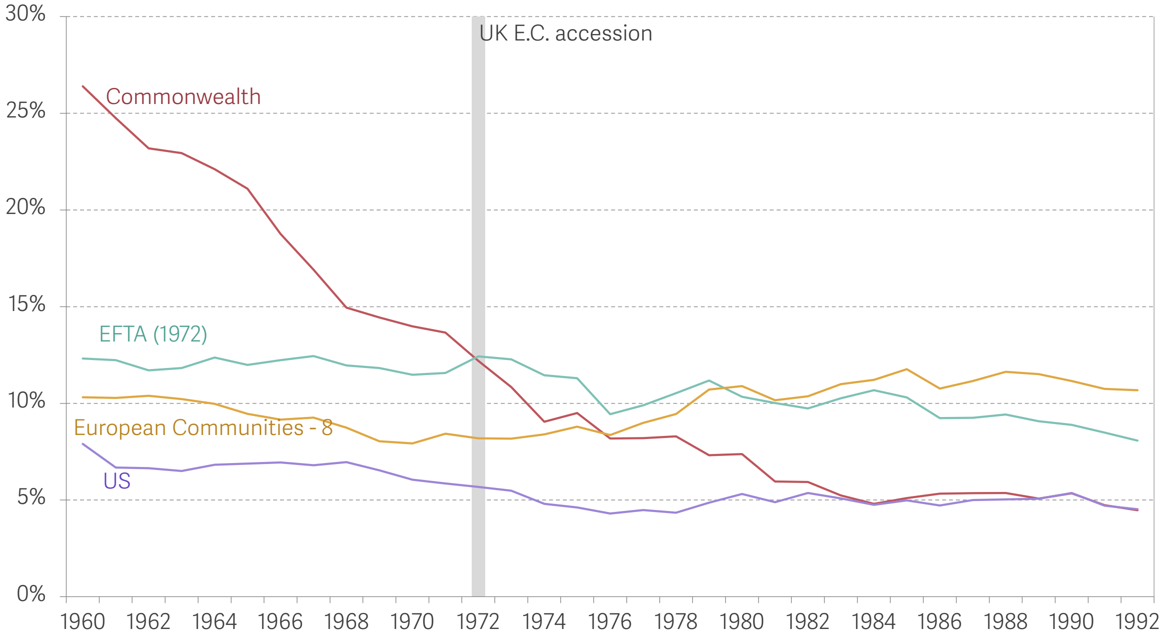
EU integration led to large direct impacts on UK trade which brought down prices

The UK's integration with the EU led to changes in both the relative and absolute levels of trade with Europe. Figure 1 shows that, following the accession of the UK to the forerunner to the EU (the European Community, or EC), there was a rise in the UK's share of total EC trade from 8 per cent in 1972 to 11 per cent by the end of the 1980s. As the relative openness with the EC increased, trade and the relative importance of the UK to EC trading partners grew, overtaking the UK's trade share with European Free Trade Area

(EFTA) states and the Commonwealth in 1978 and 1980 respectively.[2] The pace of growth in trade with the EU outstripped the UK's average trade growth between 1970 and 1999, with average annual EU trade growth of 12 per cent, relative to annual average non-EU trade growth of 10 per cent. As trade with the Commonwealth fell, countries such as New Zealand, who had previously been able to send around 50 per cent of their exports to the UK, had to adapt their own economic strategies.[3]

FIGURE 1: **Economic integration reshaped global trading patterns**

Share of EC8, EFTA, USA and the Commonwealths goods trade with the UK



Notes: EC8 is the eight countries (France, West Germany, Italy, Belgium, Luxembourg, Netherlands, Ireland and Denmark) which were EC members when the UK joined. Germany is included, as separate data is not available for West Germany. EFTA includes the countries that were part of the EFTA agreement in 1972 (Austria, Norway, Portugal, Sweden and Switzerland).

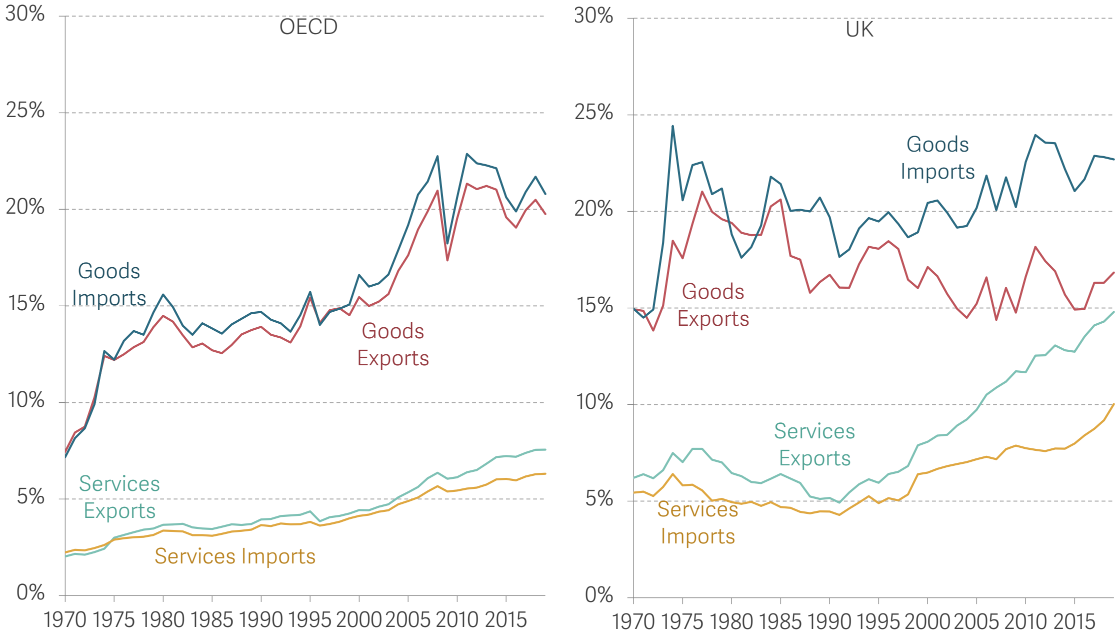
SOURCE: Analysis of IMF imports and exports to counterpart countries data.

The nature of UK trade also changed profoundly. Figure 2 shows how UK trade evolved compared with average OECD trends. Trade grew rapidly through the 1970s across OECD countries, driven by increasing global integration through initiatives such as the General Agreement on Tariffs and Trade (GATT), and technological advances that reduced transport costs. The UK experienced a sharp increase in both imports and exports in 1973, when it joined the EC, a trend that was particularly pronounced for imports of goods.

2 Commonwealth trade will of course also have been affected by changes to those countries' trade strategies over this period.
3 K Grier & M Munger, Breaking up is hard to do: Lessons from the strange case of New Zealand, Social Science Quarterly, 2021.

FIGURE 2: **Import competition and the growth of services**

Goods and services exports and imports as a share of GDP



NOTES: The set of countries included in the OECD excludes those with missing data over the period.
SOURCE: World Bank Trade and Services Exports and Imports as a share of GDP.

The change in openness also led to a renewed economic strategy

More importantly, the past shows us that changes to UK openness not only have a direct impact on the economy, but can also alter the context in which the country sets its economic strategy.

The change in openness brought about by EU membership became a foundation of the Government's strategy to address weak productivity in the UK manufacturing sector. Increased imports from the EU brought down prices by reducing mark-ups and created more choice to consumers.[4] This new approach exposed UK firms to foreign competition from the EU, driving the most unproductive firms out of business, and forcing others to invest and seek efficiency gains in order to survive. In addition, it saw UK firms import foreign innovation by encouraging direct investment into the UK. This seems to have prompted an increase in firm-level innovation, resulting in productivity gains – particularly in UK manufacturing that had been flagging relative to overseas competitors.[5]

The increased openness also pushed the UK to deepen specialisation in high-value tradeable services. Figure 2 shows that growth of UK services exports was particularly strong growing as a share of GDP by 9 percentage points, considerably faster than for the OECD average (5 percentage points), between 1972 and 2019. While UK services

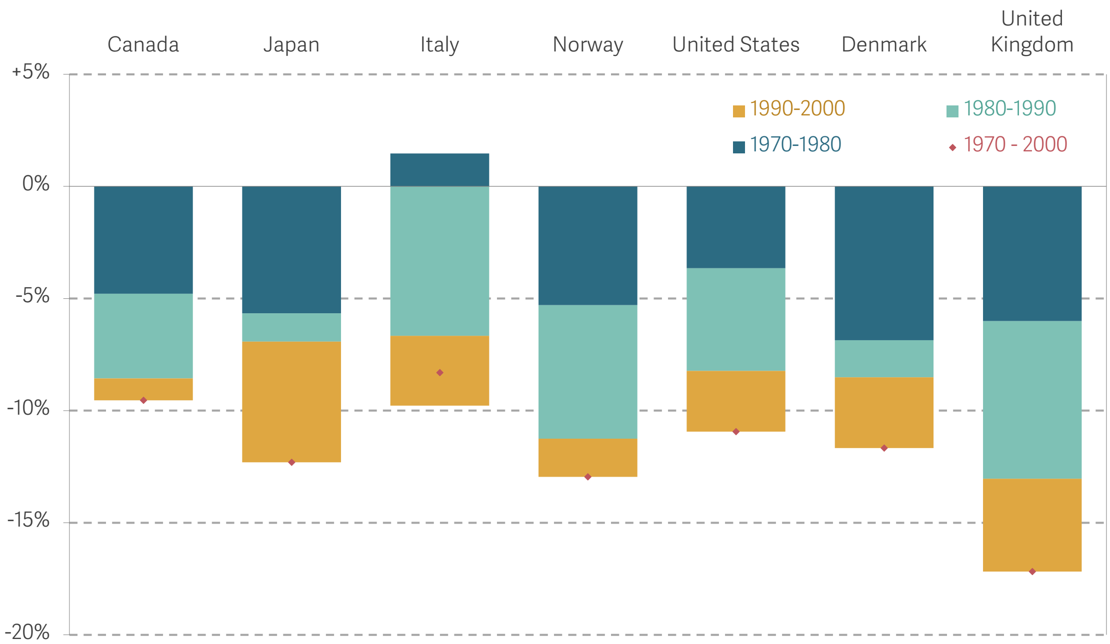
4 See: H Badinger, Has the EU's Single Market Programme Fostered Competition? Testing for a Decrease in Mark-up Ratios in EU Industries. Oxford Bulletin of Economics and Statistics, 69, 2007.
5 For supporting evidence, see: R Griffith, R Harrison & G Macartney, Product Market Reforms, Labour Market Institutions and Unemployment, The Economic Journal, 117, February 2006.

exports were approaching parity with goods exports, the average gap in the OECD was increasing. In value added terms, services exports were larger than goods exports in 2015, with nearly £7 in every £10 of UK exports (68.5 per cent) comprised of services, well above the average share for the OECD (54 per cent).[6] This was supported by the unique nature of openness within the EU which included freedom of movement of services at the core of the Single Market alongside other policies that supported services trade such as free movement of people and capital, as well as mutual recognition of standards, leading to much deeper liberalisation of services between members than was managed in any other free trade agreements.

All this has profoundly changed the nature of jobs in the UK. Indeed, the combination of increased competition from EU manufacturers and subsequent deeper transition from goods to services exports is likely to be a key factor behind the larger fall in UK manufacturing employment than in other comparable countries. Figure 3 shows that workers in the UK experienced the largest decline in the share of employment in manufacturing between 1970 and 1990 among advanced economies (for which comparable data is available).

FIGURE 3: **UK manufacturing employment declined by more than in other advanced countries**

Change in share of employment in manufacturing: 1970-2000



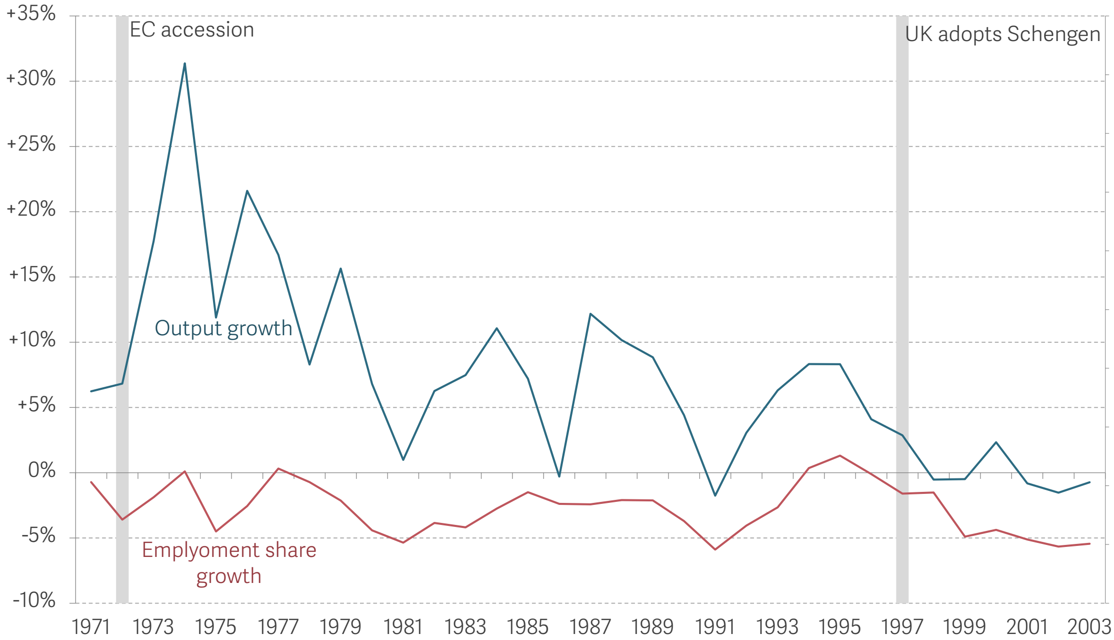
NOTES: Employment share calculated as employees in manufacturing over total for all industries. The chart includes all OECD countries for which data is available (with the exception of Germany which has been excluded because of the impact of reunification during the period shown).
SOURCE: Analysis of OECD STAN database ed2005.

6 Source: OECD, OECD Trade in Value Added Country Notes - United Kingdom, 2018.

Despite this significant fall in manufacturing employment, output continued to grow as shown in Figure 4, illustrating the scale of productivity gains in manufacturing sectors. This is consistent with opening to the EU leading to increased competition and overall higher levels of productivity. In this context, a number of studies have investigated this link finding a causal relationship between EU integration and higher productivity.[7]

FIGURE 4: **Manufacturing output increased even as employment fell**

Growth in employment and output in the manufacturing sector: UK



NOTES: Employment share calculated as employees in manufacturing as a proportion of all industries. Uses OECD STAN Ed2005 as it covers the period back to 1970, but stops at 2003.
SOURCE: Analysis of OECD STAN database ed2005.

EU membership and Government policy contributed to the UK becoming one of the world's most attractive FDI destinations

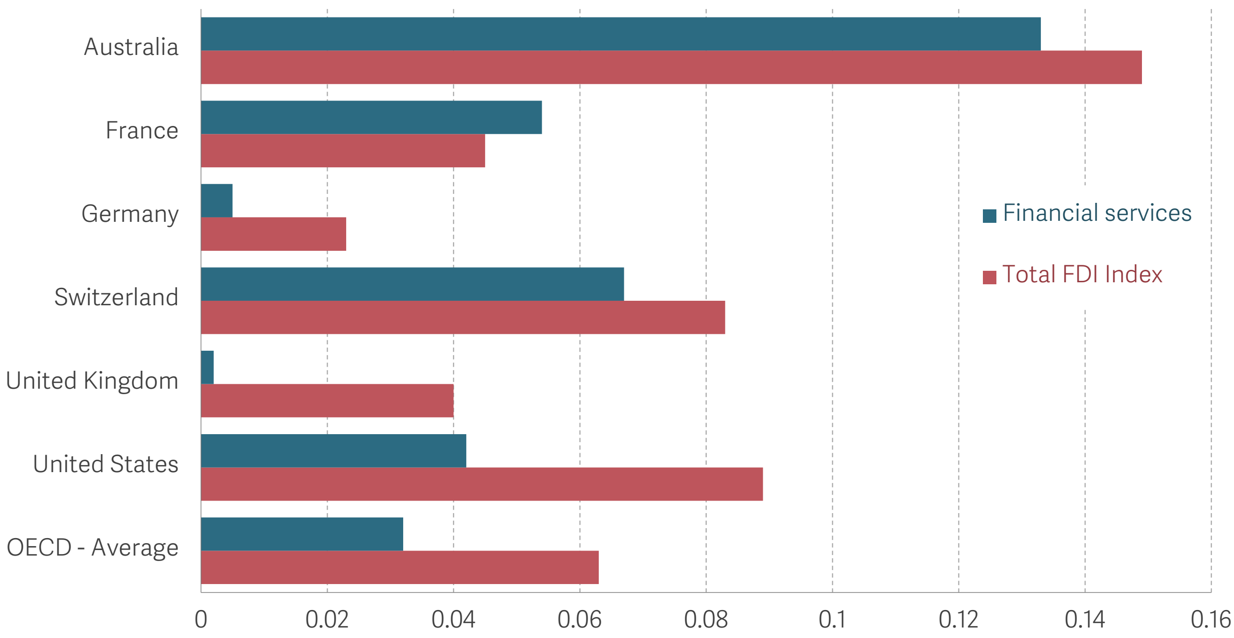
To reinforce the benefits of a large home market, the Government created an attractive regulatory environment for foreign investors by removing restrictions to foreign investment. Figure 5 shows an internationally comparable measure of the extent to which domestic regulatory regimes restrict inward foreign investment. It shows that UK restrictiveness is below the OECD average and below the level in many comparable countries, especially in financial services. Such low barriers helped make the UK more attractive for FDI but access to the EU market for UK firms was also a key factor: prior to

7 G Notaro, European Integration and Productivity: Exploring the Gains of the Single Market, January 2002; Griffith, Product market competition, efficiency and agency costs: An empirical analysis, IFS Working Papers, 2001.

the referendum, 72 per cent of investors cited 'access to the EU' as an important reason for investing in the UK and LSE research estimates that EU membership increased FDI inflows by 28 per cent.8

FIGURE 5: **The UK has removed restrictions to FDI, especially for financial services, to attract investment**

OECD FDI Regulatory Restrictiveness Index (Index between 0 completely open to 1 completely closed): 2020



SOURCE: OECD FDI Regulatory Restrictiveness Index.

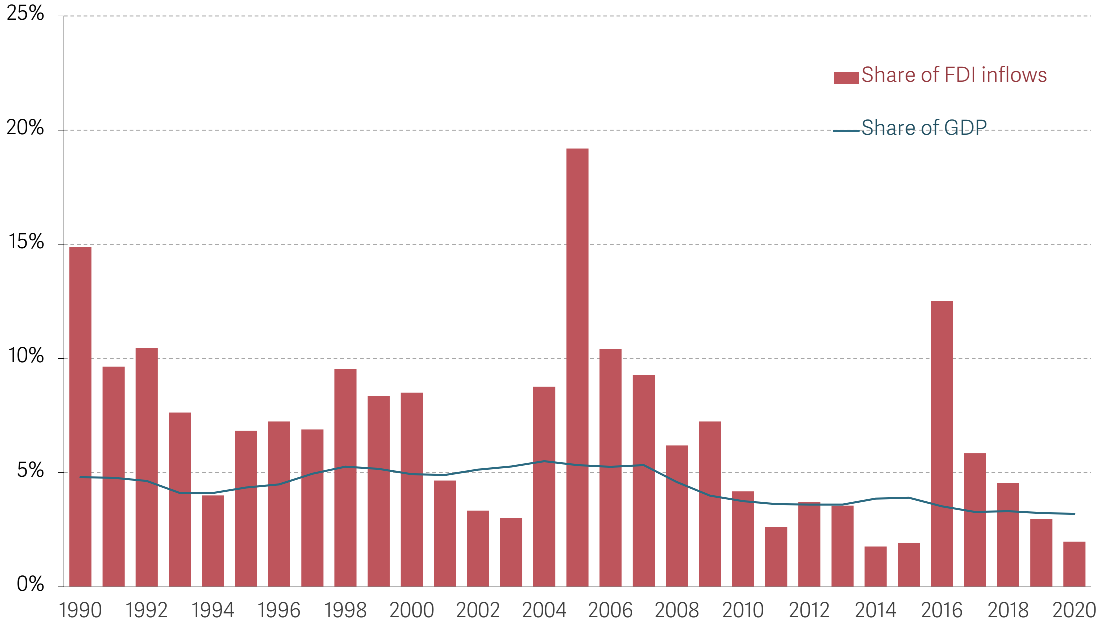
The UK attracted 6 per cent of global FDI inflows between 1990 and 2019, outstripping its share of global GDP (Figure 6). Measures of both inflows (inflows as a share of capital formation) and stocks (FDI stock as a share of GDP) of FDI point to a larger role for such investment in the UK compared to the EU and other advanced economies.[9]

This was also important in driving productivity improvements for UK firms. Companies in receipt of FDI in the UK are found to be around 75 per cent more productive than those which do not, controlling for other characteristics.[10] And multinationals have also been shown to boost productivity through enhanced technologies and management practices.[11] FDI in the UK has also been shown to have spill over benefits on productivity, employment and wages.[12]

8 S Dhingra et al., The impact of Brexit on foreign investment in the UK, CEP Brexit Analysis No. 3, April 2016.
9 Source: UNCTAD, World Investment Report Country Factsheet 2021, June 2021.
10 ONS, Foreign direct investment and labour productivity, a micro-data perspective: 2012 to 2015, October 2017.
11 N Bloom, R Sadun & J van Reenen, Americans Do IT Better: US Multinationals and the Productivity Miracle, American Economic Review, 102, 2012.
12 A Mathew et al., Understanding FDI and its impact in the United Kingdom for DIT's investment promotion activities and services, Department for International Trade, March 2021; J Haskel, S Pereira & M Slaughter, Does Inward Foreign Direct Investment Boost the Productivity of Domestic Firms?, Review of Economics and Statistics, 89, 2007.

FIGURE 6: **The UK has frequently attracted more than its expected share of FDI**

UK share of total FDI inflows and share of GDP (Current US$)



NOTES: FDI inflows, by region and economy, 1990–2020 and World Bank GDP (current US$) data.
SOURCE: Analysis of UNCTAD World Investment Report, Annex, Table 1. FDI inflows, by region and economy, 1990–2020 and World Bank GDP (current US$) data.

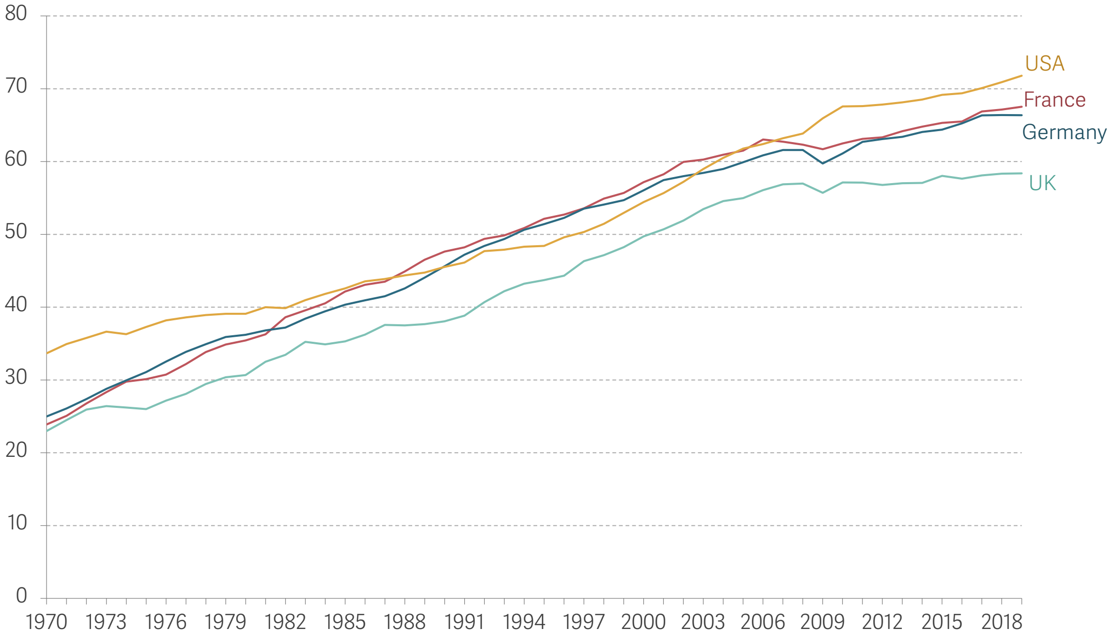
This strategy appears to have worked, but may have contributed to rising regional inequality

This strategy was successful insofar as it appears to have precipitated a period of productivity 'catch up' for the UK. Estimates suggest that the productivity gains driven by integration with the EU raised GDP by between 20-25 per cent higher, with between half and three quarters of the effect through increased investment with the remainder coming from an increased total factor productivity.[13] Indeed, as shown in Figure 7, the productivity gap with France and Germany, which had been widening up to 1975, flattened over the following decade as UK productivity growth kept pace with Europe and the UK was able to close some of the productivity gap with the US. The gap with France and Germany widened again in the early 1990s, before a sustained period of closing between 1996 and 2010. In the last decade, this gap has started to widen again, with the gap between the average productivity of Germany and France at the second highest level it's been and the gap with the US at the highest level.

13 N Campos, F Coricelli & L Moretti, Economic growth and political integration: Estimating the benefits from membership in the EU using the synthetic counterfactuals method, CEPR, Discussion Papers 9968, April 2014; H Badinger, Growth Effects of Economic Integration: Evidence from the EU Member States, Review of World Economics, 141, February 2005.

FIGURE 7: **The UKs growing productivity gap with Europe stabilised from the mid-1970s**

GDP per hour worked in US dollars, Purchasing Power Parity adjusted, 2010 prices: selected countries



NOTES: Chart taken from: HM Treasury, Build Back Better: Our Plan for Growth, March 2021.
SOURCE: OECD, GDP per capita and productivity growth.

But these gains have not been shared evenly across the country. Both tradeable services and FDI inflows are highly concentrated in London. In 2019, London accounted for 42 per cent of the UK's stock of inward FDI. It is well known that service industries benefit from agglomeration externalities – links on both the demand and supply side that provide incentives for services firms to locate in large cities.[14] Consistent with this, London accounts for 44 per cent of tradeable services exports in 2018, way more than its overall share in economic output (24 per cent). Figure 8 shows this has meant services exports as a share of GVA are concentrated in the highest income regions.

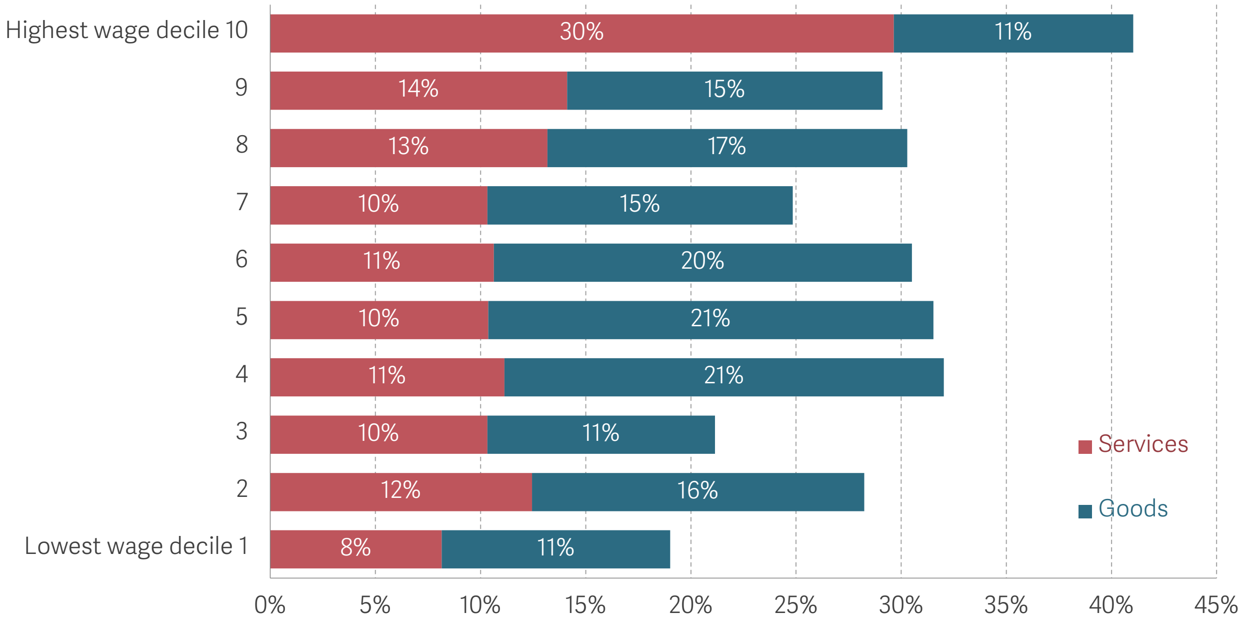
So, the pre-Brexit economic strategy is likely to have contributed to the rise in regional inequality. Attracting FDI flow to London and the South of England, likely pushed up incomes in those regions more quickly than elsewhere. Consistent with that, between 1975 and 1990, the variance in household incomes across regions and nations of the UK more than doubled.[15] These patterns were not unique to the UK, with many countries

14 D Autor, Work of the Past, Work of the Future, AEA Papers and Proceedings, American Economic Association, vol. 109, pages 1-32, May 2019.
15 S Clarke, Mapping Gaps, Resolution Foundation, July 2019.

facing similar, but smaller, challenges when transitioning from manufacturing to services, which had a much higher concentration in cities. However, the UK became "one of the most interregionally unequal countries in the industrialised world".[16]

FIGURE 8: **Tradeable services are concentrated in the highest income regions**

Goods and services exports as a share of GVA across regions grouped by real wage decile: 2018



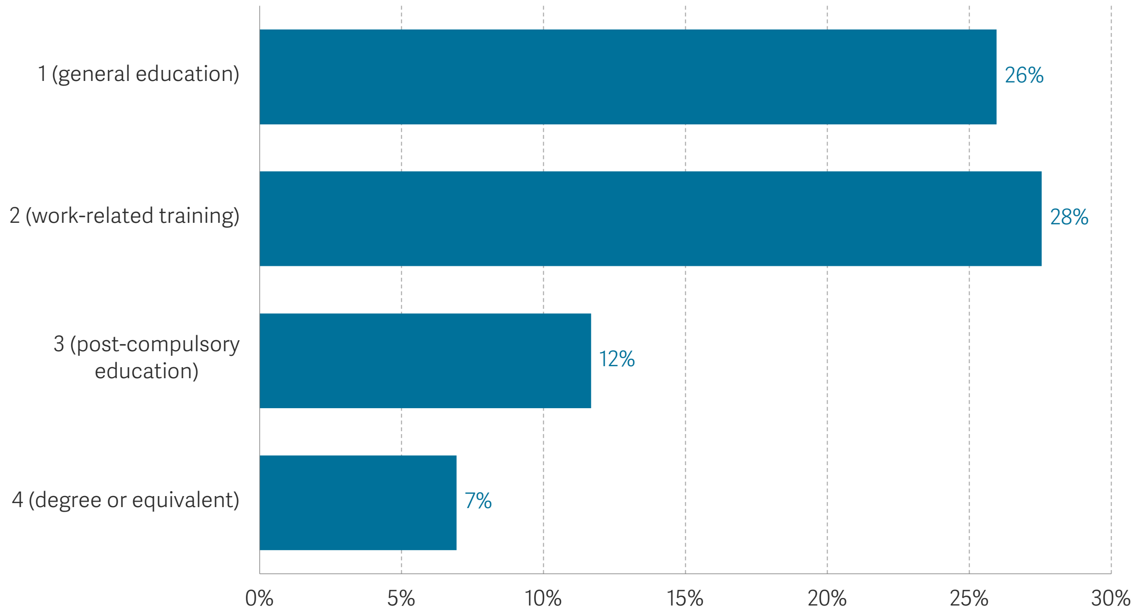
NOTES: Each NUTS region is assigned to a real income decile based on regional average real wages in 2018. The share of services and trade as a share GVA for that group of regions is calculated. Services excludes regions with no services trade data and Northern Irish regions for which no data available.
SOURCE: Analysis of ONS, International trade in services by subnational areas of the UK and ONS, UK regional trade in goods statistics disaggregated by smaller geographical areas.

Moreover, industrial change on this scale risks a period of upheaval as employment shifts across sectors. Regional and skill mismatches can emerge, leading to higher unemployment levels and duration. As manufacturing productivity increased and services sectors expanded, the opportunities available to lower skill workers were increasingly in services – typically either towards the bottom or top of the earnings distribution – rather than in manufacturing. Figure 9 shows lower skilled workers benefit from higher wages in manufacturing jobs on average, so as opportunities in manufacturing disappeared the opportunities for lower skilled workers have also deteriorated.

16 P McCann, Perceptions of Regional Inequality and the Geography of Discontent: Insights from the UK, Regional Studies, Volume 54, November 2018.

FIGURE 9: **Low skill workers benefited from wage premiums in manufacturing**

Manufacturing 'pay premium' after adjusting for observed characteristics, by skill level: UK, 2019-20



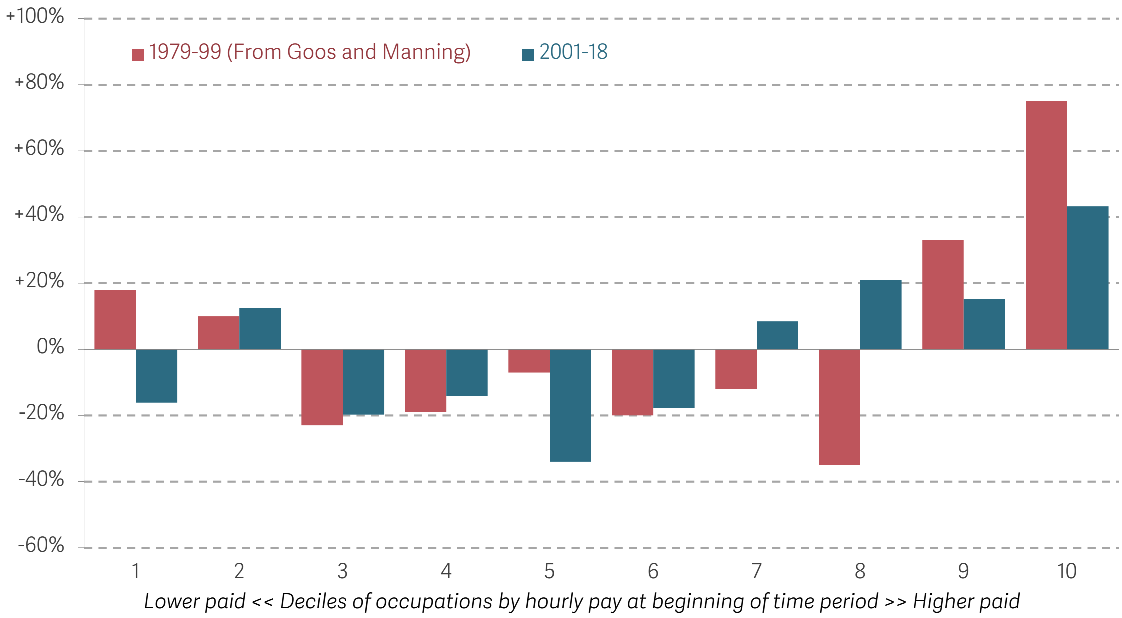
NOTES: Aged 16-64, employees only. This analysis shows the manufacturing 'pay premium' compared to services, and so excludes agriculture, utilities, and construction. We control for sex, age, age-squared, region, education, experience, occupation, qualifications, and whether public or private sector, following the same broad methodology as outlined in: J Cribb, C Emmerson & L Sibieta, Public sector pay in the UK, Institute for Fiscal Studies, October 2014. Skill levels based on occupations, as detailed in Office for National Statistics, SOC2010 volume 1: structure and descriptions of unit groups, 2010.
SOURCE: Analysis of ONS, Labour Force Survey.

The shift from manufacturing towards services during the 1980s and 1990s was associated with a shift in the nature of work, particularly for lower-skilled workers. The share of labour in both the highest and lowest earning occupations increased and the share in middle earning occupations shrank, as shown in Figure 10. Research has linked this 'hollowing out' of the labour market to a reduction in higher-paying jobs in the manufacturing sector as productivity increased and new technology was adopted.[17] But trade induced specialisation from manufacturing to tradeable services may also have contributed, with many manufacturing jobs in occupations hollowed out, and growth of high-value tradable services contributing to the growth of the highest earning occupations.

17 A Salvatori, The anatomy of job polarisation in the UK, Journal for Labour Market Research 52, 8 (2018); M Goos & A Manning, Lousy jobs and lovely jobs: the rising polarization of work in Britain, The Review of Economics and Statistics 89(1), February 2007.

FIGURE 10: **Occupational shifts have led to polarisation of the labour force**

Percentage change in employment share



SOURCE: S Clarke & N Cominetti, 'Setting the record straight', Resolution Foundation, January 2019; M Goos & A Manning, 'Lousy and Lovely Jobs: the Rising Polarization of Work in Britain', Review of Economics and Statistics, 89, February 2007.

In short, joining the EU substantially changed the extent and nature of UK openness. Increased competition from abroad, expansion in services and inflows of foreign investment were central to the UK's economic strategy, contributing to innovation, productivity, and wage growth but probably also raising regional inequality. Now, as the UK adjusts to life outside the EU, fundamentally shifting the level of openness once again, we should expect to see adjustments of trade and investment flows, the regional and industrial structure of economic activity, and changes to key features of the economic strategy. These could include the extent to which competition with the EU drives productivity gains and wage increases, and a deterioration in the UK's attractiveness as a destination for FDI.

Below we discuss the evidence of direct effects from leaving the EU, as well as the extent to which the data point to changes in the factors that have been crucial to the UK's economic strategy.

The present: direct impacts from reduced openness with the EU

The past shows us that shifts in openness, like the one the UK is currently experiencing after leaving the EU, will have large direct impacts on the economy that percolate beyond trade. Brexit is unusual both in terms of the size of the change to a country's external relationships and because it will increase barriers to trade. So, given history shows that we should expect both significant direct impacts, as well as disruption to the UK's current economic strategy, are such effects already evident?

The end of the transition period at the end of December 2020 marked the introduction of a new trading and migration relationship between the UK and EU. This is characterised by the end of free movement of goods, services and people, with the new trading arrangement governed by the new Trade and Cooperation Agreement (TCA). It also marks the start of a new era for the UK, characterised by higher trade barriers with European neighbours and a reduction in overall trade openness.

This section discusses the extent to which the impacts of these changes are already evident in the data for prices, investment and trade.

Financial and currency markets responded first bringing forward the price adjustment

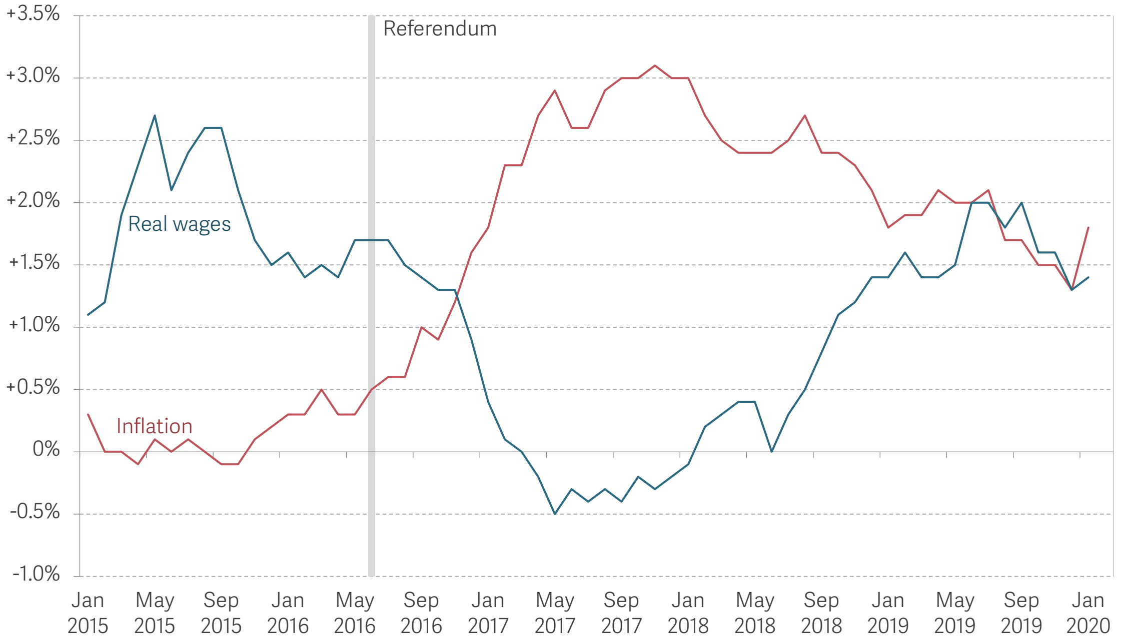
The direct impacts started immediately after the referendum, as financial and currency markets responded to the referendum result. The value of the pound depreciated sharply: at the start of 2021, sterling was 15 per cent below its level on the evening before the referendum result. This led to a sharp rise in inflation, shown in Figure 11, through the increased cost of imports and a fall in real wage growth, negatively impacting living standards. Recent research suggests the depreciation raised the price level by 2.9 per cent, equivalent to an £870 increase in the cost of living per year for the average household.[18]

Figure 12 provides further evidence that living standards were impacted directly by the referendum result. It shows the difference in real wage growth in sectors that had above and below average exposure to the depreciation shock through the use of imported inputs. Businesses in sectors that were more exposed to the depreciation shock through import costs experienced a relative decline in real wage growth and in employer-provided training, seeing a return to real wage stagnation similar to that in the early 2010s.[19]

18 H Breinlich et al., The Brexit vote and inflation – updated evidence, March 2020.
19 R Costa, S Dhingra and S Machin, Trade and Worker Deskilling, NBER Working Paper 25919, June 2019.

FIGURE 11: **Depreciation immediately after the referendum led to an immediate real wage impact**

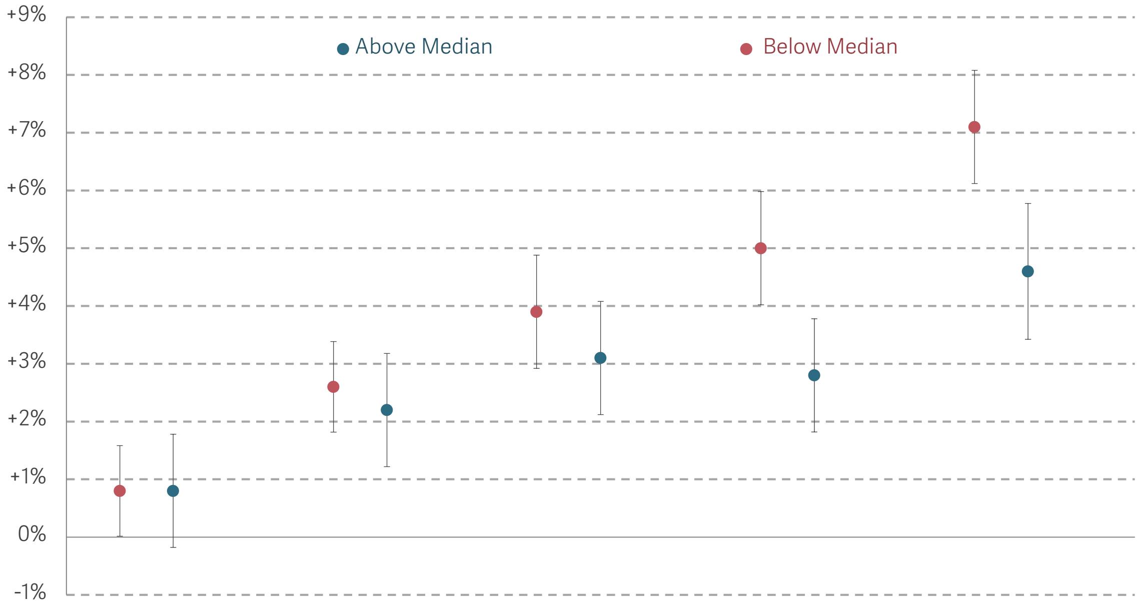
Twelve-month CPI inflation and real wage growth: UK



SOURCE: ONS, CPI inflation and Labour Market Statistics. Real wage growth: EARN01 3-month average percentage change year on year in Total pay, seasonally adjusted (series A3WW).

FIGURE 12: **Depreciation induced increases in intermediate import prices hurt workers**

Real wage growth for workers in industries with above and below median depreciation impacts on import costs



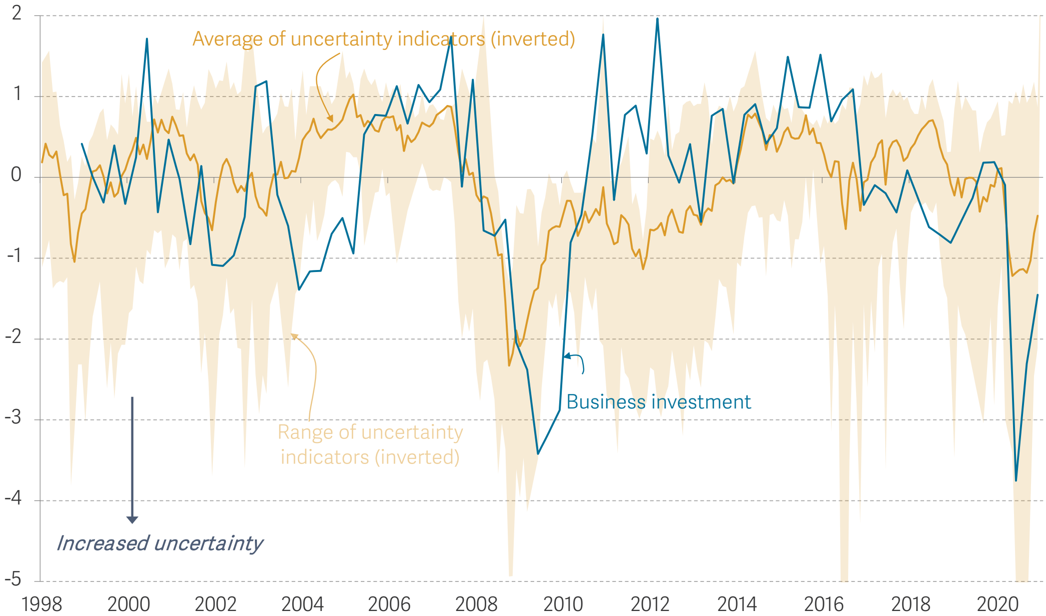
NOTES: Years refer to Q3 to Q2, e.g. 2016/17 is from Q3 2016 to Q2 2017.
SOURCE: R Costa, S Dhingra & S Machin. R Costa, S Dhingra and S Machin, Trade and Worker Deskilling, NBER Working Paper 25919, June 2019.

Uncertainty impacted firms' investment decisions

The referendum was followed by a period of greater uncertainty for firms, primarily due to a lack of clarity about the nature of the future trading relationship with the EU. Even by December 2020 the prospect of 'no deal' had not been ruled out, but just 59 per cent of businesses considered themselves to be at least somewhat prepared for a 'no deal' Brexit.[20] This uncertainty, alongside adjusted expectations of future productivity, is likely to have weighed on UK-based firms' investment decisions. This manifested as a slowing in business investment growth following the referendum relative to the overall economy (Figure 13).[21] Quarterly business investment growth for the three years post referendum (Q3 2016 to Q2 2019) was just -0.1 per cent compared to 1.9 per cent in the three years prior to the referendum. Firms also responded by changing their foreign investment decisions, with a rise in outward investment announcements to the EU and a fall in inward investment announcements from the EU.[22]

FIGURE 13: **Weak investment post referendum is associated with higher uncertainty**

Measures of economic and policy uncertainty and four-quarter growth in business investment (standard deviations from the sample mean)



NOTES: The swathe shows a range of uncertainty indicators: CBI survey measure of demand uncertainty as a factor likely to limit capital expenditure for manufacturing and services; an index of UK policy uncertainty based on newspaper articles; household survey responses on their personal financial situation and unemployment expectations; the six-month option-implied volatility for the FTSE 100; the 12-month option-implied volatility of short sterling. All indicators are shows as number of standard deviations from the mean. The line shows the mean of these indicators. Business investment data are adjusted for the transfer of nuclear reactors from the public corporation sector to the central government in 2005 Q2.
SOURCE: Analysis of ONS, Bank of England, GfK, 'Measuring Economic Policy Uncertainty' by Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com.

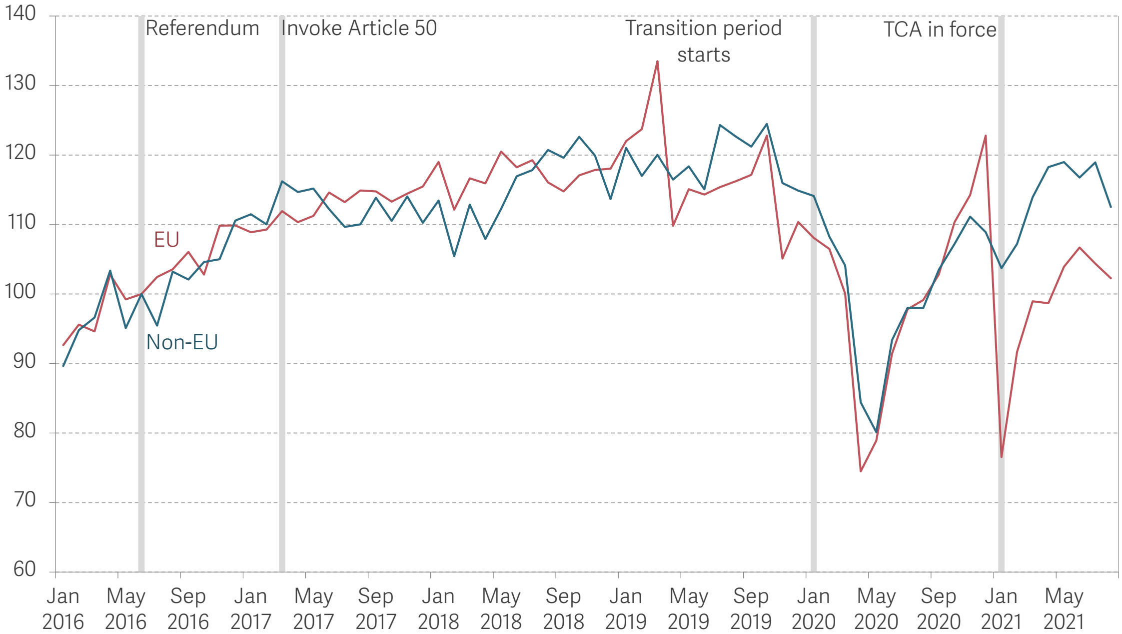
20 J De Lyon, S Dhingra & E Tolva, COVID-19 has disrupted businesses' ability to prepare for Brexit, but the lack of clarity on the UK-EU relationship is worse, LSE, December 2020.
21 J Smith, The Macroeconomic Policy Outlook Q1 2021, Resolution Foundation, April 2021.
22 H Breinlich et al., Voting with their money: Brexit and outward investment by UK firms, European Economic Review, 2020.

Firms only changed their trading behaviour once the new barriers were in place

Goods trade flows appear to have been relatively unaffected until trading arrangements changed. The referendum result itself, the related currency depreciation and subsequent uncertainty surrounding the negotiations appear to have had little impact on trade flows. Figure 14 shows that UK-EU goods trade kept pace with non-EU trade until after the TCA was introduced in 2021 and new barriers to trade with the EU introduced. This is despite significant fluctuations in the exchange rate and uncertainty weighing on investment decisions. However, there is evidence that uncertainty over future trade barriers deterred UK firms from entering the EU market and increased the rate of exit from the EU market.[23] Trade with the EU in 2021 is 18 per cent lower than it was in the same period in 2019, compared to just 5 per cent lower for non-EU partners. Since the referendum goods trade with the EU has underperformed relative to non-EU trade by 10 per cent.

FIGURE 14: **Large trade impacts materialised after the new agreement came into place**

Monthly UK goods trade (exports plus imports), excluding precious metals, index (June 2016 = 100): UK



SOURCE: Analysis of ONS, UK Trade Time Series data July 2021.

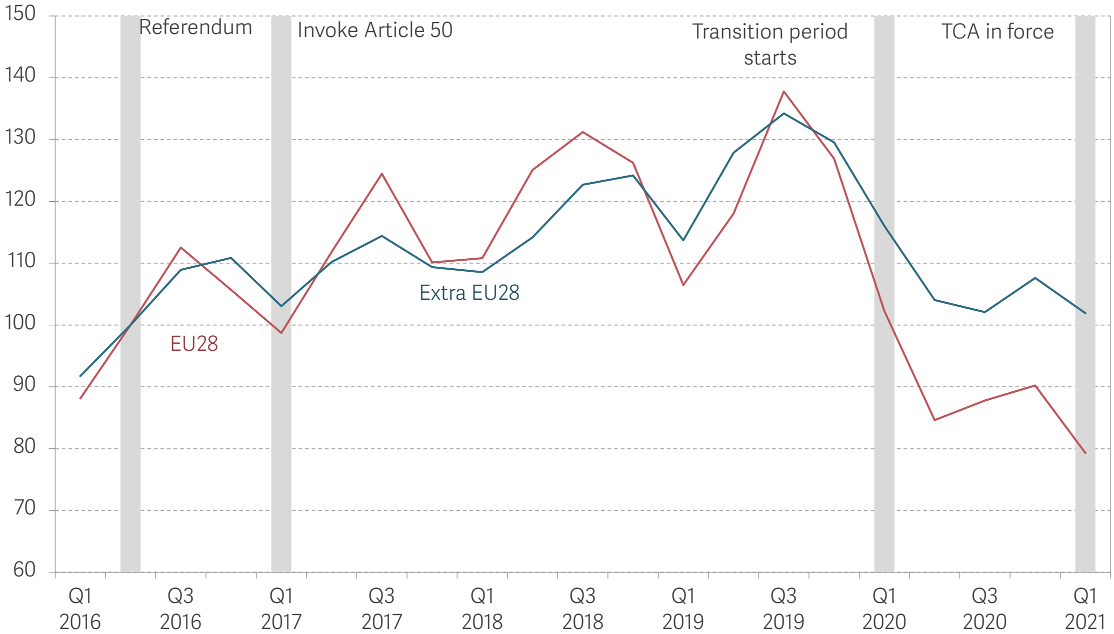
Meanwhile, UK-EU services trade diverged from non-EU in 2020 before the TCA was implemented. This is likely to reflect differences in the way services trade is delivered to the EU and non-EU. Since a larger share of services trade with the EU relies on the movement of people across borders, UK-EU services trade may have been impacted not

23 M Crowley, O Exton & L Han, Renegotiation of Trade Agreements and Firm Exporting Decisions: Evidence from the Impact of Brexit on UK Exports, Society of International Economic Law (SIEL), July 2018.

only by Brexit and anticipated changes to the free movement of people and services, but also by measures introduced in response to the pandemic, for example travel restrictions. The fall in services trade with the EU is larger than the equivalent for goods, with EU services trade underperforming non-EU trade by around 20 per cent since the referendum. For an economy highly specialised in exporting services, this may well indicate significant challenges down the road.

FIGURE 15: **Divergence in services trade started before TCA came into place**

Index of quarterly UK services trade with the EU and non-EU (Q2 2016 = 100)



SOURCE: ONS, UK trade in services: all countries, non-seasonally adjusted.

The trade data is difficult to interpret due to the influence of Covid-19 which has led to volatility in trade globally. In 2020 global trade fell by 8.9 per cent, with services trade worst affected, falling 20 per cent, almost four times the fall in goods.[24] While simple comparisons of UK's trade performance across Brexit-affected countries and others is instructive to understand the macro drivers of trade, much more analysis is needed to attribute the divergent paths of trade performance to different drivers. The large country-specific, even local, trade impacts of Covid-19 now overlay the longer-term impacts arising from new trade barriers under the TCA.

In addition, the impact of Brexit is also clouded by stockpiling activity of firms ahead of the introduction of the TCA. This led to spikes in trade with the EU in the months leading up to and including March 2019 and December 2020, coinciding with EU negotiation deadlines. This contributed to a subsequent sharper fall in trade immediately afterwards as some of the following months' trade was effectively brought forward.

24 Bank of England, How has covid affected global trade, June 2021.

Interpretation is also made difficult by differences in the UK and EU goods data, making it hard to concretely conclude which firms are struggling most so far. Both data sources suggest weaker bilateral trade, consistent with a decline in openness between the UK and EU. But UK data attributes this to particularly weak imports from the EU, while the EU data indicates it is due to weak UK exports.

Notwithstanding these data issues, the trade data indicates that firms have struggled with the new trade barriers introduced by the TCA. This is corroborated by ONS survey data which shows that a sizeable share of firms which export and import reported that the end of the EU transition period negatively affected trade. The share of importers and exporters facing challenges appears to be relatively similar, with around 20 per cent of trading businesses reporting challenges due to EU exit at their peak at the end of March.[25]

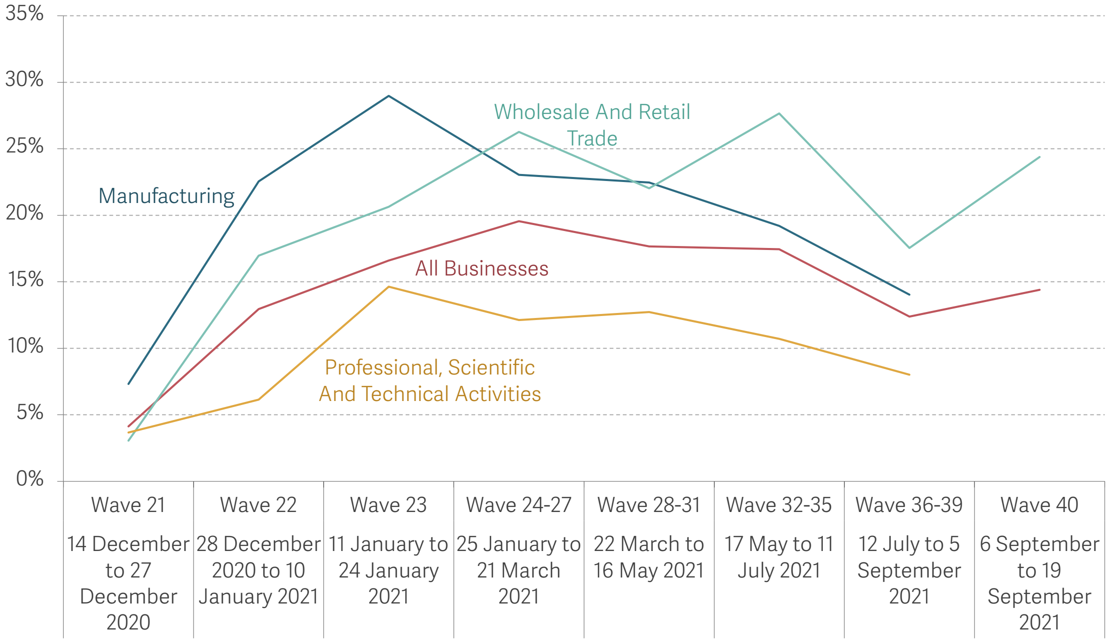
Figure 16 shows that exporters of goods from manufacturing and wholesale and retail trade sectors were more likely to report challenges, indicating the new barriers in the TCA have been more problematic for goods exporters to date. The share of exporters reporting exporting challenges mainly due to EU exit has fallen, from 19 per cent to 14 per cent between March and September, driven both by fewer firms reporting export challenges and fewer attributing this primarily to EU related issues. Figure 17 shows a similar trend for importing firms, with the share reporting challenges falling from 22 per cent to 11 per cent over the same period. This may show signs that firms are starting to adapt towards the new normal. Moreover, as the UK has delayed the implementation of certain border checks, further impacts on imports should still be anticipated along with an increase in the share of firms reporting challenges related to the arrangement with the EU.

Accommodation and food services importers face acute challenges, with two-in-five reporting they were not able to import as normal in January due to EU exit, and after an initial recovery this has been increasing again in recent months. These importers were also more likely to report barriers relating to customs and this could be exacerbated if further border checks are introduced next year.

25 It is not possible to evaluate this on a trade weighted basis which could affect the total.

FIGURE 16: **Exporting firms seem to have overcome the worst of their challenges**

Share of currently trading exporters that report export 'challenges' and cite 'end of the EU transition period' as the sole main cause



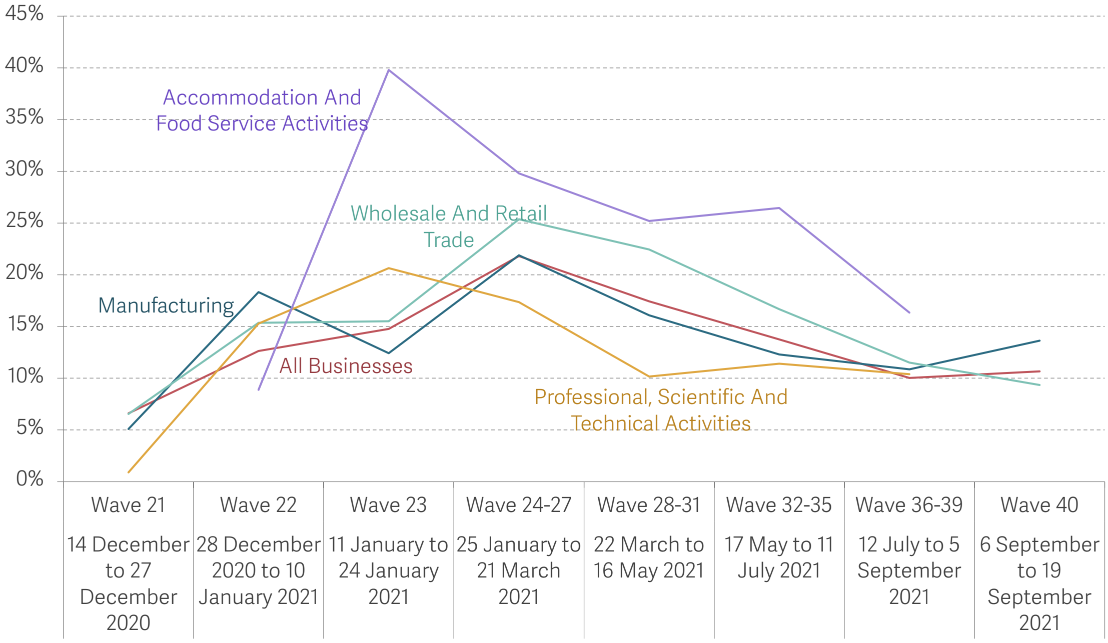
NOTES: The averages of four waves are taken to smooth volatile results for industries with small samples. Where values are suppressed averages are taken of the waves for which data is available. Waves 21-23 are included stand alone to show the impact on firms over the period the TCA was implemented. Wave 40 increased suppression, so most industry results were suppressed. Export challenges represents the share of businesses reporting either exporting less or unable to export. Uses the share of businesses reporting EU transition as the sole main reason for exporting challenges, so excludes firms reporting both the EU transition and Covid-19 as the reason.
SOURCE: Analysis of ONS, Business insights and impact on the UK economy survey data.

At the time of writing, it is hard to avoid news of supply shortages in the UK. While there have been global supply issues related to Covid-19 – for example in the semi-conductors' market – anecdotally the issues in the UK have been more acute and widespread. A survey of 500 mid-sized UK businesses found more than 1-in-4 businesses stated reduced stock, caused by supply chain disruption, is putting pressure on their operations and nearly a third of businesses expected to make long-term reductions to product lines and services on offer.[26] More analysis is needed to understand the extent to which these disruptions have been amplified by changes in migration or new trade barriers. While labour shortages and issues recruiting heavy goods vehicle (HGV) drivers is clearly one challenge, this survey evidence suggests firms in accommodation and food services are struggling with barriers relating to customs as well.

26 Binder, Dijker and Otte (BDO), UK's mid-sized businesses warn of reduced stock and higher prices because of staff shortages, October 2021

FIGURE 17: **Importing firms in some sectors are still facing challenges**

Share of currently trading importers that report import challenges and the end of the EU transition period as the sole main cause



NOTES: The averages of four waves are taken to smooth volatile results for industries with small samples. Where values are suppressed averages are taken of the waves for which data is available. Waves 21-23 are included stand alone to show the impact on firms over the period the TCA was implemented. Wave 40 increased suppression, so most industry results were suppressed. Export challenges represents the share of businesses reporting either importing less or unable to import. Uses the share of businesses reporting EU transition as the sole main reason for importing challenges, so excludes firms reporting both the EU transition and Covid-19 as the reason.
SOURCE: Analysis of ONS, Business insights and impact on the UK economy survey data.

Although the survey data does not provide information on the changes in overall volumes of trade, it provides further direct evidence that the changes in observed trade flows are, at least in part, driven by businesses facing problems under the new arrangement with the EU.

Regional trade data is only available to the end of Q2, and only for goods and at the greatest regional disaggregation (NUTS1). Figure 18 shows the relative size of the impact on EU trade across regions. London, the North and the West Midlands experienced the largest fall in EU exports relative to non-EU exports, while the smallest relative declines were seen in Northern Ireland and the South East.

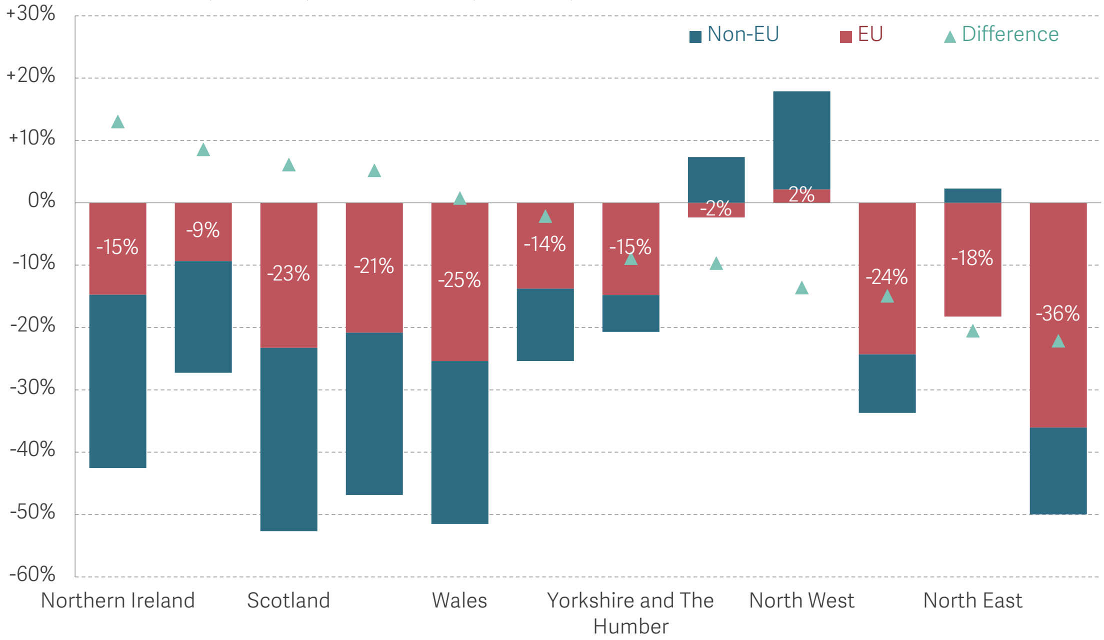
Northern Ireland exports to the EU fell by over 10 percentage points less than their exports to the rest of the World, which likely shows early signs of the Northern Ireland protocol protecting trade between Northern Ireland and the EU. This has however coincided with British firms reporting difficulties in trading with Northern Ireland.[27] But resilience of the share of trade with the EU in the South East, Scotland, East Midlands and Wales trade is more surprising. That said, the East Midlands was affected by weak

27 J De Lyon & S Dhingra, The impacts of Covid-19 and Brexit on the UK economy: early evidence in 2021, CEP Covid-19 021.

automotive sector exports outside the EU, likely related to global supply shortages of semi-conductors.

FIGURE 18: **The North and London experienced the largest relative fall in EU exports**

Change in UK nations and English regions goods trade with the EU and non-EU between Q1 and Q2 2019 and Q1 and Q2 2021



NOTES: Excludes unallocated known and unknown region categories.
SOURCE: HMRC, Regional Trade Statistics (Q2 2021).

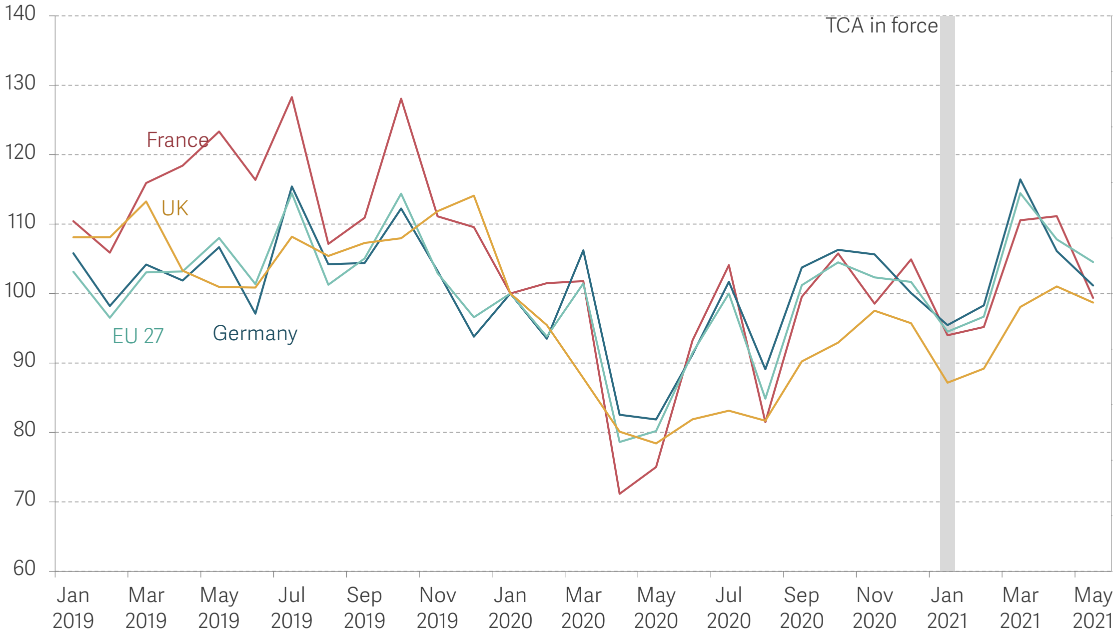
Continuity agreements appear to have been successful in preventing UK firms losing market share

The good news for UK firms and for the DIT is that the programme to rollover the agreements which the UK was member to under the EU, for example with Canada and Mexico, appears to have largely been a success. Since invoking Article 50, the UK Government restored agreements with more than 60 countries, covering the majority of pre-existing EU agreements.

While Figure 19 shows the UK's trade with non-EU countries fell relative to its key EU comparators in 2020, since the rolled over agreements became active in January this year UK trade growth has kept pace with the EU average. Over the year to date, goods trade with countries with a rolled over agreements is up 20 per cent, compared to no change for the non-EU countries without an agreement in place. Services trade declined in Q1 2021 by a similar level for both groups (5.3 per cent).

FIGURE 19: **Rolled over agreements seem to have been effective in preventing the UK losing competitiveness relative to the EU**

Index of monthly goods trade to outside the EU and UK (January 2020 = 100)



NOTES: Extra EU trade is total trade excluding the EU 27 and the UK for all EU countries.
SOURCE: Analysis of ONS, Trade Time Series data July 2021; Eurostat, Monthly trade data (available to May 2021 for EU-27).

The evidence suggests that the direct effects of Brexit on firms engaged in trade have been substantial but more direct adjustment is still to come

Overall, then, we can already see the direct effects of Brexit starting to emerge: reducing trade flows, particularly in services, and increasing the prices of imported goods thereby eroding the value of incomes. These effects are clouded by the impact of Covid-19, but direct evidence on firms' experience navigating new trade barriers strongly suggests that increased frictions have had an impact.

The OBR estimates that exports and imports will be around 15 per cent lower in the long run relative to the counterfactual of being within the EU. This is based on the average estimate of a number of external studies. Separately, estimates contained in the Government's EU exit analysis pointed to a 10 per cent reduction. These indicate that as trade recovers from the impact of Covid-19, some further trade adjustment should be anticipated, and that could lead to the current gap between EU and non-EU trade doubling from its current level. Some of this might materialise when additional border checks are implemented on imports into the UK, which were delayed until 2022 to ease adjustment. Further adjustment will arise as firms implement different investment decisions, changing their exporting and importing patterns. For example, firms may choose to expand production focussed on supplying the domestic market over exporting to the EU as the new barriers weigh on the relative benefits and prices faced by firms.

The future: a strategy for post-Brexit

With the direct impacts of Brexit starting to emerge, now is the time for policy makers to focus on the key questions about the future of UK trade. But the current political and policy debate has become preoccupied with the details of the individual trade deals missing the more fundamental issues. So, in order make clear what policy makers should be doing, in this section we focus on three key questions: How open should the economy be? Should the UK maintain its existing economic strategy, or change it? And, what is the UK's place in the world trading system? The answers to these questions will be key to determining what policy makers should do today.

First, how open should the UK economy be?

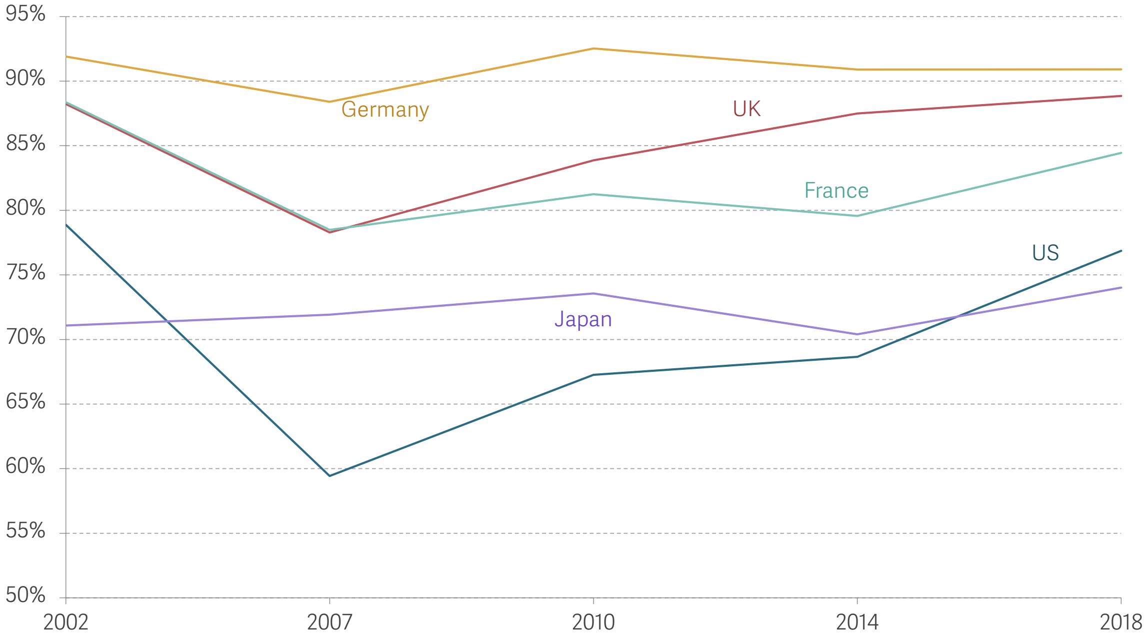
The opportunity for the UK to pursue a new and independent trade strategy for the first time in half a century has occupied the debate on post-Brexit trade. The Government's 'Global Britain' agenda has been designed to signal that the UK will be open, outward facing and free trading.[28] Consistent with this, it has signalled ambitions for trade agreements covering 80 per cent of UK trade by the end of the 2022. To achieve this, it has been rapidly negotiating agreements which rollover those the UK benefited from as part of EU membership. In this respect there has been success with over 60 per cent of trade now covered by existing trade deals.

Much has also been made of deals that may be in the offing, at least in part because such deals are popular with the UK public. According to Government surveys around three quarters of the public supports the UK pursuing free trade agreements, with only 8 per cent against.[29] In addition, Figure 20 shows that public support for trade in the UK is high relative to many international comparators and support recovered quickly following the financial crisis. Here it is clear that the UK Government faces a very different public sentiment to the US, for example, where public support is around 10 percentage points lower.

28 Foreign Affairs Select Committee, Appendix: Memorandum from the Foreign and Commonwealth Office, March 2018.
29 Department for International Trade, Public Attitudes to Trade Tracker - Wave 3 Report, September 2021.

FIGURE 20: **The UK public are among the most supportive of trade**

Share of respondents that think trade is very good or somewhat good for their country



NOTES: The vertical axis shows the share of respondents agreeing that trade with other countries is 'very good' or 'somewhat good'.
SOURCE: Pew Global Attitudes Surveys, Summer 2002 & Spring 2007, 2010, 2011, 2014 and 2018.

The constraint on future deals is a lack of willing partners

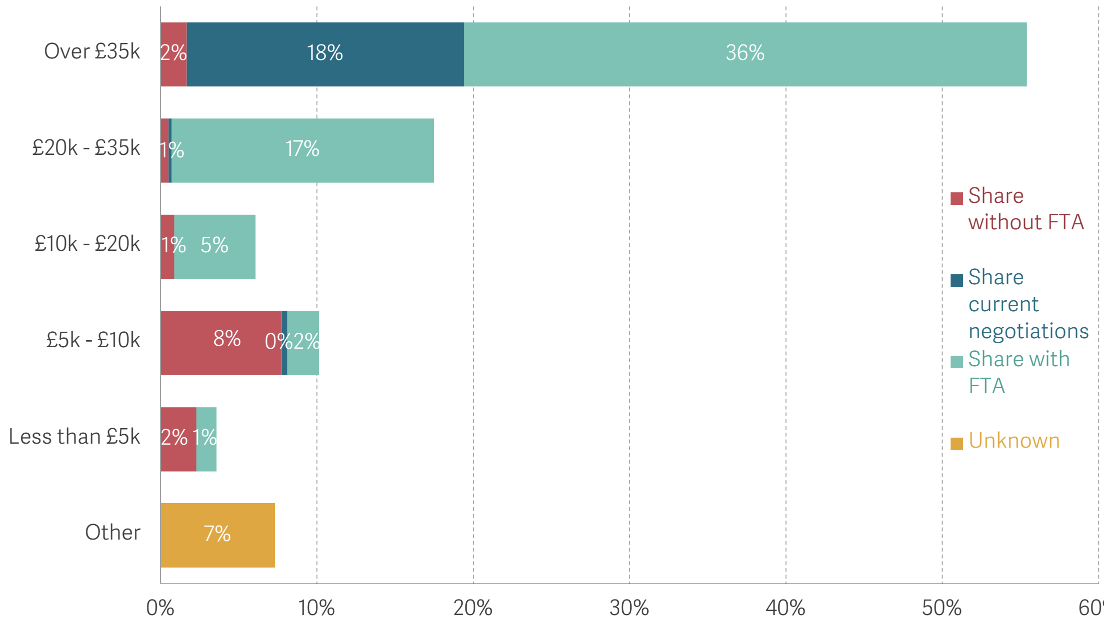
The depth and breadth of deals available to the UK are more likely to frustrate attempts to increase openness. This is because the UK is limited in its ability to liberalise trade with partners that represent a large share of trade and to deliver agreements of comparable depth to the Single Market, especially in services which is particularly important for the UK given the high relative importance of services exports.

An important example of the limitations facing the UK is the possibility of a deal with the US. This has been touted as one of the main prizes to be achieved from the UK's new independent trade policy. The UK wasted no time in starting negotiations with US counterparts, formally launching negotiations in May last year. This made sense given the US is by far the UK's largest trading partner outside of the EU, making up 16 per cent of trade in 2019 (China is the next largest at just 6 per cent). However, the Biden administration has reset the US trade agenda and taken the decision not to pursue new trade agreements, pausing negotiations with the UK indefinitely. This will substantially limit the scope for the UK to offset any of the fall in openness with the EU with new trade deals.

Even looking beyond a possible US deal the opportunities appear limited. Having initially focused on rollover deals, the Government's trade strategy now appears to be to target growth markets in the Asia-Pacific region. The idea here is to capitalise on future trade opportunities created by a growing middle class. This has included negotiating bilateral deals with Australia and New Zealand as a first step to accessing the Comprehensive and Progressive Agreement for Trans-Pacific (CPTPP). These have drawn a lot of public interest due to their potential impact on UK farming. But Figure 21 shows why this strategy can do little to offset EU market access: trade with the whole of Asia and Australasia makes up just 22 per cent of UK trade in 2019 (a quarter which was with China) and the UK already has agreements in place with many of its largest partners in the region, including South Korea, Japan and Singapore. The largest opportunities now sit with countries with significantly lower GDP per capita. And outside those in the current negotiation programme or with existing agreements, there are just a handful of countries or trading blocs which represent more than 1 per cent of UK trade.[30]

FIGURE 21: **A large share of trade is covered by existing deals or negotiations**

Share of UK trade by partner GDP and free trade agreements status: 2019



NOTES: Other includes groups of countries / institutions where a GDP per capita couldn't be appointed e.g. Africa – other, International Organisations. Uses 2019 exchange rate and prices to convert GDP to £.
SOURCE: Analysis based on ONS pink book 2020 Ch 9; Department for International Trade Collection: The UK's trade agreements collection; World Bank GDP per capita (current US$) 2019 or most recent available; Bank of England average annual exchange rate USD:GBP (2019).

But is not just the availability of deals that is an issue, it is also their depth. Average global goods tariff rates are low, following decades of WTO liberalisation, so most of the gains from future liberalisation will come from non-tariff barriers. Negotiations over non-tariff barriers are complex because they involve measures that may legitimately aim to protect the welfare of domestic citizens, such as standards, regulations and recognition

30 These include China, Hong Kong, the Mercosur trade bloc (of South-American countries), India, Russia and the Gulf Cooperation Council.

of qualifications. It is especially complex when trying to align with a number of different countries that have contrasting measures, such as the EU and US. Services trade, an area of large and growing importance to the UK economy, is not subject to tariffs and liberalisation has historically proven difficult. Even the EU's most ambitious free trade agreements on services to date have managed very little liberalisation of current barriers to trade relative to the liberalisation within the Single Market. According to Government analysis, using the OECD Services Trade Restrictiveness Index (STRI), the UK's deal with Canada reduced a tiny fraction, significantly less than 1 per cent, of the barriers to services liberalised within the EU.[31]

In short, the Government's emerging trade strategy – focussed on quickly striking simple deals on goods trade – is not consistent with one that would prioritise achieving deep services liberalisation.

All this adds up to a limited scope for increasing openness beyond the EU given the limited availability of willing partners. The reality, then, is that leaving the EU will ultimately make the UK less open. This raises a number of important questions about how the Government should respond to this change in openness.

Second, what does all this mean for the economic strategy of the UK?

As the UK becomes less open, the associated drivers of productivity – and hence longer-term prosperity and living standards – linked to openness will weaken. A key decision for the next decade is whether to try to offset this by adapting the UK's economic strategy, or whether to continue the previous approach. To help with this discussion we start by looking for signs of a shift in the structure or drivers of productivity of the UK economy.

A key place to look for such an effect is on FDI flows. Here there is some evidence the referendum prompted a reduction in inward FDI transactions to the UK, and increased outward FDI transactions into the EU. Figure 22 shows there was something of a divergence between EU and non-EU FDI positions. In 2016, there was a notable jump in FDI positions from the UK to the EU, consistent with firms being concerned about greater trade frictions. But this was not sustained. And while inward FDI was low or even negative in 2020 (Figure 23), it seems more likely that this is to do with the pandemic than with Brexit. The UK did lose out relative to other countries, as shown by the decline in the share of FDI going to the UK in 2020 in Figure 6.[32] However, UK output was also hit more strongly than other advanced economies which may have made the UK relatively less attractive in 2020.[33] Overall, then, inflows have not yet fallen anywhere near as much as

31 DIT, Impact of the EU-Canada Comprehensive Economic and Trade Agreement on the UK, January 2018.

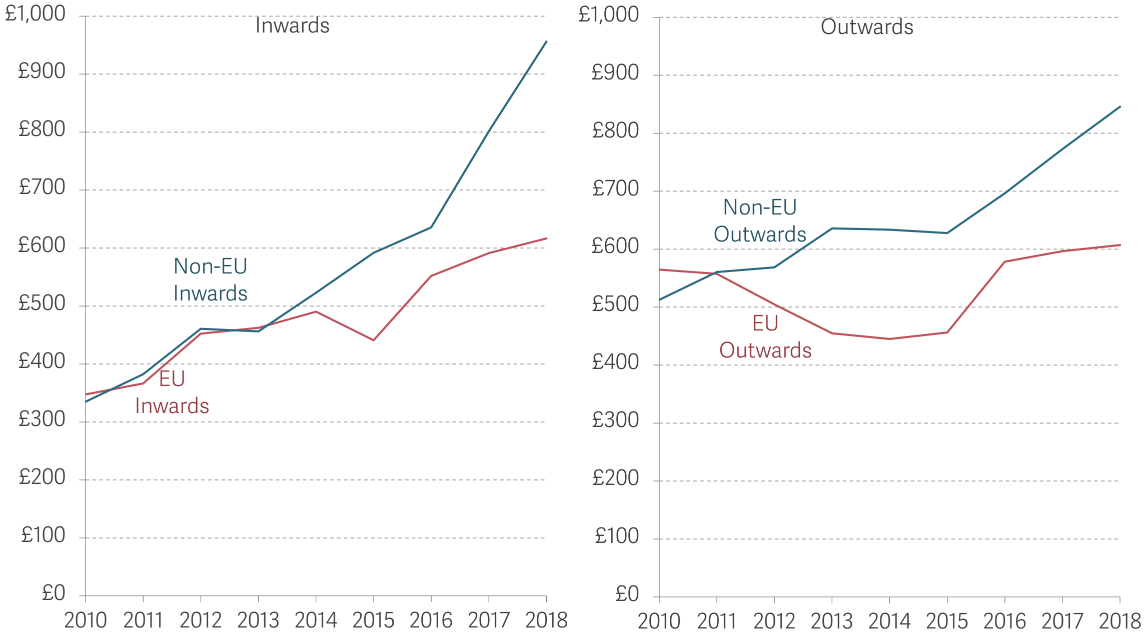
32 In 2020, the UK ranked 16th for FDI inflows among all countries, having fallen consistently since 2016 when the UK ranked 2nd, although FDI flows can be volatile with the UK ranking 14th in 2015. Figure 6 also shows that the UK continued to attract more than its share of FDI in 2016, 2017 and 2018, despite the uncertainty in the UK.

33 ONS, International comparisons of GDP during the coronavirus (COVID-19) pandemic, February 2021.

estimates prior to leaving suggested they might – with estimates of the fall in the size of such inflows as high as 22 per cent over 10 years.[34]

FIGURE 22: **EU and non-EU FDI positions have diverged**

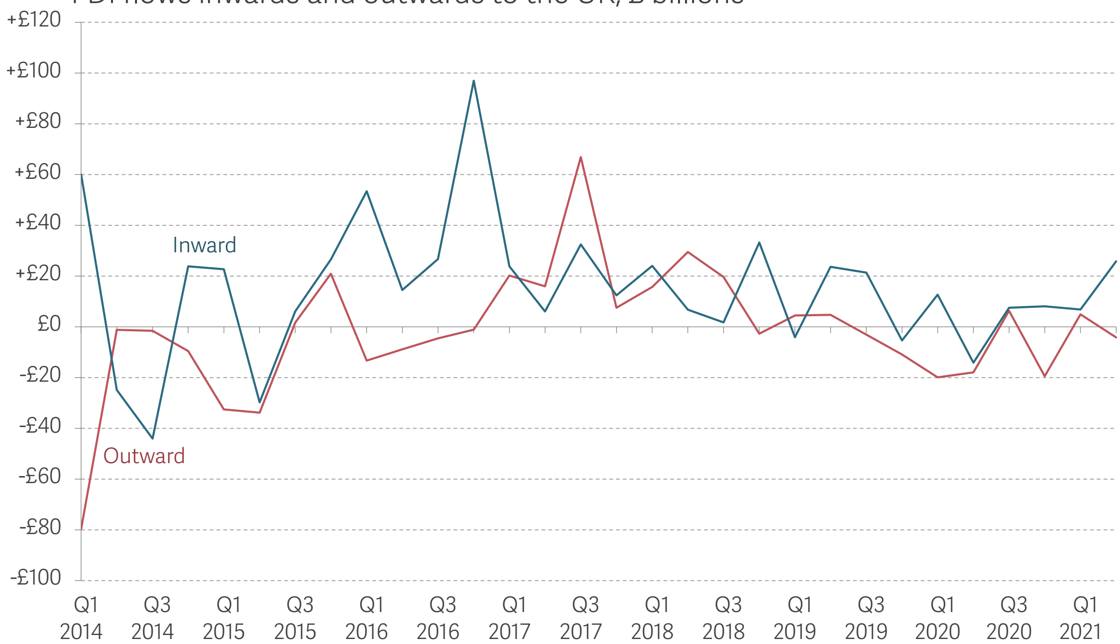
FDI international investment positions in the United Kingdom, £ billions



SOURCE: ONS, Foreign direct investment involving UK companies (outwards and inwards).

FIGURE 23: **FDI inflows were low in 2020 but show early signs of recovery**

FDI flows inwards and outwards to the UK, £ billions



SOURCE: ONS, Earnings, flows and positions, 2005 to 2021, directional and asset liability.

34 S Dhingra et al., The impact of Brexit on foreign investment in the UK, CEP Brexit Analysis No. 3, April 2016.

A choice is needed between the status quo and a new economic strategy

While it is early days since the adoption of the TCA, the lack of clear evidence of broader structural changes since the referendum may be reinforcing the belief of some that nothing substantial has changed. Despite the evidence suggesting that adjustment to trade shocks can be costly and take years to materialise, the Government position has been to downplay the scale of trade policy change that Brexit entails, and therefore the impact that might have for the UK's economic strategy. This is in marked contrast to the Prime Minister's argument that the UK's new migration regime post-Brexit will be the key driver of change to our economic model, with an end to the availability of lower paid migrant labour forcing firms to invest and driving "a high wage, high skill, high productivity" economy.[35]

But as evidence of a shift in the degree and nature of openness becomes clearer over time, this will matter for the shape of the UK economy in the longer term. As discussed above, trade has differential effects across jobs, industries, and regions. Here, the Government's own analysis of EU exit indicates that Brexit will lead to larger relative declines in output and an associated movement of jobs out of sectors including chemicals, motor vehicles, agri-food and financial services. The chemical sector, for example, is expected to be almost 20 per cent smaller in GVA terms than within the EU, which is between 10 and 15 percentage points larger than for the economy overall.[36]

As the pressures for change arise, policy makers will be required to make tough decisions: whether to maintain the status quo (for example by providing more support to struggling sectors) or accept that changes to the economic strategy may be desirable or unavoidable as the UK transitions to a different level of openness. Here the Government has shown signs that it is willing to support change in a few areas. For example, there has been political support for bringing more manufacturing jobs into the UK. This aligns with the likely outcome of Brexit – fewer service exports and more manufacturing for the domestic market – and the cross-party consensus in favour of rebalancing regional economic activity, albeit at the price of lower productivity in aggregate. In addition, the Government has been exploring reforms to mergers and acquisitions and becoming more actively involved in funding private sector innovation. For example, the establishment of the UK infrastructure bank has seen the UK take an equity stake in a number of start-up businesses across a variety of sectors. This could indicate an ideological shift to a more interventionalist approach that would enable more control over competition, in place of encouraging FDI through highly liberalised capital markets.[37]

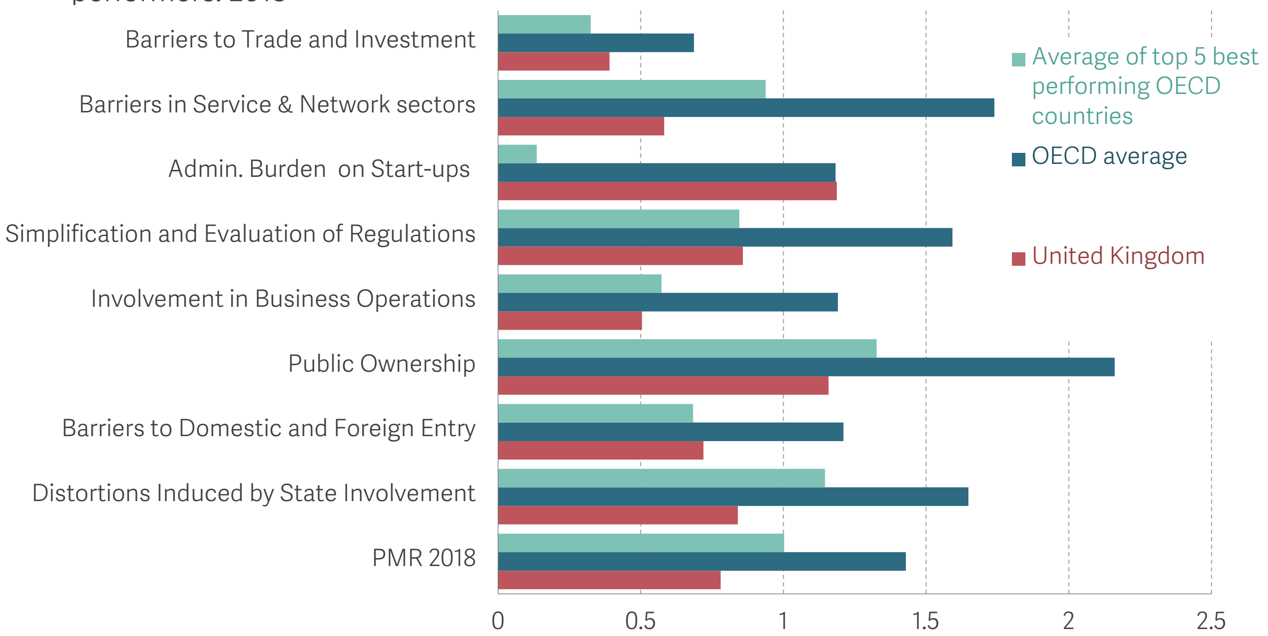
35 Boris Johnson Keynote Speech, We're getting on with the job, October 2021.
36 HM Government, EU Exit - Long-term economic analysis, November 2018.
37 BEIS, Impact assessment on reforms to merger control, July 2021.

A new economic strategy, should be about more than embracing some elements of change which are politically desirable but would, ultimately, drive down productivity. In order to deliver the higher wage, higher productivity economy the Prime Minister desires, the new strategy would also need to put scaling up alternative drivers of productivity at the centre of the strategy to mitigate some of the lost benefits from foreign competition and investment.

The Government has indicated that it believes regulatory reform will be an important driver, as it sets out its approach to reshaping regulation and using the regulatory freedom the UK has gained outside the EU. This includes creating 'a pro-growth, trusted data regime' and overhauling clinical trial frameworks to boost R&D.[38] Ultimately the aim would be to give UK firms a competitive advantage over foreign competitors by giving them the flexibility and agility needed to react quickly to global changes and to encourage more domestic competition.

FIGURE 24: **The UK is among the top performers on most measures of product regulation**

OECD Product Market Regulation Index for the UK, OECD average and the 5 top performers: 2018



NOTES: The 5 best performers represent the average for the 5 countries with the best scores for each indicator.
SOURCE: OECD Indicators of Product Market Regulation.

However, regulations are often, although not always, in place for a reason – to protect consumers or workers, or to stabilise markets, such as financial services regulation.[39]

38 Cabinet Office and The Rt Hon Lord Frost CMG, Lord frost statement to the house of lords, September 2021.
39 K Watson & S James, Regulatory Protectionism Hidden Threat Free Trade, CATO Institute, April 2013.

If the strategy is focussed simply on removing regulatory standards, there may be associated costs and the gains may be limited, as the UK already has relatively low levels of product market regulation. The UK had the lowest value of the OECD Product Market Regulation indicator, and was ranked 8th on the World Bank's 'Ease of Doing Business' index. The OECD index, shown in Figure 24 does point to some scope for regulatory improvement in some areas, such as the administrative burden for start-ups, which could support delivering more domestic competition in place of foreign competition.

Going beyond regulation could require a more active role for the state in driving growth in particular sectors. Here the idea would be that well-designed state support can drive productivity growth through a more interventionist view on where and what jobs are needed, for example R&D subsidies and funded apprenticeships and technical education.

And third, what is the UK's place in the world?

Of course, the UK will not be adapting its economic strategy or setting its trade policy in isolation, and will be influenced by how the geopolitical situation evolves over the next decade. The current era of geopolitics is predominantly defined by the actions of the three global-trade superpowers: the US, the EU and China. Collectively they make up nearly 60 per cent of world GDP on a market exchange rate basis. These economies are deeply interconnected. The recent tensions and conflicts between the three have been primarily economic in nature, in particular trade conflicts.

Firms from China, the EU and the US are often in competition with each other, producing and exporting many of the same goods and competing within their own markets as well as for market share in third countries, for example in Latin America.[40] Governments have become involved when there are accusations that the firms in one country are not playing by the rules agreed by the WTO. And in recent years the US has applied retaliatory tariffs to both the EU and China. In both cases, China and the EU responded with their own tariffs against the US. At the start of 2018 average US tariffs on Chinese imports were 3 per cent; by the start of 2021 this had risen to 19 per cent. Chinese tariffs on US imports have increased by a similar amount.[41] New digital policies in the EU have also been considered or implemented, including changes to rules on digital localisation and a new digital tax, but have been unpopular with large US tech firms who see them as creating unfair new trade barriers.

The size of the three economies has meant they are also among each other's most important trading partners, with China the largest source of imports for both the EU and the US. Cross-border supply chains have meant the three powers are also reliant

40 A Garcia-Herrero, T Marbach & J Xu, European and Chinese trade competition in third markets: the case of Latin America, Bruegel Working Paper Issue 06, June 2018.
41 C Brown, US-China Trade War Tariffs: An Up-to-Date Chart, Peterson Institute for International Economics, March 2021.

on one another's economies. The largest company in the world in 2021 was Apple, a US company that undertakes a considerable amount of its manufacturing activity in China, and relies on China for 15 per cent of its revenue in 2020.[42] Almost 20 per cent of the foreign content of US exports came from China, through their supply chains, however, the interlinkages go beyond supply chains, with considerable FDI flows between the countries and the ownership of debt.[43] China holds over $1 trillion of US debt, making it the second largest foreign owner of US debt after Japan.[44] This means that any actions taken by one country towards another can directly impact their own citizens and firms.

Since leaving the EU, the UK must choose how to set its own policy in this global context, deciding to what extent it should align with any partner. These three global trade superpowers jointly account for almost 70 per cent of UK trade. So, although it may be desirable to minimise any further disruption to trade with any of its major partners as it adjusts to the change in openness with the EU, the UK risks being caught up in rising US-China tensions. Even if the UK does not become directly involved, it faces risks if the lost US export opportunities for Chinese firms result in a diversion of lower cost Chinese imports into the UK. A growing literature on the impact of China's entry into the global trading system suggests that the living standards of those on lower incomes in the UK are particularly at risk from a surge in Chinese imports.[45]

The actions of the Government to date have seemed to imply the UK is aiming to align politically with the US. As discussed above, the UK had prioritised signing a trade deal with the US pivoting trade from Europe to across the Atlantic. Since the trade negotiations were put on hold, the Government has stepped up collaboration on security, for example UK membership of AUSUK, that aligns the UK with the US (and Australia) against China. In addition, the UK has taken bilateral action on the back of concerns about Chinese involvement in critical national infrastructure, including the delivery of 5G networks and nuclear power services. This ban of Chinese firms' involvement risks raising tensions with China and represents an alignment with the approach taken in the US.

However, the Government will need to ask to what extent the alignment with the US, in the absence of a trade deal being available, is consistent with the aims to liberalise trade with the rest of the world and promote a pivot to trade with the Asia-Pacific region. China has recently requested to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) which the UK has already applied to join and sits at the centre of its trade strategy. This will require the UK to directly confront this conflict in foreign relations and trade strategy.

42 Apple Inc., Form 10-K from 2020, 2021.
43 World Bank, Trade in value-added and global value chains: statistical profiles – United States.
44 Department of the Treasury/Federal Reserve Board, Major foreign holders of Treasury Securities, September 2021.
45 J De Lyon & J P Pessoa, Worker and firm responses to trade shocks: The UK-China case, January 2001.

It is not only relations with China that have potentially deteriorated in recent years. The EU-UK relationship remains strained following the Brexit negotiations, with unresolved issues around the Northern Ireland protocol a continuing source of tension. Whatever position the UK chooses will present trade-offs. Returning to a more aligned approach with the EU, in the absence of a US deal being available, might be most valuable from a trade perspective, but runs directly counter to the Government's objectives of securing trade and regulatory freedoms. Alternatively, the UK could follow the path of other smaller and very open economies, who remain open to all by avoiding taking an active role in global tensions, and possibly benefitting from any barriers to trade raised between the three main actors. While from a purely economic lens the UK may benefit from this approach, it would require the UK to sacrifice international influence and activism which the UK has historically been reluctant to do and does not align with recent public political positioning of the UK with respect to China.

A roadmap for answering these important questions as part of the Economy 2030 Inquiry

Tackling these three big questions about the future of the UK's trading relationships makes it clear in broad terms what the Government must do. First, policy makers must shift their focus away from individual trade deals and instead recognise the underlying reality that the UK will be a less open economy. Second, they must decide what the new economic strategy should be. And third, they must consider how to make this consistent with global situation.

All this points to the need for a post-Brexit trade policy informed by an economic strategy. Delivering such a strategy is at the centre of the work of The Economy 2030 Inquiry. In doing so we will seek to further unpick the relationship between openness and the structure of the UK economy – including the impact of changes to the regime for migration. Over the next two years the Inquiry will investigate the nature of the economy today and the change to come; and explore what this means for people, places and firms across the UK. We will also consider how the availability of trade deals with countries around the world could fit into a coherent strategy for generating lasting improvements in living standards. Most importantly, such evidence must inform wider thinking on how the UK economy will change and how we can successfully shape the decisive decade ahead.

THE ECONOMY 2030 INQUIRY
SHAPING A DECADE OF CHANGE

The UK is on the brink of a decade of huge economic change – from the Covid-19 recovery, to exiting the EU and transitioning towards a Net Zero future. The Economy 2030 Inquiry will examine this decisive decade for Britain, and set out a plan for how we can successfully navigate it.

The Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics. It is funded by the Nuffield Foundation.

For more information on The Economy 2030 Inquiry, visit economy2030.resolutionfoundation.org.

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