The Impact of Brexit on UK Economic Development in Trade and Foreign Direct Investment

Boqian Deng

Shandong University, Shandong, China

Corresponding author: 201900810201@mail.sdu.edu.cn

Abstract. Changes in the UK economy have a significant impact on global economic developments. Accurate analysis and forecast of the impact of the recent Brexit are important for predicting the future development of the global economy. In this paper, two perspectives, trade and FDI, are selected to make a review of the forecast of economic development in the UK.

Keywords: Brexit, trade, FDI.

1. Introduction

Prime Minister Johnson declared on December 24, 2020, that the United Kingdom had accomplished its withdrawal from the European Union and agreed to some new trade deals with the European Union in which the United Kingdom will regain its control over borders, laws, money, trade and fishing waters, and the deal also ensures that the United Kingdom will be free from European rules. In consequence, the United Kingdom will become fully independent politically and economically from January 1, 2021. From the June 2016 referendum whose result is to leave the European Union to the January 2020 formal Brexit, and then to the end of the transitional period on 31 December 2020, the curtain was finally lifted on the Brexit drama between the United Kingdom and the European Union.

The UK is one of the world's principal economic systems, which means any tiny change in it will have a considerable impact on the world economy, not to mention Brexit, a historic landmark event. Because of this, many scholars have made various studies and predictions on the impact of Brexit on the UK. In this paper, we focus on the pros and cons of Brexit, especially on trade and foreign direct investment, and provide an overview of the studies conducted by many scholars.

2. Benefits of Brexit

If the UK leaves the EU, the UK will indeed gain some benefits and solve some of the problems mentioned above. First, the UK would no longer have to fund part of the EU's economic budget. Though the UK pays the least of all EU members into the EU budget because of the UK rebate,which was implemented in 1985, it always forms part of the net contributors to the European Union budget because it receives less from the EU than it pays to the EU.[1] By HM Treasury figures in 2013, the UK's net financial contribution to the EU budget was about 0.53% of national income.

Second, the UK can be free from the restrictions of the free movement system of EU workers, so it can effectively alleviate the impact of the mass migration of labor from Poland, Romania, Bulgaria, and other Central and Eastern European countries on the UK's labor market, social welfare system and health care system. As Yang [2] said:" According to figures released by the Office for National Statistics, the figure for in-migration to the UK in 2015 was a whopping 333,000, and there will be 250,000 migrants each year in the future, 60% of these migrants are from the EU and every 100 migrants entering the UK results in 23% job losses for UK natives." The impact of so many immigrants on the labor market is very significant, and it is also considered to be detrimental to the interests of low-income groups in the UK. It also led to an outcry from low-income groups who felt that the EU's free movement policy increased competition for jobs and thus took away their welfare guarantees.[3]

Third, the leaving will enhance the autonomy and independence of British enterprises in trade and investment and improve the discretionary power of the British government in international economic and trade cooperation. [4]

3. Cost of Brexit

Although Brexit can solve some of the above problems and bring some direct benefits to the UK, the indirect losses to the UK's future economic development from Brexit will far outweigh the immediate benefits it will gain. This view is also consistent with Dhingra et al.'s prediction [5]: In both optimistic and pessimistic cases, the costs of trade reduction far exceed budgetary savings. In terms of liquidity, the cost of Brexit for the average UK household is 850 pounds per annum in the optimistic scenario and 1700 pounds per annum in the pessimistic scenario. If all goes as they predict, there will be a significant drop in the standard of living of the UK population.

4. Trade

4.1 Before Brexit

According to Li [6]:" The UK Treasury has measured that trade already accounted for 65% of the UK's national income in 2015, compared to just 23% in 1965, before the UK joined the EU." Such a large increase is a good indication that EU membership makes sense for the UK in its quest for trade growth. Baier et al. [7] estimate that increased UK trade with other EU member states by a quarter or more due to the UK's EU membership (compared to EFTA membership). The increased trade created by the EU for the UK not only brings benefits to UK consumers via lower prices and better products but also brings more export opportunities for the UK, which means higher profits and more sales, allowing the UK to invest more in its dominant industries and create more jobs for the UK workforce, effectively boosting UK output, income, and living standards.

So specifically, what benefits does EU membership bring to UK trade? The EU provides the UK, and to be precise all EU member states, with four elements that can stimulate trade development.

The first is the free movement of goods, services, capital, and labor, and the second is zero tariffs and quotas and harmonizing regulations to reduce trade barriers. According to Dhingra et al. [5], "there is a customs union between EU members, which means that all tariff barriers have been removed within the EU, allowing for free trade in goods and services." Initiatives such as the abolition of tariffs in the EU and the establishment of a customs union aimed at reducing the cross-border costs of goods and services have significantly reduced trade barriers and transaction costs when trading between the UK and EU countries and even in the world market. Analyzed in terms of economic theory, as in Franklin's case of free trade, free trade means higher levels of output and income for the world as a whole, along with higher levels of production and consumption, due to the optimal allocation of resources it achieves. The continuous reduction of trade barriers, on the other hand, is bringing the real conditions closer and closer to the ideal conditions in the theoretical analysis, which means that lower trade barriers within the EU market will lead to a better allocation of resources and better economic efficiency within the EU market as a whole. This also explains why low trade barriers are extremely beneficial to the progress of trade in the UK.[8]

The third one is the Single Market since 1992. The reduction of non-tariff barriers is equally vital in reducing trade costs, and it is why the EU put continuing efforts to create the Single Market with Europe. [9]

These initiatives have reduced the barriers to trade between the UK and the EU and thus increased trade between the English and the EU. According to Dhingra et al. [5], before the UK joined the European Economic Community (EEC) which was established in 1973, around a third of the UK's trade was with the EEC. In 2014, the other 27 EU members made up 45% of UK exports and 53% of UK imports. EU exports accounted for 13% of the UK's national income.

And the last one is the largest market in the world: $19 trillion GDP. EU member states account for a large share of trade with the UK, as shown in the grayed-out portion of the table below. Between 2006 and 2016, 55% of the UK's goods exports went to other EU member states, while 54% of the UK's goods also came from the EU.

Table.1. UK imports and exports from major trading partners in 2016

UK imports from major trading partners in 2016 (million $)			UK exports to major trading partners in 2016 (million $)		
Country or Region	Amount	Percentage	Country or Region	Amount	Percentage
Germany	89,092	14.1%	United States	63,012	15%
United States	58,483	9.2%	Germany	44,348	10.6%
China	55,264	8.7%	France	26,739	6.4%
Netherlands	47,434	7.5%	Netherlands	25,906	6.2%
France	36,587	5.8%	Ireland	23,190	5.5%
Belgium	32,102	5.1%	Switzerland	19,905	4.8%
Switzerland	26,303	4.2%	China	18,541	4.4%
Italy	24,552	3.9%	Belgium	15,965	3.8%
Spain	22,209	3.5%	Italy	13,308	3.2%
Ireland	18,358	2.9%	Spain	13,160	3.1%
Norway	17,394	2.7%	Hong Kong	9,487	2.3%
Canada	13,565	2.1%	UAE	9,250	2.2%
Japan	12,544	2%	Saudi Arabia	6,715	1.6%
Poland	12,534	2%	Japan	6,620	1.6%
Turkey	12,283	1.9%	Canada	6,309	1.5%

Source: Research on Influence of Brexit Referendum to Economic and Trade Relation Between UK and China

4.2 After Brexit

If the UK leaves the EU, it will lose access to the European single market, which will lead to higher trade barriers and higher tariffs; in other words, its trade in goods and services will face a significant increase in costs, the total amount of transactions will also decline, domestic industries will shrink, national income and employment rate will also decline. According to a study by the London School of Economics and Political Science, the UK's exit from the EU will lead to a 1.3% to 2.6% drop in GDP.

Since the EU as an enormous market contribution to the UK trade will undoubtedly be partly missing, it also means that the UK will have to seek the possibility of trade with other countries. When trading in other countries, the tariffs on trade costs will not be neglected; in addition, the customs entry policies of other countries will lead to more time costs and storage costs compared to the previous consumption of customs procedures. In addition, due to the geographical location, the UK's trade with the EU involves relatively small transport costs. But after Brexit, the UK seeks new trade with international markets, and will inevitably face a significant increase in transport costs, which will also hit the UK's trade.

Leaving the EU will mean that the UK will not continue to enjoy the trade agreements established within the EU and will also mean that the UK will lose the right to enjoy the benefits of trade agreements entered into by the EU with other economies. The UK will need to negotiate trade agreements with EU countries and other non-EU countries on its own and then enter into new trade agreements. For example, the EU-Canada free trade agreement would lapse for the UK, negotiating with Canada alone to obtain new trade facilities. But the UK, as a single country, has less bargaining power than the EU as a whole, which means that it may enjoy significantly fewer preferential trade agreements, and the time cost consumed by the negotiations is not to be underestimated.

In the short term, as the UK is forced to look outward for new trade partnerships, its trade will undoubtedly receive a blow. But in the long run perhaps the UK will open up new world trade lanes under this trade pressure and even regain its previous level of trade

Most scholars still believe that Brexit will hurt UK trade, such as Winston W. Chang [10], who believes that the emergence of tariff barriers will hurt UK exporters and shrink trade volumes, and Harald Oberhofer and Michael Pfaffermayr [11], who believe that Brexit will lead to a decline in trade flows, in addition to Ottaviano et al. [12], who argue that even under very optimistic assumptions, the loss in trade would be as large as nearly 2.2% of GDP.

5. Foreign Direct Investment

5.1 Before Brexit

EU membership has also enhanced the UK's position as a recipient of overseas direct investment. Around 3/4 of overseas investors surveyed attributed their reasons for investing in the UK to its ability to act as their gateway to the European market. The investors, especially the large multinational companies that can take advantage of the opportunities to deploy resources across borders, treat the UK as an export to take advantage of the EU Single Market and “enjoy frictionless trade with the rest of the EU.” [13] The “free movement of capital-one of the ‘four freedoms’ central to the EU Single Market” (Bisciari,2019) gives the UK a unique investment condition, leading to more investment from the investors of other EU members. Many countries, such as Japan, value the UK market because of the agreements signed within the EU that provide zero-tariffs and barrier-free trade preferences. Japanese government-backed investors keep announcing that tariff-free and barrier-free trade with the EU decides the future investment in the UK.

The Just-In-Time (JIT) supply chain takes full advantage of this efficient resource allocation, which is used in many UK car production. JIT originated in Japan as a management concept applied to the manufacturing industry, the core of which is the entire system has the right quantity and quality of items at the right time and place [14] The frictionless delivery is the key to the effectiveness of JIT, and frictionless trading facilitated by the EU Customs Union and the Single Market makes this model work well in the UK and the EU.

In terms of the Foreign Direct Investment, the UK's economic growth highly depends on the inflows of capital. According to Eurostat data, by 2012, the Foreign direct investment stock of the UK had reached 59.7% of the GDP of the UK.

As the figure below shows, since 2008, the EU has been the most significant contributor to the inward investment to the UK, and the EU membership significantly increased the UK’s FDI inflows by around 28%. [15]

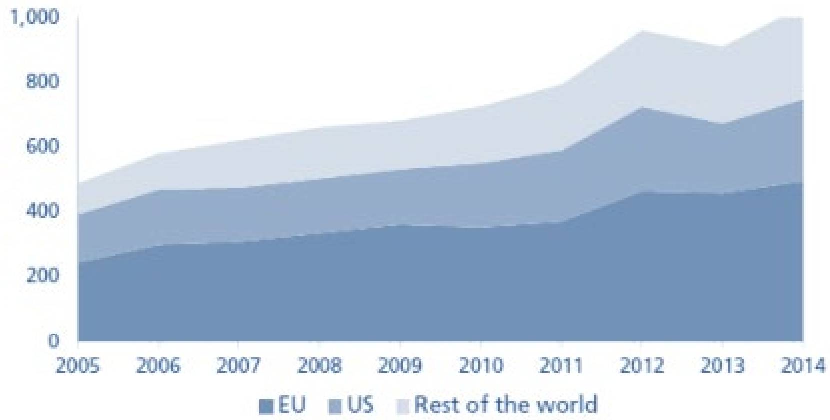

Figure 1. Inward investment to the UK by source (stock, £ billion) [15]

5.2 After Brexit

Leaving the EU could lead to a disinvestment in the UK by companies that see it as a door knocker to the European market and companies that value the low asset transfer costs and low people transfer prices that characterize the intra-EU. This is because once the UK leaves the EU, it will no longer enjoy the benefits of intra-EU agreements and will no longer be able to be an access point to the European market.

As the Japanese government says, they are not optimistic about continuing the trade between Japan and the UK if the EU leaves the EU single market. [16]

Leaving the EU could make it less attractive for investors in industries that use JIT-like models, such as automotive and aircraft manufacturing, to inject capital into the UK.

As mentioned above, the operation of JIT is highly dependent on the frictionless delivery brought about by the part of the EU internal agreement on customs duties and clearance procedures. So, if the UK chooses to leave the EU and exclude itself from the agreement, then JIT will no longer be able to continue to function in the UK. Specifically, post-Brexit border inspection and customs delays will seriously affect the just-in-time supply of raw materials. Companies will have to bear losses due to the time wasted on customs clearance and spend considerable costs for the storage of raw materials. This increase in cost will reduce the UK's priority as a location for the automotive industry; in other words, it will reduce the FDI the UK achieves in manufacturing. Companies using the JIT-like model that invested in the UK before Brexit will choose between withdrawing their investment in the UK and building a large number of warehousing facilities to make up for temporary material shortages caused by over-customs. Since the latter implies considerable storage costs and a readjustment of the entire JIT chain, most investors will choose to withdraw their investments in the UK. As KPMG noted, the simplicity and flexibility may be the fundamental reasons why the UK is invested in the original equipment manufacturers, such as the automobile manufacturers. So, Brexit may push original equipment manufacturer companies into a marginalized place which will hurt the FDI in the UK.

When the UK was a member of the EU, there were bound to be some countries that invested in the UK for political reasons. If the UK is no longer part of the EU, there will be some inevitable effects on investments in the UK from some of these countries, which means that capital on a large scale will come out. This will have an extremely serious negative influence on the UK's economic development.

Interestingly, although some scholars, such as Ellen R. McGrattan and Andrea Waddle [18], are optimistic about the impact of Brexit on UK FDI, they believe that UK FDI will benefit if the UK reduces restrictions on major investors other than the EU. But most scholars still feel that its impact on UK FDI is very huge and bad, such as Alfaro et al. [17] who argue that based on some academics' projections, Brexit will lead to a reduction in FDI flows to the UK by approximately 22% and Mihaela Simionescu [18] who think the exit will definately have a negative influence on the number of FDI projects, as well as on the new and guaranteed employment generated by these FDI projects.

6. Conclusion

On the whole, the advantages of Brexit for the UK outweigh the disadvantages it brings. In terms of trade, although it allows Britain to seek new trade objects, develop new trade channels and form a new world trade pattern, it will give Britain a bigger blow to trade in the short term. As mentioned in the article, the UK will be forced to leave the European single market, which can significantly reduce trade barriers to promote British trade, resulting in the UK can no longer enjoy the previous EU agreements concluded in favor of trade, which means that the UK will be a separate country and some countries or regions to negotiate trade issues, which will inevitably lead to the UK in trade losses. All in all, Brexit will have an impact on the UK's trade development.

What about looking at FDI, the conclusion does not seem to be too different from the TRADE part. What about looking at FDI, the conclusion does not seem to be too different from the TRADE part. Brexit means that some companies that previously saw the UK as a market to expand into Europe will withdraw their investments in the UK, while companies that have the intention to invest but have not yet invested in the UK will also choose a better option. In addition, Brexit will also severely impact the UK's attractiveness to the automotive and aircraft manufacturing industries that rely heavily on the EU import/export model using a JIT-like production model. Some EU member states that encouraged investment in the UK after Brexit because of political considerations will also re-examine the need to invest in the UK, which will also have an impact on FDI in the UK. All in all, Brexit is not good for FDI in the UK.

References

[1] Begg I. Who pays for the EU and how much does it cost the UK? Disentangling fact from fiction in the EU Budget[J]. The UK in a Changing Europe, 2016, 27.
[2] Yang Yi. The economic reasons behind Britain's exit from the EU
[3] Jiang Xiaohan. Analysis of the Result of Brexit and its influence
[4] Li Dawei, Jin Ruiting. The Impact of the UK's Brexit on the EU and the Global Economy and China's Countermeasures
[5] Dhingra S, Ottaviano G I P, Sampson T, et al. The consequences of Brexit for UK trade and living standards[J]. 2016.
[6] Li Chengxi. Research on Influence of Brexit Referendum to Economic and Trade Relation Between UK and China
[7] Baier S L, Bergstrand J H, Egger P, et al. Do economic integration agreements actually work? Issues in understanding the causes and consequences of the growth of regionalism[J]. World Economy, 2008, 31(4): 461-497.
[8] Ma Jing, Lu Yuduo. Free Trade or Protection: A Literature Review on Trade Barriers
[9] Breinlich H, Dhingra S, Estrin S, et al. BREXIT 2016: policy analysis from the Centre for Economic Performance[R]. Centre for Economic Performance, LSE, 2016.
[10] Chang W W. Brexit and its economic consequences[J]. The world economy, 2018, 41(9): 2349-2373.
[11] Oberhofer H, Pfaffermayr M. Estimating the trade and welfare effects of Brexit: A panel data structural gravity model[J]. Canadian Journal of Economics/Revue canadienne d'économique, 2021, 54(1): 338-375.
[12] Ottaviano G I P, Pessoa J P, Sampson T, et al. Brexit or Fixit? The trade and welfare effects of leaving the European Union[J]. 2014.
[13] Bisciari P. A survey of the long-term impact of Brexit on the UK and the EU27 economies[J]. 2019.
[14] Javadian Kootanaee A, Babu K N, Talari H. Just-in-time manufacturing system: From introduction to implement[J]. Available at SSRN 2253243, 2013.
[15] Tetlow G, Stojanovic A. Understanding the economic impact of Brexit[J]. Institute for government, 2018: 2-76.
[16] McGrattan E R, Waddle A. The impact of Brexit on foreign investment and production[J]. American Economic Journal: Macroeconomics, 2020, 12(1): 76-103.

[17] Alfaro L, Chanda A, Kalemli-Ozcan S, et al. FDI and economic growth: the role of local financial markets[J]. Journal of international economics, 2004, 64(1): 89-112.

[18] Simionescu M. The influence of BrExit on the foreign direct investment projects and inflows in the United Kingdom[R]. GLO Discussion Paper, 2017.