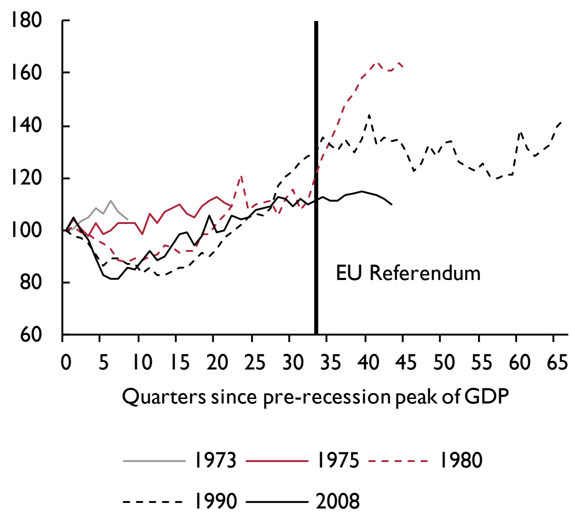
The disappointing picture of business investment

Business investment in the UK is estimated to have fallen for each of the four quarters of 2018 and recent surveys of business leaders indicate that there is no rebound on the horizon. Sustained low investment constitutes a major area of concern for the UK economy, with consequences for living standards in the longer term. In this box we review the latest data and discuss what has made the United Kingdom a less attractive place to invest in the midst of Brexit uncertainty. A key question is whether investment would recover should there be more clarity about the UK's future trading relationship with the rest of the world.

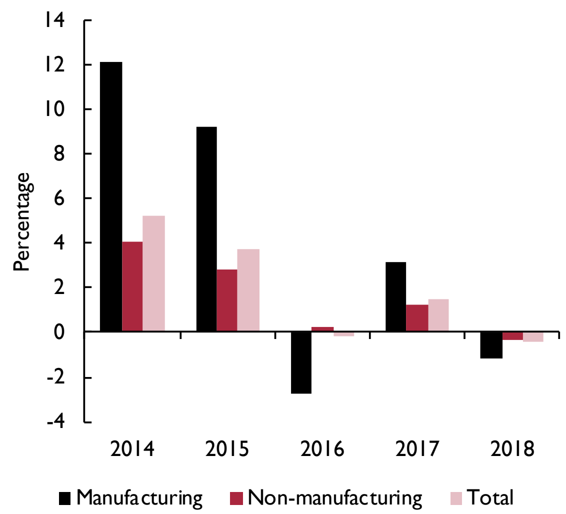
Relative to the past four recessions, this expansion phase has been prolonged. As figure 1 shows, it is only in the past 2½ years that the level of investment has clearly disappointed relative to previous expansions, corresponding to about the same date as the EU Referendum. The level of business investment in the last quarter of 2018 was about 13% less than an extrapolation of the 2010–16 trend would have predicted. The UK picture also compares unfavourably to other advanced economies as the UK is the only G7 country where business investment is estimated to be declining. Even in the rather favourable modal scenario of a soft Brexit where the UK retains a very close trade relationship with the EU, we expect no rebound in business investment this year: we forecast ¼% growth for 2019 as a whole, reflecting the likely persistence of uncertainty, and the Bank of England forecasts a fall by ½% for each of the first three quarters of 2019 (Bank of England, 2019).

Figure 1. Business investment after previous recessions



Source: ONS and NIESR calculations.

Figure 2. Annual growth in business investment (UK)



Source: ONS and NIESR calculations.

The slowdown in business investment since 2016 has been apparent in both manufacturing and non-manufacturing sectors (figure 2). Manufacturing investment has been growing strongly ahead of the referendum before contracting in 2016, recovering slightly in 2017, and contracting again in 2018. There was a brief rebound in business investment in 2017, but this rebound proved short-lived, in both manufacturing and non-manufacturing sectors.

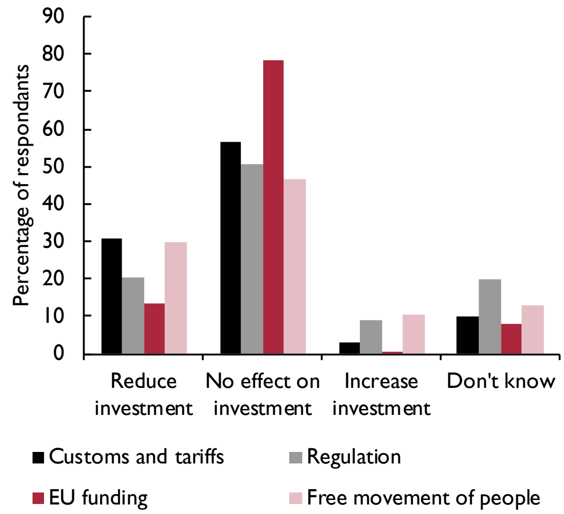
To what extent has Brexit dampened investment in the UK? Brexit affects business investment in two ways. First the uncertainty related to the future trading arrangement between the UK and the EU-27 causes business leaders to delay or forego investments until they feel more confident about how the new arrangement will affect the profitability of their investments. According to the Deloitte CFO survey (2019), 58% of Chief Financial Officers consider that the current level of uncertainty affecting their businesses is either high or very high, which is the highest reading since the summer of 2016. Bloom *et al.* (2018) estimated that the increase in uncertainty led to investment being 6% lower than otherwise predicted. Faced with the risk that a disorderly Brexit might create disruptions to their businesses, business leaders are currently more focussed on stockpiling than investing in the future.

Second, even when businesses know for sure what the new trading arrangements will be once the UK is out of the EU, they may still wish to reduce their investment because the additional trade frictions could warrant a lower equilibrium level of investment. The Bank of England Decision Maker Panel Survey (DMP, 2018) confirms that more businesses expected to reduce their investment than to increase it directly as a result of Brexit. In a survey between November 2017 and January 2018, about 30%

The disappointing picture of business investment (continued)

of business leaders expected changes in customs and tariffs and in the freedom of movement of people to lead to lower investment, and only 10% expect Brexit to lead to higher investment (figure 3). NIESR estimates that in the case of a no-deal exit from the EU, business investment would be reduced by 3.5% in the long run compared to continued membership in the EU because of reduced international competition and lower foreign direct investment (Hantzsche *et al*., 2019). It is important to note that while only businesses trading with the EU are expected to be directly impacted by Brexit, other businesses will also be impacted by second round effects as a result of changes in the exchange rate, inflation, financing conditions and consumption.

Figure 3. Expected impact of Brexit in investment due to potential changes



Source: Bank of England Decision Maker Panel (Nov. 2017–Jan. 2018).

The loss in attractiveness of the UK economy as an environment for investment has been reflected in lower-than expected foreign direct investment (FDI). Serwicka and Tamberi (2018) estimated that since the EU referendum, UK inflows of FDI have been reduced by between 16 and 20 per cent. They found that the service sector was particularly hit, with a reduction in FDI of about 25 per cent. Conversely, Breinlich *et al*. (2019) estimated that the number of new investments made by UK firms in European Union (EU) countries since the EU referendum was 12% higher than it would otherwise have been expected to be. Overall, these two effects suggest that there may have been some diversion of investment from the UK to other European countries as a result of the loss of attractiveness of the UK as a base for international business. We should however take those results with a degree of caution because while the UK's share of FDI in Europe has been reduced, the UK is still one of the largest recipients of FDI in the World, and FDI flows are very volatile from one year to the next.

While the Brexit vote is widely cited as a primary factor behind relatively low investment, other long-term factors like the labour market and productivity may also help explain the disappointing investment figures. An expanding labour market (unemployment at record low and employment at record high) along with unit labour costs growing very moderately has meant that businesses have invested relatively more in labour than in fixed capital. But this argument does not explain the relative weakness of UK business investment compared to other advanced economies that are broadly in the same business cycle position and with similar employment situations. Another argument is that weak investment growth may be related to the productivity puzzle. UK productivity growth in the past ten years has lagged behind all other advanced economies except Italy. If businesses doubt that additional investment can lift their productivity, then it could explain why they have limited their investments.

The combination of Brexit uncertainty and lagging productivity performance appears to have made investing in the UK less appealing. The more worrying feature would be that, if the low business investment trend were to continue, it could impair future economic growth prospects.

This box was prepared by Cyrille Lenoel.

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