This is a repository copy of *Paying our way in the world? Visible and invisible dangers of Brexit*.

White Rose Research Online URL for this paper:
http://eprints.whiterose.ac.uk/130811/

Version: Accepted Version

Article:

Perraton, J.R. orcid.org/0000-0003-3743-6847 and Spreafico, M.R.M. (2019) Paying our way in the world? Visible and invisible dangers of Brexit. New Political Economy, 24 (2). pp. 272-285. ISSN 1356-3467

https://doi.org/10.1080/13563467.2018.1484718

This is an Accepted Manuscript of an article published by Taylor & Francis in New Political Economy on 19/06/2018, available online: http://www.tandfonline.com/10.1080/13563467.2018.1484718

Reuse

Items deposited in White Rose Research Online are protected by copyright, with all rights reserved unless indicated otherwise. They may be downloaded and/or printed for private study, or other acts as permitted by national copyright laws. The publisher or other rights holders may allow further reproduction and re-use of the full text version. This is indicated by the licence information on the White Rose Research Online record for the item.

Takedown

If you consider content in White Rose Research Online to be in breach of UK law, please notify us by emailing eprints@whiterose.ac.uk including the URL of the record and the reason for the withdrawal request.

eprints@whiterose.ac.uk
https://eprints.whiterose.ac.uk/

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

Jonathan Perraton[a*] and Marta R. M. Spreafico[b]

a Department of Economics, University of Sheffield, United Kingdom ORCID: 0000-0003-3743-6847; b Cambridge Centre for Economic and Public Policy, University of Cambridge, United Kingdom. Correspondence: Jonathan Perraton j.perraton@sheffield.ac.uk , Department of Economics University of Sheffield, 9 Mappin Street, Sheffield S1 4DT, United Kingdom.

Keywords: Brexit, balance of payments, British growth model

Jonathan Perraton is Senior Lecturer in Economics at the University of Sheffield and an associate follow of the Sheffield Political Economy Research Institute. He has published on economic globalisation, political economy and economic methodology.

Marta Spreafico is an Associate Member of the Cambridge Centre of Economic and Public Policy, Department of Land Economy, University of Cambridge, UK. She undertook her PhD in Economic Policy at the Catholic University of the Sacred Heart, Milan on Institutions and Growth: The Experience of the Former Soviet Union Economies. Her research interests include the economics of inequality and growth.

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

The UK economy has long been associated with a weak balance of payments, reflecting an underlying growth model reliant on private household consumption. A deficit in goods trade, chiefly with the EU, has been offset by surpluses in services trade and foreign investment earnings. The Single Market provided wider markets for the UK, but did not fundamentally alter Britain's structural weaknesses. The Brexit vote took place against the background of Britain running its largest peacetime current account deficit. Financing Britain's external position represents a key challenge post-Brexit. Post-Brexit models for Britain partially address this. Any emergent model will critically depend on the nature of the Brexit deal with the EU, not least in terms of the impact on financial services and on supply chains.

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

Keywords: word; Brexit, balance of payments, British growth model

1. Introduction

In 2016 the United Kingdom's current account deficit hit a peacetime record of more than 5 per cent of GDP. It has been claimed that a country's current account enters a danger zone for sustainability around 5 per cent of GDP; indeed, the 5 per cent limit has often been taken as an early warning indicator for crises in emerging economies. There are, of course, key differences between Britain and emerging economies, but Brexit still poses an unprecedented challenge for the British economy. Although this deficit has fallen back since then, it remains high despite the depreciation of sterling since the June 2016 referendum result.

By definition, such a deficit requires overseas financing, leading Bank of England governor Mark Carney (channelling Blanche DuBois) to comment that Britain

is now relying on the ‘kindness of strangers’ to finance its external deficit (Carney 2017). Brexit is widely forecast to have a negative impact on Britain’s trading relations and its ability to attract foreign investment. Much of the discussion has focused on the direct impact of Brexit on trade, but the effects on the capital account are key too as the UK will either have to continue to attract capital inflows to offset the current account deficit or to engineer a marked improvement in its current account position. The former would require continued international investor confidence in the UK; without a new economic strategy the latter could only be achieved through lower living standards.

This paper examines Britain’s balance of payments in the context of the British growth model. It examines the likely impact of Brexit on this, and how the economy may respond over the medium term to the challenges of achieving external balance. Section two of this paper considers the balance of payments in the context of the UK’s growth model, locating external deficits in terms of reliance on periodic consumption booms. Although Britain has a trade deficit, the worsening of the current account was mostly driven by the income balance, raising questions over its sustainability. Section three considers trade and current account developments, particularly in relation to the EU. Section four considers the potential impact of Brexit on Britain’s external position and the resulting policy implications; consensus forecasts predict significant losses from Brexit, but there may be policy strategies to mitigate this. Section five concludes.

2. The British Growth Model and the Balance of Payments

The United Kingdom has run a current account deficit almost continuously since the mid-1980s, averaging around 2 per cent of GDP (see figure 1). The UK experienced an extreme version of trends seen in other developed economies with deindustrialisation – a relative decline in manufacturing employment and output. The UK experienced a

particularly marked fall in the balance for manufactures, from high surpluses initially in the post-war period to continuous deficits from the early 1980s (Coutts and Rowthorn 2013, Perraton 2015). Much of this deindustrialisation had occurred by the early 1990s, but the process has continued since and the manufacturing balance has continued to deteriorate with a strong fall in this balance from the mid-1990s. The UK has seen its share of world goods trade decline and this was forecast to continue even before Brexit (OECD 2017). These developments were of particular significance in the context of the Brexit referendum vote; key drivers of the vote to leave were voters in areas that had experienced deindustrialisation and negative effects of globalisation generally.

[FIGURE 1 HERE]

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

[FIGURE 2 HERE]

From the mid-1980s, though, the continued deterioration in the balance for goods trade has only partially been offset by improvements to the services trade balance. Before 2012 the UK's current account was usually supported by net inflows on the primary income balance, the difference between income earned by UK residents on investment abroad and income paid on foreign-held investments in the UK. This item fluctuated, but on average there was a rate of returns differential with the returns on British overseas assets exceeding returns on foreign-held assets held in the UK. There was something of a *rentier* economy element here, deficits on trade being partially offset by net overseas investment earnings despite a weakening net international investment position. The positive rates of return differential appears to have reversed since 2011.

The balance of payments plays a key role in the operation of the British economic model. The 'privatised' or 'house price' Keynesianism underlying the British economic model has led to recurrent consumer spending booms based in part on rising property prices (Crouch 2009, Hay and Smith 2013); worsening trade deficits are in part the external counterpart to the falling households savings rates and rising debt associated with these consumption booms. Growth of credit is strongly associated with weakening current account positions. These developments can be traced back to the 1980s with financial liberalisation and rising homeownership, leading to a marked deterioration in Britain's external position (Muellbauer and Murphy 1990). Anglo-Saxon economies have evolved to this growth model, with weak current account positions (Baccaro and Pontusson 2016, Schwartz 2009). During the 'great moderation' period before the 2007/08 global financial crisis countries operating house price growth models typically experienced faster growth than the 'repressed rich', those current account surplus countries which relied more on export-led growth (Schwartz 2009: ch.

4). However, although consumption booms can promote short term growth, they are associated with slower longer term growth and credit crunch episodes (e.g. Kharroubi and Kohlscheen 2017). Household credit boom episodes tend to distort economic activity, channelling resources to low productivity sectors such as construction. The consolidation period following the end of debt build-up typically leads to financial instability, credit squeezes and subdued economic recovery. Commentators have noted the unsustainable nature of Britain's pre-crisis household consumption boom.

This Anglo-Saxon growth model is associated with relatively high levels of inequality. In the Britain case inequality rose significantly in the 1980s and early 1990 and has largely stabilised since at relatively high levels. The links between inequality and current account positions are not straight-forward, but higher inequality does appear to be associated with a weaker current account position from periodic private consumption booms (Behringer and van Treeck 2015, Kumhof *et al*. 2012). In principle increased inequality could lead to a shortfall in aggregate demand and a current account surplus to the extent that richer households consume less than poorer ones; instead, Anglo-Saxon economies have seen periodic episodes where poorer and middle income households maintained desired consumption levels in the face of squeezed living standards through lower saving and higher borrowing with an associated deterioration in these countries' current account positions.

The consumption boom in Britain from the mid-1990s led to a real appreciation of the exchange rate and thereby a current account deficit. A domestic consumption boom raises the price of non-tradable goods. The Bank of England, as an inflation-targeting central bank, responded to this rise in domestic demand by tightening monetary policy and thereby strengthening the currency. The real exchange rate appreciated from 1996 by around 20 per cent, and remained high until 2007 (see figure

3); this appreciation was particularly marked relative to other European currencies (Dury *et al*., 2003). This is a highly schematic account, though; the strong real appreciation of sterling from 1996 cannot be explained entirely in terms of the monetary policy response and sterling appeared over-valued on some estimates. The Bank of England had no target for sterling, effectively regarding it as a macroeconomic shock absorber, and arguably neglected the impact of its appreciation on tradable industries including manufacturing (cf. Alvaro and Arestis 2007, Cobham 2006). The UK also benefited from terms of trade improvements, partly reflecting growing imports from low cost emerging economies. These developments helped to dampen inflationary pressures from expansion.

[FIGURE 3 HERE]

A current account deficit must by definition have its counterpart in net borrowing by sectors within the economy. The government has run a deficit since 2002. Although the fiscal deficit has been widely noted, the weakening of household balances - both in the run up to the financial crisis and during the post-crisis recovery – also contributed to weakening the external balance. Partially offsetting this, the corporate sector has been in surplus for much of the period since 2003, reflecting subdued investment even before the financial crisis. This aggregate position though obscures key developments within this sector – whilst non-financial corporations have usually been in overall surplus, financial corporations overall have been net borrowers. Thompson (2013) sets out in detail the accumulated debts of this sector and its substantial overall contribution to the UK's total debt position. Since the onset of the financial crisis there

has been little private sector debt consolidation in the UK and much of that was by the non-financial corporate sector.

Since 2007 sterling has depreciated, with broadly similar movements relative to EU countries and the rest of the world, but the current account deficit has also risen. This real depreciation has been a key channel through which living standards have been squeezed with real household incomes having flat-lined since the mid-2000s. In particular, the current account deficit has risen sharply from 2011 at a time when, although economic activity was recovering, it was still weak. By comparison, the only occasions in the post-war period when the UK had a comparable current account deficit were during the mid-1970s oil crisis and in the late 1980s at the height of the Lawson boom. The deterioration in the current account during previous episodes was primarily driven by a worsening trade balance. By contrast, Britain's rising current account deficit since 2011 has been largely driven by a marked deterioration in the primary income balance; around 80 per cent of the increase in the deficit was due to a fall in net income on direct investment (ONS 2016). Further, much of this was driven by transactions with the EU – both a fall in returns on UK FDI in the EU and a decline in net FDI in the EU as British companies divest from Europe whilst European companies have increased their FDI in the UK.

[FIGURE 4 HERE]

This is part of a more general shift; historically movements in the UK's current account were largely driven by developments in the trade balance. The trade deficit remains a key component of the current account and typically accounts for the majority of the deficit. However, during this century the majority of *changes* in the UK current

account were accounted for by changes in the primary income balance (Bénétrix *et al*. 2015, Forbes 2016). Financial globalisation processes before the 2007/08 crisis led to growth of cross-border financial flows amongst developed economies and rises in their external assets and liabilities over that period. The figures for the UK are exceptional so that both UK foreign and assets and liabilities now exceed 500 per cent of GDP, having risen from around 150 per cent in 1997. These figures have fallen from their peaks with the decline in cross-border financial flows since the crisis (Forbes 2014; Bank of England 2015). More than half of British external assets and liabilities are accounted for by financial institutions.

The rate of return differential is volatile and not fully understood. The UK's position partly reflects the portfolio mix of UK assets – the UK has a positive net asset position in foreign direct investment (FDI), which would be expected to have relatively high returns, but it also reflects differences in the nature of the UK banking system's foreign asset and liability profile. In particular, the UK has run a persistent positive returns differential on FDI whereas the yield differentials for equity were typically negative (Bordon *et al*. 2016). The recent weakening of the primary income balance may reflect relatively short term factors, but it cannot simply be assumed that Britain's past positive rates of return differential will persist indefinitely or that the income inflows will return to earlier levels.

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

European) companies, although these flows are still relatively low – as a percentage of GDP these flows are now only around half the average levels of inflows since 1988 (Bank of England 2015). The UK's net international investment position worsened during the 1960s and 1970s, but improved substantially in the 1980s peaking in the mid-1980s. During the 2000s the net international investment position remained broadly stable relative to GDP even with continuous current account deficits; since 2012 the net international position has deteriorated, although this partly reflects valuation effects. There are considerable margins of error in estimating external wealth in relation to valuation of the total foreign assets and liabilities. Nevertheless the most recent estimates shown in figure 5, and based on wider surveys than hitherto, have revised downwards earlier measures of Britain's net international investment position point to a greater fall since 2007 despite the positive valuation effects of sterling depreciation. These revisions also point to continued worsening of relative returns on assets.

[FIGURE 5 HERE]

The UK is approaching Brexit with a large current account deficit despite subdued economic activity and sterling depreciation. The IMF estimated that the UK has an excess current account deficit relative to long term fundamentals (demographics, relative growth potential and net foreign asset position) even before the Brexit vote (IMF 2017). A weak trade position was compounded by a negative primary income balance from 2011. Britain has continued to attract FDI inflows to finance this deficit, mostly from EU-27 companies, and its net international investment position appears to have weakened. Previously the UK had been able to earn a net positive return on

overseas assets despite an apparently negative net international investment position, but this may be weakened by a fall in the net FDI position.

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

Britain's trade and financial relations with the rest of the EU are central to its overall external position. The EU accounts for around 45 per cent of British exports of goods and services, a share that has fallen from around 55 per cent at the start of the century. Imports from the EU account for around 54 per cent of UK imports; a figure that has been broadly stable this century. These figures understate the role of the EU in British trade given the preferential trading arrangements with over 50 further countries. With relatively slow growth in the Eurozone and the broader shifts in global patterns of economic activity, a fall in the EU's share of British exports is a predictable development and the EU remains Britain's largest trading partner. A clear deficit on goods trade is partially offset by a surplus on services trade. Britain has a small trade surplus with the rest of the world (chiefly with the US). As noted, the primary income account position has shifted to a deficit. The EU accounts for a similar share of foreign investment stocks; FDI in the EU accounts for around 41 per cent of the UK total, with the EU accounting for 43 per cent of total inward FDI in the UK. These shares have fallen from around half earlier in this century.

Forecasts of a negative impact from Brexit are largely expected to operate through lower trade and FDI inflows. Trade integration through the European Single Market is presumed to have pro-competitive effects raising productivity and lowering price mark-ups. FDI is also expected to stimulate competition and promote the transfer of best practice technology. Estimates of losses from leaving the Single Market assume that much of these gains would be lost with Brexit.

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

The UK retains some key areas of advantage in advanced manufacturing, but overall it has continued to lose market share in high technology manufactures. The entry of China and other emerging economies into global markets was associated with lower export shares for most major developed economies, including the UK. The relative technology intensity of exports is significantly associated with changes in export share and Britain's falling relative technology intensity since the mid-1990s partly explains the decline in Britain's share of world export markets over this period. In addition to adverse exchange rate movements, UK exports continue to suffer from longstanding weaknesses in non-price competitiveness. Benkovskis and Wörz (2014) show that the UK's loss of export share was largely driven by price factors from the mid-1990s, reflecting sterling appreciation; however, from the 2000s non-price competitiveness

explains an increasing proportion of the continued fall in the UK's share of global markets and accounts for the majority of the fall since the financial crisis. In general, the limited effect of the Single Market is not surprising; the programme was more extensive in eliminating barriers to cross-border trade in manufactures than for services (Mustilli and Pelkmans 2013), frequently across goods in which the UK does not have a strong comparative advantage. The European Commission has regularly noted the limited development of a single market in services. Successive British governments have pushed for deepening of the Single Market to promote services trade within the EU.

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

Over the longer term, growth must be consistent with balance of payments equilibrium; the UK patterns of specialisation are biased towards exports with relatively low income elasticities of demand whilst the UK tends to have relatively high demand for imports. This implies a relatively low long run growth rate consistent with balance of payments equilibrium (cf. Garcimartín *et al*. 2012); faster growth is possible in the short term, but this tends to be followed by a period of subdued growth. To the extent that Brexit weakens Britain's export position, longer run growth would be

reduced. Current account imbalances reflect underlying macroeconomic conditions and therefore it cannot simply be assumed that these could be improved by reorienting trade from countries with which Britain has bilateral deficits in the EU towards countries with which Britain currently runs a surplus. The EU remains central to Britain's trade and the evolution of its external position.

4. The Potential Impact of Brexit

Before the referendum official analysis predicted a range of negative developments in the immediate aftermath of a Brexit vote (HM Treasury 2016a), and independent forecasters made similar predictions. In the event, although the fall in sterling was broadly in line with expectations and inflation rose from higher import prices, the British economy did not experience a recession and unemployment continued to fall. Asset prices did not fall and there was no major increase in the premium on lending to UK businesses and households. Foreign demand for UK gilts has been strong since the referendum result and the UK has continued to attract FDI inflows, although there has been some decline in other inflows.

Growth since the referendum result, though, has almost entirely been driven by consumer expenditure as household savings rates fell to record lows and household debt-to-income ratios rose to levels close to their pre-financial crisis peaks. Moreover, forecasts indicate that this is likely to continue with little or no improvement in net exports (OBR 2018). Thus, activity has been maintained through a resumption of the debt-fuelled household consumption growth model, but this cannot be maintained indefinitely.

Sterling depreciation episodes since 2007 have only had a limited impact on raising exports. The initial fall from 2011 only led to limited improvements in export

performance as many companies used a lower pound to raise their margins rather than expand overseas sales (SPERI 2014). The depreciation of sterling following the referendum vote has had some effect on expanding export volume, but again producers have raised margins.[1] This will not necessarily lead to higher investment in export industries – if the fall in sterling is in anticipation of Brexit then this may reflect higher expected costs of trading; alternatively, the fall may, at least in part, be a temporary response to short run developments. It is not surprising that exporters have raised margins – profitability in the tradable sectors has been persistently lower than in non-tradable sectors, in part from the earlier period of real appreciation of sterling (cf. Broadbent 2017). To the extent that the deterioration of the UK's trading position reflects weaknesses in non-price competitiveness it cannot simply be offset by sterling depreciation but would require further investment in tradable industries.

Consensus forecasts indicate that Brexit will have a negative impact over the longer term is through reduced trade and FDI inflows. There is clearly considerable uncertainty over this, not least over the nature of the final arrangements after leaving the EU. Current projections are that post-Brexit arrangements will lead to Britain leaving the Single Market, with the British government's preferred outcome to be to negotiate a specific free trade agreement preserving tariff-free access to EU markets. The complexity of such trade negotiations effectively precludes concluding a final deal before Britain leaves the EU. Treasury forecasts before referendum predicted that GDP would be around 3-10 per cent lower over a decade against a baseline, depending on the nature of the final settlement (HM Treasury 2016b). Most forecasts made similar loss projections, some estimating that the hardest Brexit option of defaulting to trading on WTO rules would lead to even higher losses (e.g. Ebell and Warren 2016, Emmerson *et al*. 2016, OECD 2017, Van Reenen 2016). These studies also predict that Brexit would

lower immigration, although not by the levels projected by the government, with a further negative impact on output and productivity. Brexit has the potential to disrupt supply chains in the UK. Intermediates now account for a majority of the UK's trade in goods and services with the EU is in reflecting integration with European supply chains, and these exports and imports have grown during the current century (Levell 2018). Reportedly 63 per cent of supply chain managers in the EU27 with UK suppliers are planning to move some of their supply chains from the UK and around 40 per cent of British companies are looking to move away from EU suppliers.[2]

Estimates of potential losses from Brexit are clearly subject to margins of error. Gudgin *et al*. (2017) estimate that the Treasury study and similar independent estimates are likely to overstate the impact of Brexit. Such estimates are based on the now standard gravity model of trade and FDI, estimating the additional stimulus to flows that EU membership provides beyond the 'natural' levels predicted by the gravity model (and other controls). The gravity estimates of the impact of EU membership are based on average effects across a large number of economies; Gudgin *et al*. (2017) note that this is an average effect and re-estimate a gravity model for a more representative sample and report a lower expected impact of Brexit on trade and FDI. Gudgin *et al*. (2017) also query the assumed impact of Brexit on productivity in the estimates from the Treasury and others; in particular, the estimated impact of lower trade and FDI on productivity is based on an average effect across a wide range of economies; a narrower focus on developed country evidence suggests smaller effects of changes in trade and FDI on productivity. Much of inward FDI into the UK is in the form of mergers and acquisitions rather than new capital investment; this form of FDI is likely to have a lower impact on productivity than new investment in the capital stock. Gudgin *et al*.

(2017) estimate that supportive macroeconomic policy and a lower pound could largely offset any negative impact.

Beyond the details of any future trading arrangements with the EU, there is no clear post-Brexit economic model. Visions of a 'global Britain' as a free trading nation with low taxes and regulation negotiating bespoke trade deals (and/or pursuing a global services trade deal) have large elements of continuity with the current model. Defaulting to WTO rules would lead to further erosion of the manufacturing sector through the elimination of remaining tariffs; assumptions that adjustment to this would be smooth are belied by historical experience. The UK already has some of the lowest product and labour market regulations, and lowest corporate tax rates, amongst developed economies; the OECD (2017) identifies low skill provision and infrastructure weaknesses, rather than regulation, as central to the UK's post-crisis stagnation in productivity. Further, if the Britain has a negotiate post-Brexit arrangement, rather than moving to WTO rules, then this is likely to retain some degree of regulatory alignment with the EU. The UK has attracted inward FDI flows, but there is little evidence that further deregulation and corporate tax reductions would significantly increase inflows.

The challenge of balance of payments adjustment post-Brexit is to provide mechanisms for the UK to improve its current account position over the medium term and finance continued deficits over the short term. Visions of a 'global Britain' echo successive UK governments' policy assumptions that the UK can be expected to gain significantly from increased services trade with high income elasticity of demand for commercial services and on-going negotiations to reduce barriers to services trade both regionally and globally. The issue here is whether the combination of global growth and possible services trade liberalisation could generate the expansion in UK commercial services trade that could compensate for a deteriorating goods balance. Barattieri (2014)

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

Estimates indicate that withdrawal from the Single Market itself could cost the UK services sector up to 2 per cent of GDP (CEBR 2017, Emmerson *et al*. 2016). The position of the City of London faces competitive challenges, although it is likely that the City would still be able to retain much of its business post-Brexit; London has longstanding advantages relative to other financial centres in its time-zone, notably in terms of established networks and the common law system (SPERI 2017). At least some sections of the UK financial services industry would prefer a Brexit deal beyond EEA membership with regulatory alignment; Single Market membership outside the EU would leave the UK subject to EU financial services rules without any formal input to their development. Britain appears likely to leave the Single Market but attempt to negotiate a trading arrangement preserving tariff free trade with the EU; this would result in services trade with the EU facing greater barriers than goods trade.

There would be challenges to expanding services trade beyond the EU to compensate for any loss of trade after Brexit. British services exports beyond the traditional markets of Europe and North America remain small. India apart, the UK has

relatively low services exports to the major emerging economies but these have grown. There is a particular issue here that services trade frequently requires mobility of labour given the nature of the product and the requirement for interaction between suppliers and consumers; the tradable services industry has also been a key employer of foreign labour. Global negotiations for liberalisation through the WTO are effectively stuck, though. The EU is currently party to negotiations of 23 WTO members for a Trade in Services Agreement (countries that together account for 70 per cent of world services trade), but negotiations are currently on hold. There is the potential for services trade liberalisation to raise UK exports, but the political economy currently militates against negotiating trade liberalisation deals either globally or bilaterally. Further, broader global trends may also have become less favourable. Before the financial crisis the continuation of globalisation processes was largely assumed and it was widely predicted that growth of global services trade would accelerate. Since then, although services trade has been more resilient than trade in goods, there has been a downturn in global services trade since the crisis. There has been clear retrenchment of financial globalisation since the crisis; although this primarily reflects a decline in international capital flows, particularly cross-border banking, this may also impact on commercial services trade more generally (Credit Suisse Research Institute 2017, Forbes 2014, McKinsey 2016). The assumption of continued strong growth in global services trade, and with it demand for UK exports, may not hold.

Although deindustrialisation is common across developed economies, manufacturing is particularly weak in the UK even relative to comparable economies. Weak performance alongside some high technology strengths reflects a long tail of companies with low productivity and exports (OECD 2017). This is central to Britain's high regional inequality – these companies are concentrated in poorer regions that also

have greater exposure to EU trade. Exports and productivity could be raised if the gap between leading British companies and laggards were to be reduced; this would not necessarily entail directed industrial policy, but would require not simply the greater provision of skills and infrastructure but also a specific regional dimension to such measures. Gudgin *et al*. (2017) advocate fiscal expansion to mitigate the impact of Brexit. More generally, there is a case for higher public investment with an emphasis on lagging regions (Weisbrot and Merling 2018); whilst this would not directly address trade, it would be likely to boost capacity in these regions and encourage private investment. This could also promote more broadly-based growth that would tend to reduce inequality, both individual and regional.

Consensus estimates indicate a negative impact of Brexit, although this may be limited with a negotiated arrangement to preserve tariff-free trade. Large British companies are already relatively oriented in their sales towards non-EU markets and have developed extensive offshoring networks. Britain's relative advantage in services could provide the basis for export expansion, but negotiating further liberalisation through bilateral agreements or globally through the WTO appears problematic. Further, the pre-crisis phase of rapid growth of global services trade may have passed. The key to addressing the trade challenges of Brexit may lie less in targeting leading edge sectors than in addressing longstanding weaknesses of lagging companies and regions.

5. Conclusions

Brexit is being undertaken at a time when the UK is running a large current account deficit, despite subdued economic activity and sterling depreciation since the referendum result. A weak external balance position is a corollary of the British growth model that has emerged from the 1980s – periodic private consumption booms leading

to a deterioration of the current account and a financial sector that has accumulated high past debts. Underlying this is an economy characterised by high inequality and latterly weak productivity and stagnating real incomes. Deindustrialisation left the UK with a relatively weak manufacturing sector; this was only partially offset by a sustained improvement in the services trade balance. The rise in inequality from the 1980s reflected a combination of structural changes and policy choices; deindustrialisation and the rise of the financial services sector have raised inequality, both personal and regional.

Although strong growth in services exports partially offset a worsening trade balance from deindustrialisation, the current account was previously supported by surpluses on the primary income balance reflecting a favourable rate of returns differential on British overseas assets. This now appears to have been eroded as Britain's net international investment position has weakened; over the medium term Britain thus needs to raise its net exports. Brexit is likely to aggravate these developments, both through its impact on trade but also on foreign investment flows. If foreign investors respond to Brexit by increasing the risk premium required on investment in the UK then this would erode further any positive rates of return differential. The EU is central to the UK's primary income balance. A key mechanism for adjustment since the financial crisis has been the depreciation of sterling; this has only had a limited effect on stimulating exports, but has been significant in squeezing living standards.

Any continued current account deficit requires funding. In short term it now appears unlikely that Brexit will lead to a sudden stop balance of payments crisis of the type seen in emerging economies in the 1990s. There remains strong demand for UK gilts and as yet no indicators of a rise in the risk premium, whilst outstanding UK

government debt is relatively long-dated. The currency composition of UK overseas assets and liabilities is favourable. There have been outflows on some assets; a sudden loss of confidence could still precipitate further falls in sterling.

The challenge over the medium term is to expand net exports to compensate for deterioration of the primary balance and the negative impact of Brexit on trade with the EU. There are few precedents for a policy change in a developed economy of this magnitude. A post-Brexit settlement that largely preserved market access might lead to relatively small losses. One that leads to significant disruption of financial services trade and production networks could potentially lead to losses comparable to a major recession. Whilst past precedents of major adjustment to balance of payments disequilibrium amongst developed economies are limited, they do point to much of this occurring through pressure on living standards. Although the UK has continued to attract inward investment since the Brexit vote to offset the current account deficit, these inflows may not continue at current levels. Britain's ability to attract FDI inflows may weaken as Brexit makes the UK a less attractive location for overseas companies

Overall Brexit poses major challenges to Britain's external balance. Whatever the final settlement, trade is particularly vulnerable in key areas –Britain's strong position in commercial services trade, not least with the EU, is likely to be undermined. The UK is thus likely to continue to run a current account deficit. A fall in sterling is unlikely to boost net exports sufficiently. In the 'global Britain' vision, the UK may negotiate new trade agreements to boost exports with non-EU countries, but it is unlikely that these could offset lost EU trade. An alternative strategy may be to raise public investment in infrastructure and skills, particularly in lagging regions.

Acknowledgements: versions of this paper were presented at the Britain and Europe: The political economy of 'Brexit' in trade and finance Workshop at the University of York, 14 June 2016 and the Political Studies Association annual conference, Cardiff, April 2018. We thank participants and three *NPE* referees for their comments. The authors remain solely responsible for the paper.

References:

Alvaro A. and Arestis, P. (2007), 'Monetary Policy in the UK'**,** *Cambridge Journal of Economics*, 31, pp. 863-884.

Baccaro, L. and Pontusson, J. (2016), **'**Rethinking Comparative Political Economy: The Growth Model Perspective', *Politics and Society*, 44, pp. 175–207.

Bank of England (2015), Financial Stability Report. Issue No. 38 (London: Bank of England).

Barrell, R., Choy, A. and Kirby, S. (2006), 'Globalisation and UK Trade', *National Institute Economic Review*, 195, pp. 63-67.

Barattieri, A. (2014), 'Comparative Advantage, Service Trade, and Global Imbalances', *Journal of International Economics*, 92 (1), pp. 1-13.

Behringer, J. and van Treeck, T. (2015), Income Distribution and the Current Account: A Sectoral Perspective, Society for the Study of Inequality Working Paper 379.

Bénétrix, A., Lane, P. and Shambaugh, J. (2015), 'International Currency Exposures, Valuation Effects and the Global Financial Crisis', *Journal of International Economics*, 96 (S1), pp. S98-S109.

Benkovskis, K. and Wörz, J. (2014), What Drives the Market Share Changes? Price versus Non-Price Factors. European Central Bank Working Paper 1640.

Borchert, I., Gootiiz, B. and Mattoo, A. (2014), '*Policy Barriers to International Trade in Services: Evidence from a New Database', World Bank Economic Review*, 28, pp. 162-188.

Bordon, A., Mrkaic, M. and Shirono, K. (2016), 'United Kingdom: Selected Issues.' IMF Country Report No. 16/58. (Washington, DC: International Monetary Fund).

Broadbent, B. (2017), 'Brexit and the Pound', Speech 23 March (London: Bank of England).

Buisán, A. and Sebastia-Barriel, M. (2006), 'UK Export Performance by Industry', *Bank of England Quarterly Bulletin*, 46 (3), pp. 308-316.

Carney, M. (2017), 'A Fine Balance', Speech 20 June (London: Bank of England).

CEBR (2017), The economic impact on services from the UK losing Single Market access (London: Centre for Economics and Business Research).

Cobham, D. (2006), 'The Overvaluation of Sterling Since 1996: How the Policy makers Responded and Why', *The Economic Journal*, 116, F185–F207.

Coutts, K. and Rowthorn, R. (2013), ‘The UK Balance of Payments: Structure and Prospects’, *Oxford Review of Economic Policy*, 29 (2), pp. 307–325.

Credit Suisse Research Institute (2017), Getting over Globalization. https://www.credit-suisse.com/media/assets/corporate/docs/about-us/research/publications/csri-getting-over-globalization.pdf

Crouch, C. (2009), ‘Privatised Keynesianism: An Unacknowledged Policy Regime’, *British Journal of Politics and International Relations,* 11*, pp. 3*82-399.

Dury, K., Piscitelli, L., Sebastia-Barriel, M. and Yates, A. (2003), ‘What caused the rise in the UK terms of trade?’, *Bank of England Quarterly Bulletin*, Summer, pp. 164–76.

Ebell, M. and Warren, J. (2016), ‘The long-term economic impact of leaving the EU’, *National Institute Economic Review*, 236, pp. 121-38.

Emmerson, C., Johnson, P. and Mitchell, I. (2016), *The EU Single Market: The Value of Membership versus Access to the UK* (London: Institute for Fiscal Studies).

Forbes, K. (2014) Financial “deglobalization”?: capital flows, banks, and the Beatles. (London: Bank of England).

Forbes, K. (2016), The UK Current Account Deficit: Risky or Risk-Sharing? Speech 21 March (London: Bank of England).

Garcimartín, C., Alonso, J. and Rivas, L. (2012), ‘Convergence and Balance of Payments Constrained Growth: Is There a Puzzle?’, in Soukiazis E. and Cerqueira P. (eds) *Models of Balance of Payments Constrained Growth* (London: Palgrave Macmillan), pp. 189-216.

Gudgin, G., Coutts, K., Gibson, N., and Buchanan, J. (2017), The Macro-Economic Impact of Brexit**,** Centre for Business Research, University of Cambridge, Working Paper No. 483.

Hay, C. and Smith, N. (2013), ‘The Story of a North Sea Bubble: The Strange Demise of the Anglo-Liberal Growth Model in the United Kingdom and Ireland’, *European Political Science Review*, 5, pp. 401-430.

HM Treasury (2016a), The Immediate Economic Impact of Leaving the EU. Cmnd 9292.

HM Treasury (2016b), The Long-term Economic Impact of EU Membership and the Alternatives. Cmnd. 9250.

IMF (2017), External Sector Report. IMF Policy Paper (Washington DC: International Monetary Fund).

Joy, M., Lisak, N., Lloyd, S. Reinhardt, D., Sajedi, R. and Whitaker, S. (2018), Mind the (Current Account) Gap. Bank of England Financial Stability Paper No. 43.

Kharroubi, E. and Kohlscheen, E. (2017), 'Consumption-led Expansions', *BIS Quarterly Review*, March, pp. 25-37.

Kumhof, M., Lebarz, C., Rancière, R., Richter. A. and Throckmorton, N. (2012), Income Inequality and Current Account Imbalances, IMF Working Paper 12/8 (Washington DC: International Monetary Fund).

Levell, P. (2018), Firms' supply chains form an important part of UK-EU trade: what does this mean for future trade policy? Institute for Fiscal Studies.
https://www.ifs.org.uk/publications/10302

Marin, D., Schymik, J. and Tscheke, J. (2015), Europe's Export Superstars – It's The Organisation! Bruegel Working Paper 2015/05.

Mayer, M., Hautz, J., Stadler, C. and Whittington, R. (2017), 'Diversification and Internationalization in the European Single Market: The British Exception', *Business History Review*, 91, pp. 279-299.

Miroudot, S., Sauvage, J. and Shepherd, B. (2013), 'Measuring the cost of international trade in services', *World Trade Review*, 12, pp. 719-35.

McKinsey Global Institute (2016), The New Dynamics of Financial Globalization:
https://www.mckinsey.com/industries/financial-services/our-insights/the-new-dynamics-of-financial-globalization

Muellbauer, J. and Murphy, A. (1990), 'Is the UK Balance of Payments Sustainable?', *Economic Policy*, 5 (11), pp. 347-395.

Mustilli, F. and Pelkmans, J. (2013), Access Barriers to Services Markets: Mapping, tracing, understanding and measuring. CEPS Special Report No. 73 (Brussels: Centre for European Policy Studies).

OBR (2018) Economic and Fiscal Outlook – March 2018.

OECD (2017), *Economic Surveys: United Kingdom* (Paris: OECD Publishing).

ONS (2016), An analysis of the drivers behind the fall in direct investment earnings and their impact on the UK's current account deficit. Office for National Statistics.

Perraton, J. (2015), 'Globalisation and the UK Economy since the 1990s', in J. Green, C. Hay and P. Taylor-Gooby, (eds), *The British Growth Crisis: The Search for a New Model* (Basingstoke: Palgrave Macmillan), pp. 242-60.

Schwartz, H. (2009), *Subprime Nation: American Power, Global Capital, and the Housing Bubble* (Ithaca NJ: Cornell University Press).

SPERI (2014), Sterling depreciation and the UK trade balance. SPERI British Political Economy Brief No. 2.

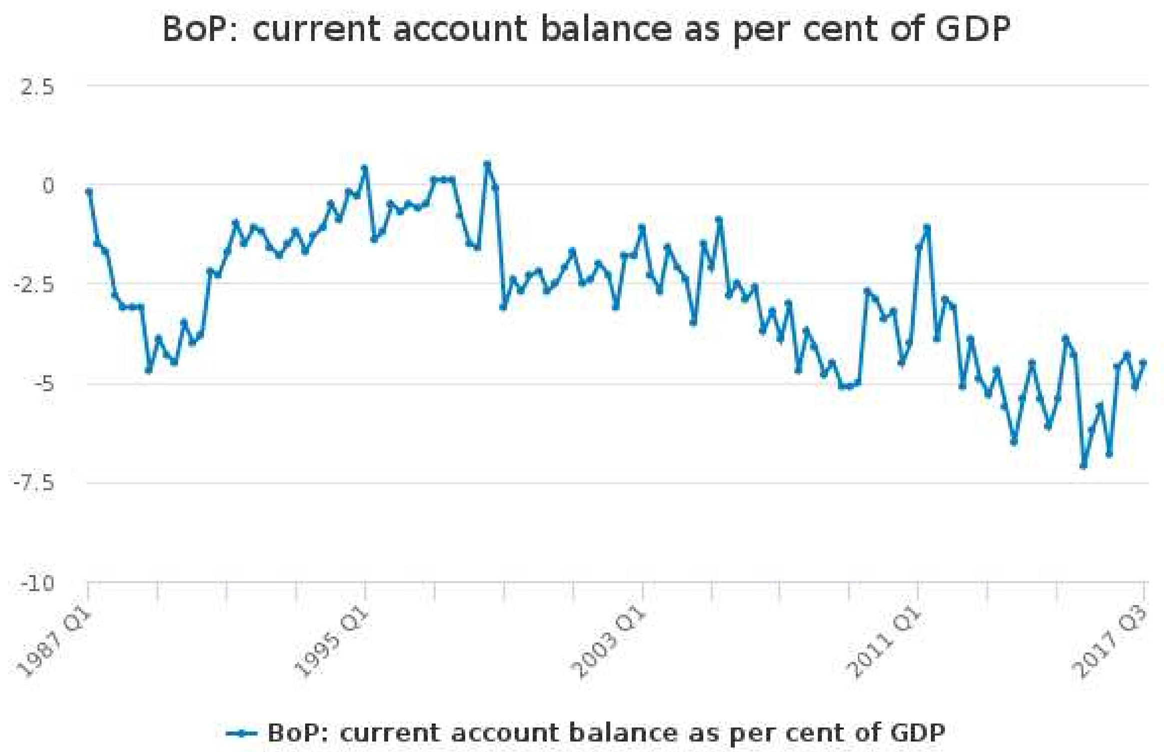
SPERI (2017), Frankfurt, Paris and Dublin: Post-Brexit Rivals to the City of London. SPERI Global Political Economy Brief No. 6.

Thompson, H. (2013), 'UK Debt in Comparative Perspective: The Pernicious Legacy of Financial Sector Debt', *British Journal of Politics and International Relations*, 15, pp. 476–492.

Van Reenen, J. (2016), 'Brexit's Long-Run Effects on the U.K. Economy', *Brookings Papers on Economic Activity*, Fall, pp. 367-83.

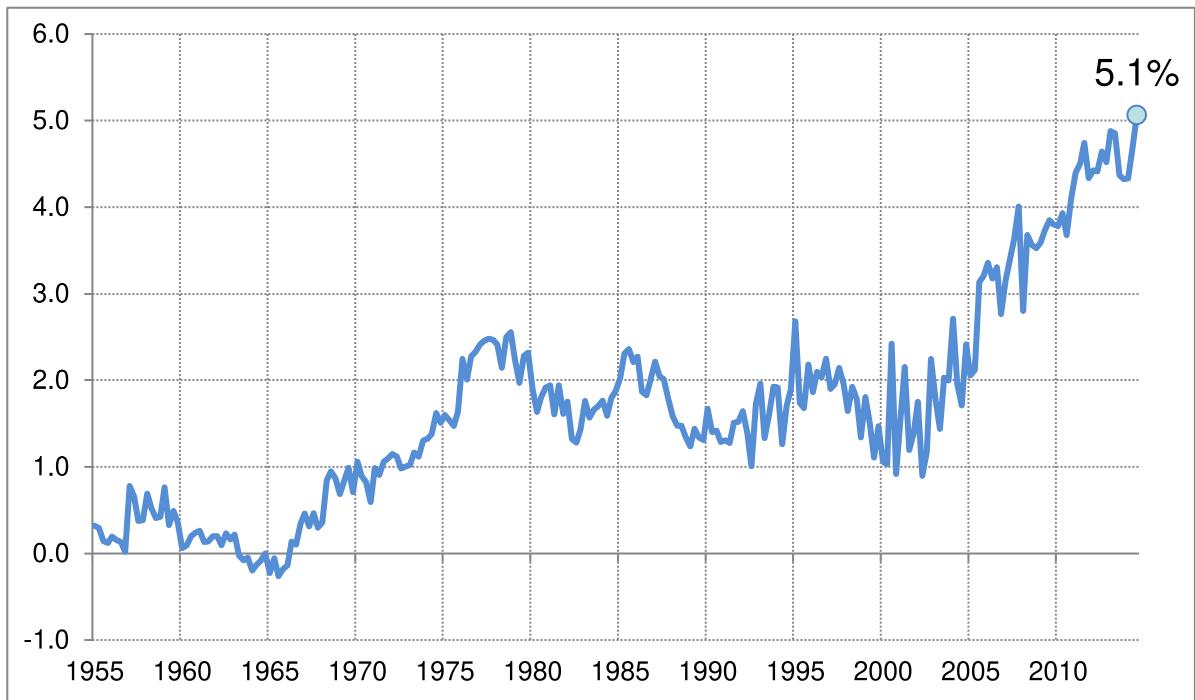
Weisbrot, M. and Merling, L. (2018), The UK Economy at the Crossroads (Washington DC: Center for Economic and Policy Research).

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



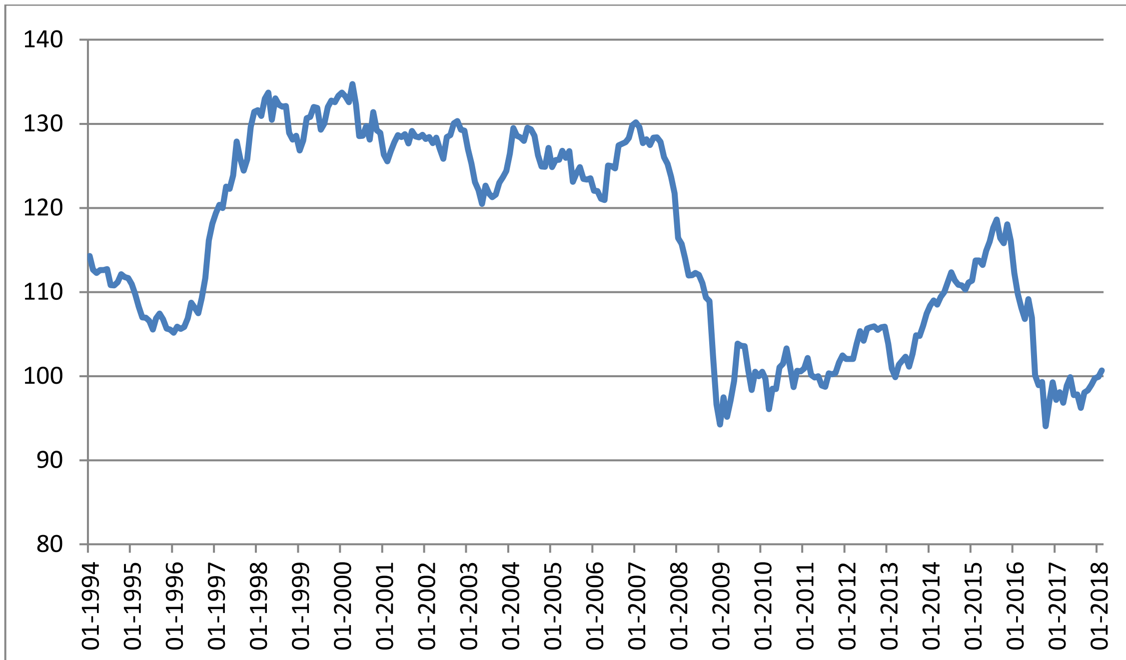
Source: Office for National Statistics

Figure 2: United Kingdom Services Balance as Per Cent GDP



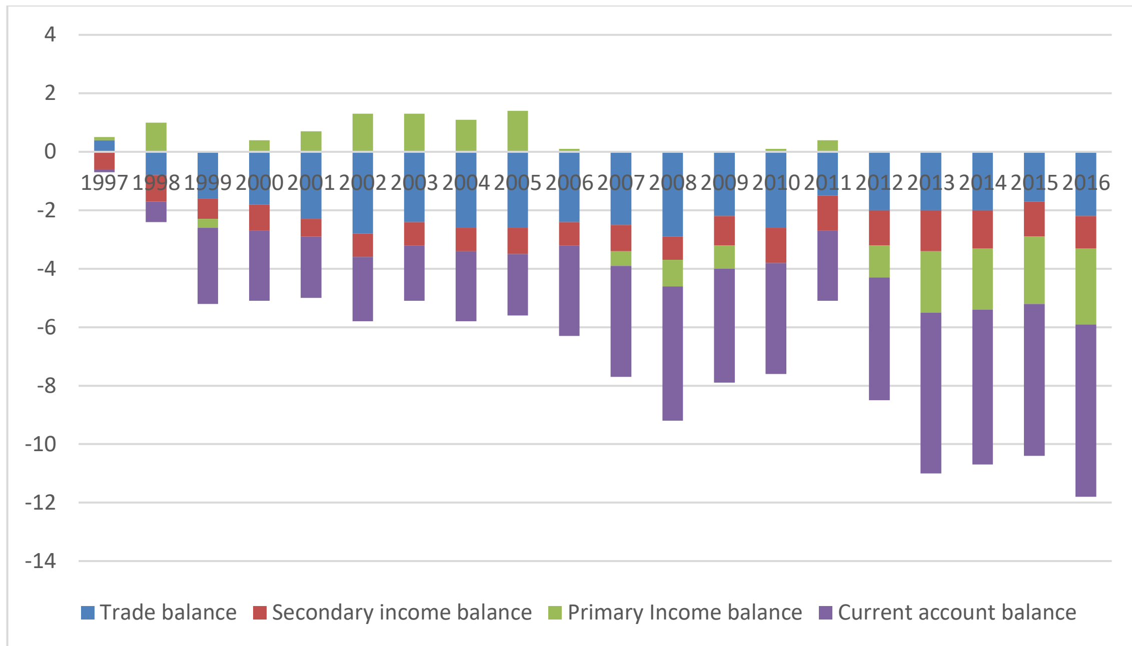
Source: Office for National Statistics

Figure 3: UK Real Effective Exchange Rate



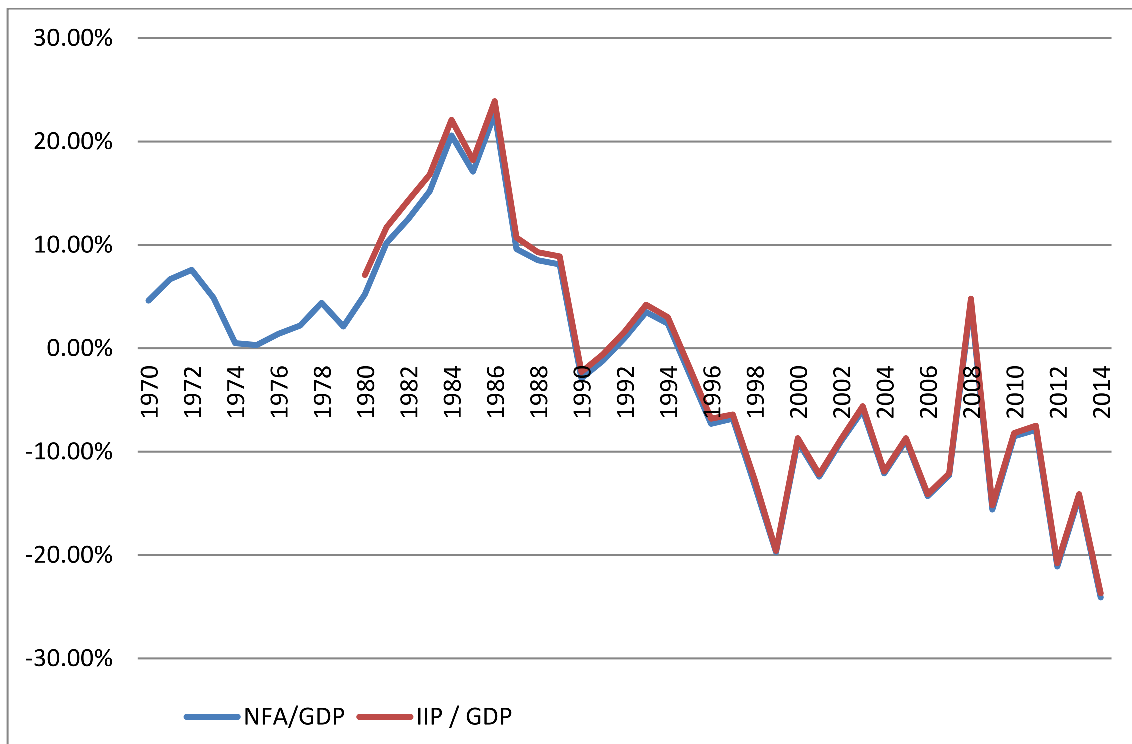
Source: Bank for International Settlements

Figure 4: UK current account balance and constituent parts as a percentage of nominal GDP, 1995 to 2015



Source: Office for National Statistics

Figure 5: UK Net Foreign Assets/International Investment Position (% GDP)



Source: Office for National Statistics

---

[1] See the ONS analysis at: https://www.ons.gov.uk/economy/inflationandpriceindices/articles/theimpactofsterlingdevaluationonpricesandturnoverinthemanufacturingsector/2017-09-15

[2] Chris Giles, 'UK-EU supply chains begin to break amid Brexit trade fears', *Financial Times*, November 6, 2017.