# Brexit and its effect on the pound, the UK's trading position and productivity

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The authors of this blog post are members of the LSE's Student Union Economics Society and wrote this as a contribution to the LSE Growth Commission. Please see Investing in the future of the UK: LSE relaunches its Growth Commission for an overview and a video of the panel debate with Vince Cable, George Osborne, Lord Alistair Darling, Stephanie Flanders and Lord Nicholas Stern. For a list of the commission's evidence sessions, click here.

The 23 June referendum had a clear effect on the pound's value in the currency markets. Overnight, it dropped 10 per cent relative to the dollar, and reached its lowest value in 31 years. While the currency is still widely fluctuating months later, there is an overall downward sloping trend in its value.

Most analysts consider that Brexit will have a negative impact on trade. In this context, a depreciated pound presents both benefits and setbacks.  Moreover, there is also likely to be a negative impact on capital and labour productivity in the long run.

**A weaker pound and the UK's trading position**

Following depreciation of the pound, British imports are more expensive. Given that the UK is the world's fifth largest importer (as of 2014), this has far-reaching consequences, especially for consumers. Unilever recently wanted to increase the prices of its goods by 10 per cent, the most notable example being Marmite, in order to compensate for the increase in the cost of imports. This shows that increases in the prices of imports are likely to be passed onto consumers. Moreover, the Bank of England's Inflation Report for November 2016 projects that Consumer Price Inflation could rise to 2.75 per cent by 2018.

The UK's current account deficit has progressively increased in the last 10 years. At the beginning of 2006, the UK had a current account deficit of £5 billion, and this had risen to £28.7 billion in the last quarter. **A weaker pound** could improve the UK's current account, increasing foreign demand for cheaper British exports, while decreasing domestic demand for more expensive imports, further incentivising British firms to cheaply produce goods and services.

This potential increase in aggregate demand would be particularly beneficial in a post-Brexit UK with more tariffs and barriers to trade, and could help offset the estimated negative impacts of Brexit. It is estimated that UK income per capita could fall between 6.3 per cent and 9.5 per cent in the long run due to the future loss in trade from leaving the European Union.

**Brexit and productivity**

Post-Brexit it is expected that trade volumes and foreign direct investment (FDI) will be reduced. This would affect, capital productivity, as UK companies are impeded from the latest technological developments. According to a report by Woodford Funds, Britain captured 28 per cent of all FDI inflow to Europe in 2014, with firms and investors using Britain to enter the European market at-large because of factors such as the free flow of labour and capital. According to a report by UKTI, the UK attracted the highest number of headquarter-based investments in Europe.

However, post-Brexit this FDI inflow will be redirected towards the EU as firms choose to relocate there. Analysis also shows that Brexit will reduce FDI inflows to the EU by around 22 per cent, creating adverse effects on productivity. Also, it is important to note that total factor productivity (TFP), which measures the efficiency of how labour and capital inputs are used in the production process, has already been in decline in the UK since the financial crisis.

Moreover, after Brexit, immigration from the EU to the UK could become harder if EU citizens are put on the same standing as non-EU citizens, and this would be likely to adversely impact the UK's labour productivity growth. It has been shown that UK productivity growth increases by 0.32 per cent per year with a 50 per cent increase in net migration rate, higher than the OECD average.

EU immigrants are generally younger and more educated as compared to UK citizens. They may possess skills complementary to that of the UK workers or skills that their UK counterparts lack, and increase labour productivity due to a higher human capital stock and knowledge spillovers. Labour productivity in the UK already lags main G7 economies, and restriction of generally skilled EU immigration could further stifle it.

Reduction in FDI inflow would also hurt labour productivity as it reduces competition to UK managers who would otherwise be compelled to perform better. Moreover, foreign multinationals have been shown to have higher labour productivity than British multinationals, where the productivity advantage for service firms is 25 per cent.

**Conclusion**

Although there are high levels of uncertainty surrounding the likely form, and impact of Brexit, the implicit implications of tougher non-trade barriers would inevitably hurt capital and labour productivity. Productivity growth, which is already low in the UK, would be further muted following a decrease in capital inflow and net immigration, and restricted access to the single market. Britain's economic future hinges on securing FDI and trade, both which depend on the pound's value. Although we already observe negative short-run effects on consumers due to the pound's depreciation, its long run effects could cushion the suspected loss in volume of trade due to the enactment of less favourable trade policies and average income per capita.

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*Notes:*

- *The post gives the views of the author, not the position of LSE Business Review or the London School of*

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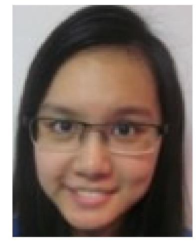

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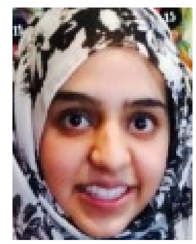

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