With Increased Pessimism Over UK Prospects, Is It Time To Think Again About The Costs Of Brexit?

Vicky Pryce

The Bank of England in its latest forecasts that accompanied the Monetary Policy Committee's (MPC) decision to raise interest rates by a further quarter of a per cent in early May made grim reading, as was well documented by Steve McCabe in an earlier BCU blog. But are we paying enough attention to the causes? Yes, energy prices are an issue that all countries have to deal with. And yes, food price rises are a problem worldwide. But while inflation is thought to be near to peaking across the Eurozone and in the US, price pressures in the UK are instead expected to intensify. And the slowdown in growth that is expected in the next few months, culminating in an overall fall in GDP next year, is not in line with general trends elsewhere.

So what is going in? The relative tightness of the UK labour market vis-à-vis the Eurozone has been well documented as a source of extra cost pressures. There has also been a lot written about supply chain issues being exacerbated by Brexit. But recent weeks have seen a series of reports by government statisticians and by academic researchers which are suggesting that the problem may well be greater than we thought.

First came analysis by the former MPC member Professor Adam Posen arguing that some 80% of the inflation we are seeing in the UK was due to Brexit. In his view, Brexit explains why the UK is likely to have the highest inflation in the G7 next year, as the International Monetary Fund's latest forecast suggests [i]. In advance of the interest rate increase we saw on May 5 in the UK, Posen argued that while the Eurozone countries' increase in inflation was mostly a reflection of higher energy and food pieces, the UK, "on the other hand, has Brexit, which is going to restrict the supply of labour over the longer term, and trade restrictions that will keep prices higher than they would otherwise be" [ii]. So while the European Central Bank(ECB) has managed to keep interest rates so far at record low levels, the Bank of England had no choice according to Posen but to raise rates quite aggressively to deal with the high inflation rate even though that would inevitably plunge the UK economy into recession.

Trade data nevertheless can be confusing. There is no doubt that trade intensity with the EU has been reduced. Data from the UK government showed that Germany has now dropped into number two position among the UK's largest trading partners, having been eclipsed by China. Both exports to Germany and imports from Germany fell in the four quarters to 2021 Q4 by 6.2% and 5.4% respectively[iii]. Looking at it over a longer period, the drop in bilateral trade is more startling. According to Germany's statistical bureau, Germany's exports to the UK dropped by 27% in the three years to March 2022 while rising by 16% overall during that period[iv]. With Germany traditionally a major partner, one does not need too much imagination to work out what it might mean for supply chain management by British businesses.

But the question about whether it is exports or imports that are most affected by Brexit and the timing of the impact remain hotly debated. Earlier research by the Centre for European Reform (CER) had found that there was an entrenched drop in exports to the EU since the Brexit referendum that continued following the end of the transition period in December 2020. But a new study by the London School of Economics is now suggesting that in fact most of the trade disruption came after the Trade and Cooperation Agreement(TCA) was put into operation, i.e. since the beginning of 2021. [v]

Their analysis also shows that whatever small effect there may have been on exports, this has not been material. While lots of small firms have given up exporting to the EU because of the difficulties involved, something that has been well documented by the British Chamber of Commerce and others, it seems that larger firms have been able to absorb the extra costs involved in trading with the EU and made up whatever gap was left by those exiting the field.

Instead, the major drop seems to be in imports from the EU to the UK, which the German trade data certainly affirms, though it is rather surprising given that the UK government has so far kept import checks to the minimum. And yet the LSE academics found that there was a sudden, sharp and what now looks like persistent 25% drop on imports from the EU at the start of 2021 which has indeed become entrenched and which may partly explain the sudden, sharp and persistent rise in inflation we are witnessing. So Adam Posen may therefore well be right though not necessarily for all the right reasons.

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[i] https://www.thelondoneconomic.com/politics/brexit-explains-80-of-uk-inflation-and-why-it-is-here-for-the-long-run-320946/

[ii] https://www.theguardian.com/business/2022/may/01/bank-of-england-duty-bound-to-trigger-recession-to-curb-inflation#:~:text=Adam%20P

[iii] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1072381/germany-trade-and-investment-factsheet-2022-05-04.pdf

[iv] https://www.thetimes.co.uk/article/why-cant-we-talk-about-brexit-r673n7v2p

[v] https://blogs.lse.ac.uk/businessreview/2022/04/26/brexit-the-major-trade-disruption-came-after-the-uk-eu-agreement-took-effect-in-2021/