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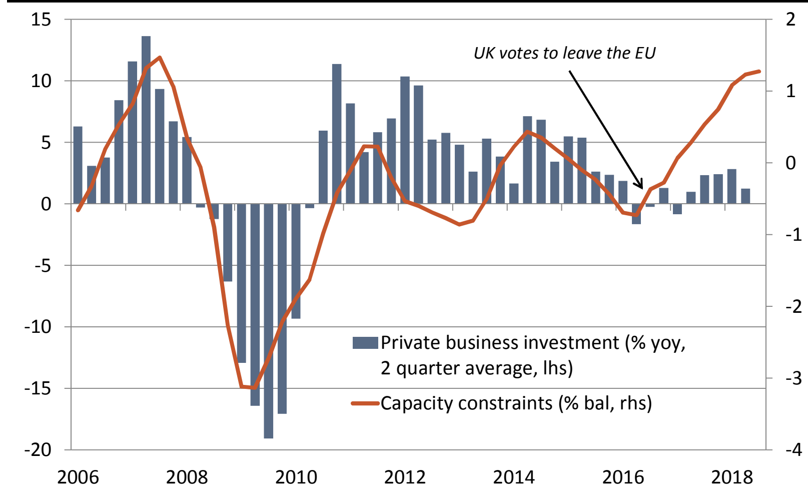
# UK: mind the gap – Brexit impact on investment

**The Brexit effect – rising capacity constraints, but reluctant to invest**




*Quarterly data. Source: Bank of England, ONS, Berenberg calculations*

- **Risky business:** Companies take on long-lived investment projects when a) they need to, and b) are confident about the future. As our chart shows, trends in business investment track companies' reported capacity constraints, which roughly follow trends in the real economy. During the pre-Lehman boom, companies responded to serious capacity constraints with rapid investment growth. When a collapse in demand opened up spare capacity in 2008, investment tanked. Despite somewhat sluggish global growth during the post-Lehman upswing, the link between capacity and investment held up. That is, until recently. A gap has started to emerge since the June 2016 Brexit vote. Investment has stagnated despite mounting capacity constraints.
- **The Brexit factor**: The decision to leave the EU has cast a long shadow of doubt over the UK's long-run economic prospects. Businesses and financial markets wonder to what extent the UK will remain a dynamic, open, fast growing economy. In our view, the long-term damage will likely be modest if the UK and the EU come to a sensible agreement on trade. UK potential growth may fall by around 0.4pt from the c2.0% rate inside the EU. Still, due to the threat of a damaging no-deal hard Brexit, companies shy away from major investments.
- **Missed out on the upswing:** Annual growth in UK private business investment averaged 4.9% in the five years before the Brexit vote. Since then, the growth rate has averaged a dismal 1.3%. Although investment growth had already softened ahead of the Brexit vote due to the correction in global production and demand in late-2015/early 2016 – linked to China worries and low oil prices – the post-Brexit vote weakness is a result of Brexit. By late 2016, the global cycle had started to gain momentum. Our chart shows the sharp rise in capacity constraints – to a post-Lehman high – that followed the improvement in global demand growth.
- **The lesson from abroad:** Thanks to the global upswing in demand, major parts of the advanced world are enjoying faster rates of productivity-enhancing investment growth than before. In the UK, which stands as an exception, the shortfall in investment shows up in one major way. UK output per worker was just 0.7% higher in Q2 2018 than in Q3 2016. German worker productivity increased by 1.5% over the same period (+2% for US workers). The good news is that, as long as a hard-Brexit is avoided (80% chance), UK companies will probably go through a period of partial catch-up to compensate for the lack of investment during the past two years.
- **A Brexit deal could herald an investment surge:** Despite the recent market wobbles, the global economic outlook remains favourable. The US looks set to grow by an impressive 2.8% next year, while growth in the Eurozone will likely come in at just under trend (1.4%). At home, demand growth is poised to pick up nicely when the hard Brexit risk is out of the way. Furthermore, UK companies will likely feel more confident to step up investment to meet the growing demand and ease the pressure on stretched productive capacities. Now that the UK has reached full employment, higher investment would drive productivity rates higher. When productivity rises, companies can raise wages without putting prices up. A Brexit deal would be great for workers' pockets. With luck, UK parliament will follow this economic logic and go for it. With a little bit more luck, this will happen in the next few weeks.

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