United Kingdom: A Brexit deal could see the release of pent-up demand for business investment

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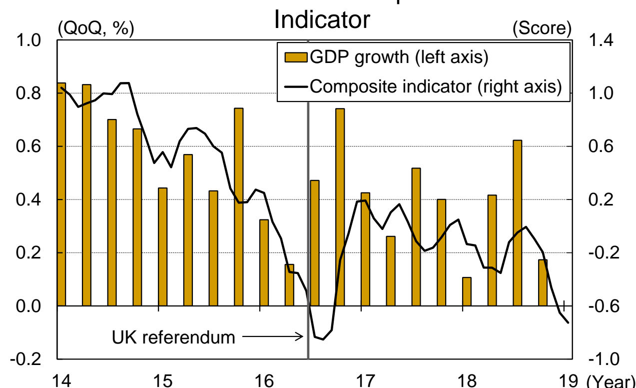
1. Introduction

The UK's latest GDP release showed that growth slowed to just 0.2% QoQ in Q4 2018 (from 0.6% in Q3). The monthly figures suggested a downbeat end to 2018 with output falling by 0.4% MoM in December, and recent surveys do not point to an imminent rebound at the start of 2019 (Chart 1).

By expenditure component, it was the slump in business investment that stood out, especially when contrasted against remarkably resilient consumer spending (Chart 2). Uncertainty has been the main obstacle to investment as the risk of a cliff-edge 'no deal' Brexit remains elevated.

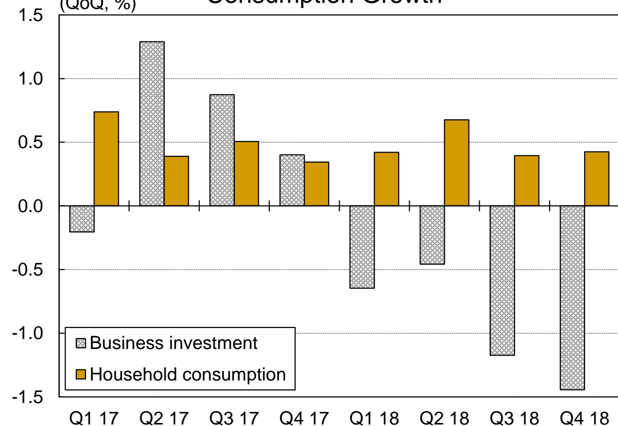
However, if a Brexit deal is reached then we believe there is scope for business investment – which accounts for around 9% of GDP – to bounce back. Companies have built up cash reserves by deferring investment decisions, and 'no deal' contingency funds could be released. Importantly, survey measures of investment intentions remain relatively resilient. There may also be a more fundamental shift away from labour as a factor of production if wage costs continue to increase and skilled workers become harder to recruit once the UK leaves the EU.

Chart 1: GDP Growth and Composite Confidence Indicator



Note: The composite indicator is constructed using standardised survey measures weighted according to GVA shares.
Source: European Commission, IHS Markit, MUFG Bank Economic Research Office

Chart 2: Business Investment and Household Consumption Growth

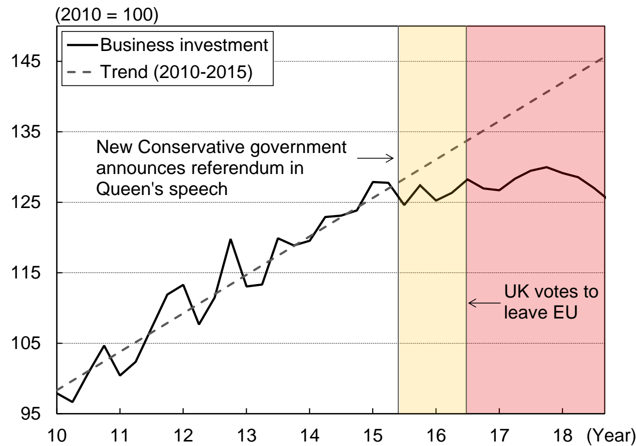


Source: ONS, MUFG Bank Economic Research Office

2. Scope for some rebound in investment

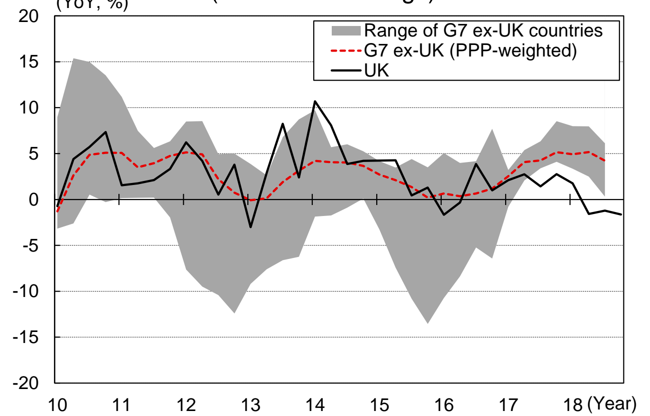
There has been a clear departure from the pre-referendum trend in business investment growth in the UK (Chart 3). This does seem to be a Brexit story rather than a global trend: investment growth has been noticeably weaker in the UK than in any other G7 economy since Q1 2017 (Chart 4). The UK may not have left the EU yet but the increase in uncertainty – both ahead of the vote and since the result – has probably contributed to investment plans being put on hold. With under a month until the UK's departure on March 29 there is still a lack of clarity about the future relationship and the threat of a 'no deal' in particular remains uncomfortably high. However, we believe that conditions remain suitable for a modest rebound in investment if a deal is reached.

Chart 3: Business Investment



Source: ONS, MUFG Bank Economic Research Office

Chart 4: Gross Fixed Capital Formation in the G7 (excludes dwellings)

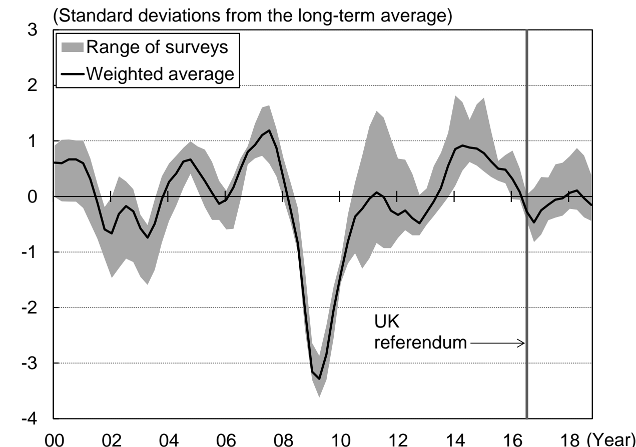


Source: OECD, IMF, MUFG Bank Economic Research Office

(1) There may be pent-up demand

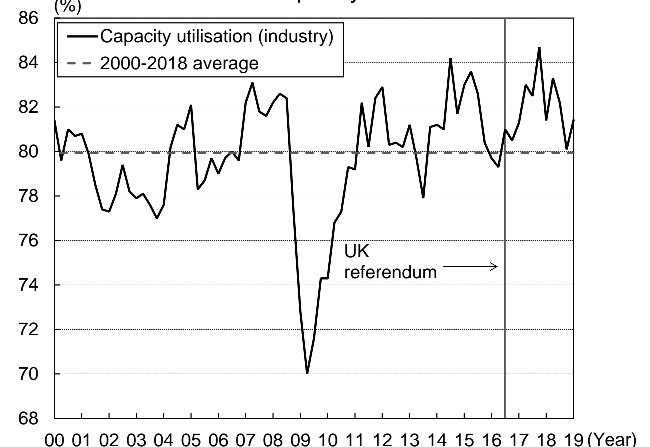
Business investment may have been muted since 2015, but investment *intentions* remain relatively firm, despite the heightened uncertainty. Our gauge of survey measures (weighted by sectoral share of investment) remains close to the long-term average (Chart 5), and is markedly stronger than during the global financial crisis (GFC). High capacity utilisation (Chart 6) is probably a factor, although that is likely to have been supported by the global upswing from mid-2016 to early 2018.

Chart 5: Investment Intentions



Source: BCC, BoE, MUFG Bank Economic Research Office

Chart 6: Capacity Utilisation



Source: Eurostat, MUFG Bank Economic Research Office

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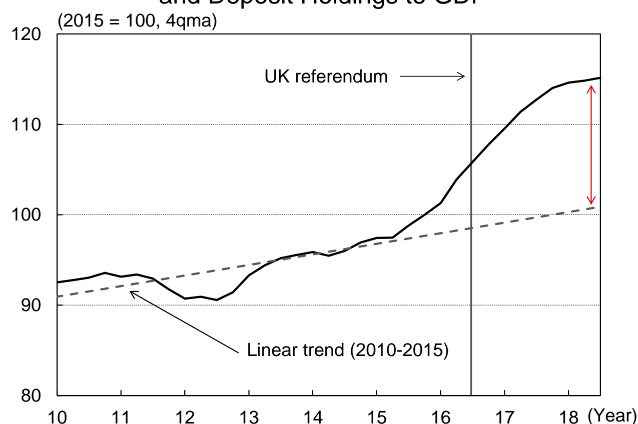
Taken together, Charts 3-6 suggest that there could be pent-up demand for business investment, not least because the UK economy has been fairly resilient to Brexit uncertainty. While investment figures were gloomy, we do note 1.9% YoY growth in total domestic expenditure in the last two quarters of 2018. Although uncertainty around the shape of the UK's eventual relationship with the EU would remain, some of the demand for investment could be released if 'no deal' is avoided. Indeed, a Bank of England (BoE) agents' survey on preparations for the UK's departure from the EU showed a positive net balance of companies that expect investment to increase if a Brexit deal is reached.

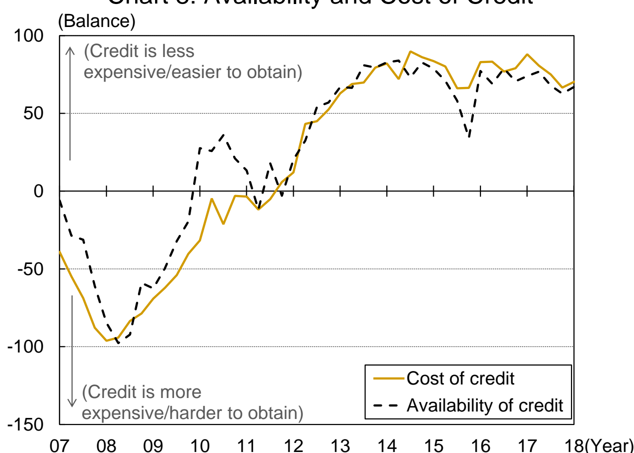
Funding is unlikely to be an issue. Recent reluctance to invest has meant that firms have built up cash reserves (Chart 7), and surveys have also suggested that some companies are setting aside specific contingency funds for a 'no deal' scenario. This money may be released if a Brexit deal is agreed. On top of this, credit remains both cheap and available (Chart 8).

Chart 7: Private Non-Financial Corporations - Currency and Deposit Holdings to GDP



Source: ONS, MUFG Bank Economic Research Office

Chart 8: Availability and Cost of Credit



Source: Deloitte CFO survey, MUFG Bank Economic Research Office

(2) Higher labour costs could prompt a pivot back from labour towards capital

We also suspect there could be a more fundamental change in the factors of production if a Brexit deal is agreed. Since the GFC there have been signs of a relative shift from capital to labour (or 'capital shallowing'). The net capital stock of manufacturing firms per employee fell by 7.4% between 2008 and 2017 (Chart 9). Over the same period, almost three million jobs have been added, while the average number of hours worked per worker has been steady.

Why has there been this shift? It is not the case that capital investment has been unprofitable: there has been a gradually increasing net rate of return on fixed capital in manufacturing (and a relatively high rate for services) over the last decade (Chart 10).[1] Instead, improving labour market dynamics could be related in part to post-GFC uncertainty and subsequent underinvestment in capital. Firms are likely to have been cautious about expensive capital expenditure plans, but employment decisions are generally easier to reverse given the UK's flexible labour market. For example, exporting manufacturers helped by weaker sterling after the Brexit vote may have hired additional staff rather than invest in plants and machinery to increase capacity.

[1] The UK's Office for National Statistics (ONS) defines its measure of net rate of return on capital as the operating surplus in the market sector (net of depreciation and holding gains or losses) divided by the productive fixed capital stock. We do note

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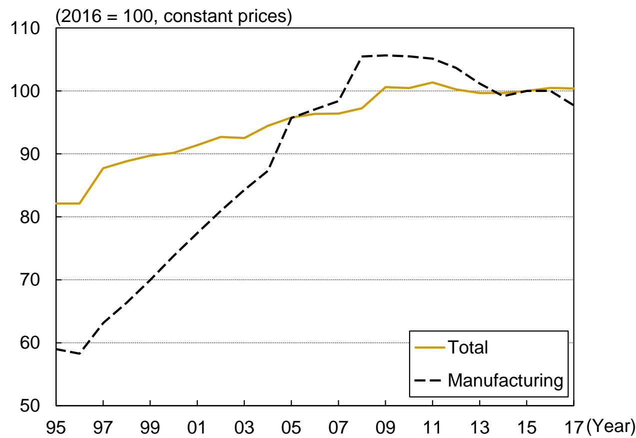
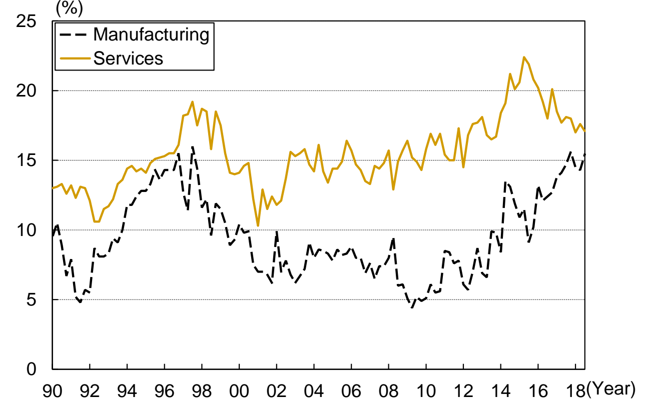
that if companies are reluctant to invest then they may only commit to the most profitable capital expenditure opportunities. That may result in a higher net rate of return on capital under this measure.

Chart 9: Net Capital Stock per Employee



Source: ONS, MUFG Bank Economic Research Office

Chart 10: Net Rate of Return on Capital

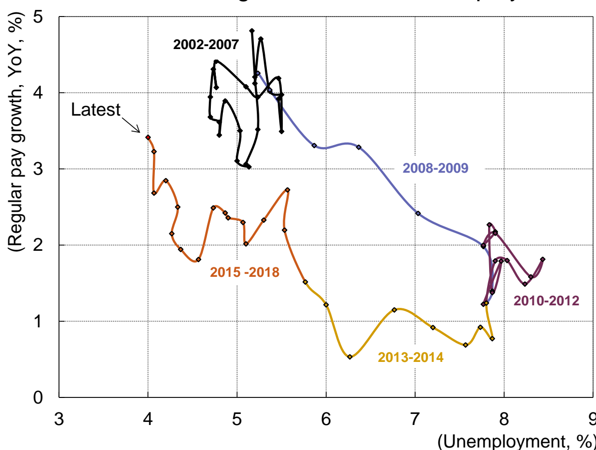


Note: Chart shows profit as a percentage of the capital used in production after accounting for depreciation.
Source: ONS, MUFG Bank Economic Research Office

However, labour market tightness has finally prompted some signs of life in the Phillips curve (Chart 11). The unemployment rate (4.0%) has not been lower since the 1970s and nominal pay growth has now risen above 3% for the first time in almost a decade. In real terms there was a 1.1% YoY increase in regular pay in Q4 2018. Looking ahead, there are few signs that pay growth is slowing, and there will be further support from the scheduled 4.9% nominal increase in the minimum wage in April this year. We also note that higher minimum employer pension contributions are adding to companies' labour costs.

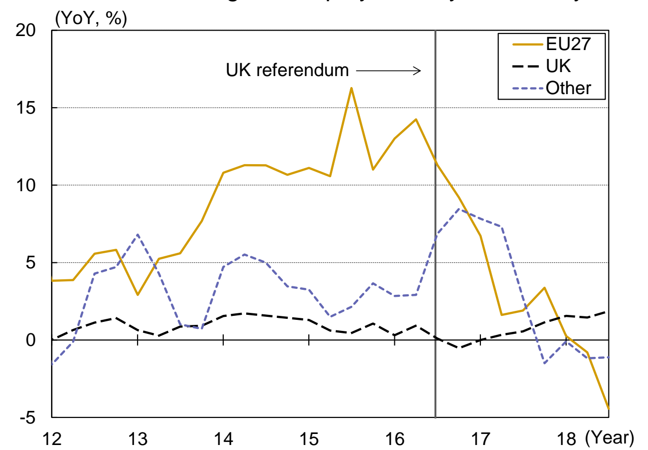
At the same time, firms may find it increasingly hard to attract appropriately skilled workers given the weakness in sterling and possible fears over the UK's economic prospects. Net migration growth from the EU to the UK has slowed, and there has been a notable decrease in employment of both EU27 and other non-British workers since the referendum (Chart 12). Any difficulty in attracting skilled workers from abroad is likely to result in higher nominal wages (and lower labour productivity growth).

Chart 11: UK Wage Growth and Unemployment



Source: ONS, MUFG Bank Economic Research Office

Chart 12: Change in Employment by Nationality



Source: ONS, MUFG Bank Economic Research Office

Survey evidence suggests that firms are increasingly concerned about these higher wage costs and the availability of workers. The BoE's agents' survey shows that perceived labour

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costs per employee in the services sector have not been higher since early 2008. The Q4 2018 report also explains that companies "continued to invest in projects aimed at increasing efficiency and productivity, particularly when faced with growing labour constraints and rising costs". We also note the CBI industrial trends survey is suggesting that many firms are considering capital expenditure to expand capacity. Taken together, we think the conditions are there for some capital deepening if a Brexit deal is reached. However, the flipside of that might be more muted employment growth.

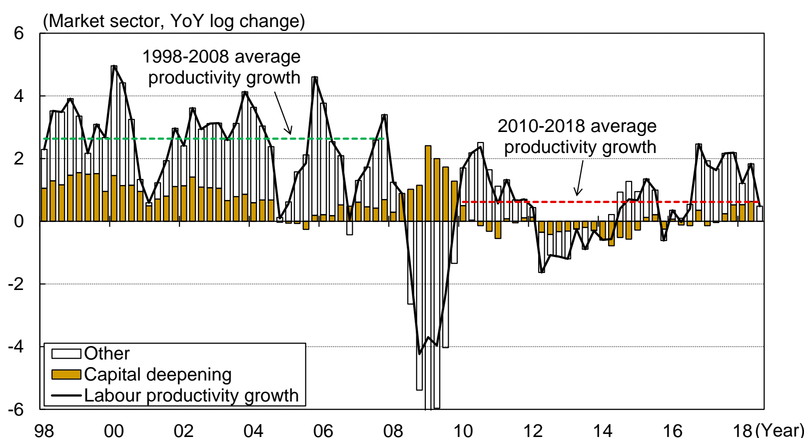
3. Outlook

Business investment in the UK has declined in QoQ terms for four consecutive quarters. Uncertainty has been the main obstacle with the high risk of a 'no deal' Brexit. The outlook largely depends on whether a withdrawal agreement can be reached: we would expect a bounce in the investment figures if there is clarity that a 'no deal' is likely to be avoided. At that point, deferred spending and contingency funds may start to be released given that firms' investment intentions have remained relatively resilient.

However, the UK is unlikely to recover all the deferred investment, not least because uncertainty will remain high even if a deal is agreed. The length of the transition period remains unclear (the current draft states the transition will end on 31 December 2020 with the option of an extension for one or two years), and the accompanying 'political declaration' leaves the door open to a wide range of eventual trading models. On top of this, there is heightened uncertainty around domestic policy as an increasingly fragmented political landscape raises the risk of a snap general election ahead of the next scheduled vote in May 2022.

Over the medium term we think the recent trend of 'capital shallowing' may unwind. With high uncertainty, first during the GFC recovery and then around the Brexit vote, firms may have judged that employment decisions are easier to reverse than capital expenditure. Now, labour costs are increasing and employers are likely to find it harder to attract skilled workers from abroad after Brexit. This could spur a relative increase in fixed investment. Higher capital intensity may in turn help with the UK's longstanding problem with productivity (Chart 13). For now, though, businesses continue to wait for clarity over the terms of the UK's departure from the EU.

Chart 13: Contributions to Annual Growth of Output per Hour Worked



Source: ONS Multi-factor Productivity Estimates, MUFG Bank Economic Research Office

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