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Perspectives on topical foreign direct investment issues

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Inward investment will fall in the UK, post Brexit[*]

by

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Both in the run up to the referendum, and since the UK voted to leave the EU, there has been a good deal of speculation over the likely impact on inward FDI into the UK. In a timely recent *Columbia FDI Perspective*,[1] Laza Kekic suggested that UK inward investment will remain robust post Brexit. We beg to differ.

Japanese inward investors, backed by the Japanese government, have been keen to stress that future investment in the UK depends on tariff-free and barrier-free trade with the EU that is as uncomplicated and predictable as possible. A Japanese government memorandum has expressed concerns over the continued viability of Japanese investment in the UK in the event of a hard Brexit without access to the Single Market. Nissan has also commented that it will review its decision to build the next generation of the Qashqai model in the UK when the form of Brexit is clearer. Meanwhile, Toyota's recent investment announcement only follows through on a decision to build the next generation Auris and Avensis that was made well before the Brexit vote last year. Those that are household names (such as Nissan and Toyota) are lobbying hard to cut special deals with the government.

When the Single Market was created, many commentators speculated that intra-EU FDI would plummet. This turned out to be far from the case, as firms took advantage of the opportunities to coordinate resources across countries, and location advantage dominated issues relating, for example, to economies of scale. The Single Market, through EU regional policy and structural funds, allowed firms to take full advantage of location economies where labor was available in low-cost locations. Supply chains cross borders several times before components go into, say, a final assembled car, which could happen in several EU countries. Equally, as firms redesign their production systems to a more compartmentalized network system, free movement of labor also becomes important, allowing firms to move labor quickly and cheaply to respond to short-term changes or to address skill shortages. The UK has chosen to cut itself off from much of this.

Finally, we have already seen a big devaluation in sterling. On the one hand, this makes domestic assets cheaper for foreign investors, and there has been some investment into the UK on the back of this. On the other hand, devaluation lowers the expected returns from UK investment when translated into the home country's currency. An analysis of 50 years of time-series data for UK inward investment suggests that in (typically brief) periods of uncertainty, a depreciated sterling offers a temporary, albeit positive, effect on FDI.[2] But when the economy returns to being stable once again (the much more common state, at least over the past half century), the effect is not only annulled, but becomes both reversed and persistent. In other words, a weaker currency will eventually lead concerns over lower future returns to dominate strategic thinking. This, in turn, will inevitably drive investment elsewhere.

Nevertheless, there are some big projects that will take place in the UK irrespective of Brexit—the HS2 train line or Hinckley Point Power Station are examples. Foreign investors will be attracted by such activity. Still, they are not bringing new business as such activity is proceeding independent of Brexit.

More realistically, locations need to consider the nature of their value proposition to inward investors, backed up by land availability, which possibly involves some difficult decisions regarding opening greenbelt land. Part of this proposition needs to involve building more robust supply chains to support inward investors; addressing skill shortages in overheated labor markets; and working with firms and universities such that they become anchors for both foreign and domestic investment. Some of these will require a more activist industrial policy in terms of, say, rebuilding supply chains in the UK and encouraging "reshoring." It is possible that UK regions may be able to be more proactive in attracting inward investment—although one hopes that this does not herald a return to the excessive subsidies that were paid in the 1990s.

Above all, however, the government needs to avoid a hard Brexit that sees tariff barriers returning, and, ideally, to execute a trade deal that prioritizes access to the Single Market for as many sectors as soon as possible. It is possible that digital tracking of goods may offset many of the concerns expressed pre-1992 regarding goods awaiting physical customs clearance between the UK and EU, that may in turn protect some supply chains. The importance of such costs and delays must not be underestimated. This however is potentially incompatible with the desire of the UK to prevent free movement of labor between the UK and EU, which may in itself deter FDI.

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[1] Laza Kekic, "FDI to the UK will remain robust post-Brexit," *Columbia FDI Perspectives*, No. 195, March 13, 2017.

[2] Nigel Driffield and Michail Karoglou, "Brexit and foreign investment in the UK," May 5, 2016, https://ssrn.com/abstract=2775954.

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