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1 SINCE THE REFERENDUM: A DECEIVING RESILIENCE FOR BRITISH BUSINESSES?

Businesses have held up well over the past year

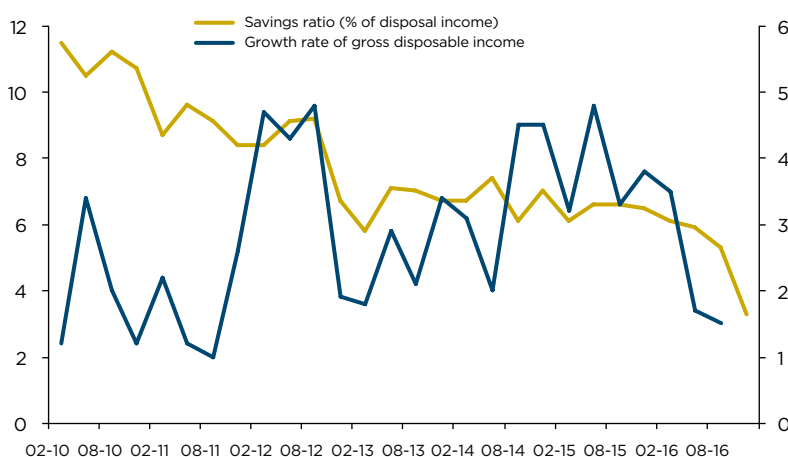
1/ Favourable domestic economic conditions

Household consumption helped support the business activity in 2016, which increased by 2.8% in 2016, its largest rise since 2007. Its contribution to growth (+1.8 points) was much greater than that of investment (+0.3 points) and that of the net exports, which was negative (-0.3 points). However, after rapid growth in disposable income in 2014 and 2015 (between 3% and 4% per year), it decreased dramatically during 2016. Nevertheless, households continued to consume more by saving less, as highlighted by the decline in the savings rate, which reached a record low of 3.3% in fourth quarter 2016 (Chart 1). At the same time, household debt in 2016 saw its strongest growth since the 2008-2009 crisis (nearly 10% in level in March 2017 over one year), reaching 143% of disposable income at the end of last year. In a context of moderate inflation and a low unemployment rate (4.6% in March 2017, its lowest level since July 1975), consumers also would have chosen to make purchases

sooner than expected, rightly anticipating a future increase in inflation that is evident today (2.7% in April 2017). This support from households contributed to limiting the impact of the 23 June referendum on growth and especially on business activity.

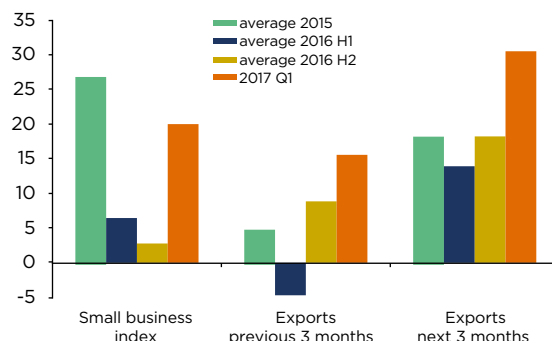
In this promising economic environment, the financial situation of businesses has remained favourable for two years. Business profits reached more than 105 billion pounds sterling in the last quarter of 2016, the highest level ever recorded, and the net rate of return on capital improved, increasing from 12% to 13% between 2015 and 2016 (Chart 3). In addition, business confidence rebounded strongly after the decline observed just after the referendum, particularly among small and medium-sized businesses, which saw especially good demand. According to a survey by the Federation of Small Businesses¹ (FSB) in the first quarter of 2017, the small business confidence has also improved significantly, approaching its average level of 2015 (Chart 2). This survey also shows that optimism is even more pronounced in the manufacturing sector due to a particularly favourable foreign demand. Exporting businesses seem to be doing well: three-month export forecasts are at their highest level

Chart 1:
Savings ratio and household disposable income growth



Source: ONS
Latest available data: Q4 2016

Chart 2:
Results of the "Voice of Small Business" survey (balance of opinion as a %)



Note to the reader: Balances of opinions correspond to the weighted sum of the number of businesses reporting a deterioration and those reporting an improvement in their situation. A positive balance indicates an improvement for the indicator in question.

Sources: FSB, Coface

1/ FSB, "Voice of small business index, Q1 2017"

since the survey's creation in 2012. A report by the Confederation of British Industry (CBI)² confirms this trend by indicating that new orders issued to SMEs in the first quarter of 2017 reached their highest level since 2013. On the other hand, the study indicates that investment intentions are well below their average in recent years.

Despite the positive trend in demand as well as continued high profits, businesses have delayed some of their investment because of uncertainties regarding Brexit. The share of business investment in GDP declined by nearly 1 point since 2014 to 8.8% of GDP in 2016, its lowest level since the crisis (Chart 3). Total gross fixed capital formation increased only very slightly in 2016 (+0.5%, the smallest increase since 2009), but business investment decreased by 1.5% (the difference in momentum is explained by the rebound in investment in residential real estate and in public investment over the period).

Businesses are also supported by very favourable financial conditions. The monetary policy of the Bank of England (BOE) allowed businesses to free up cash through the lowering of the key rate in July 2016 (from 0.5% to 0.25%) as well as the extension of the asset purchase programme, which increased from 375 to 435 billion pounds sterling. A recent survey by the Central Bank³ also indicates that credit standards for businesses have remained favourable and stable since the referendum. However, the same survey notes a significant drop in the demand for lending from businesses since the result of the 23 June referendum, thus confirming the reluctance of businesses to invest in a context of strong uncertainty. The decline in the demand for lending was particularly great at the end of 2016 for large businesses. Demand for lending has also been reduced but showed greater resilience in the first quarter of 2017 (Chart 4). This phenomenon of postponing investments contrasts with the recent good performance of businesses. Business investment is expected to remain fragile during the period of negotiations between the United Kingdom and the European Union (until March 2019) because of uncertainties about the outcome of the agreement.

2/ British exports benefited from the depreciation of the exchange rate, but in a limited way

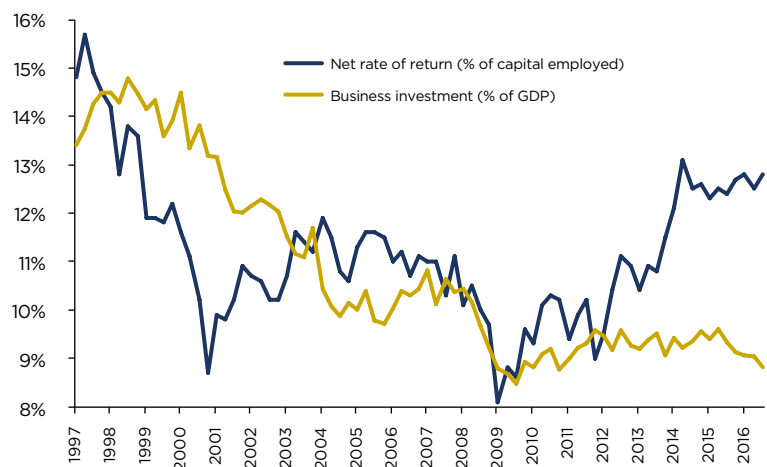
The British economy's resilience since the referendum is also explained by more favourable external conditions. Exports in volume grew by 9% between June 2016 and March 2017. Foreign demand was therefore relatively dynamic: according to the ONS, the volume of exports to the United States, which represents 16% of total exports, grew by 15% between the first quarter of 2016 and the first quarter of 2017. For the eurozone, which represents nearly 45% of exports, export growth for the same period was 3% with an even more favourable trend in March 2017. China also contributed to the vitality of British exports with 34% growth in the first quarter of 2017 compared with the first quarter of 2016.



British businesses paradox: high profits but sluggish investments.

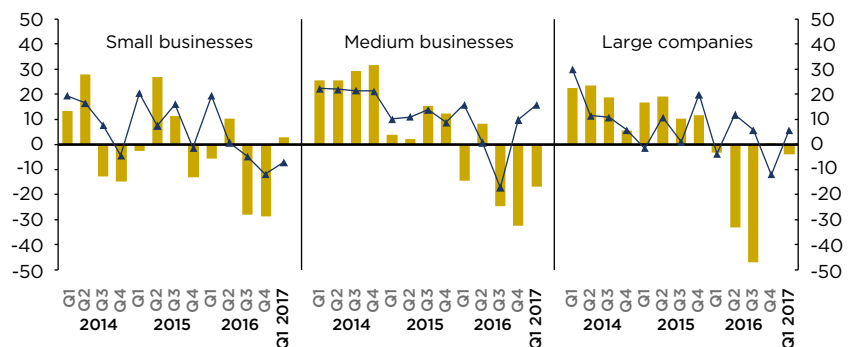


Chart 3: Investment and profitability of businesses



Sources: ONS, Coface
Latest available data: Q4 2016

Chart 4: Demand for lending from businesses according to their size (balance of opinion as a %)



Source: Bank of England

Note to the reader: The results correspond to the responses to the following question asked to lenders: How has the demand for lending from small businesses, medium-sized businesses, and large businesses changed? The balances of opinion are calculated as the weighted sum of respondents reporting a deterioration and those reporting an improvement in demand for credit. The yellow bars indicate responses concerning the last three months, and the blue triangles indicate responses concerning the next three months. A positive balance indicates an increase in the demand for credit.



2/ CBI, "Quarterly SME Trends Survey", April 2017

3/ BOE, "Bank of England Credit Conditions Survey - 2017 Q1"

However, beyond foreign demand, the momentum of exports since the referendum has been notably tied to the depreciation of the pound sterling, which, for the time being, appears to be the most visible sign associated with Brexit. Between the referendum of 23 June and the month of March 2017, the pound sterling's real effective exchange rate depreciated by almost 10%. The pound first suffered a sharp depreciation between June and October 2016 on the order of 15%. Then, after a period of stability, it appreciated slightly over the last few months. Nevertheless, this depreciation has only a moderate impact on export growth in volume. According to our estimates, the pound sterling's observed depreciation of 15% would have an impact of 3.5 points on export growth at the end of six months and 1.6 points at the end of one year compared with a scenario without depreciation⁴. The rather limited impact of this exchange rate fall can be explained by two reasons.

First of all, the depreciation also had the effect of increasing import prices for British businesses. The import price index increased by nearly 10% between June and October 2016 (Chart 5). In concrete terms, this resulted in a significant increase in costs incurred by businesses. This increase is especially significant given that the share of imported intermediate goods is particularly high in the manufacturing sector (approximately 40%). At the same time, there was also an increase in

the export price index (in pounds sterling). This rebound was at first due to the fact that a substantial share of British exports is denominated in foreign currency. Therefore, a depreciation of the exchange rate leads to a mechanical rebound in export prices in pounds sterling. Furthermore, some British businesses have passed the increase in costs on to their export prices in order to maintain their margins. Consequently, the price competitiveness gains brought about by the depreciation are severely limited by the simultaneous increase in export prices in pounds sterling (terms of trade have only slightly decreased over the past year - Chart 5). The second reason limiting the positive effect of the depreciation of the exchange rate is tied to the fact that the price elasticity of foreign demand is relatively low for goods exported by British businesses, according to a report by the BoE⁵. These goods are far from being perfectly substitutable (such as pharmaceuticals and certain automobile models). As a result, a decrease in prices - in the buyer's currency - has only a moderate impact on demand seen by businesses and therefore on export volumes.

The first symptoms of Brexit should manifest during the negotiation phase

Since the beginning of 2017, the services sector has experienced a downturn, particularly distribution and hotels/restaurants, which are starting to suffer from the slowdown in household consumption resulting in particular from the increased inflationary pressures. This would explain in part the weaker activity in the first quarter of 2017, when quarter-on-quarter GDP growth was 0.2%, after 0.7% growth in the last quarter of 2016. However, industrial production remained strong, particularly in the manufacturing sector, which benefited from the depreciation of the pound sterling. During the negotiation phase (until March 2019), businesses should be more sensitive to the negative effects related to the decision to leave the European Union, but maintaining access to the common market during the period should nevertheless limit these effects. The negative consequences of Brexit for businesses should manifest through three transmission channels: slowing households demand, rising costs for businesses, and sluggish investment.

Chart 5:
Exchange rate and terms of trade (indices)



Sources: ONS, Coface
Latest available data: March 2017

4/ These results are estimated using the following equation:
 $\Delta EX = 3,1 \Delta PIB_M - 0,29 \Delta TCER + Q1_2006 + Q2_2006 + Q3_2006 - 0,3 (EX(-1) - PIB_M(-1))$ where REER is the real effective exchange rate, GDP_G is global GDP (with (-1) signifying the previous period), and the other variables are dummies.

5/ BOE, "Accounting for the stability of the UK terms of trade", 2009

Starting in 2017, British businesses will suffer a slowdown in private consumption. The strong growth in household consumption is likely to face inflationary pressures, which hamper their purchasing power. Inflation increased from 0.6% in July 2016 to 2.7% in April 2017, above the central bank's 2% target. In addition, households have already largely drawn from their savings. Against this backdrop, the past pace of consumption growth does not appear to be sustainable and should show its first signs of slowing this year. This slowdown should weaken British businesses, particularly in the distribution sector, which depends heavily on domestic demand (the sector was also downgraded from medium risk to high risk in March 2017). The automotive sector would also be affected, but to a lesser extent because manufacturers anticipate dynamic growth in foreign demand, according to the Society of Motor Manufacturers and Traders (SMMT). This momentum could compensate for the decline in domestic sales caused by weaker household purchasing power. Indeed, 77% of automobile production is intended for export, including 57.5% to the European Union. With that in mind, access to the common market until 2019 should continue to be favourable for premium or even high-end vehicles. The ICT sector, particularly telcoms, could also suffer the consequences of a slowdown in private consumption.

Moreover, businesses should continue to face higher input costs. In the future, the exchange rate is expected to remain volatile and evolve according to the negotiations. Nevertheless, it is very likely that the pound sterling will remain at a relatively low level due to uncertainties surrounding the outcome of the negotiations, and a further fall is not out of the question if a "hard Brexit" scenario materialises. Business profits should gradually reduce as increased costs require them to reduce their margins in order to remain competitive. The slight increase in the price of raw materials should also weigh on margins by putting more pressure on their costs. According to a report by the Confederation of British Industry (CBI)⁶, in the first quarter of 2017, manufacturing SMEs saw the greatest increase in their unit costs in six years. The increase in costs should gradually be passed on to the consumer prices, intensifying inflationary pressures. The distribution sector would be particularly affected insofar as most business costs come from the import of intermediate goods. Other sectors, such as automotive, textile/clothing, and transport, should be strongly affected by the observed depreciation of the pound sterling. The automotive sector is heavily dependent on imports, particularly from the European Union (nearly 50% of the sector's added value). Its integration into the European value chain therefore makes the sector vulnerable to increased import prices and would be heavily destabilised by the occurrence of a "hard Brexit". The textile/clothing sector, already experiencing



Lower household consumption and wait-and-see attitude: bad mix for companies.



difficulty, would suffer additional pressures on its margins due to rising costs and deteriorated household confidence. Nevertheless, luxury would benefit more from the depreciation since it makes these goods more attractive for foreign tourists. The transport sector, particularly air, already very competitive, should suffer a decline in profitability since business costs are mostly denominated in foreign currencies.

The persistent uncertainties surrounding the negotiations with the European Union will continue to elicit the wait-and-see attitude within businesses with regard to their investment decisions. The weakness of investment, already observable since the referendum, is expected to intensify over the next two years. Capital-intensive sectors, such as metallurgy and automotive, should be particularly affected insofar as their future production capacities would be limited by postponed investments. The automotive sector, which represented nearly 10% of industrial production in 2016, already saw its investments fall from 2.5 billion pounds sterling in 2015 to only 1.7 billion in 2016, while sales and exports reached record highs. In addition, investment decisions come from foreign shareholders, generally large groups calling for clarification from the May government on its strategy for negotiation with the EU. Furthermore, the construction sector should be negatively affected by decrease in investments. Investment postponements should initially focus on the most expensive ones and, in particular, the construction of factories and infrastructure. However, residential construction should continue to be dynamic due to the strong demand for housing.

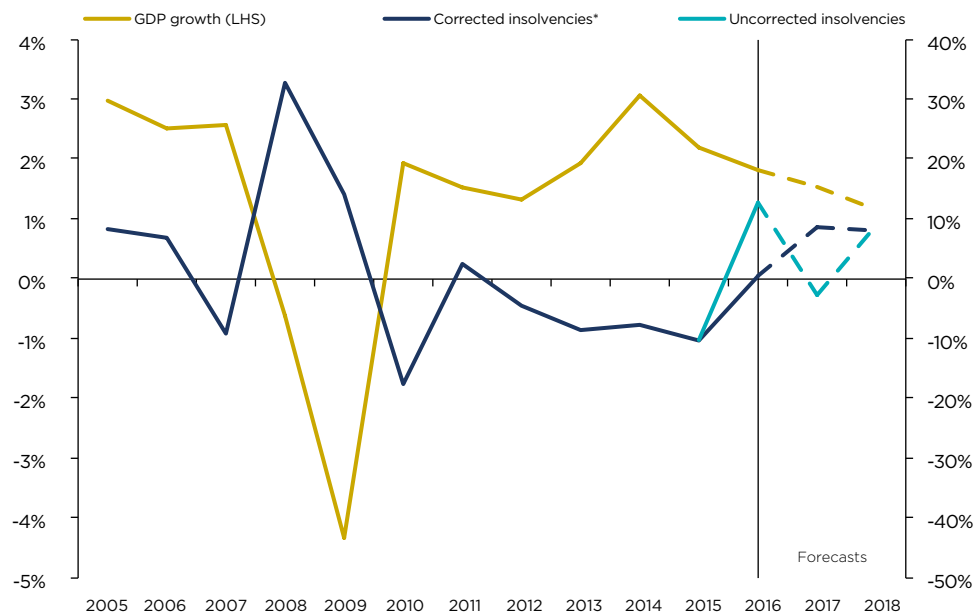




The agri-food sector is also among the most likely to be affected by Brexit. Its production should suffer from weak investment, increased input costs, and decreased European public aid. This last effect will materialise when the country exits the EU and therefore the Common Agricultural Policy (CAP). This reduction in aid to farmers could nevertheless be offset by greater aid from the British government. On the other hand, the sectors that are relatively more spared up until 2019 would be pharmacy and energy in particular. The pharmaceutical sector (9% of total exports in 2016) would benefit from strong demand from emerging countries (particularly in China and India) as well as the United States. The energy sector, especially hydrocarbon production, should be relatively resilient in the short term. The slight increase in oil prices has helped to improve the situation of businesses, even though the low investment levels should continue due to uncertainty, thus adversely affecting long-term production.

In this context, total British business insolvencies should increase by 8.7% in 2017 and then by 8% in 2018 according to our estimates (Chart 6). These estimates were made by removing an exceptional event in the last quarter of 2016 involving the failures of 1,796 individual businesses due to a regulatory change. This increase of business insolvencies is logically explained by the decline in growth in 2017 and 2018, which would reach 1.4% and 1.2% respectively, according to our forecasts. Maintaining the official figures without restatement, business failures should decrease by 2.7% in 2017 and then increase by 8.8% in 2018.

Chart 6:
Business insolvencies and GDP growth



* the data on business insolvencies are adjusted in the last quarter of 2016 due to the presence of 1,796 additional business failures related to a regulatory change.

Sources: ONS, Coface calculations
Latest available data: Q4 2016

2 POST-BREXIT: BUSINESSES' AGILITY IN THE FACE OF MULTIPLE SHOCKS

The protectionist shock should have a significant impact on growth in the UK

In April 2019, the rules of the game that governed trade between the United Kingdom and the European Union are expected to change. This central scenario is true only if the negotiations between the two parties are finalised by that date, which is far from being guaranteed (historically, free trade agreement negotiations go well beyond two years). On this date, the British would lose their unrestricted access to the single market and their preferential access to non-European markets (33 free trade agreements have been entered into covering the EU and 53 non-European countries). British businesses, highly integrated into the EU (destination of 45% of total exports and nearly 12% of GDP), will see their transaction costs increase (customs controls, administrative, compliance, etc.), while European imports represent nearly 16% of GDP.

A number of studies have been conducted to assess the impact on British growth of a protectionist shock associated with Brexit. They indicate overall that GDP would fall by around 5% by 2030 in the case of a favourable scenario (soft Brexit) compared with no Brexit (-0.3 points of growth per year between 2016 and 2030) and by approximately 7.5% in the case of a pessimistic scenario (hard Brexit)⁷. Several scenarios can be considered according to the more or less restrictive degree of the trade policy.

In the case of a pessimistic scenario ("hard" Brexit), trade by the United Kingdom, then outside the European Economic Area and the Customs Union, would be governed by the WTO's rules. Businesses would face a sharp increase in import costs because of the increase in tariff and non-tariff barriers and would lose the financial passport in particular⁸. However, the country will still need to export in compliance with the EU's rules but should also renegotiate all its trade relationships governed by agreements between the EU and non-EU countries, which would take time. In this scenario, the OECD estimates that imports of intermediate products used in the value chain would fall by 9% compared with a scenario without an exit from the EU. The average rate would be around 3% but would be much higher for automotive (10%) and tobacco

(70%), while financial services are not immune to additional regulatory constraints. In the end, in terms of activity, the sectors likely to be affected by the trade shock are agriculture (-7%), which exports massively to the EU, and transport equipment (-12%) according to the OECD. The organisation believes that total exports would be reduced by 8% in this scenario.

In the case of an agreement with the EU ("soft" Brexit central scenario, which we feel is most likely), an agreement similar to that achieved with Norway with more favourable conditions is entered into. The country cannot influence the regulations but would continue to contribute to the European budget and be exempt from tariff barriers and quotas and would allow the financial sector to maintain its passport in order to access the European market. In this scenario, the OECD considers in particular that exports would be reduced by 6.4% compared with a scenario without an exit from the EU.

Obviously, the exit scenario can take many forms other than those mentioned above. A compromise between the two parties could also be reached with bilateral agreements (cf. EU/Switzerland agreement), with a moderate impact on growth.

Businesses are expected to suffer from a lack of attractiveness

Leaving the European Union is not limited to overcoming tariff barriers, but also means losing attractiveness. In the eyes of foreign investors, access to the common market is a key determining factor in decision-making, as the country offers a basis for trading with the rest of Europe. They will be tempted during Brexit to redirect their investments to other European countries (even though the context of uncertainty is already detrimental to investments).

However, foreign direct investments (FDI) play a major role in the United Kingdom: the country is the main destination of FDI in Europe. FDI inflows reached almost USD 40 billion in 2015 and represented 8% of GFCF. Mainly from the United States and Germany, these FDI stocks are particularly important in the financial sector (46% of the total), information and communication (19%), and transport and logistics (8%). The flows were particularly

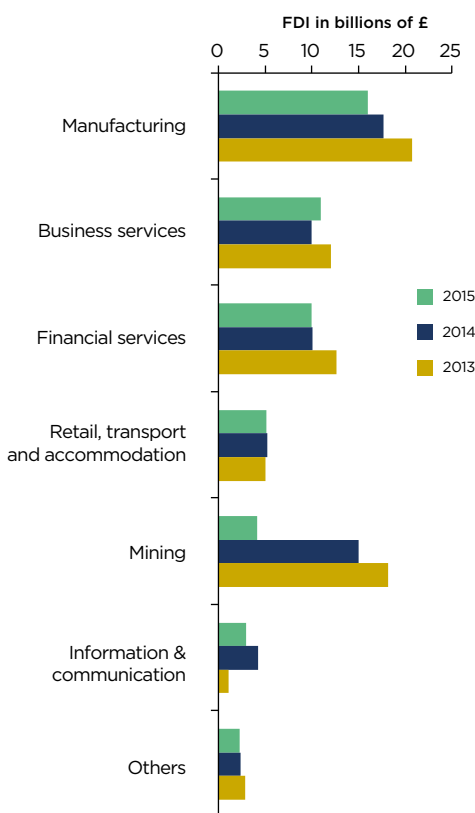
7/ OECD Economic Policy paper, « The economic consequences of Brexit: a taxing decision », April 2016. For example, the British Treasury considers the impact by 2030 to be around -3.8% of GDP if the country remains a member of the European Economic Area (soft Brexit similar to the EU-Norway agreement) and -7.5% if there is no agreement (hard Brexit, back to the WTO rules).

8/ Thanks to the European financial passport, businesses within the EU can sell their products and services within the European bloc by being regulated in a single country.



very significant in these sectors in 2015 (between 10 and 16 billion pounds sterling), especially in manufacturing, technical and administrative services to businesses, and financial and insurance services (Chart 7). This means less innovation and less R&D in these sectors. This decline in FDI brought about by the prospects of Brexit will have a negative impact on business investment and the accumulation of the capital stock. In particular, multinationals (the 25 largest businesses received 51% of FDI assets in 2015) will be adversely affected and will also need to incorporate the legal constraints, causing additional costs. Moreover, worsening financing conditions are not out of the question, even though the markets are anticipating Brexit (decline of the exchange rate and the stock market, increased bond yields, etc.).

Chart 7:
FDI inflows by industry



Source: Office for National Statistics,
Latest available data: 2015



**The automotive sector
is among the most vulnerable
to the Brexit.**



The quantitative studies thus indicate that the loss of access to the common market would have significant consequences on FDI: on average, EU membership increases FDI flows by around 28%⁹, while the United Kingdom's exit would result in a decline in FDI of around 22%. This loss of investment would lead to a decline in productivity (less progress in technology and managerial practices and fewer positive spillovers) and would lower real income by around 3.4%¹⁰. The OECD assumes a drop in investment inflows between 10% and 45%, depending on which type of EU exit scenario is considered.

Among the sectors where the impact would be high as already mentioned in the first section, automotive features prominently. Head and Meyer (2017)¹¹ believe on one hand that trade costs should grow, making British production less attractive relative to the rest of Europe and, on the other hand, that the costs of coordinating between head offices and local production sites would increase. The restriction of immigration (see next section) and regulation could make R&D, services to consultants and engineering more expensive. Accordingly, automobile production would fall by around 12% according to the study (nearly 180,000 cars) because automobile manufacturers like BMW could relocate, and prices for the British consumer would increase by around 2.6% (increased import prices).

In the case of financial services, the outlook is rather vague inasmuch as the sector is one of the largest recipients of FDI inflows. The sector could lose its European passport but will need to comply with the European rules for its transactions with the EU. Nevertheless, it is possible that the country will be able to negotiate access to the single market like Norway, but the situation should be clearly less favourable than in the past. According to Ernst&Young, 222 financial institutions are already considering relocating their activities outside the country, owing to the possible transformation of their branches into subsidiaries, which could be required by the BoE. This would involve an increase in their equity of approximately €40 billion according to the Boston Consulting Group. In addition, euro clearing activities in London could be

9/ Bruno, R., N. Campos, S. Estrin and M. Tian "Gravitating towards Europe: An Econometric Analysis of the FDI Effects of EU Membership", 2016.

10/ CEP, "The impact of Brexit on foreign investment in the UK", Dhingra & al, 2016.

11/ CEPR Discussion Paper No. 10797., Head, K. and Mayer, T., "Brands in Motion: How frictions shape multinational production", 2016.

jeopardised in view of the European Commission’s proposal to potentially relocate the euro clearing activities to EU territory, which could not only increase investment costs, but, in the worst case, generate risks on financial stability.

Businesses will face labour shortages in some sectors

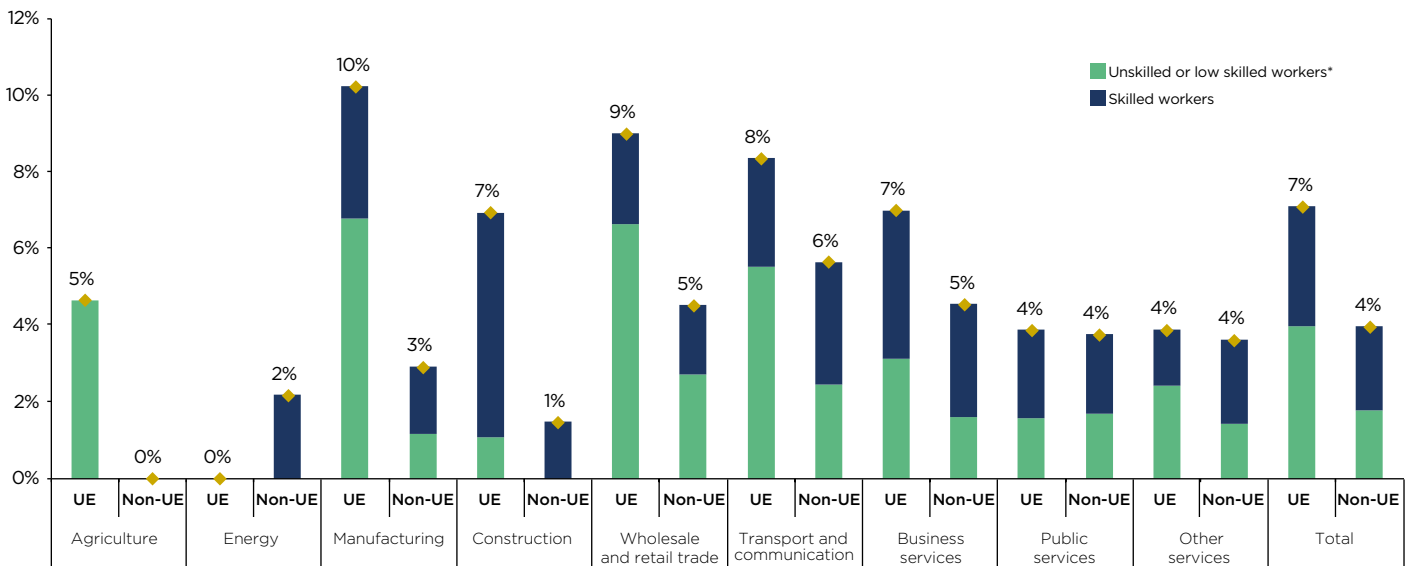
While the United Kingdom clearly wants to toughen its immigration laws, the methods remain unclear. The country is expected to introduce restrictions against the freedom of movement of persons (unilaterally), and Theresa May maintained that she would like to reduce net immigration to a few tens of thousands while reaffirming that it was important to ensure a sustainable level. Nevertheless, this view does not appear credible in the eyes of the population: according to a survey of 1,000 people conducted by Ipsos MORI in late April, only 18% of the population believes that this goal will be achieved. In addition, the latest report of the IFG¹²

highlights the fact that the rules on the rights of the 3 million Europeans living in the United Kingdom will need to be reviewed and that it is unlikely that the new regime will be implemented in two years (given past performance, the report counts on five years instead) and will require a post-Brexit gradual implementation phase, which could last for several years.

In concrete terms, we can consider several scenarios depending on the more or less restrictive degree of the migration policy (see details in inset). Our central scenario (“soft” Brexit) urges us to reduce the flow of incoming Europeans by around 1/3, which would lead to a loss of potential growth of 0.3 points of GDP in 2019 (the same magnitude as the protectionist shock in the same type of scenario), resulting from the shock on productivity and employment (and 0.6 points in the case of an extreme scenario of “hard Brexit” with a very sharp reduction of immigration from the EU of 2/3).



Chart 8:
Share of foreign workers in each sector by nationality and by skill level



Source: Office for National Statistics (2016), Coface calculations.

Note to the reader: The whole of workers of foreign nationality belonging to the EU represent 7% of jobs in the construction sector. Skilled workers of foreign nationality belonging to the European Union represent 6% of employment in the UK’s construction sector.

*The distinction between skilled and unskilled workers incorporates the distinctions made by the ONS: the skilled worker category groups together the “High” (e.g., engineers, professors) and “Upper Middle” (e.g., electricians) categories, while the category of unskilled or low-skilled workers combines the “Low” (e.g., cleaners, waiters) and “Lower Middle” (e.g., childminders).

What is the impact of a decline in migration flows on potential growth?

THREE SCENARIOS OF THE IMPACT OF BREXIT ON MIGRATION FLOWS

Our forecast is structured around three scenarios, from the most to the least likely^a: a central scenario of a moderate reduction of European immigration, an extreme scenario of a sharp reduction of immigration from the EU, and an optimistic scenario of maintaining

the current conditions (status quo scenario – net inflow is projected to reach 276,000 people in 2019). The central scenario reflects the British authorities’ desire to reduce immigration from the EU, thereby challenging the principle of free movement of persons

and workers. In this scenario, gross immigration from the EU is reduced by one-third starting in 2019, once the exit from the EU takes effect, while gross emigration to the EU is reduced to a much lesser extent: this would lead to a reduction in net

immigration of 70,000 people. In the extreme scenario, the gross immigration flow from the EU is reduced by two-thirds starting in 2019 also, and the reduction in emigration is doubled, which would lead to a reduction in net immigration of 136,000 people^b.

Chart 9:
Change in net migration and share of foreigners in the working population

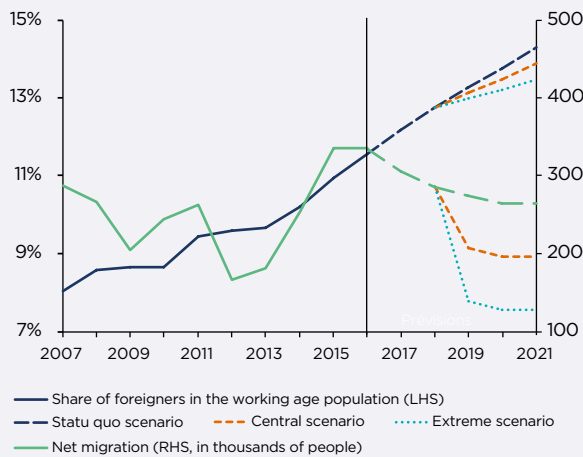
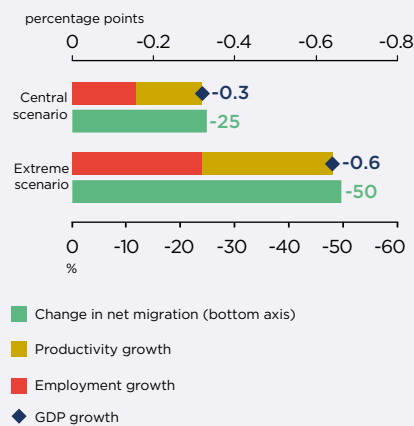


Chart 10:
Difference in 2019 compared with the status quo scenario



Sources: ONS, Coface calculations.

THE IMPACT OF A REDUCTION IN EUROPEAN IMMIGRATION ON THE UK’S POTENTIAL GROWTH

The reduction in net immigration negatively affects potential growth through two main effects, which reflect the particular composition of the flow of immigrants. Insofar as immigrants are characterised by a high proportion of 15 to 64-year-olds and skilled workers relative to the rest of the population, a double shock results from the decrease in net immigration: a demographic shock negatively affecting employment growth and a shock on productivity associated with lower growth in the stock of human capital. In addition, the impact of the decrease in net immigration on employment growth would be especially stronger in the United

Kingdom given that the increase in the working population over the recent period was in large part driven by the increase in the number of foreign workers^c, considering the ageing of the British population. The share of foreigners in the working population thus increased from 8% in 2007 to 11.6% in 2016 without any drastic increase in net immigration (Chart 9). With regard to the impact on productivity, the impact of a decrease in net immigration is particularly pronounced in the United Kingdom, knowing that the skill level of immigrants is relatively high (Chart 8). The impact of a decrease in net immigration is thus calculated

by combining the effect on employment and the effect on productivity as follows: $\Delta GDP = \Delta \text{employment} + \Delta \text{productivity}$. In theory, an increase in net immigration has a positive impact on productivity if the contribution of migration flows to the stock of human capital is high enough to compensate for the mechanical capital dilution associated with the increase in the labour force (Mankiw et al., 1992). According to Boubtane et al. (2013)^d, a 50% increase in net immigration results in a 0.32% increase in productivity in the United Kingdom. We maintained this elasticity to calculate the impact on GDP growth, assuming that the effects are symmetrical

downwards, as the effect on productivity identified by the authors is net of the productivity dilution mechanism. Concerning employment, we assume that its evolution will follow that of the working population (adjusted ONS projection).

The negative impact on potential growth of a decline in migration flows with the EU is thus estimated at 0.3 points of growth in 2019 in the central scenario and 0.6 points in the extreme scenario (Chart 10). In each of the scenarios, the contribution of the effect on employment is ultimately the same in 2019 as that of the effect on productivity.

a) Our estimate focuses only on the impact of a decrease in flows with the EU, without taking into account the effects of Brexit on the stock of European workers in the United Kingdom and without any offset of the decline in immigrants from the EU by immigration from third countries.
b) Our forecasts of net migration flows are constructed on the basis of the ONS’s latest migration flow projections produced in 2014, which we have adjusted for the difference with the most recent actual data. The correction made to the ONS projections is also in line with the forecasts by the Office for Budget Responsibility (OBR).

c) Between the first quarter of 2016 and the first quarter of 2017, the number of British workers increased by 179,000 people to 28.31 million according to the ONS, while the number of foreign workers increased by 207,000, including 171,000 Europeans, for a total of 3.55 million (2.32 million for Europeans).
d) Boubtane, E. and J.-C. Dumont, “Immigration and Economic Growth in the OECD Countries 1986-2006: A Panel Data Analysis”, Working Documents of the Centre d’Economie de la Sorbonne (CES - Sorbonne Economic Centre), No. 2013.3, 2013



The implementation of a very restrictive migration policy will have consequences for certain sectors. The number of immigrants from the EU tripled in 20 years to 3.3 million people. Net immigration reached 273,000 people over one year in September 2016. The share of Europeans in total migrants is close to 45% according to the ONS (268,000 people), hence a potentially significant impact on activity. The proportion of Polish migrants is particularly high (29%). European immigration, often bringing skilled workers, allows the real labour needs of businesses to be met and plays a significant role in certain sectors, particularly in manufacturing (10.2% of employees), wholesale and retail (9%), transportation and communication (8.3%), and financial and business services (7%). The share of skilled workers (which we define as the upper middle and high categories) is particularly large (on average, more than one-third of European workers in these sectors, Chart 8). Concerns about changes in the migration policy have led many industrial groups to alert the government through a dozen submission forms in order to maintain a flexible migration system with regard to the EU¹³. The Russell group, which includes universities such as Cambridge and Oxford, has also stressed the significant risk of attracting fewer talents (risk for research, education, innovation, etc.).

In addition, the impact on the labour market of lower immigration could be significant, even if only in view of the low level of available labour. Not only is the labour pool already relatively low in a context of low unemployment (4.6% in March), but the substitution of European workers with UK labour is far from evident with pairing problems on the labour market. In the light of the role of international businesses located in the United Kingdom, lower immigration could also harm managerial quality, as the OECD points out.

British businesses will have to be agile in order to face this shake up

In the end, the combination of these short-term and long-term shocks demonstrates that the most exposed sectors are numerous, like automotive, distribution, and agri-food, while the pharmacy and energy sectors should hold up better.

The diagram below highlights the risk associated with each sector and linked to Brexit over the next five years. It thus combines (i) the short-term risk (before April 2019) associated with the impact of the depreciation of the rate of the pound sterling, which increases inflation and import costs, and lower investment in the context of negotiation of terms (see details in section I) and (ii) the longer-term risk associated with the impact related to the United Kingdom's exit from the EU, which involves increased tariff barriers, decreased FDI appeal, and reduced immigration (see section II).



SECTORAL IMPACT OF BREXIT (2017-2022)*:



In a moderate Brexit scenario, the loss in European immigration would have an impact of 0.3 points on growth (0.6 points in the hard Brexit scenario).



13/ www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/inquiries/parliament-2015/brexit-and-the-labour-market/brexit-and-the-labour-market-publications.

Of course, the Brexit shock is a source of concern for businesses, but this is not the primary determining factor of their actions. EY's survey on Europe's attractiveness published in January 2017¹⁴ points out that the volatility of markets (foreign exchange, commodities, etc.) and economic and political instability within the EU are the main concerns of the continent's investors ahead of Brexit, according to the 254 respondents. However, this survey shows that 34% of the surveyed investors see a decrease in UK's attractiveness versus only 16% in the March 2016 survey before the referendum. European investors are the most pessimistic (43%), and Brexit is a greater source of concern for foreign businesses established in the United Kingdom than for others.

Businesses are already used to operating in an uncertain, volatile, and rapidly changing economic and technological environment. The structure of trade is changing profoundly with the transformation of value chains, the regionalisation of trade, and the rise of digital (digitised services and goods, big data, etc.)

as Institut Friedland points out¹⁵. Of course, the complexity of value chains does not make a rapid change possible (establishment of standards, transfer of know-how, trust, etc.), but the modification of the nature of flows makes trade barriers more ineffective, and businesses are quickly adapting to new forms of protectionism. Businesses must now demonstrate agility, taking advantage of the establishment of new, less traditional barriers (particularly local content or location obligations) where the conventional protectionist measures are detrimental

to their activity. Digital has also fostered the emergence of forms of protection related to competition law and even taxation, for example.

In this context, the protectionist threat, even if it grows stronger, is not a novelty, and the United Kingdom remains an attractive destination despite everything. Even though they are used to dealing with it and act on a long-term basis, businesses will now certainly have to operate in a more protectionist environment: today, the benefits of globalisation are increasingly called into question, and Donald Trump's arrival at the head of the United States goes in the direction of weakening trade openness. Brexit does not totally undermine the structural attractiveness of the country, which will continue to be characterised by significant comparative advantages. Investors are

looking for stability and a good business climate, which the United Kingdom offers (ranked 7th out of 190 by Doing Business): transparency, good governance, strong financial markets, flexible, skilled, and diverse labour market, skills in many areas of research or technologies, attractive taxation, etc. Certainly, some of these strengths will be affected by Brexit, but to a certain extent. London remains the most attractive city in Europe according to the survey, benefiting in particular from a cosmopolitan environment and a business ecosystem.

In the face of the Brexit threat, businesses can opt for several strategies. Since the referendum, and even though most had not anticipated the results, businesses have needed to make it a priority to mitigate rising costs related to the depreciation of the exchange rate and the impact on the supply chain, update contracts with customers, and even begin to search for new business opportunities. EY's survey indicates that 71% of foreign investors already feel the impact of the decision to leave the EU. Businesses, which have two years to prepare for the exit from the EU, must therefore demonstrate flexibility and agility, by developing scenarios or striving to increase their flexibility to cope with the coming shock according to their degree of vulnerability. Their strategy could be refined with better knowledge of the terms of the exit as the negotiations go on. The specificity of each sector and even the size of the business make the generalisation of strategies difficult:

- **Exposed businesses, small business and businesses with little financial resistance** are likely to disappear or restructure themselves through mergers/acquisitions. Some could change their business model in order to develop their resilience. Changes are to be expected for investment strategies in financial services (cf. potential loss of the passport) and technology-intensive sectors (for example, SMEs may fear a loss of external financing). For example, the pharmaceutical industry's influence could decrease with the European Medicines Agency's departure from its London headquarters.

- **Other companies should make adjustments in their sector-based or geographic strategies by moving towards other more promising segments.** EY's survey indicates that 14% of companies active in the United Kingdom would like to transfer all or part of their activity in the next three years. As part of this relocation strategy, the main alternative destinations cited are by far Germany, followed by France, Ireland, or the Netherlands. Other destinations like Italy, Spain, and even countries of Central and Eastern Europe (Czech Republic, Hungary, and Poland, which have a skilled workforce, attractive costs, and a good business environment) are also mentioned. However, this relocation would



Despite Brexit, the United Kingdom remains an attractive location for businesses.



14/ EY, "Plan B... for Brexit A boardroom view on investment and location strategies in Europe", January 2017

15/ Institut Friedland, Corinne Vadcar, « Les stratégies des entreprises au défi du protectionnisme », April 2017

not be determined solely by Brexit as previously explained (context of technological changes but also sources of demand coming more from the emerging markets).

- **In terms of labour force requirements**, businesses are already anticipating less freedom of movement, which may change recruitment and training strategies. While the prospects are uncertain, businesses can decide to freeze the recruitment of workers or reduce their staff, even attempt to refocus the workforce around British workers, although there are substitutability and availability issues. They could also see their compliance and taxation costs increase by using, for example, more temporary workers coming from non-EU countries.

Lastly, changes in public policies may also play a role to cushion the Brexit shock and may be likely to influence business strategies. In particular, changes in taxation are possible. It is indeed likely that the tax rate on businesses will be reduced (from 20% to 17% by 2020) to promote attractiveness to timid foreign businesses in this context of Brexit. The loss of comparative advantages could thus be limited if the government introduces incentives.

RESERVATION

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