

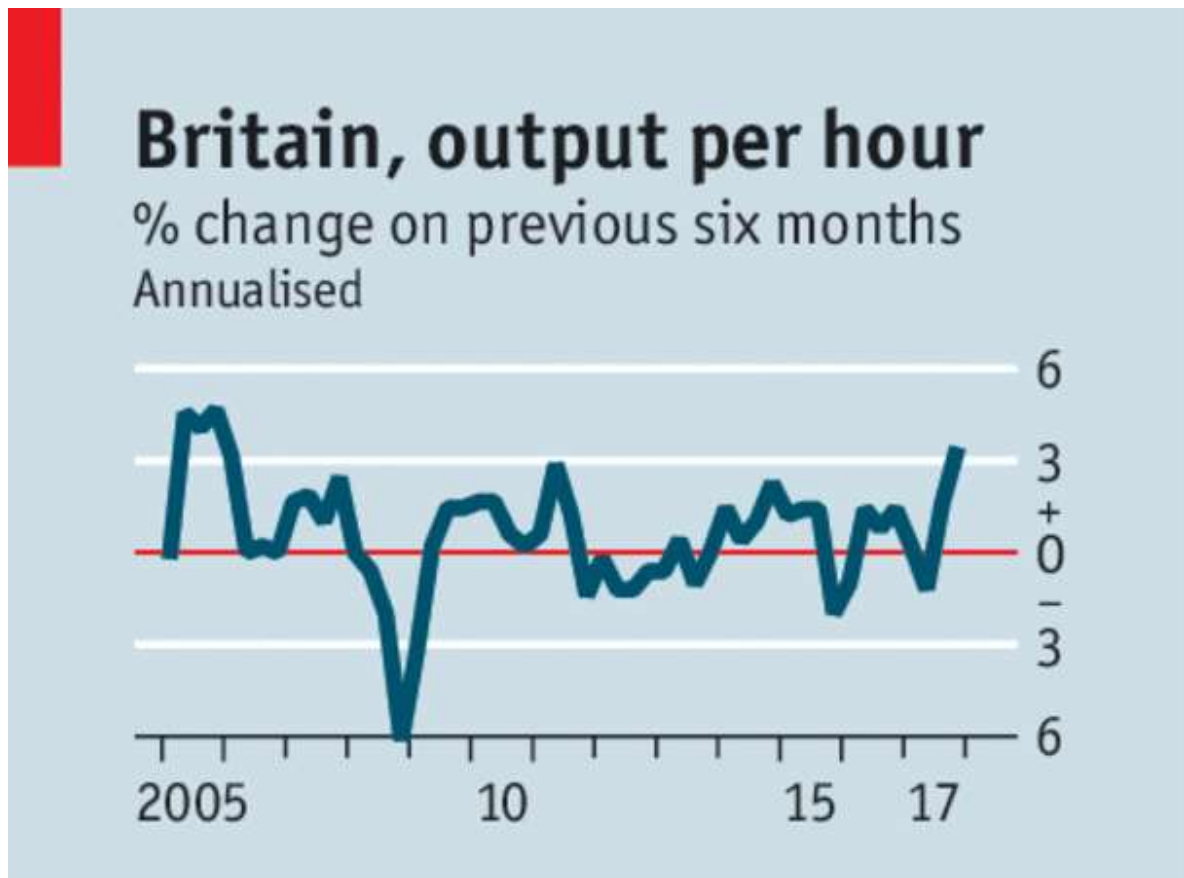
British productivity is rising at last. But Brexit looms over the economy

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LOW productivity growth has plagued Britain's economy since the financial crisis. From 2010 to 2016 output per hour grew, on average, by just 0.2% a year, down from 2.5% between 1950 and 2007. In the G7 group of rich countries, only Italy has done worse. Productivity drives a country's living standards in the long term. It is a relief, then, that the stagnation may at last be coming to an end. In the second half of 2017 productivity grew at an annual rate of 3.4%, the fastest growth since 2005.



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Accelerating productivity is the latest, and most important, piece of good news on Britain's economy. Capital spending is improving. As a share of GDP, total investment is a percentage point above its average since the crisis. Foreign firms are readily investing. A tenth of global mergers and acquisitions announced so far in 2018 have involved a British target. Wage growth is picking up in nominal terms and, with inflation falling, real wages may soon start to grow again.

The strength of Britain's labour market stands out. America may have a lower official unemployment rate, but nearly a fifth of people there aged between 25 and 54 are not even looking for work, meaning they are not counted in the figures. Not so in Britain, where the employment rate for this age group is 84%, among the highest of large economies.

Inevitably in a country still riven by the referendum decision to leave the European Union, Britain's economic performance is analysed through the prism of Brexit. Those in favour of leaving the EU gleefully recall predictions, made by the Treasury and others, of a collapse in confidence after the referendum, and then a recession. Not only have those forecasts proved wrong but, some Brexiteers say, Brexit may actually be helping the economy. On their view, productivity is rising because falling net migration from Europe has led to a tighter labour market, spurring firms to find ways to do more with less.

Too soon to celebrate

Not so fast. The reasons for the rise in productivity are not yet clear (see article). But there are two ways in which the recent economic news must be put into perspective.

The first is that the aftermath of the referendum has coincided with a broad, sustained rise in global growth. Against that backdrop, it is not surprising that Britain's economy has performed better than anticipated. It has nonetheless slowed. The economy grew by only 1.4% in the year to the end of 2017, down from 2% a year earlier. And it has slipped sharply relative to others. Not long ago Britain had the fastest growth in the G7 group of rich countries. Now it has the slowest. Comparing Britain's growth with that of the world economy, one estimate puts the running cost of Brexit at 1.3% of GDP, or £300m (\$426m) a week. Had the global economic cycle not turned in 2017, some of the more blood-curdling forecasts made before the referendum might not have looked quite so silly.

Second, the biggest downside to Brexit was never going to be immediate economic pain. If Britain leaves the single market and customs union in an orderly manner, the short-term shock should be manageable. But there is still the swingeing cost to longer-term growth from higher trade barriers. Firms selling to the continent will gradually cut Britain out of their supply chains. Britain's workers and capital will have to be redirected to produce things that previously

were imported more cheaply. Britain's exports to Europe will cost more. With free movement curtailed, it will be harder for knowledge to flow across borders. The economy will be less efficient.

Brexiters retort that economists have been proved wrong once and will be proved wrong again. Yet the profession is much better at predicting trade flows than it is at guessing how investors will respond to events. Few economic models have had as much success in explaining the real world as the one saying that as distance between trading partners doubles, trade flows fall by roughly half. There is no replacement for frictionless trade with a single market of 450m people on Britain's doorstep, whatever the government's hopes for trade deals with countries, like America, that are oceans away.

Reliable trade models predict long-term losses from Brexit of up to 10% of GDP, depending on how it is conducted. According to analysis by civil servants, even if Britain retained tariff-free access to the single market and maintained free movement of people, as Norway does, the eventual hit to GDP per person could be as high as 2.6%—enough to undo its growth during 2017 almost three times over.

In theory, investment could boost productivity enough to outweigh the effect of lost trade. Policymakers are, slowly, getting some things right. Government investment, as a share of GDP, may soon reach its highest sustained level for 40 years. Philip Hammond, the chancellor of the exchequer, is saying some sensible things about solving Britain's housing shortage.

Yet the government is walking down a train that is speeding in the opposite direction. The effects of merely tinkering with policy will be of a different order of magnitude to those of upending Britain's trading relationships with its neighbours. For productivity, as for so much else, how Brexit is conducted is the thing that matters most.