Brexit and COVID-19 are a toxic mix

by Tomas Hirst and John Springford

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The second wave of COVID-19 is arriving just before the UK leaves the single market. The pandemic will make it harder for the economy to adjust to Brexit.

Britain's finance minister, Rishi Sunak, announced last week that his furlough scheme would continue, after vowing it would end on October 31st. Infections are rising in the UK, as they are across much of Western Europe, and hours worked are falling again. But, unlike its peers, the UK will leave the EU single market and customs union in January, which will raise the cost of imported goods, reducing household spending power, and curb European demand for UK products, leading to job losses in Britain's export industries. The pandemic will make it harder for the economy to adjust to Brexit, and the government needs an economic policy programme designed for a period when unemployment is high and household consumption weak.

Given that the economy contracted by 20 per cent in the second quarter – a record decline in output – the relatively modest impact of the pandemic on household disposable income should be seen as a major policy success (it fell by 0.9 per cent in the second quarter). At 80 per cent of pre-COVID income, the UK's furlough scheme was more generous than the average furlough/short-time work scheme on the continent, which protected closer to 60 per cent of incomes. That allowed the UK economy to bounce back strongly through the third quarter.

Yet while these schemes have been extended in many other European countries, Sunak planned to close the furlough scheme at the end of this month before his recent U-turn. He is replacing the furlough scheme with the Job Support Scheme (JSS), which requires employees to work at least one-third of their normal hours, with their pay being topped up by equal contributions from the government and their employer. Because employers have to top up wages for short-time workers when they are off, they have an incentive to fire some workers and employ the remainder on a full-time basis.

And as the UK started to see rising coronavirus case numbers, new local restrictions on pubs and bars to curb the spread have compelled the government to provide more support. Last week Sunak revised the JSS so that the government will now support businesses that are forced to close by paying two-thirds of each employee's salary, up to a maximum of £2,100 a month.

These measures will help but will not prevent a sharp rise in unemployment over the next few months. Indeed, it is difficult not to see a higher unemployment rate for the near term as the deliberate aim of policy, with the government having apparently shifted from attempting to preserve existing matches between workers and employers, to a large-scale reallocation of workers. And Sunak's view is that "everyone is having to find ways to adapt and adjust to the new reality".

Given that some of the most directly affected sectors such as retail, hospitality and tourism tend to have relatively high job turnover rates, the JSS is unlikely to stop most redundancies in those sectors. As of July 31st, there were still 3.5 million workers on full furlough, with a further million on partial furlough. Of those, over 2 million were in the retail, hospitality, arts and entertainment sectors that will be among those worst impacted by any increase in the stringency of measures to reduce the spread of COVID-19.

The UK's Office of National Statistics estimates that the number of online job adverts remains almost 40 percentage points below its 2019 average, suggesting large-scale reallocation of workers was already going to be a challenge even before the latest round of restrictions were announced. Someone earning the median wage who loses their furloughed job and moves onto unemployment benefit will suffer from a 54 per cent fall in income. The hit to aggregate demand of a prolonged period of high unemployment in the UK could be substantial.

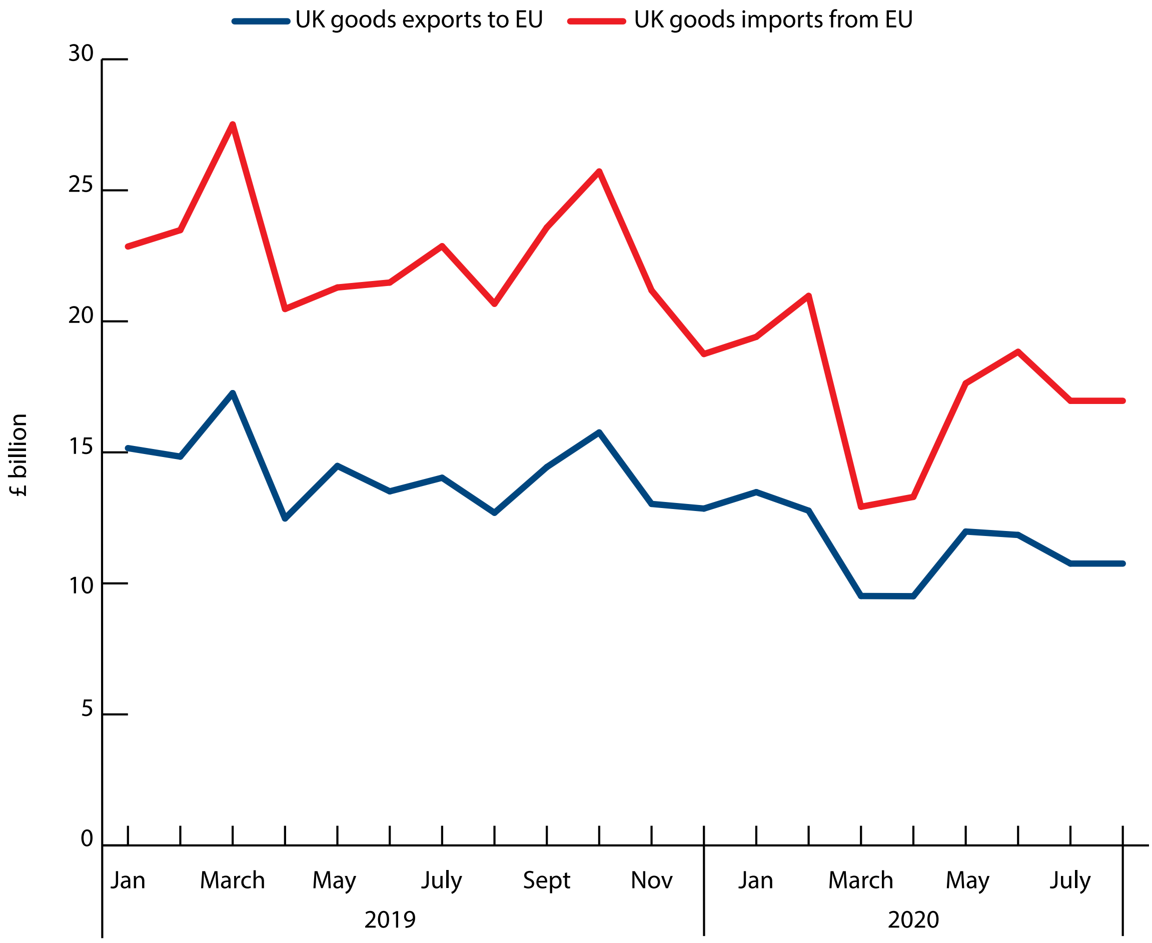
Overall, the UK has left itself beholden to the path of the virus, first providing support, then scaling it back, before raising it again but to a level that will not be enough to forestall a large rise in unemployment and fall in household incomes. No doubt more support will be needed, especially an increase in Universal Credit, because many unemployed people will not find jobs again until the pandemic is over, or at least is under control. This stop-start approach has meant that some people will have been fired by employers who would have kept them on if they had known more support was coming. And it undermines the confidence that households could get from a clear, consistent and dependable support scheme, helping to prevent a persistent increase in the level of precautionary saving.

The UK economy will then find itself extremely weak going into the Brexit shock. And, while Brexit will hurt different sectors of the economy than COVID-19, the pandemic will make it harder for capital and labour markets to adjust to the hit.

In the long-run, the Treasury's estimate of the cost of no deal is about 7-8 per cent, and the cost of a standard trade deal about 5 per cent. But that is over the long-term: the immediate hit is difficult to model, and no one knows how bad the disruption will be, deal or no deal. Even if there is a deal, there will be higher customs and regulatory costs, and visa restrictions for migrants. Some of these frictions may be introduced gradually, if there is a formal implementation period for the trade deal, or if France, Ireland, Belgium and the Netherlands only gradually enforce EU law. But if they are not, higher trade costs will be felt immediately.

If the second COVID-19 wave continues into January, the volume of cross-Channel trade may fall again, after recovering somewhat from the first wave (Chart 1). With fewer lorries making the crossing, queues caused by customs checks may be shorter than expected, and therefore less of a political problem for the British government.

Chart 1: UK goods trade with the EU



Source: HM Revenue and Customs.

However, this increase in the regulatory and tax burden will raise the cost of trade with the EU, whatever the state of the pandemic. This will mean that businesses will do less of it. Importing companies in the EU will look for suppliers within the single market. Over time, British workers and capital engaged in EU-facing businesses will have to be redeployed to satisfy other sources of demand. Some of that will be domestic: EU companies have lots of other choices for places to source imports, but British firms do not. That means that British capital and labour will be diverted to provide those goods and services that were previously imported from Europe. While that will offset some of the lost jobs in exporting firms and produce a temporary increase in business investment, it will result in a hit to household consumption, because consumers will have to pay more or receive inferior products than they do now.

In the event of no deal, some of those costs will come through rapidly through a fall in sterling. This can have a big impact on consumption: so far, according to one estimate, the 10 per cent devaluation since the referendum has raised the cost of living for the average UK household by £870 a year.

COVID-19 will make the process of reallocating workers and capital harder. Businesses will be less willing to expand production during the pandemic than usual. Social distancing and the risk of further lockdowns will discourage some companies from taking on permanent new staff. And there are few sectors of the economy with growing sales since the pandemic started: workers leaving exporting firms will find there are few vacancies available, adding to the congestion in the labour market.

Another potential source of demand is from outside the EU. If sterling devalues further in January, UK exports will become more price-competitive, both with EU countries and the rest of the world. In theory, this should ease adjustment by raising external demand for UK exports. In practice, even without the pandemic, this effect is likely to be muted as the evidence of the UK's unimpressive export performance since the EU referendum attests.

How can the government get out of the trap it has laid for itself? There are immediate and more medium-term priorities. It would be absurd to reject a deal with the EU because of opposition to a state aid regime with appropriate safeguards for both sides (which would be good for British taxpayers and consumers) and access to UK fisheries (fishing makes up a tiny share of the UK economy). But it is as important to agree some sort of implementation period, so that checks are phased in over time – preferably after the pandemic is over – rather than being imposed immediately. On the pandemic front, more generous wage subsidies and unemployment benefits will be needed to stop spending across the economy from falling rapidly.

To tackle unemployment, the government could invest in retraining programmes and expand public sector employment. As the UK repatriates responsibilities from the EU, it will need to replicate many of the functions that EU institutions performed: it will need customs officers, conformity assessment inspectors and other specialists – all of which will mean a larger public sector headcount. It could also increase funding for social care and public health, both of which require more staff.

In the medium term, the government needs an economic policy programme that is tailored more for the consequences of Brexit than COVID-19. The pandemic will end either with a vaccine or by becoming endemic in the population, and the economy will recover (with the right government support). But Brexit will make the British economy permanently more closed than it would otherwise have been, since free trade agreements cannot make up for costs of Brexit. That requires policies that will strengthen domestic competition, improve conditions for foreign direct investment and raise real household incomes.

Higher trade barriers with the EU will reduce household incomes by raising the cost of imported products. This can be offset by seeking to reduce other household bills. Britain's housing stock is among the least energy efficient in Europe, and stronger subsidies and regulations to retrofit buildings are needed. Energy efficiency measures are labour intensive: more plentiful retrofitting jobs would help to reduce unemployment. Strong competition policies to hold down utility bills and personal finance costs will be more important than ever, as will a state aid regime that ensures value for money to taxpayers.

Before Brexit, the UK attracted a high degree of foreign direct investment from the US and Japan, as a comparatively low-cost bridgehead to European markets. The English language was also a major advantage. But Brexit is making Britain less attractive. The UK needs a liberal visa regime, so that skilled workers can enter its labour market easily. It needs to improve commuter transport links, expanding the size of its cities' labour markets, so that employers can more easily access the skills they need. Better broadband might help (although the evidence that the internet raises productivity growth is weak). So too might bigger tax breaks for investment (although these can lead to tax avoidance, or reward investments that would have been made in any case).

All of this will be expensive. Boris Johnson was right to insist on raising public investment when he took office, and he should face down any attempt by the Treasury to include investment in a fiscal consolidation programme. Taxes will have to rise at some point, as the pandemic and Brexit will both impose permanent costs on the economy. But the Treasury should not fear high debt and wait until growth is robust, unemployment is falling, and inflation and interest rates are rising before tightening fiscal policy. Given the battering the economy will take over the next six months, it may be some time before recovery is in sight, and the government should use this time wisely.

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