**What does Brexit mean for UK Automotive, Manufacturing, and Industrial Policy?**

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**Introduction**

The UK’s automotive industry has been one of the ‘star performers’ of the UK economy in recent years – unlike most other manufacturing sectors. Output has increased by 60% since 2010 and there has been over £8bn worth of investment in the industry in the last four years (SMMT, 2016). The industry supports some 800,000 jobs in the UK (ibid). This upturn has benefitted regions, such as the West Midlands which have struggled with deindustrialisation and plant closures (Bailey and de Ruyter, 2015). The industry is seen as having benefitted from EU membership (KPMG, 2014). So what might Brexit mean for the UK automotive sector (hereafter ‘UK auto’), and in turn for industrial policy in the UK?

This short paper considers short run impacts, before turning to the impact of uncertainty on foreign direct investment inflows and then the nature of a possible trading relationship. Some concluding thoughts highlight the need for a renewed industrial policy to support UK auto and manufacturing.

**Short run impacts**

Clearly the first thing to consider is the impact of the decision on the wider UK economy, both in terms of economic growth and the value of sterling.  For example, a possible slowdown in economic growth (as suggested by the latest PMI figures) is likely to impact on car sales in the UK, so at best car sales are likely to grow more slowly than otherwise and at worst may fall. However, this negative outlook for the auto market may be offset to some extent by looser monetary policy, which could help in reducing financing rates on new cars.

On the currency issue, the UK has already seen a significant depreciation in the value of sterling. For UK based auto assemblers, this depreciation should boost exports. Firms will have a choice of whether to increase output or boost prices to take higher profits. Nevertheless, this should help boost UK auto output in the short term to over 1.7m units. So ‘output up but domestic sales down’ seems the immediate likely impact on UK auto.

At the same time, though, imported cars and components will become more expensive. This is an issue as on average around 60% of the components going into a UK assembled car are imported (SMMT, 2016).  This will impact on different firms in different ways. Jaguar Land Rover, for example, sources a higher proportion of components in the UK and also has higher margins to play with than, say, General Motors through its Vauxhall brand. Both firms have worked hard in recent years to raise their levels of UK sourcing. That could now be pushed further if sterling settles down at a lower exchange rate.

Those auto brands that do not assemble in the UK and only import cars will be negatively affected by the fall in sterling as their cars will become more expensive here (or as their margins are squeezed). So in terms of the auto market in the UK, the bottom line is that imported cars are likely to become more expensive. And as noted, a slowdown in economic growth is also likely, which will impact on car sales.

**Uncertainty and FDI**

The really big issue, though, for UK auto is the huge uncertainty over future trading relations with Europe - that is likely to hit inward investment in the industry in the UK. Foreign investment is key to the renewal of the industry, with some £8bn invested in the sector over the last five years (SMMT, 2016).

As Driffield and Karoglou (2016) note, the biggest single deterrent to foreign investment is uncertainty. The more uncertainty that firms attach to their ‘net present value calculations’, the less likely they are to invest. They note that the single event that caused the greatest decline in inward investment in recent history was Britain leaving the Exchange Rate Mechanism, not because it necessarily implied any particular weakness about the UK economy, but because of the uncertainty that surrounded it. In contrast, they note that the single event that has had the greatest positive impact on inward investment in the UK in recent history was the creation of the single market. This was because it became easier for firms to conduct business within their organisation but across national borders.

For example, automotive and engine assemblers like GM, BMW and Ford all import sizeable inflows of components to the UK from their other EU operations. Anything which puts these trading relationships at risk, whether currency risk or higher transactions costs from having to deal with EU and UK regulations separately, reduce the likelihood of further investment. As Driffield and Karoglou (2016) note, if one looks at similar events in terms of magnitude, Brexit may have a short term negative shock on inward investment. They suggest that it would then take about 4 years to get back to a new lower long-term trend of inward investment.

The trade issue is critical as over 80% of cars assembled in the UK are exported, and neatly 60%over 50% of these exports go to Europe. Maintaining access to the Single Market is therefore critical.

The uncertainty on trade needs to be ‘nailed down’ as soon and as clearly as possible so that investors can retain confidence that they can assemble in the UK and export to Europe without tariff or non-tariff barriers. It is the mass market production which is seen as most exposed: a recent PA Consulting (2016: 2) report suggests that it is the British plants operated by Japanese companies - Honda, Toyota and Nissan - which are at greatest risk of eventual closure if the factories become uneconomic after Brexit, as they have a “high reliance on exports to Europe and relatively low margins”.

**What trading relationship?**

As noted, the UK has yet to say what trading relationship it wants with the EU (Brexiters didn’t actually spell out what they wanted and may not actually agree) and it’s not clear how the EU will in turn respond. It is not clear how this will play out. During the referendum campaign, some suggested that Norway and Switzerland are examples that could be followed, as they are outside of the EU and enjoy forms of free trade with the EU.

Switzerland's position is somewhat complicated and based on a number of bilateral agreements. Some sectors of its economy are not covered (services, for example). It's a kind of a-la-carte ‘Swiss Cheese’ approach. Like Switzerland, Norway pays in to the EU budget and gets access to the single market (on a comprehensive basis in its case), but must follow EU rules and has no input into devising EU regulations. In both cases, they are free to negotiate trade deals independently of the EU.

So, could the UK ‘do a Norway’ and stay in the single market? That would minimise the economic damage of leaving the EU, but will be tricky given that the Leave campaign had immigration as a core issue. Complete freedom of movement for people in the single market is likely to be a sticking point for the UK, as would be paying in to the EU budget.

Of course, some auto firms based in mainland Europe will want to continue to trade with the UK (the UK is BMW’s second largest market in Europe for example) and are already taking a hit on exports to the UK with the depreciation of sterling. There will be some desire to get a deal of sorts done. Yet completely free trade on all goods and services (as now) *but without* paying into the EU budget or agreeing to free movement of people is probably going to be a non-starter.

A deal will have to be done, but the compromise will take time to sort out, and that uncertainty is itself a major risk in terms of inward foreign investment in the auto industry. So there is uncertainty and industry is uncertain as to how long it will go on.

**Other impacts**

Even with a trade deal, there is one area where UK auto will definitely lose out, and that is via the ability to influence regulation in the industry. Regulation is not going away and if anything will be become more important as we move towards connected and autonomous cars. The UK will have no influence on those regulations in Europe when it leaves. JLR, for example, will have to look to the Slovakian government to represent it at the European level when the UK does exit. A final possible impact needs to be highlighted in that the auto industry in the UK currently has some 5,000 vacancies and needs to be able to hire skilled workers from Europe (SMMT, 2016). Again, this needs to be sorted out as quickly as possible.

**Conclusions and Industrial Policy needs**

The Brexit vote and its aftermath is likely to have a number of impacts on UK auto and manufacturing, through impacts of economic growth, the exchange rate and heightened uncertainty. The latter is likely to impact especially on inward foreign direct investment in the industry. Clarity on the broad form of a new trading relationship with Europe is needed sooner rather than later to underpin confidence for investors in the industry.

Overall, though, the UK government has to do more than just strike a new agreement with Europe. For example, Britain will need to do much more to create its own skills; this means developing better systems for education, skills training, and re-training as part of a wider industrial policy. Just as the government and Bank of England are having to rethink fiscal and monetary policy, so too industrial policy needs to be re-examined.

Given the recent depreciation in sterling, there is potentially a new opportunity here for reshoring the auto supply chain further. That is not going to happen automatically, though, given the barriers to reshoring we have identified in our own work (Bailey and De Propris, 2014). On this there is much more that the government could be doing in really trying to ‘rebalance’ the economy, for example by stimulating investment in manufacturing such as through enhanced capital allowances, by resurrecting something like the Advanced Manufacturing Supply Chain Initiative (preferably on a much wider scale), and by plugging funding gaps for small firms in the supply chain.

More broadly, there is a strong case for UK industrial strategy to be afforded an institutional status similar to both UK monetary and fiscal policies. At the very least, it should be the subject of regular strategic long-term reviews. By giving it that sort of priority, the new government would send out the kind of powerful message that British industry badly needs to hear.

The key point is that given both opportunities and risks arising from Brexit for UK auto, a better funded and more active industrial policy is now needed to support UK auto and manufacturing. That has been recognised by the new May administration making reference to the need for an industrial strategy. Quite what that involves is yet to be seen.

**References**

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