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Global UK

Charting a course from challenges to opportunities in life after Brexit

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The future for Global UK is fraught with opportunity.

As we write we have just gone past the 49th anniversary of the UK's accession to the EU (18th October, 1972) and are almost a year on from the end of its membership. Time to take stock. We've scanned the horizon for the opportunities and the challenges. Short-term growth forecasts have recently been upgraded by the IMF and others but those remain caveated by COVID-19 and by the so-called teething troubles in the post-Brexit relationship with the EU. Longer-term growth is expected to slow (everywhere) but is the more likely period in which to produce any material net economic benefits from the decision to leave the EU.

This report looks at some of the remaining short-term challenges that are likely to be material in shaping the longer-term post-COVID and post-Brexit future. We take the possibility of an early general election (before 2024) as defining the boundary between the two time-frames: the outcome could bring important changes on the path towards at least the foothills of a longer-term post-Brexit landscape. Its sunny uplands may still be shrouded in mist but while there are many unknowns, the inevitable rebalancing of the UK economy, both domestically and overseas, will create opportunities for some.

Exec summary

- The next UK general election (GE) could come well before the currently scheduled date in 2024 and have material impact on the course of the UK's future outside the EU. Using recent opinion polls Electoral Calculus points to another but greatly reduced majority for the Conservative Party with a probability of 50%; it estimates a 30% chance of a Labour-led minority
- Those two scenarios could produce rather different long-term outcomes for the future of the UK outside the EU compared to the current direction of travel and its accompanying robust rhetoric – hence our use of the next GE as a boundary between the short and long-term scenarios
- The run up to the next GE will continue to be dominated by the UK's pandemic response, including the tapering of job support schemes, and by remaining issues in the implementation of the Withdrawal Act and the Northern Ireland Protocol - see here for a summary of latest developments
- Economic recovery since the COVID recession has been faster than originally expected – driven by the vaccination programme. Latest OECD forecasts show UK growth expected to be among the fastest of western developed economies in 2021. But it also expects growth rates to slow (everywhere) from 2022 onwards - another argument in favour of calling the GE sooner rather than later
- Substantive new trade deals are unlikely to be inked in the time remaining to the next GE: they can take considerable time to negotiate including around substantive matters such as the Northern Ireland Protocol where President Biden has previously indicated some conditionality before signing an FTA with the UK
- The greatest opportunities for the UK overseas appear to lie in the longer term and in Asian and emerging economies, generally expected to produce faster growth than the UK, EU27 and the US. Hence the UK application to join CPTPP - the recently formed trans-Pacific trade bloc. But models of international trade suggest greater distance diminishes the impact of that potential on the UK domestic economy
- A significant challenge for service sectors overseas is that almost all of the UK's most important target markets have stricter controls on their domestic service sector than does the UK
- A blueprint for the future of the UK economy was outlined in a government policy paper which set out three broad priority areas for investment and thus for opportunity: infrastructure (with a particular focus on ESG), skills and innovation. We outline sector opportunities under each of those headings

Short-term: COVID, post-Brexit and a GE

The next UK GE defines the boundary

Under current legislation (the Fixed Term Parliaments Act 2011), the next GE is scheduled for 2 May 2024. But the Government has introduced a Bill to repeal that legislation and, although its passage has been interrupted by the COVID pandemic, it still intends to restore the Prime Minister's power to call an election at a time of his or her choosing. This bill is a constitutional curiosity in that it increases the scope of the Royal Prerogative (as exercised by the prime minister).

If given the power again to choose the election date, the prime minister is widely expected to opt for a date considered optimal for his party rather than be constrained by a fixed date. Many commentators suggest 2023 as a preferred option for a GE to maximise advantage rather than waiting for the hard and very visible stop in May 2024 that is already dialled into people's diaries.

So, we're taking the period to the end of 2022 as defining the short-term: after that, we think the risk of a GE begins to rise sharply and with it the different scenarios for the long-term future of the UK.

Defining the short-term agenda: the COVID/Brexit intersection

The period to the next GE, whenever it occurs, is likely to be dominated by remaining issues around Brexit and COVID. As we have noted before there is a significant overlap between the demographic who, when asked in opinion polls, have voted for a swift return to the workplace/end of social restrictions and those who voted Leave in the 2016 referendum.

Government policy may be expected to seek at least to maintain support in both cohorts across a wide range of issues/challenges including.

- Resolving Brexit-related issues around the operation of
  - the Northern Ireland Protocol (NIP) – a matter in which President Biden takes a close personal interest and over which others have suggested a resolution is a pre-condition of any Free Trade Agreement between the UK and the US. Separately, Prime Minister Ardern of New Zealand appears to have linked resolution of the NIP issues to the UK's application to join the CPTPP.[1] Recent statements from the chief negotiators for the UK and the EU and from leader of one of the main political parties in Northern Ireland suggest there is increasing frustration with the status quo but no easy solution beyond unilateral action by the UK to extend grace periods for the movement of certain food products
  - supply chains across all borders between the UK and the EU
  - mechanisms to ensure the enforceability of parties' contractual choice of jurisdiction given the EU's decision to block the UK's accession to the Lugano Convention in its own right
  - any mandate for a second independence referendum in Scotland that may be claimed following elections to the Scottish Parliament in May, 2021. Scottish local elections in 2022 will provide the next big test of Scottish public opinion ahead of which the UK government may use the provisions of the UK Internal Market Act to boost infrastructure spending and other state aid in favour of Scotland as part of its levelling up agenda
  - international trade agreements. Given the time needed for substantive trade deals to be negotiated, the government may have to go to the next GE with warm words of progress but no deal on what are already clearly the major pillars of the UK's ambition beyond the EU: deals between the US and the UK, with China and membership of the CPTPP
- Resolving COVID-related issues including
  - vaccine rollout to younger cohorts
  - booster shots for older cohorts especially given some emerging data pointing towards continuing risks even among vaccinated cohorts (co-author Prof. Wendy Barclay is a member of SAGE) and of waning immunity after vaccination
  - whether or not to move back to some social restrictions as cases rise ahead of the onset of winter
  - managing the tapering of job-support and other financial aid programmes related to COVID-19 without causing any material economic dislocation or significant spike in insolvencies/unemployment

Clearly there will be other agenda items for the government ahead of the next GE. But these two, resolving remaining Brexit and COVID-related issues, and their complex intersection in key electoral demographics, are possibly the most significant in determining the short-term backdrop to the next GE and the longer-term future of the UK.

[1] CPTPP is the Comprehensive and Progressive Agreement for Trans-Pacific Partnership between (currently) Japan, Australia, Canada, New Zealand, Vietnam, Singapore, Malaysia, Brunei, Mexico, Chile, Peru

GE 2023 - a brief scenario analysis

Recent opinion polls in the UK show a modest narrowing of the lead held by the governing Conservative Party. That lead appears to have narrowed particularly since around the time (mid July - "Freedom Day") that most social restrictions associated with COVID were finally lifted.

Nonetheless, on current political arrangements and forecast models the Conservative Party would win the next GE but on a significantly reduced majority - well down from its current 80-seat advantage which could see some changes in political nuance and maybe more substantive than that.

Outlier scenarios: Boundary Commission versus electoral pact

There are two other factors that could produce a different outcome. In favour of the Conservative Party are changes proposed by the Boundary Commission to the geographic boundaries of some parliamentary constituencies due to take effect from 2023. On one estimate those changes, all else equal, could increase the Conservative party majority by some 20 seats.

Against that is the possibility of an electoral pact among the opposition parties under which they would agree not to stand against the party which was deemed to stand the best chance of beating the Conservative Party candidate.

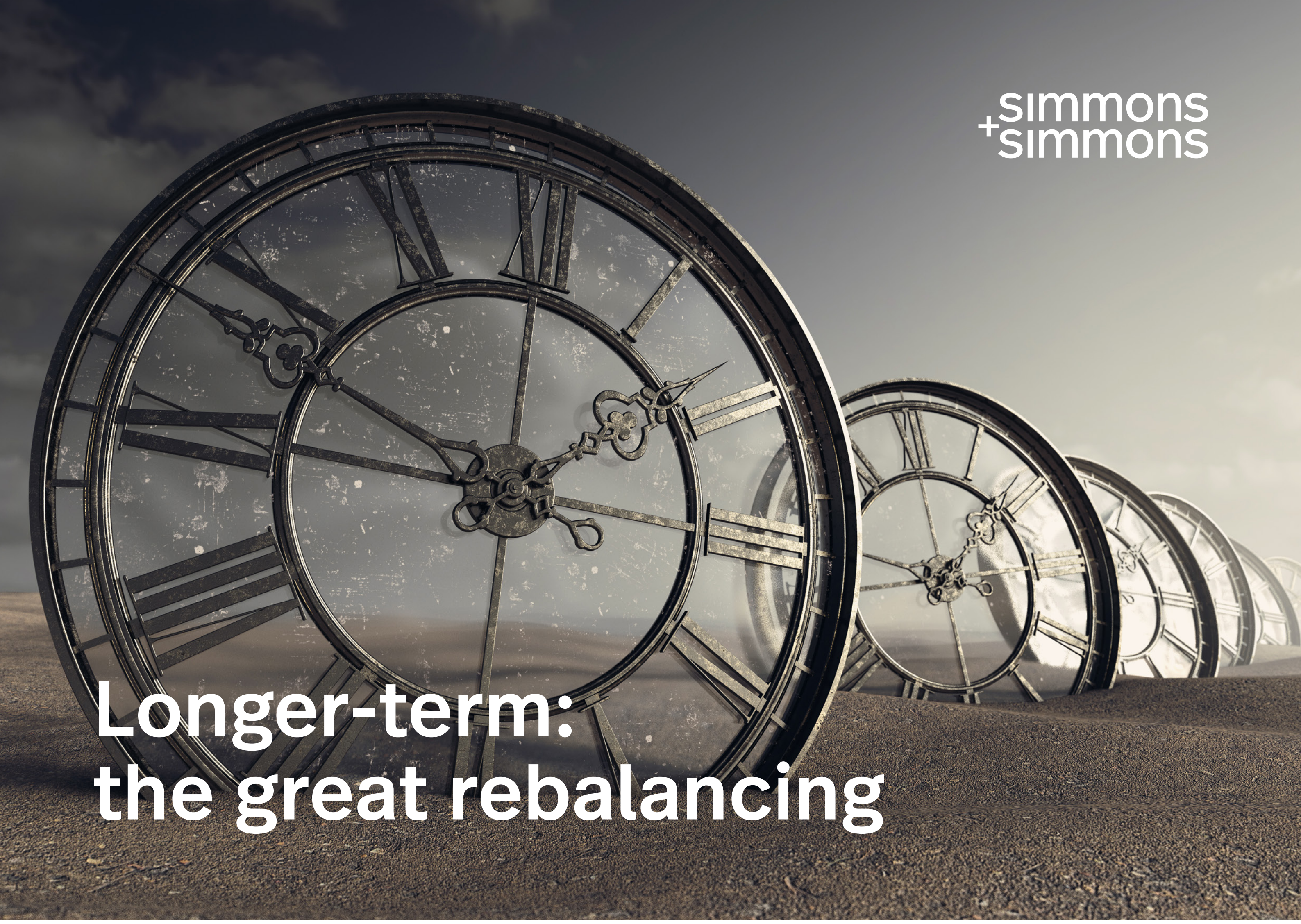
Such a pact could reduce the Conservative Party to being the largest party in the next Parliament but without a working majority thus opening the door to a rainbow coalition led by the Labour Party.

Occam's Razor

Neither of the outlier scenarios above is guaranteed to come about: previous boundary change proposals have not been implemented for various reasons (this one would see Scotland lose some representation in Westminster) and the leader of the Labour Party has ruled out any such electoral pact.

But taken at face value the changes to constituency boundaries is probably the more likely of the two outlier scenarios especially if either of the Brexit or COVID agendas outlined earlier becomes problematic in 2022.

Here we make the simple assumption that the Conservative Party remains in government with a sufficient majority to avoid anything approaching the guerrilla warfare and policy grid-lock which characterised much of the 2017-19 parliamentary session and culminated in the 2019 GE.



Longer-term: the great rebalancing

At the highest level and using the broadest brush strokes the signposts to the long-term future of the UK and its “sunny uplands” seem to point geographically to the East and North for the main thrust respectively of economic rebalancing overseas and domestically.

The trouble with gravity: distance matters - even for services

In 2019 PWC showed that models for trade in goods and services followed almost identical laws with non-tariff barriers (NTBs) having similar trade-friction effects for services as tariff barriers and freight costs do for the trade in goods.

The so-called gravity model of trade suggests that $1,000 of local market opportunity in a country 10,000 miles away is worth only 10% of a similar opportunity in a country only 1,000 miles away.

For example, the gravity model suggests that to compensate a $1bn disturbance to UK-EU trade (in goods or services) would require a trade deal giving access to around $10bn of local opportunity in a market situated 10,000 miles away. Such a scale of increased global trade may be hard to achieve in an era of trade nationalism - putting further emphasis on the need for pragmatic solutions to protect existing UK/EU trade.

Economic drivers point East for post-Brexit growth

One of Boris Johnson's first major policy initiatives in 2021 was formally to apply for membership of the CPTPP which is described by Chatham House as a trade pact between 11 countries[2] around the Pacific rim comprising some 13% of global GDP - close to that of the EU27 and of the US, each representing about 16%.

The attractions for the UK are two-fold:

1. The UK Trade Policy Observatory (UKTPO) believes it could enhance some terms of trade with the seven CPTPP countries with whom the UK already has continuity/free trade agreements (marked with an * in the footnote below)

2. The region is widely expected to produce faster economic growth than the UK or the EU27 over coming years (see IMF forecasts noted earlier). Longer term lies the possibility that one or more of US, China, and South Korea joins CPTPP

UK-US FTA... conditional on the NIP

A trade deal with the US is clearly on the wish-list of UK policy-makers. But President Biden has fired some pretty weighty warning shots across the bows of UK ambition over the integrity of the Northern Ireland Protocol (NIP).

Doubtless the special relationship will survive and progress will be made towards a deal. But the warning shots were loaded with politically sensitive materiel for Boris Johnson: how to honour the NIP and simultaneously keep the hard Brexit wing of his party onside - especially if opinion polls continue to point to a much reduced majority at the next GE?

Service sector - will the UK be a victim of its own success?

Perhaps the greatest challenge facing the UK in its post-Brexit ambitions on the global stage comes from its own success in making itself historically attractive to overseas companies in the service sector.

The OECD maintains a Services Trade Restrictiveness Index (STRI) that measures the ease or otherwise of doing business in the service sector of another country. On that measure the UK ranks among the easiest (lowest score) for doing business in its service sectors.

But the flip-side of that ease of doing business in the UK service sector is that almost all the other countries with which the UK seeks trade agreements - ideally to include their service sectors - are more difficult. Their STRI scores are higher than the UK's reflecting stronger non-tariff barriers including local regulation.
The notable exception is Japan.

[2] CPTPP member countries = Japan*, Australia, Canada*, New Zealand, Vietnam*, Singapore*, Malaysia, Brunei, Mexico*, Chile*, Peru*
See UK gov website for further details: UK Trade Agreements with non-EU Countries

Domestic UK economy: Build Back Better - sector opportunities

Long-term plans for the UK economy are outlined in the HM Treasury Policy Paper Build Back Better: our plan for growth. It identifies three pillars of investment to act as the foundation on which to build the economic recovery: increased infrastructure spending, increasing skill levels and boosting the UK's research and development capabilities. The government hopes the plans will deliver improvements in domestic productivity and attract increased inward investment.

In the following sections we highlight what appear to be some of the opportunities and challenges at sector level that may be created under each of the plan's three main pillars. COP26 will provide a showcase for the UK's ambitions in climate-change related investment.

Infrastructure - sector implications

Priorities identified in the infrastructure pillar include driving long-term productivity improvements with significant investment in broadband, roads, rail and cities. It will help to achieve the UK's ambition to become a net zero carbon economy as described in its Ten Point Plan for a Green Industrial Revolution. Investment in these areas will be funnelled through a new UK Infrastructure Bank that will also draw in private investment to accelerate progress to net zero.

Forecasts for the UK[3] suggest that an investment programme of some $1.8tn is needed by 2040 focused on projects in rail and road transport, energy and telecommunications.

Given the UK government's desire to reduce or at least contain levels of national debt, the scale of required infrastructure investment implies the need to attract a significant participation by private capital (see Innovation below). That in turn may pose questions as to the use of golden shares (or similar) to protect assets deemed to have significance for the UK's national security. Note the National Security and Investment Act due to come into force fully on January 4th, 2022 will "modernise" the government's powers to intervene in M&A deals which it deems have national security implications. The Act also grants government a 5-year retrospective power to call in some deals.

See also the FCA's Regulatory Initiatives Grid which covers initiatives around climate related disclosures as well as a wide range of other, consumer focussed initiatives of relevance to asset managers and financial institutions. See for example the recent HM Treasury publication "Greening Finance: A Roadmap to Sustainable Investing".

The effects of those (ESG-related regulations) are likely to be felt also in transactions: a recent survey[4] of M&A practitioners from APAC, EMEA and the Americas showed that ESG as a factor in M&A due diligence is ranked as Important or Very Important by over 75% of respondents - that proportion is expected to rise to over 90% by 2025.

[3] Global Infrastructure Outlook
[4] ESG climbs the M&A due diligence hitlits (ICAEW)

Skills - sector implications

Increasing the skill level across the UK labour force has been on the agenda for several years now as necessary to address the stall in productivity of the last several years. On the measure of output per hour worked in the economy, UK productivity's most recent golden period was from the mid-1970s to the onset of the Global Financial Crisis in 2007 when - using ONS data - it rose on average by some 2.3% annually. Since the recovery from the GFC labour productivity has pretty much flat-lined.

A recent report from McKinsey[5] has suggested that the adoption of automation, including AI and the Internet of Things, is "likely to unleash profound structural shifts in the UK workforce" alongside other factors such as the aging of the population.

Among sectors and functions where McKinsey expects to see an above average skills shortage are managers, technology specialists (both of which a headache for Fintech companies already) and health professionals in all of which demand could rise by 20% "while demand for administrative and manual roles could decline just as steeply".

McKinsey goes on to estimate that, by 2030, "two thirds of the UK workforce could be lacking in basic digital skills, while more than 10 million people could be underskilled in leadership, communication and decision making".

Our own research (ESG beyond E - the rise of stakeholder governance) showed that talent acquisition/retention was among one of the main benefits as seen by our own clients expected to flow from their ESG programme - a likely reflection of other work showing that millennials and younger college leavers use the ESG credentials of employers in choosing to join or remain with an employer.

Taken together, the skills agenda of the UK government as part of its Build Back Better programme, our own research and that of McKinsey suggest a post-pandemic new normal for employment law.

Innovation - sector implications

A key feature of the UK government ambition in relation to innovation is to improve access to finance, including through reforms to address disincentives for pension funds to invest in high-growth companies and programs, such as the British Patient Capital Programme, which was launched by the British Business Bank in 2018 to enable long-term investment in innovative companies across the UK.

A focal point of the government's innovation programme is the innovation it believes necessary to unlock private capital to co-fund its infrastructure programme (see above).

Democratisation of private assets

HM Treasury launched a review[6] of the UK funds regime earlier this year to explore ways in which it (DC pension schemes in particular) could improve "the routes through which capital can be committed into long-term assets" so as to help "fund the post-COVID recovery, modernise and upgrade infrastructure ..."

Given the extent to which any such change could involve retail clients in the funding of long-term infrastructure projects it has come to be known as the Democratisation of Private Assets and is the subject already of considerable activity with our clients - here, for example, is our response to the HM Treasury Call for Input.

The flip-side of that democratisation is of course the need for (retail) investor protection on which we are similarly actively engaged. See our recent roundtable survey among our clients.

[5] UK's looming skill shortage
[6] HM Treasury - review of the UK funds regime (Jan 2021)

Fintech

Innovation in fintech has already been rapid, accelerated by COVID (which has accelerated digital adoption globally), so that the Kalifa Review of UK Fintech (Feb, 2021) found that the sector - with £11bn in revenues - represents 10% of the global market. Total tech spend by UK financial services firms was £95bn in 2019 of which some £4bn came from FDI. Both figures are likely to increase as the UK looks to consolidate its position as a global leader and in response to the skills shortages noted above. The Kalifa report noted that, post Brexit the fintech sector was having to "navigate the immigration system for European Union talent for the first time". See here for our fintech insights.

Digitalisation

The World Economic Forum (WEF) sees digitalisation as weaving its way through all components of what it calls the Fourth Industrial Revolution (4IR). It represents a fundamental change in the ways we live and work and COVID-19 has created an opportunity to further embrace this revolution.

The components of 4IR, at the highest level of the WEF taxonomy, include:

- **Technology innovation:** including sustainable development, drones; employment, circular economy and taxes
- **Frontier technologies:** such as blockchain, augmented reality quantum computing and biotechnology
- **Technology access:** covering factors such as COVID-19, social justice, gender parity and human rights
- **Ethics and identity:** including systemic racism, future of health and healthcare, justice and law and precision medicine
- **Agency and trust:** cybersecurity, internet of things, banking and capital markets, digital identity and internet governance
- **Agile technology governance:** global governance, digital communications, media, entertainment and sport

We expect to see several of these elements feature in the UK government's digital transformation strategy when it is published later this year or early in 2022. In the meanwhile, the government has announced its intention to publish a new artificial intelligence strategy focused on accelerating economic growth, ensuring ethical and (data) secure development and improving resilience in the context of global change.

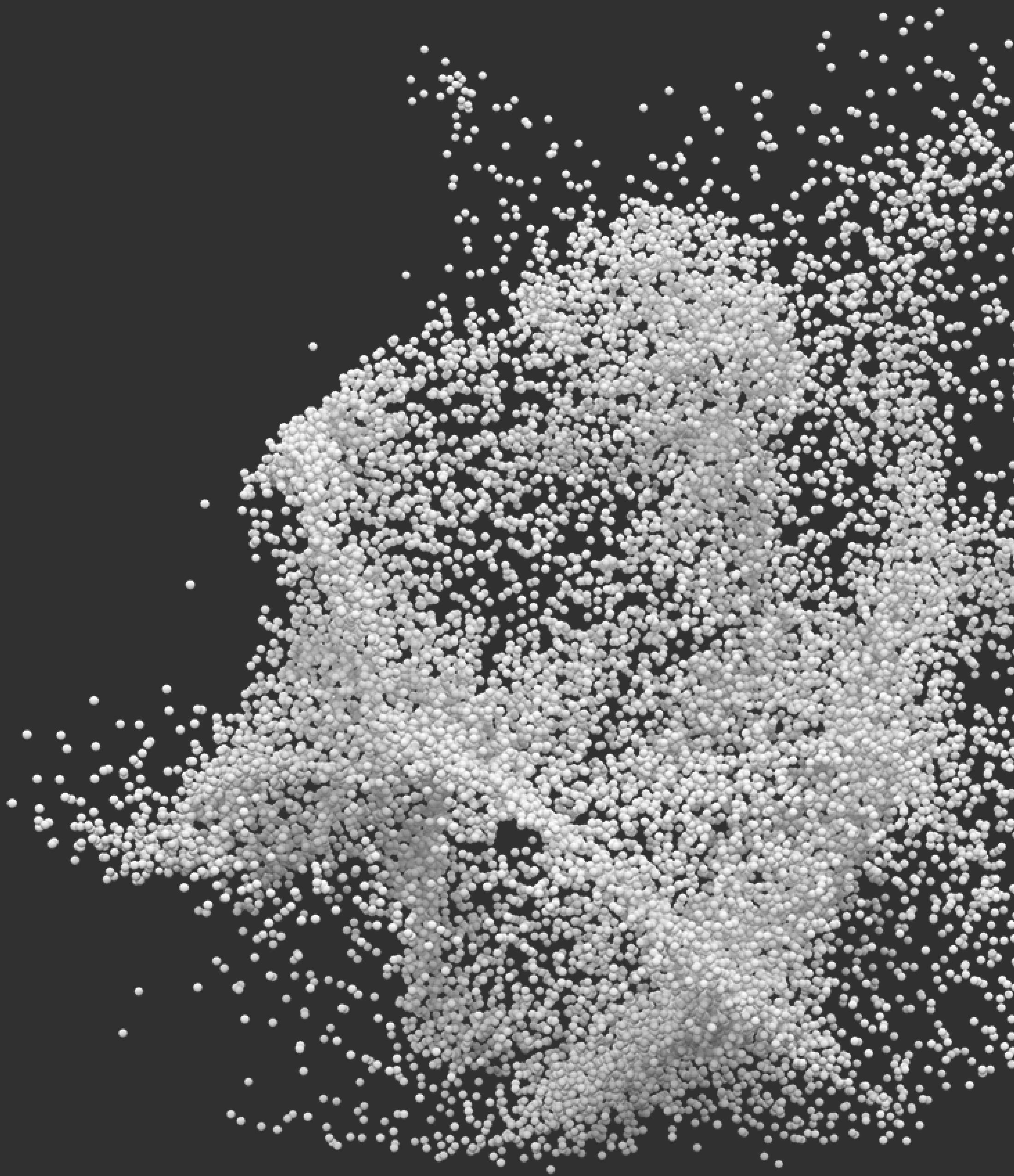
Our own Accelerate digital programme reflects those priorities by offering clients solutions to the challenges affecting them under four headings: Data, Growth, Regulation and Talent.

Healthcare and life sciences

The World Economic Forum's 4IR taxonomy (see above) shows the significance of the healthcare and life sciences sectors in the Fourth Industrial Revolution globally - from biotechnology and precision medicine to pandemic preparedness and response.

The UK, now with a medicines regulator (the MHRA) independent of the European Medicines Agency, is reported to have put "life sciences ... at the centre of the UK's post Brexit policies". Following the pace of the UK's vaccine development/roll-out programme it has introduced the Innovative Licensing and Access Pathway (ILAP) which aims to accelerate the time to market offering future new medicines the same rolling review of data that allowed the rapid deployment of the Pfizer/BioNTech Covid-19 vaccine.

More generally the UK government has committed to increasing investment in life sciences "in line with (its) ambition to increase R&D spending to 2.4% of GDP by 2027 and 3% over the longer term".



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