Japan’s three messages for Britain on Brexit

Blog post by Chief Economist Gregor Irwin, 6 September 2016

As a £400bn investor in the British economy, the Japanese deserve the attention of the UK Government on the question of how Brexit is handled. The economic relationship with Tokyo is important. Japan is a big trading partner, providing the destination for 1.5% of British goods exports and 2.6% of services last year. It’s a top tier inward investor, accounting for 3.5% of the stock of direct investment in Britain. But it is in a different class as a portfolio investor, with no less than a 5.3% share.

Thrifty, reliable and deep-pocketed Japanese investors have helped drive up total Japanese investment in the UK by over 60% during the past ten years (Fig 1). It may surprise some Whitehall policymakers to learn that Japanese direct investment is much smaller than either portfolio investment or the loans, deposits and currency holdings that make up most of the “other investments” shown in the chart. These are not as visible as the activities of Nissan, Hitachi or Fujitsu, but are important, particularly as they are easy to reverse.

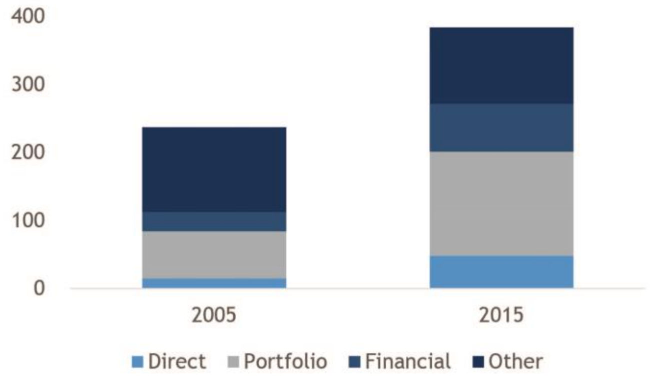

Fig 1. The stock of Japanese investment in the UK

How then should Japan’s message to the UK and the EU in which it has set out its interests in the Brexit negotiation be interpreted by the British Government? The unmistakable message is that what Japan really wants is as little change as possible. They don’t quite use this language, but in effect the message is: stay in the single market; don’t leave the EU customs union; maintain harmonised regulation; allow companies to access labour from across Europe; and avoid disruption to the free movement of capital. And much more. It does not concede much space for any negotiation to redefine the relationship between the UK and the EU, without impacting on Japanese interests.

There is a second message, however, which is also significant. This is that if there is to be change, the Japanese want to be kept informed and given as much warning as possible. They also want adequate transitional arrangements to allow companies to adjust their operations without unnecessary disruption. There is nothing unreasonable about any of that. Unfortunately, neither the UK nor the EU may be able to deliver it. For one, the UK Government does not yet know what it wants and internal divisions may mean its objectives, once set, are prone to subsequent revision. Moreover, no one knows what is yet acceptable to the EU, least of all the EU itself. For now, the focus in Brussels is on principles, with red lines being drawn, but a negotiation with high stakes on both sides inevitably means compromises will be required at some point. The lack of precedent means we don’t know how much flexibility exists on the EU side and where, but you can be sure there will be some.

The final message – and perhaps the most important of all – is about trust and how investors are treated. The Japanese note that many of their investors were invited to the UK and actively courted by successive British governments. Solid institutions and policy stability – with access to the EU – were core elements of the offer. The Japanese will not be alone now in questioning the reliability of the UK; other non-European governments and investors are likely to share Japanese concerns. The British Government will therefore have to work hard to rebuild this trust. The starting point is to recognise that others have a valid stake in Brexit. They should be kept informed and consulted. And their interests should be taken into account, where possible, as the UK policy on Brexit develops. That will not only help to maintain the confidence of international investors and keep their money in the UK, it will almost certainly make for better policy choices.