8 January 2019

ECONOMIC REPORT | Brexit

Challenging Path Ahead – Impact Analysis of Brexit on the UK's Economy

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- *Hard Brexit will cause contraction for the UK economy by -5.9%. The UK had its worst exports performance in 2009, the global financial crisis aftermath besides European debt crisis. The exports for that year contracted by -24.8%yoy with shipments to both EU and non-EU plunged by -25.8% and -23.6% respectively.*
- *Malaysia's total output to drop by -0.38%. Following the simulation results, we notice the fall in demand by the UK will cause -0.38% contraction in Malaysia's total output. By sector, among others Research & Development, machinery & equipment, rubber & plastic products and electrical machinery are the top four sectors most impacted in the event final demand by the UK reduced by -1%.*

Slowdown economic growth as Brexit near to its deadline. By national account perspective, investments and exports in the UK are recording negative growth rates for the past two quarters since 2Q18. Latest in 3Q18, investments contracted by -0.2%yoy, thanks to fell in private investments by -1.4%yoy and exports of goods & services shrank by -1.4%yoy, worst since 2013. Market uncertainties over Brexit and domestic political stress are among dragging factors pressuring economic performance in the UK. On top of that, volatility in global energy prices, trade war and normalisation of US monetary policy are among external downside factors. Moving forward, we foresee challenging path for the UK particularly during post-Brexit era. We expect the economy to grow less than 1% in 2019.

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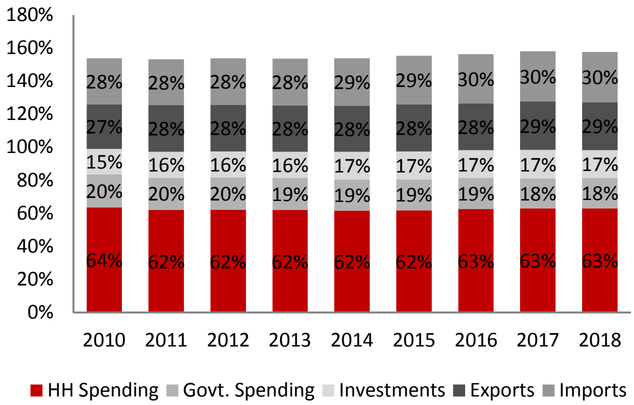
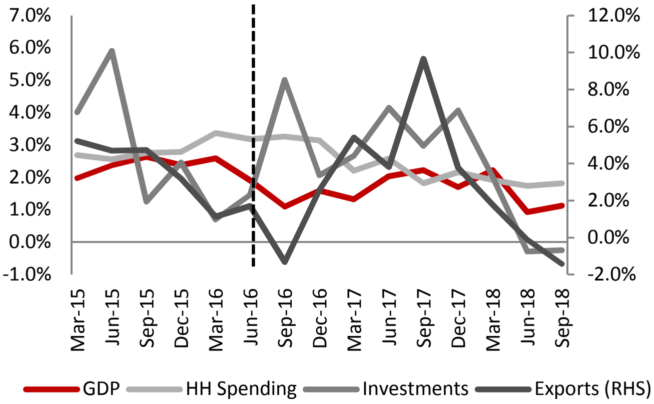
Chart 1: Component Share of GDP by Expenditure (%)



Source: CEIC, MIDFR

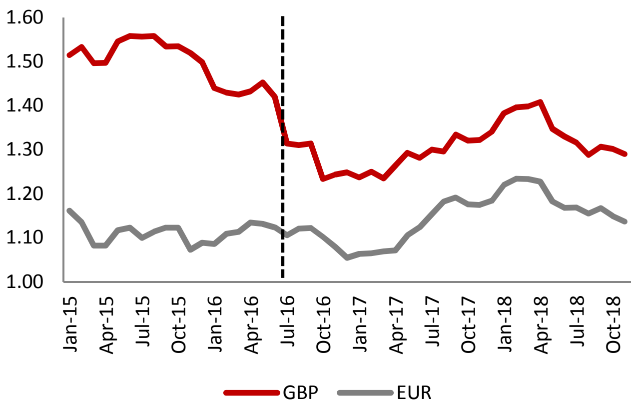
Chart 2: GDP by Expenditure (YoY%)



Source: CEIC, MIDFR

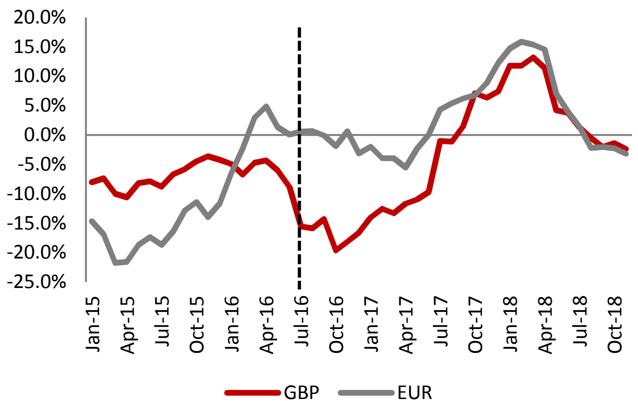
Brexit & Fed's normalisation plan put pressure on GBP. The movement of GBP is very much influenced by internal and external factors. Monetary normalisation in the US, trade war and geopolitical risks in Europe, Middle East and Asia are putting pressures on global currencies including GBP. On a flip side, USD is gaining strength out of these global economic risks. Without a deal, GBP is predicted to depreciate further when the UK parliament votes down the PM's deal on 14th Jan-19 and post-Brexit. In addition, the Fed is predicted to continue increase its interest rate this year amid sound economic growth and steady pick-up of inflationary pressure in the US. We forecast two rate hikes in 2019.

Chart 3: GBPUSD & EURUSD



Source: CEIC, MIDFR

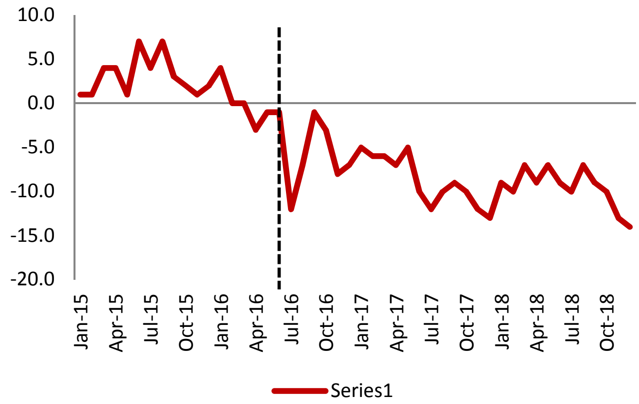
Chart 4: GBPUSD & EURUSD (YoY%)



Source: CEIC, MIDFR

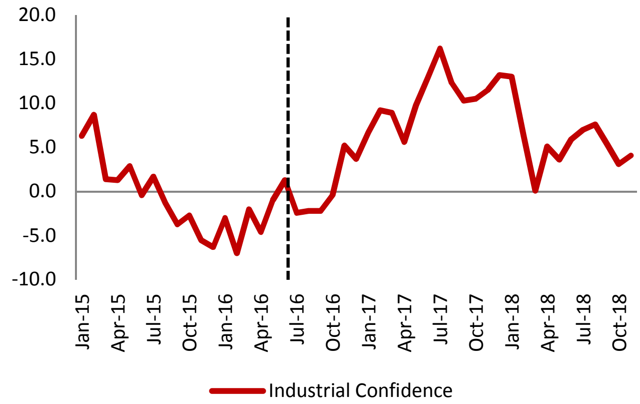
Economic sentiments turn pessimistic. Consumer confidence in the UK has been on pessimistic mood for almost 3-year. The pessimism is seen few months before the Brexit referendum until latest Dec-18. Job losses and high inflationary pressure are among two major reasons causing consumer confidence to drop. Brexit will lead shifting of businesses out from the UK and prices of imported goods & services from EU to jump. More than 50% of the UK imports are from EU. On a flip side, industrial confidence is not affected much in the short term due to strong upbeat momentum in global trade activities in 2017. Nevertheless, the industrial confidence is tapering down since mid-2018 as market uncertainties over Brexit heighten.

Chart 5: Consumer Confidence Index



Source: CEIC, MIDFR

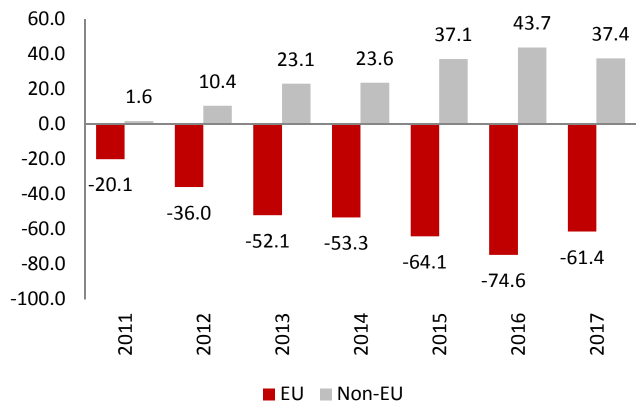
Chart 6: Industrial Confidence Indicator



Source: CEIC, MIDFR

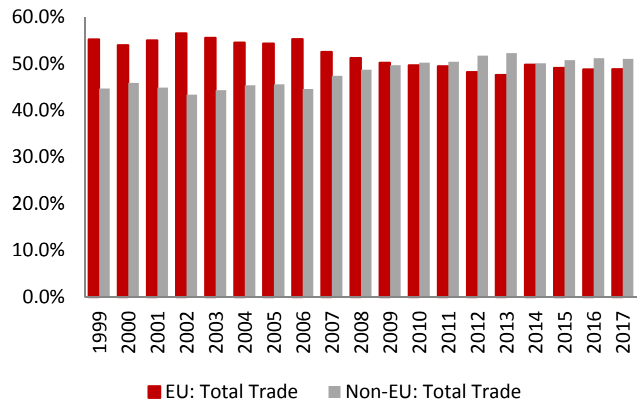
Trade deficit with EU, trade surplus with non-EU. The UK had always recording trade deficit with EU since 1999 while trade with non-EU has been on surplus account since 2011 and hit highest ever at £43.7 billion in 2016. Trade deficit with EU registered the widest ever in 2016. Post-GFC'09, non-EU has taken majority share of the UK's total trade. In 2010, the share of non-EU climbs 50.3% while EU's at 49.7%. From trade standpoint, fall in demand by EU has lesser impact than non-EU but yet EU still holds significant share in the UK's external trade market.

Chart 7: Trade Balance EU vs Non-EU ('000)



Source: CEIC, MIDFR

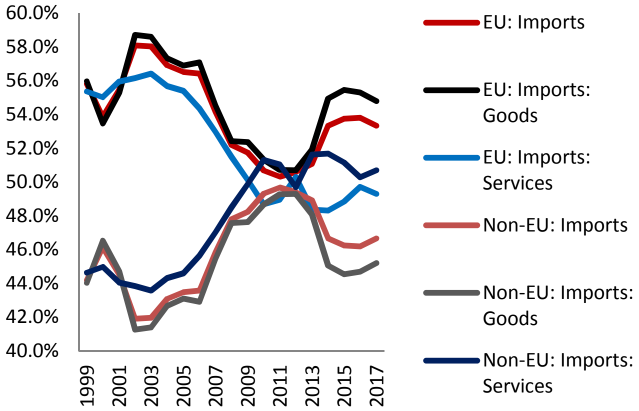
Chart 8: Total Trade Share of EU vs Non-EU (%)



Source: CEIC, MIDFR

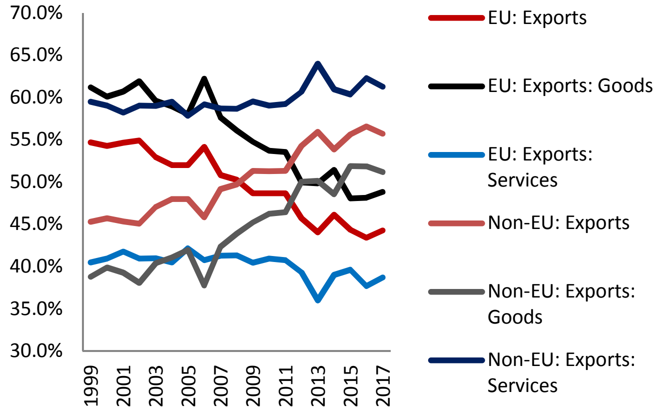
The UK imports mostly from EU. 55.3% of the UK's imports is from EU particularly goods in 2017. Services imports from EU stay below 50%. If the UK leaves EU without a deal, WTO rules will be in place and therefore prices of imported goods from EU to rise due to cost of trade barriers. On the other hand, most of the UK exports shipped to non-EU. In 2017, for every £1 of exports value, 56 cents goes to non-EU while 44 cents to EU. Brexit without a deal will cause the UK economy to decelerate post-Brexit given that structurally EU holds significant shares of the UK's external trade market.

Chart 9: Imports Share of EU vs Non-EU (%)



Source: CEIC, MIDFR

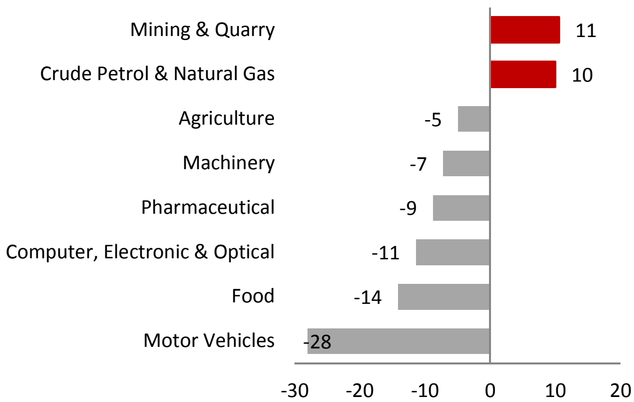
Chart 10: Exports Share of EU vs Non-EU (%)



Source: CEIC, MIDFR

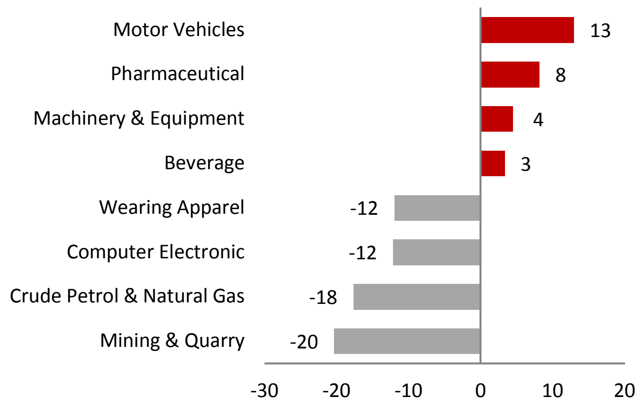
Widening trade deficits with EU ahead. Mining & quarrying includes crude petroleum and natural gas is among the main surplus contributors to the UK's goods trade balance with EU whereas motor vehicles, food and computer electronics products are among trade items widen its trade deficit with EU. If Brexit without a deal, we project widen trade deficit with EU especially those products that the UK currently had deficits with. Exports of mining products may face slight reduction due to the separation. As for non-EU, the UK had trade surplus in which mostly contributed by motor vehicles, pharmaceutical, machinery & equipment and beverage products.

Chart 11: Trade Balance (Goods) with EU ('000)



Source: CEIC, MIDFR

Chart 12: Trade Balance (Goods) with Non-EU ('000)



Source: CEIC, MIDFR

Customs union and single market benefit the EU members. Currently, EU countries including the UK are copiously benefiting from the EU's customs union and the single market. The general benefits of it are to build a large unified economic area to grasp economies of scale through having unhindered access to a large number of customers. Under a customs union, goods could move duty-free between member states and their relationship with the outside world has also been established which means individual state has no direct control over the international trade policy. In a single market, goods, services and even people could move freely across the countries within the market without facing any form of tariffs or restrictions including rules of origin checks.

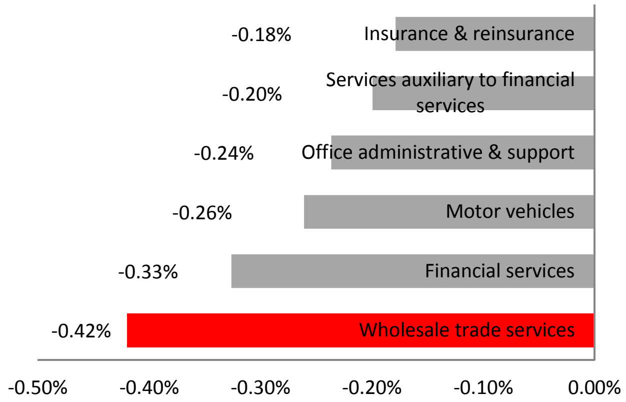
'Hard' Brexit vs 'Soft' Brexit? Brexit is likely to make UK worse off regardless of the way: hard or soft. However, there is a wide variation in how much worse it could be under the two scenarios. As the UK leaves the EU, it must decide what economic arrangements it seeks to retain, whether it should embark on a hard Brexit or the soft one. A hard Brexit arrangement would mean that the UK is completely out of the EU, giving up full access to both single market and customs union. The arrangement would give the UK full control over its borders, immigration and trade deals. Meanwhile, soft Brexit approach would keep the UK closely aligned with the EU in which the country could still gain special access to the single market and remain within the customs union in order to minimize the economic damages. However, it's not all sunshine and roses as the UK might have to compromise certain things in return such as on immigration agreements. In addition, the UK would still be bound by some of the bloc's rules, less of a say in decision making and limited authority to sign its own new trade deals. The migration per se is a key issue for the UK as they seek to limit employees from the EU member states, securing jobs for the locals.

Rest of the world matters. Brexit is not always about the member states as it will also affect the trade with the rest of the world. Over the past forty years, the EU has successfully secured 36 trade agreements for its member-states, spanning more than 60 countries. On top of that, there are many other trade agreements which are in the process of being ratified or under negotiation. As a result of Brexit, the UK is unlikely to continue participating in these deals. Without the deals, the UK would be pushed into World Trade Organization (WTO) terms with these countries. Hence, the UK's exporters would face exorbitant tariff increases and even more stringent customs checks. On a flip side, the UK would become an independent player, free to seek its own trade deals with the rest of the world. Such freedom can be exploited to look for a new trade deals with big economies such as China, India and the US. However, the new trade deals and renegotiation of existing ones with non-EU countries will be a costly and time-consuming process. Another downside risk is that foreign businesses may re-evaluate the attractiveness of the UK as a footing in Europe due to its withdrawal from the EU.

Hard Brexit will cause contraction for the UK economy by -5.9%. The UK had its worst exports performance in 2009, the global financial crisis aftermath besides European debt crisis. The exports for that year contracted by -24.8%yoy with shipments to both EU and non-EU plunged by -25.8% and -23.6% respectively. We assume the same pessimistic fall in exports to the EU and non-EU to be observed under a hard Brexit. Based on our estimate, the UK economy could be up to -5.9% smaller if the country embarks on a hard Brexit. Under a more optimistic scenario, we assume a smaller drop of exports at -12.4% with shipments to both EU and non-EU fell by -12.9% and -11.8% respectively. Hence, our estimate shows that soft Brexit could deliver a lesser hit of -3% to the economy.

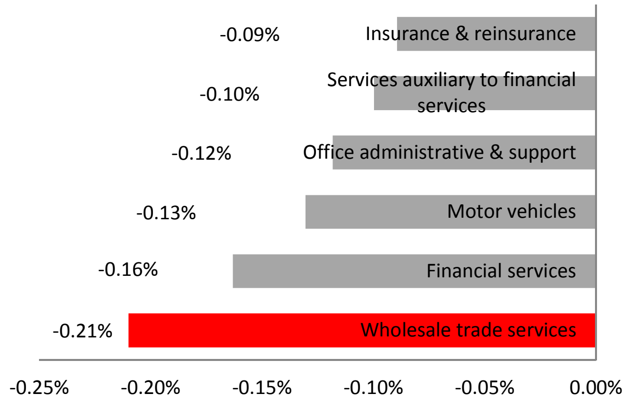
Wholesale trade services to be impacted the most. Sector-wise, our results indicate that the UK's sectors namely wholesale trade services, financial services and motor vehicles to be impacted the most regardless of hard or soft Brexit. Under a hard Brexit, wholesale trade services, financial services and motor vehicles will shrink by -0.42%, -0.33% and -0.26% respectively. Meanwhile, under a soft Brexit, the contraction shall be reduced by half for each sector.

Chart 13: Trade Impacts of Hard Brexit on UK sectors (%)



Source: UK National Stats, MIDFR

Chart 14: Trade Impacts of Soft Brexit on UK sectors (%)

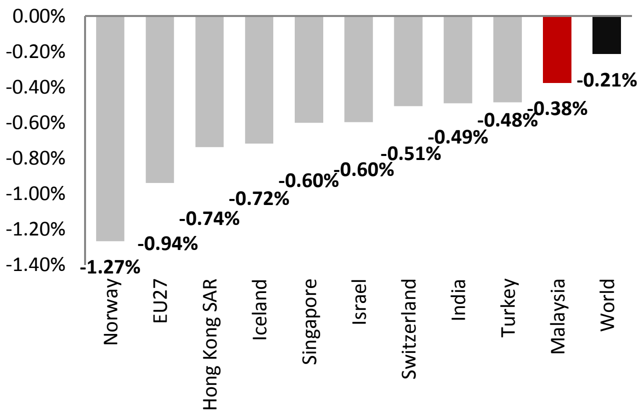


Source: UK National Stats, MIDFR

Global economy to be drag down by -0.2%. Based on our economic modelling, ceteris paribus, global output is expected to shrink marginally for every 1% drop in United Kingdom's final demand. Zooming into various countries, Norway and EU27 are among economies that will be significantly impacted, -1.27% and -0.94% respectively. Some Asian economies such as Singapore and India are predicted to experience slight slowdown of -0.6% and -0.5% respectively. Overall, we opine the impacts of contractionary in the UK are minimal towards global economy, possibly due to its small relative economic size relatively. Nevertheless, economic landscape in the European region is expected to change in the medium and long terms, thanks to Brexit.

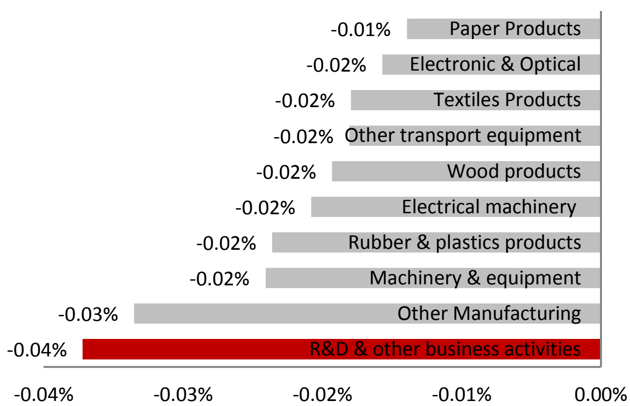
Malaysia's total output to drop by -0.38%. Following the simulation results, we notice the fall in demand by the UK will cause -0.38% contraction in Malaysia's total output. By sector, among others Research & Development, machinery & equipment, rubber & plastic products and electrical machinery are the top four sectors most impacted in the event final demand by the UK reduced by -1%.

Chart 15: Impacts of Slower UK Demand by 1%



Source: OECD, MIDFR

Chart 16: Indirect Sectoral Impacts in Malaysia (%)



Source: OECD, MIDFR

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