June 2016

Brexit: Potential trade and economic impacts

(A research note prepared for the Fung Group by Fung Business Intelligence)

Some key points:

- **Asia's exports will be significantly hurt** if Brexit triggers problems in the EU and other major economies, as the EU currently accounts for 14% of their total
- **Asia will be less impacted by a decline in trade with the UK** as the UK only accounts for a small share of Asia's exports (e.g. 2.6% of China's total exports, 2.4% of Vietnam's total exports, and 1.0% of Indonesia's total exports)
- A more subdued EU economic outlook is expected to **exacerbate already-sluggish demand for Chinese exports**
- A likely consequence of the Brexit decision is a **significant appreciation of the Yuan** against the currencies of most of China's trading partners, further dampening its export performance and prospects
- Eventual **FTA negotiations between China and the EU** are set to be more difficult without the advocacy and involvement of the UK, which has been playing a constructive role in promoting deeper China-EU ties
- Brexit is likely to bring **fresh challenges and greater unpredictability for the sourcing business** over the short and medium term
- In the post-Brexit world, the harmonized standards and procedures which greatly improved the efficiency of trade between EU and non-EU countries, will no longer apply. **Goods will have to be assessed separately for the UK and EU** markets
- The UK will likely come up with a different set of product standards (such as chemical composition, certification, product safety, etc.) and customs procedures/documentation system from that of the EU, which will bring **extra cost to importers/sourcing companies/retailers**
- **Inward and outbound EU cargos** presently transiting the UK may be re-routed to continental ports and airports if Brexit heralds a customs regime with bonded trucks, seals, checks, etc
- **Bangladesh, Vietnam and other major production countries** currently enjoying tariff preferences under the EU's Generalized Scheme of Preferences (GSP), which covers apparel, footwear and many light-manufactured goods, are set to lose preferences when exporting to the UK. They will need to negotiate with the UK for reduced or zero import duty preferences and rules of origin, but it is uncertain whether the terms the UK will offer these developing countries will as generous as the EU's
- **Non-EU trade partners currently negotiating an FTA with the EU** - such as the Philippines, India, Thailand and Vietnam - will have to negotiate an FTA separately with the UK, though that could be easier than negotiating, post-Brexit, with the 27-member trade bloc

Brexit: Potential trade and economic impacts

(A research note prepared for the Fung Group by Fung Business Intelligence)

I. Impact on the economy

1. Brexit will be a heavy blow to the UK economy in the short and medium term (but less so for the longer term)
    - Output: According to the IMF, the worst-case Brexit scenario would see real GDP lowered by 5.6% in 2019 and 4.5% in 2021
    - Investment, consumption and employment: Uncertainty harms consumer confidence, and firms may delay/abandon investment and hiring decisions.
    - Exports: Nearly half of UK goods and services exports go to the EU. Disruption of single market benefits may mean a plunge in UK exports. (Note, however, that the Pound Sterling's depreciation would help boost UK's exports and therefore mitigate that impact.)
    - FDI: Inward FDI has been important for the UK economy, and FDI has been drawn to the UK largely because the UK provides a gateway to the EU single market.
    - Financial market: Worries over the economy and next steps for Brexit may also translate into prolonged financial market volatility.
    - Financial sector: The financial sector headquartered in London is highly exposed to loss of access to the single market. Currently about a third of the UK's financial and insurance services exports are to the EU, and most investments by UK banks are in the EU. Firms may also shift away from London when the UK is cut off from its European hinterland.

2. Brexit's indirect impact on the EU will be felt more than its direct impact
    - The direct economic impact will be relatively limited. The Economist Intelligence Unit forecasts that the average annual real GDP growth in the eurozone will be trimmed by 0.2 percentage points in 2016-20.
    - EU countries with the largest trade exposure to the UK market include Ireland, Malta, Cyprus, Belgium and the Netherlands.
    - Much more severe would be the indirect economic impact, which would hold back the already-very weak recovery of the region. Economic activity in the EU will be adversely affected by financial market volatility, depreciation of the euro, an increase in bond yields and capital flight. The threat of an EU crisis/collapse will also undermine government effectiveness and affect consumer and business sentiments.

3. The global economy faces a prolonged period of instability and uncertainty
   - Fear of an EU crisis/collapse may lead to financial turmoil around the globe, characterized by plunges in stock markets, currency depreciations (except for 'safe haven' currencies such as the US dollar and Japanese Yen), capital flight and steep increases in bond yields. The impact on global economic activity could be severe and prolonged.
   - Sharp appreciation of US dollar and Japanese Yen (particularly against Pound Sterling, Euro, and emerging economies' currencies) would greatly hurt US and Japanese exporters.
   - Commodity prices will be weaker for those commodities linked to economic growth, such as oil and copper.

4. Asian economies will be badly hit by a weaker EU economy
   - Exports to the UK amounted to only 0.6% of Asia's total GDP (2014 figures), meaning that even a British recession would pose no major threat.
   - But the EU matters: Currently, around 14% of Asia's exports go to the EU market. Asian exports would be significantly hurt if Brexit triggers problems in the EU and other major economies.
   - Besides, volatility in the exchange rates of emerging economies' currencies will increase. For example, the Malaysian ringgit and Indonesian rupiah, which have in the past been the most vulnerable to periods when investors are more risk averse and seek safe havens, may be hit the hardest.

5. China's export performance will further deteriorate
   - As the EU accounts for some 16% of China's total exports, a more subdued EU economic outlook is expected to exacerbate already-sluggish external demand for Chinese goods.
   - An even more difficult time for decisions on the Yuan exchange rate: Post-Brexit, China's policymakers may find themselves caught between letting the Yuan depreciate naturally, in line with China's trade-weighted basket of emerging economy currencies - whose value is falling as a result of the Brexit shock - and a need to maintain the Yuan at a certain level against the US dollar to fend off "short" speculation of the Yuan. It is likely that Chinese policymakers will opt for the latter course, which would result in a significant appreciation of the Yuan against the currencies of major trading partners, further dampening China's export performance and prospects.
   - A disrupting factor in Sino-EU trade relations: The UK has been playing a constructive role in promoting and deepening China-EU ties, and has been a major advocate for a

free trade agreement between China and the EU. To that end, it is anticipated that any future negotiations would become more difficult without the UK's involvement.

II. **Impact on goods trade**

1. Bilateral trade between the UK and the EU
    - Once Brexit becomes effective, the UK will no longer enjoy the myriad benefits of EU membership, including tariff-free imports and exports, streamlined customs procedures, and the free flow of services, capital and people.
    - The UK government would have to negotiate a new agreement with the remaining EU member states within a two-year deadline. Negotiation will be no easy task for the UK, in part due to the huge disparity in bargaining power on the two sides; the EU accounts for over 40% of UK's exports, whereas about 7% of the total exports of other EU countries' go to the UK.
    - The extent of disruption to UK-EU trade depends on the result of the negotiation outcomes. The worst-case scenario would be one in which a new agreement fails to be reached in two years. Goods traded between the UK and EU would then be subject to WTO MFN tariff rates and higher administrative costs, such as those arising from more cumbersome customs procedures. On the other hand, if the two sides are able to strike a deal similar to the European Economic Area ('EEA,' comprising the EU, Norway, Liechtenstein and Iceland), the long-term impact on trade will be limited.

2. Trade between UK and non-EU countries
    - The EU has trade agreements in force with 60 other economies, and is negotiating prospective agreements with 67 more, including Brazil, Canada, China, India, Japan, and the US. The UK will now need to negotiate separately the terms on which it trades with these economies.
    - Developing countries that currently enjoy tariff preferences under the EU's Generalized Scheme of Preferences (GSP) are set to lose preferences when exporting to the UK. It is unclear whether the UK government will set up an equivalent scheme in time for a smooth transition.
    - Standards and conformity assessment procedures, which are largely harmonized in the EU single market, have greatly improved efficiency of trade between EU and non-EU countries. For instance, businesses exporting to multiple EU countries, or whose supply chains span multiple EU countries, only have to comply with a common set of

standards and obtain certification once. In the post-Brexit world, goods will have to be assessed separately for the UK and the EU markets.

3. Trade between UK and developing Asia
   - Several major production countries are beneficiaries of the EU's GSP.
     - Vietnam, Indonesia and India are beneficiaries of 'Standard GSP,' which grants duty reductions for about 66% of all EU tariff lines.
     - The Philippines is a beneficiary of 'GSP+', which grants it complete duty suspension for the same tariff lines specified under 'Standard GSP'.
     - Bangladesh and Cambodia are beneficiaries of the 'Everything But Arms' (EBA) GSP sub-scheme for least-developed countries. The EBA grants full duty-free, quota-free access for all products except arms and ammunition.

     Upon Brexit, the above countries will lose GSP preferences when exporting to the UK.
   - FTAs and prospective FTAs between the EU and certain Asian countries, such as the EU-Vietnam FTA and the EU-Indonesia Closer Economic Partnership Agreement, will not apply to the UK when it leaves the EU.
   - However, as the UK only accounts for a small share of Asia's exports (e.g. 2.6% of China's total exports, 2.4% of Vietnam's total exports, and 1.0% of Indonesia's total exports), the impact on Asia's overall trade volume may be limited.

III. Implications for Sourcing

In view of the potential drag on economic growth and consumption in both the UK and the EU following the Brexit decision, weaker retail sales in these two economies plus accompanying uncertainties will bring fresh challenges and greater unpredictability for the sourcing business over the short and medium term.

1. For those countries that rely heavily on the duty preferences offered by the EU under the GSP (which covers apparel, footwear and many light-manufactured goods), they need to re-negotiate reduced or zero import duty preferences and the stipulated rules of origin with the UK. It is uncertain whether the UK will make such a generous offer as the EU did to those developing and least-developed countries, as the latter do not offer symmetric trade opportunities to the UK.
   - Among standard GSP beneficiaries, the utilization rate of GSP benefits of India, Indonesia and Vietnam stood at 86.9%, 67.7% and 58.4%, based on January-June 2015 data.
   - Among Everything but Arms (EBA) beneficiaries, the utilization rates of duty-free and quota-free benefits of Bangladesh, Cambodia, Myanmar and Ethiopia were all over 90%.

- For GSP+ beneficiaries, the Philippines utilized only 62.8% of the GSP benefits in the period mentioned above mainly due to insufficient local contents to fulfil the rules of origin, while Pakistan used 94.5% of those benefits.

UK's imports by selected countries as a percentage of UK's total extra-EU imports in 2015

	Knitwear	Woven garments	Footwear
Bangladesh	16.4%	16.6%	0.3%
Cambodia	6.7%	3.8%	5.6%
India	8.3%	9.2%	12.0%
Indonesia	0.9%	1.3%	6.8%
Vietnam	2.2%	4.8%	13.9%
Philippines	0.3%	0.2%	0.04%
Pakistan	4.0%	3.5%	0.3%
Turkey	15.5%	7.5%	0.7%

Source: Eurostat

2. For non-EU trade partners that currently have a FTA with the EU, such as Turkey, it will take a long time for them to renegotiate the terms with the UK. It is still uncertain whether the UK will offer the same terms to those trade partners as the EU does.

3. For non-EU trade partners that are negotiating a FTA with the EU, such as the Philippines, India, Thailand and Vietnam, they will now have to negotiate separately with the UK for a FTA, though it could turn out to be more flexible and easier than negotiating with a 27-member trade bloc after Brexit.

4. The UK will likely come up with a different set of product standards (such as chemical composition, certification, product safety, etc.) and customs procedures/documentation system from the EU, which will bring extra cost to importers/sourcing companies/retailers.

5. There are likely practical consequences for the global logistics industry. Presently, a significant volume of EU inbound or outbound cargo is handled daily by UK ports and airports on a transfer basis without having to go through customs. The implication of Brexit is that, eventually, such cargo would have to be transported in bonded trucks with customs seals and checks, prompting a re-routing to continental ports and airports.

(Drafted by Helen Chin, Denise Cheung and Winnie He)