

# BREXIT'S AFTERSHOCKS – WHAT TO EXPECT?



PREPARED BY SERC, 11 JULY 2016



# MAKING SENSE OF BREXIT'S AFTERSHOCKS

- ❑ **BREXIT**, an event uncharted by history
- ❑ **A long period of uncertainty** is a certainty
- ❑ A number of **questions and issues** stand out:
  1. What does Brexit mean for the UK and Europe?
  2. And what comes next? A break-up of the UK? EU's disintegration?
  3. Will the global economy sink into a recession? Is it like the 2008-09 Global Financial Crisis (GFC) or Great Recession?
  4. What can the major central banks do to firewall the risk of a global financial contagion?
  5. Can Malaysia withstand the Brexit's aftershocks?



# THE PATH TO BREXIT – A WAITING GAME

- ❑ Negotiation process cannot proceed immediately if **Article 50 of the Lisbon Treaty is not invoked**
- ❑ **It is entirely up to the UK** to trigger Article 50
- ❑ If triggered, the UK has **two years** to negotiate trade, business and political links with the EU
- ❑ It's membership of the EU **will automatically cease** if the deal is not concluded within two years, **unless there is a unanimous vote to extend the deadline**
- ❑ **A political stalemate is the key risk-** a sustained period of uncertainty and instability will rise across the continent
- ❑ Markets will be watching closely who the main **hopefuls of the new PM** (Home Secretary Theresa May and Energy Minister Andrea Leadsom), which will be known by **9 September**
- ❑ **Political risks** associated to the Brexit:
  - i) Trigger a **potential break-up of the UK**; and
  - ii) Cause the **disintegration of EU**

# NEGATIVE FOR THE UK ECONOMY IF THE UNCERTAINTY PROLONGED

- ❑ **Uncertainty over the pace, breadth and scale** of the UK's future trade and political relationship with the EU
- ❑ **How soon** the negotiation process starts and **how successful** new agreements are ratified?
- ❑ **Issues of focus:** the terms of UK's withdrawal; content of trade, investment and financial-related agreements; what form of Brexit model?
- ❑ Negative factors reinforced through **financial market and confidence channels:** weak consumer sentiment and shattered investor confidence, deflation risk, dent consumption, trade and firms delay investment
- ❑ Will **London be dislodged** as Europe's **leading international financial centre**? Sustained by inherent advantages, a large network of financial and professional services. However, some business would be likely to move to Eurozone financial centres or be lost to Europe

*The UK economy may well dip into recession over the next 6 months*

# THE UK-EU TRADE, INVESTMENT AND FINANCIAL LINKS

## Britain and the EU\* : By the Numbers



### EU BUDGET

**£8.5 billion:** 2015 UK contribution to EU budget

**1%:** EU contributions as share of total UK budget



### TRADE

**45%:** UK exports going to the EU

**53%:** UK imports coming from the EU

**60%:** Trade in the overall UK economy



### FOREIGN DIRECT INVESTMENT

**48%:** Foreign investment coming from the EU

**40%:** British foreign investment going to the EU



### FINANCIAL SERVICES

**10%:** Financial services in the overall economy

**40%:** Financial services exports going to the EU



### JOBS

**3 million:** UK jobs associated with EU trade

**10%:** Trade-related jobs in the overall UK workforce



### MIGRATION

**1.2 million:** British citizens living in the EU

**3 million:** EU citizens living in the UK



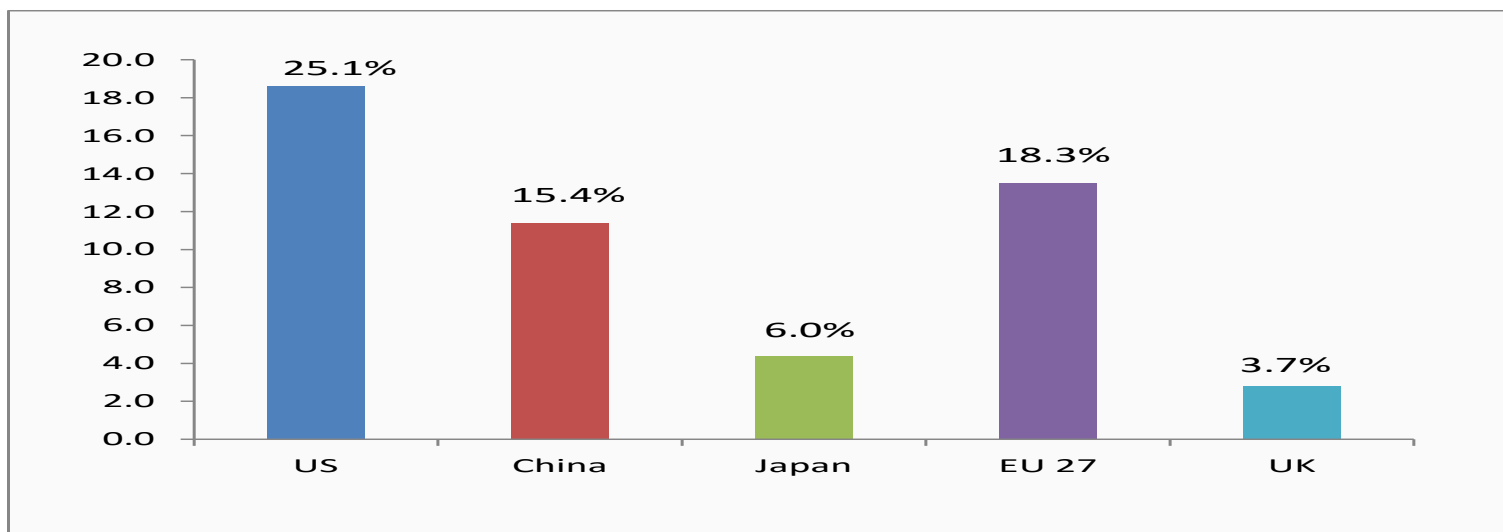
# WILL BREXIT CAUSE A GLOBAL RECESSION?

- ❑ **Cast a shadow** over a “weak and fragile” global economy
- ❑ Policymakers in major advanced and emerging economies **must take all necessary steps to safeguard financial stability** amid limited monetary and fiscal policy buffers
- ❑ **Fundamentally differences** between Brexit and the 2008-09 Global Financial Crisis (GFC)
  - ❖ The **Brexit-induced turbulence is not inflicted by financial distress or bursting of assets bubble**. Major central banks have ring-fenced to stem a liquidity crisis and credit crunch
  - ❖ The **2008-09 GFC** was inflicted by the **implosion of a scalable US subprime mortgage crisis**, which was uncontrollable and morphed into a full-fledged financial crisis
  - ❖ As **the US was at the epicentre** of the GFC, this accentuated the depth of global recession, worsened by the European sovereign debt crisis erupted in the wake of the Great Recession around late 2009

# THE RISK OF A GLOBAL RECESSION IS LESS THAN 50%

- ❑ Global economy still “muddling through” amid the risk of “secular stagnation”
- ❑ BoE will do more monetary easing; ECB and BoJ will either maintain status quo or go even further
- ❑ The Fed is likely to **recalibrate its interest rate hikes** because of Brexit uncertainty
- ❑ The **US economy** should be able to withstand Brexit’s headwinds, growing by 2.0-2.3% this year but not that exciting
- ❑ **China and India** economies are still riding on the path of expansion, albeit moderately in the case of China

2016 World GDP ranking (Value in US\$ trillion and % share of world GDP)



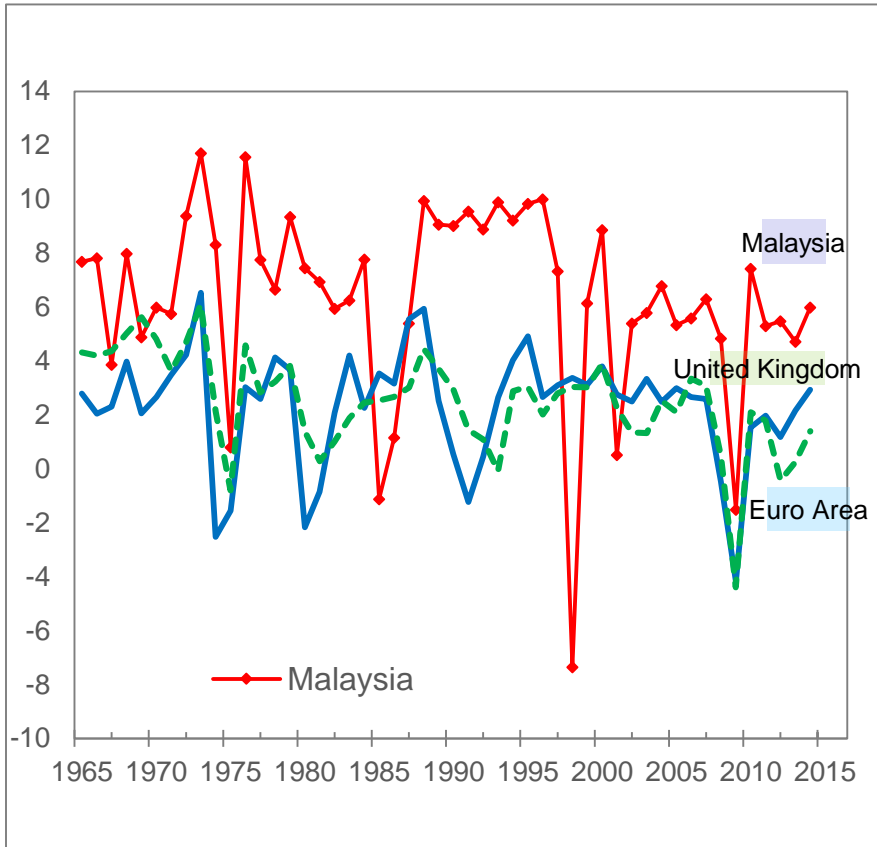
# QUANTIFYING THE BREXIT'S IMPACT ON MALAYSIA

- ❑ Brexit's impact on Malaysia via **trade and financial channels** are expected to remain manageable
- ❑ Even there is a recession in the UK economy (1.1% of Malaysia's exports; 5.1% of FDI stock and 1.7% of Malaysia's tourist arrivals)
- ❑ **A prolonged period of economic disruption and financial disturbance in the UK could drag the recovery pace of EU** (the EU makes up 9.3% of Malaysia's exports; 2.6% of tourist arrivals and 20.1% of FDI stock)
- ❑ The **strengthening of ringgit** against the pound sterling (+18% from RM6.3607 at end-Dec 2015 to 5.3910 at end-June 2016) means lower education cost for Malaysian students studying abroad. It also presents lower entry cost of investment into the UK
- ❑ The **exchange rate volatility remains** until the dust settles
- ❑ **Malaysia's GDP growth** is estimated at **4.2% in 2016** and **4.0-4.5% in 2017** (Official estimates: 4.0-4.5% in 2016; Market consensus: 3.9%-4.5%)

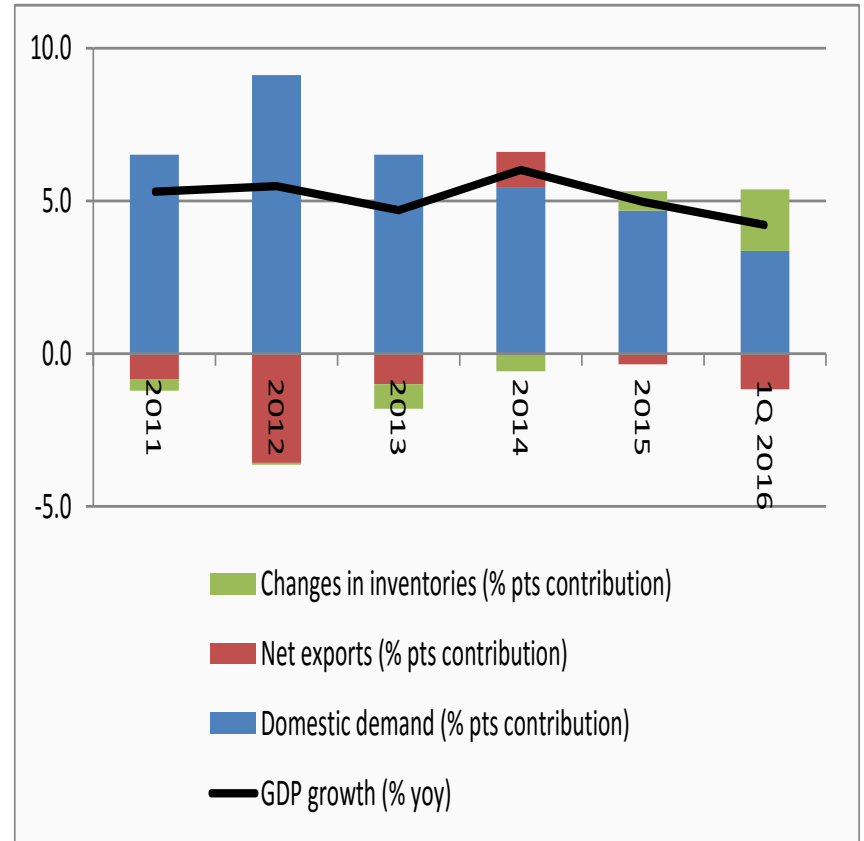


# MALAYSIA-UK-EURO AREAS GDP GROWTH TREND

Mal-UK-euro area GDP growth trend



Malaysia's GDP growth: Domestic demand remains the prime mover



# MALAYSIA-UK'S TRADE AND INVESTMENT LINKS

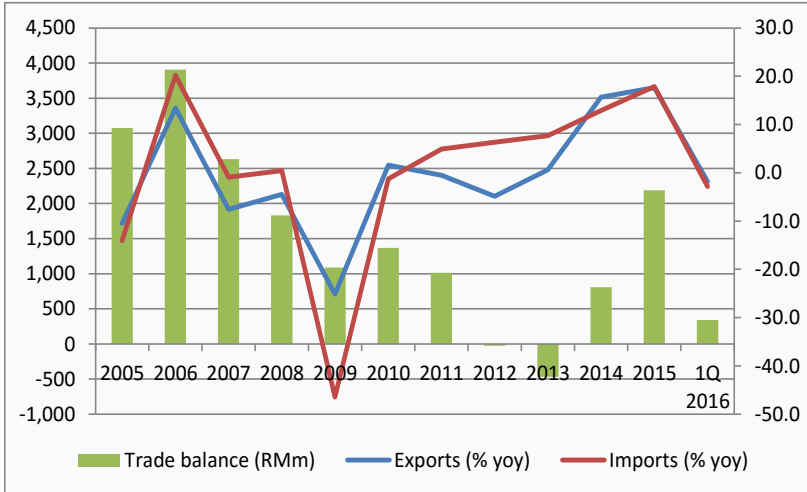
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|---|---|
| <ul style="list-style-type: none"><li>• <b>Malaysia's total trade with the UK</b> declined by 0.4% pa in 2004-15 as exports contracted 1.1% while imports grew 0.7%.</li><li>• The <b>share of bilateral trade</b> between Malaysia-UK currently <b>stands at 1.1%</b> of Malaysia's external trade (exports and imports share at 1.1% each).</li><li>• With the exception of incurring small trade deficits in 2012-13, Malaysia had enjoyed trade surpluses ranging between RM0.8 billion and RM3.9 billion in 2004-2015.</li></ul> | <ul style="list-style-type: none"><li>• Malaysia's major export items to the UK are transport equipment (&gt;50%), machinery appliances and equipment (&gt;25%). The balance are mining and commodity-related.</li><li>• Exports of services: finance, wholesale and transport, IT and professional services</li></ul>  |
| <ul style="list-style-type: none"><li>• British companies' <b>long-term direct investment</b> in Malaysia accounted for an average of <b>5.1% of total FDI stock</b> in 2008-2015.</li><li>• Since the 2008-09 Global Financial Crisis, the UK's investment interests in Malaysia has been dwindling over the years, from 6.8% of total FDI stock at end-2009 to 4.3% at end-2015.</li></ul>  | <ul style="list-style-type: none"><li>• Investment in chemical and chemical products, petroleum products (including petrochemicals), electronics and electrical products, rubber products and plastic product industries.</li><li>• A prolonged sharp economic downturn in the UK economy would dampen its investors' investment interests in Malaysia.</li></ul> |

# MALAYSIA-UK'S TRADE AND INVESTMENT LINKS (CONT'D)

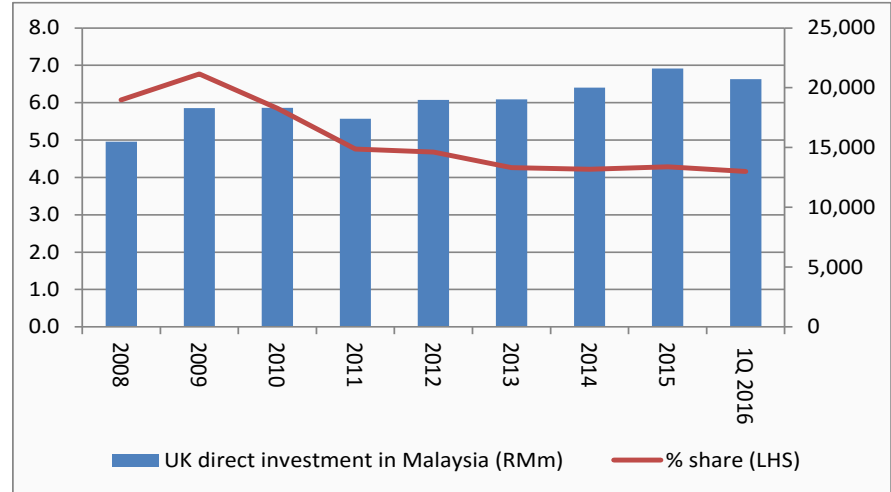
<ul style="list-style-type: none"><li>• UK investors' cumulative <b>portfolio investment</b> in Malaysia registered <b>net inflows of RM23.4 billion</b>, making up <b>55.0% of cumulative net portfolio investment</b> inflows in 2008-2015. In 1Q2016, it recorded a net inflow of RM1.6 billion.</li></ul>	<ul style="list-style-type: none"><li>• In the face of persistent market uncertainty and volatility associated to Brexit, the risk of capital reversals may ensue as investors could liquidate their position to meet some redemption back home.</li></ul>
<ul style="list-style-type: none"><li>• Malaysian <b>companies' outward investment</b> in the UK economy have increased in recent years, bringing an <b>average of 3.4%</b> of total outward investment abroad during the period 2008-2015.</li></ul>	<ul style="list-style-type: none"><li>• Malaysia's investment interests are in utilities, hotels, automobiles, healthcare and retail.</li><li>• Malaysian companies and institutions are also among the largest investors in London's commercial and residential property, namely the Battersea Power Station Project.</li><li>• While the cloud of uncertainty in the UK economy would cause investors to remain cautious in the short-term, Malaysians are expected to take a long-term view of committing large-scale investments in the UK given its potential growth prospects and steady economic fundamentals.</li></ul>

# MALAYSIA-UK'S TRADE, INVESTMENT AND FINANCIAL TREND

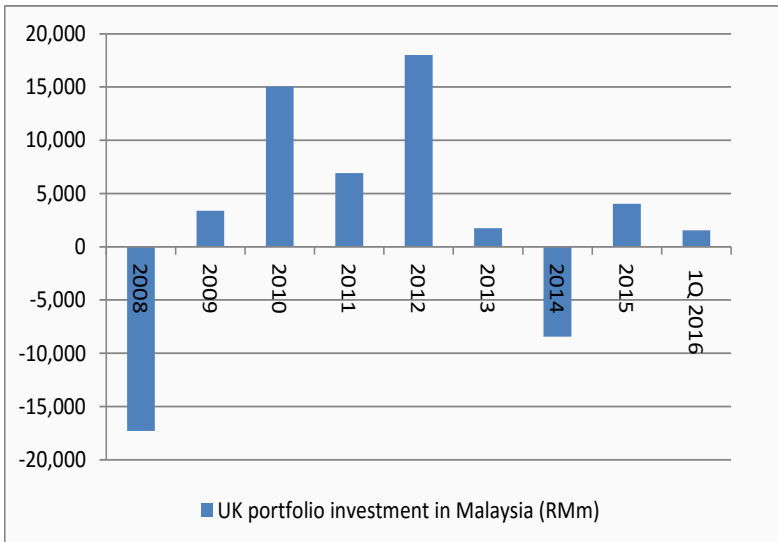
**M'sia-UK trade makes up 1.1% of Malaysia's total trade**



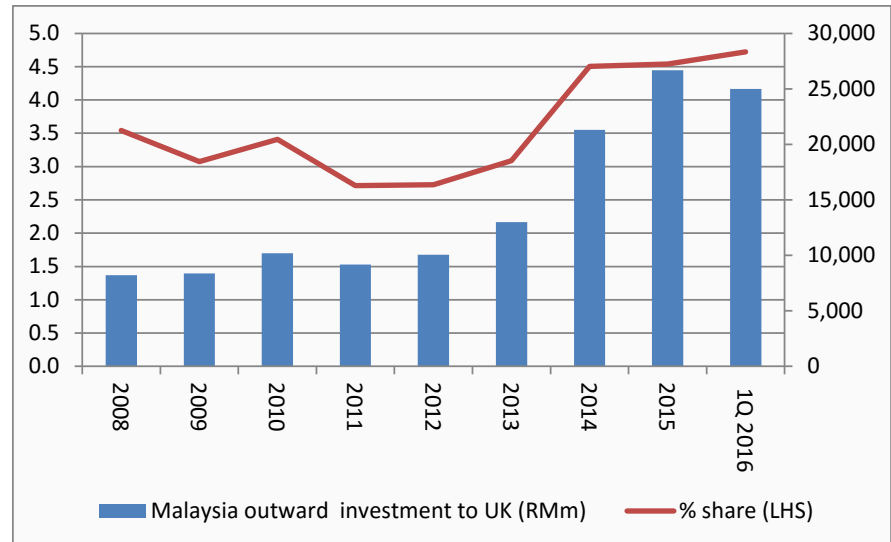
**UK's direct investment in M'sia reduced to 4.2-4.3% of total FDI stock in recent years from 6.1-6.8% in 2008-09**



**UK's portfolio investment flows into Malaysia have been volatile in recent years**



**Malaysia's outward investment to the UK rose to 4.5-4.7% of Msia's outward investment in 2014-1Q16**



# MALAYSIA-EU\*'S TRADE AND INVESTMENT LINKS

<ul style="list-style-type: none"><li>• The EU is Malaysia's third largest trading partner. Malaysia's <b>total trade with the EU</b> has been declining steadily from 10.9% in 2007 to 9.1% at end-1Q16. Exports share to the EU stood at 9.3% and imports share at 8.8%.</li><li>• During the period 2004-2011, Malaysia had enjoyed a <b>sizeable trade surplus</b> averaging RM11.9 billion per year before reversing into deficits of RM3.3-4.6 billion in 2012-13. Since 2014, the trade balance was in Malaysia's favour.</li></ul>	<ul style="list-style-type: none"><li>• More than 90% of trade is dominated by industrial goods such as machinery and appliances. Other products of relevance are plastics and rubber and animal and vegetable fats and oils.</li><li>• The level of trade in services between the EU and Malaysia currently remains low but has experienced gradual yet steady average annual growth of 8% during the past 10 years.</li></ul>
<ul style="list-style-type: none"><li>• The EU is the <b>second largest foreign investor</b> in Malaysia, contributing 20.1% of Malaysia's FDI stock as at 1Q 2016.</li><li>• EU's FDI share of total FDI stock has been rising steadily after the 2008-09 Global Financial Crisis</li></ul>	<ul style="list-style-type: none"><li>• Investment primarily in greenfield investments in manufacturing (mainly consumer products), but increasingly also in financial services such as insurance.</li><li>• A prolonged slow economic growth in the EU would hamper the inflows of investment in Malaysia.</li></ul>

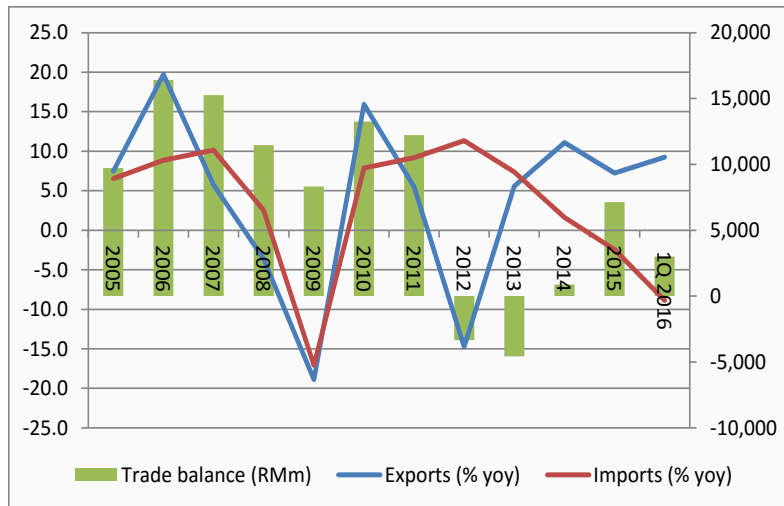
\* Excludes the UK

# MALAYSIA-EU'S TRADE AND INVESTMENT LINKS (CONT'D)

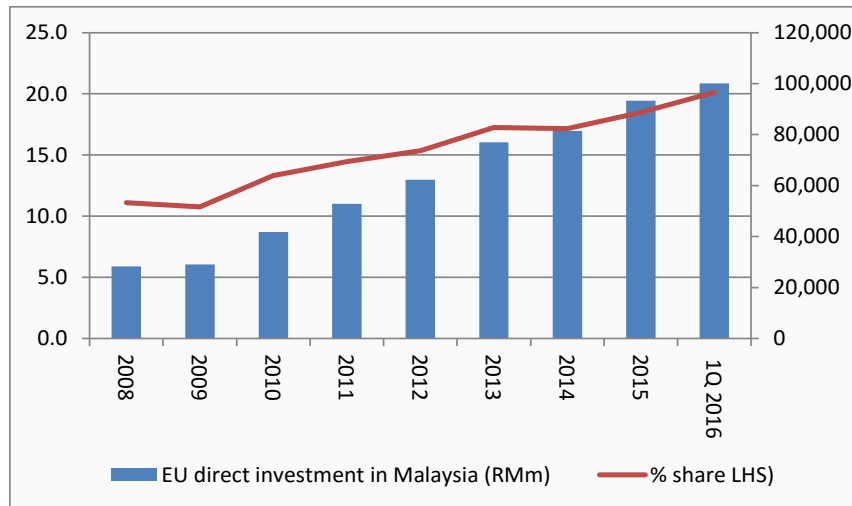
<ul style="list-style-type: none"><li>• EU investors' <b>portfolio investment</b> in Malaysia recorded cumulative net outflows of RM52.7 billion in 2008-15. However, it reversed to a net inflow of RM10.9 billion in 1Q16 from –RM14.3 billion in 2015</li></ul>	<ul style="list-style-type: none"><li>• Faced with market uncertainty and volatility induced by the Brexit, the risk of capital reversals may ensue as investors could liquidate their position to meet some redemption back home.</li></ul>
<ul style="list-style-type: none"><li>• <b>Malaysian companies' outward investment</b> in the EU reduced to a mere 0.2% of Malaysia's outward investment from 2.4% in 2008</li></ul>	<ul style="list-style-type: none"><li>• Investment in IT and telecommunications as well as oleo chemicals.</li><li>• Malaysia's investment in the EU continues to grow, particularly through acquisitions in the mining and quarrying sectors (oil and gas), as well as in financial services. This demonstrates the breadth and diversity of mutual trade and investment interests.</li></ul>

# MALAYSIA-EU'S TRADE, INVESTMENT AND FINANCIAL TREND

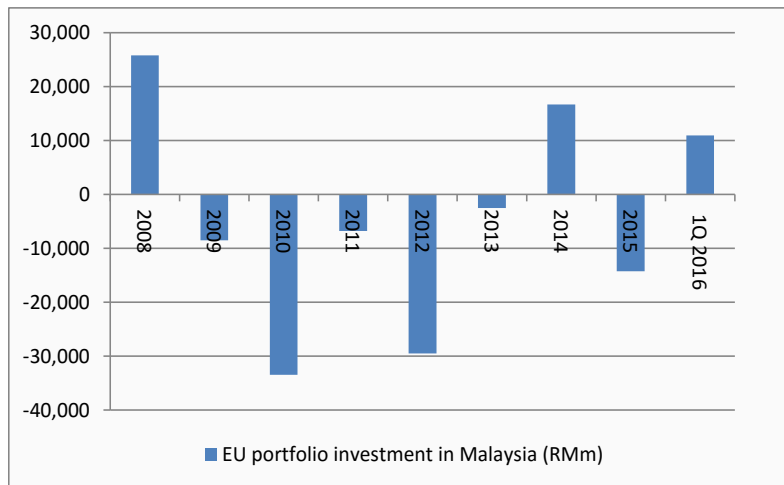
Exports to EU make up 9.3% of Malaysia's exports



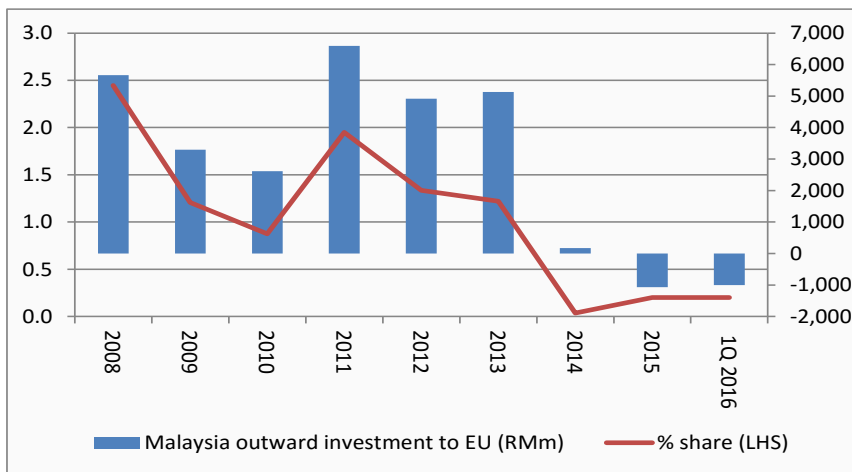
EU's direct investment in Malaysia has risen steadily



EU registered net portfolio investment outflows from Malaysia in most years



Malaysia's outward investment to the EU has been trending lower



# ASIA'S EXPORTS SHARE TO THE UK AND EU

% share of total exports matrix (YTD 2016)

Exports to (% share)	US	EU	UK	China	Japan	ASEAN	North Asia NIEs
... from (% share)							
China	17.4	18.6	2.6	-	6.4	12.7	20.0
Japan	20.7	12.0	2.2	16.9	-	14.7	17.7
<b>Asean-5</b>							
Singapore	6.6	9.2	0.9	12.6	4.7	28.7	20.8
Malaysia	10.4	10.2	1.1	11.2	8.8	29.2	10.7
Indonesia	11.2	13.4	1.1	10.0	12.1	22.2	9.6
Thailand	10.8	10.3	1.3	10.1	9.9	24.1	8.6
Philippine	16.1	9.6	0.8	9.6	22.0	13.7	18.2
<b>North Asia NIEs</b>							
Korea	14.4	9.9	1.6	24.4	4.7	13.3	8.0
Taiwan	12.1	10.0	1.3	24.8	7.3	18.2	17.8
Hong Kong	9.2	9.4	1.5	52.5	3.5	7.9	3.4
US	-	19.4	3.9	7.3	4.2	4.9	6.8
UK	15.1	47.5	-	4.3	1.6	2.7	4.3
EU	15.3	-	15.4	7.4	2.4	3.8	4.2

Based on Asia's trade exposure matrix above, UK leaving EU would seem minimal since UK is not a major trading partners with most Asian countries. However, because the uncertainties are rather difficult to quantify, the repercussion of a global economic slowdown can be a threat to many Asia trading countries, including Malaysia. The risk of a global economic slowdown may pose challenges to the Asian interests especially in on-going preferential trade agreements such as TPPA, RCEP, etc.



# CONCLUSION

- ❑ Brexit raises fears of a global recession and financial contagion
- ❑ Brexit uncertainty will escalate the risk of recession in UK. Prolonged negative spillovers will dent the recovery of the EU
- ❑ Prompt policies intervention to safeguard financial stability as well as adopting pro-growth measures
- ❑ Malaysia will be affected via both trade and financial channels but should remain manageable
- ❑ Malaysia's decent economic growth has been propelled by the strength of domestic demand, albeit slower amid anemic export growth
- ❑ Amid the limited fiscal space, selective and targeted fiscal spending programmes are expected to cushion domestic economy
- ❑ Bank Negara Malaysia's policy priority is to safeguard financial stability. A cut in interest rates is warranted if the downside risk to GDP growth rises