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Policy Discussion

PD-05

A brief on impacts of Brexit on the World Economy and Vietnamese economy

VEPR Research Division

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Background of Brexit

Summary of the Relationship between the UK and the European Union (EU)

Throughout history, the United Kingdom is an island relatively isolating from the rest of Europe. Even when the European nations established a union after the World War II, the UK seemed to be an outsider. The UK refused to join the European Coal and Steel Community (ECSC) in 1951 and the European Economic Community (EEC) in 1957.

After the great economic revival experienced by France and Germany, as well as the foundation of a powerful union, the UK leaders started to reconsider their decision about whether to join the EEC. The UK government's first attempt to join the EEC was in 1961. Their attempt, however, confronted the rejection of French President Charles de Gaulle twice in 1963 and 1967. Until 1973, the UK was officially a member country of the EEC. A referendum was held in 1975 with 67% of electors voting for a stay.

In the following years, the relationship between the UK and the EU was not so harmonious. In 1990, the UK joined the European Monetary System (EMS) with the aim of stabilizing fixed exchange rate in the entire bloc. Nonetheless, after merely two years, the UK decided to withdraw from such system after the crisis of the pound sterling. In 1995, the UK refused to join the Schengen agreement on the freedom movement among member countries as well as to adopt the single currency. After the global financial and public debt crisis in some Europe countries, the UK again refused to sign the Fiscal Compact introduced by the EU in 2011 in order to remedy the financial situation.

A Referendum on the EU Membership of the UK

Background

Since 2010, some polls have revealed differences in the opinion of the UK citizens towards remaining or leaving the EU. In January 2013, Prime Minister David Cameron committed to deliver an in/out referendum if he remained Prime Minister in 2015. Before the election, a large number of senators from many parties (e.g. the UK Independence Party (UKIP), the British National Party, etc.) urged for a referendum. The EU is an economic and political bloc with 28 member countries, established after the World War II to reinforce the economic collaboration among members. Nonetheless, such senators argued that the EU has changed significantly since its first establishment, expanding its control over daily life of citizens.

All surveys revealed that the main reason for such referendum is the migration matter. In addition, some argued that the UK has been restrained by the EU regulations on business, as well as the considerable membership fee, while only minor benefits could be received. Despite opposing Brexit, Prime Minister David Cameroon still agreed that the referendum could take place.

Progress and Results

Brexit is the combination of "Britain" and "exit", implying the leaving of the UK from the EU. The referendum on this issue was conducted on June 23, 2016 in the UK. The number of electors casting their ballots was 33.58 million, accounting for 72.21% of the total electorate.

The results showed that there were 17.4 billion people voting for an exit, about 51.89% of the UK electorate. Nevertheless, there were differences in terms of ages and geography of the voters. While those from Britain and Wales mainly voted for Brexit with 62%, the majority of electors from Scotland and Northern Ireland expected for a "remain" with 55.8%.

In terms of ages, there was a positive correlation between the age of voters and their decision on leaving the EU. In particular, about 60% of the electorate over 65 years old voted for Brexit while the rates for the age groups of 45-54 and 55-64 were 56% and 57% respectively. In contrast, only 27% of voters in group 18-24 years old agreed. The supporting rates in the age group of 25-34 and 35-44 were 38% and 48% respectively.

Therefore, vote "leave" won the referendum, putting an end to the relationship between the UK and the EU. Nonetheless, the legal route to achieve a Brexit is still left open.

Brexit and Article 50 of the Lisbon Treaty

The UK set their own future with 52% supporting votes for Brexit. Nonetheless, the country has not triggered Article 50 of the Lisbon Treaty on the withdrawal from the EU of member countries.

Article 50 sets out the process for a member state to make their own decision of leaving the EU. Nevertheless, this article does not clarify how such process is conducted. Moreover, the due date for an official announcement of the UK is not clear. Hence, the rest countries of the EU are not allowed to force the UK.

After the referendum, Prime Minister Cameron declared for a resignation and passed the Article 50 trigger to his successor. As soon as the Article 50 is triggered, the UK and EU will have a two-year negotiation period about their future relationship. The most concerning issues were the future of Free trade agreements (FTAs) signed by the UK as an EU member, the intra-EU labor migration and the commercial barriers post-Brexit.

On July 13, 2016, Prime Minister David Cameron officially resigned, sooner than the plan in October. His successor was Theresa May, the Home Secretary for 6 years and also the only remaining candidate for the Prime Minister position. In the beginning of Q3, Theresa May asserted the deadline to trigger Article 50 was Q1/2017. Nonetheless, in an interview on October 2, 2016, May has not specified how Brexit will be implemented, easing the pressure between the two parties, when politicians of the EU consistently urged the UK to negotiate procedures for an early leaving.

Impacts of Brexit on the UK Economy and the World Economy

Short-term Impacts

Stock Market

At the center of the Europe in Q2 was the UK referendum on June 23, 2016 and whether this country was about to leave or to stay in the EU. Most of the predictions were inaccurate when 51.9% of the UK electorate voted for Brexit. At once, financial and monetary markets of not only the UK but also other regions confronted a significant shock. In the first session after the referendum, 2 trillion USD was wiped off the global stock market, the largest absolute loss ever. The EU markets experiencing the most severe drop were Italy and Spain (above 12%), London (7.2%), Nikkei of Japan (7.9%), and S&P500 of the US (3.6%). After the weekend, many stock exchanges around the world have continued the downward trend before experiencing a slight recovery right after that. After the two sessions, FTSE 250 index of the UK was down by 13.65% while Italian and Spanish stock exchanges also fell by 15.90% and 14.00%. Meanwhile, S&P 500 index of the US and Nikkei 225 of Japan also lost by more than 5% after these two sessions.

Table 1. Fluctuations in the Index of Major Stock Exchanges in the World after Brexit

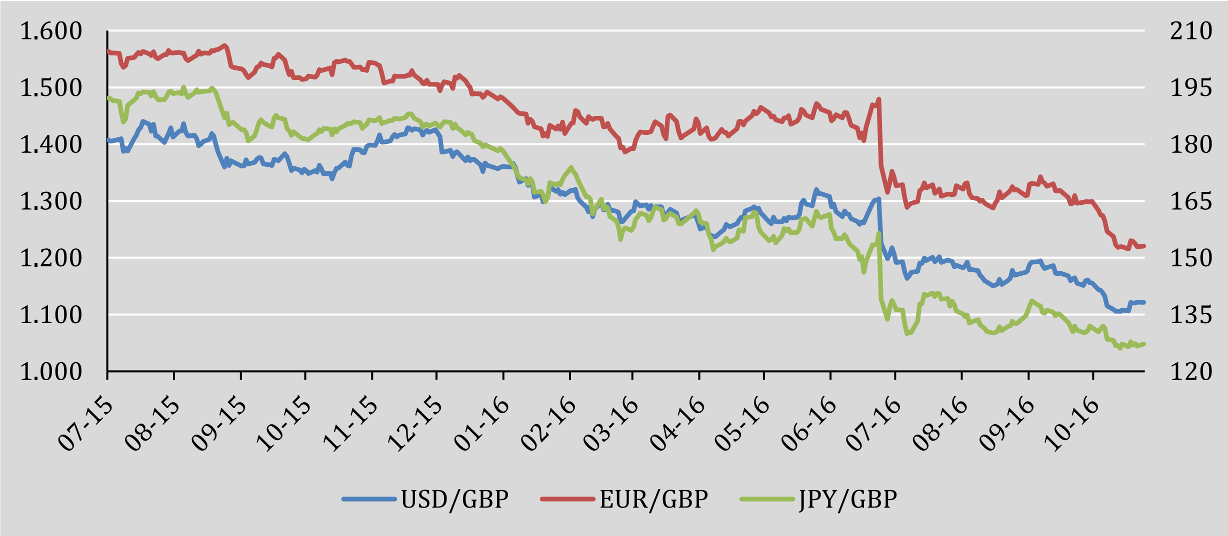
Session	FTSE 250 (The UK)	S&P 500 (The US)	Nikkei 225 (Japan)	FTSE MIB (Italy)	IGBM (Spain)
24/06	-7.19%	-3.59%	-7.92%	-12.48%	-12.47%
27/06	-6.96%	-1.81%	2.39%	-3.94%	-1.73%
Total	-13.65%	-5.34%	-5.72%	-15.93%	-13.98%

Source: Authors' calculation based on CEIC Database

Forex Market

In the forex market, the GBP strongly depreciated against other major currencies such as EUR, USD or JPY. Following the same trend, the EUR was slightly devalued against USD. The GBP has continuously devalued and recorded the lowest level in the past 31 years. After the last session of June 30, the GBP devalued by 11.6% compared to the level before the referendum. Meanwhile, the EUR depreciated by 3% compared to the USD. Due to concerns over the uncertain future of the UK and EU economies, investors have sought for other safe currencies and assets. The two most interested currencies at that time were the USD and the JPY. In contrast, the JPY was being considered as the safest choice. It even followed an upward trend compared to the USD. This currency appreciated by 3.0% and 4.4% in the end of Q2 and Q3 compared to the USD on June 23.

Figure 1. Reference Exchange Rate in the Bank of England



Source: CEIC Database

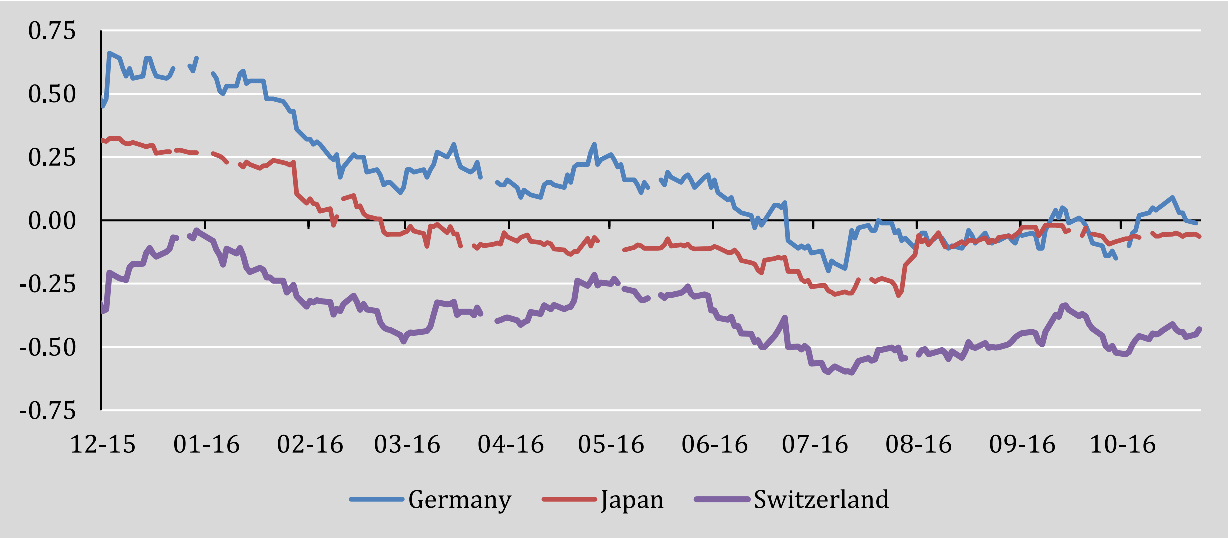
In Q4, the confirmation of the deadline for Brexit caused a marginal shock in the market. After this announcement, the GBP devalued by about 2% compared to the end of September. In particular, the GBP spot price on the 4th October was 1.28 USD/GBP, down 1.7% compared to the level on 30th September and 13.5% compared to the pre-Brexit period.

Asset Market

In the asset market, the gold price widely fluctuated due to an increasing demand for investing in safe assets. In the UK, after the result of the referendum was announced, the gold price surged by 3.8%. In the session of July 4, 2016, the gold price reached USD 1,348.8 /troy oz., up 9.3% compared to the end of Q1. During Q2, the gold price remained stable at USD 1,340/oz. with the amplitude of fluctuation of ±2.2%. Nonetheless, after the deadline to trigger Article 50 was confirmed by the UK Prime Minister, the asset market experienced a volatile session. The gold price on October 4 was down 3.6% to reach USD 1,268.0 /oz. while the GBP devalued by 2%.

Not only gold but also other strong currencies and highly safe government bonds of the USA, Switzerland, Japan or Germany were also chosen by investors during this period. The interest rate of government bonds in these countries plunged after the referendum. In Japan, Switzerland and Germany, interest rate of 10-year government bonds dropped to lower than 0%.

Figure 2. Interest Rate of 10-year Government Bonds (%)



Source: CEIC Database

Nevertheless, we believe that such impacts would exist only in the short term when the UK and the EU have not reached a consensus on the deadline and the procedures of Brexit yet, as indicators in every market gradually recovered and was stabilized again in Q3. In the long run, the impacts of Brexit would depend on the new economic relationship along the English Channel. Currently, although the time has been confirmed, there are still no alternatives for post-Brexit. Hence, it takes at least 10 years for Brexit to be stabilized.

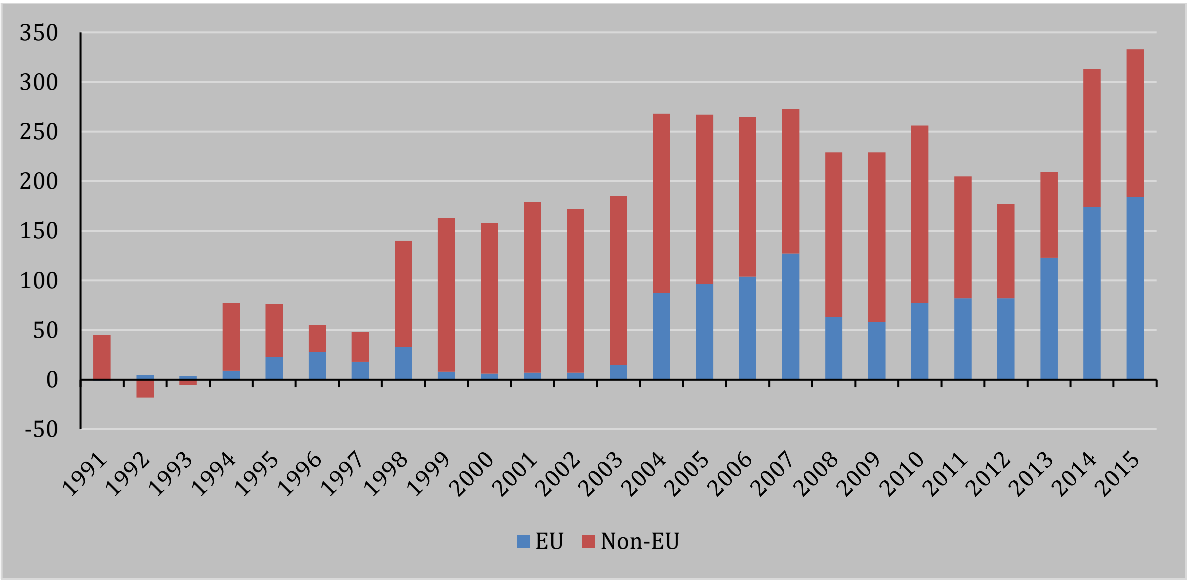
Long-term Impacts

Immigration

The most controversial issue in this breakup is immigration. Each year, the UK let about 300,000 immigrants into the country, of which 200,000 immigrants are from the EU. According to Woodford Fund (2016), this number of immigrants would increase the workforce by 0.5% each year in the country. It is undeniable that these immigrants could help drive the economic growth without placing the country under any pressure on wage increase, keeping inflation and interest rates at low levels over a long period of time.

Nevertheless, many Britons do not agree with this opinion. They argued that the migrants from the EU depressed Britons' wages or pushed up the native unemployment rate. Hence, immigration policy would be one of the central points of Brexit. That the UK imposes restrictions on immigrations from the EU as well as e from other countries, if any, will significantly affect the UK economy.

Figure 3. Immigration to the UK (net, thousands of persons)



Source: CEIC database

In the short term, due to the rigidity of provisions, the number of migrants to the UK is likely to surge. In addition, as the EU migrants who are already in the UK know that it would be hard to get back to the country if they leave, they might stay longer than they otherwise would have. Emigration out of Britain to other EU countries would also follow the same trend. Hence, despite the UK's announcement on a restriction on immigration, the net migration may experience minor changes in the short term.

Nevertheless, in the long term, the net migration from the EU to the UK would be highly likely to fall if the restrictive policy comes into effect. According to Woodford Fund (2016), both positive and negative impacts will be recorded. A reduction in the growth rate of workforce may lead to upward pressure on wages and inflation. Most importantly, the government would gain the ability to implement a different migration policy, with criteria probably set according to people's skills and professions, rather than where they come from. Accordingly, the quality of migrant labor could rise, boosting Britain's productivity performance.

International Trade

The UK's international trade is considered the second facet directly affected by Brexit. According to the data of 2015, about 47.3% of Britain's exports went to the rest of the EU28 and about 55.1% of its imports was from these countries. Moreover, there were approximately 13.6% of Britain's exports trading to countries signing FTAs with the EU (Global Counsel, 2015). In contrast, the EU's volume of goods traded to the UK accounted for only a modest part of the total traded goods of EU countries. It means that if Brexit happens, the UK will receive more influences.

Many assumptions revealed that the UK would have to renegotiate FTAs with the EU and other countries signing an FTA with the EU. Nonetheless, in the two-year negotiation period, the UK still fully receive benefits as a member of the EU. Most quantitative researches put forward three scenarios for this relationship in the post-Brexit period (Woodford Fund, 2016), (Schoof, Petersen, Aichele, & Felbermayr, 2015).

+ *The Norway scenario:* the current situation of the UK is similar to that of Norway in the sense that this country will not be a member of the EU but the European Economic Area (EEA). Therefore, the UK's market will still be a part the EU's single market and not strongly affected by Brexit. Nonetheless, this case is unlikely to happen.
+ *The Switzerland scenario*: the UK will follow the track of Switzerland, staying outside of the EEA but negotiating bilateral agreements with the EU. According to this scenario, the two sides will have to confront several matters (e.g. additional trading cost, non-tariff barriers, rules of origins, etc.) Nevertheless, in the long run, trade will still be assured. This scenario is reasonable but time-consuming.
+ *The worst scenario, WTO scenario*: In the case the UK fails to negotiate FTAs with the EU, the UK's trade with the Europe will be governed by the "most-favored nation" rules. Accordingly, the EU countries will be treated as other countries signing no FTAs with the UK, which highly affects the trade between the UK and the EU. Nonetheless, according to Woodford Fund (2016), it is probable that the UK will negotiate FTAs with non-EU countries. If the UK can take full advantage of this opportunity, the UK can enjoy huge benefits in the long term. Egert and Gal (2016) said that the trade openness may drop 4 percentage points after 10 years.

Foreign Direct Investment

According to the UK Office for National Statistics (ONS), accumulated FDI capital poured into the UK was GBP 1,043.3 billion. Of which, capital from EU countries was GBP 495.8 billion, accounting for 47.9% of the total FDI capital. Nonetheless, the annual FDI from EU countries to the UK plunged in the past few years, replaced by the capital from non-EU countries. The proportion of EU countries' FDI capital to the UK fell from the average of 50.1% in the period of 2005-2009 to 48.4% in the period of 2010-2014.

However, most foreign investors in the UK aim at the access to the EU single market. Therefore, the amount of capital is highly likely to dip due to the anxiety of investors about the uncertain future of the relationship between the EU and the UK. Hence, FDI capital of some manufacturing industries is believed to follow a downward trend in the coming time (Kierzenkowski, Pain, Rusticelli, and Zwart, 2016; Woodford Fund, 2016). According to Global Counsel (2015), the UK is less attractive as a gateway to the EU.

Public Sector

Public finance is also one of the main reasons for Britons' decision of Brexit. In principle, the EU does not impose direct tax on member countries but receive their contributions. Accordingly, the UK contributed GBP 18.8 billion, about 1% of its GDP in 2014. Although the majority of its contribution to the EU budget is served for itself, Brexit supporters still argued that spending this sum should be decided by the UK's government. Brexit could help the country save on the annual payments to the EU budget. According to Emmerson, Johnson, Mitchell, Phillips, and Payne (2016) from the Institute for Fiscal Studies, London, the overall impact on the public finances will depend on two distinct components:

+ *The mechanical effect*: Of GBP 18.8 billion contributed to the EU budget, GBP 4.4 billion was refunded by the EU while GBP 8.7 billion was spent on services in the UK. Hence, the UK's contribution to the EU budget excluding rebate and spending by the EU in the UK was GBP 5.7 billion, equivalent to 0.3% of its GDP and GBP 100 million per week. According to Emmerson *et al.* (2016), the UK's public finance could be strengthened by GBP 8 billion /year to fund other spending, cut taxes or reduce the deficit. On the other hand, the contribution of the UK to the EU is also served for FTAs in the EEA of around GBP 4 billion (it is assumed to be equivalent to the contribution that Norway makes). Hence, the UK's withdrawal from the EEA may affect the ability to access financial market of this country, affecting the UK economy.
+ *The national income effect:* the public finance will also be affected by the effects of UK national income. If leaving the EU is to have no effect on national income, then the public finance will be strengthened. According to Emmerson et al. (2016), if the UK national income is reduced by 0.6% that will be enough to outweigh the positive mechanical effect on the public finance. Nevertheless, there are still uncertainties about the impacts of Brexit on trade deals, immigration policies, which could leave the effects of each of them on growth open.

In the short run, the public finance of the UK will be highly likely to be negatively affected as the national income effect outweighs the mechanical effect. Emmerson et al. (2016) applied NIESR model and demonstrated that there will not be a budget surplus until 2019-2020.

Economic Growth

Based on all possible scenarios, many researches have been conducted to analyze the impacts of Brexit on the UK economic growth in the long term. The effects on GDP may be seen through different channels (e.g. trade, budget, investment, immigration, and regulations). The table below shows the assessments of 2030 economic impact of Brexit on the UK according to different scenarios.

Table 2. Assessments of 2030 economic impact of Brexit

Organization	Scenario	Estimate (%GDP)	Range	Impacts modelled
CEP (2016a)	Dynamic EEA/FTA Static EEA Static WTO	-7.9 -1.3 -2.6	(-6.3 to -9.5) N/a N/a	Budget, trade, productivity Trade only Trade only
HM Treasury	EEA FTA WTO	-3.8 -6.2 -7.5	(-3.4 to -4.3) (-4.6 to -7.8) (-5.4 to -9.5)	Budget, trade, FDI, productivity
OECD	WTO/FTA	-5.1	(-2.7 to -7.7)	Budget, trade, FDI, productivity, migration, regulations
NIESR	EEA FTA WTO WTO+	-1.8 -2.1 -3.2 -7.8	(-1.5 to -2.1) (-1.9 to -2.3) (-2.7 to -3.7) N/a	Budget, trade, FDI
PwC/CBI	FTA WTO	-1.2 -3.5	N/a	Budget, trade, FDI, regulations
Oxford Economics	FTA	-2.0	(-0.1 to -3.9)	Budget, trade, FDI, migration, regulations
Open Europe	FTA	-0.8 to +0.6	(-2.2 to +1.6)	Budget, trade, migration, regulations
Economics for Brexit	WTO	+4.0	N/a	Budget, trade

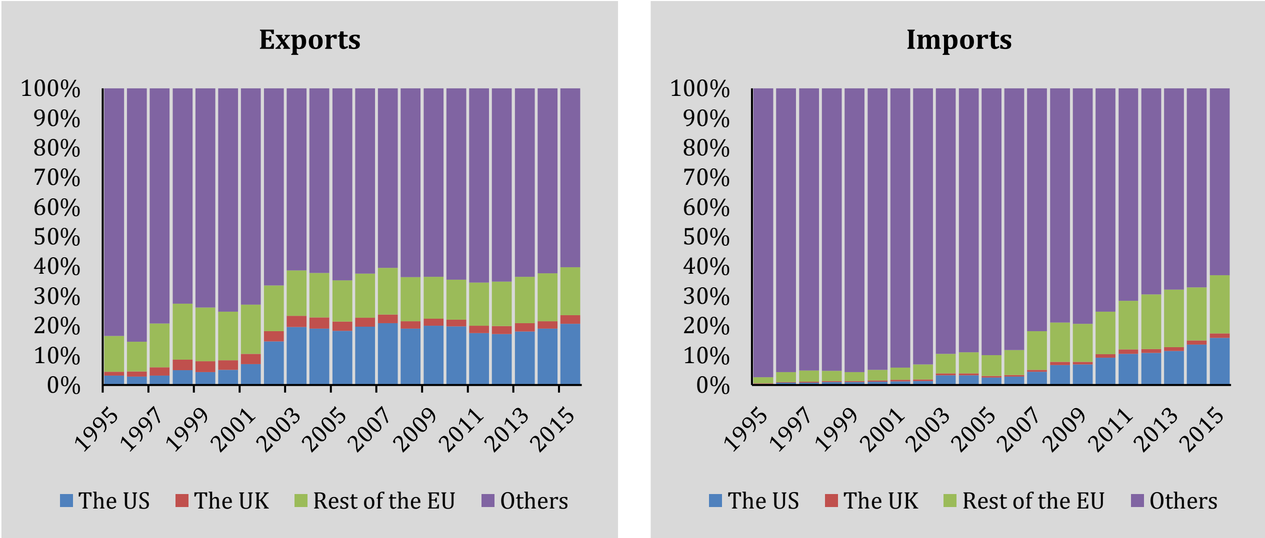
Source: Emmerson et al. (2016)

Six out of eight researches show a negative economic impact of Brexit on the UK in the long run. From the six different scenarios, the average effect was from -1.2% to -7.9% of GDP in 2030. Even when the range was expanded, no researches of these six show positive impacts on the GDP, except the rest two researches.

The Economic Relationship between the UK and Viet Nam and Impacts of Brexit on Viet Nam's Economy

Up to now, the economic relationship between Viet Nam and the UK is marginal compared to other partners such as the US, China, ASEAN. In terms of trade, exports of Viet Nam to the UK in 2015 was USD 4.5 billion, making up 2.87% of the total exports and 15% of the total imports of Viet Nam to EU countries. Imports from the UK to Viet Nam were merely less than USD 1 billion. In 2015, imports of the UK to Viet Nam was USD 0.8 billion, accounting for 0.4% total exports of Vietnam and 7% imports from EU countries. Of which, major articles are chemical products and electronic equipment and machinery.

Figure 4. Imports and exports structure of Viet Nam by partners



Source: CEIC database

Meanwhile, foreign direct investment from the UK to Viet Nam is not significant. Accumulation of projects having effect as of June 2016 from the UK were 266 projects, with the total capital of USD 3.6 billion (equivalent to 1.2% of the total FDI capital to Viet Nam). Hence, we believe that the impacts of Brexit on Vietnamese economy are modest, mostly in an indirect manner through the forex market or the asset market.

Since the early 2016, Viet Nam Dong have been stable against the USD and Brexit has boosted the VND relatively stronger than the GBP. Meanwhile, the domestic gold price, which is often slightly affected by the world market, increased only in the end of June and remained nearly the same in the early October.

Conclusion

The referendum in the UK closed with the winning of the leaving side. The new government of Prime Minister Theresa May also declared that the deadline for Brexit was the end Q1/2017. Such event imposed considerable effects on the UK economy as well as the global economy.

In the short term, the uncertain future of the relationship between the UK – EU may affect through the following channel: (i) the financial market; (ii) the forex market; and (iii) the asset market (e.g. government bond and gold). Clearly recognized changes include the downturns in several stock markets, a sharp depreciation of the GBP against the USD and other strong currencies, the tumble of interest rates of many government bonds and the soar in gold price due to increasing demand for these kinds of assets. Nonetheless, such impacts are temporary as the market quickly got stabilized. In the long term, the UK economy is forecasted to confront much more disadvantages deriving from immigration, labor, international trade and foreign direct investment.

For Viet Nam, we believe that Brexit would have inconsiderable impacts in both short term and long term as the economic relationship between Viet Nam and the UK is marginal against the relationship of Viet Nam and other major partners such as the US, China or Japan.

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Disclosure appendix

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Additional disclosures

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