Brexit – what does it mean for the Australian economy?

by NAB Group Economics

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National Australia Bank

- **The direct effects of Brexit on the Australian economy are likely be minimal, and will largely flow through trade relationships, which are relatively small between the UK and Australia. Indirect effects through financial market channels (including equity markets and currency markets) are not quantifiable as yet, but do suggest some downside risks to confidence, household consumption and business investment and therefore GDP, and upside risk to unemployment. But unless financial markets deteriorate significantly from here, implications for the Australian real economy will be limited.**
- **In terms of Australian monetary policy, our core view remains for the Reserve Bank to remain on hold although heightened global risks suggest a higher probability of a rate cut in coming months. A cut at the July meeting appears unlikely given the relatively orderly financial market movements to date and a desire to see how the dust settles. In addition, the RBA would prefer to have an up-to-date reading on inflation pressures, which suggests any upcoming cut would be more likely in August after the release of the Q2 CPI.**
- **The Brexit vote leads us to cut our UK growth forecasts (from around 2% to 1%) but as the UK is only 2.4% of the world economy, that is not enough on its own to impact global growth by much. Ongoing global financial market volatility or concern that other countries could exit the EU or Euro-zone are needed to produce a significant dent in the 3% pace of global growth.**
- **Although one in twenty of Australia's population was born in the UK, the two economies have pursued very different regional economic strategies in the last 50 years – the UK economy integrating into the European Union and Australia integrating ever closer with its Asia-Pacific neighbours.**
- **The outcome is that goods trade between Australia and the UK is less than 2% of each countries merchandise earnings – UK trade is dominated by flows to and from the EU, Australia's trade by flows to and from Asia.**
- **Bilateral services trade and foreign investment are of greater importance – at end 2015 the UK was the second biggest foreign invester in Australia and held the second largest stock of Australian overseas investment.**
- **The direct effects of Brexit are probably negative for Australian exports as weaker outlooks for UK incomes and Sterling lower the demand for our goods and services. However the reorientation of Australian trade toward East Asia greatly reduces the size of the adverse impact.**
- **While it is clearly a negative for the global economy, provided that the fallout on global financial markets and exit contagion to the Euro-zone is contained, the costs should remain concentrated in the UK and EU. A hard landing for the Chinese economy would be of much greater concern for Australia than Brexit.**
- **The consequences for Australia of Brexit would be far more severe if it led to a break up of the Eurozone or major countries like France leaving the EU. That could spill over into a global recession.**

Contents

Contacts

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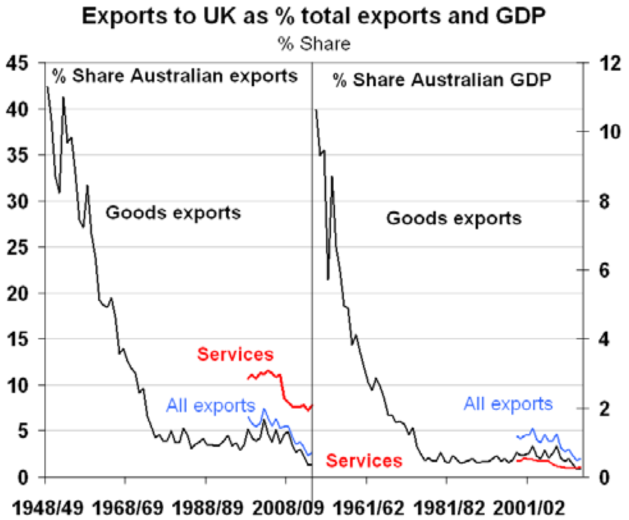
Direct effects - You can go your own way

The personal ties remain strong between Australia and the UK. Around 1.2 million people living in Australia in 2015 were born in the UK, one in 20 of the population. There were also 113000 Australians living in the UK in 2013, around half of them in London and SE England. These ties result in large amounts of two-way travel with almost half of the 650000 UK residents visiting Australia coming to visit friends and relations and spending $500 million as they went about it. Going the other way, almost half of the 1 million or so Australian visits recorded to the UK in 2015 were to catch up with friends and relations, injecting £400 million in direct spending into the UK economy.

Despite these close personal ties, the economic reality is that both economies moved onto different economic paths long ago. Once the UK decided in the 1960s to seek entry into the European Common Market (the distant predecessor of the EU), its trade had to shift away from preferentially treating its Commonwealth partners who were left wringing their hands over where they would now sell their food and fibre.

In the event, Australia integrated ever more closely into East Asia as its resource base complemented to the needs of the fast growing heavy industries of Japan and the Asian Tigers. The outcome was that the share of East Asia soared as an Australian export destination while that of the UK fell sharply. In the late 1940s the UK bought over 40% of

Australian merchandise exports. By the-1960s the UK share of our goods exports was down to 12% and now it is under 2%. The UK still looms much larger as a market for Australian service businesses, buying almost 10% of all service credits. Back in the late 1940s around 10% of Australia's entire GDP ended up as exports sold into the UK, now the percentage is around half of 1%.



Around two-thirds of Australia's exports now go to East Asia and China is easily Australia's biggest export market (its share of 2015's goods and services exports was almost 30%, accounting for around 6% of Australian GDP). As a result, the focus of concern for Australian trade is now its immediate region and, in particular, the direct consequences and spill-over effects through the region of any slowdown in the Chinese economy. UK trade has followed a similar trend of concentration in its region – meaning the EU. By 2015 Australia only accounted for 1.4% of UK exports of goods while other EU markets took almost half of the total.

While Australia has gone a long way toward reorienting its trade toward the Asia Pacific region, the UK is still our eighth largest export market with goods and services exports totalling $ 8.8 Billion in 2015. 5722 local businesses were active in selling Australian made goods into the UK market, involving tens of thousands of transactions.

The UK market remains particularly important for a diverse group of Australian industries linked to:

- UK household spending and Australian competitiveness as a supplier (tourism, wine).
- Australia's traditional role as a supplier of food and commodity raw materials to the UK (lead, meat, coal).
- London's role as a centre for storing and trading gold and precious stones.
- Australian service providers in finance, telecom/IT and other business services.
- High-tech manufacturing operations in Australia – pharmaceuticals, measuring equipment, computers.

Australian exports to the UK 2015

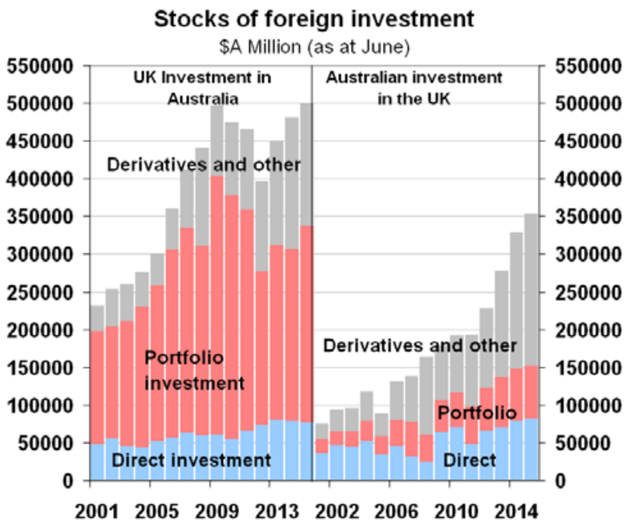
Category	*$ Million*	*% Total to UK*	*Share Australian expo*
Tourism	2166	24.6	6
Other business services	813	9.2	8
Finance	806	9.1	21
Lead	467	5.3	45
Business travel	448	5.1	10
Gold	424	4.8	3
Alcoholic drinks	387	4.4	16
Precious stones	359	4.1	45
Telecom. IT services	286	3.2	9
Coal	212	2.4	1
Education	181	2.1	1
Beef	120	1.4	1
Other meat	105	1.2	3

Even in these areas of trade specialisation with the UK, Australia is shifting toward other markets. For instance, inbound tourism is increasingly oriented towards visitors from East Asia rather than the UK.

Similarly, wine has long been one of the most important Australian exports to the UK but here too we can see a re-orientation of trade toward the Asia-Pacific region.

While Australia and the UK have largely gone their separate ways on trade, the ties remain much closer when it comes to foreign investment. The UK remains the second biggest foreign investor in Australia and the UK is the second biggest outlet for Australian overseas investment. By the end of 2015 there was around $500 billion of UK capital invested in Australia and $200 billion in Australian money invested in the UK.

These stocks of investment have also been growing quite rapidly in recent years and are concentrated in portfolio assets and derivative positions rather than direct investment. Despite this focus on portfolio assets, Australian business still had over $80 billion in direct investment in the UK in mid-2015, highlighting the extent to which earnings could be vulnerable to a downturn in the UK economy.



Brexit creates uncertainty for both inbound investment (especially given the weaker pound) and outbound investment amidst the poorer outlook for the UK economy and the reduced incentive for Australian businesses to establish a presence in the UK as a gateway to Europe.

Indirect effects on the Australian economy

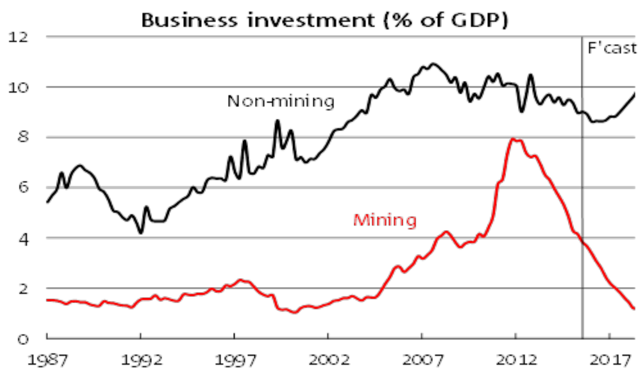
Australia starts from a position of relative strength, with transition towards non-mining sources of growth occurring relatively smoothly, although the divergence between mining and non-mining states is becoming more pronounced as mining investment trails off.

Beyond trade and investment relationships, the main channels through which Brexit will impact on the Australian economy will be via financial markets, particularly equity markets and the currency. Also there is a possibility that business confidence will deteriorate on the back of global uncertainty. The magnitude of these effects however is impossible to quantify until we have greater clarity around how and when financial market conditions will settle. At this stage, at least, global markets have been reasonably resilient. Unless markets deteriorate substantially from here and remain depressed, the expectation is that Brexit will be relatively limited impact on the outlook for the real economy in Australia – and one that in any event policy makers have reasonable scope to deal with.

In terms of equity market channels, there are potential (modest) implications for both household and business expenditure. Household wealth and consumer confidence will be weaker should equity market losses be sustained or extend further, which is likely to weigh on household consumption (55% of GDP) amidst a backdrop of weak household income growth. Current forecasts for household consumption by NAB, Treasury and the RBA are predicated on some modest ongoing decline in the household savings ratio, which is unlikely to transpire if uncertainty is heightened.

Sustained lower equity valuations and general uncertainty may also have some repercussions for local business balance sheets (currently healthy), with follow-on risk to non-mining business investment and employment. On this, we will be watching business confidence quite closely (the next NAB monthly business survey commenced in the field immediately after the Brexit vote was announced). Direct investment between Australia and the UK is also large, with risks to both inbound and outbound investment as highlighted above.

At this stage however, we have only factored in a modest pick up in non-mining business investment into our forecast trajectory, so further downside risk appears somewhat limited. Brexit is unlikely to have significant repercussions for the mining sector, with the decline in mining investment "baked in".

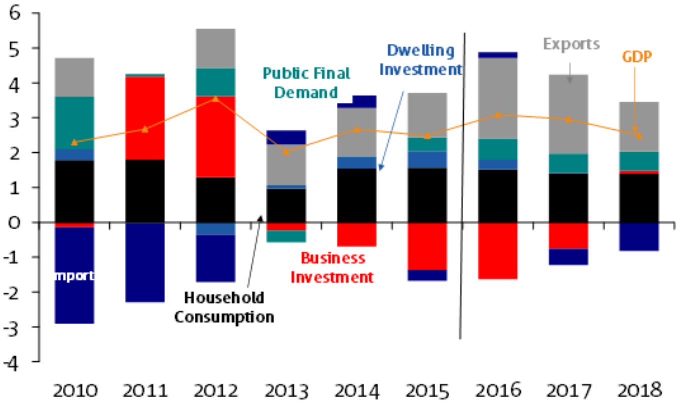


General uncertainty may also weigh on demand for labour if uncertainty continues for an extended period. Again this is impossible to quantify, although employment will continue to be supported by the shift towards labour-intensive services sectors.

There is also a risk of a slightly higher AUD, particularly if the Fed delays its next rate hike until late in the year, with our AUD forecasts currently under review. So far however, the impact on the AUD has been relatively muted.

Bringing this together, these potential implications suggest some modest downside potential to our current moderate and stable GDP growth forecasts (3.1% in 2016, 3% in 2017 and 2.5% in 2018), and some modest upside risk to our unemployment forecasts (decreasing slightly to 5 ½% by mid-2017 before inching up in 2018). A hard landing for the Chinese economy would be of much greater concern to the Australian economy than Brexit.

Real GDP growth (with NAB forecasts)



Source: NAB, ABS

In terms of Australian monetary policy, our core view remains for the RBA to remain on hold although heightened global risks suggest a higher probability of a rate cut in coming months. The RBA appears to be a "reluctant" cutter, and a cut at the July meeting appears unlikely given the relatively orderly financial market movements to date and a desire to see how the dust settles. In addition, the RBA would prefer to have an up-to-date reading on inflation pressures, which suggests any upcoming cut would be more likely in August after the release of the Q2 CPI on 27th July.

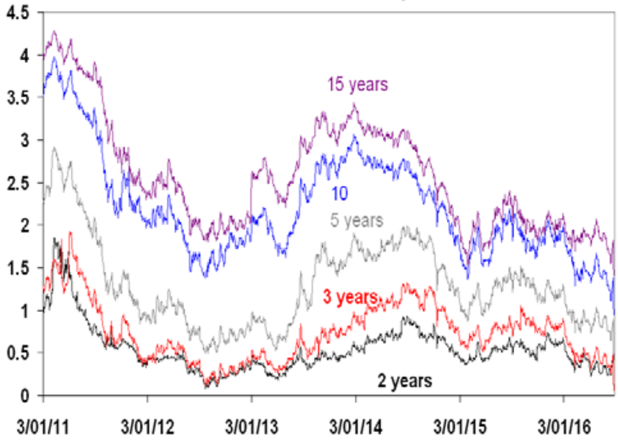
The UK & Global Economies - There are more questions than answers

The impact of Brexit on the UK economy has been hotly debated but the consensus of opinion has been that it will have adverse consequences for economic growth and incomes. The precise magnitude of the loss depends on all sorts of assumptions

- What sort of market access deal will the UK get for its goods and services into the EU if it leaves?
- How big an adverse impact the lower working age population that stems from potential lower immigration as well as the loss in productivity that could come from less openness to trade with the EU will have on the pace of growth.
- How rocky will the road be toward reaching a satisfactory deal between the EU and UK prove to be and how will that affect business confidence, investment and hiring decisions.
- Could other countries now be more willing to leave the EU or Euro-zone? (eg Denmark from the EU)
- Will global financial markets settle down once they have got over the shock of the UK vote and recall that the UK is only 2.4% of the global economy? If they do, that limits the damage inflicted by wealth losses from lower share prices.

So far, however, despite concerns over the UK's fiscal and current account deficits and the country's need to attract external funding, one area that has not shown much impact has been the sovereign bond market. Unlike in the Euro-crisis when spikes in sovereign bond yields highlighted eroding creditworthiness, UK bond yields have stayed down – despite the ratings downgrades from Fitch and S&P.

UK Government bond yields



With nearly half of UK exports going to the EU, accounting for around one-eighth of total UK GDP and millions of jobs reliant on the EU trade, the stakes are considerable. The UK economy will clearly take a hit and some analysts say recession looks inevitable, but it is too early to go that far. UK growth has been running around 2% annually. It could easily fall into the range of 1% to 1½% through the next few years, with the risk of markedly weaker outcomes in the near term as business plans are put on hold because of uncertainty.

There are two issues here:

- What is the immediate impact on growth as financial markets, business and households adjust to the likelihood that the UK will leave the EU – the size of that effect depends on the extent to which markets remain volatile, business defers plans, the Bank of England responds with lower interest rates and the drop in Sterling lifts UK competitiveness. This is the area of greatest uncertainty as so much of this is simply unknown.
- The longer term impact on growth - and here we have more information to go on. If the UK gets

continued access to the EU single market, the loss in output might be a loss of 2 or 3 percentage points by 2020. Deals that produce more restricted access generate bigger losses in output with some finding losses of 5 to 8% in GDP out to 2030 quite possible.

As a shock like Brexit must have some impact on growth we are inclined to cut our UK growth forecast track (1.8% this year and 2% in 2017 and 2018) to around 1% in each year. Given that the UK accounts for 2.4% of the world economy, the direct effect is barely enough to shift global growth from the 3% track we were already predicting. However, if the Euro-zone's promising upturn falters, that is much more significant as it accounts for 12% of the world economy. So far, the Euro-zone's growth has been based more on rising domestic demand than export led growth which its leaders see as a sign of resilience in the face of Brexit. If we flat-line Euro-zone growth at 1% through the next few years, that still leaves global growth not far off 3%. This lack of impact reflects the way that big emerging market economies like China and India have been responsible for the bulk of global growth for some time and their expansion looks set to continue, despite Brexit and the problems it poses in W Europe.

Consequently, it takes Brexit to flow into something much bigger that has a substantial lasting negative impact on markets and economies outside the UK to significantly derail our forecast of continued, albeit sub-trend, growth.

The obvious risk here is that the public opinion that produced Brexit is strong in other parts of the EU as well and we have general elections next year in France and Germany with anti-EU parties polling very strongly in the former. Then there is the ongoing political uncertainty in Spain as another minority government looks likely as well as the vote on reforms coming up in Italy, another country where anti-Euro parties are polling strongly. It is this political uncertainty that presents much of the uncertainty now hanging over the EU economy.

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