BREXIT AND WORLD GROWTH

by NAB Group Economics

12 July 2016

- **The UK is expected to enter a shallow recession post Brexit.**
- **Direct implications of this for the world economy aren't large.**
- **However, spillovers to other countries or regions could lead to a more significant impact on the world economy. The most obvious concern is Europe, whose share markets have already been hit hard.**

In our latest global forecast update we revised down our United Kingdom (UK) year-average GDP growth forecasts in the wake of the UK vote to leave the European Union (EU) – so called Brexit. We expect to see a shallow technical recession in the UK around the turn of the year.

In this note we look at what such a slowdown might mean for growth in the rest of the world.

The main finding is that, by itself, a UK slowdown has relatively little impact on global growth. The main risk to global growth comes from the extent to which financial market disruptions and uncertainty also impact other countries, in particular the rest of Europe.

Short-term impact of Brexit on the UK

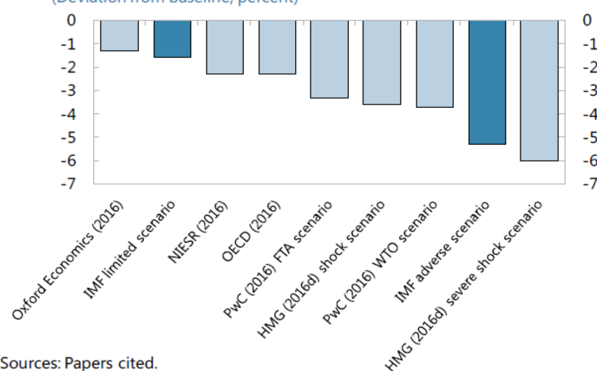
At this stage there has been no change in the UK's relationship with the EU as the referendum on 23 June 2016 was not a formal trigger for exit. The process could take several years depending on the approach taken to exit (and how the EU reacts to it).

Nevertheless, even before exit occurs, there can be an impact on the UK economy. This reflects several, inter-related, factors:

- The referendum result has created lots of uncertainty - the form exit will take, and the nature of the UK's future relationship with the EU is unknown. This is most obviously a concern for businesses that trade with the EU, but also for individuals employed by those firms, and for others such as EU nationals residing in the UK (will they able to stay?).
- Increased uncertainty is generally a negative for economies. It can result in financial market volatility and lead to risk aversion and market stress. Faced with an uncertain future, businesses may defer investment decisions and households may defer major purchases.
- While studies of the long-run economic impact vary from the positive to the negative, the general finding is that the impact will be negative for the UK. This reflects the impact on productivity from a less open economy, the direct impact on trade from tariff and non-tariff barriers with the UK's major trading partner (the EU), the possibility of reduced net immigration, and industry specific issues such as the loss of 'passporting' rights for the financial sector.
- Expectations of reduced future income can have an effect now, particularly in forward looking markets such as share markets. Any wealth affects can also affect consumer behaviour.

Reflecting these considerations, assessments of the short-term impact (made prior to the referendum of a vote to leave) were for a negative impact on activity. This can be seen in the chart below, taken from an IMF report released at the start of June. The change to our UK forecast is consistent with around a 3ppt reduction in GDP by end 2018 is in the middle of the range reported by the IMF.

Estimates of Short-term Brexit impact on UK economy

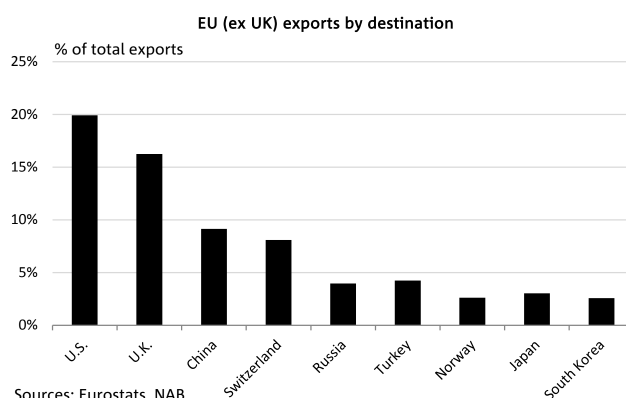


Source: IMF Country Report No.16/169, United Kingdom, Selected Issues, June 2016

Trade linkages to the UK and the European Union

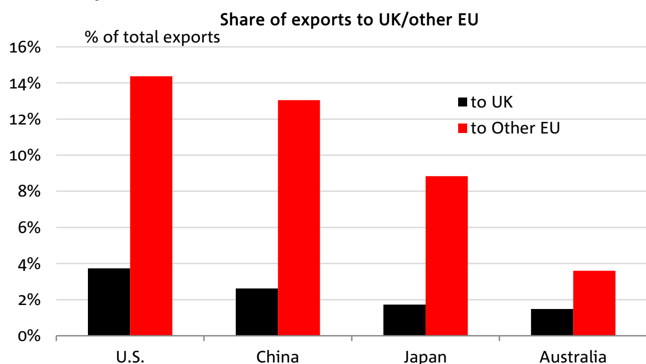
Not surprisingly, trade ties between the UK and the rest of the European Union (EU) are strong. In 2015, 47% of the UK's goods exports were to the EU. The UK is less important to the rest of the EU, but with an export share of above 15%, it is still their second most important export destination, only falling behind the US. Of course, within the EU, the exposure to the UK varies widely, with countries such as Ireland, Netherlands and Belgium more closely linked.

UK is an important goods export destination for other EU members



However, for other major economies outside the EU, the linkages to the UK are minor; less than 5% of US, Chinese and Japanese exports go to the UK. However, the whole of the EU is far more significant, accounting for 15-20% of US and Chinese goods exports.

Rest of the EU more important than UK to world economy



Sources: Econdata DX (CEIC), Eurostats, U.S. Census Bureau, NAB

Implications for the Rest of the World

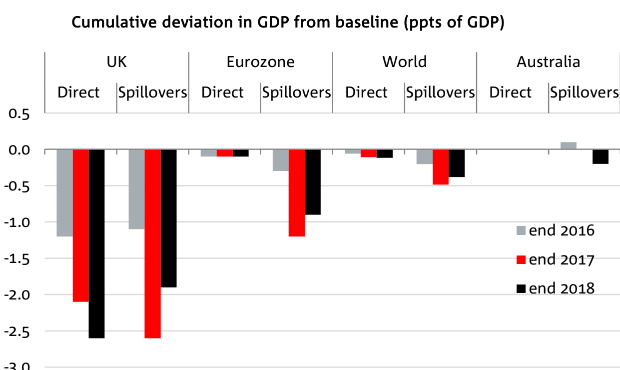
With exports to the UK only a small part of other major economy trade this might suggest a limited impact on the global economy. However, a trade focus is too narrow as it ignores potential spillovers from financial markets and confidence.

To test the implications of Brexit we ran two scenarios through an integrated global economic model (from Oxford Economics).

- Direct impact scenario: The first involves incorporating a shock similar to that we have built into our own forecasts directly into the key GDP variables such as consumption and investment.
- A ‘spillover’ scenario: The second approach is to generate a similar sized shock but to change variables that explain why consumption, investment etc might decline. Specifically, this was done by variables relating to equities, financial market stress, spreads and confidence. Immediate (non-trade) spillovers to Europe were also included (proxied using an equity price shock a somewhat larger than we have already seen).

The results from these two approaches of modelling a similar sized UK downturn on the world economy are shown in the chart below.

Contagion to Europe – the main risk to global growth



Source: NAB

What they illustrate is that while the direct impact of a shock to the UK (primarily through trade) is small, the potential fall out for the world economy could be more significant if some of the negative factors at play - asset market declines, financial market stress or a loss of confidence – spill over into other countries or regions such as the rest of the EU. This is not surprising when considering that the UK’s share of the global economy in 2015 was around 2.4% while the rest of the EU was a far more significant 14.6%.

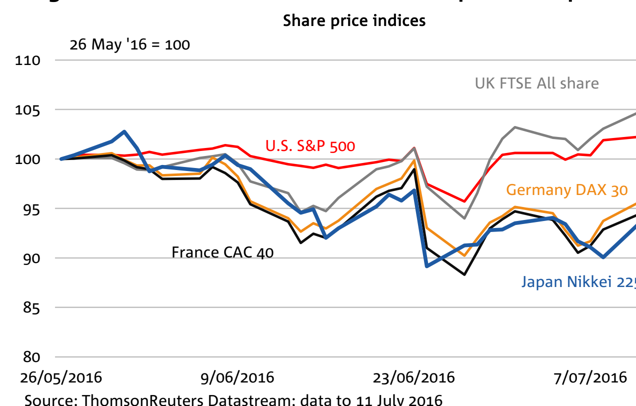
In the scenario we have modelled, the uncertainty and financial market spillovers, particularly to Europe, lead to a peak decline in world GDP of 0.5ppts relative to baseline. It is worth noting that in either scenario, the impact on Australia is small; the ‘spillover’ scenario generates a depreciation of the Australian dollar which limits the impact on real GDP growth. See our recent research note, Brexit – what does it mean for the Australian economy? for more discussion of the impact on Australia.

That there would be some impact on the EU outside of direct trade impacts would be expected. While it was the UK’s decision to leave, the rest of the EU now (involuntarily) faces the prospect of being in a smaller trading block, with some of the same negative consequences. Moreover, there are concerns that the UK vote will trigger similar pressures in other EU countries which could even threaten the existence of the EU at the extreme. Of course, there are some differences; if UK growth were to be negatively affected by business (such as banking or manufacturing) moving to other EU countries or by reduced immigration from EU countries then this a positive for the EU.

So far, while there are signs of spillovers to Europe, some financial market indicators have held up better than others, suggestive of an outcome somewhere in-between the two scenarios at this early stage.

The UK vote has already had an impact on European stock markets. Other European stock markets actually fell by more than the UK market following the referendum and have only partially recovered their losses. Indeed the UK stock market is higher than it was pre-referendum (possibly reflecting translation benefits to profits of overseas operations from the large devaluation in the Pound).

Large decline in share markets in Europe and Japan

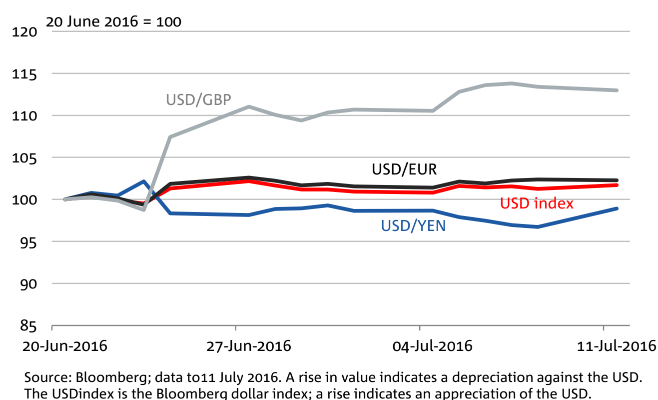


Source: ThomsonReuters Datastream; data to 11 July 2016

While the rest of the EU is the most obvious location to feel the brunt of the Brexit decision, it is possible that it could

also trigger a loss of confidence in other regions. For example, a similar size fall in the stock market has been seen in Japan. Part of the explanation for this may lie in the strong appreciation of the Yen since Brexit – reflecting 'safe haven' flows – and the negative impact on Japan's competitiveness. However, this would also represent an improvement in competitiveness for other countries; currency moves while potentially important for individual countries should generally not have much impact on global growth.

Currency moves since the UK referendum



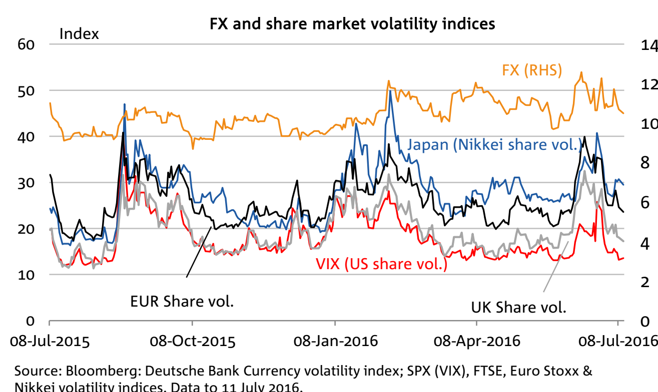
Source: Bloomberg; data to11 July 2016. A rise in value indicates a depreciation against the USD. The USDindex is the Bloomberg dollar index; a rise indicates an appreciation of the USD.

Looking at changes in other financial market measures since the Brexit vote, the only one that stands out are long-term government bond yields. Corporate spreads in Europe did increase somewhat but quickly stabilised. The US VIX – the so-called fear index – quickly fell back after an initial jump; similar measures for other countries also stabilised fairly quickly although they remain a bit above their typical level.

In contrast long-term government bond yields have fallen substantially across a range of countries, including the US, as well as the more obvious candidates of the UK and Europe. While lower interest rates are, by themselves a positive for growth, they can also reflect a negative view of future growth prospects (or inflation pressures). If this view were to be proven correct, then the low yields only serve to mitigate the consequences. The decline in yields may also reflect expectations of monetary policy easing (particularly in the UK and Eurozone) or a delay to rate hikes (US Fed).

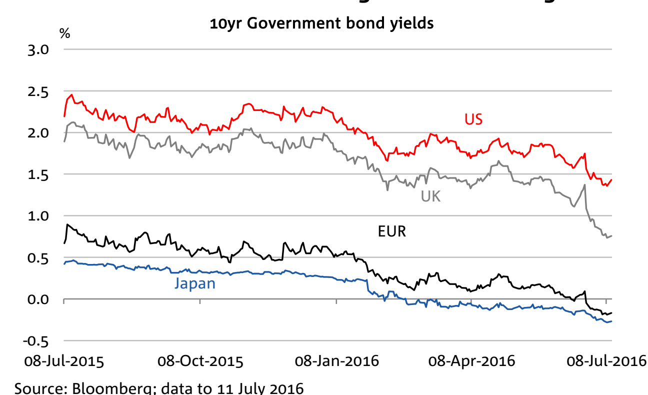
Spreads and volatility indices have generally stabilised…

Source: Bloomberg (U.S. LUCI, ITraxx Europe). Data to 8 July 2016.



Source: Bloomberg: Deutsche Bank Currency volatility index; SPX (VIX), FTSE, Euro Stoxx & Nikkei volatility indices. Data to 11 July 2016.

…but bond markets are sending a downbeat signal



Source: Bloomberg; data to 11 July 2016

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