Policy Brief

BREXIT AND ITS AFTERMATH: IMPACT AND POLICY RECOMMENDATIONS FOR ASIA

Aédán Mordecai, Pradumna Bickram Rana and **Phidel Marion G. Vineles**
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Executive Summary

This policy brief focuses on the implications of Brexit for Asia and particularly the ASEAN countries. A brief summary of the recent developments and an assessment of the impact of Brexit on Britain and the EU is provided, together with the various scenarios that could be realised based on available information. This allows us to assess the economic impact on Asia. Policy recommendations are also made on how Asian countries could respond to the Brexit.

I. Background and Introduction

On 27 July 2016, RSIS' Centre for Multilateralism Studies (CMS) organised its inaugural seminar under its Seminar Series on Multilateralism Studies entitled "Brexit and its Aftermath". The event sought to identify the possible consequences of the United Kingdom (U.K.) leaving the European Union (EU). This Policy Brief builds on the discussions at the seminar and identifies the potential impact of Brexit on Asian countries. It also derives a number of policy implications for these countries.

On 23 June 2016, the people of Great Britain and Northern Ireland went to the polls in a historic in/out referendum to determine whether the country should remain in the European Union or leave. With a victory for the leave camp, the world economy entered a period of prolonged uncertainty, as a significant member departs from the largest trading block in the world. These fears are compounded by signs of a slowing Chinese economy, which has been largely driving economic growth since the global financial crisis of 2007-2009. Several other countries within Europe are also grappling with the rise of far right nationalism. The populist movement has affected the US where recently Donald Trump was elected as the 45th President, on a campaign filled with isolationist rhetoric. Since Asia is highly integrated to the global economy there is much at stake for businesses and governments in Asia. Many are asking the question "how will we be affected by Brexit and what could be the magnitude?". Although it is too early to make precise predictions as the situation is still evolving, several possible scenarios and possibilities can be discussed based on the available information.

The objectives of this Policy Brief are, therefore, to (i) provide a brief summary of the recent developments and immediate impact of Brexit on Britain and the EU (ii) outline various possible scenarios that could evolve based on available information (iii) assess the impact on Asia, and (iv) propose policy recommendations for Asian stakeholders.

II. Brexit – An Update

The referendum result has triggered a chain of events that will eventually lead to Britain leaving the EU. The formal withdrawal process will begin only when the government invokes Article 50 of the Lisbon Treaty. The European members want the process to begin as soon as possible, while the U.K. government wants more time to develop more concrete plans. The latest proposed date is End-March 2017, but a recent High Court ruling of 3 November has put this timeline in jeopardy as the Parliament may have to discuss and vote on invoking the Article. This would only delay the process at most and not reverse it, because doing so would undermine the British democratic system.

The process of exiting will be implemented by the new government from the U.K. side. David Cameron stepped down after the defeat of the referendum and the former Home secretary Theresa May took over as Prime Minister and leader of the Conservative Party. This change also led to a cabinet reshuffle. Several prominent “leave” campaigners have taken key roles in the new government. The newly created position of Secretary of State for Exiting the European Union (or Brexit Secretary) has been filled by David Davis, who has long been a strong Eurosceptic. Two other roles significant to the Brexit process have been filled by “leave” campaigners, with Boris Johnson controversially becoming the Foreign Secretary and Liam Fox becoming the International Trade Secretary. This is the most likely group which will plan for Britain’s exit strategy and carry out the negotiations with the EU. The early rumours of a snap early general election seem to have subsided, though with the opposition Labour Party in disarray, it is unlikely that we will see a change in government.

The reaction of the private sector has been one of shock with a rapid decline in the value of the Pound Sterling and a loss of confidence. Businesses are hesitant to invest until at least a clearer picture of the future unfolds. Foreign investors have also expressed their concern with the situation, as leaving the EU will affect the ability of the U.K. to act as an efficient gateway to the rest of the continent. Britain has tried to calm fears of the public, businesses and investors alike. The new Chancellor of the Exchequer, Philip Hammond, has pledged to fulfil any shortfall in EU funding when Britain leaves the EU until 2020. This covers many areas, including the agricultural sector, as well as research funding for educational institutions. This will hopefully help to normalise the situation a bit. The Bank of England (BoE) has reduced interest rates to a record low of 0.25 per cent and loosened its quantitative easing policy, in order to encourage banks to continue lending in this uncertain period. The U.K. hopes this monetary stimulus will stave off a recession or significant downturn.

Unsurprisingly, the EU was also disappointed with the result of the referendum and has also started planning for a future without the U.K. They are keen to avoid a long period of uncertainty and would like for the U.K. to invoke Article 50 as soon as possible. France and predominantly Germany will be leading the negotiations from the EU side. Although official discussions cannot begin until Article 50 is invoked, informal bilateral discussions between the U.K. and some EU member states have likely taken place already. Upcoming elections in the major EU member states, such as Germany and France later this year, further complicate matters when attempting to make any prediction.

Europe is fighting off further exits from the union by other disillusioned members. Eurosceptic parties within Europe are lauding the Brexit decision and promising an in/out referendum if elected. France’s nationalist Le Pen party is possibly the biggest danger to EU’s future as a union, with the presidential election in 2017 expected to be tightly contested. Europe is also facing challenges with slow growth in the major economies, with economic woes continuing in Greece. The Eurozone is also flirting with deflation. Brexit has brought up serious questions about the future of the Transatlantic Trade and Investment Partnership (TTIP), the proposed trade agreement between the EU and the USA, with senior figures in Europe casting doubts as to whether it can be completed. The future direction of member states and the ability for the EU to handle the refugee crisis stemming from the Middle-East, and the ongoing economic malaise will determine the EU’s status in the future.

III. Political and Economic Scenarios

It is not possible to predict accurately what the relationship (both economic and political) between the U.K. and the EU will look like in the future. We can, however, draw up three broad potential scenarios that could evolve in the next five years or so.

Scenario 1
Limited Short Term Damage

The "best case" scenario is that the economic implications from Brexit are largely limited to the British Isles. If negotiations go well with the EU, and the U.K. can swiftly resolve an exit package, we have a "Soft Brexit" scenario where investor confidence will be restored soon. The loss of economic output will be minimised and Britain will quickly return to the pre-Brexit level of growth. Britain may even benefit if advantageous trade deals can be negotiated with countries outside the EU. The EU could also benefit from a resilient U.K. as the knock on effect is minimised.

Under this scenario, the EU as a political bloc would also be able to function more coherently. This is because Britain's departure would permit the social democratic members, which make up the core of the EU, could consolidate with less compromise in the future. As a result of greater shared ideology and one less "big power", the EU could be more efficient.

Scenario 2
Stagnation and Contagion to EU

Under the second scenario, we would witness a difficult and protracted period of negotiations between the U.K. and the EU. Negotiations would stall, for example, on the U.K.'s reluctance to accept freedom of labour movement. The outcome could be either an unfavourable deal for the U.K. or a "Hard Brexit" where the U.K. cuts all ties with the EU. A "Hard Brexit" would mean the U.K. leaving not only the political union, but also the single market and customs union. The U.K. would then have to negotiate new deals not only with the EU, but also the countries that the EU has trade deals with. The latter presently stands at 50, with many others under negotiation. Resolving this matter will be a monumental task which would take years, especially given the limited trade negotiating capacity of the U.K. Previously, the U.K. had relied on the EU to negotiate trade agreements on its behalf. The "Hard Brexit" scenario would have serious adverse impacts on the U.K. in the short to the medium term. A recession would also be likely in the U.K. The hugely significant financial sector of the U.K. will be hurt, as they lose the "passporting rights" which allows them to operate within Europe with no barriers or complications. Europe would also be adversely affected, as the U.K. is a significant member of the Union both economically and politically and with regards to regional security. The already low growth in the region would likely slow further after Brexit. Economic stagnation in EU would result in higher unemployment and political strife could increase, putting pressure on the region and beyond.

Scenario 3
Dissolution of the Union

The final scenario is the "worst case" scenario under which we could witness the breakup of the EU. This scenario would lead to major political and economic upheaval in the EU. The dissolution of the EU would result in a global economic crisis with a magnitude similar to that of the Great Recession, following the global financial crisis of 2008-2009. With national elections due in the major EU members within the next 18 months, political stability in the region is fragile. Many nationalist parties are threatening the previously-dominant political parties. Referendums could be held and other countries could also follow the path of the U.K. and pull out of the EU. Anti-EU groups from France, the Netherlands, Germany, Italy, Austria, Sweden and Denmark have all been encouraged by the Brexit vote and will be pushing for their own referendums on the issue. The far right National Front (FN) Party of France and the Dutch Party for Freedom (PVV) represent the main threat to a major EU member exiting the EU.

At present, it looks as though Scenario 2 or the "Hard Brexit" scenario will be the most likely one to be realised. This is because the U.K. Prime Minister has prioritised greater control over the country's borders, leaving the U.K.'s future position as part of the single market seriously at risk. Donald Tusk, President of the European Council, has also said that “Hard Brexit” will be the only course available unless the U.K. changes its demands. Given this situation, it is believed some members of the cabinet and senior members of the Conservative Party are advocating a quick “Hard Brexit” instead of a long drawn out scenario.

One caveat to the prospect of a “Hard Brexit” is the High Court Ruling that stated that the government will have to get approval from Parliament before invoking Article 50. If the government’s appeal to the Supreme Court to overturn the High Court Ruling fails, then the likelihood of a “Soft Brexit” would be boosted. Opposition parties within Parliament would pressurise the government to be more transparent and make a greater attempt to remain in the single market.

Scenario 3 is unlikely at this point as the possibility of referendums in other European countries is low. In France, the National Front candidate, Le Pen is expected to get to the final stage of their presidential elections but lose to the centre right Republican’s Party candidate, François Fillon. Elsewhere the Dutch Party for Freedom is expected to be the largest single party in the Netherlands, but there is little chance that they would be able to form a governing coalition. Italy, the third biggest economy of the eurozone, has stoked fears that they might leave the single currency, the Euro. These fears come from Prime Minister Renzi’s resignation following his referendum defeat, potentially allowing the populist Five-Star Movement to power in 2017. However, many difficult obstacles still make Italy’s rejection of the Euro unlikely. Austria possibly had the greatest chance of holding a referendum similar to that in the U.K., but Norbert Hofer, competing in the recent Austrian presidential elections, lost in a narrow presidential vote. The examples show that there are a lot of potential “exits”, and though none individually seem likely, developments should be watched carefully to gauge the future of the Union.

IV. Impact on Asia

Table 1: Exports of Asian Countries to the U.K. and EU as a Percentage of Their Total Gross Exports, 1995-2011 (Data Source: OECD-WTO TiVA database)

	1995		2000		2005		2010		2011	
Country	**U.K.**	**EU**	**U.K.**	**EU**	**U.K.**	**EU**	**U.K.**	**EU**	**U.K.**	**EU**
ASEAN	4.03	20.59	3.9	17.07	3.43	15.51	2.4	12.82	2.26	12.68
Brunei Darussalam	0.43	2.18	0.17	2.36	0.05	1.32	0.07	1.09	0.1	0.87
Cambodia	2.11	8.88	4.86	18.13	4.34	19.63	5.51	21.32	6.53	22.66
China (People's Republic of)	2.78	17.15	3.5	17.71	3.23	19.82	3.06	19.92	2.98	18.62
Chinese Taipei	2.29	13.95	3.47	14.79	1.79	10.35	1.48	8.29	1.56	7.62
Hong Kong, China	2.95	14.14	3.53	14.89	3.42	13.21	2.62	11.16	2.83	12.32
India	5.66	26.52	6.04	24.67	8.49	27.45	6.39	24.15	5.49	25.15
Indonesia	2.84	16.8	2.39	13.43	1.82	12.23	1.1	9.02	0.94	9.27
Japan	3.58	17.28	3.31	15.44	2.93	14.67	1.91	10.27	1.92	9.6
Malaysia	4.39	16.95	3.76	13.33	2.45	11.18	1.4	7.96	1.26	7.65
Philippines	2.95	16.48	4.21	11.84	2.31	9.3	1.55	9.42	1.35	9.54
Singapore	3.27	15.97	3.1	14.08	4.25	15.25	3.31	13.86	3.24	13.09
South Korea	2.1	13.78	3.07	14.31	1.81	14.17	0.98	10.1	0.93	8.66
Thailand	3.34	20.18	3.1	16.38	2.89	13.8	1.97	10.18	1.75	9.9
Viet Nam	2.31	19.07	3.13	20.73	3.06	16.07	2.01	13.93	2.29	15.56

*Trade Data for Myanmar and are not Laos not available

The direct impact of Brexit on Asian countries can be assessed by analysing the shares of their total exports which go to the U.K. and the EU.

The data in Table 1 show that the share of Asian countries' exports destined to the U.K. is relatively low (only about 2-3 per cent). The only exceptions are India (5.3 per cent) and Cambodia (6.5 per cent). Besides, in most cases, the export share of the U.K. in Asian exports has been falling in recent years. Therefore, the impact of Scenario 1 on Asian countries would be modest and manageable.

The data also show that, as expected, the share of Asian country's exports going to the EU are higher but still, in most cases, they less than 10 per cent of the country's total exports. The exceptions are India (25.2 per cent), Cambodia (22.7 per cent), China (18.6 per cent), Vietnam (15.6 per cent), Singapore (13 per cent), and Hong Kong (12.4 per cent). This means that the adverse impacts of Scenario 2 (where the entire EU is affected by Brexit) on Asian countries will be higher than that of Scenario 1 with the adverse impacts dependent of the share of their exports going to the EU. India, Cambodia, China, Vietnam, Singapore, and Hong Kong will be affected the most.

If Scenario 3 were to be realised with the breakup of the EU as well as strong contagion to the rest of the world, then Asian countries, which are heavily integrated with the global economy, would be affected a lot more seriously. Asian countries would experience sharp economic slowdowns as they did during the time of the global financial crisis in 2008-2009. Some countries would also experience economic recessions. There would also be financial instability in the region, as the existing financial safety nets are unlikely to be adequate to prevent a crisis.

Summing up, as mentioned in Section IV, however, the likelihood of Scenario 3 unfolding in Europe at the present time is low and should not be a concern. The most likely scenario is Scenario 2 where the entire EU would be adversely affected by the Brexit. The direct impact of this scenario would be quite serious in Asia with some countries being more affected than others, depending on their export shares going to the EU.

V. Policy Recommendations

Some have argued that the main lesson to Asia from Brexit is that Asia should be cautious and slow its pace of regional economic integration. But this is not correct. The main lesson is that Asian countries should be more aware of the benefits and costs of economic integration and try to ensure that these are more evenly distributed, so that the groups of people will not be left behind. In the EU, many of the rules, including those related to immigration, were agreed at the supranational bodies in Brussels and were implemented by the member countries without regard to the impact that they might have on the rural and the relatively uneducated population. This led to the erosion of trust with the political establishment within this class of the population and they chose to vote for the “leave” campaign. As compared to the “top-down” EU approach to economic integration, the Asian approach is “bottom-up” and so the likelihood of disenchantment among any segments of the population is unlikely.

A number of policy implications for Asian countries could also be derived. First, as discussed above, the most likely scenario is Scenario 2 where the entire EU could experience an extended economic slowdown if not an economic recession. This means that the demand for Asian exports will be low. Asian countries should therefore “rebalance” and find regional and domestic sources of demand. At the regional level, they should continue to negotiate and sign bilateral Free Trade Agreements with neighbouring countries. They should also expedite the on-going negotiations on the RCEP, which is an FTA among the ASEAN countries and its six dialogue partners. At the domestic level, Asian countries should seek to promote domestic demand, mainly consumption demand. This is easier said than done, however, because it requires the establishment of social safety nets and the provision of healthcare and education benefits to consumers.

Second, Brexit could lead to a pull out of capital from the Asian countries, as the U.K. and other EU members attempt to meet the needs of domestic investors. This, in turn, could lead to financial instability in Asian countries. Asian countries should, therefore, strengthen their ASEAN+3 Financial Safety Net which comprises the Chiang Mai Initiative Multilateralization (CMIM), a $240 billion crisis fund, and the ASEAN+3 Macroeconomic Research Office (AMRO), the CMIM’s surveillance unit.

Third, efforts should also be made to address the development gaps among countries. A case in point is ASEAN, which is trying to translate the benefits of economic integration into the closure of development gaps, both within the region and within countries through the Initiative for ASEAN Integration. Work Plan III for this Initiative, part of the larger ASEAN 2025 goals, which has been recently announced will help. Trade facilitation, governance and capacity in customs, harmonisation of rules and regulations and standards and codes are the key strategic areas of this new Work Plan (ASEAN, 2016).[1]

Finally, the countries in the region should strive to enhance competitiveness. The ASEAN Economic Community (AEC) was announced in 2015. Since the establishment of the AEC is an on-going process a new vision, the AEC 2025, has been announced. The new vision seeks to establish a networked, competitive, and innovative ASEAN by 2025. This vision should be supported.

[1] ASEAN (2016) *Initiative For ASEAN Integration (IAI) Work Plan III*, The ASEAN Secretariat, August

ABOUT THE AUTHORS

Aédán Mordecai is a Senior Analyst at the Centre for Multilateralism Studies (CMS) at the S. Rajaratnam School of International Studies (RSIS), Nanyang Technological University. Prior to his appointment at CMS, he has worked in Taiwan and China. His research interests include comparative international development, globalisation, and political and economic risk analysis. He completed his undergraduate studies in Geography at King's College London and his master's degree in International Political Economy at RSIS.

Dr Pradumna B. Rana is Associate Professor and Coordinator of the International Political Economy Programme at the Centre for Multilateralism Studies (CMS) of the S. Rajaratnam School of International Studies (RSIS), Nanyang Technological University (NTU). Prior to this, he worked for 25 years at the Asian Development Bank. His last appointment at the ADB was Senior Director of the Office of Regional Economic Integration which spearheads ADB's support for Asian economic integration. He obtained his PhD from Vanderbilt University where he was a Fulbright Scholar and a Masters in Economics from Michigan State University and Tribhuvan University. He has authored/edited 15 books, and published over 50 articles in peer-reviewed international academic journals.

Phidel Vineles is a Senior Analyst at the Centre for Multilateralism Studies (CMS) at the S. Rajaratnam School of International Studies (RSIS), Nanyang Technological University. He holds a Bachelor's degree in Asian Studies from University of Santo Tomas, Philippines and a MSc in International Political Economy from RSIS, Singapore. Prior to joining RSIS, Phidel worked as an Information Officer at the Philippine Institute for Development Studies (PIDS), where he wrote press releases about PIDS research studies and disseminated them to the institute's media contacts and affiliated institutions. He was also part of the institute's Public Affairs unit, organising conferences held in the institute. He had also worked both in a private sector and non-governmental organisation in the Philippines.

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