TRADE AND INVESTMENT NOTE

BEYOND BREXIT:
POTENTIAL IMPLICATIONS FOR AUSTRALIAN TRADE AND INVESTMENT

JULY 2016
Austrade has made reasonable efforts to confirm the accuracy of the information contained in this paper. However, it has relied on external sources and cannot guarantee the accuracy of that information. Readers should not rely on the information provided and should make their own inquiries when making trade and investment decisions.
BEYOND BREXIT:
POTENTIAL IMPLICATIONS FOR AUSTRALIAN TRADE AND INVESTMENT

Key points

- This note takes a preliminary look at some of the potential consequences of the 23 June 2016 Brexit vote for Australia’s trade and investment relationship with the UK in particular, and with the EU more generally.
- In the **short term**, the main risk is that greater uncertainty leads to slower UK and EU growth that will depress demand for Australian exports into Europe.
- In addition, the contribution of a weaker UK and European growth performance, plus any adverse global market reaction, will put at least some downward pressure on world growth overall. This could lead to lower commodity prices, which would further depress total Australian export values.
- There is also scope for large currency movements that would lower the relative competitiveness of Australian exports to the UK and EU.
- The short-term impact on foreign direct investment (FDI) flows from the UK and the rest of the EU is less clear, although it seems possible that the general increase in economic uncertainty might encourage some businesses to postpone or even cancel some investment projects, including outward FDI.
- In the **longer term**, a key risk is that higher trade costs and other adverse supply side consequences associated with less favourable access to the EU Single Market work to depress UK growth and wealth, which would in turn mean weaker demand for Australian exports than would have been the case absent Brexit. A less wealthy UK economy could also lower the profitability of UK businesses, with potential knock-on effects on the funds available for overseas investment, including into Australia. There could also be negative implications for those Australian businesses that currently use the UK to access the rest of the EU. The importance of these kinds of effects will depend on the nature of the agreement(s) the UK now negotiates with the EU, the time taken to negotiate them, and the amount of uncertainty generated in the meantime.
- On the other hand, it is also possible that reduced access to the EU could prompt a shift in the future direction of UK trade and investment flows. Post-exit, UK businesses might be more inclined to invest in and trade with markets outside the EU, including Australia. In addition, if the UK were to revert to WTO rules for its trade, it would then be able to **reduce** some import tariffs that are currently imposed as part of its membership of the EU customs union. Some of these tariffs (particularly in the case of agriculture) are currently quite high by developed country standards. Finally, there might be scope for an Australia-UK free trade agreement.
- Australia’s existing trade ties with the UK are now relatively modest, indicating a low level of overall export exposure (exports of goods and services to the UK are only about 0.5 per cent of GDP), although the UK is an important market for Australian services exports. Export reliance on the EU as a whole is larger, but still relatively limited. FDI ties with both the UK and EU are much more significant.
- One hard to quantify but potentially significant tail risk is the possibility that Brexit prompts further disruption within the EU, even to the extent of an unravelling of the EU and the Single Market itself. That would imply a much greater disruption to regional and global trade and investment flows. This would also produce a much bigger hit to global growth, with larger second-round consequences for Australia’s trade and FDI outlook.
- The vote for Brexit further complicates an already-complex and challenging global environment. It also sounds a warning about the potential for rising protectionist pressures more generally to the extent that some voters may now be more inclined to reject the broader case for open borders.

Mark Thirlwell
Chief Economist
Sources:


PWC. *Leaving the EU: Implications for the UK economy*. PWC (2016).
ANALYSIS

Limitation of this analysis

This note takes an early look at some of the potential implications of last month’s vote for Brexit. The focus is on Australia’s trade and foreign direct investment (FDI) relationship with the United Kingdom (UK) in particular, but also with the European Union (EU) more generally.\(^1\) It sketches out some of the potential channels through which recent developments are likely to influence bilateral trade and FDI flows, highlights some of the key issues in play, and provides a brief overview of existing ties. Given that we are very early in the process and that a high degree of uncertainty still surrounds eventual outcomes both for the UK and for the rest of the EU, this note is not intended to provide a definitive assessment but rather seeks to canvass some of the possibilities.

Much of the following is based on the analysis presented in IMF (2016a, b), OECD (2016) and HM Treasury (2016a, b). For more detail on sources and for further reading, see the list provided at the start of this note.

Brexit begins

To the surprise of pollsters, financial markets and betting agencies, on 23 June 2016 the UK voted to leave the EU: 51.9 per cent of those voting opted for leave against 48.1 per cent for remain. Turnout was 72 per cent.

UK Prime Minister David Cameron subsequently announced that he planned to resign and said that his successor should be the one to decide when to trigger Article 50, the mechanism which would see the UK exit the EU.

The immediate economic and financial reaction was negative, pretty much as expected. Sterling slumped to multi-decade lows against the US dollar, accompanied by high market volatility; the yield on UK 10-year gilts fell to a new record low, and the FTSE 100 share index also sank. Internationally, investors fled to safe havens as global stock markets lost more than US$2 trillion of value in their worst day since at least 2007. The Eurozone was particularly hard hit, with share prices in continental Europe falling by even more than those in the UK. Subsequent days brought continued market volatility along with sovereign ratings downgrades by Standard & Poor’s and Fitch, although by the end of the first week there were signs that markets were stabilising.

At the time of writing, the consensus view among market watchers was that the Brexit vote would not be another ‘Lehman Brothers moment’ for the world economy, despite some angst about the health of European banks.

---

\(^1\) The EU currently has 28 members: Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the UK.
Market impact 1: UK 10-year government bond yield

Per cent

1.75
1.50
1.25
1.00
0.75


Market impact 2: Sterling against US dollar

£1 = US$ 1.50
1.45
1.40
1.35
1.30


As noted, there has already been a degree of market fallout in the form of some substantial declines in asset prices. If those recent falls were sustained, that could imply some fairly significant and adverse wealth effects, which would in turn be harmful for growth. And if there is further financial volatility in the weeks and months ahead, then these effects will obviously increase. At the same time, higher risk premia may also lead to tighter financial conditions for businesses in the UK and EU, increasing the cost of financing while also reducing its availability.

The negative consequences of these developments are likely to be partially offset by a monetary policy response from the Bank of England and the impact of a weaker currency on UK net exports. In addition, however, any hit to economic activity is likely to be amplified by the high degree of uncertainty triggered by the vote, both in the UK and across the wider EU. The most probable outcome of this increase in uncertainty is likely to be lower investment, consumption and employment than would otherwise have been the case. In the short term, a lower trajectory for economic growth means that there is now a greater risk that the UK falls into recession later this year and through 2017. Weaker UK growth is also bad news for EU growth, as the UK is a major trading partner for the rest of the bloc. There could also be other indirect spillovers acting to drag down overall EU growth even further, for example through the impact on confidence, implying that EU recession risk has also increased.

Another channel for wider Brexit-contagion relates to the region’s banking system, with the Brexit vote triggering an immediate and sharp decline in bank share prices across the Eurozone as well as the UK.

---

2 In fact, the decline in gilt yields noted above has actually allowed UK total corporate borrowing costs to fall slightly over recent days. Bank of England (2016).
The majority of the economic modelling produced in the run-up to the Brexit vote suggested the potential for a significant shock to UK growth rates over the next couple of years. Before the vote, the IMF, for example, put the short-term hit to output at between 1.3 per cent and 5.2 per cent of UK GDP, while the UK Treasury was more pessimistic, with a forecast GDP loss ranging from 3.6 per cent to six per cent of GDP. According to the UK Treasury, Brexit 'would cause an immediate and profound economic shock creating instability and uncertainty which would be compounded by the complex and interdependent negotiations that would follow . . . the effect of this profound shock would be to push the UK into recession and lead to a sharp rise in unemployment.' For its part, the Bank of England warned back in March this year that the Brexit referendum brought with it ‘near-term domestic risks to financial stability’.

The consensus forecasts for GDP growth (per cent)

<table>
<thead>
<tr>
<th>Country</th>
<th>Pre-Brexit vote (13 June)</th>
<th>Post-Brexit vote (28 June)</th>
<th>Change to forecast after vote</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>1.9</td>
<td>2.1</td>
<td>1.4</td>
</tr>
<tr>
<td>Eurozone</td>
<td>1.6</td>
<td>1.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Germany</td>
<td>1.7</td>
<td>1.5</td>
<td>1.8</td>
</tr>
<tr>
<td>France</td>
<td>1.5</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Italy</td>
<td>1.1</td>
<td>1.2</td>
<td>0.9</td>
</tr>
<tr>
<td>Spain</td>
<td>2.8</td>
<td>2.3</td>
<td>2.8</td>
</tr>
<tr>
<td>Memo:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>1.9</td>
<td>2.3</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: Consensus Economics, 29 June

IMF (2016b) and HM Treasury (2016b).
HM Treasury (2016b).
Consistent with pre-vote predictions of a short-term hit to activity, the immediate reaction of market forecasters to the vote has been to downgrade their growth projections for both the UK and the EU. As table 1 shows, before the vote, consensus forecasts had UK growth at 1.9 per cent this year and 2.1 per cent in 2017. By 28 June, the consensus had trimmed half a percentage point from the growth outlook for this year and cut 1.7 percentage points from next year’s projections. For the Eurozone as a whole, the cuts were 0.1 percentage points this year and 0.6 percentage points next year.

Recently, Mark Carney, the Governor of the Bank of England, has said that some of the risks that the central bank had previously warned of ‘have begun to crystallise.’ He noted that portfolio flows into UK equities and corporate debt appeared to have slowed, that adjustments in commercial real estate were threatening to tighten credit conditions for UK businesses, and that there was ‘growing evidence that uncertainty about the referendum had delayed major economic decisions, such as business investment, construction and housing market activity.’

What does this short-term outlook imply for Australian exports?

- There is a clear risk that slower UK and EU growth will depress the demand for Australian exports from Europe. That said (and as set out below), our total direct export exposure to both the UK and the EU is relatively limited, so the impact on overall export values is likely to be modest.

- In addition, the impact of a weaker UK and EU growth performance, plus any adverse global financial market fallout, will put at least some downward pressure on overall world growth. This could lead to softer commodity prices, which would further depress total Australian export values, all else equal.

---

Australia: Nominal exchange rates

![Graph of Australian Dollar to British Pound exchange rates and TWI index, May 1970 = 100, from January 2012 to July 2016.](image)

*Source: RBA and Austrade. Data to 5 July 2016.*

A third channel to take into account is the possibility for further large currency movements that would impact the relative competitiveness of Australian exports to the UK and the rest of the EU. The initial shift in the bilateral exchange rate has seen the Australian dollar move from buying about GBP0.51 on 22 June to a bit more than GBP0.56 by 5 July, which although not negligible, is still within recent fluctuation ranges for the bilateral rate. Australia’s trade-weighted index (TWI) has been little changed over the same period.

The short-term impact on FDI flows from the UK and the rest of the EU seems less clear, although it’s possible that the overall increase in economic uncertainty might encourage some businesses to postpone or even cancel some investment projects.

The longer-term outlook and the role of the European Single Market

In the longer term, the likely impact on bilateral trade and investment flows will be influenced heavily by what happens to the UK’s relationship with the EU, and in particular, its access to the EU Single Market. Currently, nearly half of all UK goods and services exports go to the EU (worth about 13 per cent of UK GDP in 2014), and about a third of the UK’s financial and insurance services exports.7

Membership of the EU customs union currently provides the UK with zero tariffs on exports to and imports from the rest of the EU, along with lower administrative costs of trade. EU membership also gives the UK access to the Single Market, which is intended to deliver deeper economic integration than a standard customs union by turning the EU into a unified economic area without any internal borders or other regulatory barriers to the free movement of goods and services. And EU Membership also gives UK-based firms a ‘passport’8 which provides the right to provide businesses with services across the whole European Economic Area (EEA)9 – something which is of particular benefit to the UK services sector in general and financial sector in particular (services account for about 40 per cent of UK exports).

In addition, EU membership also provides trade access to a range of other countries outside the EU, as the EU currently has trade agreements in force with 60 other economies.

The Single Market also has an important influence on investment flows. The stock of FDI in the UK is currently about 57 per cent of GDP, the UK receives by far the largest share of intra-EU FDI and almost half of the UK’s inward FDI comes from the rest of the EU.10 It seems plausible that a significant share of the FDI received by the UK from both EU and non-EU resources is related to some combination of UK-specific factors plus Single Market access. According to the UK Treasury, for example, almost three quarters of foreign investors cite access to the European market as a reason for their investment into the UK.11 Loss of access to the Single Market could therefore risk a significant fall in FDI inflows alongside any drop in exports, which would reduce UK business investment and the level of the capital stock.

7 Looking at flows in the other direction shows that the value of exports from the rest of the EU to the UK is three per cent of rest-of-EU GDP. Expressed as a share of their GDP, the other EU economies with the largest exposure to the UK through their exports are Ireland, Malta, Cyprus, Belgium and the Netherlands. IMF (2016b).
8 The EU passport is a document issued by national authorities to help service providers going cross-border show that they comply with the requirements applicable to them in the member state to which they want to provide the service in question.
9 The EEA comprises the 28 member states of the EU plus three of the four members of the European Free Trade Association (EFTA): Iceland, Liechtenstein and Norway. (Switzerland, the fourth member of EFTA, is not a member of the EEA.) Note that the EEA agreement excludes agriculture and fisheries, and that EEA countries are outside the EU’s customs union.
10 The largest EU contributors to UK FDI are the Netherlands, France, Luxembourg and Germany.
What happens next?

Article 50 of the Lisbon Treaty sets out the path for a member state to leave the EU, although it has never been used before and its precise implications are still the subject of legal debate. In theory, Article 50 sets out the voting rules for exit (which requires a weighted majority for agreement) and incorporates a two-year deadline on the exit process that can only be extended by a unanimous decision of the other 27 EU member countries. Once it has been invoked, in the event that the UK has not reached an agreement with the EU within that two year period, it would then lose access to the Single Market unless an extension was granted. In the meantime, however, the UK continues to be part of the EU and benefits from / is bound by all of the existing rules of the game as far as trade and FDI are concerned.

There are two important features of Article 50 that are worth stressing.

- First, it’s up to the exiting government to decide when to invoke it. While some EU members have already said that they would like to see things move quickly, on the UK side no notification now looks likely before a new Prime Minister is installed, at the earliest.

- Second, and critically, Article 50 is only about setting the terms of exit. It would not determine future trade or investment arrangements between the UK and the EU. These would need to be agreed in a separate trade agreement. The EU has previously said that such an agreement would need to be negotiated after the UK has left the EU, and indicated it may take several years. For its part, however, the UK would want to secure an agreement as quickly as possible, even ideally as part of the exit process. A further complicating factor is that a new trade deal would in theory require unanimous acceptance by existing EU members, followed by ratification by national (and in some cases regional) parliaments. On one count, more than 30 national, European and regional assemblies would have a veto over any pending agreement.

What might a new UK-EU trade and investment framework look like?

The general view is that post-Brexit trade and investment relations are most likely to fall into one of four broad categories: membership of the EEA (the so-called ‘Norway option’), a bespoke deal (the ‘Switzerland option’), a new UK-EU free trade agreement (FTA), or – as a last resort – a default to existing WTO rules. To at least some extent, UK negotiators seem likely to have to trade-off market access against the amount of independence they want to secure from Brussels: the greater the former, the lower the latter, and vice versa.

Table 2 below, adapted from IMF (2016b), provides a summary of the four options and how they compare. So, for example, under the Norway option the UK would retain membership of the EEA but at the price of submitting to many of the same constraints that the UK’s Leave camp has claimed to find most onerous about EU membership and which have defined much of the case for Brexit. On the other hand, a default to WTO-only rules would remove many of these annoyances but only at the cost of losing much of the UK’s preferential access to the EEA along with passporting rights and hence entail a greater economic hit.

12 Note that some members of the UK ‘Leave’ campaign have in the past argued that the UK would not need to formally trigger Article 50 but could instead rely on unilateral UK legislation. However, according to at least some press reports, going down this route would risk the EU deciding to suspend the UK’s access under the Single Market as a retaliatory measure.
### Table 2: Potential relationships for the UK with the EU, pre- and post-Brexit

<table>
<thead>
<tr>
<th></th>
<th>EU membership</th>
<th>EEA membership (‘Norway option’)</th>
<th>Bespoke arrangement (‘Switzerland option’)</th>
<th>New UK-EU FTA</th>
<th>WTO rules only</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ability to ignore EU rules</strong></td>
<td>Very limited (some UK opt outs)</td>
<td>Limited</td>
<td>Partial</td>
<td>Unknown</td>
<td>Full</td>
</tr>
<tr>
<td><strong>Say over EU rules</strong></td>
<td>Full voting rights</td>
<td>Limited (some formal engagement)</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Access to Single Market</strong></td>
<td>Full access</td>
<td>High</td>
<td>Medium</td>
<td>Unknown</td>
<td>Low</td>
</tr>
<tr>
<td><strong>Passporting rights</strong></td>
<td>Full</td>
<td>High</td>
<td>None</td>
<td>Unknown</td>
<td>None</td>
</tr>
<tr>
<td><strong>Fiscal contribution to EU</strong></td>
<td>Full</td>
<td>Likely slightly less than current</td>
<td>Likely less than current</td>
<td>Unknown</td>
<td>None</td>
</tr>
<tr>
<td><strong>Independent immigration policy</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Independence to negotiate own trade deals</strong></td>
<td>No (represented by EU)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: Appendix II in IMF (2016b).

### Thinking about the longer-term impact of Brexit

The wide range of outcomes that are possible mean that at this stage it is difficult to know what the UK’s trade and investment environment will end up looking like down the track. This injects a large degree of uncertainty into any estimate about what the longer-term impact of Brexit will be on the UK economy, although in many economic models this very uncertainty comes with a short-term economic cost attached, in the form of postponed or cancelled consumption and investment decisions.\(^{14}\)

### Table 3: Selected long-run estimates of impact of Brexit on UK GDP

<table>
<thead>
<tr>
<th>Study</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>PWC (2016)</td>
<td>-1.2</td>
<td>-3.5</td>
</tr>
<tr>
<td>Oxford Economics (2016)</td>
<td>-0.1</td>
<td>-3.9</td>
</tr>
<tr>
<td>IMF (2016b)</td>
<td>-1.5</td>
<td>-4.5</td>
</tr>
<tr>
<td>OECD (2016)</td>
<td>-2.7</td>
<td>-7.7</td>
</tr>
<tr>
<td>NIESR (2016)</td>
<td>-1.8</td>
<td>-7.8</td>
</tr>
<tr>
<td>HM Treasury (2016a)</td>
<td>-3.4</td>
<td>-9.5</td>
</tr>
</tbody>
</table>

Sources: See list of sources at end of this note for detailed references for each study.

The consensus view as represented by the majority of studies reviewed for this note is that the UK will see a permanent net loss in the level of output and income over the long run as a result of Brexit. The estimated scale of those losses varies quite significantly, however, ranging from just 0.1 per cent of GDP in the most optimistic of the

---

\(^{13}\) In 2014 the UK made a net contribution of seven billion euros to the EU budget. This was the third largest contribution among EU members in absolute terms but as a share of GDP (0.3 per cent) it was the ninth largest. (IMF 2016b).

\(^{14}\) And this short-term impact can have longer-term implications, for example through a lower capital stock due to less investment.
scenarios considered by Oxford Economics to 9.5 per cent of GDP in the most pessimistic of the scenarios considered by the UK Treasury (table 3).

In particular, most of these studies assume that the UK would be unable to fully offset any loss of access to the Single Market by switching to other markets. The larger the disruption to trade (that is, the further the UK moves along the spectrum of outcomes towards the ‘WTO only’ option set out in table 2) the greater the predicted economic damage. Likewise, the greater the amount of uncertainty around future trade and investment relationships, the greater the predicted economic damage.

For example, the IMF considers two scenarios based around different levels of uncertainty.\(^\text{15}\) The first assumes only a limited level of uncertainty and envisions the UK converging in a relatively smooth manner to a 'Norway-option' type outcome, while the second assumes that negotiations with the EU do not go well and the UK ends up forced to rely on the WTO-only option. In the case of the former scenario, the modelling results indicate UK output could be lower by about 1.5 per cent in the long run. In the case of the latter, however, the hit to output is assumed to be appreciably larger, at about 4.5 per cent of GDP (see table 3 above).

Some studies also assume that, in addition to the direct losses arising from lower trade, Brexit would also trigger significant falls in UK labour productivity that would further damage economic prospects.

There were also a (much smaller) number of studies produced before last month’s vote that found that the UK could enjoy net gains from Brexit in the long run. In these models, the boost to economic performance comes either from complete unilateral tariff liberalization and/or substantial domestic deregulation following Brexit, combined with new FTAs.\(^\text{16}\)

**Which UK sectors look most vulnerable post-Brexit?**

Subject to the same caveats about the significant degree of uncertainty involved, the IMF judges that the UK’s financial sector and high value-added manufacturing are most exposed to post-Brexit risks.\(^\text{17}\)

Analysis by the UK Treasury suggests that those UK sectors that are closely connected to the EU via supply chains would be particularly vulnerable, including the pharmaceutical, aerospace and automotive sectors, with the pharmaceutical sector in particular quite reliant both on passporting rights and EU sponsorship of joint research and development projects.\(^\text{18}\)

For its part, the OECD sees large negative impacts on food and agriculture, chemicals, metals, transport equipment and financial services.\(^\text{19}\)

\(^{15}\) IMF (2016b).

\(^{16}\) For an example of one of these more optimistic studies see Minford (2016).

\(^{17}\) IMF (2016b).

\(^{18}\) HM Treasury (2016a).

\(^{19}\) OECD (2016).
Longer-term risks and opportunities for Australian trade and FDI

Assuming that the preceding analysis turns out to be broadly correct, there would be two, potentially offsetting, factors at work post-Brexit for Australia’s bilateral trade and investment relationship with the UK in the long run.

- On the one hand, the higher trade costs and other adverse supply-side consequences associated with less favourable access to the EU could depress UK growth and wealth, which would in turn mean less demand for imports. At the same time, a less wealthy UK economy could have knock-on effects on the funds available for overseas investment, including into Australia. There could also be adverse implications for those Australian businesses that currently use the UK to access the rest of the EU. The precise nature and size of these kinds of effects will, of course, depend on the nature of the agreement(s) the UK negotiates with the EU, the time taken to negotiate them, and the amount of uncertainty generated in the meantime.

- On the other hand, reduced access to the EU Single Market could also prompt a shift in the direction of UK trade and investment flows. UK businesses might be more inclined to trade with and invest in markets outside the EU, including Australia, where the UK is already one of our largest direct investors. In addition, if the UK were to revert to WTO rules for its trade, it would then be able to reduce some import tariffs that are currently imposed as part of its membership of the EU customs union. Some of these tariffs (particularly in the case of agriculture) are quite high by developed country standards. Finally, there might also be the opportunity for a future Australia-UK FTA, which could provide additional support for bilateral trade and investment flows (although it’s not clear how long it would take to start and then complete any such negotiation).

What about the implications for Australia-EU trade and investment flows more broadly?

- One hard to quantify but potentially very significant tail risk is that there is at least some possibility that Brexit prompts further disruption within the EU, even to the extent of an unravelling of the EU and the Single Market itself. That would of course imply a much greater disruption to trade and investment flows with Europe overall. There would also be a bigger hit to global growth in this scenario as well, with larger adverse second-round effects on Australia’s economic outlook and export prospects.

How big will spillover effects be from Brexit to the rest of the world?

Another way in which Brexit could potentially influence Australia’s trade and FDI flows is if it has large consequences for any of our other key economic partners. For example, the IMF work reviewed for this note does suggest that while the most adverse effects of Brexit would fall on the UK, other countries would also suffer an economic loss. However, the Fund’s analysis finds that negative spillovers from Brexit to the rest of the world would be concentrated in the rest of the EU, with output falling by 0.2 per cent to 0.5 per cent below baseline in the rest of the EU. The impact on the rest of world beyond the EU is expected to be much more modest, with output only projected to fall by between zero and 0.2 per cent in 2018.

Inside the EU, the Fund highlights Ireland, the Netherlands and Belgium along with Cyprus and Malta as likely to experience the largest losses, with Ireland particularly exposed due to substantial trade, financial and labour force linkages.

Outside the EU, the Fund notes that Hong Kong, Iceland, Norway and Singapore all have relatively high goods and services exports to the UK as a share of their own GDP, while other markets which have the UK as a substantial

---

20 The average tariff rate in 2014 was 5.3 per cent, compared to 3.5 per cent for the United States, for example. IMF (2016b).
21 IMF (2016b).
goods export destination (that is, an export share above the EU average) in Australia's region include Cambodia, Vietnam, Tuvalu, and Fiji.

Other forecasters tend to have similar projections. For example, the OECD estimates that losses to the EU overall would be about one per cent of GDP by 2020, equivalent to about one-third of the size of the loss they predict for the UK in the same scenario.\(^\text{22}\)

It's important to note that, in general, Australia is not considered to be one of the economies most exposed to Brexit fallout. That judgment is confirmed by the analysis below of our existing trade and investment ties with both the UK and the EU more generally, and is likewise supported by the results sketched out here that predict quite limited fallout for most of our largest regional trading partners.

However, one caveat to these judgments is that, as noted above, Brexit could yet prompt more widespread financial market dislocations or disruptions to the operation of the EU more widely, which would have larger spillover implications.

**How important are Australia's trade ties with the UK?**

Last year, the UK was Australia's seventh largest trading partner overall, accounting for about 3.5 per cent of total trade (exports plus imports) in goods and services and our eighth largest export market, taking $8.8 billion of goods and services, or about 2.8 per cent of the total.\(^\text{23}\)

As table 4 below shows, in relative terms the UK is a much more important destination for our exports of services (it is our third largest export market, accounting for more than seven per cent of total exports) than for goods (our 12\(^{th}\) largest market accounting for 1.5 per cent of total merchandise exports).

<table>
<thead>
<tr>
<th>Table 4. The role of the UK in Australian trade (2015)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise</td>
</tr>
<tr>
<td>Exports</td>
</tr>
<tr>
<td>Imports</td>
</tr>
<tr>
<td>Two-way trade</td>
</tr>
</tbody>
</table>

| Services                       | Rank* | A$ billions | Share of total (%) |
| Exports                        | 3     | 5.0         | 7.6               |
| Imports                        | 2     | 7.3         | 9.5               |
| Two-way trade                  | 2     | 12.3        | 8.6               |

| Goods and services              | Rank* | A$ billions | Share of total (%) |
| Exports                        | 8     | 8.8         | 2.8               |
| Imports                        | 8     | 14.4        | 4.1               |
| Two-way trade                  | 7     | 23.2        | 3.5               |

Source: DFAT (2016). *In this table, the ranking excludes regional aggregates like the EU or ASEAN.

As a general point, Australia's export dependence on the UK has been declining since Federation (and before).

---

\(^{22}\) OECD (2016).
\(^{23}\) By way of comparison, that was a bit less than ten per cent of the value of our exports to China in the same year.
More recently, the absolute value of merchandise exports to the UK has fallen since the financial crisis: in 2009, Australia sold more than nine billion dollars of goods to the UK, but this had slumped to around $3.8 billion in each of the past two years.

Despite the shift away from the UK in terms of overall export flows, however, at the level of individual businesses the UK remains an important destination for exporters: in 2014-15, 5,722 Australian businesses exported goods there, or almost 12 per cent of total goods exporters. That made the UK Australia’s sixth most popular destination by exporter numbers.

What about at a more disaggregated level of exports?

For exports at the three-digit SITC level, the data show that the UK is a particularly important destination for Australian exports of lead, pearls and gems, cinematographic film (developed), artwork and antiques, and coke and semi coke, where it accounts for around 30 per cent or more of total exports sales for each category. So for these sectors, and others like them, developments in UK demand are potentially very important. However, most of these items are only a small share of Australia’s total merchandise exports, which are dominated by iron ore, coal, gas and gold.

The Australian merchandise exports to the UK which have the largest share in Australia’s total exports are lead, gold and alcoholic beverages. In each case, exports to the UK of that commodity are only equivalent to about 0.2 percentage points of total Australian exports.

---

24 No comparable data are available for exporters of services. Businesses can export to more than one market.
25 Excluding regional aggregates such as the EU.
As already noted, however, the UK is a relatively more important market for Australian businesses when it comes to exports of services, which hit a new high of just over five billion dollars in 2015.
Within that total, the UK accounted for more than 20 per cent of Australia’s exports of financial services in 2015, more than 12 per cent of all exports of personal travel excluding education, more than ten per cent of exports of business travel services, and more than nine per cent of exports of telecommunications, computer and information services.
Finally, a measure of Australia’s overall export exposure to the UK can be calculated by looking at the size of our total exports to the UK relative to GDP. At $8.8 billion, exports of goods and services to the UK in 2015 were only equivalent to about 0.5 per cent of Australia’s $1.6 trillion GDP, indicating a relatively low level of direct export exposure. By way of contrast, our exposure to China, our largest export market in 2015, was roughly ten times larger, at about 5.6 per cent of GDP.

How important are our FDI links with the UK?

While the previous analysis indicates that our overall trade relationship with the UK is now a quite modest one, the FDI relationship is more significant. Last year, the UK was the third largest source of the stock of FDI in Australia, accounting for just over ten per cent of the total.

<table>
<thead>
<tr>
<th>Stock of FDI in Australia</th>
<th>Rank</th>
<th>A$ billions</th>
<th>Share of total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock of Australian FDI overseas</td>
<td>2</td>
<td>81.3</td>
<td>15.0</td>
</tr>
</tbody>
</table>

Source: ABS (2016). *In this table, the ranking excludes regional aggregates like the EU or ASEAN.

In dollar terms, the stock of UK FDI in Australia peaked at a little bit shy of $80 billion in 2013, and has fallen over the past two years as what were very large net FDI inflows in 2011, 2012 and 2013 were followed by two consecutive years of net disinvestment. In relative terms, the UK’s share of the inward FDI stock has fallen by about ten percentage points over the past decade, reflecting the rising share of East Asia as a source of capital.

Stock of UK FDI in Australia, 2001-15

![Graph showing the stock of UK FDI in Australia, 2001-15](Graph.png)

Source: ABS 5352.0

Although Australian Bureau of Statistics (ABS) data do not provide a breakdown of UK investment in Australia by sector, the UK’s Office for National Statistics (ONS) does provide some information along these lines. Based on ONS data for 2014, the bulk of the stock of UK FDI in Australia is split between mining and quarrying (about one third of
the total), financial services (about 28 per cent) and professional, scientific and technical services (about five per cent).\(^{26}\)

It’s also important to note the importance of the FDI relationship running in the opposite direction. In 2015, the UK was the second most popular destination for Australian FDI abroad, accounting for 15 per cent of the stock of total Australian outward FDI. Moreover, over the last three years the UK’s relative popularity as a destination for Australian FDI has been on the rise.

**Stock of Australian FDI in UK, 2001-15**

Here, data from the ONS show that the stock of Australian FDI in the UK as of 2014 was concentrated in the services sector, and more specifically in financial services (about 47 per cent of the total), professional, scientific and technical services (a bit less than 13 per cent) and administrative and support services (almost ten per cent).\(^{27}\)

**How important are our trade ties with the EU?**

While the direct trade impact of Brexit is likely to be felt on bilateral trade with the UK, the preceding analysis also suggests that there could well be consequences for trade with the rest of the EU. Not surprisingly, the data for the EU overall (including the UK) shows somewhat greater scope for a potential impact on Australian exports, although the aggregate numbers remain modest.

---

\(^{26}\) Data released in December 2015 and latest available. The ONS only provides a sectoral breakdown for about £9.4 billion of the total UK FDI stock in Australia of £19.9 billion. In addition, however, it also provides an estimate for mining and quarrying for ‘Australasia and Oceania’, all of which is here allocated to Australia for the purposes of this ‘back of the envelope’ estimate.

\(^{27}\) Latest available data is for 2014. The ONS provides a sectoral breakdown for about £9.5 million (about 83 per cent) of the total stock of £11.5 million of Australian FDI.
Last year, for example the EU accounted for more than 13 per cent of Australia’s two-way trade, or about $89.4 billion, and was the destination for more than seven per cent of total exports (table 6). The EU was also Australia’s largest trading partner, and export market, for services in 2015.

At the level of individual businesses, 10,560 Australian exporters sold goods into the EU in 2013-14, or about 23 per cent of all goods exporters. That made the EU the second most popular destination by exporter numbers.

### Table 6. The role of the EU in Australian trade

<table>
<thead>
<tr>
<th>Merchandise</th>
<th>Rank</th>
<th>A$ billions</th>
<th>Share of total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports</td>
<td>5</td>
<td>13.1</td>
<td>5.2</td>
</tr>
<tr>
<td>Imports</td>
<td>2</td>
<td>46.4</td>
<td>16.8</td>
</tr>
<tr>
<td>Two-way trade</td>
<td>3</td>
<td>59.5</td>
<td>11.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Services</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports</td>
<td>1</td>
<td>10.5</td>
<td>15.8</td>
</tr>
<tr>
<td>Imports</td>
<td>1</td>
<td>19.5</td>
<td>25.5</td>
</tr>
<tr>
<td>Two-way trade</td>
<td>1</td>
<td>29.9</td>
<td>21.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Goods and services</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports</td>
<td>3</td>
<td>23.5</td>
<td>7.4</td>
</tr>
<tr>
<td>Imports</td>
<td>1</td>
<td>65.9</td>
<td>18.7</td>
</tr>
<tr>
<td>Two-way trade</td>
<td>2</td>
<td>89.4</td>
<td>13.4</td>
</tr>
</tbody>
</table>

Source: DFAT (2016). *Ranking does not include other regional aggregates such as ASEAN or APEC.

Australian exports of goods and services to the EU in 2015 were equivalent to a bit less than 1.5 per cent of GDP, once again indicating a relatively modest level of exposure.

### How important are our FDI links with the EU?

The EU (including the UK) is a major FDI partner for Australia. In 2015, direct investments from the EU accounted for more than 21 per cent of the total stock of overseas FDI in Australia, behind only the United States. The EU was also the most important destination for Australian outward FDI, accounting for more than 20 per cent of the total stock.

### Table 7. The role of the EU in FDI (2015)

<table>
<thead>
<tr>
<th>Stock of FDI in Australia</th>
<th>Rank</th>
<th>A$ billions</th>
<th>Share of total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock of Australian FDI overseas</td>
<td>2</td>
<td>157.6</td>
<td>21.4</td>
</tr>
</tbody>
</table>

Source: ABS (2016). *Ranking does not include other regional aggregates such as ASEAN or APEC.

### So finally, is there anything else to worry about?

The preceding analysis has focused on the impact of Brexit on UK and to a lesser extent EU growth prospects, and hence the implications for Australian exports and FDI. While it is still too early to make any definitive judgments about the longer term consequences, at this stage the balance of evidence suggests that the Brexit vote risks creating lower demand for Australian exports than would otherwise have been the case. However, the ultimate magnitude of any change relative to a non-Brexit world will depend on a range of factors, including the nature of the eventual agreement(s) that the UK reaches with the rest of the EU, and the impact of a Brexit on the future of the EU itself.

---

28 No comparable data are available for exporters of services.

29 Excluding regional aggregates other than the EU.
The numbers also show that Australia’s overall export exposure to the UK is now quite modest, although FDI ties are more substantial.

Finally, there are at least two other issues associated with Brexit that should be considered:

- First, the Brexit vote represents a negative shock to the world economy at a time when global GDP growth is already subdued, global trade growth is lacklustre, and there are several other risks to the world economic outlook, including rebalancing in China. While the current market consensus is that the Brexit vote is not another ‘Lehman Brothers moment,’ it does further complicate an already complex and challenging international economic environment, adding yet one more straw to the already-bowed back of the world economy.

- Second, the vote for Brexit could be seen as another piece of evidence that many voters across large parts of the rich world may be losing faith in the benefits of open borders. Granted, there are always difficulties involved in interpreting the motives behind any given vote. And the major source of voter angst in this context in the case of Brexit appears to have been labour mobility rather than trade or capital mobility, with at least some on the Leave side arguing that Brexit would allow the UK to move toward freer trade. Nevertheless, for now the broad view among outside observers is that the vote can be seen as part of the same general backlash against international economic integration that has seen US presidential candidates apparently back away from the Trans-Pacific Partnership (TPP) agreement and the long-running failure of the WTO to deliver new trade deals in the face of a dearth of member enthusiasm for additional liberalisation. If that interpretation is right, it does not augur well for future efforts to jump start world trade growth through more liberal trade policies, and may indicate increased risks of trade protectionism and economic nationalism at the global level further down the road.

30 This list is not intended to be exhaustive. The note does not look at any potential economic consequences of the geo-political implications of Brexit, for example.