Box 2.1

Brexit and its possible impacts on the Hong Kong economy

In late June, the United Kingdom (UK) voted in favour of leaving the EU (Brexit). The surprise referendum outcome has far-reaching implications for the UK economy. It could also add hurdles to the fragile recovery of Europe, weakening the global economic outlook. This box article gives an overview of the latest developments of Brexit and the possible impacts on the Hong Kong economy.

The UK joined the European Economic Community in 1973, which later evolved into the EU today. As an EU member, the UK is part of the European Single Market, which upholds free movements of goods, services, capital and people between its member states. For years, the access to the vast European market has provided support to the UK's trade and investment expansion. Its access to the market of financial services in the European Economic Area(1) (EEA) has been an important pillar for the UK's position as an international financial hub. Besides, the UK also shares the benefits of better terms of market access when the EU reaches trade agreements with the rest of the world on behalf of its member states. On the other hand, the benefits of EU membership come with obligations and reduction in policy autonomy. For example, the UK is required to comply with the EU regulatory framework and contribute to the EU budget.

Hence, if the UK withdraws its membership from the EU, it would be essential for the UK to negotiate with the EU and other global trading partners on the terms of their economic relationships in future.

At this stage, how Brexit will unfold remains highly uncertain. Firstly, the timing for triggering the UK's exit process is still unclear. While the UK's new prime minister reassured that "Brexit means Brexit", she also pointed out that the exit process should not be invoked until the UK's negotiating strategy is established and a UK-wide approach is agreed. Given the division of local opinions on Brexit and the possibility of Scotland rejecting plans to exit the EU, it seems that it would take a while to build up the necessary consensus in the UK.

Secondly, an exit by a member state from the EU is unprecedented in the EU's history. Hence, the time needed and possible results of the negotiations are full of unknowns. The exit arrangements are set out in Article 50 of Treaty on European Union. Accordingly, upon the UK's formal notification to the EU, the UK will have two years to negotiate its future relationship with the EU, unless it is mutually agreed to extend this period. At the same time, the UK will need to negotiate the trading arrangements with other non-EU countries. Prior to the completion of the negotiations with the EU, the UK remains a member in the EU. However, if no agreements are formed within the time limit, the trading relationships between the UK and other economies will by default revert to the basic form provided by the World Trade Organisation (WTO), which could result in marked increases in trade barriers.

Amid uncertainties, the UK economy would bear the brunt of the shock. Indeed, the UK economy has already entered a likely extended period of uncertainty, which could take a toll on its investment and economic sentiment, dampening its output. Worries about the potential increase in economic barriers with the EU would also affect mutual trade and investment flows.

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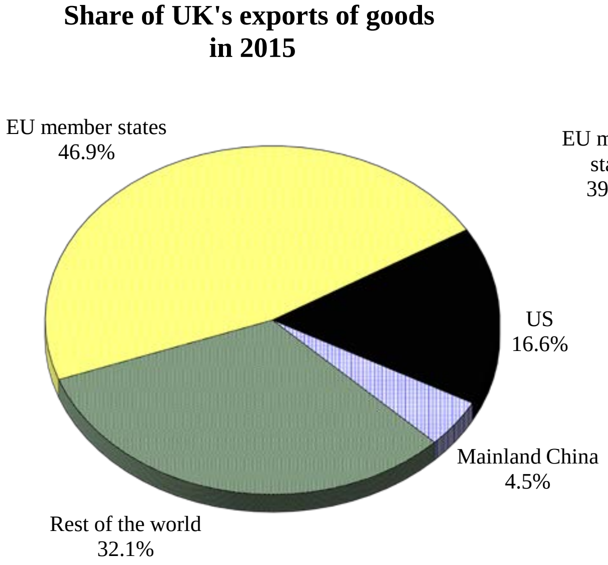
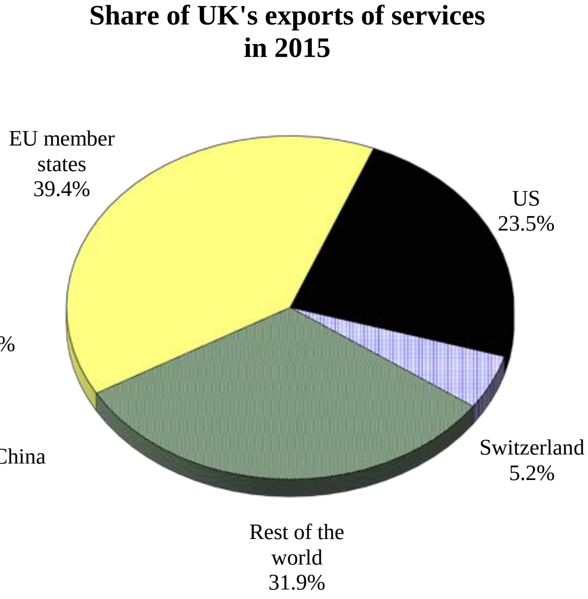
(1) As of July 2016, the European Economic Area includes EU member states plus Norway, Iceland and Liechtenstein.

Box 2.1 (Cont'd)

The EU market features prominently in the UK's trade. In 2015, 47% of the goods exports and 39% of the services exports in the UK went to the EU (***Chart 1***). These exports together accounted for 12% of the UK's GDP(2) in 2015.

Chart 1 : The EU is the UK's largest export market for both goods and services





Source: Office for National Statistics, the UK.

Brexit could also have negative effects on some member states of the EU, because of their trade and financial ties with the UK. For instance, the UK took up around 10% of intra-EU goods exports in 2015. Given the slow and fragile recovery of the euro area economy, the uncertainties associated with Brexit may further dim its economic outlook.

The extent of the adverse economic impacts on the UK and the EU would partly hinge on their post-exit trading arrangements. According to the International Monetary Fund (IMF) in June(3), the economic impacts on the UK would be milder if it could maintain an EEA-type relationship with the EU, which allows considerable access to the European Single Market after Brexit.

Apart from the above, the extent of the impacts would also depend on policy responses of UK authorities and global policy makers. Immediately after the referendum, the Bank of England (BoE) pledged to provide £250 billion in liquidity. In early July, it eased capital requirements for banks by reducing their countercyclical capital buffer rate to zero, reversing a decision to raise it to 0.5% taken in March, in order to support banks' lending to companies and households. In August, the BoE loosened monetary policy by a package of measures, including cutting Bank Rate to 0.25%, launching a new scheme that will provide funding for banks at close to Bank Rate to reinforce the pass-through of the rate cut, increasing the stock of purchases of UK government bonds by £60 billion to £435 billion and purchasing up to £10 billion of corporate bonds.

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(2) "HM Treasury analysis: the long-term economic impact of EU membership and the alternatives", April 2016.
(3) "United Kingdom : Selected Issues", IMF Country Report No. 16/169, June 2016.

Box 2.1 (Cont'd)

Major central banks also vowed to secure adequate liquidity and guard against systemic risks. The pledges thus far have helped underpin market confidence. The sell-offs in global stock markets, though severe immediately after the referendum, were reversed quickly. Comparatively, the foreign exchange market turned more volatile, with the British pound depreciated by around 10% against the US dollar at end-July from that before the referendum.

As Brexit is still unfolding, its impacts on the real economy have not been fully reflected in the latest economic data yet. The preliminary GDP estimate for the UK and the preliminary flash estimate of the GDP in the euro area showed that the two regions still registered moderate growth in the second quarter. The composite purchasing managers' index (PMI) of the euro area rose slightly and stayed above 50 in July, indicating continued activity expansion. However, in July, the composite PMI in the UK worsened markedly to the lowest level in more than seven years and slid below the boom-bust level of 50, indicating contraction in economic activities. Consumer confidence in the UK also weakened notably.

In light of the possible negative impacts of Brexit, granting that the EU and the UK would settle with a post-Brexit arrangement that would avoid a large increase in economic barrier, and barring major financial market disruptions and severe political fallout, the IMF in July marked down the euro area's growth forecasts for 2016 and 2017 by 0.1 and 0.3 percentage point, to 1.6% and 1.4% respectively. The UK's economic growth forecasts were revised down more visibly, by 0.2 and 0.9 percentage point, to 1.7% and 1.3% respectively in 2016 and 2017. In this relatively benign scenario, the economic impacts outside Europe are relatively muted. Overall, the IMF lowered the global economic growth forecast only by 0.1 percentage point in both 2016 and 2017, to 3.1% and 3.4% respectively.

As a small open economy, Hong Kong will inevitably be affected by the headwinds associated with Brexit through trade and financial channels. Negative spillovers to the European economies, if materialised, would also hurt Asia's trading and tourism sectors, including Hong Kong's. The recent weakening of British pound might dent import demand from the UK and their visitors' spending power in the near term.

In terms of trade, the UK only accounted for 1.5% of our total merchandise exports in 2015 and 6.6% of our total services exports in 2014 (***Table 1***). Thus, the direct impacts from Brexit through the trade channel would likely be not very large. In the second quarter, our goods exports to the UK fell by 7.5% year-on-year in real terms, but our exports to the EU including the UK grew moderately. Hong Kong's total exports also reverted to modest growth in volume terms over the same period. As the data through June have not fully reflected the impacts of Brexit on trade flows, the situation needs to be closely monitored.

Box 2.1 (Cont'd)

Table 1 : Hong Kong's economic relations with the EU and the UK

	EU	Share in total	UK	Share in total
Goods and services trade	($Bn)	(%)	($Bn)	(%)
Merchandise exports (2015)	335.1	9.3	54.8	1.5
Services exports (2014)	119.3	14.9	52.5	6.6
External Direct Investment (DI) (from Hong Kong's perspective)	($Bn)	(%)	($Bn)	(%)
Inward DI position (at end-2014)	1,019.2	8.8	131.9	1.1
Outward DI position (at end-2014)	374.1	3.3	242.0	2.2
Number of offices in Hong Kong (as of June 2015)	(Number)	(%)	(Number)	(%)
Number of regional headquarters (RH)	452	32.3	126	9.0
Number of regional offices (RO)	693	28.9	220	9.2
Number of RH + RO	1 145	30.1	346	9.1
	(Number)	(%)	(Number)	(%)
Visitor arrivals (2015)	1.53 million	2.6	0.53 million	0.9

The UK has a prominent position in international finance. The possible impacts of Brexit on the Hong Kong economy through the financial channel are harder to assess. In early July, several commercial-property funds in the UK suspended redemptions as the investors rushed for withdrawals upon heightened risk aversion towards the UK property market. Fortunately, this had not generated notable ripple effects. While the global financial markets have also stabilised shortly after the Brexit vote, the uncertainties associated with the exit process will still linger on for an extended period and could trigger further shockwaves in future. Moreover, there are also market worries about another referendum on Scotland's independence and the potential rise in anti-EU sentiment in other EU members, which could have implications for market sentiment and expose vulnerabilities in certain weak links in European economies, generating knock-on impacts on the global economy and financial markets. The possibility of these adverse developments happening could not be ruled out at this stage.

Hong Kong is equipped with a sound financial system and resilient fundamentals. It is more than capable to handle the abrupt changes in financial conditions and capital flows and navigate through the ups and downs of the global economy. Our regulatory bodies had already reminded financial institutions to guard against the risks in the case of the UK's vote to leave the EU. The healthy position of current account balance, the absence of external debt by the government, and the strong net external financial asset position altogether point to the solid fundamentals of our economy. Yet, there is no room for complacency. In the face of increased uncertainty due to Brexit, exercising prudent risk management is of great importance in safeguarding our financial and macroeconomic stability. The Government will closely monitor the developments and their impacts on the Hong Kong economy.