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Brexit and Its Aftermath

Brexit's Impact on Asia

By Pradumna B Rana

Synopsis

The aftermath of Brexit is unfolding, hence its impact on Asia is difficult to assess. It is, however, likely to be moderate and manageable. In response, Asia should strengthen its regional financial safety net.

Commentary

THE SHOCKING decision of the United Kingdom to pull out of the European Union (EU) has reverberated around the world. Financial markets have been jittery. In the UK, the centre of the storm, the pound sterling has plunged to a four-decade low and the FTSE has fallen sharply. Moody's quickly downgraded the UK's credit rating from stable to negative and a number of US banks in London have initiated the process of relocating to other European capitals. Bank of England has announced a 250 billion pound sterling contingent facility.

"Contagion" effects of Brexit has been felt worldwide. In the US, the Dow Jones plunged by more than 500 points last Friday. Asian markets also crumbled with Tokyo's Nikkei falling by 7.9 per cent - its worst fall since March 2011. Hong Kong's Hang Seng fell by 2.9 per cent and Singapore's benchmark Strait Times index by two per cent. A flurry of high level meetings are also being held both in the UK and various European capitals on how to deal with the first exit by a sovereign country from the EU. Leaders of the EU are worried about the demands from populist anti-EU parties in France and the Netherlands for referendums of their own on EU membership. Scotland could pull out of the UK and Northern Ireland could reunify with the Republic of Ireland.

Longer Term Scenarios

In the longer term, the focus will shift to the economic impacts of the Brexit. These are difficult to predict as negotiations between the UK and the EU, which could take years, have yet to begin. But three scenarios could be considered.

Scenario 1: Britain muddles along

This is the optimistic scenario which assumes that Brexit will be an orderly process with short-term instability in financial markets and the economy. Eventually the UK will successfully negotiate new trade and investment agreements with its major trading partners (including the EU countries, US, China, and India). In the longer term, Brexit will bring about prosperity to the British people and also the world.

Scenario 2: The troubled transition

Leaving the EU will be nasty for the UK. Businesses could hold off on new investments or relocate to other safer locations. Despite the regulatory reforms implemented at the time of the global economic crisis nearly a decade ago, a systemic collapse of the UK's financial sector is possible. This could lead to a recession in the UK.

Scenario 3: The disastrous scenario

This is the worst case scenario where the EU and the Eurozone unravel, and the world heads towards a recession similar to the Great Recession experienced at the time of the global economic crisis.

Impact on Asia

The UK is a declining but still a major trading and investment partner of Asia. The impacts of the above scenarios would, therefore, be felt on Asia through the trade and financial channels. In 2012, the EU and the US each accounted for about 12 per cent of Asia's trade, while the level of intra-regional trade in Asia stood at 35 per cent. If Scenario 1 were to prevail in the UK, then the impact on Asia is expected to be modest.

If, on the other hand Scenario 2 were to prevail, then the adverse impact on Asia would be higher but still manageable mainly because of the cushion provided by the growing volume of intra-regional trade and investment in Asia. However, if we land up with Scenario 3, then a worldwide recession similar to the recession experienced at the time of the global economic crisis in 2008-2009 cannot be ruled out. Asia and the rest of the world would not be spared under this scenario. Although the situation is still evolving, Scenario 2 is the most likely outcome as of now.

What can Asia do? Like the global economic crisis, and the possibility of Grexit in 2015, Brexit is a crisis "made in the West". Asia can do little directly. In order to reduce the adverse impact of Brexit and also to respond to future financial crises,

Asian countries should strengthen their regional “self-help” mechanism or regional financial safety net (RFSN).

The ASEAN+3 RFSN now comprises the US\$240 billion crisis-fund called the Chiang Mai Initiative Multilateralisation (CMIM) and the independent surveillance unit called the ASEAN+3 Macroeconomic Research Office (AMRO). This RFSN was, however, not used when the countries in the region were hit by the global economic crisis.

Strengthening ASEAN+3 RFSN

My research finds that, following the “Troika” model in Europe, we need to promote a more structured form of ASEAN+3 RFSN and IMF cooperation.

I have specifically suggested three cooperative activities between the ASEAN+3 RFSN and the IMF: (i) joint analysis and evaluation of applications for funding; (ii) joint AMRO-IMF missions, joint surveillance, and jointly developed conditionality; and (iii) co-financing of programmes. In the past, the IMF has been hesitant to deepen its cooperation with AMRO.

Now that the ASEAN+3 Finance Ministers and Governors have upgraded the AMRO to an international organisation with a mandate for regional surveillance of ASEAN+3 countries, both individually and collectively, the IMF should have no hesitation in entering into a more structured form of cooperation. This action would also go a long way in reducing the “stigma” against the IMF in Asia.

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