

Implications of Brexit to the Asia-Pacific region: with a focus on least developed countries

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Highlights

- Brexit might affect trade of some countries in the region disproportionately more than others. Sri Lanka, Cambodia, Bangladesh, Turkey, Pakistan, French Polynesia, Fiji, Maldives, India, Hong Kong, China; are found to have higher chance of being exposed to direct trade disruption risk, owing to their relatively high proportion of exports to the UK.
- It is uncertain whether UK will continue to provide preferential access to LDCs and developing countries after the Brexit. The paper runs simulation exercise under two scenarios. First simulation changes all UK tariffs to current MFN applied tariffs of the EU. Under this scenario, LDCs in Asia and the Pacific might witness a reduction of their exports to the UK at the range of 30% to 50% in key sectors such as fish, clothes, textiles and footwear.
- Under the second scenario of UK removing all tariffs unilaterally to all countries, the LDCs in the region will face significant preference erosions. The simulation suggests that trade diversion from LDCs can still result in a potential reduction of 16 % to 48% of their current export value in key export sectors.
- Asia-Pacific LDCs, especially Bangladesh, Cambodia, Lao PDR, Myanmar and Nepal, who have a significant reliance on UK market for exports, will need to be wary of potential trade disruptions. Simulations also show that it is the larger developing countries from the region that would benefit from any trade diversion that ensues in these sectors. Countries with higher exposure to Brexit induced risks to engage in deeper analyses of the extent of such impacts and brace themselves for proactive discussions with the UK in order to limit negative impacts. LDCs may consider jointly negotiating for the continuation of their DFQF access to the UK.
- Countries might want to think of ways to transform Brexit into an opportunity to renegotiate trade agreements with the UK that are mutually beneficial and integrates emerging issues in trade such as non-tariff measures, ecommerce and digital trade.
- The Asia-Pacific region should carefully analyze the political economy factors that led to the Brexit in order to avoid 'Brexit type' events in the region, which could potentially hamper the regional integration efforts.
- Investment and ODA could be other two channels through which the Brexit can impact the region. Countries that have significant investments in the UK might face some ripple effects of Brexit through the investment channel. At the same time, the top recipients in the region of UK

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FDI might see a fall in the investment if the UK investors cut down on their investment due to economic uncertainty. In terms of ODA contributions, Afghanistan, Bangladesh, Nepal, and Pakistan receive substantial ODA from the UK (as percentage of GDP) and any slow-down of the British economy can result in fall in these contributions.

Introduction

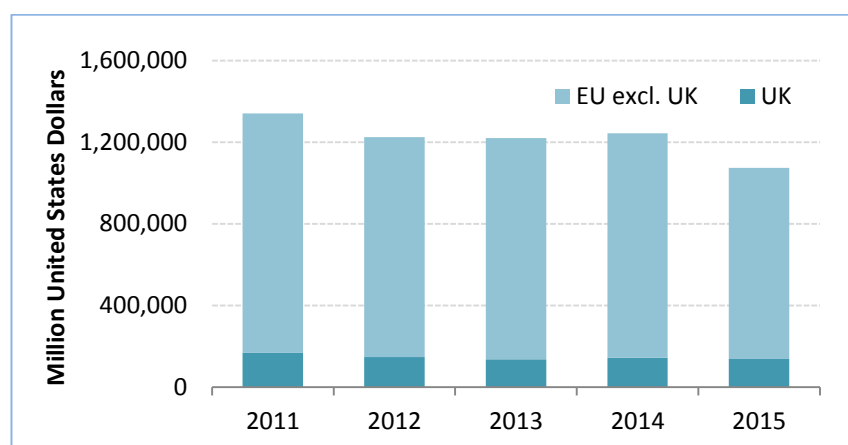
After the result of the referendum within the UK on European Union membership on July 23rd 2016, the UK seems all set to leave the European Union and possibly the European Single Market. The new British Prime Minister Theresa May announced that the formal negotiation process will begin in late March 2017, which means that the UK is likely to formally leave the EU in 2019¹. Little is yet known about what shape or form the exit negotiations will take and whether Britain will retain access to the Single Market (a so-called ‘soft Brexit’) or have to leave completely and then attempt to negotiate new trade agreements with the EU and other countries (‘hard Brexit’). The recent statement by the British Prime Minister has hinted at the prospect of a ‘hard Brexit’².

These uncertainties have certainly rattled international markets, including a historic slide in British Pound exchange rate, and present significant threats to global markets in the future. Nevertheless, Brexit may also present opportunities for UK trading partners as it might open up ways to negotiate or renegotiate trade agreements. In this commentary, we will first provide a brief overview of the potential threats associated with Brexit and an analysis of UK trade relations with Asia-Pacific, emphasizing which countries have the highest exposure to the UK market. We conduct partial equilibrium simulations of selected sectors of significance to LDCs in the Asia-Pacific region to gauge the impact of removal of preferences given by UK to these countries. Together with comments on FDI and ODA flows, the commentary highlights some of the challenges and opportunities that Brexit potentially presents for the Asia-Pacific region, especially its LDCs.

1. Impact of Brexit on Trade

Europe and the UK are important trading partners for the Asia-Pacific region. In 2015, the EU accounted for 19.2% of total exports from the Asia-Pacific region, while the UK by itself accounted for 2.2%. Some of the region’s biggest bilateral trading partners with the UK include Sri Lanka, Cambodia, Bangladesh, and the Solomon Islands (in terms of exports to the UK). However, uncertainty remains over what trade relation the UK will maintain with the EU, and indeed whether it will adopt the EU’s bilateral and multilateral trade agreements or revert to MFN status under the WTO. As Thirlwell (2016) points out, political uncertainty alone may cause slower UK and EU growth in the short-term which will lower imports from trading partners.

Figure 1.1: Value of Asia-Pacific exports to the UK and EU (2011-2015) in USD millions



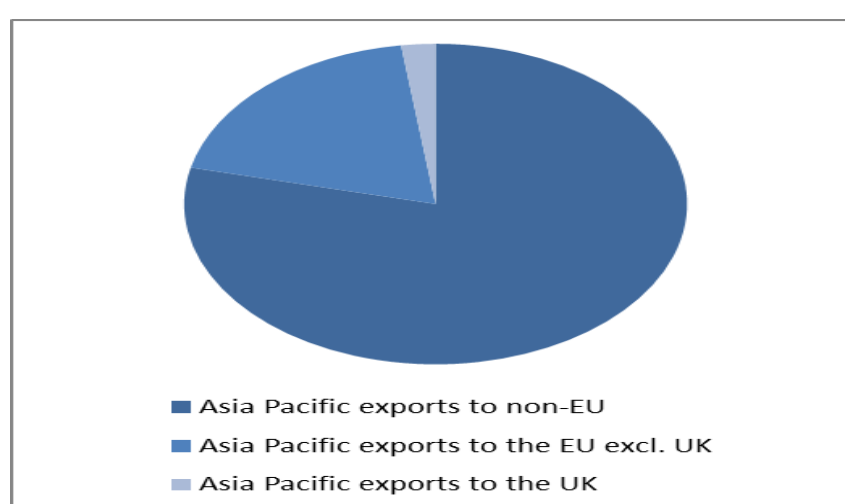
Source: UN COMMTRADE DATA accessed through WITS. Note: Calculated using mirror data

¹ Source: BBC News (2016).

² <http://www.thetimes.co.uk/article/pm-gives-clearer-hint-uk-is-heading-for-hard-brexit-nqzhvrp7m>

Some analysts argue that the Asia-Pacific region as a whole is unlikely to be affected much in the short run due to its relatively low reliance on exports to the UK³. However, there are concerns that even if Brexit does not immediately impact regional economies, it may further reduce global trade growth which has already been slowing down in recent years (Iskryan, 2016a)⁴. First, trade disruptions may slow down economic growth in the rest of the EU which would slacken demand for imports from European trade partners. Second, a British exit from the EU – which is the largest trading block in the world – may reflect (and reinforce) a general increase of protectionist and anti-globalization attitudes. In turn, this may pose challenges for future trade integration efforts.. A gradual slowdown in globalization would not only harm economies that are highly dependent on global trade, such as Malaysia, Singapore and Hong Kong, China (where trade accounts for 138%, 351% and 439% of GDP, respectively)⁵, but also – in turn – reduce long-term growth prospects for the region. A further uncertainty lies in whether the UK will adopt the same preferential access to developing and LDC countries. Mendez-Parra et al (2016) estimate that the combined effect of a devalued GBP and lower GDP growth can result in a reduction of 500 million GBP worth of imports from LDCs.

Figure 1.2: Share of Asia-Pacific exports to the UK and the EU, 2015



Source: UN COMTRADE DATA accessed through WITS. Note: Calculated using mirror data

Under the EU's Generalised Scheme of Preferences (GSP) system, developing countries are granted greater access to EU markets where – in effect – approximately two-thirds of all product categories have their tariffs lowered or abolished for developing-country exporters. An additional system, the “Everything but Arms” (EBA) arrangement, grants duty-free and quota-free (DFQF) access on all goods except arms and ammunitions to LDCs⁶. The issue, then, is whether or not the UK will extend the GSP allowances to developing countries and DFQF preferences to LDC countries, as its absence may severely compromise existing trade. Therefore, whether or not the UK replicates EU trade regulations (including the GSP and EBA system) is the biggest risk associated with Brexit from a trade perspective.

If EU regulations and trade agreements are not “grandfathered in,” the UK might have to trade under WTO MFN rules while negotiating new trade deals⁷. It is moreover uncertain whether it is even possible for the UK to take over existing EU trade agreements, even on a temporary basis⁸. This presents significant economic risk to nations which rely heavily on exports to the UK, as reverting to MFN standards during negotiations will lead to higher tariffs and NTMs applied to goods previously liberalized under EU trade deals and (thus) result in significant trade disruptions.

Some analysts have predicted a relatively mild impact on Asian economies, arguing that “even a 25 percent decline in U.K. imports would knock less than 0.2 percent off from regional GDP” (Simpson,

³ Source: Moody's (2016).

⁴ Iskryan (2016a).

⁵ Iskryan (2016b).

⁶ Source: European Commission (2016)

⁷ Provided UK's GATT status is recognized and it doesn't have to negotiate separate accession to the WTO.

⁸ Walker (2016).

2016). In China, for example, UK exports only amount to some 0.5% of GDP and so an anticipated 25% reduction in UK imports would only shave off around 1.25% in GDP of China. However, economies like Cambodia, Viet Nam and Hong Kong, China have strong trade ties with the UK stand to see a higher impact on economic growth. It is also speculated that the impact of exporters to the UK “may be more immediate if an anticipated slowdown in the UK economy materializes” (Cohen and Gumede, 2016).

The top 10 countries with the highest UK export exposure in the Asia-Pacific region (in terms of exports as a percentage of their total exports) are summarized in the table 1. These are the economies at highest risk of being impacted by restricted trade with the UK, as a significant proportion of their global exports are sold in British markets. The table also summarizes the main components of their exports, based on standard product grouping consisting of 1-14 HS categories at the 2-digit level. Six countries rely primarily on exporting textile and cloth products, while others also export large amount of e.g. footwear, transportation goods, and mechanical and electrical machinery. On the converse, negotiating new trade deals with the UK that improves trade relations and make them more favourable to developing nations may also present a window of opportunity to boost exports and economic growth. In particular, developing countries may wish to identify specific industries where value may be gained from greater access to UK markets. One such example is agricultural goods, which faces relatively high tariffs in the EU by developed country standards.

Table 1: Top ten UK trade partners in Asia-Pacific by export share in 2015

Country	Exports to the UK as % of total exports	Top exports to the UK
Sri Lanka	10.75%	Textile and cloth (84.09%), Plastic and rubber products (4.18%), and vegetables (4.01%)
Cambodia*	10.26%	Textile and cloth (75.96%), and Footwear (17.52%)
Bangladesh*	9.99%	Textile and cloth (93.52%), and Animal products (2.78%)
Turkey	9.11%	Textile and cloth (24.46%), transportation goods (24.01%), mechanical and electrical machinery (19.68%), and stone and glass products (12.14%).
Pakistan	7.83%	Textile and cloth (80.29%), Vegetables (5.77%), hide & skin products (2.79%), and misc. goods including toys, optical equipment, furniture and other manufactured items (6.17%)
French Polynesia	7.58%	Paintings, drawings etc. (97.99%), stone and glass products (0.85%)
Fiji	6.73%	Food products (93.15%), textile and cloth (1.96%).
Maldives	5.72%	Animal Products (78.60%), food products (19.51%).
India	4.54%	Textile and cloth (26.06%), mechanical and electrical machinery (13.04%), chemicals (10.86%), stone and glass products (7.81%) and metals (6.06%).
Hong Kong, China	4.08%	Mechanical and electrical machinery (25.19%), Stone and glass products (18.91%), textile and cloth (8.46%), wood products (7.66%), misc. goods including toys, clocks and watches, optical equipment, art, and furniture (24.96%).

Source: WITS

* = LDC

Another measure reflecting on trade dependency is the share of export in countries GDP. From this perspective, Bangladesh is for example relatively less dependent on trading with the UK than Cambodia, Vietnam and the Solomon Islands (which together with Papua New Guinea make up the top five).

Table 2: Top ten UK trade partners in Asia-Pacific by export (as a % of partner GDP)

Partner	Exports to the UK (as % of country's GDP)
Cambodia	8.63%
Vietnam	3.16%
Solomon Islands	2.35%
Bangladesh	2.26%
Papua New Guinea*	1.60%
Sri Lanka	1.42%
Turkey	1.22%
Fiji	1.22%
Hong Kong, China	1.10%
Thailand	0.92%

Source: WITS and ESCAP calculations

*Based on 2014 data

Note: excludes Cook Islands, French Polynesia, Guam and New Caledonia due to lack of data

A further trade concern is the implication of Brexit to existing trade between Asia-Pacific economies and the EU as a whole. The UK has been a vocal promoter of creating free trade agreements between the EU and other economies, and there is a concern that the EU could become more trade restrictive after their exit (Panda, 2016). This could potentially influence some of the 16 FTAs between the EU and the different Asian economies that are currently in various stages of implementation⁹. Moreover, the political uncertainty surrounding the future of the block creates risk of further destabilization in the Single Market which, in turn, may disrupt EU trade¹⁰. Cambodia, Vietnam, Bangladesh and the Solomon Islands are also among the largest EU trading partners in Asia-Pacific region (in terms of exports as a % of their GDP), but the top ten also include several central-European economies while the Marshall Islands tops the list with nearly 228% of GDP, suggesting a very large dependency on exports to the EU. These countries thus face significant risk of being affected by any potential changes in EU trade policies.

1.1 Impact on LDCs: A simulation exercise

LDCs are of particular interest since trade (and, hence, economic growth) plays a vital function in their national development, and it is often harder for them to diversify into new markets and products easily. The exports to the UK constitute approximately 2% of the total combined GDP of the Asia-Pacific LDCs, with this share reaching approximately 9% in Cambodia and 2% in Bangladesh¹¹. Most of them rely heavily on textile and clothes exports (HS code 50-63), which account for between 66% and 94% of the country's exports to UK (see table 3). The current MFN tariffs of EU in Textile and cloth sector, footwear sector, animal product sector and wood product sectors stands at 5.96, 11.06, 06 and 2.23 % respectively. So these might be the levels of tariffs that can potentially get imposed on these sectors, if the preferential access to LDCs is discontinued by the UK. Some of these tariff rates,

⁹ Source: ADB (2016: pg. 6).

¹⁰ Thirlwell (2016).

¹¹ Author's calculations using data from WITS and WDI data set.

especially in textile and cloth and footwear sectors, can significantly erode the competitiveness of exports from LDCs. The partial equilibrium simulation exercise in the next section provides further evidence on the magnitude of trade disruptions.

Table 3: Top LDC trade partners in Asia-Pacific by export share and top two export industries

Country	Exports of the country to the UK as % of its global exports	Top two export industries	Current EU MFN rates (simple average)
Cambodia	10.26%	Textile and cloth (75.96%)	5.96
		Footwear (17.52%)	11.06
Bangladesh	9.99%	Textile and cloth (93.52%)	5.96
		Animal products (2.78%)	0.06
Nepal	3.39%	Textile and cloth (75.96%)	5.96
		Wood products (5.08%)	2.23
Lao PDR	1.48%	Textile and cloth (75.96%)	5.96
		Footwear (9.73%)	11.06
Myanmar	1.26%	Textile and cloth (75.96%)	5.96
		Animal products (18.57%)	0.06

Source: WITS

1.1.1 Methodology and Data

The paper conducts simulations using a single market partial equilibrium model implemented by the SMART software. SMART looks at one market (in this case UK) and one product at a time. Using import demand elasticity, export supply elasticity and the Armington elasticity (which governs the substitutability between different varieties of product coming from different countries), SMART simulates the impact of a variation in tariff on bilateral trade flows. The paper estimates the impact of a removal of tariff preferences given to LDCs by the UK under two scenarios. First scenario assumes that the UK will employ the current MFN applied rates of the EU to all countries including LDCs. The second scenario assumes that UK will unilaterally reduce all its tariffs to zero for all products to all its trade partners. We use the SMART simulation methodology that allows use of user's own data to conduct this analysis¹².

The following assumptions are used in these simulations. The import demand elasticities of the EU are estimated and used for the UK for each of the product categories. The Armington Elasticity for each product is obtained from Global Trade Analysis Project (GTAP) version 5¹³. The trade import values of the UK for 2015 are used as the baseline case (or the counterfactual) and the simulation derives the percentage change in trade value from this baseline. For each of the exporter country-product pair the simulations provide the total trade effect that comprises of trade creation and trade diversion effects. Hence, for a tariff increase scenario, we can estimate how much trade gets reduced due to the overall increase in prices due to the tariff (the trade creation). Also, the model estimates how much of the existing trade from a specific exporter, whose exports face tariff increase, gets diverted to other exporters (trade diversion). We conduct simulation exercise for 5 HS2 digit product categories (namely, Fish; Apparel And Clothing Accessories-Knitted; Apparel And Clothing Accessories-Not-Knitted; Textile Articles ; and Footwear) that comprises of 95% of Asia –Pacific LDCs' exports to the UK in 2015.

¹² The ready to use SMART online version does not allow to conduct simulations on a tariff increase by the UK as it is part of the EU. Hence, we use the offline version of the SMART tool that allows use of user-provided data. The simulation tool is available at : <http://wits.worldbank.org/simulationtool.html>.

¹³ <https://www.gtap.agecon.purdue.edu/>

1.1.2 Results

Table 5 and 6 summarizes the simulation results from SMART. The table 5 provides the total trade impact of the potential tariff increase following Brexit for the LDCs in the Asia-Pacific region¹⁴. This scenario assumes that UK imposes the current MFN applied rates of the EU to all countries (defined as scenario 1). Hence, the LDCs lose the DFQF preferences and developing countries lose their GSP tariff preferences and all other countries also lose any preferential access that they receive currently to the UK market. This means that all countries need to separately renegotiate trade deals with the UK under this scenario. Hence, this scenario is useful to measure the potential impact for the interim period when UK will be negotiating trade deals with countries. Scenario 2 assumes that UK will unilaterally reduce all tariffs to all countries. While this would have a high trade creation effect worldwide, it can lead to a high degree of trade diversion from LDCs due to ensuing erosion of preferences.

The simulation results show that selected sectors that matters the most to the Asia-Pacific LDCs will be hard hit by a removal of preferential access to the UK market. Under scenario 1 (see table 4), the fish sector can see a reduction of 38% of the current export value, while various sub-sectors under textile and clothe categories may see a reduction of export value of the range from 30% to 52%. Under scenario 2 (see table 5), fish sector in Asia-Pacific LDCs might experience a reduction of about 25 % in their current export values. While in the other top export categories, the reduction in export value can range from 17 % to 49 %. For example, a 50% reduction in value of exports to the UK from Cambodia and Bangladesh translates to approximately 4% and 1% reduction in their current GDP. Many of these sectors are very labour intensive and a contraction in these sectors can have high impact on employment. Hence these disruptions can be quite significant in these countries.

Table 4. : Scenario 1 : Potential trade disruptions in Asia Pacific LDCs (APLDCSs) due to UK raising all tariffs to EU MFN rates

HS code (Item)	Total Trade Effect	Trade Creation	Trade Diversion	Trade Value (2015) in 1000 USD	Potential percentage change in export value to the UK due to Brexit
3 (Fish)	-49122	-17586	-31533	127719.05	-38.46
61 (Apparel And Clothing Accessories-Knitted)	-934287.62	-266760.81	-667501.75	2417640	-38.64
62 (Apparel And Clothing Accessories-Not-Knitted)	-900823.18	-247878.31	-652944.87	2012436.62	-44.76
63 (Textile Articles)	-22455	-9840	-12595	76743.27	-29.25
64 (Footwear)	-138831.78	-23911.74	-114920.03	265229.75	-52.34

Source: Author's calculation using SMART simulation tool

Table 5 : Scenario 2 : Potential trade disruptions in Asia Pacific LDCs (APLDCSs) due to UK unilaterally reducing all tariffs to zero

HS code (Item)	Total Trade Effect	Trade Creation	Trade Diversion	Trade Value (2015) in 1000 USD	Potential percentage change in export value to the UK due to

¹⁴ Annex tables A1 and A2 provides country level breakdown of trade disruptions. Further detailed country level simulation results are available on request from authors. Please contact jacoba@un.org

					Brexit
3 (Fish)	-31536	8	-31545	127719.1	-24.6917
61 (Apparel And Clothing Accessories-Knitted)	-670441	0	-670441	2417640	-27.7312
62 (Apparel And Clothing Accessories-Not-Knitted)	-653207	0	-653207	2012437	-32.4585
63 (Textile Articles)	-12778	0	-12778	76743.27	-16.6503
64 (Footwear)	-128966	192.5844	-129159	265229.8	-48.6243

Source: Author's calculation using SMART simulation tool

The simulation also shows who benefits from the potential reduction of preferences to the Asia-Pacific LDCs from the associated trade diversion from these countries. As shown in table 6 and 7, it is mostly the larger developing countries from the Asia and Pacific region that might stand to gain the most from the preference erosion of LDCs under both scenarios.

Table 6. Top 5 countries that stand to gain the most from trade diversion in specific sectors under scenario 1

3 (Fish)	61 (Apparel And Clothing Accessories-Knitted)	62 (Apparel And Clothing Accessories-Not-Knitted)	63 (Textile Articles)	64 (Footwear)
China	China	China	China	China
India	India	India	India	India
Russian Federation	Sri Lanka	Vietnam	United States	Indonesia
Indonesia	Vietnam	Sri Lanka	Hong Kong, China	Vietnam
Thailand	Indonesia	Indonesia	Other Asia, nes	Thailand

Source: Author's calculation using SMART simulation tool

Table 7. Top 5 countries that stand to gain the most from trade diversion in specific sectors under scenario 2

3 (Fish)	61 (Apparel And Clothing Accessories-Knitted)	62 (Apparel And Clothing Accessories-Not-Knitted)	63 (Textile Articles)	64 (Footwear)
Russian Federation			China	

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