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# The exit of the United Kingdom from the European Union – Its short-to-medium term impact on the Maltese economy

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## **Abstract**

This note studies the impact that the UK's exit from the EU might have on the Maltese economy in the short-to-medium run using the Central Bank's macro-econometric model. The study, which starts by reviewing economic relations between the two countries, takes into consideration both direct effects emanating from lower demand from the UK, as well as indirect effects due to the negative economic impact to the EU of this development. Any study of this kind is surrounded by a high degree of uncertainty as the terms of the UK's exit are still unknown. In balance, the economic consequences for Malta are likely to be negative, with a peak effect on GDP ranging between 0.24% to around 0.54%, with the external sector featuring as the main contributor. However given Malta's GDP is projected to grow by 12% over this period, the impact, even in the worst-case scenario, is relatively limited.

**JEL Classification:** F47, F15, E02.

**Keywords:** Impact of trade agreements, Economic integration, Malta.

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## Executive Summary

Malta and the UK have strong historic ties, and since 2004, these have included membership of the EU. Thus, the UK's decision to exit from the EU has macroeconomic implications for Malta. This policy note seeks to discuss the latter by answering three questions:

- **How has Malta's economic relationship with the UK evolved over recent decades?**

Malta's relative dependence on the UK market has fallen greatly over time, with the share of export of goods to the UK dropping from 40% in the early 1970s to about 3% in recent years. The fall in the relative share of UK tourists, though less strong, is also considerable, from nearly 80% in the early 1980s to less than 30% currently. While Maltese exports of goods to the UK amounted to nearly 10% of GDP in the mid-1970s, in 2016 they stood at just 1.4%. Expenditure by UK tourists now amounts to 4.9% of GDP, down from 9.4% in 2001. Eurostat data suggest that services exports to the UK are equivalent to some 13% of GDP, though a considerable amount are financial services flows, which tend to have nearly equivalent entries as imports of services. In fact, Malta's net exports of services to the UK amount to 6% of GDP. The Maltese financial sector's exposure to the UK is broadly in line with the two countries' trade relationship.

Malta's reliance on UK workers has risen over time. About 1.8% of all persons currently in employment in Malta are British citizens, a proportion higher than the proportion of all foreign workers at the time of Malta's accession to the EU. Besides this growth, there has also been a strong rise in the number of UK citizens who retire in Malta, from 1,930 in the 2005 Census to 3,537 in the 2011 Census.

- **What are the likely effects of the UK's exit from the EU on the UK and EU economies?**

At this stage, there is a high degree of uncertainty surrounding the terms at which the UK is likely to exit the EU. Despite this uncertainty, formal assessments conducted by researchers and international institutions point at significant downward economic risks to the UK economy. Indeed, the downside risks of reduced access to international trade are judged to outweigh possible increases in the UK's long-run productivity due to eventual deregulation processes.

The EU is an important partner for the UK attracting around half of the UK exports. The EU also exports significant amount of goods and services to the UK implying that some EU countries are likely to lose economically due to the departure of the UK from the EU. Moreover, given its size, the UK's exit from the EU is projected to have global effects, even though these are anticipated to be more contained when compared to the contractions in economic growth expected in the EU and UK.

The quantification of these effects depends on the outcome of the negotiation process between the UK and the EU. The three most likely scenarios considered in literature are: an EEA membership allowing the UK to retain access to the single market; a series of bilateral agreements similar to the Swiss-model; the default WTO rules that would come into place should the talks between the two parties yield no results.

- **How could this affect the Maltese economy?**

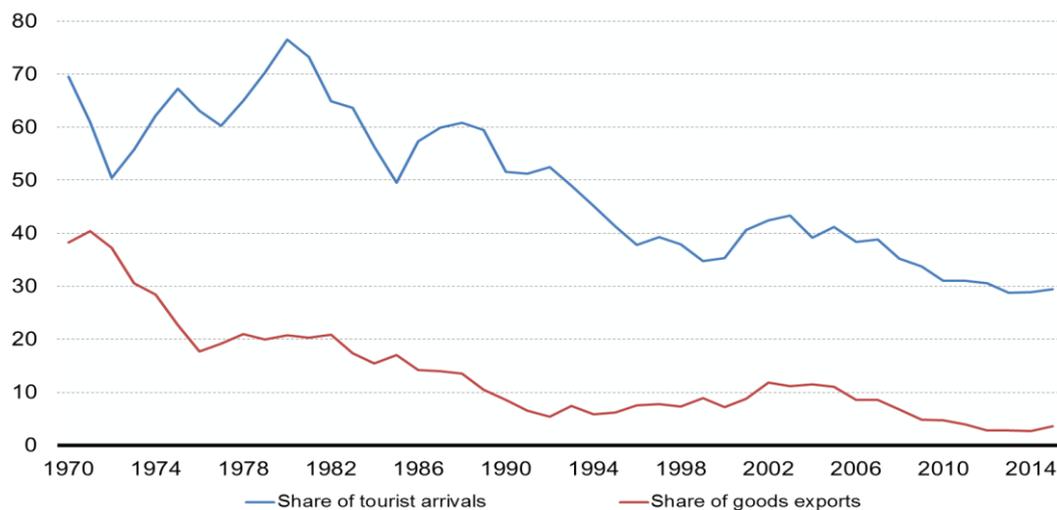
To quantify these effects, this study conducts an analysis using STREAM, the Central Bank of Malta's macro-econometric model (Grech and Rapa, 2016) exploring two scenarios which stand at opposite ends of the spectrum of agreements likely to be struck by the UK and the EU: a best-case scenario assuming that the UK will remain a member of the EEA and a worst-case scenario that assumes unsuccessful negotiations between the two parties. The peak effects on Maltese GDP are projected to lie between -0.24% and -0.54% with the main contributor at least in the first two years being the external sector.

Given the uncertainty surrounding the terms of the UK's exit from the EU, these results should be treated with caution. The results presented focus solely on the impact of a drop in foreign demand and a change in foreign exchange rates. The analysis undertaken, for instance, does not take into consideration the possible benefits for the Maltese economy should UK companies relocate to Malta to retain access to the EU market. Finally, over the next three years, the Maltese economy is projected to grow by close to 12%, implying that even under the worst case scenario, the UK's exit from the EU would have a negligible impact on Malta's pace of economic expansion.

## How has Malta's economic relationship with the UK evolved over recent decades?

Given Malta was part of the British Empire until 1964 there are strong economic ties with the UK. At the time of Independence, the strength of these ties was such that economic experts had argued that mass emigration was the “only feasible solution in the long run” for the Maltese economy.<sup>2</sup> However, post-independence the Maltese economy evolved relatively quickly and diversified greatly. As a result the relative dependence on the UK market declined substantially over time. The share of Malta's export of goods to the UK has fallen from 40% in the early 1970s to about 3% in recent years,<sup>3</sup> whereas the share of UK tourists has fallen from nearly 80% in the early 1980s to less than 30% currently.

**Chart 1**  
**TRENDS IN MALTA'S DEPENDENCE ON THE UK MARKET**  
(% of total)



Source: Authors' calculations using CBM macroeconomic time series database.

Besides the decline in the UK's relative share of goods exports and tourist arrivals, one also needs to note the fall in the relative size of these two activities in Malta's GDP. While Maltese exports of goods to the UK amounted to nearly 10% of GDP in the mid-1970s, in 2016 they stood at just 1.4% of GDP. Expenditure by UK tourists was estimated at €485.1 million for 2016, up from close to €400 million in 2001, but in terms of share of GDP, this expenditure now amounts to 4.9% of GDP, down from 9.4% in 2001.

<sup>2</sup> See Grech (2015) for more details.

<sup>3</sup> Malta imports more goods from the UK than it exports. In 2016, imports of goods from the UK amounted to €343.3 million, or 5.3% of goods imports.

Eurostat data suggest that services exports to the UK amounted to €1.2 billion in 2015, equivalent to some 13% of GDP. However a considerable amount of these exports are financial services flows, which tend to have nearly equivalent entries as imports of services. In fact, Malta's net exports of services to the UK amounted to €559 million, or 6% of GDP – the bulk of which represent the expenditure of UK tourists in Malta. This share is unchanged from its 2011 level.

In 2016, Malta's core domestic banks had an exposure to the UK equivalent to 7.4% of their total assets. About two-thirds of this exposure was constituted by loans to UK residents, while the rest was UK securities, prevalently relating to the UK sovereign. On the liabilities side, the exposure is much smaller, at 1.3%, mostly short-term deposits of UK residents. The domestic insurance sector's asset exposure to the UK in 2016 stood at 5.2% of total assets, while domestic investment funds hold 4.1% of their total assets in UK securities. This suggests that financial ties with the UK are broadly in line with the trade relationship between the two countries.

On the other hand, there is evidence that Malta's reliance on UK workers has risen over time. There were 3,985 UK citizens working in Malta in 2016, about 17.6% of all foreign workers.<sup>4</sup> This constituted 1.8% of all persons currently in employment, a proportion higher than the proportion of all foreign workers at the time of Malta's accession to the EU. Since EU accession, the number of UK citizens working in Malta has risen by 381%, constituting nearly one in six of the growth in foreign workers. Besides this rise in the number of UK workers in Malta, there has also been a rise in the number of UK citizens who retire in Malta. The 2011 Census indicated that there were 3,537 UK citizens aged 60+ in Malta, or 3.6% of this age bracket. This was up from 1,930, or 2.5%, in the 2005 Census.

Office for National Statistics data<sup>5</sup> suggest that there could be 9,000 Maltese citizens in the UK, and that many are not there for working purposes. The same source indicates that there are about 28,000 Maltese born persons living in Great Britain, but the bulk of these appear to be former Maltese migrants who now hold UK citizenship.

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<sup>4</sup> See reply to Parliamentary Question 27178

<http://pq.gov.mt/PQWeb.nsf/7561f7daddf0609ac1257d1800311f18/c1257d2e0046dfa1c125803e00508f5f!OpenDocument>

<sup>5</sup> Data can be downloaded from:

<https://www.ons.gov.uk/file?uri=/peoplepopulationandcommunity/populationandmigration/internationalmigration/datasets/populationoftheunitedkingdombycountryofbirthandnationality/2015/populationbycountryofbirthandnationalityjan15todec15.xls>

## **What are the likely effects of the UK's exit from the EU on the UK and EU economies?**

At this stage, there is a high degree of uncertainty surrounding the terms at which the UK is likely to exit the EU. Consequently, given the large number of alternative arrangements that the UK can negotiate with the EU, the channels by which the UK and EU economies could be affected vary substantially.

Despite this uncertainty, formal assessments conducted by researchers and international institutions point at significant downward economic risks to the UK economy. The main factors contributing to these conclusions relate mainly to direct effects due to reduced access to international trade. The likelihood of an increase in long-run productivity due to possible deregulation in the UK is especially low considering the low degree of regulation already in place in the UK. Moreover, the probability that these increases in productivity outweigh losses in productivity due to restrictions on migration is very slim. Moreover, it is argued that the UK is unlikely to be able to quickly negotiate new trade agreements with other countries to substitute those already in place with the EU. These factors coupled with the uncertainty caused by the still untested withdrawal process are likely to weigh negatively both on the short-run and long-run UK GDP growth. This is also likely to cause a substantial depreciation of the Pound Sterling against other key currencies, mostly the Euro and the US dollar.

The EU is the UK's largest trading partner and attracts around half of the UK exports. The EU also exports a significant amount of goods and services to the UK, mostly originating from Germany, France and the Netherlands. Expressed as a share of the GDP of the exporting country, the UK economy is substantially important to Ireland, Malta, Cyprus, Belgium and the Netherlands (IMF, 2016). All-in-all, all EU countries will lose economically due to the UK's exit from the EU, although the effects are likely to be much smaller than those directly affecting the UK. Given their combined size and importance, developments in the EU and the UK economies are likely to have global economic effects. Most studies point at a possible deterioration in the UK's main trading partners, mainly the US. However, these are projected to be more contained when compared to the economic contractions likely to occur in the UK and the EU, thereby helping to push up the value of the US dollar against both the Pound Sterling and the Euro.

An assessment of the relevant literature therefore concludes that there is a general consensus amongst international institutions and researchers that the likely effects of the UK's exit from the EU will likely be negative for both parties.

However, in light of the uncertainty surrounding the aftermath of the UK's exit from the EU, there is no consensus on the magnitude of these negative effects<sup>6</sup>. Indeed, the quantification of the effects of the UK's exit from the EU depends on the agreements that the two parties will be able to reach. The negotiation process that will start once the UK formalises its intention to leave the EU has a number of possible outcomes:

1. *EEA membership*: The best case scenario is that the UK adopts the so-called Norwegian model that would allow it to retain access to the single market. In return, however, it would need to accept free movement of people as well as pay contributions to other EU countries. Moreover, under such a scenario the UK would not be allowed to benefit from the customs union and other third party trade agreements struck by the EU.
2. *Bilateral agreements*: The Swiss-model is similar to the Norwegian model, but allows free-trade to occur within specific goods categories and does not feature trade concessions in financial services.
3. *WTO rules*: This is the worst case scenario and is the default agreement that would come into place should negotiations fail. Under the WTO rules, the UK and the EU would trade under fixed maximum tariffs established by the WTO. The UK would lose access to the single market, but will be free to set its own rules concerning migration and would not contribute to the EU budget.

## **How could this affect the Maltese economy?**

Given its openness, the Maltese economy is likely to be affected in two ways. First, foreign demand for Maltese exports is likely to slow down both due to direct effects caused by subdued economic growth in the UK, as well as due to indirect effects caused by the likely

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<sup>6</sup> A literature review of the studies assessing the impact of EU exit on the UK can be found in IMF (2016), Country Report No. 16/169, Selected Issues. Estimates of the impact of the exit of the UK from the EU range from +4% to -9.5% of GDP in the long-run. However, in the balance the vast majority of studies, most notably those conducted by the IMF (2016) and HM Government (2016a, 2016b) point at a significant long run deterioration in UK GDP ranging from -1.3% to around -9.5%.

slowdown in EA, EU as well as US economic growth. Secondly, the real effective exchange rate (REER) for Malta is likely to be negatively affected by the depreciation of the Pound Sterling vis-à-vis the euro, and positively affected by the appreciation of the US dollar vis-à-vis the euro<sup>7</sup>.

To quantify the effects of these shocks, this study conducts a scenario analysis using STREAM, the Central Bank of Malta's macro-econometric model (Grech and Rapa, 2016). In the light of the uncertainty surrounding the negotiation process between the UK and the EU, we follow the approach adopted by the IMF (2016) and explore two scenarios which stand at opposite ends of the spectrum of trade agreements that are likely to be struck by the UK.

1. *Scenario 1* is the best case scenario and assumes that the UK will become an EEA member, in line with outcome 1 described above. The main negative economic consequences are related to a limited period of uncertainty (surrounding the negotiations) as well the exit from the customs union.
2. *Scenario 2* assumes unsuccessful negotiations between the UK and the EU, so that the trade agreement between the two parties defaults to the WTO rules, in line with outcome 3 explored above.

The scenarios are constructed as follows. The direct and indirect effects on foreign demand are assumed to follow predictions made by the Bank of England (2017) for the UK, those of the IMF (2016) for the EA as well as those published by Goldman Sachs (2016) for the US and rest of the world. These predictions are consistent with the scenarios explored in this study. Moreover, we simulate an appreciation of the US dollar vis-à-vis the Pound Sterling and to a lesser extent vis-à-vis the euro. This in turn implies an appreciation of the euro vis-à-vis the Pound Sterling. The magnitude of the appreciation is in line to the one assumed by Hatzius and Stehn (2016)<sup>8</sup>. The projections used in this study are summarised in Table 1.

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<sup>7</sup> The REER is also expected to appreciate due to an increase in import prices should the EU start imposing import duties on UK exports. This scenario has not been explored in this note.

<sup>8</sup> The magnitude of the exchange rate shocks is equal to the change in bilateral exchange rates that happened between Thursday 23<sup>rd</sup> and Friday 24<sup>th</sup> June 2016. Assuming that the markets were not expecting the exit vote to win, the change in the exchange rate that followed the referendum result should in theory price in the UK's decision to exit the EU.

**Table 1: Impact on key foreign variables following the UK's decision to exit the EU**

	2017	2018	2019
<b>UK GDP (percentage deviation from baseline)</b>			
Scenario 1	-0.3	-1.0	-1.6
Scenario 2	-0.8	-3.7	-5.2
<b>EA GDP (percentage deviation from baseline)</b>			
Scenario 1	-0.05	-0.11	-0.18
Scenario 2	-0.14	-0.29	-0.43
<b>ROW GDP (percentage deviation from baseline)</b>			
Scenario 1	-0.03	-0.06	-0.09
Scenario 2	-0.03	-0.06	-0.09
<b>Exchange rate (percentage deviation from baseline)</b>			
GBP/EUR	6.19	6.19	6.19
USD/EUR	-2.35	-2.35	-2.35

Once weighted for their relative importance in the Maltese trade basket, these projections result in a peak fall of 0.7% on Maltese foreign demand under the worst case scenario, as opposed to a fall of around 0.2% under the best case scenario. The NEER for Malta from the import side is assumed to appreciate by around 2.5% while that on the export side is assumed to appreciate by around 3.5%.

**Table 2: Impact of Maltese variables following the UK's exit**

	Scenario 1			Scenario 2		
	2017	2018	2019	2017	2018	2019
<b>Economic activity (percentage deviation from baseline)</b>						
Real GDP	-0.12	-0.20	-0.24	-0.16	-0.40	-0.54
Private consumption	-0.02	-0.08	-0.09	-0.02	-0.14	-0.28
Exports of goods & services	-0.22	-0.27	-0.31	-0.30	-0.59	-0.71
Imports of goods & services	-0.13	-0.19	-0.22	-0.18	-0.42	-0.54
<b>Contributions to growth (percentage points)</b>						
Domestic	-0.03	-0.08	-0.11	-0.04	-0.16	-0.29
Foreign	-0.09	-0.10	-0.12	-0.12	-0.22	-0.24

The results of the scenario analysis are summarised in Table 2. The peak effects on baseline GDP are projected to lie between -0.24 to -0.54%. As expected given the nature of the shocks under consideration, the main contributor behind these falls at least in the first two years emanate from the external sector. Falls in aggregate demand then lead to a reduction in private consumption and investment, leading to a peak contribution of domestic demand which equates or slightly exceeds that of foreign sector by 2019.

Needless to say, the results should be considered preliminary and treated with caution given the high degree of uncertainty surrounding the terms of the UK's exit from the EU. As a result, the simulations presented here focus solely on the impact of exchange rate movements and foreign demand on economic activity, using assumptions provided by international institutions. The scenarios taken in consideration in this note can be improved especially as more information on the UK's terms of exit from the EU becomes available.<sup>9</sup> Moreover, given the high degree of uncertainty surrounding the UK's terms of exit from the EU this note does not take into consideration the negative effects of a rise in the volatility of financial markets that could hamper the ability of the Maltese banking sector to extend credit to local agents<sup>10</sup>.

On the upside, fuelled by robust domestic performance as well as by an increasing momentum in the global economy, economic growth recently registered in the UK has been stronger than what has been initially envisaged in the immediate aftermath of the vote to leave the EU. Moreover, in the medium to long run, Malta could also benefit from the UK's exit from the EU, especially if it manages to attract companies that seek to relocate outside the UK, for instance, in the financial sector, especially given the high proficiency of Malta's workforce in the English language and in the light of the similarities that exist between Maltese and British legislations.

Finally, over the next three years, the Maltese economy is projected to grow by close to 12%, implying that even under the worst case scenario, the UK's exit from the EU would have a negligible impact on Malta's pace of economic expansion.

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<sup>9</sup> For instance, the results presented in this note do not take into consideration the impact of higher import prices on Malta's competitiveness due to potential rises in tariff barriers

<sup>10</sup> In an effort to gauge the sensitivity of these results to the indirect effects of an increase in financial market volatility, the scenarios presented in this study were enhanced with a negative shock to the ability of banks to supply credit to Maltese agents. While these scenarios are still very preliminary, it is useful to highlight that the results presented in this note are not affected substantially.

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