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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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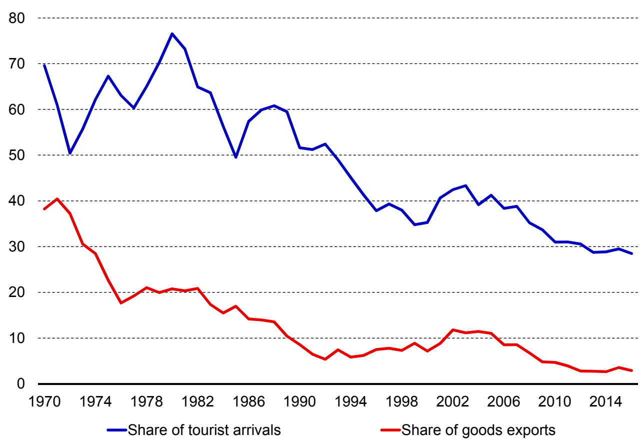
BOX 3: THE EXIT OF THE UNITED KINGDOM FROM THE EUROPEAN UNION – ITS SHORT TO MEDIUM-TERM IMPACT ON THE MALTESE ECONOMY[1]

On 23 June 2016, the United Kingdom voted to leave the European Union. At this stage there is still a high degree of uncertainty surrounding the terms at which the United Kingdom is likely to exit the European Union. However, one can safely predict that any post-Brexit agreement is bound to trade-off some degree of market accessibility with more independence for the UK policy makers. In light of their mutual trade dependence, the United Kingdom's exit from the European Union is bound to have important effects on the two economies. Moreover, given Malta's strong economic ties with both the European Union and the United Kingdom, the latter's decision to leave the European Union is likely to impact the Maltese economy. This Box focuses on the short to medium-run economic implications of Brexit on the Maltese economy.

Malta's economic relationship with the United Kingdom

Since Malta was part of the British Empire until 1964, it has traditionally held strong economic ties with the United Kingdom.[2] 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. Chart 1 shows that the share of Malta's export of goods to the United Kingdom has fallen from 40% in the early 1970s to about 3% in recent years,[3] whereas the share of UK tourists has fallen from nearly 80% in the early 1980s to less than 30% in 2016. Moreover, Maltese exports of goods to the United Kingdom fell from nearly 10% of GDP in the mid-1970s to just 1.4% of GDP by 2016. Expenditure by UK tourists was estimated at €485.1 million in 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.

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



Source: Author's calculations using CBM macroeconomic time series database.

By 2015, Maltese exports of services to the United Kingdom amounted to €1.2 billion, equivalent to

[1] Prepared by Noel Rapa. The author is a Senior Research Economist in the Economic and Research Department. The views expressed in this Box are the author's own and do not necessarily represent the views of the Bank. This Box summarizes the main conclusions presented in Rapa, N. (2017), The exit of the United Kingdom from the European Union – Its short to medium-term impact on the Maltese economy, *Policy Note*, Central Bank of Malta, March 2017.

[2] For more details See Grech, A.G. (2015), *The evolution of the Maltese economy since independence*, Central Bank of Malta.

[3] Malta imports more goods from the United Kingdom than it exports. In 2016, imports of goods from the United Kingdom amounted to €343.3 million, or 5.3% of goods imports.

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 United Kingdom amounted to €559 million, or 6% of GDP – the bulk of which represent the expenditure of UK tourists in Malta.

By 2016, Malta's core domestic banks had an exposure to the United Kingdom 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 made up of short-term deposits of UK residents. This suggests that financial ties with the United Kingdom 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.[4] This constituted 1.8% of all persons currently in employment, a proportion higher than the share of all foreign workers at the time of Malta's accession to the European Union. Moreover, the Office for National Statistics suggests that there could be 9,000 Maltese citizens in the United Kingdom, and that many are not there for working purposes.

The effect of Brexit on the United Kingdom and the European Union

The European Union is the United Kingdom's main export partner. Thus, the exit of the United Kingdom from the European Union and the potential loss of access to the single market are likely to have substantial effects on the UK economy. At this stage however, there is a high degree of uncertainty surrounding the terms at which the United Kingdom is likely to exit the European Union. Consequently, given the large number of alternative arrangements that the United Kingdom can negotiate with the European Union, 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 stemming both from reduced access to international trade as well as from the potential loss of the United Kingdom's banking system EU passporting rights. On the other hand, the likelihood of an increase in long-run productivity due to a possible deregulation in the United Kingdom is especially low considering the low degree of regulation already in place in the United Kingdom. Moreover, potential long-run productivity gains driven by deregulation are likely to be outweighed by productivity losses caused by restrictions on migration. 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 GDP growth in the United Kingdom. All this seems to be weighing on the pound sterling which has depreciated substantially against both the euro and the US dollar since the Brexit vote.

EU economies, mostly Germany, France and the Netherlands, also export a significant amount of goods and services to the United Kingdom.[5] Thus even EU member states

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[4] See reply to Parliamentary Question 27178 http://pq.gov.mt/PQWeb.nsf/7561f7daddf0609ac1257d1800311f18/c1257d2e0046dfa1c125803e00508f5f!OpenDocument

[5] See IMF (2016). *IMF Country Report No. 16/169*, United Kingdom, Selected Issues.

stand to lose economically from Brexit, although the effects are expected to be smaller than those affecting the United Kingdom. Moreover, 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 United Kingdom's and the European Union's main trading partners, mainly the United States. However, these are projected to be more contained when compared with the economic contractions likely to occur in the United Kingdom and the European Union, thereby helping to push up the value of the US dollar against both the pound sterling and the euro.

Still, in light of the uncertainty surrounding the aftermath of the United Kingdom's exit from the European Union, there is no consensus on the magnitude of these negative effects. Indeed, the quantification of the effects of the United Kingdom's exit from the European Union depends on the agreements that the two parties will be able to reach. The negotiation process has a number of possible outcomes. First, the best case scenario is that the United Kingdom adopts the so-called Norwegian model thereby becoming a member of the European Economic Area (EEA). This option would allow the United Kingdom to retain access to the single market. In return, however, it would need to accept free movement of people as well as contribute to the EU budget. Moreover, under such a scenario the United Kingdom would not be allowed to benefit from the customs union and other third party trade agreements struck by the European Union. The second option is to adopt the Swiss-model which is similar to the Norwegian model, but allows free-trade to occur within specific goods categories. Crucially however, this option does not predict (at least for the time being) trade concessions in financial services. The third scenario would come into place should negotiations between the two parties fail. Under this option all UK trade including that with the European Union will be governed by the WTO Most Favoured Nation rules. The United Kingdom 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.

The effects of Brexit on Malta

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 due to both direct effects caused by subdued economic growth in the United Kingdom, as well as from the indirect effects caused by the likely slowdown in the United Kingdom's main trading partners, such as the euro area and the United States. 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.[6]

To quantify the effects of these shocks, a scenario analysis is conducted using STREAM, the Central Bank of Malta's macro-econometric model.[7] In the light of the uncertainty surrounding the negotiation process between the United Kingdom and the European Union, this Box explores two scenarios which stand at opposite ends of the spectrum of trade agreements that are likely to be struck by the United Kingdom. S*cenario 1* is the best case scenario and assumes that the United Kingdom will become an EEA member, in line with

[6] The REER is also expected to appreciate due to an increase in import prices should the European Union start imposing import duties on UK exports. This scenario has not been explored in this note.

[7] Grech, O., & Rapa, N. (2016). STREAM: A Structural Macro-Econometric Model of the Maltese Economy. Working Paper WP/01/2016, Central Bank of Malta.

outcome 1 described above. *Scenario 2* assumes unsuccessful negotiations between the United Kingdom and the European Union, so that the trade agreement between the two parties defaults to the WTO rules, in line with outcome 3 explored above.

Table 1 summarizes the main assumptions used for the two scenarios. The direct and indirect effects on foreign demand are assumed to follow predictions made by the Bank of England for the United Kingdom, IMF for the euro area and Goldman Sachs for the United States and rest of the world. Both scenarios assume 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 with the one assumed by Goldman Sachs in a study published in 2016.[8]

The results summarised in Table 2 show that 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 2018.

Needless to say, the results should be considered preliminary and treated with caution given the high degree of uncertainty surrounding the terms of the United Kingdom's exit from the European Union. 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.

Table 1
IMPACT ON KEY FOREIGN VARIABLES FOLLOWING THE UNITED KINGDOM'S DECISION TO EXIT THE EUROPEAN UNION
Per cent deviation from baseline

	2017	2018	2019
UK GDP *(percentage deviation from baseline)*			
Scenario 1	-0.30	-1.00	-1.60
Scenario 2	-0.80	-3.70	-5.20
EA GDP *(percentage deviation from baseline)*			
Scenario 1	-0.05	-0.11	-0.18
Scenario 2	-0.14	-0.29	-0.43
ROW GDP *(percentage deviation from baseline)*			
Scenario 1	-0.03	-0.06	-0.09
Scenario 2	-0.03	-0.06	-0.09
Exchange rate *(percentage deviation from baseline)*			
GBP/EUR	6.19	6.19	6.19
USD/EUR	-2.35	-2.35	-2.35

Source: Author's calculations.

[8] Hatzius, J., & Stehn, S. J. (2016). How Has The 'Brexit-Shock' Affected Our Economic Forecasts? Goldman Sachs, Note to customers. The magnitude of the exchange rate shocks is equal to the change in bilateral exchange rates that happened between Thursday 23rd and Friday 24th 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 United Kingdom's decision to exit the European Union.

Table 2
IMPACT OF MALTESE VARIABLES FOLLOWING THE UNITED KINGDOM'S EXIT
Per cent deviation from baseline

	Scenario 1			Scenario 2		
	2017	2018	2019	2017	2018	2019
Economic activity *(percentage deviation from baseline)*						
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
Contributions to growth *(percentage points)*						
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

Source: Author's calculations.

The scenarios described above can be further improved as more information on the United Kingdom’s terms of exit from the European Union becomes available. 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. Similarly, the scenarios abstract from the potential adverse effects of a rise in the volatility of financial markets or a deterioration in the banks’ asset quality. 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 United Kingdom has been stronger than what has been initially envisaged in the immediate aftermath of the Brexit vote. Moreover, in the medium to long run, Malta could also benefit from the United Kingdom’s exit from the European Union, especially if it manages to attract companies that seek to relocate outside the United Kingdom, 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.