

Special Report

Asia-Pacific

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The UK Votes To Leave The EU — Impact On Asia-Pacific Economies

The United Kingdom's vote to leave the European Union has triggered substantial financial market volatility and investor risk aversion. Ensuing economic implications are still largely uncertain; nevertheless, it is clear that business confidence globally has been shattered, which will negatively impact investment appetite and economic growth momentum. In this environment, policymakers' efforts to restore market confidence over the coming weeks will be a key factor shaping the global outlook, as the magnitude of adverse economic consequences will depend on how large and lasting the confidence shock is. While advanced economies have fairly limited policy room to respond to the shock compared to previous crises, Asia-Pacific economies are in a reasonable shape, both in terms of monetary and fiscal policy space. Assuming that market turmoil will not intensify further, we assess that economic contagion to the Asia-Pacific region could be contained to a large extent by swift policymaking.

Direct trade channel impact will be relatively limited

The "leave" vote's direct impact on Asia-Pacific economies will be fairly limited even if it caused a significantly weaker UK economy, given that the UK purchases a small share (2.3%) of Asia-Pacific's goods exports. The largest trade impact will likely be felt by New Zealand, Vietnam, Hong Kong, and India, yet these countries ship only 3-4% of their total exports to the UK. Meanwhile, Singapore and Indonesia sell less than 1% of their exports to the UK. Nevertheless, there is potential for a more sizable trade channel impact should the confidence shock pull Europe into recession, as the continent purchases over 17% of Asia-Pacific's exports abroad. Moreover, adverse economic conditions in the UK and the rest of Europe may hamper foreign direct investment into Asia-Pacific in the medium-to-long term, as the EU is a substantial source for such investment flows.

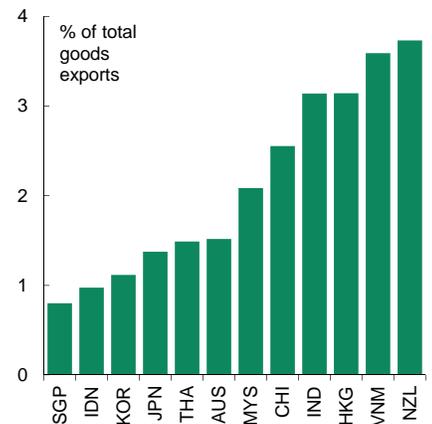
Financial spillovers will be key determinants of regional outlook

The largest impact on Asia-Pacific economies will come through the massive confidence shock the vote has triggered. This has been demonstrated by a sizable currency depreciation bias across regional emerging economies as well as an equity market sell-off. Volatility has prompted monetary authorities, such as the Reserve Bank of India and the Bank of Korea to intervene in order to limit currency weakness. Meanwhile, many other regional central banks have issued statements highlighting that they are monitoring financial market developments closely and stand ready to provide additional liquidity to the banking system if needed. The flip side of the increased risk aversion is that safe haven flows have caused the Japanese yen to strengthen against the US dollar and virtually all regional currencies. The yen strength will likely make Japan's deflation problem worse over the coming months while simultaneously adding to the challenges faced by struggling Japanese exporters. Accordingly, we expect the Bank of Japan to ease monetary policy in the near term, most likely in July.

The global confidence shock will cause spillover effects into the Asian real economy, causing output growth to slow. Depending on how much business sentiment will weaken and how deep asset price declines will be, we may see cutbacks in business spending and hiring, causing higher unemployment and weaker consumer spending. To counteract such a negative scenario and to support domestic demand, authorities across Asia-Pacific will likely unveil further fiscal stimulus. In addition, given rising expectations for delayed monetary normalization in the US and lower commodity prices that help keep inflationary pressures in check, various central banks in Asia-Pacific will likely inject further monetary stimulus into their economies over the coming months.

Chart 1

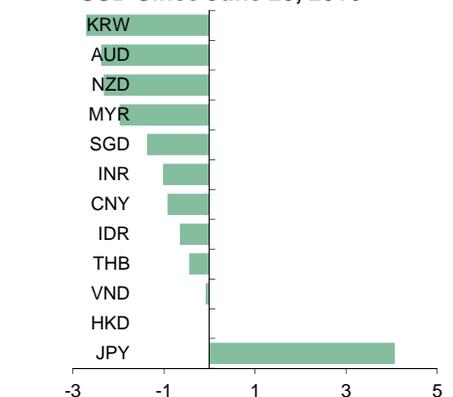
Asia-Pacific Exports To The UK



Source: Bloomberg, Scotiabank Economics.

Chart 2

APAC Currency Performance Vs. USD Since June 23, 2016



Source: Bloomberg, Scotiabank Economics.

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