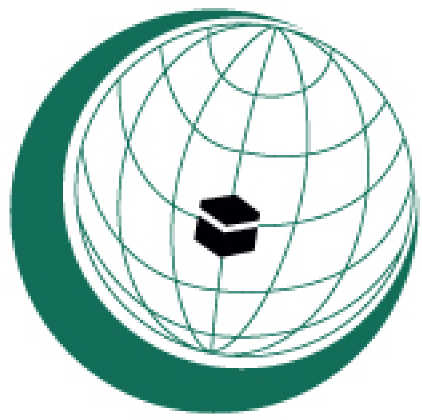

"THE IMPACT OF BREXIT ON THE ECONOMIES OF THE OIC MEMBER STATES"

Islamic Centre for Development of Trade

Impact of the Brexit on the foreign trade of the OIC countries

Summary

The British surprise vote in favor of the Brexit created a climate of uncertainty on all sides, particularly in terms of trade. Indeed, as this country is a Member of the European Union (EU), its commercial transactions with third countries are governed by the agreements concluded between the Union and these countries, including several OIC Members States.

The exit of the United Kingdom from the EU will have among other implications, to put an end to the implementation of these agreements at the level of trade exchanges of the country with the rest of the world. The possibility of having to renegotiate its accession or retention within the WTO is increasingly raised.

Several post-Brexit scenarios are to be considered and fall into two perspectives: A soft Brexit in which the United Kingdom remains linked to the EU by some trade arrangements such as those of Switzerland or Norway, on the one hand, and a hard Brexit where the UK pulls out completely from the EU on the other.

Depending on the chosen scenario, the implications on the OIC countries, and in particular those with strong trade relations with the UK, may vary significantly. However, these implications, which are often presented under their negative aspects, will also create opportunities in both the UK and EU markets.

Therefore, it is strongly recommended that OIC Member States should not wait until the effective exit of the UK from the EU to begin negotiations to establish trade agreements with this country. Moreover, the UK has already begun to approach some countries such as Turkey to explore the possibility of concluding agreements in this direction. The OIC countries will also benefit from considering the opportunities that may arise in the European market as a result of the UK exit.

BREXIT'S IMPACT ON FOREIGN TRADE OF OIC COUNTRIES

06 JANVIER 2017

ISLAMIC CENTRE FOR DEVELOPMENT OF TRADE
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The unexpected vote of the British to leave the European Union, is constantly raising a myriad of questions. Everyone seems to have been taken aback by the outcome of the vote, including many of those who voted in favor of the Brexit. Indeed, many voted in an emotional **reaction** to the appeal of Boris Johnson to "recover the country" and "ensure its independence" so as to be able to say NO to the European Commission, NO to the reception of the thousands of immigrants whom Brussels wanted to impose on their country.

Still suffering from the after-effects of the crisis, many British were sensitive to the pro-Brexit warnings that prophesied a surge of immigrants who would compete with their nationals for jobs, further unbalance and worsen the labor market as well as the State financial situation by the social and family allowances many of them would apply for as soon as they set foot on British soil.

Many of the British had not fully sized up all the consequences of their vote in favor of the Brexit. They are now helplessly looking at an overly disappointed Scotland threatening to separate from the UK invoking the same principles of democracy that motivated the British referendum. Indeed, having voted 62% to remain in the European Union, the Scots do not understand why they have to accept the decision of the English voters. Since the announcement of the results of the vote, the Scottish Prime Minister, Nicola Sturgeon, has not ceased running in the corridors of the Brussels Commission and the European Parliament endlessly repeating that her country does not feel held by the Brexit.

British Overseas Territories such as the Rock of Gibraltar are in a legal, political and geostrategic unenviable imbroglio since the announcement of the results of the vote. Most importantly, all trade partners of the UK, and among them many OIC countries, are in disarray since the referendum results were disclosed.

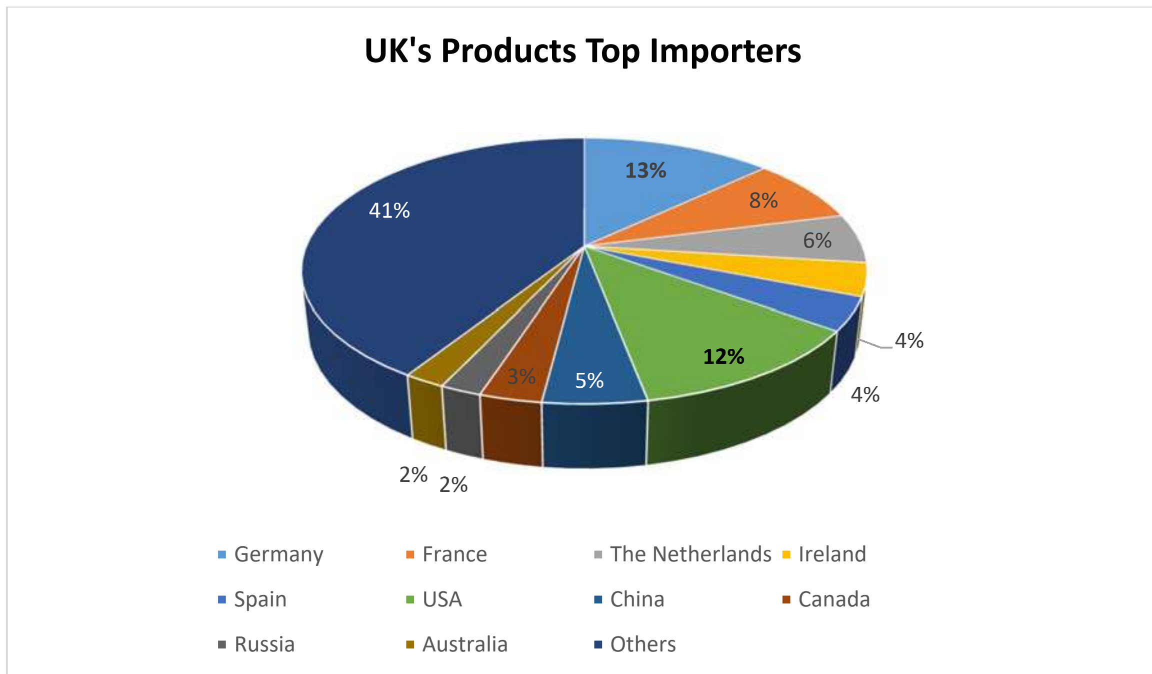
Without going into geostrategic developments, our intention in this chapter is mainly to raise questions about the future of trade between the UK and the OIC countries. It is also to shed light on some recommendations to thwart away or, at least to cushion, any possible negative effects the Brexit may have on OIC countries exporting to the UK.

I – IMPORTANCE OF THE UNITED KINGDOM IN WORLD TRADE, AND ECONOMY

The UK is a key global player, accounting for 4% of global GDP. Its economy is highly integrated in global value chains, mainly in Europe with which it has strong links. Truly, the EU accounts for half of the UK's trade and more than 40%[1] of the value added in UK exports. It also holds a key world position as a service exporter and importer with services representing 37% of UK total exports and 23% of its imports. Around 2/3 (66%) of these services are imported from non-EU members and particularly from the USA, which accounts for almost 30% of all services imported into the UK.

[1] These figures take no account of the Rotterdam effect. In other words, the UK does a large amount of trade with the Netherlands, some of which end up re-exported to countries outside the EU while being recorded as EU trade.

Figure 1



Source: Based on data from Trade Map

The UK's main suppliers of intermediate products in the EU are Germany (11%), and France (6%). These two countries are also the top importers of the UK's intermediate products accounting respectively for 9% and 6%.

In addition to the EU, the UK also has strong relationships with non-EU members. Indeed, about 60% of intermediate goods and by-products used in the production of UK exports are imported from outside of the EU, and mainly from the USA and Norway.

Table 1: EU Trade Agreements with OIC Countries

EU – Albania	EU – Lebanon
EU – Algeria	EU - Morocco
EU – Cameroon	EU – Palestine
EU – Côte d'Ivoire	EU - Syria
EU - Egypt	EU – Tunisia
EU – Guyana	EU - Suriname
EU – Indonesia (Negotiations in progress)	EU – Turkey
EU - Jordan	

With regard to the UK's trade with emerging and developing economies, the key partners of the UK are located in Eastern and Central Europe, mainly Hungary, Poland, and the Czech

Republic. They are also situated in Sub-Saharan and Southern Africa, and particularly South Africa, and Nigeria.

The main UK's exported products are Transport equipment, Electrical and optical equipment, and machinery. As for top imported products, Transport equipment ranks first (again) followed by Mining and quarrying, and by Chemicals and chemical products.

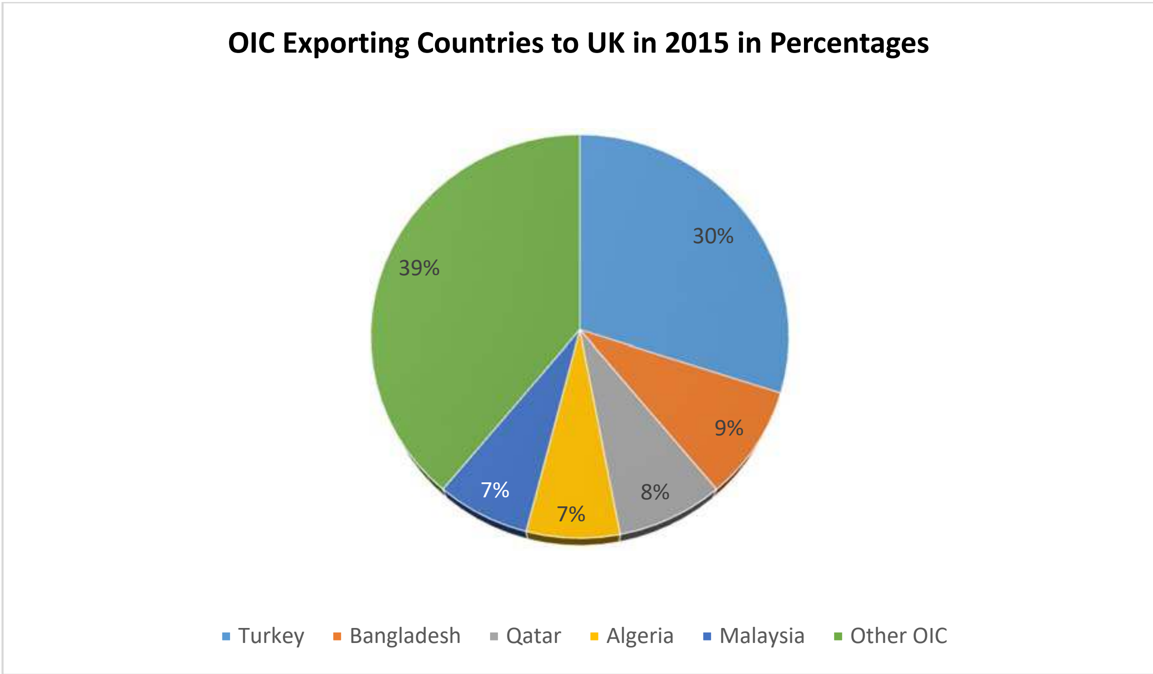
It is noteworthy that, on average, 60% of all UK exports between 2011 and 2014 were undertaken under preferential arrangements. During the same period of time, 64% of all UK imports were carried out under such arrangements[2]. However, these trade arrangements were those bilaterally negotiated between the EU and individual countries. As far as OIC countries are concerned, 14 such trade agreements are currently active (Table 1).

II – CURRENT TRADE BETWEEN THE UNITED KINGDOM AND OIC COUNTRIES

The United Kingdom (UK) maintains a steady stream of business with many OIC countries both in imports and in exports. In 2015, UK imports from OIC countries reached 37.2 billion USD, which represents about 5% of all UK imports from the world. It is noteworthy however that while quite important regarding the amount of UK trade, these imports dropped from 45 billion USD in 2014 where they accounted for 6% of all UK imports.

With regard to OIC exporting countries to the UK, they can be categorised in the four following main groups:

Figure 2



Source: Based on data from Trade Map

Group 1: Key OIC exporting countries to UK (61% of UK imports from OIC in 2015)

[2] World Bank & Competiveness Global Practices (2016). "Trade and Investment Implications of Brexit", July 11, 2016, p0. 10-11.

A few OIC countries only are responsible for 61% of these imports, namely Turkey, Bangladesh, Qatar, Algeria, and Malaysia (Figure 2). Alone, Turkish exports to UK totalised 11,1 billion USD in 2015 or about 30% of all OIC exports to that country.

Group 2: Important OIC exporting countries to UK (26% of UK imports from OIC in 2015)

A second group of OIC exporting countries to UK includes Nigeria, Indonesia, Saudi Arabia, Pakistan, UAE, and Kuwait with exports to UK exceeding 1 billion USD in 2015. Together they represent 26% of all OIC exports to the UK.

Group 3: OIC countries with some significant exports to UK (9% of UK imports from OIC in 2015)

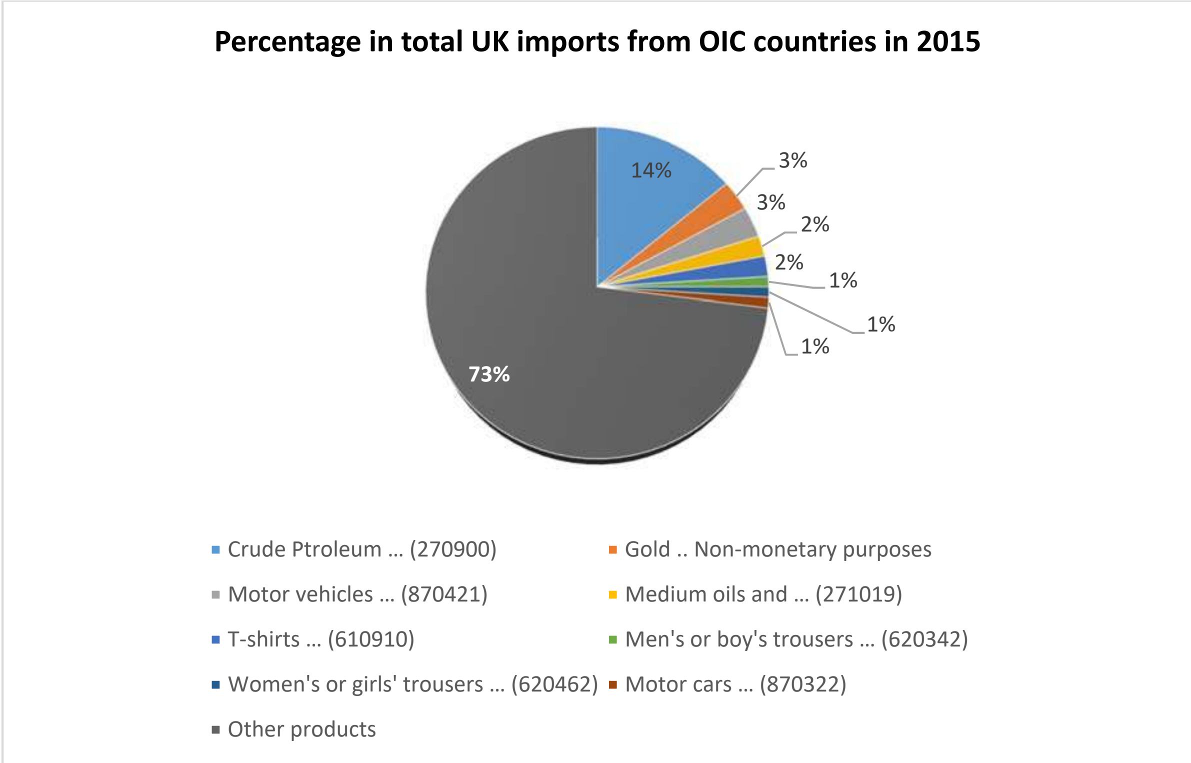
This group encompasses OIC countries with some exports to the UK. Its includes Egypt, Morocco, Kazakhstan, Côte d'Ivoire, Tunisia, and Bahrain.

Group 4: OIC countries with very limited exports to UK (4% of UK imports from OIC in 2015)

This group includes all other OIC countries whose exports accounted for about 4% only of all UK imports from OIC.

It is noteworthy that 23 OIC countries only managed to increase their exports to UK between 2014 and 2015. In value, the most important increase was recorded by Turkey (+ 510,7 million USD or 4%), Bangladesh (400 million USD or 12%), Qatar (124 million USD or 4%), Kazakhstan (+ 423.1 million USD or 147%), Côte d'Ivoire (+ 73.9 million USD or 33%), and Iraq (+76.5 million USD or 1,869%).

Figure 3



Source: Based on data from Trade Map

With regard to products imported by the UK from OIC countries, Crude petroleum oils and oils obtained from bituminous minerals (270900) accounted for 14% of all UK imports from OIC countries, followed by Gold, unwrought, for non-monetary purposes (710812) with 3%. Other important products are Motor vehicles for the transport of goods (870421), Medium oils and preparation (271019), Textile products (HS 61 and 62), etc. (Figure 3). Oil exports to UK was dominated by Algeria, Nigeria, Saudi Arabia, and Kuwait, while Qatar dominated Gas exports. As for exports of Gold to the UK, they were chiefly carried out by Turkey, which exported also Textiles and garments along with Bangladesh.

As for UK exports to OIC countries in 2015, they amounted to 42.9 billion USD, or 9% of UK exports to the world in regression by 6% as compared to 2014. Again, four groups can be identified with regard to the importance of their imports from the UK.

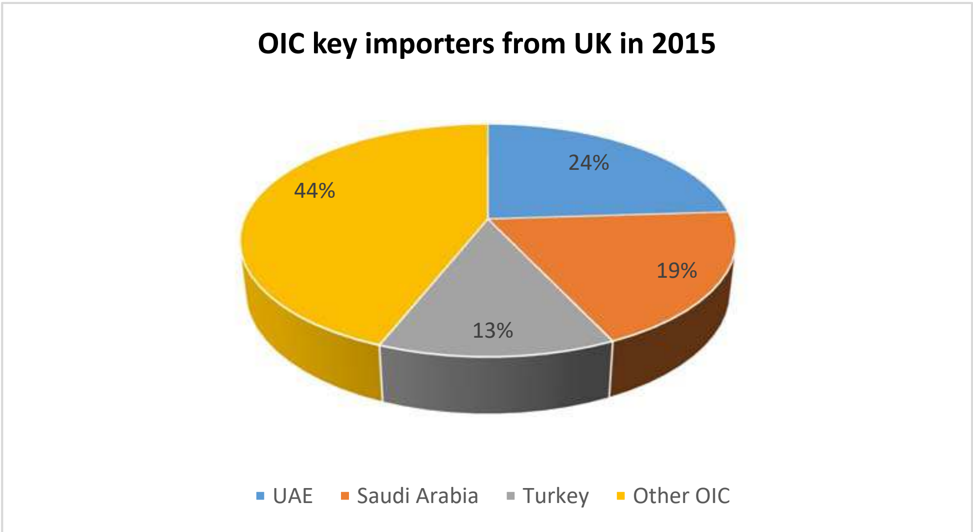
Group 1: Key OIC importing countries from UK (56%)

This group includes three important customers of the UK importing at least 5 billion USD, namely, UAE (24%), Saudi Arabia (19%) and Turkey (13%). They represent more than the half of all OIC imports from the UK (Figure 4).

Group 2: Important customers of UK products (22%)

In this group we find five countries totalising 22% of all UK exports to OIC countries. These are countries importing at least 1 billion USD from the UK in 2015. They are Qatar (7%), Malaysia (5%), Nigeria (4%), Egypt (4%), and Azerbaijan (2%). It is noteworthy that Indonesia was a part of this group in 2014, but it slipped down to the third group because of a sharp drop in its imports from the UK.

Figure 4



Source: Based on data from Trade Map

Group 3: OIC countries with limited imports from UK (14%)

This group includes OIC countries whose imports from the UK totalise more than 500 million USD. It encompasses nine countries, namely, Kuwait (2%), Pakistan (2%), Morocco (2%), Indonesia (2%), Oman (2%), Brunei Darussalam (1%), Lebanon (1%), Kazakhstan (1%), and Algeria (1%).

Group 4: OIC countries with very limited to no imports from UK (8%).

In this group we have all other OIC countries whether they import limited quantities of products from UK or not.

As for products imported from the UK by OIC countries, they are very diversified. The five top groups of products at HS-6 accounted for only 17%.

Turbojets of a thrust higher than 25 kn (841112) with 5%; Motor cars … (870324) with 4%; Gold … (710813) with 3%; Parts of airplane or helicopters (880330) with 3%; and Medicaments … (300490) with 2%.

III - IMPACT ASSESSMENT OF BREXIT ON OIC COUNTRIES EXPORTING TO UK

As a direct result of the Brexit vote, the British government of Theresa May pledged to shortly activate the now-famous Article 50 procedures to start the country's pulling out from the European Union. As soon as the divorce is officially pronounced, trade between the UK and OIC countries will no longer be bound by any existing agreement these countries may have with the European Union.

Definitely, the main impact of the Brexit on OIC countries involved in business relationships with the UK, stems from the uncertainty it has caused that exacerbates already existing uncertainties. Indeed, with economic adjustments in China, commodity prices decline, world trade downturn, and ambiguous new political era in the US with the election of Donald Trump, as a backcloth, to enumerate only a few facts, the future business environment did not need an additional fog-maker event such as Brexit.

As a matter of fact, the effects of Brexit on all countries will depend on the type and form of deal that the UK will negotiate. In other words, they will be contingent upon the post-Brexit scenario that the UK will choose provided that it will be accepted by its partners.

As a general assessment and given the current volume of trade in services between the UK and OIC countries, the effects of Brexit on the services trade flows with these countries are likely to be very small to negligible.

The impact on these countries in terms of trade flows will definitely vary according to many points including but not limited to the following:

1. OIC countries exporting to UK are likely to be much more impacted than those importing from this country. Truly, OIC countries may keep the same treatment and procedures to let UK products into their markets or they can change them. Be as it may, the decision rests with the OIC country not with the UK authorities. That is the reason we exclude imports from the UK in this impact assessment.
2. The more an OIC country exports to the UK, the more likely it is to be impacted by the Brexit. Hence, OIC countries of Group 1 and, to a lesser extent, those of Group 2 in the above classification, will be much more impacted by the Brexit than countries of Groups 3 and 4. For this reason, we limit our impact assessment to OIC exporting countries of the two first groups. However, as the Brexit may entail indirect impacts on OIC countries of the last two groups (3 and 4), we will provide some implications and recommendations in this respect.
3. With regard to the future relationships between the European Union and the UK, two very different perspectives are often evoked:

a. The first one, called **"Soft Brexit"** provides for the possibility of maintaining strong economic relationships between the UK and the Union. Various scenarios regarding the concrete form of such relationships are currently under scrutiny both in Brussels and in London. In this regards, three main scenarios are possible, namely the Swiss scenario, the Norway scenario, and an ad-hoc third scenario to be tailored to fit the specific needs of the UK;

b. The second perspective, called **"Hard Brexit"** states a complete divorce with the Union with no form of partial or total free trade agreement. In this case, future relationships between the UK and the European Union will be bound by WTO provisions unless this organization decides to renegotiate its membership with the UK as a new candidate.

We will see later that each one of the above-mentioned perspectives and scenarios entails specific consequences on trade with OIC countries. It is noteworthy however that in her last speech on January 17, Theresa May overtly opted for a Hard Brexit. However, the final outcome will result from negotiations with the EU.

On the basis of the previous key points and for the sake of sizing up the impact of the Brexit on OIC exporting countries to the UK, it is important to distinguish between OIC exporting countries to UK that are, in the same time, members of WTO and those that are not. In this respect, among all OIC countries of groups 1 and 2, only Azerbaijan is not currently a full member of WTO. It is however an observer at WTO and is expected to start accession negotiations shortly.

A – Post-Brexit Scenarios

As previously explained, several post-Brexit scenarios are currently on the table both in Brussels and in London to frame the post-Brexit trade relationships between the European Union and the UK. Among all these scenarios, four are particularly under analysis, namely, the so-called "Norway" scenario, the "Swiss" scenario, the "free trade agreement FTA" scenario, and finally, the "no-agreement" also called the "hard Brexit" scenario. These four scenarios entail varying degrees of "depth" and "scope" in economic and trade integration.

1. The **"Norway" scenario** assumes that, after leaving the Union, the UK will remain "a part of the European Single Market, enjoying free movement of goods, services, people and capital. But it will have to accept and implement EU legislation governing the Single Market without being able to influence it. In addition, it will not belong to the EU's customs union, and UK exports will need to satisfy rules of origin requirements in order to enter the EU duty free and the EU can use anti-dumping measures to restrict imports from the UK.[3]" In this scenario, there would be almost duty-free UK-EU trade, except for agriculture, and nearly full access to the EU Single Market. It will also have access to the 26 FTAs signed by the EFTA, but not to those signed by the EU.

2. The **"Swiss" scenario** is based upon the assumption that the UK will not a part neither of the EU nor of the European Single Market. Instead, it will negotiate bilateral agreements and treaties with the EU, and will adopt some EU policies and regulations in specific areas. While such a scenario would give the UK enough leeway to select which initiatives it wishes to

[3] World Bank & Competiveness Global Practices, *Op. Cit.* p. 2.

participate in, it means less economic and trade integration with the EU than the previous scenario.

3. The **"free trade agreement (FTA)"** scenario is actually an *ad-hoc* scenario close to the Swiss one. It would enable the UK to negotiate FTAs independently with the EU including a trade agreement to govern relationships between the two partners. Trade tariffs between the UK and the Union are unlikely to some extent, but the UK will have to agree common standards and regulations.

4. The **"no-agreement"** or the **"hard Brexit"** scenario means that none of the previous possible scenarios is adopted and agreed upon. In this case, trade relationships both the Union and with other countries will be bound by WTO rules and commitments. "the UK exports to the EU and other WTO members would be subject to the importing countries' MFN [Most Favoured Nation] tariffs.[4]"

Actually, there is an **additional scenario**, which even if it seems unlikely to many specialists, remains possible. It is that of having the WTO impose on the UK to renegotiate its membership to the world organization. Truly, "before the referendum [Brexit], Roberto Azevedo, the Director General of the WTO, warned that the UK would face 'torturous negotiations' over the terms of its WTO membership. He said 'pretty much all of the UK's trade [with the world] would somehow have to be negotiated'. The UK joined the WTO as a member of the EU and Mr Azevedo said the UK would not be allowed simply to cut and paste those terms.[5]"

While all these scenarios directly pertain to trade between the UK and the EU, they all entail implications on non-EU countries and mainly on those with a steady stream of business with the UK and/or with the EU itself.

B – Impact of Brexit on OIC-Exporting Countries

As previously said, the impact of Brexit on OIC exporting countries varies according to many factors including the intensity of current trade relationships with the UK, the post-Brexit scenario to be adopted, and whether the OIC country is member or not of the WTO. Table 2 summarizes the general impact of Brexit on these countries on the basis of all the above-mentioned factors.

In addition, the pressure on OIC exporting countries to engage in trade negotiations with the UK is more or less high depending on the intensity of current business stream with that country. Truly, the pressure on Turkey for instance, whose exports represent around 30% of all OIC exports to the UK, is much higher than that of a country of the fourth group, which has very limited to no exports toward the UK.

The following comments are worth-making on the basis of Table 2:

1. OIC countries of Group 1, namely, Turkey, UAE, and Saudi Arabia, are the countries with the highest pressure to cope with the current uncertainty created by the Brexit. Indeed, the share of their exports to the UK is important and it would be very painful to lose such a market almost overnight. However, as WTO members, they are more protected than other countries

[4] World Bank & Competiveness Global Practices, *Op. Cit*. p. 3

[5] House of Commons Library (2016). "Brexit: Impact Across Policy Areas", Number 07213, 26 August 2016.

against the UK market closure in all post-Brexit scenarios with exception of the last one where the UK's membership to the WTO is terminated.

2. The likelihood that these countries increase their exports to the UK market is also high. Indeed, it is likely that if the UK does not adopt the same tariff as the European Union, they may reduce it for many products imported from OIC countries. The UK has always defended the least protectionist position in trade negotiations with non-EU countries.

3. Even in the case the UK leaves the European Union with no post-Brexit trade arrangements, these OIC exporting countries would be able to improve their competitiveness on this market. As a matter of fact, in such a situation, the European products will have to pay customs duties to enter the UK market. Consequently, they may become more expensive and less competitive than some similar products imported from OIC countries. Similarly, in such a scenario, the UK products would have to pay customs duties to enter the European market giving a possible opportunity for OIC countries to increase their competitiveness. Such a comment is compliant with the findings by Ciuriak *et al*. (2015) who, using a CGE framework, find that the Brexit would have potentially positive effects on non-EU members[6].

4. Given the products currently exported by OIC countries of this Group, Turkey, while more at risk, is in a position to increase its exports both to the UK market and to the European Union.

5. OIC-countries of Group 2[7], with the exception of Azerbaijan, which is not currently a regular WTO member, are in situation close to that of countries of Group 1. However, considering the intensity of their exports to the UK, they are less at risk of being negatively impacted by the Brexit. On the other hand, they can reap almost similar benefits as countries of Group 1 if European products will have to pay customs duties to enter the UK market.

6. Azerbaijan, being a non-member of WTO, is the only country of the two groups that may face more than MFN tariffs in all post-Brexit scenarios. However, it could increase its exports if the UK sets tariffs at a competitive level for Azeri products. In all cases, Azerbaijan is strongly encouraged to engage in accession negotiations with the WTO to be eventually protected from higher-than-MFN tariffs.

7. For all countries, the worst scenario is probably that of the UK having to renegotiate its membership with the WTO. Truly, in such a case, the UK may set its tariffs at a level where some OIC products lose their competitiveness on that market.

On the basis of the approach used by Mendez-Parra et al. (2016[8]) in which the authors based their estimation on two assumptions: (i) a 10% devaluation of the Sterling Pound, and (ii) a forecast effect of Brexit on GDP of 3% drop within 18 months, Bello (2016[9]) estimated the Brexit effect on some IDB Members. His findings suggest that these countries' exports to the UK would decline by 0.3%. According to his calculations, countries to be affected most are those with high export exposure to UK such as Bangladesh (-1.2%), Turkey (-1%), Algeria (-

[6] Ciuriak, D. & Xiao, J. with Ciuriak, N. Dadkha, A. Lysenko, D. and Narayanan, B. (2015). "The Trade-Related Impact of a UK Exit from the EU Single Market", Ciuriak Consulting Inc., April 25.
[7] In addition to Indonesia, whose potential would enable it to come back into Group 2.
[8] Mendez-Parra, M. et al. (2016). "Brexit and development: How will developing countries be affected?", ODI Briefing, July 2016.
[9] Bello, A. (2016). "Trade with UK: How Brexit affects IDB Member Countries", IDB, August 2016, p. 18.

0.9%), Guyana (-0.9%), Maldives (-0.8%), Qatar (-0.7%), Pakistan (-0.7%), Gambia (-0.64), Egypt (-0.6%), and Nigeria (-0.5%).

In our opinion, such forecasts seem to be too pessimistic. First, the assumptions these estimations are based upon are not realistic; Second, the estimations omit to take into consideration the opportunities that would stem from the Brexit both on the UK and on the EU markets, opportunities than can be seized by OIC countries and that may counterbalance whatever negative effects the Brexit may have on their exports; Third, they also ignore the "strategic" moves OIC countries may make toward striking new trade deals with the UK in a bid to cushion possible negative effects of the Brexit.

Post-Brexit Scenarios / OIC Exporting Countries		Groups 1 &2		Groups 3 & 4	
		WTO Members (Turkey, UAE, KSA, Qatar, Malaysia, Nigeria, Egypt, Indonesia)	**Not WTO Members** (Azerbaijan)	**WTO Members**	**Not WTO Members**
Soft Brexit	**Norway Scenario** UK remains linked to the EU and may use the same tariffs	- OIC countries would have to pay the same tariffs as with EU if the UK adopts the same tariffs). Otherwise, they will have to pay those to be applied by the UK.	OIC countries may be required to pay higher than WTO tariffs	- OIC countries would have to pay the same tariffs as with EU if the UK adopts the same tariffs). Otherwise, they will have to pay those to be applied by the UK.	OIC countries may be required to pay higher than WTO tariffs
	Swiss Scenario	- OIC countries would have to pay the same tariffs as with EU if the UK adopts the same tariffs). Otherwise, they will have to pay those to be applied by the UK but no more than MFN tariffs. - They would be able to compete with European products on the UK market if the latter do not abide by the new UK regulations.	OIC countries may be required to pay higher than WTO tariffs	- OIC countries would have to pay the same tariffs as with EU if the UK adopts the same tariffs). Otherwise, they will have to pay those to be applied by the UK but no more than MFN tariffs. - They would be able to compete with European products on the UK market if the latter do not abide by the new UK regulations.	OIC countries may be required to pay higher than WTO tariffs
	FTA Agreement	- Depending on the FTA provisions, OIC countries may have to pay the same tariffs as those of the EU market or those applied by the UK. - The likelihood of competing with the European products on the UK market is low as that of competing with the UK products on the EU products.	OIC countries may be required to pay higher than WTO tariffs	- Depending on the FTA provisions, OIC countries may have to pay the same tariffs as those of the EU market or those applied by the UK. - The likelihood of competing with the European products on the UK market is low as that of competing with the UK products on the EU products.	OIC countries may be required to pay higher than WTO tariffs
Hard Brexit	**No-FTA / WTO** UK leaves the EU with no trade arrangements, but remains a part of WTO	- OIC countries would pay MFN tariffs to enter the UK market. - These countries may increase their exports to the UK market if EU's products lose their competitiveness as they will have to pay customs duties. - They can also increase their exports to the EU market as UK products have to pay customs duties.	- OIC countries may be required to pay higher than MFN tariffs to enter the UK market. - These countries may increase their competitiveness both on the UK and the EU markets if an arrangement is reached and/or if they provide unique products	- OIC countries would pay MFN tariffs to enter the UK market. - These OIC countries may find some of their products becoming more competitive on the UK market and/or on the EU market and increase their exports.	- OIC countries may be required to pay higher than MFN tariffs to enter the UK market. - These countries may increase their competitiveness both on the UK and the EU markets if an arrangement is reached and/or if they provide unique products
	No-FTA / No WTO	**Total uncertainty**			
Pressure to negotiate with the UK		**High**	**Quit high**	**Medium**	**Low**

IV – RECOMMENDATIONS FOR OIC EXPORTING COUNTRIES

As many countries are waiting for dust raised by Brexit to fall back, the UK has already started pre-negotiating trade agreements with its main partners. So far, it "has held talks with countries including India, China, New Zealand and Australia in the hope of negotiating full trade deals… Turkey's government is the latest to line up to sign a free trade agreement with the UK once Brexit takes place, with its economy minister promising a 'wide ranging' deal with Britain.[10]"

1. Other OIC-countries of Groups 1 and 2, namely, UAE, KSA, Qatar, Malaysia, Nigeria, Azerbaijan, Egypt, and Indonesia, which are under a high pressure to negotiate with UK, are strongly advised to start consultations with the UK with a view to engaging in trade negotiations as soon as the UK officially leaves the EU.
2. OIC-countries of the two other groups may also find it profitable to officially manifest their interest in scaling up their trade relations with the UK. Indeed, at least the two scenarios that fall within the Hard-Brexit have as a direct consequence, that the European products will have to pay customs duties to enter the UK market losing some of their current competitiveness. Consequently, some OIC countries' products may become more competitive on the UK market, which gives them an opportunity to increase their exports to that market.
3. As a corollary to the previous point, a study is highly recommended to analyse all UK imports, be they intermediate or final products, in comparison with what OIC countries can export. A simulation using various post-Brexit scenarios, would identify all OIC products with trade potential that can be promoted on the UK market. We know for instance that OIC countries with a strong automotive industry such as Morocco, Tunisia, and Malaysia have a good chance to supply the UK with intermediate and by-products.
4. Some OIC countries may find it interesting to negotiate a FTA with EFTA countries for two main reasons: First, by themselves, EFTA countries offer a very interesting market for many OIC products; Second, if the UK goes back to the EFTA after leaving the EU, it will adhere to the same trade arrangements as other countries of that trade block.
5. In uncertain times like the ones created by Brexit, OIC countries and mainly those with high exposure to UK, are urged not to put all their eggs in the same basket. Indeed, they would need to find alternative export markets for their products and diversify their trading partners.
6. All OIC countries should see the Brexit as a wake-up alarm and strengthen intra-OIC trade. They should "work closely with each other by scaling up their level of intra-trade activities, which is still below the desired level[11]".
7. All OIC countries are urged to seek assistance from OIC subsidiary organs to help them prepare, and later on, engage in trade negotiations with the UK with a view to strike beneficial deals with the post-Brexit UK. The ICDT can play a key role in this regard given its long and proven experience in trade-related technical assistance.

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[10] http://www.telegraph.co.uk/business/2016/11/11/turkey-pushes-for-free-trade-deal-with-post-brexit-britain/

[11] Bello, A., *Op. Cit.*, p. 5.

CONCLUSION

As one can see, the Brexit has been sending shockwaves throughout the world since June 23, 2016 adding to the already-high-uncertainty the world has been wading in for many years now. With regard to trade effects of the Brexit and to paraphrase the Canadian psychiatrist MacCurdy[12] in a book called *The Structure of Morale*, the world can be divided into two types of countries: The *near misses*' countries, are those with high exposure to the UK mainly as trade partners (Groups 1 and 2); and the *remote misses*, are those who feel the shockwaves without being close to the epicentre of the earthquake, those whose exports to the UK are not significant (Groups 3 and 4).

The former, the *near misses* (Groups 1 and 2), are likely to be directly impacted by the Brexit and should prepare themselves to cope with its negative effects. They can do so mainly by diversifying their trading partners, by engaging in early negotiations with the UK to prepare the post-Brexit, by strengthening their relations with other OIC countries, and by seeking more economic integration in world value chains. They are also advised to spot opportunities stemming from the Brexit as the latter is undoubtedly going to have also a positive side. Indeed, the leaving of the UK would give birth to many opportunities both on the EU market and on the UK market for OIC products that would become competitive against other products that used to be traded tariff-free between the UK and the EU.

The latter, the *remote misses* (Groups 3 and 4) are less at risk than countries with highly exposure to the UK. Nevertheless, they are also advised to seize the opportunity created by the Brexit to increase their exports both to the EU and to the UK.

Whatever the strength of their exposure to the UK and their relations with the EU, all OIC countries are advised to withdraw relevant lessons from the Brexit and the unprecedented situation it creates. Indeed, the world is engaging in an unheard of era of uncertainty where the metrics and the prediction tools used so far are no longer of help. Very few people could predict the Brexit itself, or the election of Donald Trump, or the rejection by the people of the peace treaty between the Colombian government and the FARC, or the failure of Alain Juppé to win the *primaires* of his party in France, etc. OIC countries should prepare themselves not to be dependent upon any single trade partner. They should shape their economy so that their products be attractive to world value chains rather to fit a partner's specific needs.

And to go back to the Brexit, OIC countries should act now instead of waiting for the situation to unfold with the post-Brexit. As the Italian historian Ferrero puts it, there are two types of people: those who feel the rain coming and look for a shelter or, at least for an umbrella; and those who wait to be wet before looking for them.

[12] Cited by Malcolm Gladwell in "David and Goliath", LB Edition, 2013, p. 131. Actually, McCurdy talks of three types of people during wartime. When a bomb falls, it divides people into three groups: people killed, *near misses* (people directly affected but who survive), and *remote misses* (people who hear the blast, see the smoke and the ambulances, but do not experience directly the bombing).

ISLAMIC DEVELOPMENT BANK

Financial Implications of the *Brexit* Decision for the OIC Member Countries[1]

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Economic Research and Policy Department

GROUP CHIEF ECONOMIST COMPLEX

[1] This paper was prepared by the Economic Research and Policy Department (ERPD) of the Islamic Development Bank (IBD) and is part of a broader technical study on the impact of *Brexit* on the OIC member countries. The study was requested by the OIC Resolution 6/43-E and conducted jointly by ICDT, SESRIC and the ERPD on behalf of the IDB Group.

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Executive Summary

1. The decision of the United Kingdom (UK) to leave the European Union (EU)—known as *Brexit*—is set to alter a long-standing economic relationship between the UK and the EU. This has a number of potential financial and monetary implications for the UK and the rest of the world, including the member countries of the Organization of Islamic Cooperation (OIC). These implications could include the impact on *financial flows*—namely the flows of investment, investment income, remittances and official development assistance from the UK to the OIC member countries—and the impact on *financial stocks*—namely the assets and liabilities on the balance sheets of the OIC investors and financial institutions.

2. It would be overambitious to aim to provide an unconditional quantitative assessment of the financial implications of Brexit. This is due to a very limited availability of detailed data on the OIC member countries' (MC) financial exposures to the UK, a lack of robust historical correlations between the UK's economic performance and financial flows to and from the OIC MCs, and the uncertainty about the final shape of the *Brexit* arrangement and hence its medium- to long-term economic and financial impact. Even so, this report lays out a comprehensive framework that may be used to gauge an approximate magnitude of the potential financial and monetary impact once some of the uncertainty recedes and the final *Brexit* arrangement takes shape.

3. Financial implications of the *Brexit* decision on the OIC member countries will materialize through three fundamental channels: the impact on the UK's (and global) growth, the impact on the UK (and global) monetary policy, and the impact on the path of the UK (and global) asset prices.

4. The UK and the global economy have so far shown only very limited signs of negative impact, in contrast with many pessimistic predictions made in the run-up to and immediately after the *Brexit* referendum in June 2016. Likewise, the financial markets appear to have largely dismissed their initial concerns about the economic risks that the *Brexit* might entail by more than reversing their initial negative moves. These better than expected responses to the *Brexit* decision could be explained by (1) the large exchange rate adjustment in the British pound, which will act as the key economic shock absorber, (2) a further monetary policy easing delivered by the Bank of England in August last year, and (3) the expectation of positive spillovers from the US economy should President Donald Trump deliver on his campaign promises to cut taxes and boost fiscal spending.

5. However, should the expectations of an economically benign *Brexit* change and the asset prices and the pace of economic activity begin to reflect a less optimistic scenario, the OIC MCs would could financially impacted: namely, in proportion to their exposures to the UK financial flows and to the UK (GBP-denominated) assets and liabilities on their financial balance sheets. In general, a weaker UK economy and a weaker UK balance of payments could mean weaker flows of the UK's outward investment, income, remittances and aid to the OIC MCs, as well as lower UK asset prices. Furthermore, the US dollar value of these flows and assets could be reduced by the depreciation of the British pound, above and beyond its depreciation so far.

6. The size of the past financial flows from the UK to the OIC MCs provide a useful window into assessing which of the MCs could be impacted most. Although the link between the capital flows to the individual MCs and the UK's growth and current account is not tight enough to make definitive predictions, Mali, Azerbaijan and Mozambique could be most exposed relative to the size of their own GDP. Meanwhile, Malaysia, Indonesia, Turkey, Nigeria, Saudi Arabia and the UAE have the largest exposures in absolute, US dollar terms.

7. The MCs that could be impacted most by a decline in the UK's remittances are the Gambia, Uganda, Nigeria and Pakistan. In contrast, Bahrain, Kazakhstan, Malaysia and Saudi Arabia are most exposed to the potential declines in income flows from their own investments in the UK assets. Meanwhile, Sierra Leone, Somalia, Syria and Afghanistan could be most affected by the decline in the US dollar value of the official development assistance they annually receive from the UK government.

8. Bahrain, Brunei, UAE and Maldives have the highest stock of outstanding loans from the UK-based banks relative to their own GDP and could therefore be most affected by a deterioration in the financial condition of the UK-based financial institutions. On a related subject, we conclude that the emerging financial centers in the OIC MCs are unlikely to benefit materially from a *Brexit*-related weakening of the position of London as the top global financial center.

9. The potential impact of the *Brexit* decision on the OIC MC balance sheets will be proportional to their share of the GBP/UK assets. Unfortunately, lack of publicly available data only allows us to guess that the main impact could come through the OIC MC central bank holdings of the UK government securities and that this exposure would be close to what the central banks in the emerging market and developing economies hold in GBP-denominated securities in the aggregate—approximately 5.8% of their total foreign exchange reserves. The OIC MC central banks with the highest stock of foreign exchange reserves could be impacted the most.

10. Although there are significant differences in the exposure to the UK financial flows and UK assets among the 57 OIC MCs, in aggregate (and for the absolute majority of the OIC MCs) the financial and monetary impact of the Brexit decision is likely to be either very small or highly uncertain or both. Due to the relatively small financial exposures for most MCs, this will remain the case even if the UK's economy slows in line with the initial, more pessimistic predictions and the asset prices come to reflect such negative outlook.

11. Given the uncertainty and the small magnitude of the potential financial impact, there is a limited scope for recommending *systematic* interventions that could be undertaken by the IDB Group to mitigate the financial and monetary implications of *Brexit*. However, one exception is the area of official development assistance, the US dollar value of which is likely to be reduced significantly for a number of least developed MCs as a result of the sharp depreciation of the value of the GBP exchange rate. The IDB Group could therefore focus its interventions in countries where there could the most significant shortfall relative to the MC's own GDP. Our estimates indicate that the total US dollar shortfall of the UK's country-specific annual ODA to OIC MCs in 2017 relative to 2015 could be around $740 million.

I. Introduction

In the *Brexit* referendum on 23 June 2016 the people of the United Kingdom (UK) voted to start a process through which the UK will eventually withdraw from the European Union (EU)—an economic community, which it had formally joined in 1973 and which transformed, some 20 years later, into a full-fledged economic and political union.

The UK's exit has a number of potential macroeconomic and financial implications, as the UK and the EU transition into a new economic relationship. As an EU member, the UK enjoyed a full access to the EU's internal market which was developed through harmonization of the 28 member states' legislation and economic policies. By joining the union, all of its members have committed to the so-called "four fundamental freedoms" (the freedom of movement of people, goods, services and capital within the single EU market), committed to comply with the EU laws and regulations in areas specified by the relevant EU treaties, and also committed to make annual contributions to the EU budget to support joint policy implementation and the running of the EU institutions.

The first formal step in the UK's withdrawal process will be an official notification letter that the new UK government has said it would send to the European Commission by the end of March 2017. This notice will formally trigger bilateral negotiations that will aim to establish the precise modalities of the UK's exit from the union and define the UK's new economic relationship with the EU and other non-EU countries and international bodies. According to the existing legislation, the exit negotiations may last up to two years, after which the EU treaties will cease to apply.[2] This, in turn, means that the UK might not actually leave the EU before 2019 and that the exact terms of separation may not be finalized and known before late 2018.

The goal of this report is to provide an assessment of what might be some of the most important financial and monetary implications of the *Brexit* decision for the member countries of the Organization of Islamic Cooperation (OIC).[3] For the purposes of this report, we have defined financial implications as (1) the impact of the *Brexit* decision on cross-border financial flows, including income transfers, foreign investment and development assistance, and (2) the effects of the *Brexit* vote on the OIC countries' financial balance sheets.

In Section II we briefly discuss the main channels through which the financial impact of the *Brexit* decision may potentially materialize. In the next two sections we then analyze the potential impact

[2] The process of withdrawal from the EU is governed by Article 50 of the Treaty of European Union. While there is no historical precedent, since no member state has ever left the EU, Article 50 in principle provides for an extension of the two-year negotiation period if there is a unanimous agreement among all member countries.

[3] This report deliberately does not focus on the more general economic implications of *Brexit*, such as the implications for trade and the labor markets, as those two topics are covered by separate technical studies prepared, in parallel, by the Islamic Center for Development of Trade (ICDT) and the Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC), respectively.

on financial flows (Section III) and on the OIC countries' balance sheets (Section IV). Finally, we conclude with a short summary and some policy recommendations for the IDB (Section V).

II. Channels of Financial Impact on the OIC Member Countries

Financial impact of the *Brexit* decision on the OIC member countries (MCs) will ultimately depend on the *Brexit* decision's actual economic impact. This, in turn, will depend on the final outcome of the exit negotiations. However, since the final terms of *Brexit* may not be settled and known for some time, the financial impact will, in the interim, depend on the level of the uncertainty and on the (evolving) expectations concerning the eventual economic impact.

A. Brexit Scenarios

More than six months after the Brexit referendum, the exact shape of the UK's withdrawal from the EU is still unknown and very uncertain. This is mainly due to the fundamental gap between how the UK and the EU decision makers envisage the final exit arrangement. The UK government would like its country to withdraw from some aspects of the union (such as the common immigration policy, the free cross-border movement of labor between the EU countries, or the shared approaches to banking and environmental regulation) but retain its access to the European single market for goods and services. In contrast, the EU officials have made it clear that the EU would oppose "cherry picking" from the EU privileges and responsibilities, and that any alternative arrangement would have to be renegotiated from scratch. This uncompromising approach is presumably meant to avoid creating a precedent that could encourage other national governments critical of the EU to follow the UK path, which, in turn, might undermine the 60-year old EU project as a whole.

Based on the existing arrangements between the EU and other non-EU countries, there are four plausible scenarios for the eventual economic status of the UK vis-à-vis the EU:

(1) **The "Norway" Scenario:** The UK could remain within the European Economic Area (EEA)[4] and retain its full single market access in exchange for continuing to make EU budget contributions and fully complying with the EU regulatory framework (albeit without EU voting rights). The UK would also not benefit from the third-party trade agreements negotiated by the EU as it would not be a member of the EU customs union. Those third-party agreements would have to be renegotiated.

(2) **The "Switzerland" Scenario:** The UK could leave the EEA, (re-)join the European Free Trade Association (EFTA)[5] and negotiate a set of bilateral treaties with the EU possibly securing access to the single market for *specific* sectors. Switzerland's arrangement in particular provides for free trade in most goods and grants Swiss insurance companies (but

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[4] The EEA is an arrangement that allows three economies of the European Free Trade Association (EFTA)—Iceland, Liechtenstein and Norway—to fully participate in the EU's single market.

[5] The EFTA, which in addition to Iceland, Liechtenstein and Norway includes Switzerland, is an intergovernmental organization set up to promote free trade and economic integration among its members.

not banks) a full access to the EU single market in exchange for a free movement of people, a full compliance with EU regulations, and contributions to the EU budget.

(3) **The "Turkey" Scenario:** The UK could negotiate a customized customs union with the EU, which could provide for free-trade and common tariffs for some specific segments of the goods and services market (e.g. all industrial goods but not agriculture, public procurement and services as in the case of Turkey). In this scenario, the UK would have no obligation to comply with EU regulations (although such compliance would likely be required for exported products), to make EU budget contributions and to allow free movement of people. Unless a special agreement was negotiated that covered free movement of capital and free trade in financial services, the UK-based financial institutions would lose their privileged access to the EU market.

(4) **The "WTO" Scenario:** Should the UK fail to negotiate a new set of arrangements within the two years from the official withdrawal notification letter, its trade relationship with the EU could revert to the World Trade Organization (WTO) rules and the UK would lose any preferential access to the single market. In this scenario, further bilateral negotiations would be possible (and likely) at a later date but, at least initially, as per the standard WTO rules and regulations, the UK and the EU would have to increase tariffs at each other's borders to the levels that they currently applied to other WTO members.

The above scenarios reflect different degrees of tradeoff between the UK's access to the EU's single market and greater political, economic and regulatory independence. Since the actual scenario will be a result of tough and lengthy political negotiations, it is not obvious at this stage which of the four scenarios will most likely come to pass. The first two (often referred to as "soft *Brexit*", due to the fact that the UK would retain most of its access to the EU market) do not address the key issues that have triggered the Brexit vote in the first place: the UK's contributions to the EU budget, the anxiety about the influx of immigrants (as well as migrants and refugees) from the rest of the EU, and the UK's resistance to rules and regulations being imposed by the supranational EU institutions. This will make the first two scenarios very difficult to accept for the new UK government, which has won its mandate by running a political campaign centered around these very same issues. Meanwhile, the last two scenarios (referred to as "hard *Brexit*") imply that the UK would have to give up much of the current preferential economic access to the EU's internal market. This will make the last two scenarios unattractive on practical economic grounds.

Finally, during her speech on 17 January 2017, the UK Prime Minister Theresa May for the first time revealed some details about her vision of the UK's exit from the EU and provided her view on how to reconcile between the hard and soft *Brexit* dilemma outlined above: She admitted that the UK will not be able to remain in the EU's single market after it leaves the EU but that her government will push for a "bold" new "comprehensive trade agreement" that would give the UK "the greatest possible access" to the single market. The Prime Minister also said that the UK will have to leave the EU's customs union (i.e. the common trade policies vis-à-vis the third countries) but that she wanted the UK "to have a customs agreement with the EU".[6]

[6] http://www.bbc.com/news/uk-politics-38641207 (accessed on 20 January 2017)

The bottom line is that the final shape of *Brexit* will depend on the result of the negotiations and that it may not be possible to predict the final *Brexit* arrangement and its full financial implications with any reasonable degree of certainty for some time—although some of the uncertainty may recede once the negotiations get underway in the next few months.

Fundamentally, there are three distinct channels through which the *Brexit* decision could potentially have financial implications for the OIC member countries: (1) the path of the UK and the global economy, (2) the monetary and fiscal policy responses to the *Brexit* decision, and (3) the path of the UK and global asset prices resulting from (1) and (2). In the next subsection we discuss these three fundamental channels in turn.

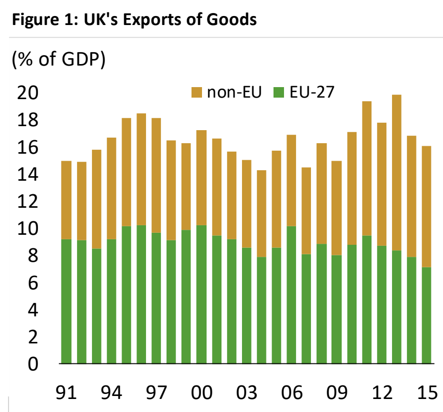
B. Real Economy Channel

Financial flows and asset prices, which affect the values of financial balance sheets, are ultimately a function of the level of real economic activity and of the expectations of what that level of activity might be in the foreseeable future. Financial capital in search of economic returns typically flows into countries where growth is higher or where it is expected to outperform over any given investment horizon. In addition, it is the countries that run current account surpluses, typically on account of a strong export performance, that are the exporters of financial capital. Furthermore, it is the governments in well-performing rich economies that have the capacity (both financial and political) to provide generous amounts of official development assistance (ODA) to the less developed parts of the world. Finally, strong economic performance typically implies rising prices of riskier assets (stocks and real estate) relative to the prices of the less risky ones (bonds and gold) which, in turn, affects the values of both financial assets and liabilities. This is why the path of the UK (and the global) economy over the next few years will be a critical channel through which the *Brexit* decision—to the extent that it affects this path—will have financial implications for the OIC member countries.

There are three principle ways in which the *Brexit* decision may impact the path of the real economic activity: foreign trade in goods, trade in financial services, and the uncertainty that typically weighs on business and consumer confidence.

Foreign Trade in Goods. Should the UK's withdrawal from the EU lead to its reduced access to the EU's internal market and an increase in trade barriers (scenarios 3 and 4 above), the UK exports, investment and output could be adversely affected. The UK could also experience some deterioration of its current account—the balance between the cross-border flows of goods, services and income. The EU is by far the UK's largest trading partner. In 2015 the EU accounted for 47% of all UK's goods exports and 39% of all its services exports. The UK's exports of goods and services to the other 27 EU member countries were equivalent to nearly 12% of UK's GDP. Underscoring the importance of the trade with the EU, a survey of empirical literature by the IMF has shown that reduced trade barriers due to the EU membership have substantially increased UK's real

Figure 1: UK's Exports of Goods



Source: IMF and ERPD calculations.

incomes by improving the allocation of resources through specialization, increased economies of scale and productivity gains due to greater competition.[7] That said, in spite of the preferential market access, the UK's goods exports to the EU have actually declined since the inception of the single market when measured as a share of the UK's GDP, possibly due to the real effective appreciation of the pound relative to the level in the 1970s and1980s (**Figure 1**).

So how much of these real income gains could be reversed once the UK leaves the EU? In an extreme case, if the UK-EU trading relationship ware to default to the standard WTO rules, which mandate an equal treatment of all WTO members unless they are part of a customs union or a free-trade agreement, the EU's average tariff on the UK's exports would have to rise from currently zero to the EU's standard most favored nation (MFN) tariff. Meanwhile, the UK would also have to impose higher MFN tariffs on imports from the economies with which the UK has a trade agreement through the EU (including the customs union with Turkey and the free-trade agreements with the countries of the southern Mediterranean).

In practice, it is difficult to quantify the size of a potential economic impact of such an increase in tariffs. The impact would depend on the price elasticity of the EU demand for UK exports as well as on the share of the tariff increase that the UK exporters would pass through to the EU consumers. That being said, the existing EU's MFN tariffs have declined substantially over time and are currently at a relatively low level, especially for non-agricultural products.[8] This would suggest that the aggregate impact of even a "hard Brexit" through merchandise trade alone would be relatively modest.[9]

Furthermore, any impact of a tariff increase (which would effectively raise the export price of the UK goods) might be more than offset by the substantial depreciation of the British pound since the *Brexit* vote (7.5% and 15% vs. the euro and the U.S. dollar, respectively as of 31 December 2016), which has made UK exports cheaper.

Trade in Financial Services. The decision to leave the EU could have a more significant economic impact on the UK's economy through the trade in financial services, although—once again—the impact will depend on the eventual shape of the exit scenario.

The size of the UK's financial sector (including insurance) is among the largest in the world. It is larger, relative to the country's own GDP, than the financial sectors in the US, France or Japan,

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[7] IMF (2016), "United Kingdom: Selected Issues". IMF Country Report No. 16/169.

[8] In 2014, the EU's average trade-weighted MFN tariff was 2.3% on non-agricultural products and 8.5% on agricultural goods. WTO, ITC, UNCTAD (2016), "World Tariff Profiles 2016". This compares to the U.S. average trade-weighted MFN tariffs of 2.1% and 3.8%, respectively.

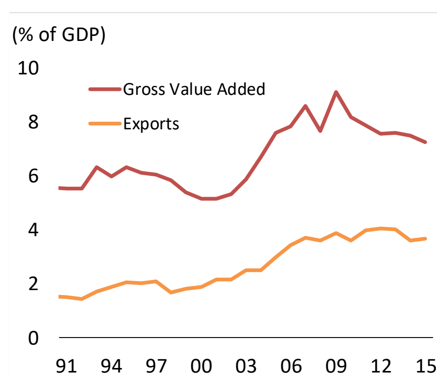
[9] Assuming, very conservatively, a price elasticity of the EU demand for UK exports of 1 and a full tariff increase passthrough by UK exporters, an increase in the EU tariff on UK exports to the standard MFN tariff could reduce UK exports by 0.2% of GDP. This, however, does not take into account any offsetting impact of the currency depreciation or the possibility that UK exporters find alternative export markets.

and similar (among the larger economies) to only that of Switzerland at more than 800% of GDP in 2014.[10] In 2015, the UK's financial sector generated 7.2% of the total gross value added in the economy and was responsible for close to 3.7% of GDP in current account receipts, which helped reduced by nearly one half an otherwise very large current account deficit.

The growth of the UK's financial sector can be linked to the UK's membership in the EU and in the EU's single market. The size of the total financial assets has more than quadrupled from 200% in the late 1970s and the financial sector's contribution to the exports of services has more than doubled from 1.4% of GDP in 1992, a year before the single market was created by the EU's Single European Act (**Figure 2**).

Within the framework of the EU single market, all banks and financial institutions head-quartered in the UK (including subsidiaries of non-EU institutions) enjoy the privilege (known as the *passport*), which allows them to provide services to the rest of the EU without having to meet individual regulatory requirements in each of the individual EU countries and without having to set up (costly) subsidiaries. In 2014, close to a third of all financial services exports from the UK (including insurance and pension services) went to the other EU countries and more than 53% of all UK banks' cross-border claims (asset) were on entities in the EU countries.[11,12]

Figure 2: UK's Financial Services



Source: Office for National Statistics and ERPD calculations.

Should the UK lose the *passporting* privileges in the EU, the UK-based banks will have to make a number of costly adjustments to their operations. Depending on the eventual agreement with the EU, the UK-based banks may be required to establish a local subsidiary in at least one of the EU member countries. In addition to the cost of additional physical investment, there would likely be expenses in terms of providing additional regulatory capital, duplication of certain centralized operations and ensuring compliance with a secondary regulatory and legal environment. At the aggregate level, the inflow of FDI into the UK's financial sector is likely to slow and might even reverse. As of the end of 2015, 30% of all inward FDI stock in the UK was in the financial sector, and during 2012-2015 the financial sector accounted for 52%-97% of all annual FDI flows (1% of GDP on average).[13] All this would be a potential drag on overall economic activity.

[10] IMF (2016).

[11] International Trade Centre, www.trademap.org.

[12] Bank for International Settlements, stats.bis.org/bis-stats-tool.

[13] Office for National Statistics, www.ons.gov.uk/releases/ukforeigndirectinvestment2015.

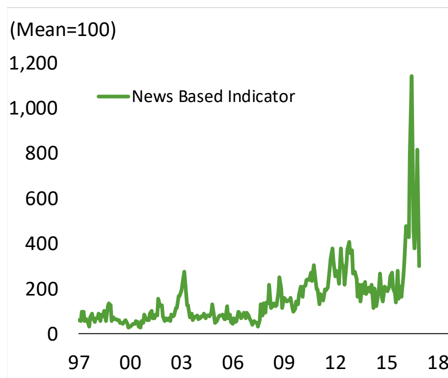
As of the time of this writing, only two large European banks (HSBC and UBS) have confirmed their plans to "definitely" move around 1,000 jobs from London to Paris and two large American banks (JPMorgan and Goldman Sachs) were said to be contemplating a similar move of about 7,000 staff combined. This would represent only about 2.5% of people in Greater London who currently work in financial services.[14]

Business and Consumer Confidence. In addition to the direct impact through potential changes to the UK-EU trade relationship, the *Brexit* decision could adversely affect the UK and the world economy though an increased level of uncertainty about future growth and investment prospects—more so if this uncertainty is protracted due to lengthy exit negotiations over the next two years. This uncertainty could dampen business and consumer confidence and erode the willingness of investors to take on risk exposures. This, in turn, could depress discretionary consumption spending, defer new investment decisions and stem foreign portfolio and foreign direct investment inflows.

Furthermore, extended uncertainty associated with *Brexit* negotiations could lead to a reemergence of sovereign and financial sector stress in Europe. Herein, the Italian banking sector is especially vulnerable due to its weak capitalization and the economy's poor performance.

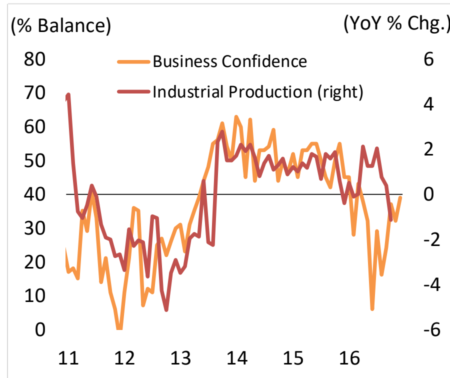
The level of policy uncertainty has indeed increased sharply once the official date for the *Brexit* referendum was announced in February 2016, following the failure of the EU and the UK government to reach a mutually acceptable compromise in the last-moment attempt at renegotiation of the UK's EU membership (see **Figure 3**). This, in turn, has led to a deterioration in business and consumer confidence which deepened further in the aftermath of the referendum. Although business confidence has since recovered, the confidence indicator remains barely above its 15-year historical average consistent with a small industrial output contraction (see **Figure 4** below).

Figure 3: Economic Policy Uncertainty Indicator



Source: Economic Uncrertainty Index and ERPD Calculations

Figure 4: Industrial Output and Confidence



Source: Office for National Statistics, Lloyds Bank and ERPD.

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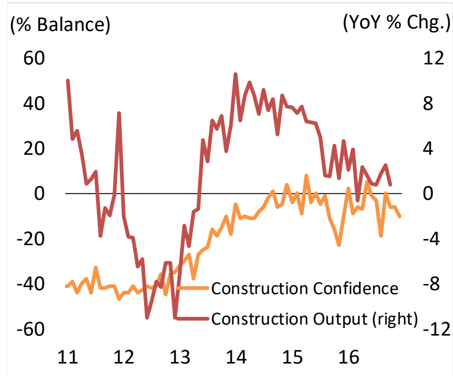
[14] http://www.bbc.com/news/business-38677504

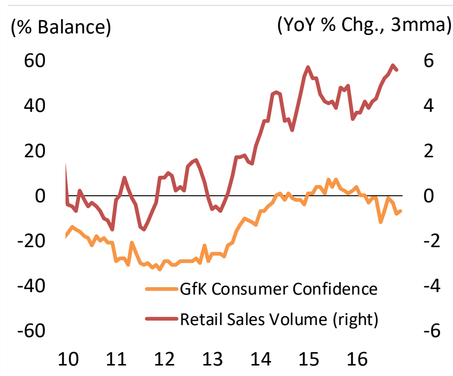
In contrast, there appears to be a lack of firm evidence that the uncertainty surrounding *Brexit* has had a major impact on construction output and, especially, on consumer spending. Despite a dip in construction sector confidence indicator, construction output slowed only slightly relative to its sluggish growth rate during the previous 12 months (**Figure 5**). Meanwhile, retails sales continued to grow very robustly at a year-over-year rate of 5.5-6.5% (**Figure 6**). Overall, the real GDP growth for the quarter immediately following the *Brexit* referendum was strong at 2.3% in seasonally-adjusted annualized terms, making it the fastest-growing G7 economy in 2016.[15]

Figure 5: Construction Output and Confidence



Source: Office for Nat. Statistics, European Commission, ERPD.

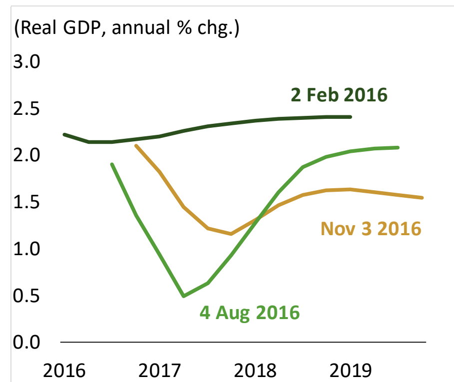
Figure 6: Retail Sales and Consumer Confidence



Source: Office for Nat. Statistics, European Commission, ERPD.

Overall, however, the medium-term impact of the *Brexit* decision on the UK economy is expected to be negative, even though there is a large dispersion around the expectation of what that negative impact might be. According to an IMF survey of 12 independent studies, the medium to long-term adverse effect of the UK's exit from the EU is expected to be on the order of 0.1%-14% of GDP, depending on the eventual exit scenario and other assumptions. Two studies that have found a potential positive impact either assume that the UK quickly negotiates a free-trade agreement with the EU and all other trading partners and benefits from deregulation and/or focuses purely on potential benefits of a scenario in which the UK unilaterally reduces all import tariffs to zero.[16]

Figure 7: Bank of England GDP Projections



Source: Bank of England and ERPD Calculations

The **Figure 7** illustrates the potential extent of the short- to medium-term impact of the *Brexit* decision on the real economy as captured in the GDP growth forecast revisions by the Bank of England (BoE). Prior to the announcement of the referendum date (when the assumption was that the pro-*Brexit* campaign would lose), the BoE was forecasting the UK GDP growth of around 2¼% throughout its three-

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[15] For globally-integrated (and relatively small) open economies such as the UK's, it is in practice very difficult to separate the impact of a single shock (such as the *Brexit* decision) from other global economic factors and trends that affect economic performance.

[16] IMF (2016).

year policy horizon. Following the *Brexit* referendum, the forecast was revised down sharply to 1.6% for the second half of 2016, 0.75% for 2017 and 1.7% for 2018. The latest forecast from early November has turned a bit more optimistic, but still assumes growth of only 1.4%, 1.5% and 1.6% in 2017, 2018 and 2019, respectively.

C. Monetary Policy Channel

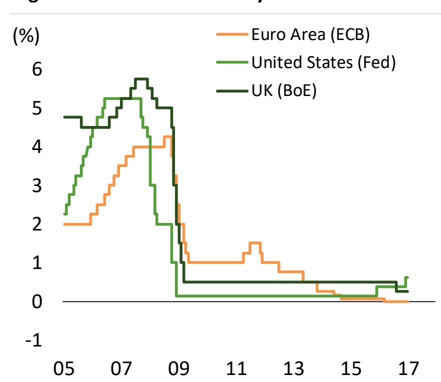
The *Brexit* decision has already had a financial impact on the OIC member countries through the global monetary policy channel, namely by delaying (even if only temporarily) the ongoing process of the global monetary policy normalization from the unprecedented level of accommodation reached in the wake of the global financial crisis.

In the United States, the uncertainty surrounding the *Brexit* decision was seen as an important factor behind the delay in the second interest rate hike by the Federal Reserve. In a press conference after the June 14-15 rate-setting meeting (ahead of the *Brexit* decision), the Federal Open Markets Committee (FOMC) Chair Janet Yellen explicitly mentioned that the upcoming Brexit referendum was one of the factors in the FOMC's decision to keep the Fed Funds target rate unchanged due to the uncertainty it created for the global and the US economic outlook.

Furthermore, based on the average of the FOMC participants' assessment of appropriate monetary policy (the so-called Fed "dots"), the average expected monetary policy path for 2016 has moved from 1.02% in March to 0.83% in June and then further down to 0.65% in September, despite continued strengthening in the US labor market and a pickup in growth of economic activity from the modest pace in the first half of the year. While several FOMC meeting participants indicated in the September meeting minutes that the risks from Brexit have receded, "a few still judged that overall risks were weighted to the downside" citing (among other things) "continued uncertainty associated with Brexit".[17] The Fed eventually delivered its second interest rate hike in December when it became clear that the immediate risks associated with *Brexit* have receded.

In the UK, the *Brexit* decision has actually led to a further easing of monetary policy. Despite a significant depreciation of the British pound, which should be expected to accelerate the return of the inflation rate to the 2% target and cause it to eventually overshoot, the Bank of England thought in August that the likely negative impact of the Brexit decision on the real economic outlook would warrant rolling out a fresh comprehensive monetary policy package of measures to support growth. This package included a 25 basis point cut in the policy rate to 0. 25%, a new term funding scheme, and an expansion of the quantitative easing through further purchases of UK government and

Figure 8: Central Bank Policy Rates



Source: Haver Analytics and ERPD Calculations

[17] www.federalreserve.gov/monetarypolicy/fomccalendars.htm

corporate bonds with an increase in the target of the stock of purchased assets by 16% (i.e. GBP 60 billion of extra global liquidity).[18]

It is likely that the delay in the US Fed tightening and the pro-growth package from the BoE, together with the depreciation of the British pound, has helped soften the initial impact of increased economic policy uncertainty associated with the *Brexit* decision and that, as a result, the UK's economy has so far not shown no clear evidence of a meaningful slowdown.

Meanwhile, the rest of the world has also benefitted from an extra few months of ultra-low global (and US) interest rates (**Figure 8** on the previous page) . This has benefitted especially the highly indebted countries and governments and a number of those with large external and public sector financing needs, including many of the OIC member countries. For example, Saudi Arabia—where the public sector deficit rose to an estimated 13% of GDP in 2016—was able to take advantage of some of the lowest 10-year interest rates in history to raise $17.5 billion of funds in what was the biggest ever bond sale from an emerging market economy.

D. Asset Price Channel

The path of the UK and global asset prices is the fundamental key channel through which the *Brexit* decision has—and will potentially still have—financial implications for the OIC member countries by affecting (1) the values of the balance sheets of both private and public sector institutions (including banks, sovereign wealth funds, asset management firms, non-financial corporations as well as households), and (2) the value of cross-border flows of investment, income and transfers between the UK and the OIC member countries.

The unexpected outcome of the *Brexit* referendum was met initially with a sharply negative market reaction. This reaction in asset prices reflected the initial market expectation of what the UK's potential loss of full access to the EU's single market might mean for the UK, EU and global economic performance. It also reflected a broader concern that the UK's exit might be a critical turning point for the overall EU project, heralding the beginning of EU's political and economic "disintegration" and an acceleration of the nascent global trend of deglobalization. Finally, the market reaction also reflected the sudden increase of uncertainty about the future economic outcomes and priced in the possibility of additional political surprises globally: if the polling agencies missed the possibility the pro-*Brexit* campaign could win, they could not be relied upon for the future critical votes, such as the US presidential election (which incidentally also turned out against most predictions), but also the upcoming elections in France and Germany during 2017.

As shown in **Table 1** below, the initial market reaction to the *Brexit* decision was a small (1-3 basis point) decline in short-term interest rates in the US, the euro area and the UK, a more substantial (14-26 basis point) decline in 10-year government bond yields in the highly rated developed economies, an increase in the sovereign risk premium in the European periphery (especially Greece), a weakening of most exchange rates (vs. USD), and a sizeable percentage

[18] www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2016/aug.pdf

decline in the global equity markets. The price of crude oil dropped by 5% while the price of gold, which typically rises in periods of increased economic uncertainty, increased more than 4%.

Table 1: Cumulative Change Since the *Brexit* Decision

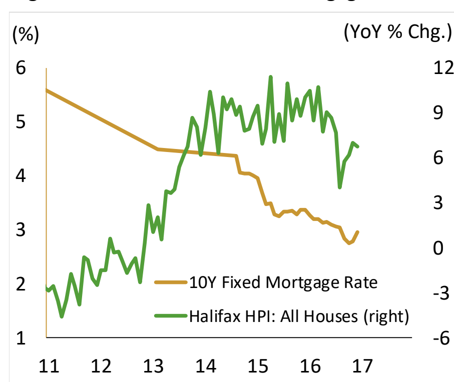
		Units	+1 day	+1 month	+3 month	US Pres. Election (Nov. 8)	End-2016
Policy Rates	**US Fed**	bp	0	0	0	0	25
	BoE	bp	0	0	-25	-25	-25
3m LIBOR	**USD**	bp	-2	8	21	24	36
	EUR	bp	-1	-3	-3	-4	-5
	GBP	bp	-3	-6	-21	-19	-22
10-Year Bond Yields	**US**	bp	-17	-17	-12	14	71
	Germany	bp	-14	-13	-15	8	11
	Spain	bp	5	-37	-59	-38	-22
	Greece	bp	82	26	66	-42	-60
	UK	bp	-26	-50	-65	-21	-20
	Japan	bp	-6	-8	9	8	19
Exchange Rates *	**GBP**	%	-8.1	-11.9	-12.8	-16.8	-17.0
	EUR	%	-2.4	-3.6	-1.4	-3.2	-7.6
	TRY	%	-1.2	-5.7	-2.5	-8.4	-17.9
	IDR	%	-1.3	1.0	1.2	1.5	-2.1
	MYR	%	-1.5	-0.9	-2.4	-3.5	-10.2
Stock Markets **	**SP500**	%	-3.6	2.9	2.4	1.2	5.9
	Brazil	%	-2.8	10.6	13.8	24.4	16.8
	Mexico	%	-2.7	3.0	3.5	5.0	-1.1
	S&P Europe	%	-6.8	-1.1	-0.1	-2.8	5.1
	UK	%	-3.8	4.7	8.0	6.7	11.2
	Indonesia	%	-0.8	6.6	10.6	12.2	8.7
	Malaysia	%	-0.4	1.1	1.9	1.5	0.1
Commodity Prices	**Gold**	%	4.2	4.6	6.1	1.6	-9.2
	Crude Oil (Brent)	%	-5.1	-8.8	-9.6	-11.0	9.9

* Exchange rates are measured gainst USD. The negative number means a depreciation.
** Measured in local currency terms. bp = basis point = 0.01%
Source: Haver Analytics and ERPD calculations.

But most of these market moves were mostly or fully reversed by the time of the US presidential election in early November and, by the end of 2016, the only meaningful asset price impact of the *Brexit* decision could be observed only in the depreciated value of the British pound (GBP) and the reduced level of the UK interest rates (the latter validated by the BoE rate cut). The strength of the US dollar versus other currencies remained, but this was mostly due to the expectations of the reflation of the US economy once President Trump takes office and resumed US monetary policy normalization rather than an increase in risk aversion which drove the initial negative market response (especially among the emerging market currencies). Importantly, the initial 3.8% decline in the UK equity prices (measured in GBP) was reversed to a cumulative 11.2% gain.

All this, together with a drop in the price of gold, indicates that by the end of 2016 the financial markets have largely shrugged of the potential risks to the economic outlook associated with the *Brexit* decision or at least judged that these risks would be outweighed by a stronger outlook for the US economy under President Trump and by the depreciation of the UK's exchange rate.

Figure 9: UK House Prices and Mortgage Rates



Source: Halifax, Bank of England, and ERPD calculations.

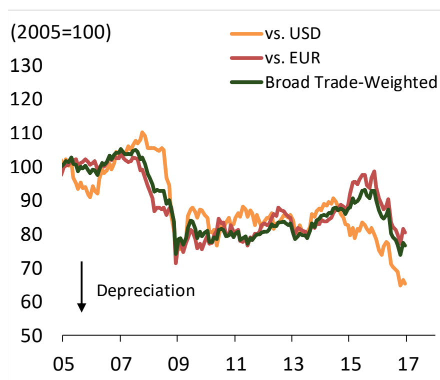
Looking beyond the market securities and exchange rates, the *Brexit* decision also had no significant impact on the UK house prices. As shown in **Figure 9**, the growth in house prices visibly slowed after June 2016 from a very robust

three-year average annual growth rate of nearly 9%, but house values—helped by a further small decline in mortgage rates—never actually declined.

III. Potential Implications for Cross-Border Financial Flows to OIC MCs

The UK's decision to leave the EU has potential implications for several types of financial flows between the UK and the OIC member countries. It may affect (A) cross-border investment flows, such as foreign direct investment and portfolio investment, (B) cross-border income transfers, such as workers' remittances and income received by the OIC member countries' from their investments in the UK, (C) cross-border lending flows by the UK-based banks, and (D) cross-border official transfers, such as the UK's official development assistance (ODA).

Figure 10: British Pound (GBP) Exchange Rate



Source: Haver Analytics and ERPD Calculations

The impact on these flows will materialize through the three channels discussed in the previous section and will critically depend on the eventual shape of the exit scenario as well as on the path towards the final arrangement. In most cases the level of the cross-border financial flows will be affected by the absolute as well as the relative performance of the UK's economy over the next couple of years (most critically for the flows of income on investments in the UK and the workers' remittances), the size and the sign of the UK's current account balance (being the flip side of the capital account balance and hence affecting the UK's outward direct and portfolio investment flows), and the financial strength of the UK-based banking sector (potentially affecting cross-border bank lending). Fixed income portfolio flows will also be affected by the interest rate differentials between the UK and the OIC MCs and hence by the relative stance of the UK's and global monetary policy. And, finally, the USD-value of most of these financial flows will be impacted by the value of the British pound (GBP) exchange rate, which has already depreciated significantly in the past 12 months and especially since the *Brexit* decision in June 2016 (see **Figure 10**).

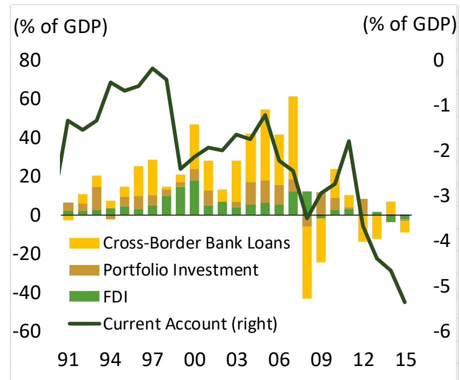
In the following subsections we endeavor to gauge the potential impact of the Brexit decision on the cross-border financial flows to the individual OIC MCs. We analyze each type of flow in turn.

A. Foreign Investment Flows

There is not a tight statistical relationship between the size of the current account balance and the size of outward investment flows. By definition it is the *balance* of capital flows (i.e. investment outflows less inflows) that should mirror the size of the current account surplus. But, in general, lower current account surpluses (or higher current account deficit) are associated with smaller outward investment flows (see **Figure 11** below). This is because a country that has fewer (or more negative) net receipts from cross-border trade and from investment returns on assets held abroad also has fewer resources to invest overseas. Hence, should the UK's exports struggle under the

new post-*Brexit* trade arrangement and should this translate into a further deterioration of the current account balance, outward investment flows from the UK might be adversely affected.[19]

Figure 11: UK's Current Account and Investment

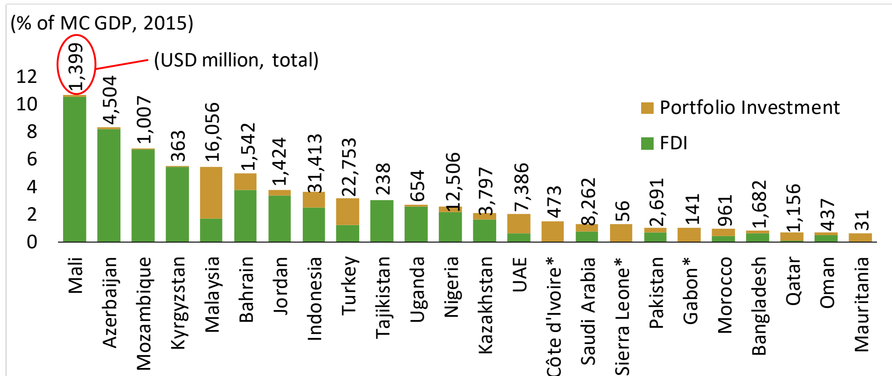


Source: Haver Analytics and ERPD Calculations

The size and the direction of outward investment flows from the UK will also depend on the attractiveness of expected investment returns overseas, and hence on both relative growth performance of the UK versus the rest of the world and the relative level of interest rates. For now, and despite many pessimistic predictions that the UK may enter a recession following the *Brexit* decision, the UK's economy may have ended 2016 as the fastest growing G7 economy, ahead of both the United States and Germany. On the other hand, the interest rate differentials, especially between the UK and the US, may increase over the next two years if the US Fed continues to push forward with the monetary policy normalization and if the dampening impact of *Brexit* on the UK economy materializes in line with the BoE projections.

OIC MCs with which have seen the largest inflows of investment from the UK in the past may be also most exposed should the outward investment flows from the UK change as a result of the Brexit decision. **Figure 12**, derived from the IMF's Coordinated Direct Investment Survey (CDIS) and the Coordinated Portfolio Investment Survey (CPIS), shows the OIC MCs which have received the largest cumulative amount of direct and portfolio investment from the UK.[20] Relative to the size of their GDP, the OIC member countries with the largest exposure to the UK investment flows include Mali, Azerbaijan, Mozambique, Kyrgyzstan, Malaysia, Bahrain, Jordan, Indonesia and Turkey. Malaysia, Turkey, UAE and Indonesia have received the largest cumulative amount of portfolio flows, whereas most other countries have primarily been recipients of the UK's outward

Figure 12: Stock of the UK's Direct and Portfolio Investment in OIC MCs



* FDI data was "suppressed by the reporting economy to protect confidentiality". Source: IMF and ERPD Calculations

[19] At the country-specific level, cross-border investment flows also critically depend on a host of non-economic factors such as the strength of recipient-country institutions, quality of governance, rule of law, political stability and quality of hard and soft infrastructure and human capital.

[20] Not all OIC countries have reported the data to the IMF and a number of them (e.g. Kuwait, Jordan) have been suppressed by the reporting economy to "preserve confidentiality". Source: IMF, data.imf.org.

foreign direct investment (FDI).

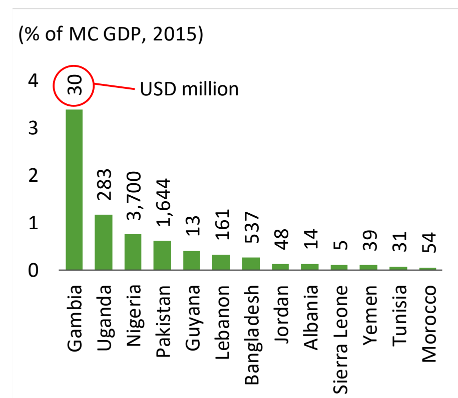
In terms of the annual cross-border investment flows, a considerably less detailed and less up-to-date Eurostat dataset suggest that among the largest OIC recipients of the UK's FDI in 2014 were Egypt ($3.1 billion), Malaysia ($1.6 billion), Nigeria ($0.5 billion) and Saudi Arabia ($0.5 billion). In contrast, Turkey saw a net outflow of FDI by the UK ($0.6 billion).

B. Cross-Border Income Transfers

In 2015, UK households and non-profit institutions made GBP 6.5 billion ($9.9 billion) worth of cross-border transfers, which included workers' remittances. Furthermore, UK companies paid GBP 155 billion worth of investment income to foreign investors. To the extent that the OIC member countries are currently recipients of these income flows, they would be affected by the weakening of the British pound versus the USD dollar. The countries where the exchange rates are fixed to the USD (or whose exchange rates have appreciated against the USD) will be among those worst affected.

Since the official data on country-by-country remittance flows in not collected by the UK government and since it is also possible that some of the household transfers are not recorded in the aggregate statistics quoted above, it is difficult to gauge the precise impact on the individual OIC member countries. However, an annual report on global remittances prepared by the World Bank may serve as a useful guide. The report generates analytical estimates of bilateral remittance flows between countries "based on logical assumptions and derived from a global estimation of bilateral remittance flows." According to these analytical estimates, in 2015 the UK residents may have sent as much as $25 billion of remittances abroad, of which around $7 billion went to the OIC member countries. Nearly 85% of this aggregate amount ended up in Nigeria, Pakistan and Bangladesh.[21] **Figure 13** shows the size of these remittances relative to the OIC MC GDPs, indicating that workers' remittances from the UK are particularly important for the Gambia, Uganda, Nigeria, and Pakistan.

Figure 13: Estimated UK Remittance Flows



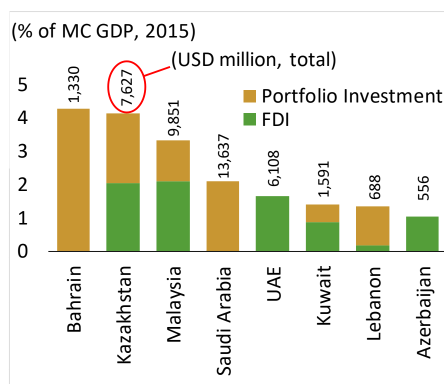
Source: World Bank and ERPD Calculations

There are no official statistics available of the breakdown of the annual investment income flows from the UK or on the detailed geographical breakdown of the stock of investments in the UK by non-residents. However, according to the Office of National Statistics, Europe and the Americas accounted for a combined 85% of total investments in the UK. Assuming that the remainder was proportional to the investor countries' GDP, the OIC MCs may have accounted for at most 1.9%

[21] www.worldbank.org/en/topic/migrationremittancesdiasporaissues/brief/migration-remittances-data

of all investments and investment income flows in the UK, which would have been equivalent to about $4.5 billion or 0.1% of the OIC member countries' combined GDP in 2015.[22] This amount seems to be relatively small to have a meaningful impact, but some countries are naturally more exposed than others. **Figure 14** shows relative significance of investments in the UK for a number of countries where the data is available. It is, however, possible that the available data is incomplete and does not capture the full extent of the exposure due to indirect ownership of the UK assets, e.g. through entities in off-shore financial centers and through investments via asset management firms headquartered in foreign jurisdictions.

Figure 14: Stock of OIC MC Investments in the UK



Source: IMF and ERPD Calculations

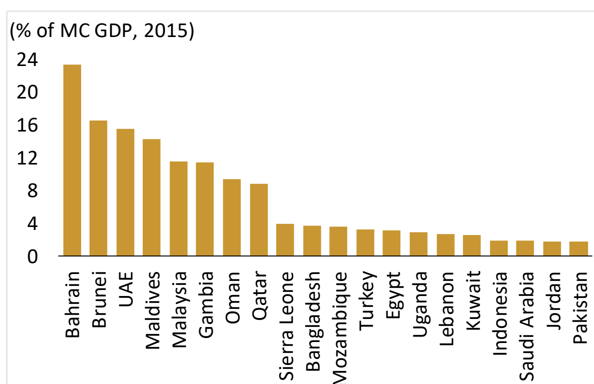
C. Cross-Border Lending by the UK-Based Banks

The *Consolidated Banking Statistics* (CBS) compiled by the Bank for International Settlements (BIS) provide useful information about the major foreign bank creditors to most economies, including the OIC MCs. The CBS foreign claims data on an immediate counterparty basis can be used to gauge the dependence of the individual OIC MCs on credit extended by the UK-based banks. Should the UK banks' ability to support credit extension to the OIC MCs weaken due to the extra costs associated with adjusting to the *Brexit*, the OIC economies with the highest reliance on the UK bank funding would be exposed the most. **Figure 15** shows the OIC MCs with the highest such exposure. Exploring the sectoral details, only in Bahrain, Qatar, UAE and Pakistan have the UK banks extended significant amount of cross-border funding to the local banking sector with 5.7%, 3.5%, 1.8% and 1.6% of the MC's GDP, respectively. In all MCs the bulk of the cross-border bank lending flows from the UK went to the non-financial private sector.

On a related point, should the loss of passporting privileges weaken the City of London's position as the leading global financial center, could some of the financial centers in the OIC MCs benefit?

In all fairness, it would be very difficult to make such an argument. The prominence of the City of London as the "number one" global financial center goes well beyond its EU passporting privileges. Surely, passporting has been critical to the growth of the UK's financial sector, possibly at the expense of the less

Figure 15: UK Banks' Consolidated Claims on the OIC MCs *

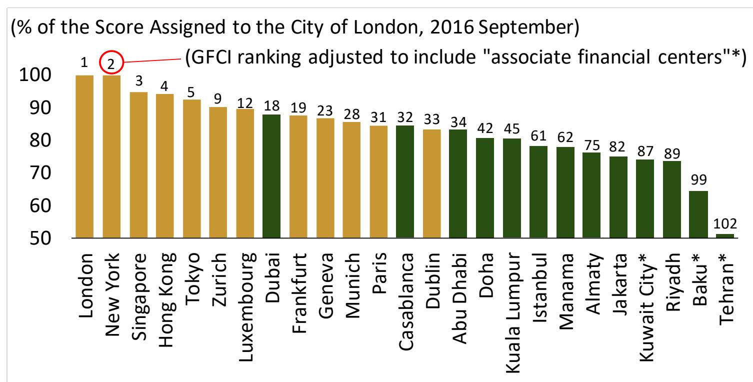


Source: IMF and ERPD Calculations
* Total foreign claims on immediate counterparty basis

[22] Office of National Statistics (2016), *UK Balance of Payments, The Pink Book: 2016*, www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/unitedkingdombalanceofpaymentsthepinkbook/2016

globally integrated centers in Germany (Frankfurt, Munich), Luxembourg, Switzerland (Zurich, Geneva), and France (Paris). But London's robust growth has been underpinned by its high level competitiveness in a number of critical areas such as the quality of business environment and infrastructure, the quality and availability of highly-skilled human capital, the overall level of financial sector development, and the sector's reputation. According to the *Global Financial Centres Index* published twice yearly since 2007 by the Z/Yen Group, the City of London has ranked number one (and occasionally number two) in all of these critical competitiveness areas which inform the decisions as to where a financial services firm should select its location.

Figure 16: Ranking of the Global Financial Centers



Source: Global Financial Centres Index (GFCI), Z/Yen Group and ERPD Calculations
* "Associate financial center" where survey data is insufficient for inclusion into official GFCI ranking

Aside from its advantage in having a preferential access to the EU market (reflected in the City of London's high score in the "financial sector development" area due to its attachment to the "EU cluster"), the *Brexit* decision is unlikely to deprive London of its competitive edge in the other areas, including in the area of global asset management or even global Islamic finance. And should the UK's financial industry lose some of its business due to the loss of passporting privileges, it would most likely be to another highly competitive financial center in the EU, e.g. Frankfurt, Paris or Dublin. There is no economically compelling reason why some of this lost business should be transferred to, say, Dubai or some of the other less competitive financial centers in the OIC MCs that has no passporting arrangement with the EU (see **Figure 16**).

D. UK's Official Development Assistance Flows

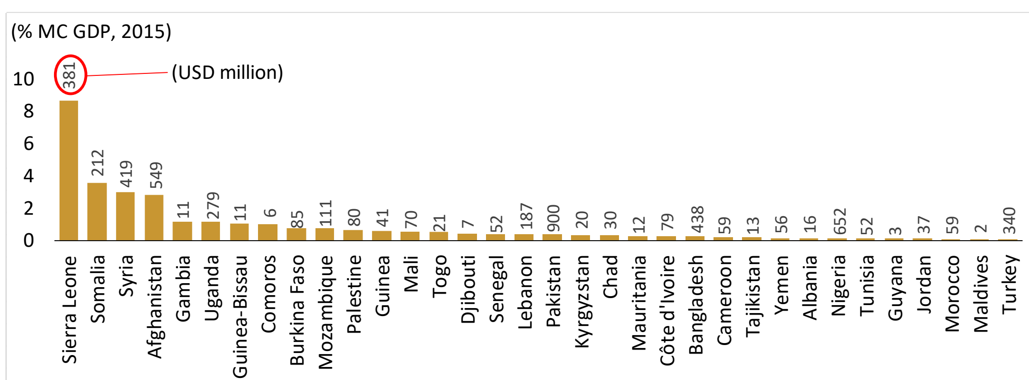
In 2015, the UK provided an amount equivalent to $18.5 billion in official development assistance (ODA). Nearly two-thirds of this amount ($11.7 billion) was delivered bilaterally, and of the country-specific bilateral ODA ($7.1 billion) 52% went to the OIC MCs ($3.6 billion). Based on the data on imputed UK share of multilateral ODA, additional $2.5 billion was delivered to OIC MCs on behalf of the UK by multilateral development organizations. The largest OIC recipients of the UK's country-specific bilateral ODA were Pakistan, Afghanistan, Nigeria, Syria, Sierra Leone and Bangladesh, which jointly accounting for over one third of the total. **Figure 17** below shows estimates of the UK's total country-specific ODA to OIC MCs during 2015).

The stated target of the pre-*Brexit* government has been to spend 0.7% of the UK's gross national income (GNI) on total ODA each year.[23] This target was met and maintained annually since 2013. Even if we assume that this policy and the country-distribution does not change with the new, more

[23] Statistics on International Development 2016, https://www.gov.uk/government/statistics/statistics-on-international-development-2016.

inward-looking post-*Brexit* government, the flow of ODA in the next few years will be affected by the impact of the *Brexit* decision on the UK's GNI and on the value of the British pound.

Figure 17: UK's Estimated Country-Specific ODA *



Source: Office of National Statistics, IMF and ERPD Calculations.
* Includes estimates of country-specific ODA via multilateral institutions

Based on the latest IMF projections for the UK GDP growth and assuming that the current exchange rate (approximately 1.25 USD per 1 GBP) prevails in 2017, the dollar value of the UK's total ODA could decline by about 12% to $16.2 billion (even though it will rise slightly in GBP terms). Furthermore, based on the estimates of the total country-specific ODA to OIC MCs (bilateral as well as multilateral), the US dollar value to the UK's ODA to the OIC MCs could decline by about $740 million. This ODA shortfall, entirely due to the currency valuations, could have the most significant impact on a number of OIC MCs where the UK's ODA is large in terms of the MC's GDP (e.g. Sierra Leone, Somalia, Syria, and Afghanistan).[24]

IV. Potential Implications for Balance Sheets in OIC MCs

The previous section has dealt with the potential impact of the *Brexit* decision on financial flows. In the current section, we will examine the potential impact on financial stocks, namely the assets and the liabilities on the balance sheets of the private and the public sector in the OIC MCs. Here the main channel through which the *Brexit* decision may have an impact would be the asset prices, including exchange rates. As with the impact on financial flows, the final effect will depend on the eventual arrangement negotiated between the UK and the EU, but the uncertainty and related market volatility in the run-up to that arrangement will impact financial stocks in the interim.

As discussed above, the only persistent asset price changes triggered by the *Brexit* decision have been the decline in the UK interest rates (and an associated a rise in the value of the UK government securities) and the decline in the value of the British pound and the euro—both of which have weakened against the US dollar and were below their pre-*Brexit* decision levels as of the end of 2016. The movements in the asset prices since June 2016 have been consistent with an expectation

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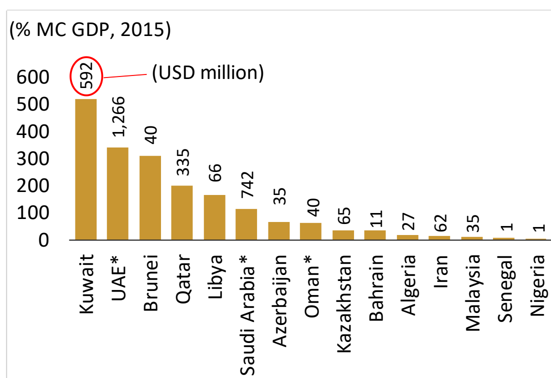
[24] An exceptionally large amount of the UK's ODA relative to the Sierra Leone's GDP appears to be due to the emergency response to the Ebola epidemic during 2014-2015. In 2011, Sierra Leone was not even among the top 20 recipients of the UK's ODA.

that the eventual *Brexit* will be a "soft" one in that the UK will be able to retain sufficient access to the EU's internal market so as to avoid a contractionary impact on the UK economy and/or that any residual negative fallout will be more than compensated for by the exchange rate depreciation and an easier interest rate environment, which have acted as the key shock absorbers. This interpretation would explain a rebound in the UK stock market and a full reversal of the initial *Brexit* decision related losses in less than a month (see **Table 1** in Section III). This would also explain a lack of any persistent downward move in the UK house prices (including in Greater London, where the impact should have been the highest due to the concentration of the financial services industry), although the house price value growth did slow during August-November. However, should this benign expectation of the *Brexit's* eventual economic impact give way to a less optimistic outlook, the UK (and EU) equity markets as well as the exchange rates and interest rates could be expected to drop from the current levels.

In either case, the most significant financial impact would be on the OIC MCs whose investors (public or private) have the largest exposure to the UK and GBP denominated assets. Most importantly, such investors would include the central banks (through their holdings of GBP and EUR denominated government securities) and the sovereign wealth funds (which in addition to the UK and EU securities may also own some less liquid GBP denominated assets such as real estate).

Figure 18 ranks the OIC MCs by the size of their sovereign wealth funds (SWFs). Unfortunately, most SWFs do not disclose the breakdown of their holdings and in many cases a large share of their holdings are domestic and/or illiquid, and therefore would not be impacted by the asset price moves as a result of the *Brexit*. It is therefore virtually impossible to estimate what a potential impact on these funds would be. In general, **Figure 14** in Section III.B could serve as a very approximate guide to what the exposure of some of the MCs might be through their holding of assets (direct and portfolio investment) in the UK.

Figure 18: Estimated Size of SWF Assets in OIC MCs

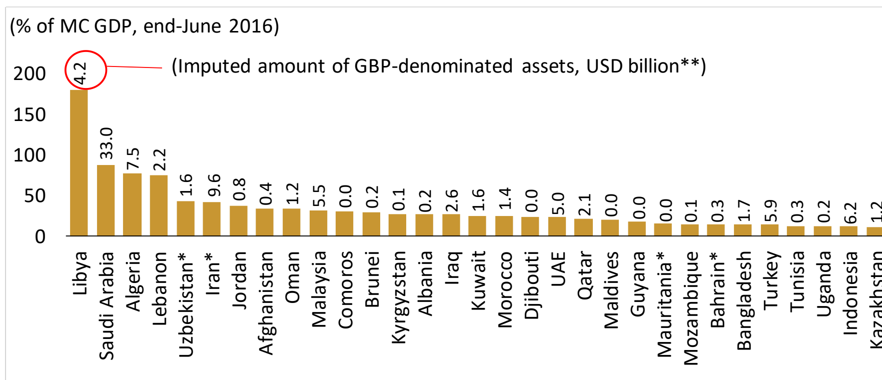


Source: Sovereign Wealth Fund Institute, Wikipedia, IMF and ERPD Calculations.
* Combined assets of several sovereign wealth funds.

A somewhat easier task would to gauge a potential impact of the Brexit decision on the assets of the central banks. Most central banks typically manage their foreign reserves assets in a combination of gold and government securities of the highly-rated G7 governments, including the UK government. Just like the SWFs, most central banks do not disclose the composition of their assets. However, an IMF's quarterly survey of the currency composition of the official foreign exchange reserves (COFER) provides a useful insight into what this composition might be at the aggregate level. The data published by the IMF shows that at the end of the second quarter of 2016, approximately 5.8% of all "allocated" foreign exchange reserves held by the emerging market and developing countries' central banks was held in assets denominated in the British pounds (gilts and treasury bills). It would therefore seem reasonable to assume that this is also an approximate share of total reserves held in GBP assets by the OIC MC central banks. **Figure 19** below ranks the OIC MC according to the size of their foreign exchange reserves (minus gold) relative to their

own GDP and an imputed amount of GBP-denominated securities included in the total. To the extent that the central banks hold GBP assets, their value has decreased in USD terms since the Brexit decision by around 17%.

Figure 19: Official Foreign Exchange Reserves (Minus Gold)



Source: IMF and ERPD Calculations

* Estimated from IMF's Regional Economic Outlook ** All central banks are assumed to hold the same share of GBP assets (5.8%)

As for the liability side of the OIC MC balance sheets, the World Bank data on the currency composition of the long-term external debt of the countries suggests that only a very small fraction of the OIC debt is denominated in British pounds (between 0%-1.9% of the outstanding total external debt, with most MCs reporting zero external debt in GBP). In terms of the absolute amounts, the size of GBP-denominated debt is largest in Indonesia ($534 million) followed by Sudan ($300 million), Bangladesh ($182 million) and Egypt ($123 million). But in all these cases the absolute as well as the relative amounts are too small for the MC to benefit materially in terms of lower debt ratios and lower debt service payments as a result of the weakening of the GBP exchange rate vs the US dollar.

V. Conclusions and Policy Recommendations

The UK's decision to leave the EU presents a new potential source of economic and financial uncertainty in a world that is already characterized by a lack of good medium- and long-term visibility, and by numerous global economic risks and developmental challenges.[25] In general, such elevated uncertainty requires greater vigilance and more careful monitoring of the global economic and financial conditions by the relevant authorities in the OIC member countries and by the OIC institutions—including the IDB Group. It also requires a more systematic approach to managing economic and financial risks and uncertainty, including by building analytical frameworks that allow for a comprehensive assessment (and for a periodic reassessment) of the potential implications of the external shocks that may affect the OIC economies by impacting the global economy and the global financial markets.

[25] For a comprehensive report on global challenges facing the IDB MCs, please refer to *Global Risks and Challenges Facing IDB Group and Its Member Countries* prepared by the ERPD (Group Chief Economist Complex, Islamic Development Bank) in July 2016.

In this study, we have endeavored to provide such a framework by (1) identifying the key channels through which the *Brexit* decision could potentially impact financial flows and financial balance sheets in the OIC member countries, and (2) by identifying the approximate magnitudes of exposure of the individual MCs to the potential shifts in the UK financial flows and the UK assets prices.

While there are significant differences among the 57 OIC MCs in terms of their exposures, in the absolute majority of cases the magnitude of the potential exposure is very modest and, in general, very uncertain. We therefore estimate that—in the aggregate as well as for most of the OIC MCs—the overall financial and monetary implications of the *Brexit* decision will likely be small, and this conclusion is unlikely to change even if the final shape of the Brexit leads to a more pronounced slowdown in the UK's economy in line with the initial more pessimistic predictions and the asset prices come to reflect such a more negative outlook.

With this general assessment in mind, we believe that there is a limited scope for recommending *systematic* interventions that could be undertaken in response to the *Brexit* decision by the IDB Group. However, one possible exception is the area of official development assistance, the value of which is likely to be reduced significantly for a number of least developed MCs as a result of the sharp depreciation of the value of the GBP exchange rate. This is the key area where the IDB Group could focus its interventions, perhaps by co-financing some of the projects led by the UK's Department for International Development (DFID), where there might be a financing shortfall due to the reduction in the US dollar value of the available financing from the UK. Our estimates indicate that the total US dollar shortfall of the UK's country-specific annual ODA to OIC MCs in 2017 relative to 2015 could be around $740 million.

Executive Summary of the Section on the Impact of Brexit on Immigration and Labor Market

Although the outcome of the referendum was a surprise to most observers, immigration issue was probably the single most important factor driving the leave vote. Moreover, it is also observed that the anti-EU campaigns were tied in with anti-Muslim themes, fuelling anti-Muslim and xenophobic sentiments across Europe. What is clear from the referendum result is that the British public wants net migration to be reduced substantially. This policy preference will have definitely some impacts on other EU countries as well as non-EU countries, including OIC member countries. However, it is difficult to assess the impacts due to enormous uncertainties on how the UK government would design any new policies towards EU and non-EU migration.

In recent surveys before the vote, majorities of respondents think that there are too many migrants, that fewer migrants should be let in to the country, and that legal restrictions on immigration should be tighter. Indeed, the total number of net migration, the difference between the number of people coming to the UK for at least a year and those leaving, reached its highest recorded level in 2015 and remains stable around these record levels in 2016.

It is evident that fear of immigration drove the leave victory. Yet the details of the referendum demonstrate a paradox – that those who have experienced the highest levels of migration are the least anxious about it. The highest levels of remain voters were in areas of highest net migration, while some of the strongest leave areas have had the fewest recent new immigrants. Based on these, it is difficult to argue that people who voted to leave made a rational decision based on the real economic effects they've suffered from the rise in immigration.

Looking at the migration statistics, it is estimated that the total number of immigrants from OIC countries living in the UK remains stable around 650,000, while the immigrants from developed and non-OIC developing countries follow an upward trend. In 2015, there were around 671,000 people living in the UK originally migrated from the OIC member countries, corresponding to 13% of total immigrants. On the other hand, the immigrants from non-OIC developing countries account almost half of the total immigrants.

In the year to June 2016, 311,000 (48%) people immigrated for work (the highest estimate recorded), compared with 294,000 in the previous year. Of those whose main reason for long-term migration was work-related, the majority (63%) were EU citizens, 25% were non-EU citizens and 12% were British citizens. On the other hand, of those whose main reason for migration was study, the majority (73%) were non-EU citizens. The difference in reason for immigration likely reflects the differing rights of EU and non-EU citizens to migrate to the UK as well as the impact of government policies and other factors.

In terms of participation of foreigners to the UK labour market, the share of working non-Brits and total unemployment rate in the UK have been increasing during 2004-2011. However, since 2011, unemployment rate steadily declined while share of foreign workers continued to increase. Accordingly, the share of foreign-citizens in total employment increased from 3.5% in 1993 to 10.7% in 2015. The growth in overall employment over the last year was 454,000 and over half of the growth in employment over the last year was accounted for by foreign nationals. Over a longer term period, most of the increase in the employment was observed for EU nationals, which increased from 0.45 million in 1997 to 2.05 million in 2015. The number of workers with Pakistan and Bangladesh nationalities, two OIC member countries for which data are available, remains stable around 100,000 over the last decade.

Overall, foreign workers in the UK constitute a major part of total employment and contribute to a wide range of occupations and sectors at various skills levels. Free movement of labour is likely to put pressures on wages, but make certain sectors more competitive. For example, London became a financial centre attracting banks and other financial services firms that are interested in the EU market. Again large multinational corporations open offices and manufacturing plants to target the local and EU markets, which not only provide employment opportunities to local workers, but also attract foreign workers to immigrate in the UK.

Free movement of labour was an important founding principle of the EU. According to Article 45 of the EU constitution, EU citizens can live and work in a member country without a work permit. However, rules for non-EU citizens are more restrictive. In line with these provisions, the numbers of migrants arriving from outside the EU has fallen since 2010, while the numbers from within the EU have risen. In this connection, supporters of Brexit argued that the only way the UK could control its borders was through leaving the EU.

In response to concerns about the perceived impact of high levels of net immigration on the labour market and public services, which was also a key factor behind the vote to leave the EU, the UK government said it is considering new measures to restrict the number of people coming to study and work in Britain from non-EU as well as EU countries. Even though the UK government seems to be determined to reduce migration from Europe once it leaves the EU, it is rather incompatible with continued tariff-free trade with the European single market. If this happens without an agreement with the EU, this will likely cause enormous friction between the UK and other EU countries. Several European leaders have already stated the free movement of people is a condition of the free movement of goods, services and capital.

It is therefore still unclear how the partnership between UK and EU will be evolved over the coming years. This will definitely have repercussions on shaping the partnership between the UK and non-EU countries. Some OIC countries have strong economic and commercial linkages with the UK and the post-Brexit policies may have an impact on these countries. However, due to uncertainties in the future immigration and labour market policies, it is hard to predict the consequences for OIC countries in terms of migration of workforce.

In light of the recent statements of government officials on potential policies, there is a clear signal on the importance of skills levels in regulating the immigration. Setting minimum salary requirement is to ensure that immigrants have at least a certain level of skills levels and standards of living while in the UK. It is estimated that work permits confined to skilled workers could reduce net EU migration by around 100,000 a year. A recent survey also revealed that Britons favour the argument that priority should be given to people with high levels of qualifications and skills to fill needs in particular professions.

In this connection, although immigration from OIC countries to the UK is not substantial, planned tightening of immigration procedures during post-Brexit process is likely to affect the OIC member countries as well. Immigration from OIC countries to the UK is already highly concentrated to few countries. Around half of people living in the UK with the origin of an OIC country are estimated to be from three OIC countries, namely Pakistan, Nigeria and Bangladesh. Noting the fact that majority of them live in low-income households, a significant number of immigrants from OIC member countries may be affected from the skill and salary requirements. Given the strong preference for skilled workforce, immigration from OIC countries are expected to be constrained mostly to skilled workforce and students only, which may contribute to greater brain drain from the concerned OIC countries.

Impact of Brexit on Immigration and Labor Market

Britain's decision to leave the EU astonished many. A majority of 51.9% of voters decided in a referendum held on 23 June 2016 that the United Kingdom (UK) should leave the European Union (EU). While the UK has been reluctant to take part in many EU initiatives in recent decades, the outcome of the referendum was still a surprise to most observers. Immigration issue was probably the single most important factor driving the leave vote. Moreover, it is also observed that the anti-EU campaigns were tied in with anti-Muslim themes, fuelling anti-Muslim and xenophobic sentiments across Europe.

The UK has a slightly different history of immigration and citizenship due to the fact that it was a major imperial power and included many countries as part of the British Commonwealth. Rapid increase in immigration from other EU countries over the recent years, particularly from lower income EU members, however, emboldened the anti-immigration sentiments in support of pro-Brexit campaigns. Today, there are over 3 million people born in the EU living in the UK, with continuing strong economic incentives to come from the poorer member countries of Eastern Europe, where youth unemployment remains exceptionally high.

On the other end of the spectrum, there were also concerns over a perceived lack of integration by Muslim immigrants. A Pew Research study conducted in 2015 found that the Muslim population has been steadily increasing, with more than 3 million Muslims now living in Britain, or 4.8% of total UK population.[1] A popular view was that there is a rapid increase in the number of Muslim population and recent refugee crises and potential accession of Turkey would increase the flow of Muslim population even further if the UK continues to remain within the EU, which were rather unrealistic arguments. However, as stated by a UK citizen in an interview, "It's not about trade or Europe or anything like that, it's all about immigration. It's to stop the Muslims coming into this country. Simple as that.",[2] a view shared by quite a number of people in the UK. But the point is that the referendum results will apply only to EU citizens.

In this connection, it is clear from the referendum result that the British public wants net migration to be reduced substantially. This policy preference will have definitely some impacts on other EU countries as well as non-EU countries, including OIC member countries. However, it is difficult to assess the impacts due to enormous uncertainties on how the UK government would design any new policies towards EU and non-EU migration. This section will try to shed light on the potential impacts of Brexit on labour market and immigration with reference to the OIC member countries.

A. Fear of Immigration as a Cause of Brexit

Although Britain was known for its positive attitude towards immigration, the desire to reduce immigration emerged undoubtedly as a key reason for the Brexit vote. Attitudes towards having immigrants as neighbours, fear of the influence of immigrants on society, fear of the UK losing national identity, its paying more to the EU while losing power in the world, and fear that native workers will lose jobs also reflect these same economic factors. Arnorsson and Zoega (2016) found that such fears are more pronounced in regions with low income, low education and higher age levels as they tend to dislike immigration and fear the influence of the EU, and therefore voted for Brexit.

[1] PEW Research Centre, goo.gl/xzfPgc.
[2] Washington Post, June 27, 2016, goo.gl/zB6lVB

A likely reason is that they feel vulnerable to immigration from other countries. Indeed, Nickell and Saleheen (2015) find that a 10% rise in the proportion of immigrants working in the semi-/unskilled service sector leads to a 1.8% reduction in pay, indicating that the lowest-skilled workers in the UK may be adversely affected by immigration. In general, however, the empirical evidence suggests only weak linkages on the effects of immigration on the labour market.

It is possible that, given the limited effect on wages, an exaggerated fear of immigration in public debate may have influenced voters to want to leave the EU. For example, according to an *Ipsos MORI* poll, if Britain votes to stay in the EU, 45% think it is true Turkey will be fast-tracked into the European Union and their population of 75 million people will have the right to free movement to the UK, although there is very little prospects for Turkey to join the EU during the next decade.[3] Moreover, voters perceive the numbers and effects of immigrants as being much greater than they actually are. In an *Ipsos MORI* poll published two weeks before the referendum, respondents thought on average that EU citizens made up 15% of the total UK population (around 10.5 million people), whereas the actual figure is around 5% (less than 3.5 million people).[4]

While many people around the world are uncomfortable with levels of immigration, global studies of the UK-based Ipsos Group shows that more educated people are also more likely to think immigration is good for the economy. Moreover, the Group finds that 38% say immigration has made it harder for native Britons to get a job, down from 48% a year ago and 62% in 2011. However, Britain is one of the countries most worried about the pressure placed on public services by immigration, with 59% concerned – although this too is down from 68% a year ago and from 76% in 2011, when Britain was the most worried of all the countries surveyed.[5] When asked if immigration has placed too much pressure on public services, 68% believe this to be the case, making Britain one of the most concerned countries about the impacts of immigration. More than half of Britons (54%) also agree that immigration is causing the country to change in ways they don't like.[6]

It is evident that fear of immigration drove the leave victory. Yet the details of the referendum demonstrate a paradox – that those who have experienced the highest levels of migration are the least anxious about it. The highest levels of remain voters were in areas of highest net migration, while some of the strongest leave areas have had the fewest recent new immigrants.[7] Based on these, it is difficult to argue that people who voted to leave made a rational decision based on the real economic effects they've suffered from the rise in immigration. This is supported by the evidence provided by Bell (2016), who found no correlation at all between areas where wages have fallen since 2002 and the share of votes for Leave in the referendum. It appears that the Brexit vote was rather rooted in xenophobia, rather than rational opposition to immigration.

B. Migration Trends in the UK

Existing evidence clearly shows high levels of opposition to immigration in the UK. In recent surveys, majorities of respondents think that there are too many migrants, that fewer migrants should be let in to the country, and that legal restrictions on immigration should be tighter. Indeed, the total number of net migration, the difference between the number of people coming to the UK for at least a year and those

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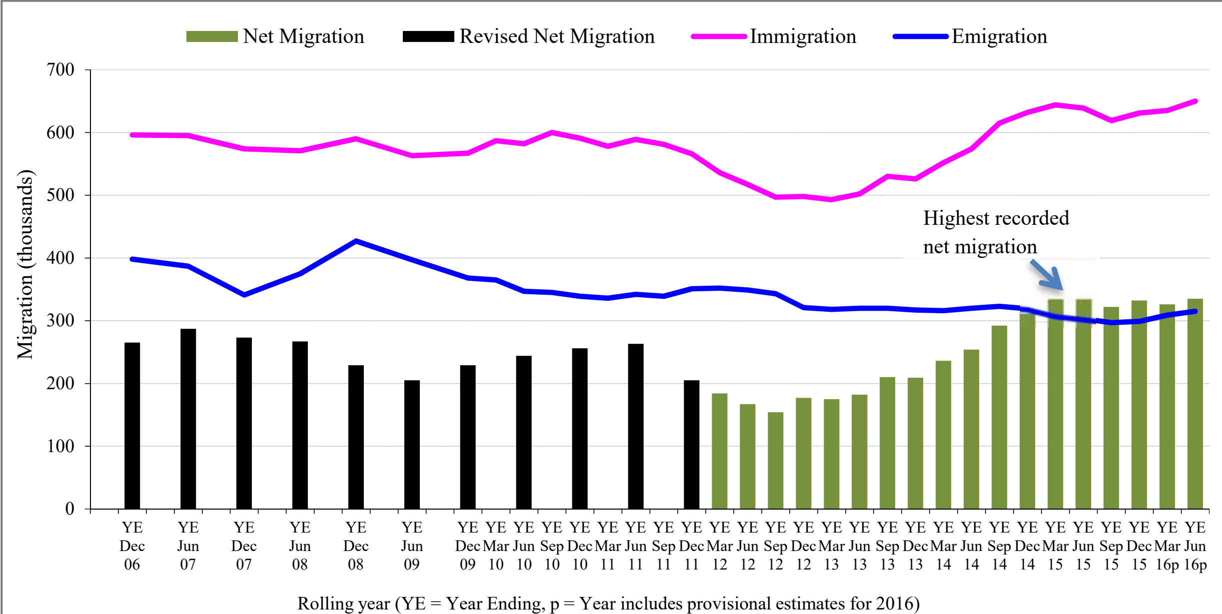
[3] Ipsos MORI Political Monitor – 16 June 2016, www.goo.gl/Wy2Kra.
[4] Ipsos MORI Poll, The Perils of Perception and the EU, 9 June 2016, www.goo.gl/218fC0.
[5] Ipsos MORI Poll, Global Survey on Immigration, 11 August 2016, www.goo.gl/EBIAb5.
[6] Ipsos MORI Poll, Ipsos Global @advisor: Wave 71, 6 August 2015, www.goo.gl/jNF3n2.
[7] The Guardian, 24 June 2016.

leaving, reached its highest recorded level in 2015 and remains stable around these record levels in 2016, according to the UK Office for National Statistics (ONS) estimates (Figure 1).

Figure 1: Long-Term International Migration to United Kingdom (All citizenships)



Source: UK Office for National Statistics.

Net migration to the UK rose to 335,000 in the year to June 2016, the second highest figure on record, comprising +189,000 EU citizens, +196,000 non-EU citizens and -49,000 British citizens (Table 1). Total immigration in the year to June 2016 was estimated at 650,000, the highest estimate recorded (up 11,000 from June 2015) and total emigration was estimated at 315,000 (up 12,000 from June 2015).

Table 1: Latest Migration Statistics, Year Ending (YE) June 2016

	All Citizenships	British	Non-British	EU	Non-EU
Immigration	**650,000**	77,000	573,000	284,000	289,000
Emigration	**315,000**	127,000	188,000	95,000	93,000
Net Migration	**335,000**	- 49,000	385,000	189,000	196,000

Source: UK Office for National Statistics.

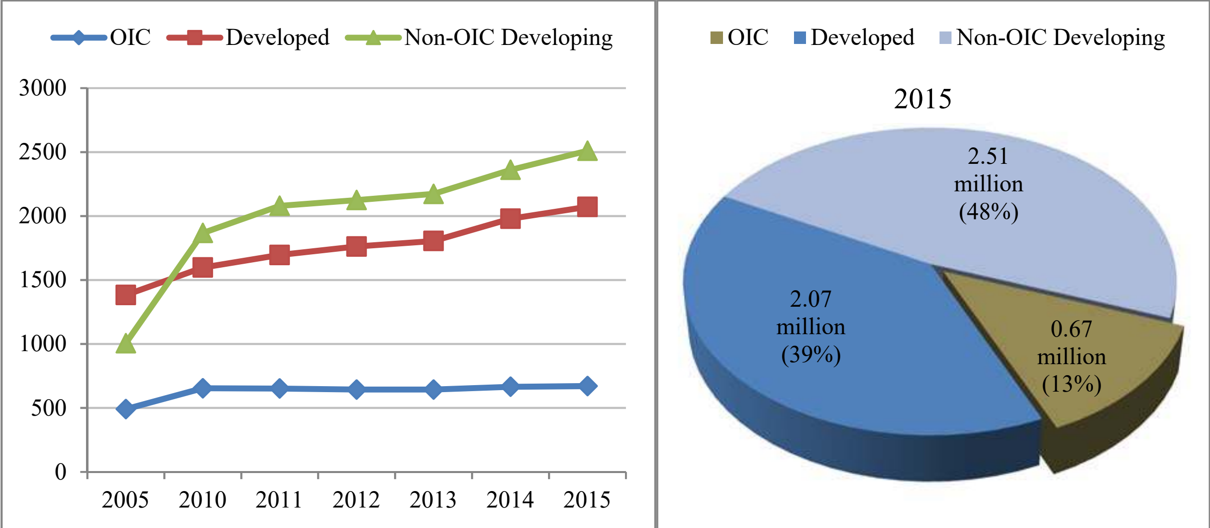
The total number of immigrants from OIC countries living in the UK appears to be stable around 650,000, while the immigrants from developed and non-OIC developing countries follow an upward trend (Figure 2, left). In 2015, there were around 671,000 people living in the UK originally migrated from the OIC member countries, corresponding to 13% of total immigrants.[8] On the other hand, the immigrants from non-OIC developing countries account almost half of the total immigrants (Figure 2, right).

Instead of reporting at individual country level, the ONS typically reports the statistics for geographical aggregates such as EU and Non-EU, and subgroups of these aggregates, such as EU15, other Europe,

[8] Actual numbers must be slightly higher than these numbers, because the UK Office for National Statistics provides data only for 60 most common nationalities for each year.

Asia and Africa. Therefore, it is not possible to make an analysis on the movement of people from OIC member countries to the UK or vice versa. According to the data reported by ONS on aggregate terms, immigration of EU citizens was estimated to be 284,000 (the highest estimate recorded), compared with 265,000 the previous year. Immigration of non-EU citizens was estimated to be 289,000, similar to the previous year, and indicating that the gap between the two citizenship groups has narrowed in recent years.

Figure 2: Non-British population in the United Kingdom

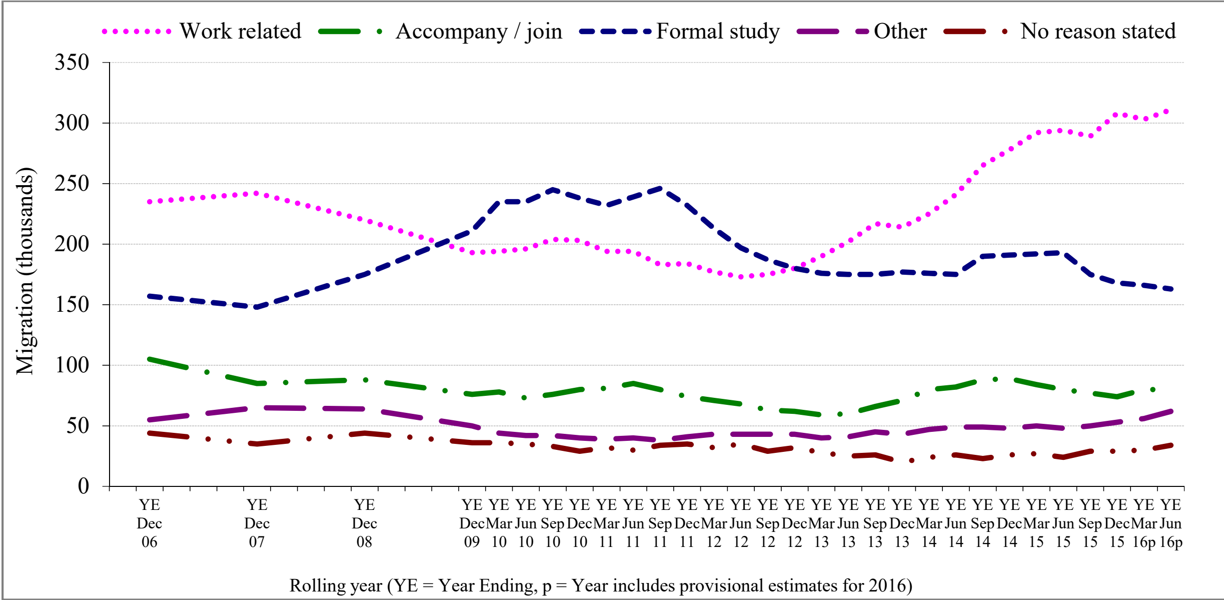


Source: UK Office for National Statistics. Statistics based on the 60 most common nationalities reported by ONS.

Nationality information on individuals that are subject to immigration controls, coming from non-EU countries, is provided by visa data produced by the Home Office, which are, however, are not publicly available. According to the ONS, the total number of non-visitor visas granted in YE September 2016 (559,344) increased slightly from YE September 2015 (up 24,177 or 5%). There were increases for Chinese nationals (up 10,144 or +11%) and falls for Nigerian nationals (down 2,789 or -18%) and Libyan nationals (down 1,551 or -68%), with the highest numbers of visas being granted to Chinese and Indian nationals.

The majority of immigrants are moving to the UK for work-related purposes, as derived from the International Passenger Survey (IPS) data by ONS. The number of immigrants for work-related purposes shows a particularly strong upward trend since 2012; while immigration for other purposes remains more stable (Figure 3). In YE June 2016, 311,000 (48%) people immigrated for work (the highest estimate recorded), compared with 294,000 in YE June 2015. Of these, 182,000 (59%) had a definite job to go to and 130,000 arrived looking for work (a statistically significant increase of 23,000 from 107,000 the previous year), as reported in the Migration Statistics Quarterly Report of ONS (ONS, 2016a).

Figure 3: Long-Term International Migration to UK by Main Reason for Migration (All citizenships)



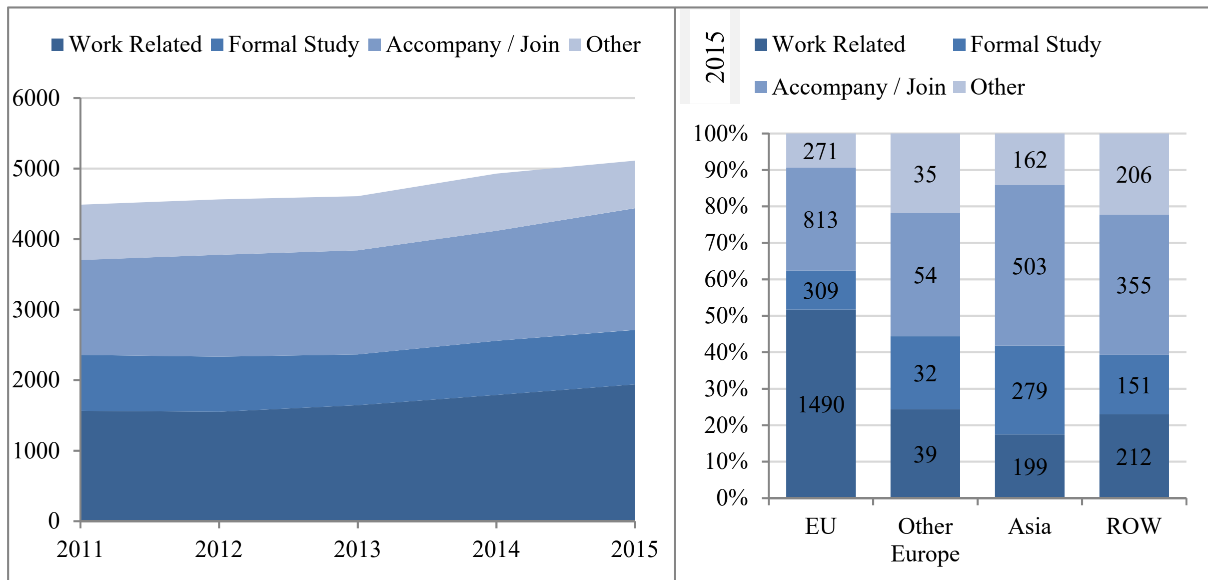
Source: UK Office for National Statistics.

IPS data show that, of those whose main reason for long-term migration was work-related, the majority (63%) were EU citizens, 25% were non-EU citizens and 12% were British citizens. In YE June 2016, 189,000 EU citizens arrived for work (the highest estimate recorded), compared with 162,000 in YE June 2015. Of the 74,000 non-EU immigrants who arrived for work-related reasons, 50,000 (68%) had a definite job to go to, compared to 57% (108,000) for EU immigrants. There was also a significant increase in the net migration of professional and managerial migrants, from 62,000 in 2014 to 98,000 in 2015. On the other hand, of those whose main reason for migration was study, the majority (73%) were non-EU citizens (Figure 4). The difference in reason for immigration likely reflects the differing rights of EU and non-EU citizens to migrate to the UK as well as the impact of government policies and other factors.

Immigration for study is particularly popular among non-EU citizens. Estimates show that 73% were non-EU citizens and 22% of those arriving to study were EU citizens (the remaining 6% being British citizens). The number of non-EU citizens migrating to the UK to study was estimated to be 113,000 in the year to June 2016. Citizens of Asian countries made up 72% of the 113,000. More than one-third of non-EU study visas were granted to Chinese students (39%), followed by United States (7%) and India (5%). In aggregate terms, the number of people immigrating for more than 12 months to study was estimated to be 163,000 in total in year to June 2016, declining from 193,000 in June 2015.

In terms of emigration statistics, the latest estimates show 93,000 non-EU citizens emigrated from the UK, somewhat higher than the previous year (86,000). Of the non-EU emigrants, 58% were of Asian citizenship. Of all non-EU emigrants, 67% were emigrating for work-related reasons. While most common 5 countries from which people immigrated were Romania, China, Poland, India and Spain, most common 5 countries to which people emigrated to in 2015 were Australia, USA, Spain, France and China.

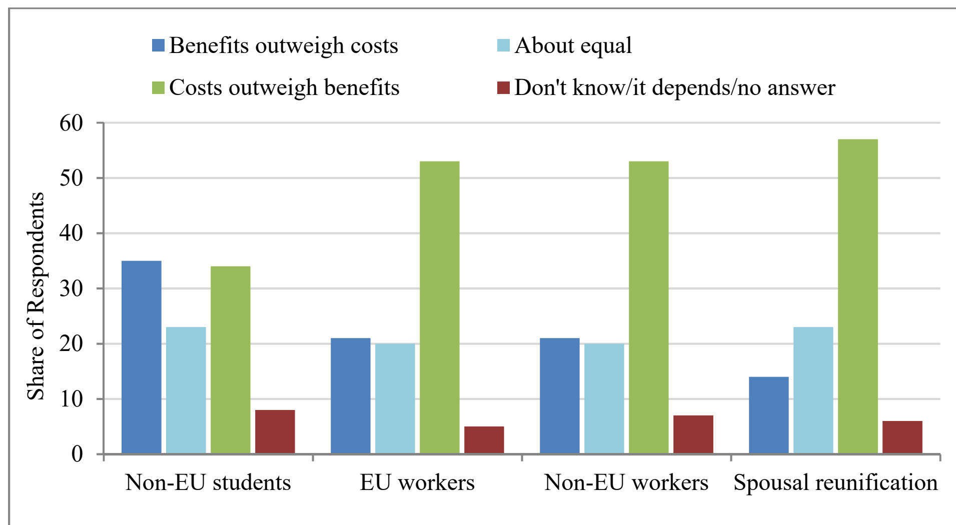
Figure 4: Non-British population in the United Kingdom by main reason for migration



Source: UK Office for National Statistics.

Finally, in order to evaluate the public perception on the benefits of migration, the British Social Attitudes survey in 2013 asked about the costs and benefits of different types of migration: students, spouses, and labour migrants from within and outside the EU. Accordingly, students were the least negatively-viewed. Labour migrants were more likely to be seen as a net negative, and were viewed similarly whether from within or outside the EU. Finally, spousal reunion migrants were the most negatively viewed by this measure, with 14% seeing them as bringing more benefit than cost, against 57% seeing such migrants as bringing more cost than benefit (Migration Observatory).

Figure 5: Perceived Costs and Benefits of Different Types of Migration



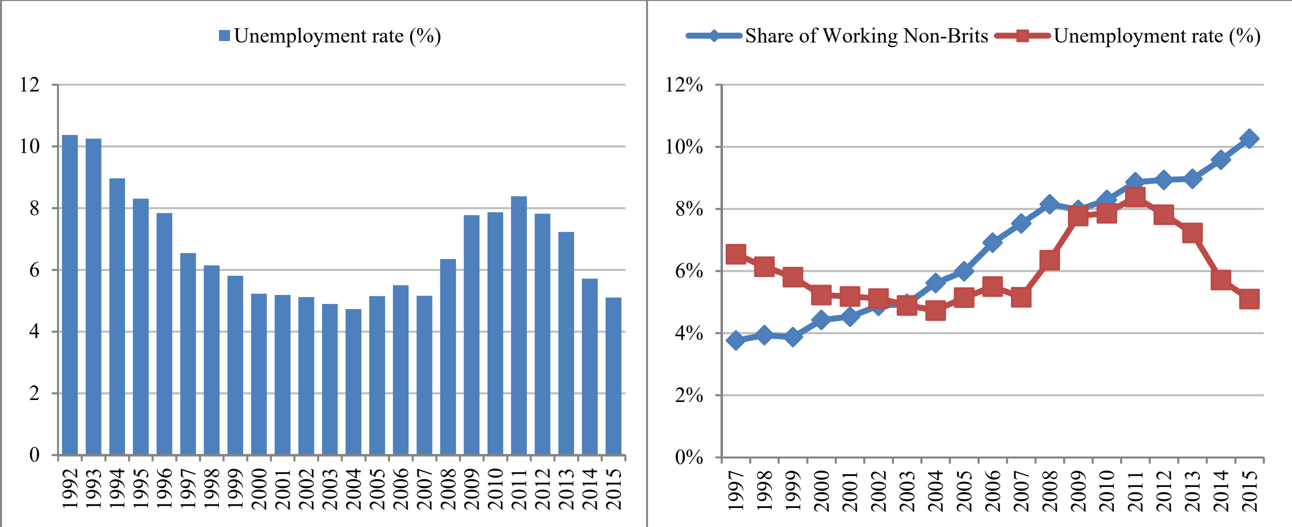
Source: The Migration Observatory at the University of Oxford & British Social Attitudes Survey 2013.

C. Labour Market Structure and Importance of Foreign Labour Force

According to the latest statistics provided by the UK Office of National Statistics, there were 31.8 million people in work in the UK, 461,000 more than for a year earlier. The employment rate (the

proportion of people aged from 16 to 64 who were in work) was 74.5% in 2015. As a comparison, this rate was only 55.3% in OIC countries as a group in 2014 (SESRIC, 2014). There were 1.6 million unemployed people, 146,000 fewer than for a year earlier. The unemployment rate during July to September 2016 was 4.8%, down from 5.3% for a year earlier and the lowest since July to September 2005 (Figure 6, left).

Figure 6: Unemployment in the UK and Share of Working Non-Brits

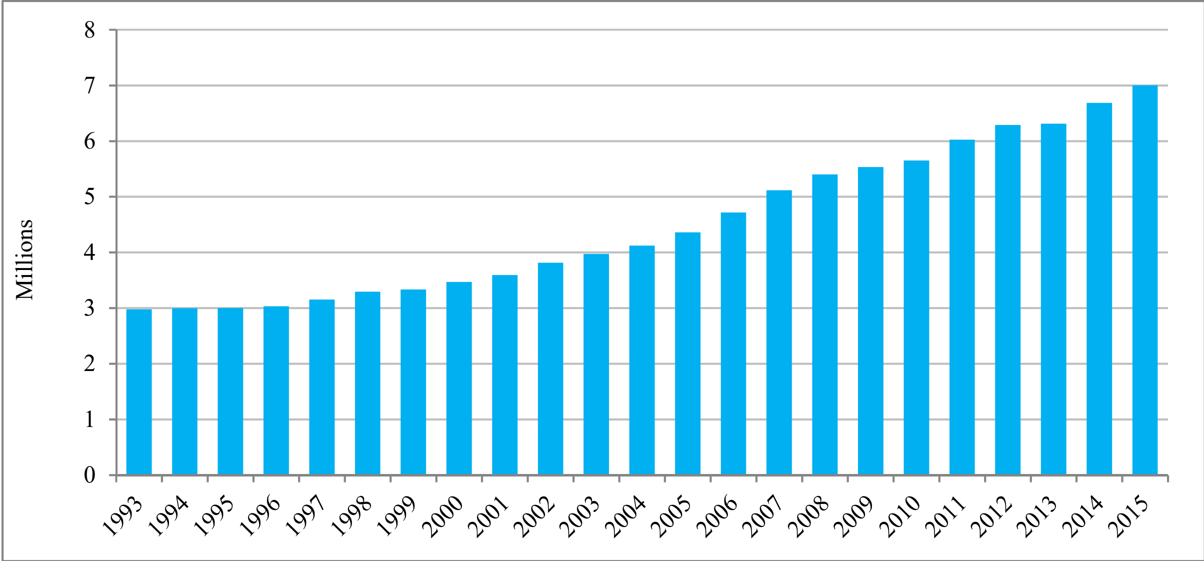


Source: UK Office for National Statistics

The number of working-age foreign-born people in the UK increased from nearly 3 million in 1993 to 7 million in 2015 (Figure 7). There was a significant jump in the number of foreign-born workers in the UK during 2006, which coincides with the opening of UK labour markets to workers from the so-called A8 countries (Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovakia, and Slovenia) in mid-2004. During 2004-2011, share of working non-Brits and total unemployment rate in the UK have been increasing; however, since 2011, unemployment rate steadily declined while share of foreign workers continued to increase (Figure 6, right). Accordingly, the share of foreign-citizens in total employment increased from 3.5% in 1993 to 10.7% in 2015.

Latest employment statistics from the Labour Force Survey show the estimated employment level of EU nationals (excluding British) living in the UK was 2.1 million in January to March 2016, 224,000 higher than the same quarter last year. British nationals in employment increased by 185,000 to 28.2 million, while non-EU nationals in employment increased by 5,000 to 1.2 million. There were 629,000 National Insurance Number (NINo) registrations by EU nationals in the year to September 2016. For non-EU nationals, there were 195,000 registration. The growth in overall employment over the last year was 454,000 and over half of the growth in employment over the last year was accounted for by foreign nationals (ONS, 2016a).

Figure 7: The Number of Foreign-born People of Working Age in the UK



Source: The Migration Observatory at the University of Oxford & ONS Labour Force Survey.

There have been increases for all nationality groupings in the employed UK labour force in July to September 2016, compared with the same quarter for the previous year (Table 2). Over a longer term period, most of the increase in the employment was observed for EU nationals, which increased from 0.45 million in 1997 to 2.05 million in 2015. Similarly, EU nationals accounted for the largest increase in employment over the last year with 10.9% increment. The number of workers with Pakistan and Bangladesh nationalities, two OIC member countries for which data are available, remains around 100,000 over the last decade (Figure 8).

Table 2: Change in labour market activity, July to September 2016, UK

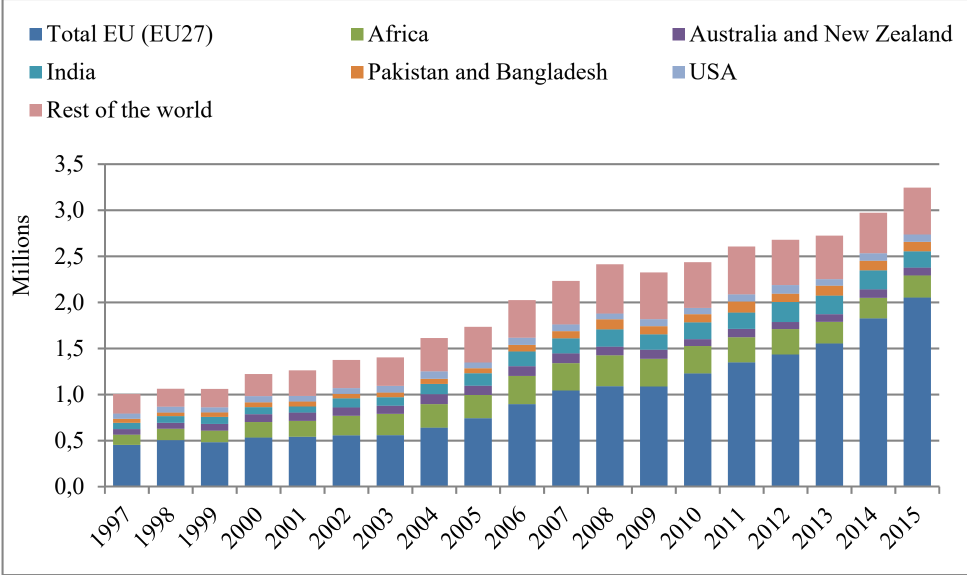
thousands

Nationality grouping	Total in employment, Jul to Sep 2015	Total in employment, Jul to Sep 2016	Difference	% Change to previous year
Total	31,426	31,880	454	1.4%
British	28,173	28,386	213	0.8%
Non-UK	3,249	3,490	241	7.4%
EU	2,040	2,261	221	10.9%
Non-EU	1,210	1,230	20	1.6%

Source: UK Office for National Statistics.

With respect to the sectors where foreign labour force is employed, it is observed that the increase in the share of foreign-born workers in employment in the UK has been highly differentiated across occupations and sectors. Compared to the early 2000s, the presence of foreign-born workers has grown fastest in relatively low-skilled sectors and occupations. The increase in the share of foreign-born workers was fastest among process operatives (e.g. transport drivers, food, drink and tobacco process operators), up from 8.5% in 2002 to 36.0% in 2015 (Migration Observatory, 2016).

Figure 8: Employment Levels by Nationality (People aged 16 and over)



Source: UK Office for National Statistics.

In 2002, there was only one low-skilled occupation (food preparation trades) in the list of top ten occupations with the highest shares of foreign-born workers. As shown in Table 3, there are now at least five low-skilled occupations on this list (i.e. elementary process plant, process operatives, cleaning and housekeeping managers, elementary cleaning, food preparation and hospitality).

In 2015, 42% of workers in elementary process plant occupations (such as industry cleaning process occupation and packers, bottlers, canners and fillers), 36% of workers process operatives (such as food process; glass and ceramics process; textile process; chemical and related process; rubber and plastic process; metal making and treating process) and 35% in cleaning and housekeeping managers and supervisions were foreign-born. The increase in the share of migrant labour has been greatest among process operatives up from 8.5% in 2002 to 36% in 2015. As discussed by Aldin et al. (2010) a significant share of relatively skilled recent migrants have taken up employment in less-skilled occupations in the UK (ONS, 2016b).

Table 3: Top 10 Occupations of Foreign-born Workers, 2015

	All migrants	%	Recent migrants	%
1	Elementary process plant occupations	42	Elementary process plant occupations	19
2	Process operatives	36	Process operatives	12
3	Cleaning and housekeeping managers	35	Elementary cleaning occupations	11
4	Elementary cleaning occupations	31	Cleaning and housekeeping managers	9
5	Food preparation and hospitality	30	Elementary storage occupations	9
6	Textiles and garments trades	28	Other elementary services occupations	9
7	Health professionals	26	Assemblers and routine operatives	8
8	Elementary storage occupations	26	Elementary construction occupations	8
9	IT and telecoms professionals	25	Elementary agricultural occupations	7
10	Assemblers and routine operatives	25	Mobile machine drivers and operations	7

Source: UK Office for National Statistics.

Overall, foreign workers in the UK constitute a major part of total employment and contribute to a wide range of occupations and sectors at various skills levels. Free movement of labour is likely to put pressures on wages, but make certain sectors more competitive. For example, London became a financial centre attracting banks and other financial services firms that are interested in the EU market. Again large multinational corporations open offices and manufacturing plants to target the local and EU markets, which not only provide employment opportunities to local workers, but also attract foreign workers to immigrate in the UK.

D. Prevailing Provisions in the Area of Migration and Employment and Possible Way Forwards

Free movement of labour was an important founding principle of the EU. According to Article 45 of the EU constitution, EU citizens can live and work in a member country without a work permit. They are also paid benefits, if they are laid off or unemployed. However, rules for non-EU citizens are more restrictive. In line with these provisions, as provided earlier, the numbers of migrants arriving from outside the EU has fallen since 2010, while the numbers from within the EU have risen. The estimated non-EU immigration and net migration have always been higher, though the gap is narrowing due to large increases in EU immigration over the past few years, and the two are now at similar levels.

Supporters of Brexit argued that the only way the UK could control its borders was through leaving the EU, which mandates that members must allow EU citizens to live and work in any country in the union. In response to concerns about the perceived impact of high levels of net immigration on the labour market and public services, which was also a key factor behind the vote to leave the EU, the UK government said it is considering new measures to restrict the number of people coming to study and work in Britain from non-EU as well as EU countries. The government commits to reducing net immigration to the *tens of thousands* from the current *hundreds of thousands*. However, business community stresses the need for strong links globally to seize new opportunities after the Brexit.[9]

Currently, *permanent residence* applications for European Economic Area (EEA) nationals and *indefinite leave to remain* applications for non-EEA nationals are the best way of ensuring the future of employees from outside the UK. Non-EEA citizens (including those on an EEA family visa) who demonstrate a commitment to the UK on a temporary visa are entitled to apply for an *indefinite leave to remain* visa after a set period of time to preserve their rights. This is similar to the *permanent residence* application that EEA citizens can make, but there are some further restrictions that apply to applicants from outside of the EEA.

Work permits for non-EU citizens are currently regulated under the Points-Based System in place since 2008, which includes Tier 1 for highly-skilled workers, Tier 2 for skilled workers with job offers,[10] Tier 5 for temporary workers,[11] as well as other categories outside of the Points-Based System. Skilled, employer-sponsored workers (Tier 2 of the Points-Based System) are the largest category of entry visas issued for work (Migration Observatory, 2016b).

In order to restrict the immigration from non-EU countries, the UK initiated a reform on its immigration policy. Under recent Tier 2 Visa reforms, non-EEA workers on a Tier 2 visa must now earn £35,000 annually to qualify for settlement. Some occupations must demonstrate an even higher salary. Between

[9] Wall Street Journal, October 4, 2016, goo.gl/pvZQFg
[10] Tier 2 is for non-EU citizens who have been offered a job doing skilled work in the UK.
[11] Tier 5 of the points-based system is for non-EU citizens who have been offered a temporary skilled job in the UK, and for young people from certain countries who would like to live and work for a short period in the UK.

2016 and 2020, this threshold will increase incrementally to £36,200, to reflect forecasted rises in salary rates. The policy was announced in 2012 and applies from 6 April 2016 for any Tier 2 applications where the applicant arrived in the UK after April 2011. The threshold does not apply to EEA residence.[12]

The Syrian refugee crisis is not related to the UK's continued membership of the EU. The total immigration figures will not be much affected as the government will admit only around 20,000 adult refugees over the next five years. Refugees given the right to remain in Germany or other EU countries have no right to live or work in the UK. It takes a number of years (usually between five and eight) before refugees are even allowed to apply for citizenship. Most of those who are settled are unlikely to seek work in the UK. The UK is not in the Schengen passport-free travel agreement, so there are border checks preventing entry of refugees. Stopping illegal entry to the UK would not be any easier after Brexit (Wadsworth et al., 2016).

E. Potential Implications for the OIC Member Countries

The UK appears to be willing to impose restrictions on new EU migrants entering the UK. Even though the UK government seems to be determined to reduce migration from Europe once it leaves the EU, it is rather incompatible with continued tariff-free trade with the European single market. If this happens without an agreement with the EU, this will likely cause enormous friction between the UK and other EU countries. Several European leaders have already stated the free movement of people is a condition of the free movement of goods, services and capital.

When renegotiating the conditions of the relations with the bloc after leaving the EU, the UK will definitely have more than one option. The easiest transition would be probably to remain still within the European Economic Area (EEA), as Norway does. The other option would include seeking membership of EFTA, whose members are Iceland, Norway, Switzerland and Liechtenstein. Alternatively, the UK can negotiate its own EEA type deal, like Switzerland, which is the only EFTA member that is not in the EEA. UK Government has prepared a report on alternatives to EU membership just before the Brexit referendum to present the possible models for the UK outside the EU (UK, 2016).

It is therefore still unclear how the partnership between UK and EU will be evolved over the coming years. This will definitely have repercussions on shaping the partnership between the UK and non-EU countries. Some OIC countries have strong economic and commercial linkages with the UK and the post-Brexit policies may have an impact on these countries. However, due to uncertainties in the future immigration and labour market policies, it is hard to predict the consequences for OIC countries in terms of migration of workforce.

In light of the recent statements of government officials on potential policies, there is a clear signal on the importance of skills levels in regulating the immigration. Setting minimum salary requirement is to ensure that immigrants have at least a certain level of skills levels and standards of living while in the UK. Noting the fact that 60% of Pakistanis and 70% of live in low-income households[13], a significant number of immigrants from OIC member countries may be affected from this requirement. A recent survey by Ipsos Mori also revealed that Britons favour the argument that priority should be given to people with high levels of qualifications and skills to fill needs in particular professions.[14] It is estimated

[12] Lexology, http://www.lexology.com/library/detail.aspx?g=f17cb057-eabe-4bbf-9494-887214d22fc0
[13] UK Department of Welfare and Pensions, http://www.poverty.org.uk/06/index.shtml
[14] Ipsos MORI Poll, 11 August 2016, goo.gl/EBIAb5

that work permits confined to skilled workers could reduce net EU migration by around 100,000 a year (Migration Observatory, 2016c).

In this connection, although immigration from OIC countries to the UK is not substantial, planned tightening of immigration procedures during post-Brexit process is likely to affect the OIC member countries as well. Immigration from OIC countries to the UK is already highly concentrated to few countries. Around half of over 700,000 people living in the UK with the origin of an OIC country are estimated to be from three OIC countries, namely Pakistan (187,000), Nigeria (106,000) and Bangladesh (72,000). Data reveals that most of the new immigrants from non-EU countries are family reunification, which is also likely to be relevant for the immigrants from OIC countries.

Given the strong preference for skilled workforce and adverse effects of low-skilled workforce as evidenced in the literature (see McGuinness and Hawkins, 2016), immigration from OIC countries are expected to be constrained mostly to skilled workforce and students only, which may contribute to greater brain drain from the concerned OIC countries.

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