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Brexit – Implications for south-east European countries

Abstract

The paper aims to identify and evaluate the risks to which the south-east European region is exposed as a result of Brexit. An exhaustive assessment of the consequences is difficult and surrounded by uncertainty related to the unknowns that will accompany the exit process itself. The potential impacts of Brexit could can be divided into two groups: (i) direct effects, deriving from the economic, trade and financial links that countries have with the United Kingdom; and (ii) indirect effects, deriving from the consequences that Brexit could have for the economies and financial markets of Europe (and beyond). The analysis concludes that Brexit will have a marginal direct impact on the economy, trade and financial sector of south-east Europe, but the region remains potentially exposed indirectly to the effects of Brexit. In the longer-term, the region stands to lose if Brexit weakens EU integration processes as a policy anchor for south-east Europe and induces a tightening of regulation with adverse effects on trade and cross-border finance. Furthermore, Brexit could jeopardise the EU itself.

Keywords: *Brexit, financial impact, trade and real sector exposure, political economy*

Introduction

On 23 June 2016 a referendum was held in the United Kingdom to decide whether the country would remain in the European Union or would leave it. The result of the referendum showed that a majority of those voting, about 52 per cent, voted for exit from the European Union, ending a 40-year relationship with it. The UK's position came as a condition of a population concerned at the consequences of the economic and financial crisis and new waves of migration. The main pro-Brexit[1] arguments were:

1. economy: it is easier for the UK to sign economic and trade agreements with other countries as a single and independent actor. EU exit would facilitate the negotiation procedures with countries such as China and Russia to establish agreements based solely on the UK national interest. At the same time, the country will be liberated from the burden of contributing to the Union's budget and it would allow the UK to save £20m every day

1 A portmanteau word combining Britain and exit – though the referendum also encompassed Northern Ireland (UK equals Great Britain (England, Scotland and Wales) plus Northern Ireland) so the derivation is, essentially, quite incorrect.

2. political freedom and governance: the UK is considered the mother of parliamentary democracies and, for Brexit supporters, EU decision-making and the decisions of a Commission unelected by the people simply violates autonomy and the freedom to decide on issues important to the country
3. full control of borders: the number of those who come to the UK exceeds the number of UK citizens who go to live and work in other EU countries. Another problem remains that illegal immigrants and terrorists were regarded as finding it easier to come to the UK, even though the UK is not in Schengen. With EU exit, the country would take full control of its borders and may impose conditions on the acceptance of any foreigners and refugees into its territory.

The United Kingdom only began the process of starting legal divorce papers from the European Union at the end of March 2017; this process will be gradual and will take time. Exit from the EU is placed on the UK invoking Article 50 of the Lisbon Treaty, which implies the use for the first time of this Article according to which 'Any member state may choose to withdraw from the Union in accordance with its constitutional requirements'. However, the process continues in negotiation with other EU member states on the withdrawal conditions albeit that, within two years, the country must have reached agreement with the EU. Brexit being the first time that this process will have been invoked, no-one can predict whether two years will be a sufficient period in which to reach such an agreement. Many experts believe that this issue is very complex and will be difficult to complete within the period prescribed by the law.

The departure of the United Kingdom from the European Union, or the process of so-called 'Brexit', could have potential consequences for the economy and financial system of the south-east Europe region. A full assessment of these is difficult and surrounded by high levels of uncertainty, mainly caused by the major doubts that are associated with this process. The transmission channels of Brexit for south-east Europe can theoretically be directly from the economic, financial and trade relations that the region has with the UK; as well as indirect, from the consequences that Brexit could have for the economies of continental Europe and global financial markets.

In the following, we present a preliminary assessment of the potential direct and indirect impacts of 'Brexit', organised as follows: in the next section, we analyse the exposure to the UK of Albania and the south-east Europe region; after that, we examine the political economy of Brexit; with the last section revealing the conclusions of our analysis.

Albania and south-east Europe's exposure to the UK

Impact of the direct effects on the Albanian economy

From a short-time perspective, the economy of Albania and south-east European countries will remain uninfected by the withdrawal of the UK from the European Union. Trade relations with the UK are almost non-existent, the number of immigrants in the UK is very low and UK investors have never had south-east Europe on their radar.

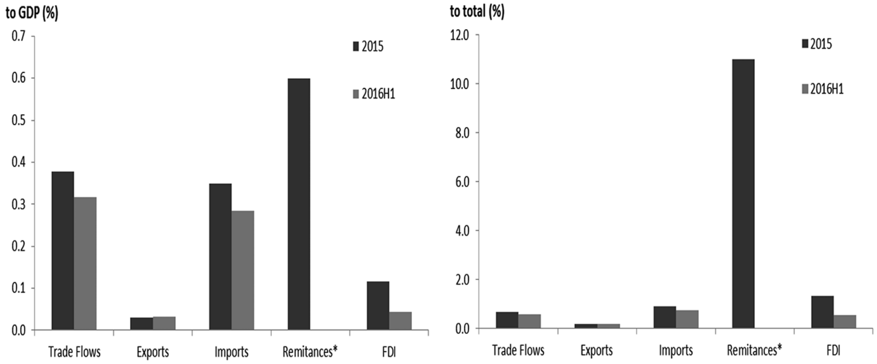
However, in the medium-term, were the exit of the UK from the EU to plunge Europe and the wider world, today more interconnected than before, into crisis, the consequences would quickly become apparent. Albania is closely connected to the rest of the European Union and cannot be regarded as being uninfected. A simple example is what happened in 2008; Albania was not directly touched by the first wave of the banking crisis stemming from low financial integration, but the country then suffered an investment brake, creating difficulties in exports and an overall slowdown in economic growth which, even today (where growth is not expected above 3 per cent), continues to be lag far behind the growth rates of 8 per cent that came before 2008. The most visible effect could be a slowdown in the process of accession to the European Union.

Trade flows with the UK occupy a small share of Albania's total trade activity. The weights of both imports to and exports from the UK in the overall totals are, respectively, 0.8 per cent and 0.2 per cent. The reduction or stoppage of Albanian exports to the UK will have a marginal effect on the Albanian economy.

The stock of foreign direct investment originating in the UK was estimated at € 19.8m in 2014. Expected investment in the same year was estimated at 0.44 per cent of the total stock of foreign direct investment in Albania and around 0.2 per cent of GDP. The withdrawal of these investments, or any curbing of the inflows of them, would likewise have an insignificant effect on the Albanian economy.

The most up-to-date complete information about the weight of remittances from residents in the UK belongs to the second half of 2015. Estimates show that the share of remittances from the UK to Albania is about 11 per cent for the reference period representing a transfer value of € 32.3m, or 0.6 per cent of nominal GDP. The complete stoppage of remittances is a low probability event. Meanwhile, their reduction could have marginal – although not completely negligible – effects at a consumer level and on the pace of economic growth.

Figure 1 – Albanian trade and real sector exposure



* Data for H2, 2015

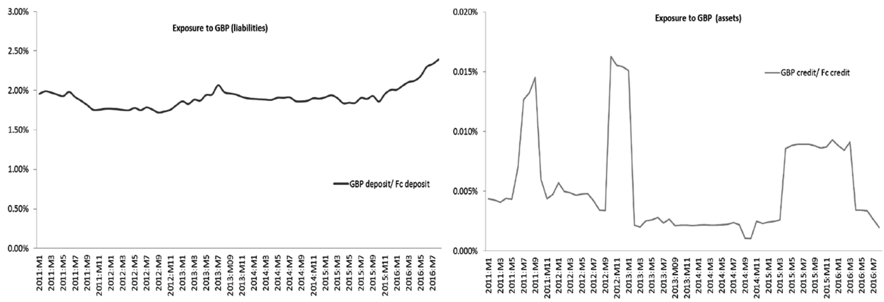
Source: Bank of Albania

The impact of the direct effects on balance in the Albanian banking system

Brexit was immediately associated with strong tendencies towards a depreciation of the sterling pound (GBP), which process was further strengthened in the next few days. Theoretically, these trends are likely to ease the burden of credit-makers in GBP and diminish the value of savings (deposits) held in GBP. Given the weight of GBP in the total volume of deposits and loans in the Albanian banking system, the intensity of action in this channel seems negligible.

Deposits and loans in GBP comprise, respectively, 0.002 per cent and 1.17 per cent of the respective totals within Albania, according to data from April 2016.

Figure 2 – Albania's financial exposure



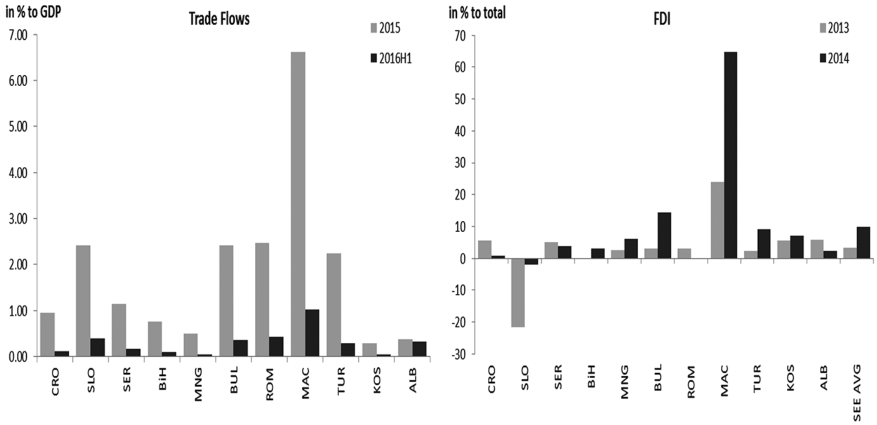
Source: Bank of Albania

From a regional perspective

The UK is not an important trading partner for south-east European countries with the exception of Macedonia, where trade flows occupy about 6.7% of the country's GDP. For the other countries of the region, trade flows with the UK occupy no more than 2.8 per cent of GDP (Figure 3).

If we refer to foreign direct investment, the UK is also not a significant source within the region. FDI from the UK takes up about 8 per cent of the total stock of foreign direct investment in the south-east European region, excluding Macedonia – which is, again, the exception. Macedonia's stock of UK-origin FDI represents 62 per cent of its total, according to 2014 data.

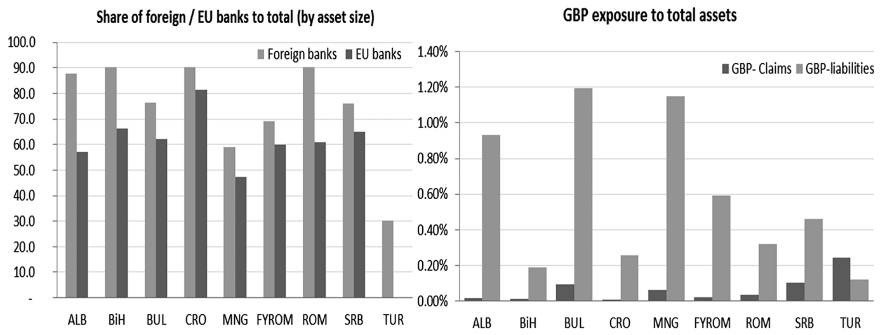
Figure 3 – South-east Europe real sector exposure to the UK



Source: Eurostat, respective central banks, Bank of Albania

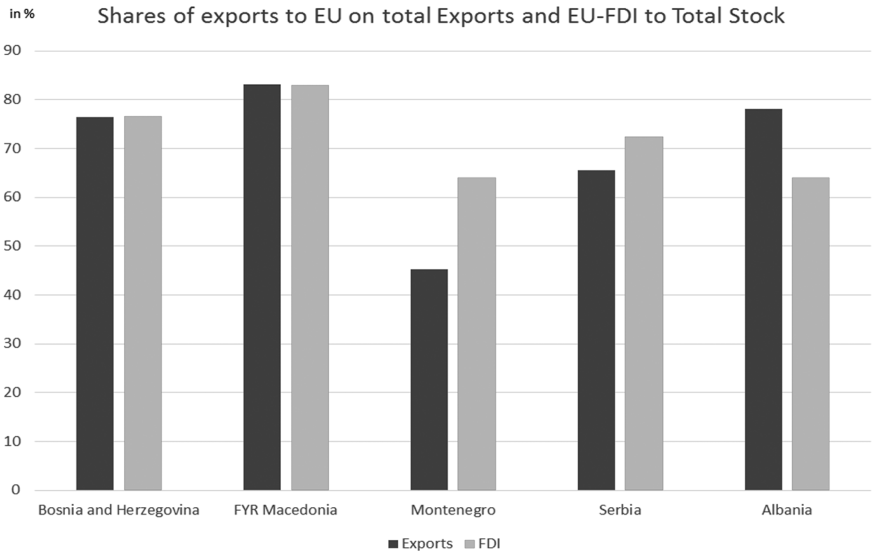
Financially, the region is not significantly exposed to fluctuations in pounds sterling because claims and liabilities in GBP have a relatively low weight in respective balance sheet totals: claims do not exceed 0.22 per cent of total assets, while liabilities occupy a maximum of 1.20 per cent of total liabilities (Figure 4). Given their weight in the total volume of assets and liabilities of the financial system of south-east Europe, the intensity of action in this channel also seems negligible. Consequently, from a regional perspective, the exposure of the south-east European financial system to the UK and to pound sterling is fairly limited.

Figure 4 – South-east Europe financial sector exposure to the UK



Source: EIB, BSCEE, respective central banks, Bank of Albania

Figure 5 – Regional exposure to EU



Source: Eurostat, WTO, Bank of Albania

Table 1 – Expected Brexit effect on EU

	Mild scenario		Severe scenario	
	2016	**2017**	**2016**	**2017**
UK	-0.3	-0.9	-0.6	-2.6
EA	-0.1	-0.2	-0.2	-0.5
EU-27	0.0	-0.2	-0.2	-0.5
EU-28	-0.1	-0.3	-0.3	-0.9

Source: European Commission (2016) *The Economic Outlook after the UK Referendum* Institutional Paper 032, July.

Potential indirect effect via the EU

Any indirect negative effects from Brexit may be materialised in the form of one or more shocks, as follows.

Economic recession in the euro area, due to the increase in extreme uncertainty

This scenario would have negative consequences for the economy of the region of south-east Europe, negatively affecting exports and the inflow of foreign direct investment from trade partners and increasing insecurity in the countries. Depending on the intensity of the crisis, the shock could take extreme forms similar to the 2008 attack.

New crisis in the European banking and financial system

This scenario would lead to the emergence of liquidity and capitalisation problems of parent banks. Depending on the intensity of the crisis, the effects could go from a reduction of appetite for expansion in the south-east Europe region to deleverage or a reduction of exposure to the south-east European economy. At the soft extreme of the spectrum, the effects on the region's economy would be relatively low as long as credit growth remained weak. At the most negative extreme, the south-east European economy might face a similar situation to that of 2011-2012, when deleverage created problems for the financing of the public and private sectors. However, it should be noted that the banking system of south-east Europe would not be affected directly by the withdrawal of funds because locally-generated deposits are more than enough to cover loans and government securities on the assets of the banking system.

Strong depreciation of the euro against the US dollar

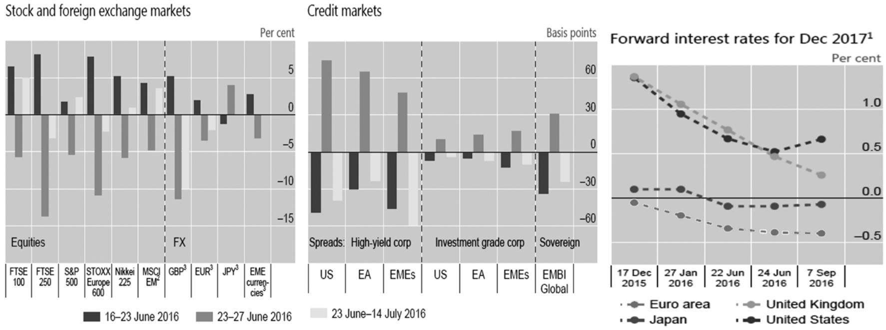
Proportionally, exports appear more oriented towards the euro (85%) than do imports (about 70%). This means that, in any case of depreciation of the euro against the dollar: (a) export receipts will fall faster than the bill for imports; but (b) the trade balance will improve because imports are valued significantly higher than exports.

In other words, the saving on import items will be greater than the decline in revenues from exports. If these savings generate additional consumption in the economy of south-east Europe, the resultant effects on economic growth would be positive. If it did not do so, the effects on growth would be negative.

Beyond that, the depreciation of the euro against the dollar may be accompanied by shifts in domestic euro portfolios, which would mean a strengthening of the exchange rate. This strengthening will be harmful and undesirable for the cyclical position of the Albanian economy and our monetary policy direction.

A materialisation of any of these negative indirect scenario effects would have consequences which were potentially harmful to the economy of south-east Europe.

Figure 6 – Financial markets



Source: *BIS Quarterly Review* (2016): 'International banking and financial markets developments' September.

The political economy of Brexit

The fundamental question remains of what would happen to the UK if it is not able to reach agreement by the deadline. Here, there are two possibilities. In the first case, in the absence of more talks on extending the deadline, there would be exit from the EU without any privilege or special treatment; with no protection from EU law for businesses and trade; and without privileges to UK citizens living and working in Europe in terms of visa-free travel. These rights may be lost by about 1.2m UK citizens who live, work and travel in EU member states, who may also lose access to health services, pensions and other public services in these countries. In the second, if the UK manages to secure agreement concerning these rights, it should probably have to reciprocate for European citizens living and working in the UK. But this would be in contrast to one of the main underlying reasons why Brexit happened.

The UK, without its vote in the EU decision-making process, will have to revise its global position and, at the same time, the EU will also be weakened at an international level. The reaction of the EU's 27 countries is expected to result in a new political treaty which will change the institutional and operational base, as the only way to discourage the growth of Eurosceptic parties. Undoubtedly, an EU without the UK is a weak international partner for the USA. The fragmentation of the EU at a time of global challenges as strong as this one would provide a cascade effect as regards economic recession, the financial crisis in the Eurozone, the phenomenon of migration, terrorism, and threats from Russia.

The UK's withdrawal from the European Union has the potential to have an impact on EU enlargement to the western Balkans in a multitude of ways. EU leaders have reaffirmed their commitment to enlargement, but accessions are likely to be pushed back several years and the remaining EU may itself seem a less attractive, although still necessary, prospect for Balkan states.

The result of the UK referendum will have a major impact on candidate countries for EU membership. Countries such as Albania, Serbia, Macedonia and Montenegro will lose a major part of their support base within the EU. The enlargement of the EU, in the strategic view of London, was a move to avoid the deepening of co-operation at European level (Schengen, Eurozone, etc.) because the more members the EU has, the more difficult it is to be managed at political level. Undoubtedly, the topic of EU enlargement will pass to the second plane for policy-makers in the EU, while western Balkan countries will lose the power of transformative force in the integration process. EU attention will be focused entirely on restoring relations with Britain in all their forms rather than on enlargement.

Less financial attention to the region implies a lack of will to make the reforms which are so greatly required by the EU which will, in turn, slow down because they incur a political and electoral cost. Less attention to the political guidance from the EU towards the region would be accompanied by increased uncertainty, while pro-European governments in some states may well lose ground against parties that are for an alternative orientation.

The UK's exit will impose a huge economic cost on EU member states, candidate countries and those aspiring to integrate into the EU. Furthermore, the potential for a domino effect of the departure of the UK from the EU will be associated directly with the growing influence of Eurosceptic parties who have begun to propose other referenda on leaving the EU. This inevitably damages the European project as a project of peace and economic prosperity. Brexit would have a wider political impact on the EU, both by disrupting its internal political dynamics and because of the risk of political contagion if the 'proof of concept' of leaving the EU encourages disintegrative forces in other member states. Europe would also lose esteem and influence around the world.

Conclusions

This article has analysed the consequences of Brexit for the region of south-east Europe and specifically as regards its economic and political situation. It emphasises, however, that predictions regarding the economic effects of Brexit are subject to a significant amount of uncertainty.

The direct influence of Brexit on south-east European countries is expected to be small, but the region does remain exposed to the indirect effects of Brexit arising from any lower than expected growth at EU level. Impacts could appear through trade, growth and financial sector channels; the EU is the biggest trading partner of south-east European countries and most of their FDI originates from the EU. Any heightened volatility could trigger investors' flight to quality as a result of rising risk aversion, having an impact on external financing through interest rates, exchange rates and capital flows. This would make it more difficult to meet the region's relatively large financing needs.

It would also increase banking uncertainty. Stability in Italy, or in other EU countries hit by Brexit, could affect the parent banks of regional intermediaries, leading to further de-leveraging and tighter credit. Across the region, however, the domestic funding situation and the inwards orientation of most financial/banking systems is a mitigating factor.

Political tensions and security concerns in Turkey may well bring about a possible slowdown in Turkey's economic growth. That could have a moderate impact on the western Balkans through existing trade and investment links, but it could also result in an increase in tourism in the western Balkans.

From a longer-term perspective, however, the region of south-east Europe stands to lose if Brexit weakens EU integration processes as a policy anchor for the countries of the region. Brexit might induce a tightening of EU regulation in this regard, with adverse effects on trade and cross-border finance. Ultimately, Brexit might jeopardise the EU itself and wither then the region, whose perspective on EU accession has been a driving force for much of the last twenty years or more?

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