

BREXIT – IMPLICATIONS FOR SOUTH EAST EUROPEAN COUNTRIES

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ABSTRACT

The paper aims to identify and evaluate the risks to which the South East European (SEE) Region is exposed to *Brexit*, the so-called process of leaving the European Union (EU) from United Kingdom (UK). The exit of the UK from the EU is estimated to have potential negative effects on the economy and financial system of the SEE Region. An exhaustive assessment of the consequences is difficult and surrounded by uncertainty related to unknowns that will accompany the process of exit. The impact of *Brexit* on SEE Region would be divided into two groups: (i) *direct effects*, deriving from economic, trade and financial links that SEE countries have with the United Kingdom; and (ii) *indirect effects*, deriving from the consequences that *Brexit* could cause to economies and financial markets of Europe and beyond. The analysis concludes that *Brexit*, will have marginal direct impact on the economy, trade and financial sector of SEE countries, but the region remains potentially exposed indirect from *Brexit*'s effects in Europe. From a longer-term perspective, the SEE region stands to lose if *Brexit* weakens EU integration process as a policy anchor of SEE countries and induces a tightening of EU regulation, with adverse effects on trade and cross-border finance. Brexit could jeopardize the EU itself.

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

JEL Classification: F17, F51, F62, G12.

1. Introduction

On 23rd June, 2016 in the United Kingdom was held a referendum to decide whether the country will remain in the European Union or will leave it. The result of referendum showed that the majority of people, about 52% of it, voted pro-exit from the European Union, ending a 40-year relationship with it. Britain's position came as a requirement of the population concerned of the consequences of the economic and financial crisis and new waves of migrations. The main arguments pro Brexit (combination of Britain and Exit) were : (i) *economy*: It is easier for Britain to sign economic and trade agreements with other countries as a single and independent actor. EU exit would facilitate the negotiation procedures with countries like China and Russia to establish agreements based solely on the British national interest. On the other hand, the country will be liberated from the burden of contributing to the Union's budget, and it will facilitate taxpayers making Britain to save £ 20 million every day. (ii) *political freedom and governance*: Britain is considered as the mother of parliamentary democracies, and for Brexit supporters EU decision-making and the decisions of the Commission unelected by the people, simply violates the autonomy and the freedom to decide for themselves on important issues for the country; and

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(iii) *Full control of border*: the number of those who come to Britain, exceeds the number of British citizens who go to live and work in other EU countries. Another problem remains even illegal immigrants and terrorists who find it easier to come to Britain, even though Britain is not in Schengen. With the emergence of the EU country takes full control of borders, and may impose conditions and acceptance of foreigners and refugees on its territory.

Currently, the United Kingdom has not yet begun the process of legal divorce papers from the European Union; this process will be gradual and will take time. Exit from the EU would then be placed on implementing Article 50 of the Lisbon Treaty, which imply the use for the first time of this article. According to this article, "Any member state may choose to withdraw from the Union in accordance with its constitutional requirements". But the process continues with negotiations with the other EU member states on the withdrawal conditions and within two years the country has to have reached an agreement with the EU. Being that Brexit is the first time that this process will be placed on implementation, no one can predict whether two years is a sufficient period to reach an agreement. Many experts believe that this issue is very complex and difficult to be completed within the period prescribed by law.

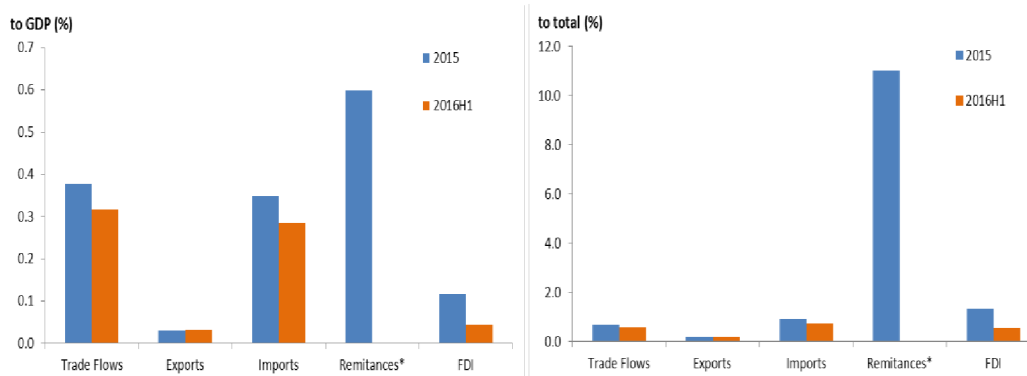
The leaving of the United Kingdom from the European Union or the process of so-called "Brexit" could have potential consequences for the economy and financial system of SEE Region. Their full assessment is difficult and surrounded by high uncertainty mainly caused by large uncertainties that are associated with this process. The transmission channels of *Brexit* for SEE region theoretically can be *directly* from economic, financial and trade relations that the Region have with the UK, and *indirect*, from the consequences that Brexit could bring to economies of Continental Europe and global financial markets. In following we present a preliminary assessment of the potential direct and indirect impacts of "*Brexit*" organized in a such way: in section 2 we analyze Albania and SEE Region's exposure to UK; section 3 examines Political economy of *Brexit* and last section 4 reveals conclusions of the analysis.

2. Albania and SEE region's exposure to UK

2. a Impact of the direct effects on the Albanian economy

From a short-time perspective, the economy of Albania and South East Europe countries will remain uninfected by withdrawal of Britain from European Union. Trade relations with UK are almost non-existent, the number of immigrants in Britain is very low, and English investors have ever had in their radars SEE countries. But in the medium-term, if the exit of Britain from the EU would plunge in crisis the Europe and the whole world, today more interconnected, the consequences would become apparent quickly. Albania is closely connected with the rest of the European Union and cannot be saved without being infected. A simple example is what happened in 2008, although was not touched directly by the first wave of banking crisis due to low financial integration, the country suffered then an investment braking difficulties in exports and overall slowdown economic growth, even today, (the expansion is not expected more than 3%) continues to be far growth rates of 8% that came before the 2008's. The most visible effect could be a slowdown in the accession process to the European Union.

Figure 1. Albanian trade and real sector exposure



Source: Bank of Albania, *data for 2015H2

Trade flows with UK occupy a small share of total Albania's trade activity. The weight of imports and exports with the UK to respective totals are respectively 0.8% and 0.2%. Reduction or stoppage of Albanian exports to the UK will have a marginal effect on the Albanian economy. The stock of FDI originating in the UK was estimated at EUR 19.8 million in the year 2014. The expected investment is estimated in 0.44% of the total stock of foreign direct investment in Albania and around 0.2% of GDP in 2014. The withdrawal of these investments or curbing inflows of them would have an insignificant effect on the Albanian economy.

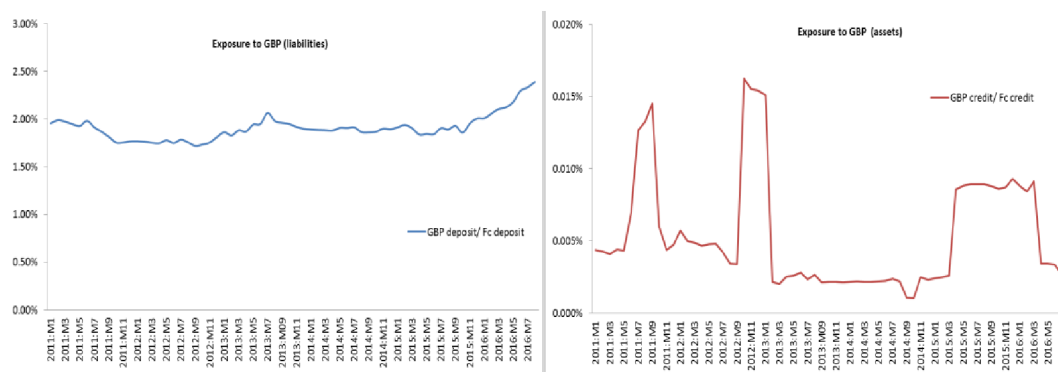
The latest complete information about the weight of remittances from residents in the UK belongs the second half of the year 2015. The estimates show that the share of remittances from UK to Albania is about 11% for the reference period, representing a value of 32.3 million euros transfer or 0.6% of nominal GDP. Complete stoppage of remittances is a low probability event. Meanwhile, their reduction could have marginal effects - although not completely negligible - at consumer level and pace of economic growth.

2. b The impact of the direct effects on the balance of the Albanian banking system

Brexit is associated with strong tendencies depreciating British pound (GBP), which further strengthened in the coming days. Theoretically, these trends ease the burden of credit-makers in GBP and diminish the value of savings (deposits) in GBP. Given their weight in the total volume of deposits and loans of the Albanian banking system, the intensity of the action of this channel seems negligible.

Deposits and loans in GBP comprise respectively 0.002% and 1.17% of the respective totals, according to data of the month April 2016.

Figure 2. Albania's financial exposure

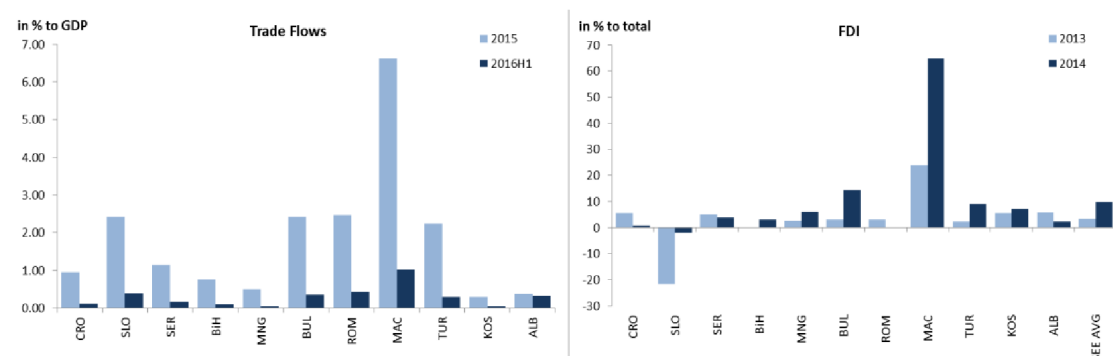


Source: Bank of Albania

2. c From a regional perspective

The UK is not an important trading partner for the SEE countries, with the exception of Macedonia, the trade flows of which occupy about 6,7% of country GDP. For the other countries of the region, the trade flows with UK occupy not more than 2,8% of their GDPs (Fig.3). If we refer the Foreign Direct Investments (FDIs), the UK is also not a large source of FDIs in the region. The FDIs from UK occupy 8% of the total stock of foreign direct investment in SEE region. Macedonia is excluded, its stock of FDIs originating from UK were 62% of the total, as per 2014's data.

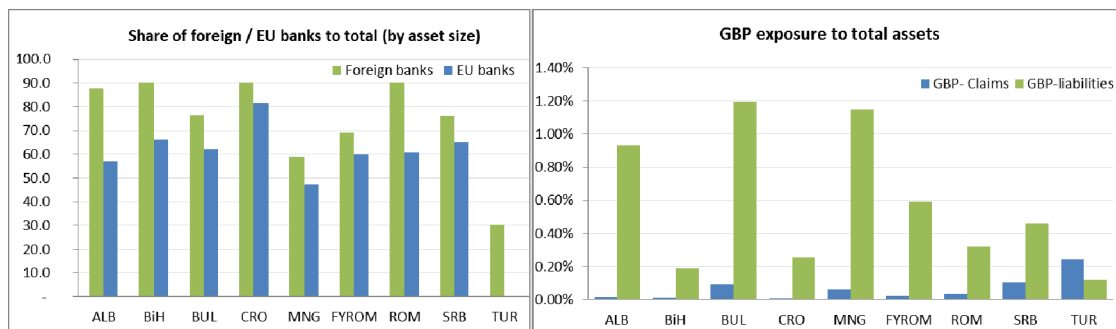
Figure 3. SEE real sector exposure to the UK



Source: Eurostat, respective central banks, Bank of Albania

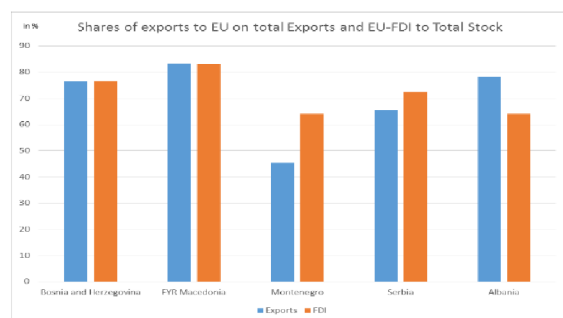
Financially, the region is not exposed to fluctuations in the GBP, because in their balance sheets the claims and liabilities in GBP have a relatively low weight in respective totals, claims do not exceed 0.22% of total assets, while liabilities maximum occupy 1,20% of total liabilities (Fig4). Given their weight in the total volume of assets and liabilities of the SEE Region financial system, the intensity of the action of this channel seems negligible. So, from a regional perspective, the SEE's financial system exposure to the UK and GBP is fairly limited.

Figure 4. SEE 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

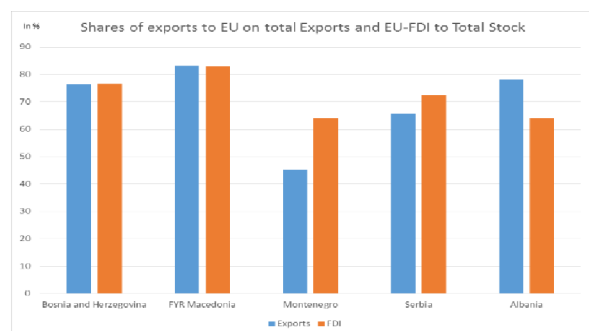
Figure 6. Expected Brexit effect on EU

Cumulative GDP growth effects as % from baseline

	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
EU27	0.0	-0.2	-0.2	-0.5
EU28	-0.1	-0.3	-0.3	-0.9

Source: European Commission. "The Economic Outlook after the UK Referendum", Institutional Paper032, July 2016

Figure 5. Regional exposure to EU



Source: Eurostat, WTO, Bank of Albania

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Source: European Commission. "The Economic Outlook after the UK Referendum", Institutional Paper032, July 2016

2. d Potential indirect impact via EU

Brexit indirect negative effects may be materialized in the form of one or more shocks as follows:

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

This scenario would have negative consequences for the SEE region economy, affecting

negatively the exports, Foreign Direct Investments inflows from trade partners, and increasing insecurity in the countries. Depending on the intensity of the crisis, the shock can take extreme forms similar to the 2008 attack.

- New crisis in the European banking and financial system

This scenario would lead to liquidity and capitalization problems of parent banks. Depending on the intensity of the crisis, the effects can go from a reduction of appetite for expansion in SEE Region, in deleverage or reduction of exposure to the SEE's economy. Soft extreme of the spectrum, the effects on the SEE's economy would be relatively low, as long as credit growth remains weak. In the most negative extreme of the spectrum, the SEE's economy may face similar situations in 2011-2012, which deleverage created problems for financing the public and private sectors. However, it should be noted that the SEE's banking system 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 asset of the banking system.

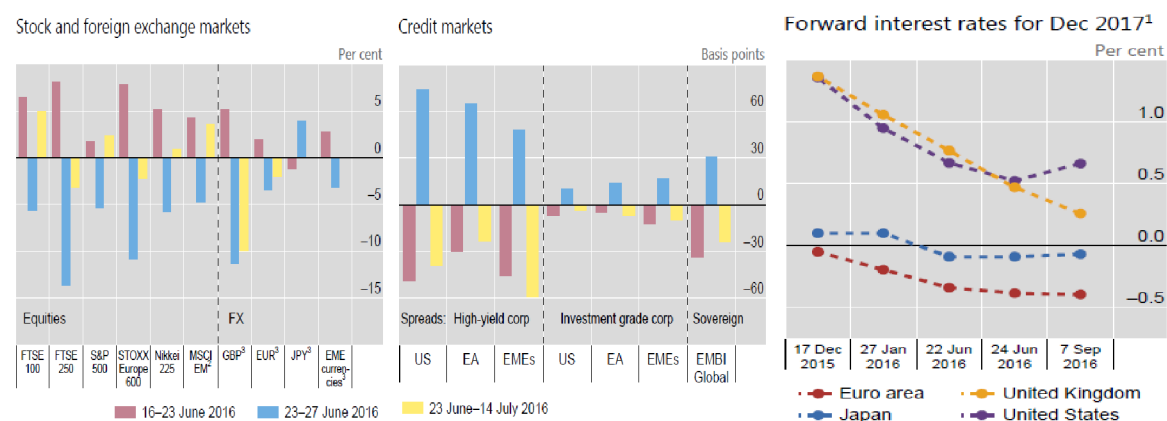
- Strong depreciation of the euro against the US dollar

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

In other words, saving on import items will be greater than the decline in revenues from exports. If these savings will generate additional consumption in the SEE's economy, the resultant effect on economic growth would be positive. In contrast, the effect on growth would be negative.

Beyond that, the depreciation of the euro against the dollar may be accompanied by shifts in domestic portfolios of the euro, 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. The materialization of the negative effects of indirect scenarios would have consequences potentially harmful to the SEE's economy.

Figure 7. Financial markets



Source: BIS Quarterly Review, International banking and financial markets developments; September 2016

3. The political economy of Brexit

"What happens to the UK if they can not reach agreement by the deadline? There are two possibilities: *first*, more talks on extending the deadline or exit from the EU without any privilege or special treatment, with no protection from the EU law for businesses and trade; without privileges to citizens of Britain to live and worked in Europe, or to travel freely and without visas. These rights may be losing about 2 million British citizens who live, work and travel in the EU member states, they also lose access to health services, pensions and other public services in these countries. *The second*, if Britain manages to secure agreement from these rights, probably should do the same for European citizens living and working in the UK. But if it happens, it falls under one of the main reasons why Brexit happened.

UK without her vote in EU decision-making will have to revise its global position and at the same time, the EU will weaken in the international level. The reaction of the EU's 27 countries are expected to be through a new political treaty, which will change the institutional and operational asset, as the only way to discourage the growth of Eurosceptic parties. Undoubtedly, the EU without the UK is a weak partner for the USA in the international table. The fragmentation of the EU at a time of global challenges like this one will provide a cascading effect on the economic recession, financial crisis in the Eurozone, in the migratory phenomenon, terrorism and threats from Russia.

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

The result of British referendum will have a major impact on the candidate countries for EU membership. Candidate countries such as Albania, Serbia, Macedonia and Montenegro will lose one of their greater supports within the EU. The enlargement of the EU, in the strategic view of the London, was a move to avoid the deepening of close cooperation at European level (Schengen, Eurozone, etc.), because the more members the more difficult it is to be managed in the political level. Undoubtedly, the topic of EU enlargement will pass into the second plan for policy maker in EU and the 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 forms, rather than enlargement.

Less financial attention to the region means lack of will to make reforms so much required by the EU, which will slow down because they have political and electoral cost. Less attention to political guidance from the EU to the region would be accompanied by increased uncertainty, which states that currently have pro-European government will lose ground against parties that are for another alternative orientation.

Britain's exit (Brexit) will be a huge economic cost on the EU member states, candidate countries and those aspiring to integrate into the EU. The domino effect of the release of the UK from the EU will be associated directly with the growing influence of Eurosceptic parties, who have begun to require other referendums to go out of the EU, which hurts inevitably European project as a project of peace and economic prosperity. Brexit would have a wider political impact on the EU, both by disrupting 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.

4. Conclusions

The paper analysis the consequences of Brexit on SEE Region and specifically on the economic and political situation of the region. The study emphasizes however that the predictions on the economic effects of a Brexit are subject to significant uncertainty.

While the direct influence of Brexit on the SEE countries is expected to be small, the region though remains exposed via the indirect effects of Brexit on EU, arising from lower than expected growth of the EU. Impacts could come through trade, growth, and financial sector channels; the EU is the biggest SEE countries' trade partner and most of its FDI originates there. Heightened volatility could trigger investors' flight to quality as risk aversion rises, impacting 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. Increasing uncertainty about banking

Stability in Italy or other EU countries hit by Brexit could affect the parent banks of regional intermediaries, leading to further deleveraging and tighter credit. Across the region, however, domestic funding and the inward 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 moderate impacts on the Western Balkans through trade and investment links but could also result in an increase in tourism in the Western Balkans. From a longer-term perspective, the SEE region stands to lose if Brexit weakens EU integration process of the countries of SEE region as a policy anchor. Brexit might induce a tightening of EU regulation, with adverse effects on trade and cross-border finance. Finally, Brexit might jeopardize the EU itself.

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