Special Report

Euro area: Risks (and opportunities) for the euro area from Brexit

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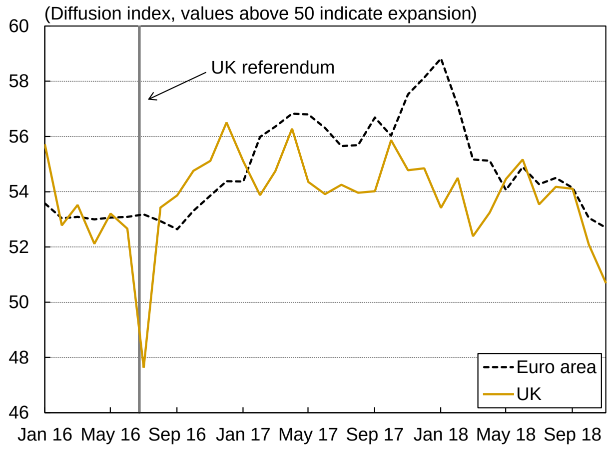
1. Introduction

The UK's membership of the EU is set to end on 29 March 2019. In this report we consider how the euro area could be affected when the EU's second largest economy, representing around 15% of total EU GDP, leaves the bloc.

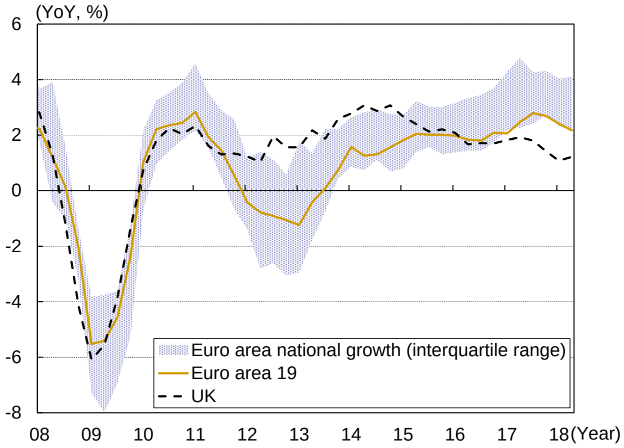
As Chart 1 shows, euro area business sentiment was little affected by the referendum result itself. In fact, the euro area went on to enjoy very buoyant growth in 2017 (with notably firmer figures than the UK, as Chart 2 shows). Now, though, there are signs that euro area growth is moderating back towards potential – and Brexit uncertainty poses an additional challenge. ECB president Mario Draghi has told the European Parliament that the impact of Brexit "*should be, in the aggregate, quite muted*". We agree, but stress that "in the aggregate" is the key phrase here. It remains far from certain that the withdrawal bill will be voted through in the UK parliament, and the risk of the hardest 'no deal' Brexit remains uncomfortably high. For the euro area, this would be painful for the countries and sectors which are most exposed to the UK. There is a clear double threat of both increased trade friction and weaker demand from a slowing UK economy. However, we also note that Brexit could also present some opportunities for euro area countries. Providers of financial services are moving operations across the channel and the UK is likely to lose its lustre as a "gateway to Europe" for foreign investment.

Chart 1: UK and Euro Area Composite PMI



Source: IHS Markit, MUFG Bank Economic Research Office

Chart 2: Euro area and UK GDP Growth Comparison



Source: Eurostat, MUFG Bank Economic Research Office

2. Trade

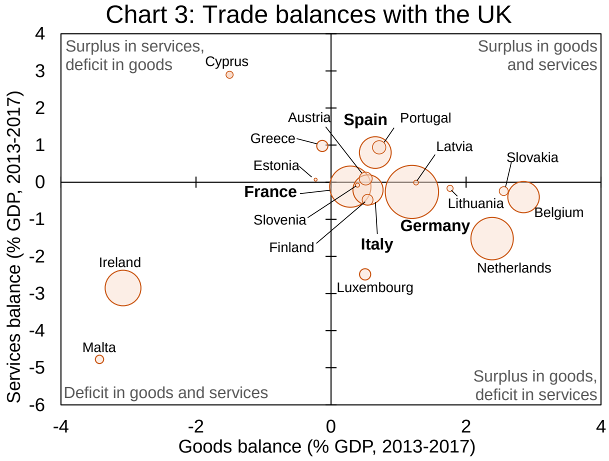
Brexit presents a clear risk to euro area exports. This can be split into two parts. First, costs may increase from tariffs and non-tariff barriers, time-consuming customs checks, and increased administration for businesses. Second, there is the risk of weak UK demand for imports. In our recent report on the Brexit risks for the UK we explain why a ‘no deal’ could prompt a recession followed by an enduring drag on the economy[1]. Sterling depreciation (and any hedging costs) would be an additional headwind for euro area exporters.

[1] See here: www.bk.mufg.jp/report/ecoeu2018e/specialreport_20180913.pdf

(1) Overview

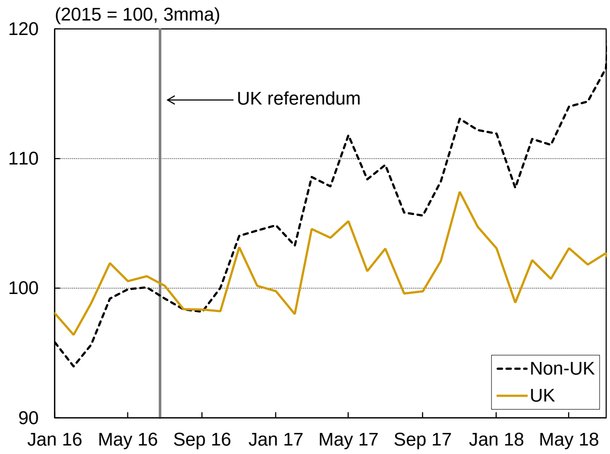
For the euro area as a whole, cross-channel trade is relatively less important than it is for the UK. According to Eurostat data, the UK accounts for around just 6.5% of the euro area’s total exports of goods and services (versus around 40% of the UK’s exports moving the other way). Chart 3 is a visual summary of trade flows between euro area countries and the UK over the most recent five years of data. The UK is a large provider of financial services but has a relatively small manufacturing sector. This means that euro area countries tend to have a surplus in goods trade and a deficit in services with the UK. Since the referendum on 23 June 2016, growth in euro area total trade (imports plus exports) with the rest of the world has outpaced that with the UK (Chart 4).

Chart 3: Trade balances with the UK



Note: Bubble size represents the value of total trade with the UK in 2017.
Source: Eurostat, MUFG Bank Economic Research Office

Chart 4: Euro Area Total Trade



Source: Eurostat, MUFG Bank Economic Research Office

(2) Goods trade

Gravity is important for trade, especially in goods. The UK trades heavily with geographically close countries: Ireland, France, Germany, Belgium and the Netherlands. Some caution should be taken when looking at these gross trade flows, though. The large size of the bubbles for Belgium and the Netherlands likely reflects the fact that many goods are shipped from these countries in transit to the UK from other countries.[2] The EU single market has fostered a highly integrated web of supply-chain interlinkages across Europe and components of final products may cross borders numerous times.

[2] This is often described as the ‘Rotterdam effect’ which the ONS has defined as “the theory that trade in goods with the Netherlands is artificially inflated by those goods dispatched from or arriving in Rotterdam despite the ultimate destination or country of origin being located elsewhere.”

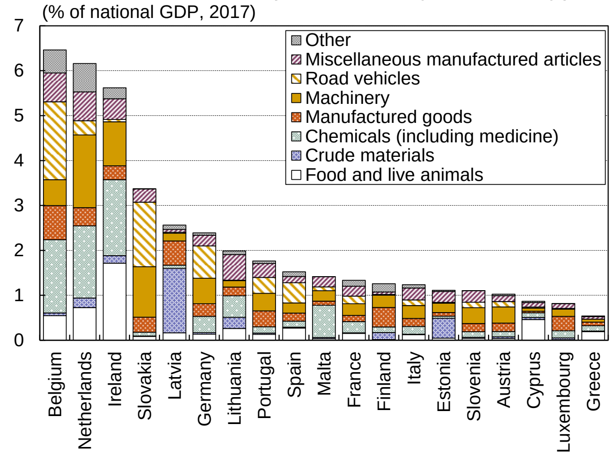
In fact, the divergence in Chart 4 could be an indication that euro area firms are already reducing their reliance on UK exporters for supply-chain items ahead of the UK's departure, which could cushion the shock from a 'no deal' outcome.

National export exposure to the UK by product type is shown in Chart 5. Broadly, the euro area exports a lot of manufacturing goods, machinery (notably cars) and chemicals (notably medicine) to the UK. Again, though, we stress that caution needs to be taken when looking at gross national export numbers as raw export data may not reflect actual gross value-added in trade flows for each EU member state. It is possible to gauge these, though. Chart 6 shows an estimate by Chen et al (2018) of "GDP exposed to Brexit".[3] The authors use world input-output data (WIOD) to split gross exports (including services) into domestic value-added and foreign value-added. The domestic value added in exports of EU countries to the UK is then presented as a percentage of each country's GDP. It also includes indirect effects (if services are supplied to industries in another country which then export to the UK, for example). Note it is not an estimate of how much each economy would be affected by Brexit, but an indication of how much trade with the UK actually benefits each country (with the caveat that the most recent WIOD data are from 2013).

[3] Chen, W., Los, B., McCann, P. et al. (2018) *The continental divide? Economic exposure to Brexit in regions and countries on both sides of The Channel.* Papers in Regional Science, 97 (1). pp. 25-54. ISSN 1056-8190 See here: http://eprints.whiterose.ac.uk/128894/

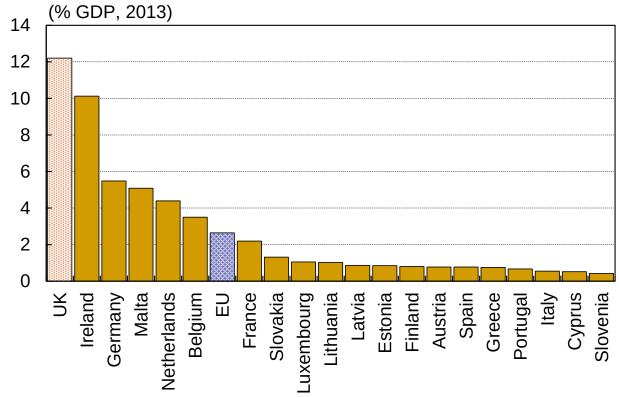
Highly integrated supply chains across the Irish Sea and border mean that Ireland is most exposed to goods trade disruption. The estimates also suggest that Belgium and the Netherlands are less exposed to increased trade friction than the gross export data would suggest – and Germany is more exposed (5.5% of GDP). French exposure is similar to the average for the EU as a whole, at 2.2% of GDP, and the other two large euro area economies – Italy and Spain – appear relatively well-placed to deal with any increase in goods trade friction with the UK.

Chart 5: Euro Area Exports to UK by Product Type



Source: Eurostat, MUFG Bank Economic Research Office

Chart 6: Trade exposure to Brexit



Source: '*The continental divide? Economic exposure to Brexit in regions and countries on both sides of The Channel*' (Chen et al. 2018), MUFG Bank Economic Research Office

There are also some particular national export exposures from smaller countries that stand out in Chart 5 such as timber from Latvia and cheese from Cyprus. There is likely to be a close relationship between local value-added and trade in these goods as their production processes are not geographically fragmented. Brexit could therefore be felt keenly by domestic producers and exporters. Note we summarise the particular risk to each euro area country in Annex 1 at the end of the document.

Much of the largest euro area country's trade exposure to the UK stems from its car industry. 17.6% of German passenger car exports – 768,896 vehicles – went to the UK in 2017 (versus 37.3% to the rest of the EU). If the UK were to crash out without a deal, we assume that the UK will retain the EU's tariff schedules (at least in the short-term). This would mean a rate of 10% on car imports. Tariffs do not stop trade – the US currently imposes 2.5% on passenger car imports, yet US consumers still buy half a million German cars a year – but it would be a major drag. Additional customs checks and paperwork would also add to the costs of trade. This is at a time when the car industry is under some pressure from global trade uncertainty[4], new emission test procedures and signs of lower demand from younger adults. In terms of UK demand, monthly new car registrations have averaged -4.75% YoY since the referendum. This would not be a firm starting point should there be a 'no deal' Brexit and a weaker economy. However, as long as the global expansion continues then extra-EU demand may mitigate some of the negative effect on the German economy: exports of German cars to Asia and Latin American countries grew strongly in 2017.

[4] See here for our report on tariff troubles: www.bk.mufg.jp/report/ecoeu2018e/specialreport_20180802.pdf

More broadly, we also note that any additional customs checks may cause disruptions at major ports. This would be despite the best efforts of the French, Dutch and Irish governments, which have all announced increased numbers of customs officials ahead of Brexit day. The Dutch port of Rotterdam handles 22% of UK maritime goods trade with the euro area, but as a major global hub it may already have the necessary infrastructure to handle any increase in friction. Instead, it could be euro area ports that are largely orientated towards (currently frictionless) UK trade which are most affected such as Calais (10% of maritime trade) or Dublin (9% of maritime trade). Delays would be particularly problematic for exporters of perishable food and drink products to the UK, as well as euro area manufacturers of final goods that rely on British component parts.

(3) Services trade

So far, we have mainly considered goods trade. Services matter too – and the change for financial services poses an immediate concern. London's status as a global financial centre means that the UK has a surplus in financial service trade with the large euro area countries (Chart 7).

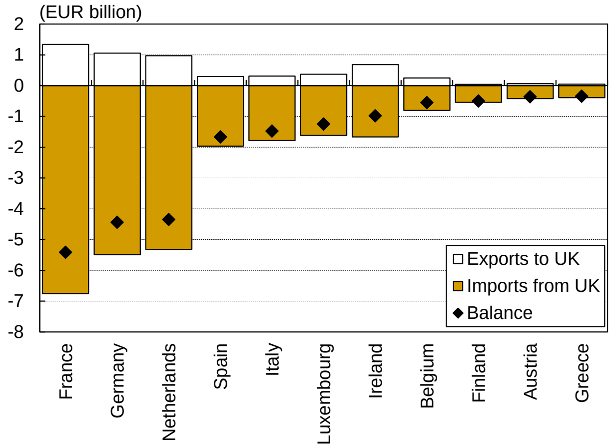
Draghi told the European Parliament that the overall impact of Brexit on **financial services** is unlikely to be significant. Firms will have had almost three years to prepare contingency plans (we discuss investment flows and staff movements later). On the regulation side, the ECB and Bank of England have convened a technical working group for risk management and, generally, we expect pragmatism from both the EU and the UK government to ensure financial stability and minimise disruption in the event of 'no deal'. Currently, any firm registered in an European Economic Area (EEA) country can provide financial services to other EEA countries through "passporting" which bypasses the need for supervision from the local regulator. For exporters of financial services to the UK, the UK government has committed to introduce a "Temporary Permissions Regime" (TPR) which will "allow EEA firms currently passporting into the UK to continue operating in the UK for up to three years after exit, while they apply for full authorisation from UK regulators".

We expect a similar arrangement from the EU for the UK with some sort of 'equivalence' arrangement in which the EU allows financial services to be carried out from beyond its jurisdiction if the local regulatory set-up can be deemed equivalent to those in the EU. However Draghi did highlight one concern: "*In some areas of centrally cleared derivatives where, if there is a sudden event, an unprepared hard Brexit of the sharpest kind, we have to see how the many contractual positions are going to be regulated after that.*" Overall, the eventual effect of Brexit on European financial services as a whole seems likely to be a more fragmented and less efficient system. Euro area imports of financial services from the UK are likely to decrease.

The euro area deficit in financial services is actually largely offset by a surplus in **travel services** (a UK citizen 'consuming' a holiday in Greece, for example, is a Greek export to the UK). According to ONS data, the main beneficiaries tend to be peripheral euro area members: Spain, France, Italy, Greece and Portugal (in that order). Of these, Spain is by far the most exposed in gross terms: it receives around 30% of total UK travel service expenditure with the euro area. But in GDP terms, smaller countries with historical links to the UK appear especially vulnerable: Cyprus exports travel services worth 4.5% of GDP to the UK, and for Malta this is even higher at 6.2% of GDP.

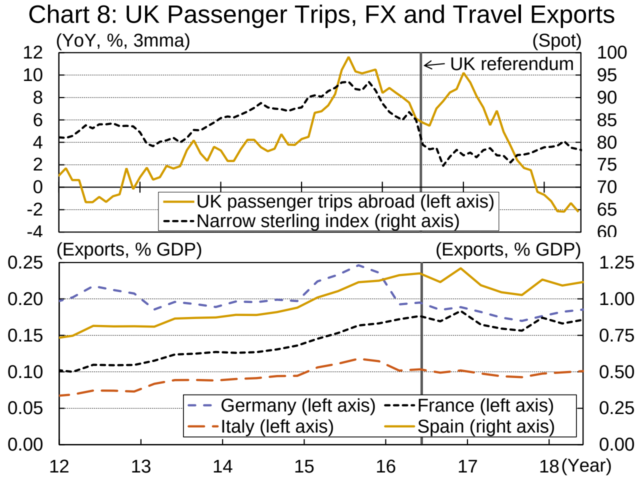
Brexit is unlikely to be positive for travel providers. For the UK economy we expect weaker growth, rising unemployment and a weaker sterling-induced uptick in inflation, all of which would be headwinds for consumers. The exchange rate is possibly one of the most important factors. Chart 8 (upper) suggests that UK passenger trips abroad have fallen since the EU referendum, perhaps due to weaker sterling. Chart 8 (lower) shows exports from the four largest euro area countries to the UK. Mostly steady growth has been followed by weaker figures since the referendum.

Chart 7: Financial Services Trade Balances with the UK



Source: ONS, BoE, MUFG Bank Economic Research Office

Chart 8: UK Passenger Trips, FX and Travel Exports



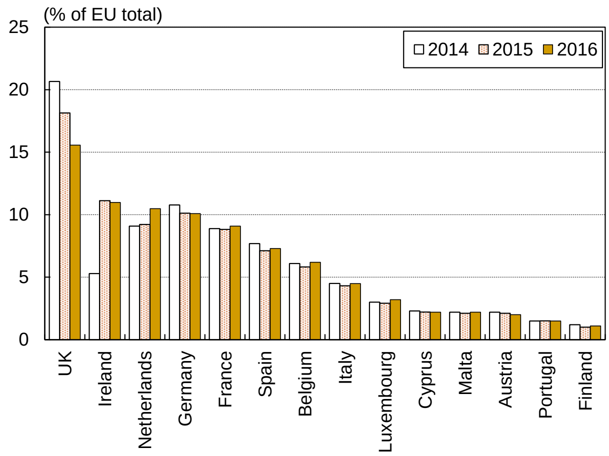
Source: ONS, Macrobond, Eurostat, MUFG Bank Economic Research Office

There could be worse to come. The EU is considering whether UK visitors will be required to have visas to travel to the EU. Even if the UK is added to the 'visa free' list, the European Travel Information and Authorisation System (ETIAS) is likely to come into force from 2021. This will mean a "travel authorisation fee" of EUR 7 on visa-exempt third country nationals.

3. Investment

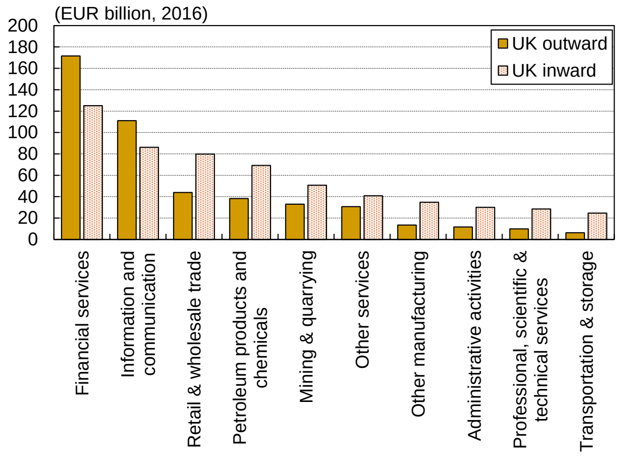
Brexit may change foreign direct investment (FDI) flows into Europe. In 2016, the UK had over 15% of the EU's total FDI stock (Chart 9). There are also significant investment flows between the EU and UK, especially in services firms (Chart 10). FDI is important for potential growth: the arrival of multinational enterprises in a country can lead to increased efficiency through competition and positive productivity spill-overs.

Chart 9: Inward FDI Stock



Source: European Commission, MUFG Bank Economic Research Office

Chart 10: UK Inward and Outward FDI stock with EU



Source: ONS, Macrobond, MUFG Bank Economic Research Office

For overseas firms, the UK has been seen by many firms as a 'gateway to Europe' due to its access to the single market as well as a large national market, English language and business-friendly policies. The UK is likely to lose some of its draw when access to the rest of the EU becomes harder after Brexit (we have noted before that the number of new overseas companies registering in the UK has been low since the referendum).

In the euro area, the main beneficiaries are likely to be those next in line in Chart 9 (generally large, Western European markets). Ireland is a smaller economy, but it is already attractive to extra-EU firms due to its low tax regime (corporation tax is just 12.5% but loopholes mean that the effective rate is even lower). After Brexit, Ireland may have the additional boost of being seen as an English-language gateway into Europe. This would go some way to easing the pain from disruption to goods trade across the Irish Sea.

Broadly, there could be some short-term disruption as decades of ever-closer business ties are loosened, but the longer-term picture for investment in the euro area after Brexit is positive. More specifically, it is worth focusing on two important industries in particular: financial services and car manufacturing. On the former, Ireland, Germany, the Netherlands and France in particular are likely to benefit from **financial services** moving from London to retain EU passporting hubs. This will boost tax revenues as well as investment. Many banks seem to have chosen Frankfurt as a post-Brexit European base, while Ireland seems to have attracted asset management firms. Further moves are likely in the case of a 'no deal' Brexit as contingency plans will be put into practice.

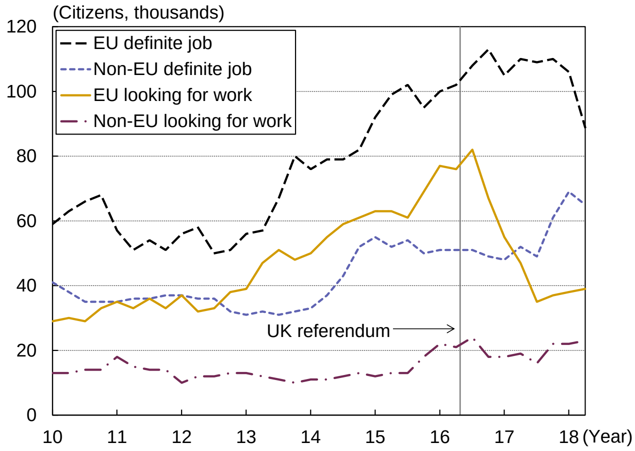
Meanwhile, **car manufacturers** could also move operations from the UK to other EU countries if post-Brexit friction interferes with complex supply-chain linkages and 'just-in-time' delivery of component parts. The European Automobile Manufacturers Association reports that the UK has over 30 car production facilities and it exports around 45% of finished cars to the EU. After the UK leaves, it seems likely that some production will be moved to the EU. Eastern European countries with established manufacturing sectors and scope for increased capacity could stand to benefit the most. For the euro area, that means Slovakia and Slovenia (in fact, Jaguar Land Rover has recently opened a new plant in Slovakia).

However, the UK also imports over two million cars from the EU annually. In the case of a hard 'no deal' Brexit then it could make some sense for manufacturers to retain at least some production in the UK to minimise the effect from tariffs. These would stand at 10% on finished cars if the UK retains the EU's most-favoured nation (MFN) schedules initially. Increased friction on cross-border trade of component parts would be a major impediment, though, and the loss of efficiency may well offset the gains from avoiding tariffs.

4. Migration

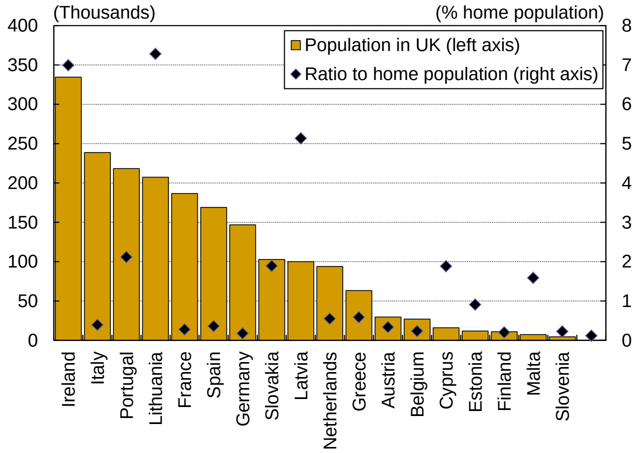
Brexit is also likely to affect migration flows between the UK and the euro area. Weaker sterling, slower growth (possibly recession) and perhaps a more hostile environment towards immigrants could all be a push factor for euro area citizens already in the UK or thinking of moving. There are already signs of this. The number of EU citizens working in the UK has fallen by 130,000 since peaking in Q3 2017, and Chart 11 shows how the number of EU citizens looking for work in the UK has tumbled since the referendum. What does this mean for the euro area? It could be positive, at the margin, for some countries if emigrants return home as they tend to be working-age, experienced (the employment rate for EU nationals in the UK is 82.8% versus 75.8% for UK citizens and 64.1% for non-EU citizens) and have English language skills. Spain and Italy, which suffered from high youth unemployment rates – and subsequent emigration – after the global financial crisis (GFC) could benefit the most. There are large populations of citizens from both these countries in the UK currently (Chart 12). However, Brexit may also mean that migration from smaller euro area countries, such as the Baltic States, is diverted to other large western economies with high GDP per capita such as Germany and the Netherlands.

Chart 11: UK Immigration



Source: ONS, MUFG Bank Economic Research Office

Chart 12: Euro Area Residents in the UK (2017)



Source: Eurostat, MUFG Bank Economic Research Office

5. Cohesion

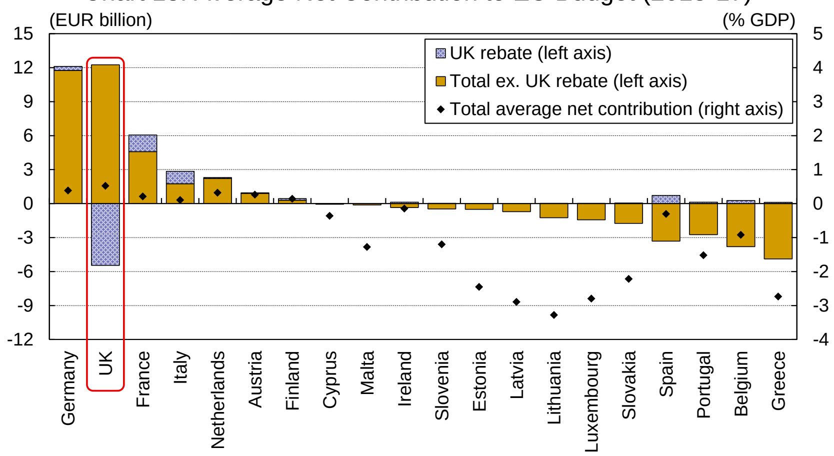
There are some signs that Brexit may have actually helped foment an *increase* in pro-Europe sentiment in euro area countries. One question in the regular Eurobarometer survey is whether the EU conjures up a positive or negative image for the respondent. The ratio of positive replies has increased in every single euro area country since the Brexit vote (by an average of over 6 percentage points). It could be that Brexit has promoted discussion and awareness of the benefits of EU membership – and the risks of leaving – for EU27 countries.

However one stumbling block, as the EU makes choices for the next Multiannual Financial Framework financing round (2021-2027), could be the budgetary hole left by the UK. The Commission has said that the "departure of an important contributor to the EU budget will have a financial impact and … will require additional contributions from all Member States". This will be further complicated by the UK rebate which reduces the UK's contribution to the budget to address a historical imbalance. Currently, EU27 countries make larger payments to make up for the difference to the overall EU budget – but some countries (Germany, Austria, Netherlands, Denmark) have negotiated a 'rebate on the rebate'. These countries currently contribute only 25% of their "normal financing share of the UK correction".

In our recent paper on the Italian budget[5] we stressed that the risk of Italy leaving the euro area is low, but post-Brexit budget discussions could pose an additional challenge. Italy is currently a net contributor to the EU's coffers (Chart 13) and is likely to have to pay more to make up for the shortfall once the UK leaves. With muted economic growth and a Eurosceptic government, it may be reluctant to do so. Similarly, Austria is another euro area country that could raise a fuss. It also has a populist, Eurosceptic government, and surveys suggest that pro-EU sentiment is weak.

[5] See here: www.bk.mufg.jp/report/ecoeu2018e/specialreport_20181109.pdf

Chart 13: Average Net Contribution to EU Budget (2013-17)



Source: Eurostat, European Commission, MUFG Bank Economic Research Office

Longer-term, and unlikely as it may seem now, any sign of a rebounding UK economy could be a challenge. If the UK does eventually adapt to its new trading relationships then any outperformance would give ammunition to Eurosceptic parties in the EU27 when questioning the benefits of single market membership.

6. Conclusion

Brexit is unlikely to be a disaster for the euro area as a whole, but it is a headache at a time when growth is slowing amid clear risks from global trade protectionism, shifting monetary policy and political uncertainty. A worst-case ‘no deal’ situation would not be a traditional ‘shock’ as firms will have had almost three years to prepare contingency plans (there are already signs of a relative slowdown in trade between the UK and the euro area as continental firms reduce their dependency on UK intermediate goods in supply-chains). That said, some short-term disruption will be hard to avoid as barriers to trade are introduced.

We show two scenarios in Table 1 below. The ‘orderly Brexit’ scenario supposes that the UK leaves the EU on 29 March 2019 with a transition period until a close, but not frictionless, trading relationship begins on 1 January 2021. The messy ‘no deal’ variant – equivalent to the scenario set out in our report on the risk for the UK – sees the UK crash out in March and automatically fall onto World Trade Organisation (WTO) terms with the EU.

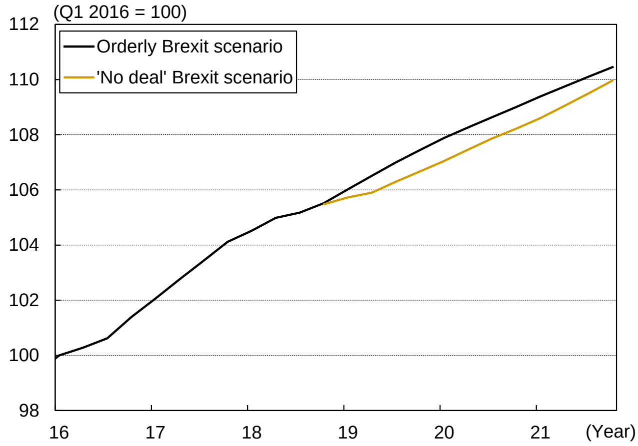
Table 1: Euro Area Real GDP Scenarios

(Constant prices, % YoY)

Scenario 1: Orderly Brexit scenario							
	GDP	Private consumption	GFCF	Government consumption	Exports	Imports	*UK GDP*
2018	1.9	1.5	3.0	1.0	3.0	2.8	*1.3*
2019	1.6	1.8	2.3	0.9	2.9	3.4	*1.4*
2020	1.6	1.9	2.1	0.9	2.8	2.9	*1.2*
2021	1.4	1.6	1.6	1.0	2.7	2.7	*0.9*
Scenario 2: Messy 'No deal' scenario							
	GDP	Private consumption	GFCF	Government consumption	Exports	Imports	*UK GDP*
2018	1.9	1.5	3.0	1.0	3.0	2.8	*1.3*
2019	1.1	1.6	1.9	0.9	1.7	2.9	*-1.8*
2020	1.4	1.8	2.0	1.0	2.3	2.7	*0.2*
2021	1.5	1.6	1.7	1.1	2.7	2.5	*1.0*

Source: Eurostat, Oxford Model, MUFG Bank Economic Research Office

Chart 14: Euro Area Real GDP Projections



Source: Eurostat, Oxford Model, MUFG Bank Economic Research Office

With the main shock at the start of the year, we think that ‘no deal’ could knock 0.5pp off annual euro area GDP growth in 2019. By expenditure component, the main shock is to exports which could slow considerably as barriers to trade are imposed. However, financial service imports are also likely to slow which would reduce the quarterly drag from net exports. Consumer spending would remain resilient but weaker consumer confidence and possible job losses from UK-export orientated firms could be a short-term headwind. Investment is also likely to be weaker initially, but could benefit further ahead as firms shift production from the UK to the continent. We have also pencilled in some increased government spending in 2020 – there is certainly scope for this in some countries that could be more affected by Brexit (Germany, Netherlands, Belgium). Taken together, Chart 14 shows the initial shock to GDP from consumer spending, investment and exports – and then some pullback further ahead as investment rebounds and the effect of lower financial service imports endures. Over our forecast horizon this equates to a loss of output of around 0.5% for the euro area (vs over 4% for the UK).

The overall impact may be relatively small but there are plenty of country-specific risks (see next page for a summary). Ireland would be most exposed to increased trade friction, along with other geographically close countries (Belgium and the Netherlands). For Germany, there are clear risks to the manufacturing sector. And smaller countries with historical ties to the UK – Cyprus and Malta – are also vulnerable.

Lastly, we note that while the focus of this report has been the euro area, a lot will depend on health of the UK economy for export demand.

Annex 1: Country-specific risk assessment from 'no deal' Brexit

Germany	There is a clear risk for exporters of manufactured goods from both increased trade costs with the UK and slowing UK demand. 18% of German car exports go to the UK. Extra-EU FDI inflows may increase. Likely to benefit from banks moving personnel from London to Frankfurt.
France	Goods exports to the UK are relatively low. There is a risk of disruption at Channel ports from increased trade friction. Likely to benefit from French banks moving personnel from London to Paris.
Italy	Goods trade with the UK is relatively low as a percentage of GDP. Travel service exports to the UK may decrease. Any financial market instability from 'no deal' would be unwelcome for a recovering Italian banking sector.
Spain	Spain has strong trade surplus in services with the UK – most of which is due to travel (0.9% of GDP in 2017). Monthly tourist arrivals from the UK are down by an average of 2.5% YoY in 2018. A 'no deal' Brexit would probably mean even weaker sterling and further reduced tourist flows. For goods, car exports (0.5% of GDP) and food (0.3% of GDP) appear most vulnerable to increased friction.
Netherlands	Data are flattered by the 'Rotterdam effect' but the UK is an important export partner. Key goods exports: food and drink (0.7% of GDP), medicine (0.9% of GDP) and machinery and transport equipment (1.9% of GDP).
Belgium	Key goods exports: Food and drink (0.5% of GDP), medicine (0.8% of GDP), manufactured goods (0.8% of GDP) and machinery and transport equipment (0.7% of GDP).
Austria	Austria has relatively low exposure to the UK economy. Most noteworthy are exports of machinery and transport equipment, worth 0.5% GDP.
Ireland	The most vulnerable euro area country due to deep and extensive links with the UK. Goods exports: food and drink (1.7% of GDP), medicine (1.1% of GDP), machinery and transport equipment (1.0% of GDP). Ireland is reliant on oil and gas imports from the UK. It may benefit from financial services moving to Dublin, and (even) higher FDI as an English-speaking gateway to the EU.
Finland	Relatively low trade exposure to the UK. Exports of paper are worth 0.3% of GDP.
Portugal	Exports of travel services to the UK are significant (1.3% of GDP).
Greece	Travel accounts for around 40% of total exports to the UK, or 1.2% of GDP. Otherwise low exposure.
Slovakia	Exports of final cars to the UK are worth 1.4% of GDP, with additional exposure through component parts made in Slovakia which are exported to other countries where final cars are assembled using these parts and ultimately exported to the UK. Could benefit if UK-based manufacturing is shifted to the EU.
Luxembourg	Luxembourg has a large trade deficit in financial services with the UK. There is the risk of near-term disruption from a 'no deal' scenario, but the country may benefit from firms moving operations to retain "passporting" rights.
Slovenia	Low exposure to Brexit but exports of intermediate automobile products could suffer.
Lithuania	Relatively low exposure to Brexit. Chemicals and related product exports are worth 0.5% of GDP.
Latvia	Latvia's exposure to the UK is concentrated in one industry: wood exports. 23% of total exports go to the UK, worth 1.2% of GDP in 2017.
Estonia	Relatively low exposure to Brexit. Some exports of crude materials and machinery.
Cyprus	Economic and cultural ties with the UK. The UK accounts for around 24% of Cyprus's total trade with the EU. Cheese – mostly halloumi – is a key export. Popular tourist destination for UK citizens (4.5% of GDP).
Malta	Strong historic ties. Malta has a large trade deficit with the UK (15% of GDP) due to financial services. Travel exports are very important (6.2% of GDP). Goods trade is low.

Key:		*At most risk from Brexit*		*Medium risk*		*Lowest risk*

Source: Eurostat, Reuters, Macrobond, MUFG Bank Economic Research Office