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The Brexit Heat Map: How Exposed Is Emerging Europe?

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With the exception of Russia, there are no net creditor nations in Eastern Europe. This means that, on a stock basis, economies in the region have less to lose than wealthier western European countries if the U.K. exits the EU. However, on a flow basis, with large emigrant populations in the U.K. and considerable export and transfer flows at risk, Brexit could become painful for the region, in S&P Global Ratings' view.

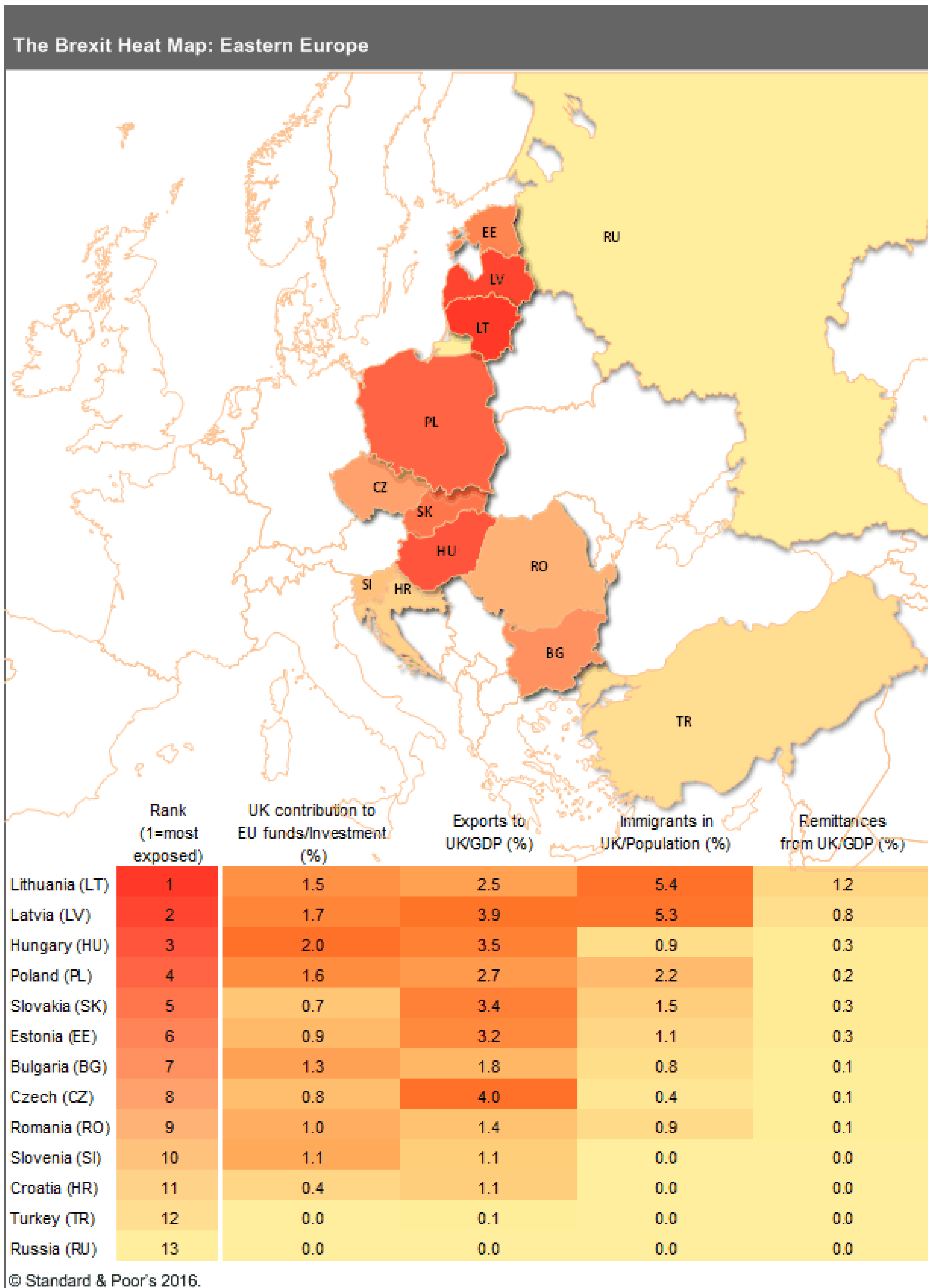
It was only a little over a decade ago that the U.K. government was a major proponent of free movement of labor for new EU member states. The resulting inflows of EU immigrants, who now make up about 7% of the U.K.'s workforce, have contributed materially to the U.K.'s superior economic performance since then. But with the result of the June 23rd referendum signaling the end of the U.K.'s EU membership, and the rising influence of UKIP and other anti-immigrant factions, this is likely to change.

Our eastern European Brexit heat map depicts the vulnerability of 13 sovereigns to the U.K.'s departure from the EU, through decreased flows and transfers, with the No. 1 ranking denoting the most exposed economy. Assessing the impact on economies in that region required separate indicators from those we used for our Brexit Sensitivity Index, which focused on creditor relationships with the U.K. (see "Who Has The Most To Lose From Brexit? Introducing The Brexit Sensitivity Index," published June 9, 2016, on RatingsDirect). Our heat map of eastern European exposures focuses on: migration to the U.K., remittance payments, exports of goods and services, and the EU's structural fund transfers to eastern European member states.

Overview

- Our Brexit heat map suggests that Lithuania, Latvia, Hungary, and Poland are the most exposed if the U.K. leaves the EU, given their large migrant populations, remittances, trade links, and the importance of EU funds to finance investment.
- Turkey and Russia, on the other hand, appear the least vulnerable, due to their relatively lower migratory links with the U.K., and importantly they won't be affected by changes in the U.K.'s trade conditions with the EU, nor do they draw on EU funds.
- We believe the direct short-term impact of Brexit on eastern Europe will likely be limited, although trade flows could feel a ripple effect through reduced consumer confidence in major EU trading partners.
- A key long-term consideration is whether the EU will reduce funding to eastern Europe after the current budget expires in 2020; cuts to structural and cohesion transfers could be substantial, particularly if the main benefactors were to take a tougher stance on the trend of unilateralism in that region.

The Brexit Heat Map: Eastern Europe



	Rank (1=most exposed)	UK contribution to EU funds/Investment (%)	Exports to UK/GDP (%)	Immigrants in UK/Population (%)	Remittances from UK/GDP (%)
Lithuania (LT)	1	1.5	2.5	5.4	1.2
Latvia (LV)	2	1.7	3.9	5.3	0.8
Hungary (HU)	3	2.0	3.5	0.9	0.3
Poland (PL)	4	1.6	2.7	2.2	0.2
Slovakia (SK)	5	0.7	3.4	1.5	0.3
Estonia (EE)	6	0.9	3.2	1.1	0.3
Bulgaria (BG)	7	1.3	1.8	0.8	0.1
Czech (CZ)	8	0.8	4.0	0.4	0.1
Romania (RO)	9	1.0	1.4	0.9	0.1
Slovenia (SI)	10	1.1	1.1	0.0	0.0
Croatia (HR)	11	0.4	1.1	0.0	0.0
Turkey (TR)	12	0.0	0.1	0.0	0.0
Russia (RU)	13	0.0	0.0	0.0	0.0

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The wide open and highly flexible Baltic economies top our heat map table. One reason for Lithuania's and Latvia's high sensitivity to Brexit is their large amount of migrants to the U.K. relative to their populations and the associated remittance flows. We estimate that more than one out of every 20 nationals from these countries is living and working in the U.K.

Hungary also seems vulnerable, but primarily via the relative importance of EU funds that finance capital expenditure, combined with important trade links. We expect that the U.K.'s exit from the EU, if confirmed, would lead to a significant reduction in transfers to newer member states. Poland, whose nationals make up the largest number of immigrants in the U.K. in absolute terms, and which receives the biggest chunk of EU structural funds in nominal terms, comes fourth.

At the other end are the two largest emerging European economies, neither of which is an EU member--Turkey and Russia--which show the least direct exposure to Brexit, thanks to smaller diaspora in the U.K., and limited flows from remittances and EU fund flows. That said, some of the migrant data we use may significantly underestimate the number of Turks in the U.K. labor market.

We emphasize that, of the four factors we examined, three capture flows and one (immigrants) stocks. In our view, it is easier to redirect flows than it is to recoup financial claims (stocks), which is why we think that, ultimately, western Europe is more exposed to Brexit than emerging Europe.

Migration and remittances: Why is Poland not the most vulnerable?

At the end of 2014, there were 853,000 Poles in the U.K., 5.5x the number of Lithuanians and nearly 15x the number of Bulgarians. The U.K. lifted restrictions on immigration from Bulgaria and Romania relatively recently, nearly a decade after it opened its doors to migrants from other east European countries, including Poland. Therefore, intuitively one would think that Poland would be the most exposed through the migratory channel. Yet despite these large nominal numbers, Polish immigrants in the U.K. make up only about 2% of Poland's population, compared with more than 5% for Lithuania and Latvia.

The risks from having a large number of migrants in the U.K. may be overstated if one looks only at the numbers. Workers' flexibility in adjusting to instability in their host countries by moving to new markets could make a difference. For instance, in the wake of the crisis in Ireland in 2008 and the fall-off in construction activity, Polish immigrants moved quickly to other markets, such as Norway.

Migration and remittances tend to go hand in hand. If Brexit were to disrupt remittance inflows, Lithuania and Latvia may be the hardest hit. This is not only because of the size of their diaspora relative to their national populations, but because they receive more in remittances (1% of GDP on average) from the U.K. than other countries in eastern Europe (0.2% of GDP on average). Indeed, a recent study indicates that Romania, Poland, Bulgaria, and Lithuania receive surprisingly little by way of remittances, even though a large number of their nationals live abroad (see "Gain Or Drain? The Effect Of Emigrant Remittances On Sovereign Creditworthiness," published June 9, 2016).

Trade flows and investment funding could decline

Through trade, Lithuania and auto manufacturers from the Visegrad group (that is, Czech Republic, Hungary, Poland, and Slovakia) appear to be the most vulnerable. Again, relative to its national income, Ireland sends more than twice the amount of exports to the U.K. than countries in eastern Europe. Compared with the other Visegrad economies, Poland's exports do not seem as large, due to the generally lower share of exports in its GDP. The trade channel might become narrower for eastern Europe in the medium term, depending on the shape of negotiations between the U.K. and the EU. But, for now, we think any immediate direct impact is likely to be minimal.

Indirect consequences could come from various quarters. We think the most likely source is a fall in consumer confidence in European markets, leading to lower demand for eastern European goods and services from EU trading partners. Currency depreciation vis-à-vis trade partners outside the EU could help improve export competitiveness and partly offset lower volumes. However, an exchange-rate-driven adjustment is an option available only to a handful of sovereigns in the region. Of the 13 countries on our heat map, only six--Turkey, Russia, Hungary, Poland, Czech Republic, and Romania--have floating exchange rate regimes. Moreover, given that the bulk of eastern European auto exports are intended for the EU market, and Visegrad economies remain closely integrated in the German supply chain, redirecting exports could prove challenging to those most exposed via the trade channel.

We think that if the EU were to scale back funding, that would likely have a more profound effect on member states from emerging Europe than trade. The U.K. is the second largest net contributor to the EU budget after Germany, and its exit could permanently shrink the EU budget unless the remaining member states make up the shortfall. On average, EU funds comprised 11% of investment in eastern Europe in 2014, of which we estimate 10% came from the U.K. alone. Hungary is particularly dependent, having financed nearly one-fifth of its investment during that year through EU funds. Lithuania, Poland, and Latvia also receive important contributions to investment from EU funds. Of course any effect of a Brexit on EU fund allocations will only be felt after the expiry of the current 2014-2020 budget, which will be executed with the U.K.'s commitments. These considerations are not valid for Turkey and Russia because they are not eligible to receive EU structural funds.

Populist rhetoric may well deter future capital inflows

Ultimately, we see only a limited direct impact on eastern Europe from Brexit in the short term. Over time, however, we think diminished investment inflows and EU cohesion funds, reflecting not only Brexit but also political shifts in some countries, could dampen the region's growth prospects.

With bank lending still subdued after the 2008-2009 global financial crisis, and a drop-off of direct investment inflows, EU cohesion funds have been an important source of investment financing in eastern Europe. Eastern European leaders' refusal to show solidarity with the EU during the Syrian refugee crisis, and rising euro skepticism across the region, particularly in Hungary and Poland, could provoke Brussels to restructure its budget and reduce allocations from cohesion funds. Moreover, direct investors may become more hesitant to invest in euroskeptic countries following a Brexit. The imposition of punitive taxes in Hungary and more recently in Poland, particularly on utilities

and banks, is also likely to be an important factor in this context.

What's more, in our view, dwindling capital inflows will exacerbate already weak supply side considerations. Eastern Europe is faced with numerous constraints to both labor and capital supply. Turkey, with its young and growing population and still positive real credit growth, is a notable exception. The effect of the region's aging and shrinking population has been made worse by one of the largest population losses in modern history, due to net emigration. Over the past two decades, populations in many of these economies have declined by double digits. And although savings rates have picked up, investment still trails behind, with spending on research and development averaging a mere 1% of GDP, half that of the EU-28 average. In addition, the predominance of deposit funding will restrict eastern European banks' ability to finance longer-term projects.

EU accession: The wait could be even longer

Five countries are currently in line to join the EU--Albania, Montenegro, Serbia, Macedonia, and Turkey--none of which has a sizeable migrant presence in the U.K.; remittances from the U.K. are therefore negligible. In addition, the U.K. is not an important export destination for these EU candidates. Exports to the U.K. account for only about 1.5% of Turkish GDP, the highest proportion among the five. The share of exports in Turkey's GDP is less than 30% because consumption drives its economy. Therefore, even though the U.K. is Turkey's second largest export market, a slowdown in the U.K. is unlikely to have a major impact. We also note a drop in tourism in Turkey, which stems from security concerns and is unrelated to Brexit.

But Brexit could have other implications for these economies. Albania, Montenegro, and Serbia have been pushing forward with various reforms to come closer to gaining entry to the EU. Macedonia faces opposition to its membership from Greece over its constitutional name, but until recently had continued to make progress by opening new accession chapters. With the U.K.'s decision to leave, we believe the EU could lose its appetite for enlargement. This could potentially impact not just pre-accession funds, which finance regional development and infrastructure projects among other things, but also efforts toward strengthening institutions that until now were anchored by the prospect of eventual accession.

The institutional framework is currently an important constraint to our ratings on all candidate countries. Therefore a slowdown in reform, which will ultimately feed into the predictability of the business environment, could make these economies less attractive to investors, likely checking upward rating momentum. Take for instance Turkey, whose relationship with the EU remains complicated. The ongoing institutional deterioration in the country is unlikely to advance its EU aspirations, despite its role in stemming the influx of refugees into Europe.

Appendix

The Brexit Heat Map Data: Eastern Europe

	UK contribution to EU funds/Investment (%)	EU fund factor	Exports to UK/GDP (%)	Export factor	Immigrants in UK/Population (%)	Immigrant factor	Remittances from UK/GDP (%)	Remittance factor	Index (Sum of all factors)
Lithuania	1.72	0.85	0.04	0.98	0.05	0.97	0.01	0.63	3.44
Latvia	1.50	0.75	0.03	0.57	0.05	1.00	0.01	1.00	3.32
Hungary	2.01	1.00	0.04	0.86	0.01	0.16	0.00	0.26	2.28
Poland	1.56	0.78	0.03	0.63	0.02	0.41	0.00	0.20	2.03
Slovakia	0.69	0.34	0.03	0.84	0.01	0.27	0.00	0.24	1.69
Estonia	0.87	0.44	0.03	0.79	0.01	0.20	0.00	0.21	1.63
Czech Republic	0.81	0.40	0.04	1.00	0.00	0.06	0.00	0.08	1.55
Bulgaria	1.26	0.63	0.02	0.38	0.01	0.15	0.00	0.11	1.26
Romania	1.03	0.51	0.01	0.27	0.01	0.16	0.00	0.05	0.99
Slovenia	1.13	0.56	0.01	0.17	0.00	0.00	0.00	0.00	0.74
Croatia	0.40	0.20	0.01	0.16	0.00	0.00	0.00	0.04	0.40
Turkey	0.00	0.00	0.02	0.29	0.00	0.01	0.00	0.00	0.31
Russia	0.00	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.01

The rankings were determined by constructing an index, the sum of four data points all normalized and converted into a scale from 0 to 1. The data points are: Exports of goods and services to the U.K./GDP + migrants as a % of population [A country's nationals resident in the U.K. divided by the country's population {ONS population by country of birth and nationality 2014}; United Nations, Department of Economic and Social Affairs (2015); Trends in International Migrant Stock: Migrants by Destination and Origin (United Nations database, POP/DB/MIG/Stock/Rev.2015; population data from Eurostat)] + remittances from the U.K. as a % of national GDP + the U.K.'s contribution to EU funds in total investment (EU 2014 budget “investment for growth and jobs” adjusted for the U.K.'s contribution to the EU budget and assuming a proportion of expenditure, including on growth and jobs, is held the same and remaining member countries will not make good the shortfall, investment data from Eurostat).

Related Research

- Ratings On The United Kingdom Lowered To 'AA' On Brexit Vote; Outlook Remains Negative On Continued Uncertainty, June 27, 2016
- Brexit Would Spell The End Of The U.K.'s 'AAA' Rating, May 20, 2016
- Who Has The Most To Lose From Brexit? Introducing The Brexit Sensitivity Index, June 9, 2016
- Gain Or Drain? The Effect Of Emigrant Remittances On Sovereign Creditworthiness, June 9, 2016
- Central And Eastern Europe Rating Trends 2016, Jan 18, 2016

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