

31 March 2017

Macro Focus

Brexit: the EU28 is dead, long live the EU?

- The die is cast – the next move is the EU's
- Limited effect of Brexit on the Baltic economies, so far
- Baltic interest – strong EU

Wheels are set in motion

On March 29, the UK gave formal notice of its intention to leave the EU, which means that the clock, set at two years, has begun to tick. The next move is the EU's, and it is well-prepared. The president of the European Council, Donald Tusk, will soon present a Brexit draft to the remaining EU27. On April 5, a vote will be taken on a resolution describing the European Parliament's negotiating priorities. Among other things, the EU's chief negotiator, Michel Barnier, wants to make sure that the EU citizens who move to the UK in the next two years still have full rights. During this time, the UK will still be a full-fledged EU member. The formal process will now progress through three stages.

First, the EU's heads of state and government (**European Council**) will convene on April 29 to adopt negotiating guidelines. After that, the **European Commission** will propose that negotiations begin. The third step is that the member states authorise the **EU's chief negotiator** to formally begin the process. Negotiations between the EU's Michel Barnier and the UK's David Davis are expected to begin in mid-May, about the same time as the second round of the French election.

Decision-making authority within the EU

When it negotiates a divorce settlement, the EU will have to consider its future relationship with the UK (according to Article 50). Negotiations on this relationship, their outcome, and approval may involve the European Commission, the European Council (EU27), the European Parliament, and the parliaments of the EU27 and the British Parliament. In some EU27 countries, such as Belgium, subnational authorities will also have a say. For example, a free trade agreement with the UK post-Brexit will require the unanimous support of the European Council.

When it's time to finalise the divorce, the EU will be represented by the European Council, where a qualified majority will be needed for approval, i.e., at least 72% of the countries, representing 65% of the population in the EU. Approval cannot be given until the European Parliament first gives its consent. In addition, the British Parliament will vote on the final deal and will give it either a thumbs up or down. "No deal is better than a bad deal," Theresa May has said.

According to Article 50, the negotiations cannot go beyond two years unless the European Council and the UK both agree to an extension. This time limit is highly ambitious, and we can't rule out that it will be extended. To gain the unanimous support of all the EU members may require concessions to holdouts in other areas that may not be directly related to the Brexit negotiations.

EU's priorities

The EU will seek to ensure that EU citizens are not discriminated against and that they keep the same rights in the UK if they move there in the next two years. This will be of particular importance to the Baltic countries, as a large number of Baltic citizens are living in the UK.¹ In addition, the EU's negotiators have said they will prioritise the following:

Important individuals going forward:

From the EU's side

- 1) **Michel Barnier** (**European Commission's** chief negotiator). Will cope with the technical challenges surrounding the Brexit process.
- 2) **Didier Seeuws**. Will lead the negotiations on the future relationship between the EU and the UK.
- 3) **Guy Verhofstadt**. Will be the **European Parliament's** chief Brexit negotiator. (Note: Today he is leader of the Alliance of Liberals and Democrats for Europe Group (ALDE) in the European Parliament).
- 4) **Donald Tusk** (European Council President)

From the British side

- 1) **Theresa May** (Prime Minister)
- 2) **David Davis** (Secretary of State for Exiting the EU). Will lead the negotiations with the European Commission on the Brexit process and the new relationship between the EU and the UK.
- 3) **Liam Fox** (Secretary of State for International Trade). Will play a key role in discussions with the EU on a future relationship. Will also lead parallel negotiations with third countries on free trade.
- 4) **Sir Tim Barrow** (Permanent representative of the UK to the EU)

Cathrine Danin, Economist
+46 70 540 68 78
cathrine.danin@swedbank.se

Laura Galdikienė, Senior economist
+370 5 258 2275
laura.galdikiene@swedbank.lt

¹ According to Eurostat, around 100,000 Latvian citizens and more than 170,000 Lithuanian citizens lived in the UK last year; the estimated number of Estonians in the UK – around 15,000.

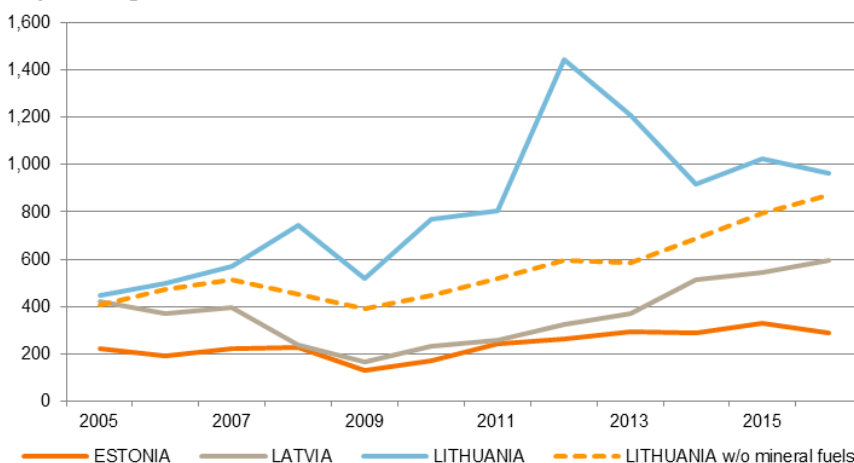
- 1) Ensuring that the UK's financial liabilities, including those extending beyond 2019, are met. Even if the UK pays its Brexit bill, the remaining EU member states are likely to face a higher net contribution to the EU's budget, since the UK is a significant net payer.
- 2) Not signing a new trade agreement before Brexit is finalised.
- 3) Creating as much clarity and certainty as possible for the citizens, companies, and member countries adversely affected by Brexit.

We expect the EU to present a united front in dealing with the UK and that all the members of the EU27 will stay on message. This has worked well so far. The EU's detailed priorities will ultimately depend on the outcome of European elections this year, especially in France and Germany.

Limited economic impact for the Baltics so far

The impact of the Brexit vote on the Baltics has so far been limited. Last year, the value of exports of goods from Estonia and Lithuania to the UK declined by 12% and 6%, respectively. For Lithuania, the fall was driven by the decreasing value of exports of mineral products, and for Estonia by a fall in value of shale oil products and exports of mobile communication equipment. Without exports of mineral fuels, Lithuanian exports of goods to the UK expanded by 10%, although growth was slower than in previous years. Lithuanian exports of services to the UK were largely unaffected and continued growing by double digits. Latvia also managed to increase the value of goods exports to the UK last year. However, it has probably been hard for exporters to avoid the squeeze on profit margins caused by the depreciation of the pound sterling of more than 10% since the referendum.

Exports of goods to the UK, mln EUR



Source: Eurostat and Statistics Lithuania

But the exporters were not the only ones affected by the depreciation of the pound. According to the Bank of Lithuania, after three years of growth the remittances by Lithuanian migrants from the UK to Lithuania declined by 20% last year. Total remittances to Lithuania are at around 3% of GDP and are an important source of income to some Lithuanian households. The decision in the Brexit referendum could have also contributed to the spike in migration from Lithuania to the UK. Migration from Lithuania to the UK increased by 22.5% in 2016, compared with the previous year. More than 23,000 more Lithuanians moved to the UK last year-- the highest outflow of people in the last five years. Almost half of all the people who left Lithuania last year chose the UK as their destination. Migrants possibly rushed to secure their place in the UK before the borders closed.

Moving forward – plenty of risk, but there is also hope

The negative migration trends may continue during the Brexit negotiation period, which would put additional pressure on the labour market and population ageing in the Baltic countries. However, we expect that the effect of Brexit-related events on the Baltic economies over the next two years will be limited. After the divorce, much will depend on the details of any future trade agreement that the parties reach--and whether they even reach one. The UK has said so far that it will prioritize lower immigration at the

expense of access to the internal market (a so-called “hard Brexit”). If free trade with the UK can no longer be ensured, this would adversely affect both exports and investment, but mostly via second-round effects. More important could be the effect of a reduced EU budget. If the other countries do not fill in the gap after Brexit, the Baltic countries could receive even less support from the EU’s budget in the form of structural funds after 2020. This would possibly have a negative effect on investment.

Nevertheless, the biggest risk to the Baltic economies is related to the strength and longevity of the EU. The Baltics are small, open economies, which have benefitted greatly from the integration of the European markets and the introduction of the common currency. A further weakening of the EU would have negative consequences on all EU countries, not excluding the Baltics. However, the risk of the EU’s falling apart has receded for now, as the populists in France and Germany are less likely to win the important elections in Europe and the economic recovery in the EMU is finally gaining momentum. Still, a lot can happen: the negotiations will be long and messy, the populists in the EU may still succeed, and the structural problems are yet unresolved. But there is also a chance that the EU will emerge stronger after this. Long live the EU!

General disclaimer

This research report has been prepared by analysts of Swedbank Macro Research, a unit within Swedbank Large Corporates & Institutions. The Macro Research department consists of research units in Estonia, Latvia, Lithuania, Norway and Sweden, and is responsible for preparing reports on global and home market economic developments.

Analyst's certification

The analyst(s) responsible for the content of this report hereby confirm that notwithstanding the existence of any such potential conflicts of interest referred to herein, the views expressed in this report accurately reflect their personal and professional views.

Research reports are independent and based solely on publicly available information.

Issuer, distribution & recipients

This report by Swedbank Macro Research, a unit within Swedbank Research that belongs to Large Corporates & Institutions, is issued by the Swedbank Large Corporates & Institutions business area within Swedbank AB (publ) ("Swedbank"). Swedbank is under the supervision of the Swedish Financial Supervisory Authority (Finansinspektionen).

In no instance is this report altered by the distributor before distribution.

In Finland this report is distributed by Swedbank's branch in Helsinki, which is under the supervision of the Finnish Financial Supervisory Authority (Finanssivalvonta).

In Norway this report is distributed by Swedbank's branch in Oslo, which is under the supervision of the Financial Supervisory Authority of Norway (Finanstilsynet).

In Estonia this report is distributed by Swedbank AS, which is under the supervision of the Estonian Financial Supervisory Authority (Finantsinspeksioon).

In Lithuania this report is distributed by "Swedbank" AB, which is under the supervision of the Central Bank of the Republic of Lithuania (Lietuvos bankas).

In Latvia this report is distributed by Swedbank AS, which is under the supervision of The Financial and Capital Market Commission (Finanšu un kapitāla tirgus komisija).

In the United States this report is distributed by Swedbank First Securities LLC ("Swedbank First"), which accepts responsibility for its contents. This report is for distribution only to institutional investors. Any United States institutional investor receiving the report, who wishes to effect a transaction in any security based on the view in this document, should do so only through Swedbank First. Swedbank First is a U.S. broker-dealer, registered with the Securities and Exchange Commission, and is a member of the Financial Industry Regulatory Authority. Swedbank First is part of Swedbank Group.

For important U.S. disclosures, please reference:
<http://www.swedbanksecuritiesus.com/disclaimer/index.htm>

In the United Kingdom this communication is for distribution only to and directed only at "relevant persons". This communication must not be acted on – or relied on – by persons who are not "relevant persons". Any investment or investment activity to which this document relates is available only to "relevant persons" and will be engaged in only with "relevant persons". By "relevant persons" we mean persons who:

- Have professional experience in matters relating to investments falling within Article 19(5) of the Financial Promotions Order.
- Are persons falling within Article 49(2)(a) to (d) of the Financial Promotions Order ("high net worth companies, unincorporated associations etc").
- Are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000) – in connection with the issue or sale of any securities – may otherwise lawfully be communicated or caused to be communicated.

Limitation of liability

All information, including statements of fact, contained in this research report has been obtained and compiled in good faith from sources believed to be reliable. However, no representation or warranty, express or implied, is made by Swedbank with respect to the completeness or accuracy of its contents, and it is not to be relied upon as authoritative and should not be taken in substitution for the exercise of reasoned, independent judgment by you.

Opinions contained in the report represent the analyst's present opinion only and may be subject to change. In the event that the analyst's opinion should change or a new analyst with a different opinion becomes responsible for our coverage, we shall endeavour (but do not undertake) to disseminate any such change, within the constraints of any regulations, applicable laws, internal procedures within Swedbank, or other circumstances.

Swedbank is not advising nor soliciting any action based upon this report. This report is not, and should not be construed as, an offer to sell or as a solicitation of an offer to buy any securities.

To the extent permitted by applicable law, no liability whatsoever is accepted by Swedbank for any direct or consequential loss arising from the use of this report.

Reproduction & dissemination

This material may not be reproduced without permission from Swedbank Research, a unit within Large Corporates & Institutions.

This report is not intended for physical or legal persons who are citizens of, or have domicile in, a country in which dissemination is not permitted according to applicable legislation or other decisions.

Produced by Swedbank Research, a unit within Large Corporates & Institutions.

Address

Swedbank LC&I, Swedbank AB (publ), SE-105 34 Stockholm.
Visiting address: Landsvägen 40, 172 63 Sundbyberg