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FOCUS NOTES

Brexit: potential implications for Greece, Cyprus and the CESEE region

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The Brexit vote is expected to have a profound impact on the UK, the EU and the rest of the world both on the economic and the political level. Some of the main transmission channels are expected to include trade, investment, banking and finance, labor markets and public finances. Yet, the exact size of output losses that other economies may encounter will depend on their individual linkages with the UK, the form of future UK-EU trade arrangements and domestic authorities' response to adverse spillover effects. According to the IMF[1], among larger EU countries, Ireland, the Netherlands and Belgium are expected to be most affected given their close trade, labor and financial ties with the UK. In more detail, under a limited scenario in which post-Brexit uncertainty dissipates relatively quickly and the UK negotiates with the EU a European Economic Area (EEA) - type of arrangement, the IMF staff project respective cumulative GDP losses of 0.2% and 0.0% for the EU-ex UK and the rest of the world by 2018. Under their adverse scenario, which assumes heightened uncertainty and new UK-EU trade arrangements defaulting to WTO rules, the Fund estimates cumulative GDP losses of 0.5% and 0.2% for the EU-ex UK and the rest of the world. Along these lines, ECB President Mario Draghi told EU leaders at the June 28th EU Summit that Brexit is estimated to have a negative cumulative impact between 0.3% and 0.5% on euro area GDP growth over the next three years, compared to the Central Bank's earlier projections. Notwithstanding, the political consequences may prove even more overwhelming. The risk of "political contagion" in the euro area prevails as Eurosceptic parties may become more vocal using the Brexit vote as an electoral argument ahead of the 2017 elections in the Netherlands (March), France (May) and Germany (September). Undoubtedly, EU leaders' agreement at the June 27/28 EU Summit to support the EU project as well as reassurances by the G4 major Central Banks that they stand ready to safeguard financial system stability, constitute steps in the right direction. Yet, market uncertainty is unlikely to fade significantly any time soon unless there is more clarity with regard to the timeline of UK's withdrawal from the EU and the future principles that will govern its trade relationships with the EU. This report, which constitutes a supplement to our June 24th note on the Brexit vote[1], takes a closer look at its potential ramifications for Greece, Cyprus and a number of developing economies in the CESEE region.

Brexit vote: a preliminary analysis of its potential impact on the outlook of the Greek economy

Greek economy: current state of play

Following the recent completion of the 1st review of the 3rd Economic Adjustment Programme, Greece received the first sub-tranche (€7.5bn) of the €10.3bn ESM loan installment. The disbursement of the remaining amount (€2.3bn) is conditional on a list of prior actions that need to be implemented by the end of September 2016. Subsequently, the 2nd review of the current programme is likely to begin in October 2016, with labour market reform and the further liberalisation of the closed professions expected to be among the most important items in the agenda.

On the fiscal front, the latest State budget execution data for the five months of the year recorded a cumulative central government deficit of -€0.81bn, which compares with a deficit target of -€3.9bn. Furthermore, the primary balance recorded a primary surplus of €2.3bn, on the back of a strong under-execution of government expenditure (by c. €2.4bn) relative to the respective budget target. General government arrears to the private sector (including tax arrears) stood at ca €6.7bn at the end of April 2016. According to the compliance report of Greece's ESM Programme (June 2016), €3.5bn of these arrears will be cleared by the end of 2016, with the entire stock expected to be settled by the end of June 2017. Note that the current programme foresees primary surpluses of 0.5%, 1.75% and 3.5% of GDP in 2016, 2017 and 2018, respectively.

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[1] IMF Country Report No. 16/169, "United Kingdom: Selected Issues", June 2016
[2] Global Economic & Market Outlook, "Brexit: a preliminary assessment of the implications for the UK, the EU and

With regard to the domestic banking system, some of the most important developments following the successful completion of the 1st review include:

1. The reinstatement of the waiver for the use of government and government guaranteed debt by Greek banks as eligible collateral for obtaining cheaper funding through the ECB's regular liquidity provision operations (positive effect up to €100mn/annum on domestic banks' profitability)[1]
2. The expected inclusion of government securities in the ECB's QE programme. Our earlier analysis on the subject[1] suggests that the inclusion of Greek marketable debt in the aforementioned programme could take place before year-end, provided that the ECB Governing Council makes a positive assessment of the progress made in the analysis and reinforcement of the sustainability of Greek public debt and assuming no major delays in the completion of the 2nd programme review. The latter condition is particularly relevant if no PSPP purchases of Greek debt take place before the initiation of formal discussions in the context of that review (expected in early October). Total central bank purchases of Greek debt could reach a maximum of c. €4.2bn, with a potential to rise to €5bn or more if the present QE programme were to be extended beyond March 2017. This could be equivalent to well over a year's worth of the present total daily trading volume in Greek government securities, having a pronounced impact on risk premia and contributing to a GGB yield spread compression of more than 100bps, in our view.

Note that an important element of the present baseline macro scenario for Greece is the expected stabilization of private sector deposits (and their gradual return to the domestic banking system), conditional on the improvement of domestic economic sentiment in the following quarters. According to Bank of Greece data, resident private sector deposits to domestic MFIs stood at €121.7bn at the end of May 2016, down 6.3% YoY and lower by c 26% from their levels in October 2014. For the domestic economy, the latest European Commission Forecast is for real GDP of -0.3% and +2.7% in 2016 and 2017, respectively. Preliminary data for the 1st quarter of 2016 showed a decline of -1.4% on an annual basis. Our own baseline scenario has envisaged a return of positive quarter-on-quarter growth rates in the second semester of 2016, with full year real GDP growth coming in slightly negative (between -0.5% and -0.7%), conditional on:

1. The *timely* completion of the 2nd programme review.
2. A sizeable positive contribution to domestic GDP from the tourism sector.
3. The partial payment of general government arrears.
4. A significant decline in government bond yield spreads and other risk premia following the successful completion of the 1st programme review.
5. The positive effect that the expected inclusion of Greek marketable debt in the ECB's QE programme would have on domestic sentiment and on investor confidence towards the prospects of the Greek economy.

Greece's trade linkages with the UK and the macroeconomic consequences of Brexit

In this Section we examine in more detail the potential consequences of the Brexit vote on the Greek economy. In Subsection 1 we analyze the trade linkages between Greece and the UK and in Subsection 2 we provide a brief analysis on the possible short - and medium - term impacts stemming from the recent decision of the British voters to leave the European Union.

1. <u>Trade Linkages – The Services Sector Dominates (Travel & Transport)</u>

Looking at the available data, the general picture that emerges with regard to the trade linkages between Greece and the UK is that the services sector dominates, both in terms of exports and imports.[5] As Table 1 demonstrates, in 2014 the nominal value of total Greek exports of services was €31.1 bn or c. 17.5% of GDP.[6] Among Greece's EU-28 trade partners, the UK had the lion's share (16.0% of the total value of Greek services exports), with total demand amounting to c. €5 bn. Germany was in the second place (13.6%), followed by France (6.0%), Italy (3.3%) and the Netherlands (3.2%). With respect to non-EU trade partners, the US had the highest share (11.1%) followed by Switzerland (6.7%) and Russia (4.4%). In the same year (2014), the total value of Greek exports of goods (merchandise trade) was €27.1bn or 15.3% of GDP (see Table 2). The UK economy ranked in the 7th place, absorbing around €979.9 mn or c. 3.6% of Greece's total merchandise exports. Overall, in 2014 UK residents (households, firms and the government) absorbed around 10.2% of total Greek exports, an amount equivalent to c. 3.4% of Greek GDP.[7]

[5] The data we present herein are not from the national accounts statistics. For services we use BOP (balance of payments) data and for goods merchandise transactions data.
[6] Data for Greek services exports to the UK are not available for 2015.
[7] In a recent study published by the IMF (e.g. see http://www.imf.org/external/pubs/ft/scr/2016/cr16169.pdf), it was estimated that the UK's contribution to total Greek exports in 2014 was around 2.0% of GDP in 2014. The respective calculation from our study is 3.3%. This divergence stems from the services sector. According to our calculations the respective contribution was 2.8% (1.5% in the IMF study). In the goods sector our results fully match those of the IMF study.

Table 1: Greece's International Trade in Services (2014)
Methodology: IMF – BPM6 Balance of Payments Manual, 6th Edition, 2009

	Exports of Services (Credit)				Imports of Services (Debit)			
	€ mn	% Share			€ mn	% Share		
		Intra EU-28 (without UK)	*UK*	Extra EU-28		Intra EU-28 (without UK)	*UK*	Extra EU-28
Total	31,051.3 (100%)*	41.2	*16.0*	42.8	12,780.3 (100%)*	44.9	*15.2*	39.9
1. Manufacturing Services on Physical Inputs Owned by Others	27.8 (0.1%)	57.6	*19.8*	22.7	26.3 (0.2%)	53.6	*19.4*	27.0
2. Maintenance and Repair Services	106.9 (0.3%)	62.8	*8.0*	29.2	226.2 (1.8%)	29.8	*9.7*	60.6
3. Transport	13,131.0 (42.3%)	27.7	*20.4*	51.9	6,258.6 (49.0)	36.5	*14.0*	49.5
4. Travel	13,393.1 (43.1%)	50.8	*12.0*	37.2	2,076.4 (16.2)	51.2	*10.1*	38.7
5. Construction	845.3 (2.7%)	37.6	*3.6*	58.8	348.6 (2.7)	49.0	*2.1*	48.9
6. Insurance and Pensions Services	432.0 (1.4%)	48.9	*26.9*	24.2	1,151.0 (9.0%)	49.5	*19.8*	30.7
7. Financial Services	135.3 (0.4%)	48.8	*26.8*	24.5	235.0 (1.8%)	68.3	*17.8*	13.9
8. Charges for the Use of Intellectual Property	80.1 (0.3%)	62.9	*8.5*	28.6	337.9 (2.6%)	49.2	*28.7*	22.2
9. Telecommunications, Computer and Information Services	868.0 (2.8)	60.3	*17.5*	22.2	655.6 (5.1%)	62.5	*22.3*	15.2
10. Other Business Services	1,643.1 (5.3%)	58.9	*18.2*	22.9	1,151.0 (9.0)	58.9	*23.0*	18.1
11. Personal, Cultural and Recreational Services	206.1 (0.7%)	30.9	*10.8*	58.4	180.4 (1.4%)	46.7	*22.9*	30.4
12. Government Goods and Services n.i.e.	182.8 (0.6%)	38.2	*3.5*	58.3	133.3 (1.0%)	58.3	*3.5*	38.2
13. Services Not Allocated	0.0	-	-	-	0.0	-	-	-

Source: (a) Eurostat, (b) Eurobank Research.
Note: (*) in the parentheses we present the shares (in total exports and imports of services) of the respective categories.

Table 2: Greece's International Trade in Goods (2014)
Standard International Trade Classification (SITC), Methodology: Intrastat & Extrastat

	Exports of Goods (Dispatches)				Imports of Goods (Arrivals)			
	€ mn	% Share			€ mn	% Share		
		Intra EU-28 (without UK)	*UK*	Extra EU-28		Intra EU-28 (without UK)	*UK*	Extra EU-28
Total	27,120.5 (100%)*	44.7	3.6	51.7	48,326.9 (100%)*	45.7	2.6	51.8
1. Food and Live Animals	3,775.2 (13.9%)	68.0	7.5	24.5	5,152.6 (10.7%)	82.0	1.7	16.3
2. Beverages and Tobacco	593.4 (2.2%)	55.3	0.7	44.0	513.0 (1.1%)	64.2	18.1	17.7
3. Crude Materials, Inedible, Except Fuels	1,036.4 (3.8%)	33.3	1.5	65.2	1,223.6 (2.5%)	46.6	3.5	49.9
4. Mineral Fuels, Lubricants and Related Materials	10,257.2 (37.8%)	21.0	0.6	78.4	16,299.7 (33.7%)	7.4	0.3	92.2
5. Animal and Vegetable Oils, Fats and Waxes	323.2 (1.2%)	76.6	1.5	21.9	282.1 (0.6%)	61.8	0.2	38.0
6. Chemicals and Related Products N.E.S.	2,694.5 (9.9%)	64.6	7.3	28.1	6,673.4 (13.8%)	76.2	4.8	19.0
7. Manufactured Goods Classified Chiefly by Material	3,782.8 (13.9%)	56.4	4.8	38.8	4,881.2 (10.1%)	56.8	2.1	41.1
8. Machinery and Transport Equipment	2,288.2 (8.4%)	50.1	5.2	44.7	8.571.9 (17.7%)	54.9	3.1	42.0
9. Miscellaneous Manufactured Articles	1,793.7 (6.6%)	63.6	6.5	29.9	4,590.1 (9.5%)	64.7	6.1	29.2
10. Commodities and Transactions Not Classified Elsewhere in the SITC	576.0 (2.1%)	55.6	0.2	44.2	139.3 (0.3%)	12.9	0.1	87.0

Source: (a) Eurostat, (b) Eurobank Research.
Note: (*) in the parentheses we present the shares (in total exports and imports of goods) of the respective categories.

On the debit side of the trade accounts, Greek imports from UK amounted to €3.2 bn, out of which €1.9 bn of services (15.2% of total imports of services) and €1.3 bn of goods (2.6% of total imports of goods). Overall, in 2014 Greece ran a €3.0 bn surplus with the UK in services and a deficit of €270.6 mn in goods. Hence, the aggregate result was a surplus of €2.8 bn or 1.6% of Greek GDP.

Greek services exports are mainly concentrated in two sectors namely, transport and travel services. In 2014, the travel sector accounted for 43.1% of total Greek exports and the respective figure for transport (mainly shipping) was 42.3%. In the former sector the contribution of the UK economy was 12.0% (or 43.1% x 12.0% = 5.2% of total exports of services) and in the latter 20.4% (or 42.3% x 20.4% = 8.6% of total exports in services).

Figure 1: Real GDP Growth and Trade Openness

(a) Real GDP Growth (b) Trade Openness (Exports + Imports % of GDP)

Source: (a) Eurostat, (b) Eurobank Research.

Note: (a) trade openness is defined as the sum of exports and imports as a percentage of GDP. The yearly change in trade openness is measured in percentage points.

In what concerns the structure of the Greek exports of goods, the category of mineral fuels, lubricants and related materials clearly dominates. Its share reached 37.8% in 2014. Other sectors with relative high shares were food and live animals (13.9%), manufactured goods classified chiefly my material (13.9%) and machinery and transport equipment (8.4%). The UK economy had a low contribution to all these categories. For example in mineral fuels, lubricants and related materials its share was 0.6% (78.4% was absorbed by non-EU trade partners).

2. Macroeconomic Consequences

The analysis that follows is based on a scenario of smooth negotiations between the UK and the EU as regards the former's exit terms from the Union. According to article 50 of the Lisbon treaty, such negotiations could last for up to 2 years, with an extension beyond that period being institutionally possible. So, what would be the potential macroeconomic consequences of a Brexit scenario for the Greek economy? In our view, the biggest threat in the short-run comes from a possible loss in consumers and investor confidence. Despite its quick recovery from a 6 year low hit in August 2015 (e.g. see Figure 2a), the economic sentiment indicator for Greece has been broadly stable in more recent months, remaining well below the corresponding EU average. It stood at 89.7 in June 2016 (latest available data), well bellow a 6-year high of 104.6 recorded in June 2014.

Figure 2: Economic Sentiment Indicator and Real GDP Growth

(a) Economic Sentiment Indicator (b) Economic Sentiment and Real GDP Growth

Source: (a) Eurostat, (b) Eurobank Research.

Note: (a) trade openness is defined as the sum of exports and imports as a percentage of GDP. The yearly change in trade openness is measured in percentage points.

In the absence of a major external shock or other unforeseen circumstances, the positive completion of the 1st programme review should normally lead to some further recovery in Greece's economic sentiment indicator in the coming months. This, along with another strong year for the Greek tourism industry could provide the base for a gradual improvement in Greece's GDP dynamics from H2 2016 onwards. These views have also been shared by the European Commission, with its latest assessment of the prospects of the Greek economy (Spring 2016 Forecast) noting that: *"Growth is expected to resume in the second half of 2016 and to pick up in 2017 thanks to the return of confidence and the impact of structural reforms. Following stronger than expected public finances in 2015 and the additional fiscal package currently finalized by the Authorities, the general government balance is expected to improve further"*. The analysis presented in this note suggests that the Brexit vote could prove out to be a drag on Greece's expected recovery process, coming in a particularly critical trajectory for the domestic economy (the unemployment rate remains firmly above 20% for the last 4 ½ years and 2015 marked the 7th year of negative real GDP growth over the last 8 years).

Looking next at the potential effects through bilateral trade linkages, let us start with the facts. Given the trade flow data presented in Tables 1&2, a potential deterioration in the trade balance between Greece and the UK (say, due to a lasting depreciation of the GBP against the Euro) would hit the economy mostly via the services sector, and, especially, through travel and transport. For instance, ceteris paribus, a 1% reduction in the Greek exports of goods and services to the UK could lead to a decrease of Greece's real GDP growth rate by 0.03 percentage points.

Finally, another potential impact on the Greek economy could come via its trade with the rest of the EU-28 countries. As depicted in Tables 1&2, in 2014 around 41.2% of total Greek exports of services was absorbed by the rest of the EU countries (excluding the UK). The respective figure for goods (merchandise trade) was 44.7%. Thus, a possible deterioration of the growth performance of the other EU-28 economies triggered by Brexit could negatively affect a major fraction of Greece's trade flows. For example, ceteris paribus, a 1% decrease in the Greek exports of goods and services to other EU-28 countries (excluding the UK) could lead to a drop of Greece's real GDP growth rate by 0.2 percentage points. As depicted in Figure 1a, there is a strong positive correlation between the growth performance of the UK and that of the rest of EU-28. Furthermore, Greece is more vulnerable to trade shocks now than it was before the outbreak of the sovereign debt crisis due to its increased trade openness (Figure 1b).

Other potential implications for the Greek economy

In the analysis below we highlight some of the channels through which the Brexit vote could affect Greece's economic developments and outlook.

1. <u>EU structural funding to Greece</u>

Currently, ca €35bn are available for Greece via the European Structural and Cohesion Funds (2007-2013 and 2014-2020) and the Agricultural Funds. A UK exit from the EU might have a negative impact on the size of the EU Budget and thus, reduce available funding to Greece. However, at this point it is difficult to access the full impact of Brexit on the EU Budget. This impact will depend, inter alia, on the new trade and other relationships that the UK will establish with the EU after triggering Article 50 of the EU Treaty. Note that according to the latest available data, the UK was a net contributor to the EU Budget for the period between 2000 and 2014.

2. <u>Potential impact on domestic financial conditions</u>

In our baseline scenario we have been expecting a significant decline of Greek government bond yield spreads following the successful conclusion of the 1st programme review and ahead of the expected inclusion of Greek marketable government debt in the ECB's QE programme. In addition to these positive developments, the gradual stabilization of domestic depositor sentiment and a more expeditious management of NPLs by domestic banks would contribute to notable improvement in domestic financial conditions in the months and quarters ahead. The Brexit vote and lingering uncertainty about the duration and the outcome of UK's exit negotiations with the EU are expected to negatively affect Greece's economic outlook, either directly via the trade and tourism channels or indirectly via a euro area growth slowdown. This could, in turn, delay the stabilization pace of domestic financial conditions relative to our earlier baseline. With regard to the evolution of GGB yield spreads, we believe that the initial net effect of Greece's inclusion in the ECB's QE programme could be a compression of at least 100bps vs. Germany, though the Brexit vote has likely added a lasting risk premium on Greek sovereign spreads, which may prove more persistent than that on other periphery economies as Greece is the only euro area economy to remain in a financial assistance programme.

3. The implications for the implementation process of the 3rd Economic Adjustment Programme for Greece

In the imminent period ahead, Greece needs to implement a number of prior actions to secure the timely disbursement of the remaining sub-tranche (€2.3bn) of the €10.3bn ESM loan instalment and to prepare the ground for the formal inception of the 2nd programme review and its timely completion thereafter. There have been arguments stating that Greek developments would be of secondary importance for the EU (and the Eurozone) in the coming period due to the Brexit vote and thus, official creditors might show some leniency in their upcoming negotiations with domestic authorities in the context of the present stabilization programme. On the other hand, there also seem to be credible arguments suggesting that official creditors may actually adopt a less flexible stance towards Greece in the following period for at least two important reasons. The first has to do with the expected rise of euro-skepticism in many EU states in the aftermath of Brexit. According to this line of reasoning, a possible relaxation on the part of EU creditors in relation to Greece's reform agenda might offer additional room to euro-skeptic movements or political parties to toughen their stance. The second argument is more technical. The triggering of the Article 50 of the EU treaty by the UK government would start a complicated process that would lead (within 2 years or more) to the exit of the country from the EU. This would create a heavy burden in terms of work (e.g. amendments to existing legislation and new trade treaties), leaving little tolerance for a repetition of lengthy negotiations in the context of Greece's stabilization programme. Clearly, the above arguments point strongly towards a swift completion of Greece's 2nd programme review.

4. Effect on the shipping industry

The effect of Brexit on the Greek shipping industry may come via three main channels. The first one has to do with the expected revision of the trade agreements between the UK and the EU and the UK and the rest of the world. Currently, the Greek merchant fleet (counted in dead weight tons by country of origin of ownership) ranks 1st among 165 countries while the UK ranks 9th (UNCTAD, 2015). Revisions of the trade agreements between the UK and the EU and the UK and the rest of the world may have a direct effect on the number of ships under the UK flag. Only 0.03% of the Greek merchant fleet is under the UK flag so we do not expect a significant effect on the Greek merchant fleet through that channel. However, the effect of trade agreement revisions could be significant for the UK fleet, which is currently under the UK flag. This presently amounts to ca 15.7% of the total UK merchant fleet as defined above. The second implication of Brexit has to do with London's status as a shipping hub. A big part (estimated at ca 20%) of the Greek merchant fleet is London based and any change in the aforementioned status might imply significant relocation costs. Some might argue that at the end this could prove beneficial for Greece due to the potential relocation to Greece of some shipping companies that will decide to leave UK. However, this will not necessarily be the case since Piraeus is still lagging behind with regard to the factors that will attract the shipping industry (e.g. taxation, access to international banks and related industries). The third implication has to do with the additional uncertainty that the Brexit adds to the current gloomy environment of the shipping industry. A negative effect on the EU growth outlook by the Brexit would have a direct impact on the demand for shipping services. This could further affect the current outlook of the shipping market, which is characterized by excess capacity, global uncertainty and China's growth slowdown.

5. Effect on tourism

Tourism is a sector of major importance to the Greek economy. For 2015, the World Travel & Tourism Council estimates its direct and total contribution to domestic GDP at 7.6% and 18.5% and its direct and total contribution to domestic employment at 11.3% and 23.1%, respectively. The UK is a very important tourism market for Greece both in terms of arrivals and receipts, second only to Germany. For the period 2005-2015 inbound travelers from the UK averaged around 2.1 million annually, accounting for 15% of total arrivals. In the same period, annual tourist receipts from the UK averaged €1.7 billion, translating into a 16% share of total receipts. Over the first four months of this year, arrivals from the UK increased by 9% YoY, but given that the bulk of tourist arrivals takes place in the summer months, UK referendum aside, these data are not necessarily indicative of how the whole year will evolve. Although it is too early to assess how the outcome of the UK referendum may affect the domestic tourism industry, its impact will most likely be negative. A recent empirical study conducted by Eurobank Economic Research, which examines the determinants of tourism demand in Greece, found that there is a negative relationship between the real effective exchange rate of Greece relative to the origin country and real travel receipts per traveler as well as a positive relationship between GDP per capita of the origin country and total travel receipts. As per the said study, a 1ppt increase in the real effective exchange rate of Greece vs. an origin country may lead to a decrease of real travel receipts per traveler by €3.6 to €3.9. In addition, a 1ppt decrease in the real GDP per capita of the origin country may lead to a decrease of €230 to €240 million in total travel receipts from this country. These findings are particularly worrying in view of the Brexit vote, given that both a persisting devaluation of the GBP against the EUR and a drop in the UK GDP per capita are considered to be quite probable scenarios in the short and medium term in the event of UK's exit from the EU.

Moreover, according to an announcement made by SETE (Greek Tourism Confederation) following the UK referendum, in the short term, the "Sun & Sea" tourist product, which constitutes by far Greece's main tourist product accounting for around 60% of total non-residents' arrivals (*SETE Intelligence, 'Who is our client?', October 2015*), may suffer a serious blow this year. This is because around 50% of reservations for this particular product are made last minute and therefore, this year's arrivals for the peak months of July and August may now be negatively affected. Decreased demand for other tourism products such as "City Break", "Cultural Tourism" and "MICE" cannot be ruled out. Considering that around 62% to 63% of UK tourists (i.e., around 1.5 million travelers or c. 6% of total visitors on the base of 2015 data) visit Greece in the third quarter of the year, a decrease in UK arrivals in the coming months would translate into lower total tourism arrivals and receipts for the full year relative to earlier projections, which foresaw a rise in receipts between 4.6% and 5.7%. Furthermore, SETE points out that a potential change in current airline itineraries and fares may also have a negative impact, as these factors are central in choosing a tourism destination.

Brexit vote impact on the CESEE region

In this section, we look at the potential impact of Brexit on the Central Eastern and Southeastern Europe (CESEE) region. Firstly, we investigate the potential transmission channels of the shock, secondly we identify key socioeconomic issues arising from Brexit and lastly we delve into the financial markets' reaction and the outlook going forward.

Our main thesis is that Brexit is a net negative from an economic growth and market sentiment standpoint, but not a catastrophic event for the region. In our view, the economic repercussions under the assumption of an orderly (and not protracted in duration) divorce from the EU are manageable. This is because the direct trade and FDI ties with the UK are rather modest while there are no significant banking sector linkages. On the other hand, the broader region is significantly exposed to a euro area slowdown due to a UK exit, given the former's role as a key trade partner and a major capital flow generator for the region. Furthermore, the long-term repercussions from a political economy standpoint could well prove far more important than the pure macroeconomic consequences.

The UK referendum outcome in favour of Brexit has sent shockwaves through CESEE financial markets. Yet, there is so far limited evidence to conceive it as a Lehman-type event with regard to its potential ramifications for the region. Even though uncertainties remain high and there is still no formal date set for the beginning of Brexit negotiations, the region is now in a much better shape to face the incipient challenges compared to 2008. The good growth performance of most regional economies in the post-crisis era, the healing of earlier macroeconomic imbalances, the rebuilding of FX reserves and the implementation of structural reforms in the context of precautionary or regular EU-IMF stabilization programs have strengthened the relative position of the CESEE economies. In what follows, we examine a number of potential channels through which the Brexit vote could affect these economies.

1. <u>Trade channel</u>

The UK is an important, but not indispensable trade partner for the region. Trade linkages appear to be stronger for services than for goods. UK typically accounts for 3-4% of the total exports of goods and 6-9% of the total exports of services for the economies of the broad region. As a percentage of individual country GDP, the exposure is even lower. Exports of goods and services to the UK account for between 1% and 2.5% of GDP for the SEE economies (Bulgaria, Romania and Serbia) and between 3% and 5% for Central Europe (Poland, Hungary and Czech Republic). In any case, there is no evidence at the moment, that trade ties would completely collapse and that a new bilateral trade agreement would replace EU membership.

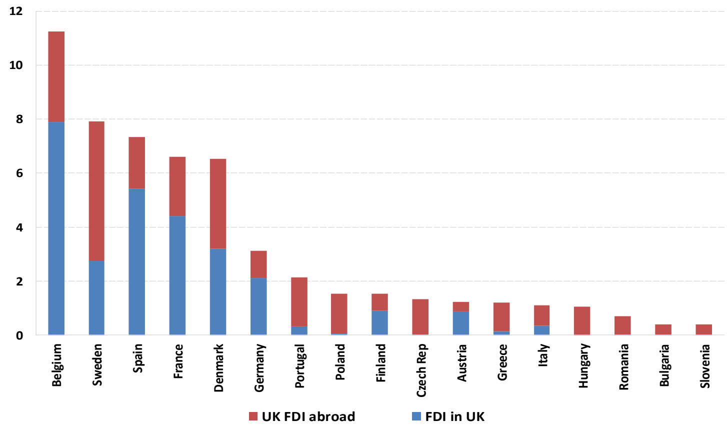
	Exports to UK 2014		Imports from UK 2014	
	Services (%GDP)	Goods (%GDP)	Services (%GDP)	Goods (%GDP)
Bulgaria	1.3%	1.1%	0.6%	1.0%
Czech Republic	0.7%	4.3%	0.5%	1.9%
Hungary	1.3%	3.0%	0.8%	1.3%
Poland	0.6%	2.6%	0.5%	1.1%
Romania	0.7%	1.4%	0.5%	0.9%
Serbia	0.8%	0.3%	0.4%	0.5%
Turkey	0.3%	1.1%	0.3%	0.9%

Source: Eurostat, National Authorities, Eurobank Research

2. FDI flows & banking sector:

First, there are no significant direct financial services linkages between UK and the region. Second, FDI ties are modest. The economies of our focus - net recipients of FDI inflows from UK- are ranked relatively low in the scale of FDI stock, way below the EU average. As such, BREXIT would not necessarily result in a dry-up of FDI inflows in the region.

FDI stock (% of individual country GDP, 2014)

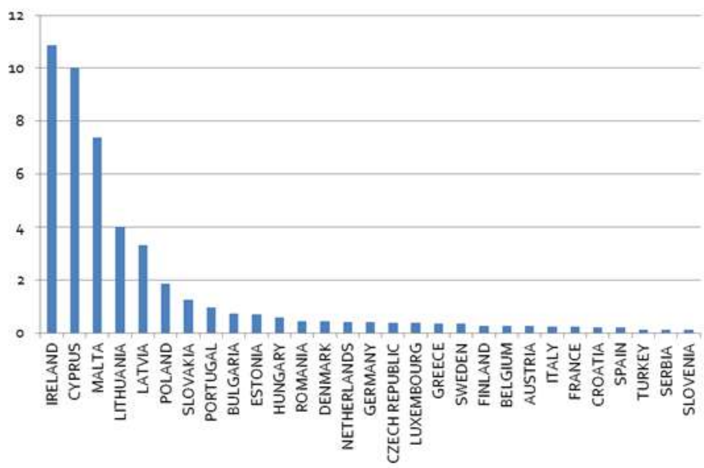


Source: ONS, Eurostat, Eurobank Research

3. Migration & remittances

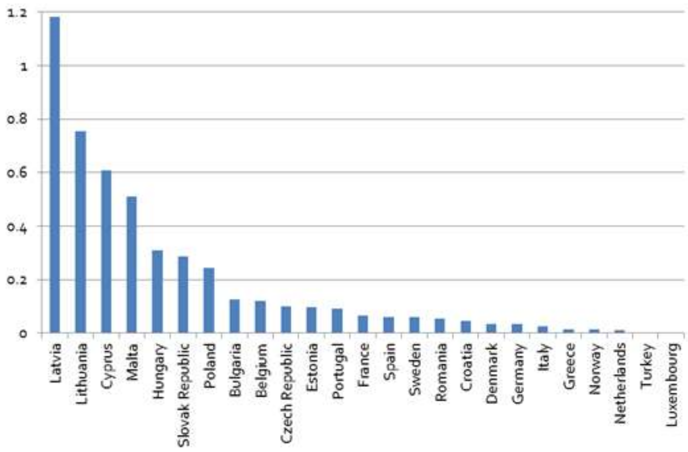
Migrants to the UK generally correspond to a small share of the total CESEE population. With the exception of Cyprus, Poland has the highest number of migrants to the UK with a population share of approximately 1.8%, while other countries in the region feature a share of less than 1% of their total population. Linkages between the CESEE economies and the UK in terms of remittances also appear to be rather limited, generally not exceeding 0.3% of a country's GDP. It is also worth noting that, even assuming its decrease as a result of Brexit, such a relatively insignificant source of income for the CESEE region is unlikely to be fully eliminated. Indeed it is rather unrealistic to assume that all migrants will be forced to leave the UK in the event of the latter exiting the EU. And, for those who will eventually decide to leave it is reasonable to assume that some of them may relocate to other EU economies, thus continuing to send remittances back home. A more immediate risk for remittances to the CESEE region may relate to the sterling's weakening after the Brexit vote. Yet, any incipient impact is likely to be manageable, given that the amount of remittances towards the region is relatively low in terms of GDP.

Migrants in the UK as percentage of origin country population (2015, %)



Source: United Nations, Eurostat, Eurobank Research

Net remittances from the UK (2015, % of GDP)

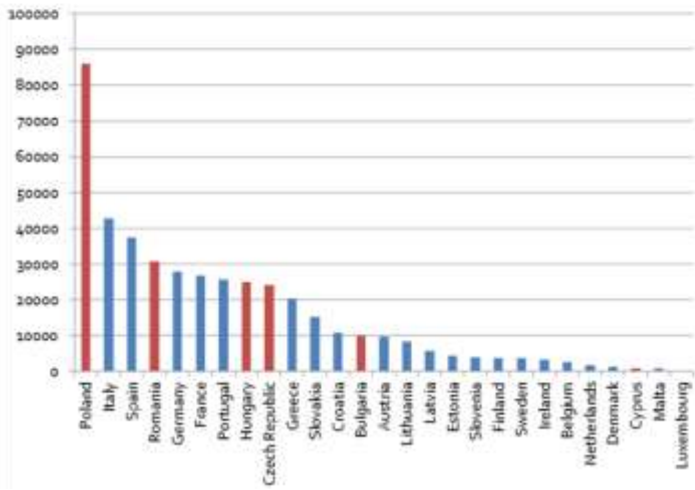


IMF, World Bank, Eurobank Research

4. EU Funds

CESEE economies are major recipients of EU structural and cohesion funds, with total EU budget commitments for the period 2014-2020 amounting to €433.3bn. Poland is the primary recipient of EU funding, scheduled to receive €86bn over the said time span, with Italy posing as the runner up, due to receive €42.7bn. Given that the UK is among the largest contributors to EU budget, this appears to be one of the biggest concerns over the impact of Brexit on the CESEE region. A renegotiation of the allocation of EU funding for 2014-2020 appears to be unavoidable after the Brexit vote. However, if there is no change in the designated funds for the period 2014-2020, any Brexit-related impact would be felt only after 2020.

EU ESI Funds (per recipient country, mn EUR)



Source: European Commission, Eurostat

5. EU Enlargement

Brexit could potentially have some important political economy ramifications for the region. It could put a temporary break on EU enlargement and future euro area membership applications. Most of the economies of our focus are relatively new EU members having the obligation (under the Accession Treaty of 2004) to become euro area members if convergence criteria are met. Some of the countries have had a tentative target of euro area accession (e.g. Romania in 2019) or were about to set a new formal target, which may be pushed back now.

6. Domestic Politics

The Brexit vote may strengthen Eurosceptic sentiment in the region, leading to an increase of the electoral power of anti-systemic political parties. Yet, the impact of the vote is unlikely to be uniform across the region. Although the governments of Romania and Bulgaria are in favour of more EU integration, this is not necessarily the case for the governments of the so called Visegrad group (Poland, Czech Republic, Slovakia and Hungary). In particular, the leaderships of Poland and Hungary have lately been particularly vocal in their criticism towards EU institutions. The Brexit vote may complicate things further and, as a best case scenario, push these countries to deepen their co-ordination on important economic and geostrategic issues at the EU level. That is, especially taking into account that the UK has often been a valuable political ally of these countries (and an advocate of their petitions) in the EU decision making process. Yet, given that both Poland and Hungary benefit from sizeable EU funding, it is rather unlikely that an exit-referendum would be initiated by these countries in the foreseeable future. In a more reassuring note, the Brexit vote occurred at a time when the near-term political risk calendar in the region is relatively light, with a number of important events having already taken place (e.g. parliamentary elections in Serbia and Cyprus, local elections in Romania). Yet, parliamentary elections in Romania and Presidential elections in Bulgaria are still ahead of us (November 2016 and October 2016, respectively). Additionally, a government has yet to be formed in Serbia, though general elections are already behind us. According to recent comments by Prime Minister Alexander Vucic, a new administration is expected to be announced in early July. The winner of the polls, the ruling Serbian Progressive Party (SNS), achieved a parliamentary majority to form a single party government. However, it appears to be seeking a stronger mandate via a coalition alliance. Among the parties that entered the parliament this year are the far-right nationalist Serbian Radical Party (SRS), which returned to the National Assembly after a four-year absence and the right-wing Serbian Movement Dveri, which is a newcomer in Parliament. In view of the recent rise in popularity of right wing/nationalist parties in Serbia, the Brexit vote may tip the scale towards a more Eurosceptic government.

The case of Cyprus: Challenges and Opportunities from Brexit

Cyprus is a special case in the broader region. A former colony of Great Britain, it gained independence in 1960 and maintains important ties with it. These ties are illustrated by the fact that around 85,000 residents in the UK, according to UN data, are of Cypriot origin (around 10% of the current population of the island).

Besides Ireland, Malta, Luxemburg and Belgium, Cyprus appears to be among the EU economies that are most sensitive to Brexit. UK is the second most important trade partner of Cyprus by value of transactions. Exports of goods to the UK stood at 9.6% of total goods exports in 2014 or 0.7% of GDP (the relevant numbers for 2015 were 6.9% and 0.8% of GDP). In addition, exports of services to the UK accounted for 20.8% of total services exports or 7.6% of GDP in 2014 (a large fraction of which is coming from the flourishing tourism sector). On the other hand, Cyprus imports a considerable amount of goods and services from the UK and currently runs a bilateral trade surplus of 2.6% of GDP with the latter. Furthermore, in recent years, the relative importance of the British tourist market has declined as the island has diversified towards other markets (Russia, Germany, and Israel).

Despite the perceived high degree of sensitivity, Brexit could pose an opportunity for the island as well. Cyprus enjoys comparative advantages such as full EU and euro area membership, a legal and judicial system based on the English Common Law, low corporate tax rates, a key geostrategic position island in the Mediterranean Sea, a facilitation of international business, and high-quality human capital. From that point of view, Cyprus could turn the Brexit into a lasting opportunity by attracting some departing businesses from the UK.

CESEE markets reaction to UK referendum and challenges ahead

EM asset prices fell sharply across the board in the wake of the UK referendum on June 23rd. The arguably unexpected result led to a knee-jerk reaction, with CESEE markets bearing the brunt of the decline as they are more closely related to the EU, both geographically and in terms of financial, economic and political linkages. Since then, most regional markets have recouped a significant part of their initial losses. Hopes about powerful policy responses and scaled back expectations for further Fed rate hikes in the coming months provided some support, following the negative initial reaction to the Brexit vote.

1. <u>Equity markets</u>

The MSCI Emerging Markets index, which plummeted by 4% intraday on June 24th, the first day after the announcement of the UK referendum results, managed to recoup more than half of its losses a week later. In the CESEE region, the main Polish WIG index firmed by ca 5% from a 5-month low hit on June 24th, while Hungary's BUX pulled back by more than 3% from a 2½ month trough and Romania's BETI rallied by more than 10% from a 3-year low reached on the same day.

2. <u>FX markets</u>

Regional currencies also recovered ground after coming under significant downward pressure in the wake of the UK referendum. The Polish zloty rose by more than 3% from a 4 ½ year trough of 4.5385/€ hit in Asian trade on June 24th. In a similar vein, the Hungarian forint firmed by 2% from a 1 ½ year low of 321.84/€, while the Serbian dinar inched up by 1% from a new record low of 124.26/€, with the €/RSD upside momentum over the last week capped by Central Bank intervention in order to halt the domestic currency's appreciation trend. Similar gains were also registered by the Romanian leu which pulled back from a 5-month low of 4.5600/€.

3. <u>Domestic rates</u>

A similar picture was evidenced in emerging sovereign debt markets, with Turkish paper that led the losses post-UK plebiscite recovering the most among CESEE peers. In more detail, the 2- and 10-year benchmark bond yield recoiled by ca 50bps each from highs hit on June 24th. In view of the sharp increase in market volatility as a result of the Brexit vote, the Polish Ministry of Finance canceled a switch auction scheduled for June 27 and the Serbian Public Debt administration failed to sell by a significant margin the planned amount of the scheduled June 24 tender.

4. <u>External debt markets</u>

In the EM credit space the first shock of the British leave vote came through the CDS market that opened on Friday morning around +50 bps wider before gradually managing to retrace part of the move, closing between 15 bps to 30 bps wider. As of today all this widening has been fully reversed, with spreads trading to levels prevailing shortly before the UK referendum. Investor sentiment was very weak for external debt bonds, which moved between 2pts and 6pts lower (up to +60 bps), but that was the initial overreaction as within a week the market recovered all of the losses.

Thursday 23/6/16													
Security	Ccy	Bid Px		Ask Px	Px Chg	SP Chg	Bid YTM		Ask YTM	Bid ZSpd		Ask ZSpd	S&P
USD*													
REPHUN 5⅜ 24	USD	111.3	-	111.8	0.15	-3	3.69	/	3.62	227	/	220	BB+
CROATI 6 24	USD	109	-	109.5	0.4	-7	4.58	/	4.51	318	/	311	BB
ROMANI 4⅞ 24	USD	110.4	-	110.8	0.25	-6	3.31	/	3.26	190	/	185	BBB-
SERBIA 7¼ 21	USD	114.8	-	115.3	0.25	-8	4.1	/	4	289	/	279	BB-
SLOVEN 5¼ 24	USD	112.9	-	113.3	0.1	-4	3.33	/	3.28	192	/	186	A
POLAND 4 24	USD	107.3	-	107.6	-0.05	1	2.92	/	2.87	151	/	146	BBB+
LITHUN 6⅝ 22	USD	120.5	-	120.8	0	0	2.66	/	2.61	141	/	137	A-
LATVIA 5¼ 21	USD	113.9	-	114.4	0	0	2.28	/	2.18	109	/	99	A-
TURKEY 4¼ 26	USD	100.3	-	100.8	0	0	4.22	/	4.16	266	/	260	N.A.
SOAF 5⅞ 25	USD	109.5	-	110	0.25	-7	4.6	/	4.53	309	/	303	BBB-
Friday 24/6/16													
Security	Ccy	Bid Px		Ask Px	Px Chg	SP Chg	Bid YTM		Ask YTM	Bid ZSpd		Ask ZSpd	S&P
USD*													
REPHUN 5⅜ 24	USD	110.4	-	110.6	0	9	3.81	/	3.78	265	/	262	BB+
CROATI 6 24	USD	107.5	-	108	-0.3	14	4.81	/	4.73	366	/	359	BB
ROMANI 4⅞ 24	USD	109.4	-	109.8	-0.15	11	3.46	/	3.4	231	/	225	BBB-
SERBIA 7¼ 21	USD	113	-	113.8	-0.25	13	4.44	/	4.29	348	/	333	BB-
SLOVEN 5¼ 24	USD	112.3	-	112.8	0	9	3.41	/	3.34	226	/	219	A
POLAND 4 24	USD	106.8	-	107.3	0.05	9	2.99	/	2.92	183	/	176	BBB+
LITHUN 6⅝ 22	USD	120.3	-	120.6	0	9	2.7	/	2.63	170	/	163	A-
LATVIA 5¼ 21	USD	113.6	-	114.1	0.05	7	2.33	/	2.23	138	/	128	A-
TURKEY 4¼ 26	USD	99.5	-	100.3	0.4	5	4.31	/	4.22	302	/	292	N.A.
SOAF 5⅞ 25	USD	108.8	-	109.5	0.25	7	4.69	/	4.6	345	/	335	BBB-

CESEE credit markets: short-term prospects post the Brexit vote

- A negative short-term shock that could prove out to be a good medium-term buying opportunity if regional markets underperform.
- Less of an argument for the FED and other CBs to increase rates any time soon, meaning that able liquidity conditions will persist. The plentiful and cheap availability of global USD liquidity is of critical importance to the pricing of emerging market assets, especially in view of the considerable rise in EM indebtedness over the past several years.
- Less likely to see significant new issuance near term, which will technically support existing credits.
- Ample global liquidity and good local demand is likely to put a floor on asset prices.

Long-term risks

- EM growth: Lingering uncertainty over the Brexit's impact on the growth outlook of the CESEE region. Impact is likely to be negative, but not overly significant.
- Monetary policy: A potential problem for CESEE economies in the event of Brexit is the potential of lower EU funding to the region. Economies such as Hungary, Poland, Czech Republic and Romania have been net beneficiaries of EU structural funds (a total of 13bn GBP paid by the UK into the EU budget in the last cycle). As long as there are no evident financial stability risks and extreme currencies depreciation, no extraordinary moves are expected from CESEE central banks in the foreseeable future. The mixture of fiscal loosening already in place (or planned) in CEE should be enough to partly counter the macro spillovers from Brexit, provided that no drying up of repatriation flows will materialize.

Outlook:

Although a potential Brexit would take time to materialize, CESEE markets will continue to follow closely related developments and official comments, with investors maintaining a cautious stance in the weeks and months ahead. Against this background, renewed bouts of increased volatility in the coming sessions cannot be ruled out, as uncertainty lingers over ensuing developments in the UK and the impact of the British vote on global growth and financial markets. That said, the recent decline in regional markets may well be perceived by some investors as a good opportunity to enter long positions in CESEE assets. That is, provided that upcoming events evolve in an orderly fashion.

Global markets' reaction to the Brexit vote

UK's vote to leave the EU came as a large surprise to global financial markets, prompting a significant *risk-off* kind of reaction. Yet, following the initial panic, major markets moved in a rather orderly fashion over the last few sessions, easing fears of a Lehman-type crisis situation. Undoubtedly, major central banks' explicit commitment to do whatever is needed to safeguard financial stability and EU 27 leaders' agreement on the need to strengthen the EU project have so far helped to sooth market tensions. Yet, sentiment remains fragile and markets may be poised for long -lasting volatility. The UK's Leave vote appears to have opened the way for a period of increased economic and political uncertainty whose duration and magnitude will likely be determined by a number of factors including, inter alia, policy makers' response to Brexit's spillover effects, the nature of the new EU - UK relationships and political developments in the UK and the EU-27 in the period ahead.

1. Equity markets

After recording hefty losses for two consecutive trading sessions (June 24 &June 27), major equity markets have recovered modestly thanks to the powerful (mostly, verbal) response of the G4 Central Banks. The BoE promptly declared that it stands ready to provide more than £250bn of additional funds through its normal banking facilities as well as substantial liquidity in foreign currency, if required. It also made clear that it will first wait to assess how economic conditions will unfold "in the coming weeks" before considering additional policy action. The rest of G4 Central Banks followed suit, providing reassuring statements of their intention to provide adequate liquidity through existing swap lines, if necessary, so as to address tensions in global funding markets. The EU-27 leaders' agreement at the June 27/28 Summit to support the EU project also helped to improve market sentiment. EU President Donald Tusk announced after the Summit's conclusion that the EU leaders reached important decisions on steps to: (i) deepen the Single Market further; (ii) continue to develop the capital markets union; (iii) stem irregular migration; and (iv) establish closer cooperation with NATO given unprecedented challenges facing the South and Eastern European borders. He also stated that the EU 27 leaders will hold an informal meeting in mid-September to discuss the UK's exit as well as the EU's future.

Against this background, the FTSEurofirst 300 index recouped some ground, recording cumulative gains of c. 5% in the sessions between June 28 and July 1. Yet, in spite of its latest recovery attempt, the index remains around 3.5% below its close on June 23. The UK' FTSE 100 outperformed hitting a multi-month peak on Monday, July 4 as the weaker GBP favours companies whose main bulk of earnings come from abroad.

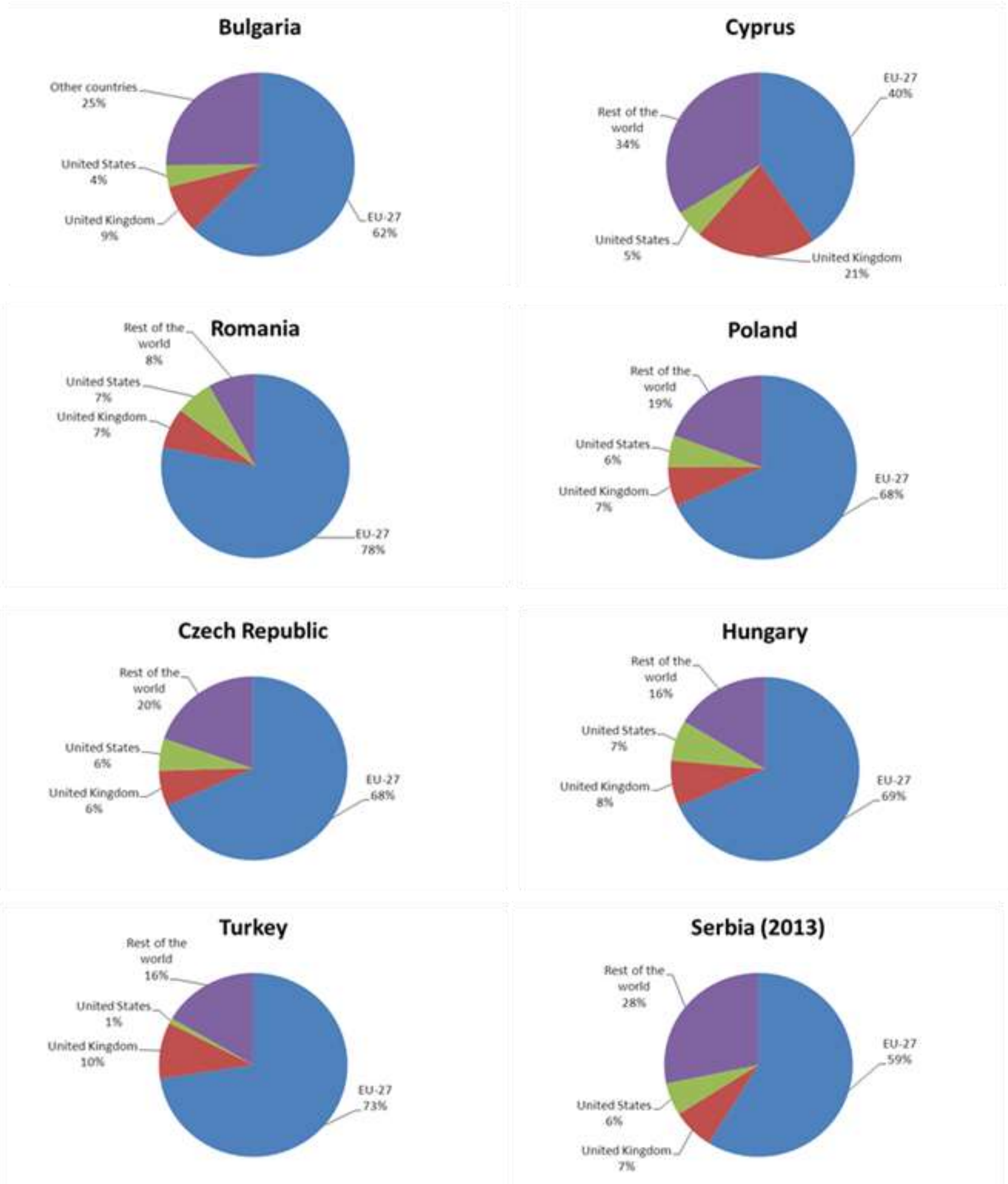
1. Currency markets

After hitting a multi-week high of 1.5020 in early trade on June 24 amid expectations that the Remain camp would win, the GBP/USD came under heavy selling pressure after the Brexit vote, hitting a 30-year trough near 1.3180. GBP's post-referendum weakness was also reflected on EUR/GBP, which hit a 2 ½ year peak of 0.8400 on July 1. Looking ahead, the sterling is expected to remain under selling pressure, regardless of how the broader risk environment will evolve. The Leave vote creates uncertainty about the growth prospects of the UK economy, while negotiations regarding the nature of the future EU-UK relationships as well as the type of post-exit trade agreements between the UK and other countries could last for a prolonged time period (two years or more). Against this background, investors are increasingly uncertain over the capacity of the UK to continue attracting sufficient investment flows to finance its large current account deficit, while many investors expect further BoE monetary easing in the period ahead in order to address increased stagnation risks in the UK economy. BoE Governor Mark Carny stated last week that, in view of the deteriorating UK growth outlook, further monetary policy easing is likely to be required this summer (e.g., a cut in the Bank Rate from 0.50% currently and/or a resumption of the QE programme). In addition deteriorated macroeconomic prospects, heightened domestic political uncertainty does not bode well for the sterling's outlook. UK Premier David Cameron's resignation paves the way for the appointment of a new party leader, and thus PM, planned for September 9th at the latest. Furthermore, Scottish people's clear support for Remain has raised the risk of another Scottish independence referendum. The technical picture for GBP/USD suggests that a retest/downward break of recent lows could open the way for further weakness towards 1.3000 or lower, while on the EUR/GBP axis, risks seem skewed for further gains towards 0.8600 or higher. Elsewhere, after hitting a three-month low of 1.0910 in the aftermath of the Brexit result, the EUR/USD regained some ground hovering around 1.1100 at the time of writing (Monday, July 4). Consolidation within the 1.0900-1.14000 range will likely prevail in the coming sessions/weeks while, further out, a lot will depend on the ECB's response to address spillover effects from a UK exit and the way negotiations about the future EU-UK relationships will evolve. The ECB is expected to retain a wait and see stance for the time being as it needs time to assess economic and financial consequences on the euro area economy from the UK vote. However, if it becomes clear over the coming weeks/months that the UK vote derails significantly the still fragile euro area economic recovery, the European Central Bank may well adopt a more dovish stance by e.g. further extending its present QE programme. In an environment of lingering uncertainty, both the JPY and the CHF are expected to remain well supported favoured by their perceived safe-haven status. Yet, the extent of any renewed upward pressure on these currencies will likely depend on the determination of the respective national central bank to intervene to prevent excessive currency strength. With respect to USD/JPY, the recent 2 ½ year low of 99.10 (June 24) appears to be the "line-in-the-sand" beyond which Japanese authorities could potentially intervene in FX markets to halt the JPY's upward momentum. Meanwhile, recent prior action suggests that the SNB is determined to contain any renewed EUR/CHF downward pressure within the 1.0600/1.0700 range.

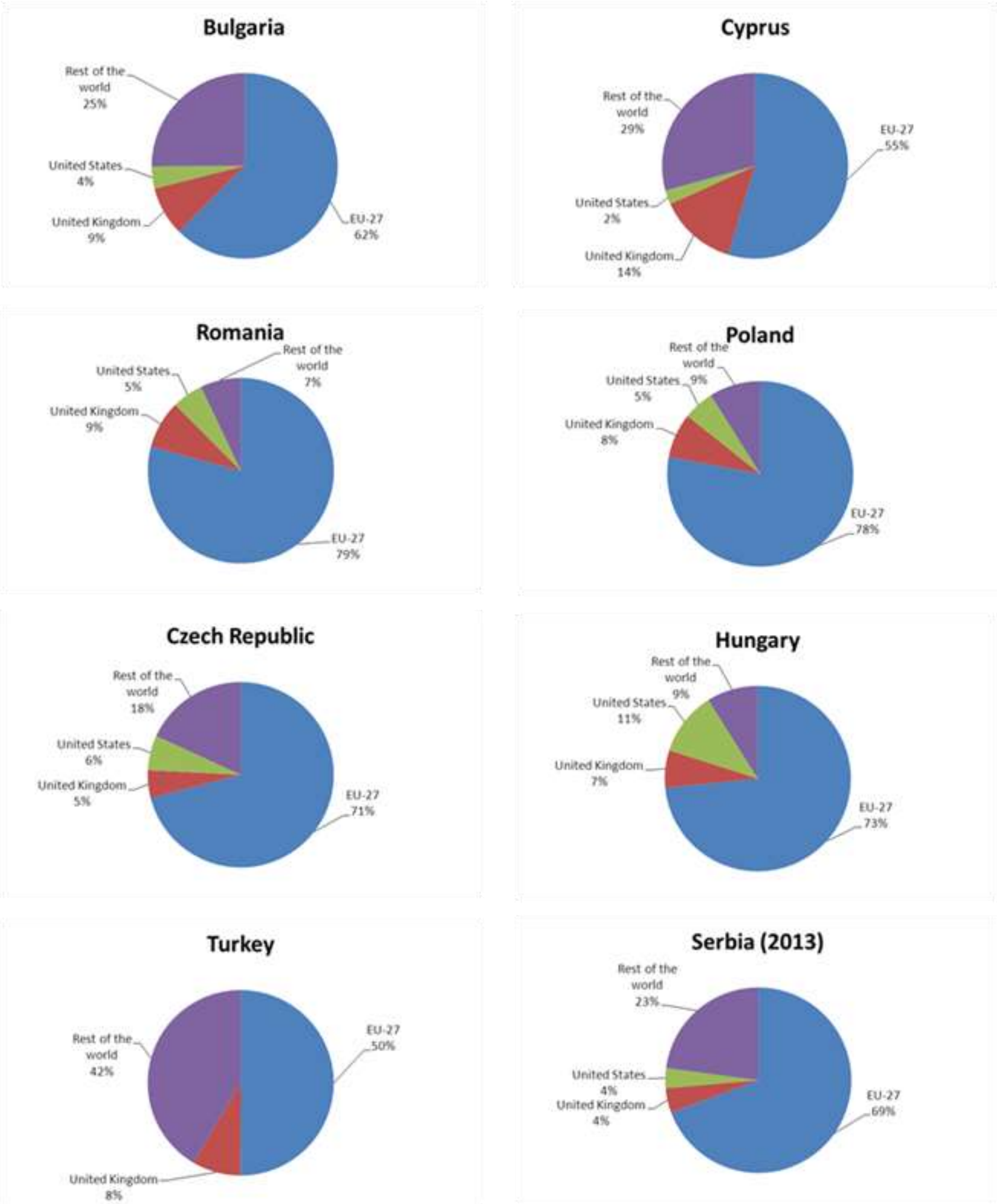
2. Fixed income

Flight to safety in the wake of in the UK vote favoured major government bond markets with yields hitting new multi-week and month lows across all tenors. Long-dated maturities outperformed on expectations about a prolonged period of uncertainty until the Brexit roadmap becomes clearer. German government bond yields with maturities up to 10 years are currently trading into negative territory, with those below 8 years having moved below the ECB's deposit facility rate of -0.40%. [1] Along the same lines, US Treasuries rallied with the 10-yr US Treasury yield falling from levels near 1.75% ahead of the UK referendum close to 1.38% all-time low. UK gilts proved the star performers with the 10-yr UK gilt falling to a new record low of 0.780% (Friday, July 1). That is, in spite of some upward pressure coming on the back of a downgrade of the country's sovereign credit rating to AA by Fitch and S&P (from AAA and AA+ previously, respectively). Against this background, the 10-yr UK/US spread widened to around 60bps, the widest since early 2006. Looking ahead, even in the absence of a new bout of risk aversion, anticipation of loose monetary policy for longer from major central banks, lower nominal growth expectations and uncertainty related to the future EU-UK trade relationships, are likely to continue favouring safe haven assets. Looking at the 10yr government bond yields of other EMU states, all of them with the exception of Italy, Greece and Portugal are currently lower than before the Brexit vote presumably supported by improving market sentiment over the last few sessions and steady ECB demand in the context of its PSPP programme. The 10-yr GGB/Bund yield spread was hovering around 820bps in European trade on Monday July 4st, c. 50bps narrower from a two-month high hit on June 24th but below levels close to 700bps tested in late May following the completion of the 1st programme review.

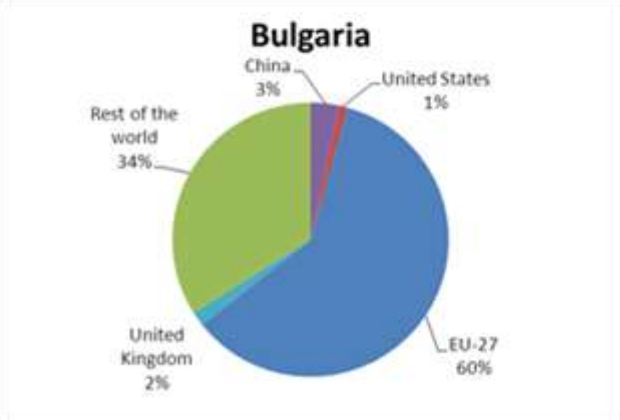
Exports of services to UK vs Rest of the World (2014)

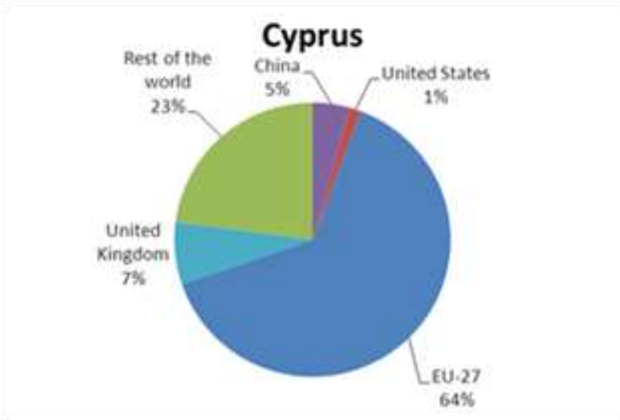


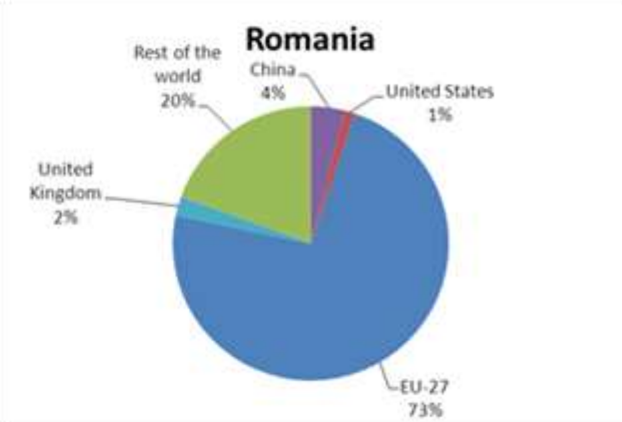
Imports of services from UK vs Rest of the World (2014)

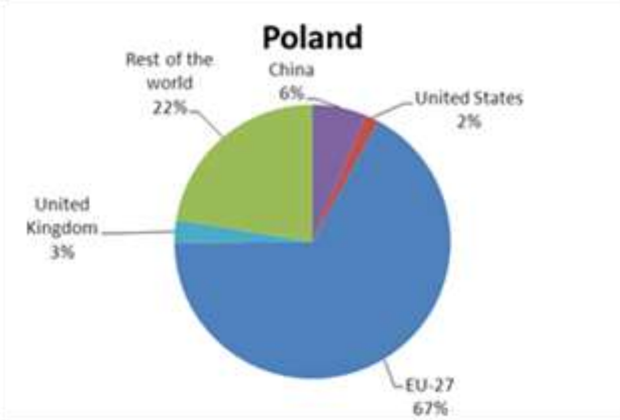


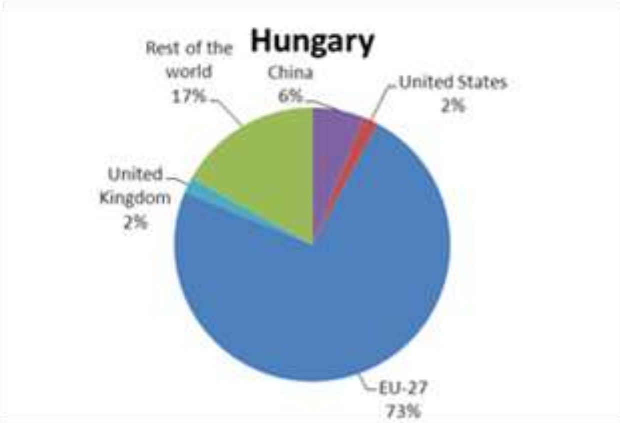
Imports of goods from UK vs Rest of the World (2014)

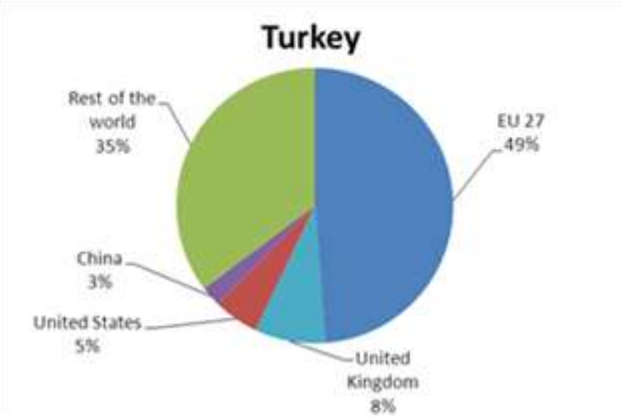


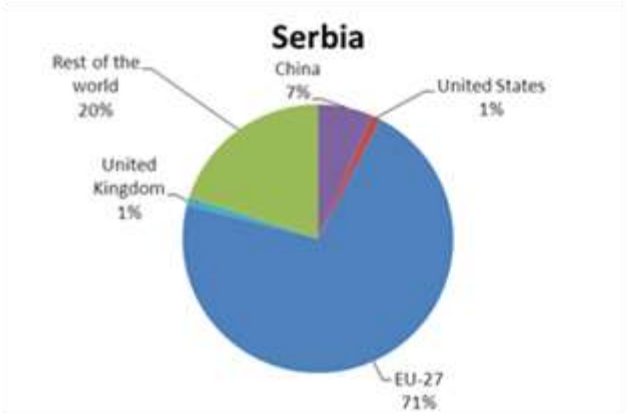




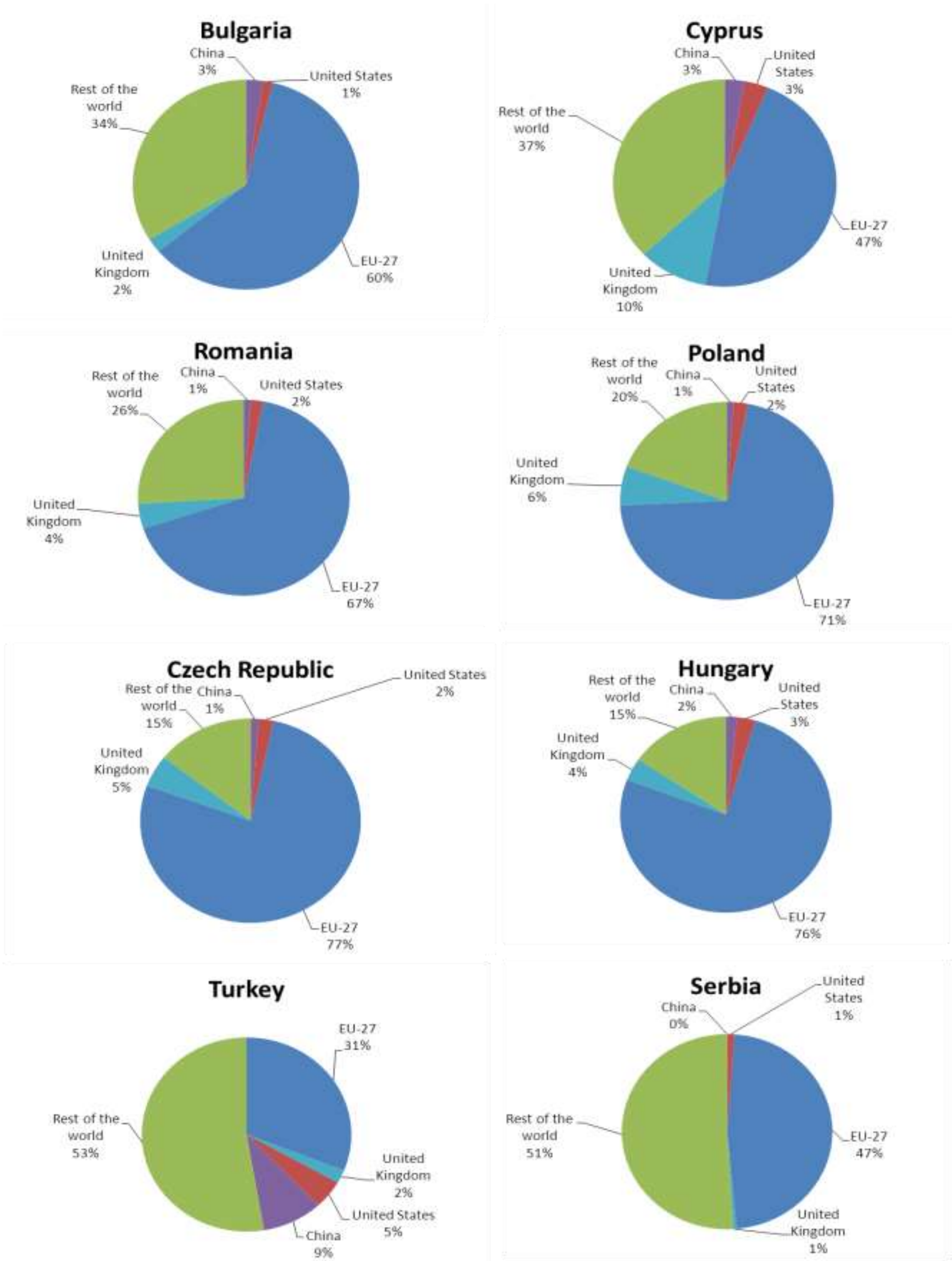








Exports of goods to UK vs Rest of the World (2014)



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