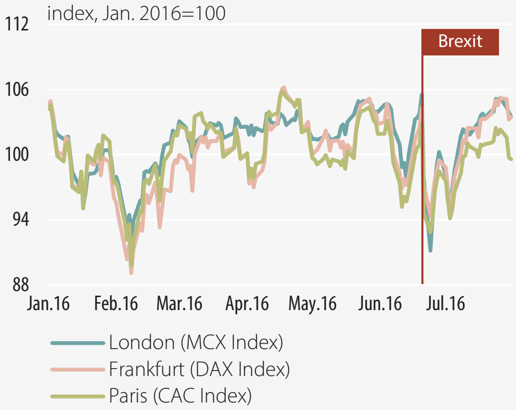
Box 3. The impact of the Brexit referendum result on macroeconomic developments in Romania

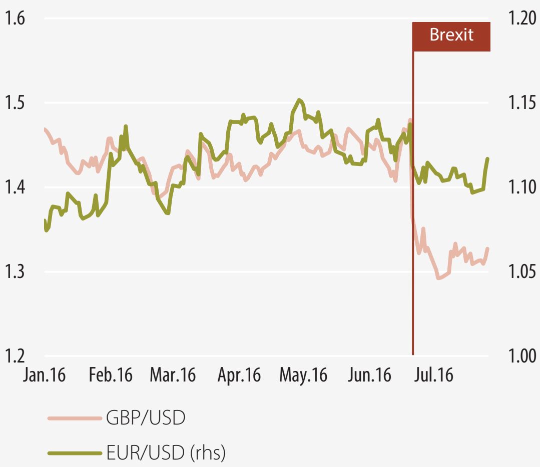
On 23 June 2016, the United Kingdom voted to leave the EU, an event with highly uncertain geopolitical and economic implications worldwide. This decision fallout is currently difficult to assess, given the numerous unknowns, all the more so as this is an unprecedented process in EU history. The most plausible scenario sees Britain's separation from the EU taking relatively long to complete, namely about two years from the moment Article 50 of the European Union Treaty is cited.

Chart A. Main Stock Exchange Indices in Europe



Source: London Stock Exchange, Börse Frankfurt, Euronext, NBR calculations

Chart B. GBP and EUR Exchange Rates



Source: Federal Reserve System

The immediate effects, that occurred amid the increase in risk aversion, referred to falls in the main stock exchange indices in Europe (Chart A) and the shift in some financial capital flows to safe haven countries, such as the USA or Switzerland, which triggered the substantial depreciation of the pound sterling and, to a lower extent, of the euro versus the major international currencies (Chart B). Although these evolutions saw a correction subsequently it is possible that they re-emerge in the future, depending on the manner negotiations are carried out during the separation process. No major adverse impact has been felt so far on financial markets in Romania.

Looking ahead, Romania's economy can be affected both directly and indirectly. Direct influences can be passed through via: trade, the financial channel, labour migration and remittances; indirect channels refer to possible contagion effects coming from a worsening of the political and economic context in the EU. The latter effects may have a relatively stronger impact, as the likely adverse bearing on the United Kingdom's main trading and financial partners in the EU (especially in the context of a worsening of investor sentiment) carries the potential to affect the Romanian economy too, given its high integration with the European bloc.

The risks arising from direct economic relationships are rather low. Accordingly, in 2015, exports to the United Kingdom accounted for 4.35 percent of Romania's total exports of goods, while imports from the UK carried 2.5 percent of total imports. Moreover, the local economy's exposure to the value added absorbed in the United Kingdom (calculated based on the fact that goods imported by this country can incorporate value added created in Romania, without their being subject to a direct trade relationship) is limited, namely below 2 percent of GDP. Consequently, both the worsening of the British economy's outlook and the likely tariff hikes or imposition of non-tariff barriers to trade with this country are expected to have a modest impact on Romania's trade via the direct channel.

The analysis of financial ties between Romania and the United Kingdom covers several aspects. Thus, the market share of Romanian credit institutions with British capital is insignificant, implying a low direct exposure of the Romanian banking system to that in the UK, although indirect exposure via the EU banking system is quite important. At the same time, according to the latest statistics[77], foreign direct investment in Romania by British entities held only 2.5 percent of total FDI and 1 percent of GDP (EUR 1.5 billion) at end-2014. Therefore, UK's exit from the EU does not pose a significant risk for such capital to be withdrawn from Romania, given also the higher resilience of these categories of financial flows. Financing from EU sources will not be affected for as long as the United Kingdom continues to be an EU Member State with full rights (over the next two years at least). Subsequently, the amount of EU funds earmarked for Romania will depend on the manner in which the United Kingdom will negotiate its financial position towards the EU[78] – limiting the contributions of this state to the EU budget has become relevant for Romania in the context of the recent improvement in the absorption rate (up to 75 percent for the 2007-2013 financial period), even if absorption is still lower than in other new Member States (90 percent in Poland and Hungary).

Based on Eurostat data, the number of Romanian immigrants in the United Kingdom amounted to approximately 178,000 in 2015, accounting for about 6.7 percent of total Romanian immigrants in Europe, trailing behind countries such as Italy, Spain or Germany. Depending on future events, should part of Romanian immigrants with residence permits in the United Kingdom return to Romania, the economic impact would be positive, but rather low. Relative to future developments of emigration to the United Kingdom, this would have dropped in the medium run even in the absence of Brexit, since on the occasion of the European Council meeting of 18-19 February 2016, a decision was taken to restrict new EU immigrants' access to social benefits for a seven-year period as of 2020[79]. Following the British labour market opening in 2014, remittances[80] were on a strongly upward trend, coming in at roughly EUR 500 million in 2015 (one fifth of total remittances by Romanian workers abroad and approximately 0.3 percent of Romania's GDP).

Looking at indirect influences, various studies and surveys among financial analysts (for instance, *Consensus Economics*) suggest that the actual Brexit, leaving aside other domino effects on the EU, would depress the economic growth rate across the EU by up to 0.4 percentage points until the macroeconomic projection horizon in the baseline scenario. In this case, the NBR's in-house assessments hint at an economic slowdown in Romania by approximately 0.2 percentage points via the trade channel for 2017 and a fall by about 0.1 percentage points in the CPI inflation rate for the end of the same year.

Should Brexit trigger a weakening of the European project across EU institutions, the contagion effects on the new non-euro area Member States could be stronger – large capital outflows, sharper exchange rate volatility, the materialisation of shocks on financial systems as a result of the deterioration of investor sentiment vis-à-vis these economies, a slowdown in local economic activity via the trade channel.

[77] *Foreign Direct Investment in Romania in 2014*, the National Bank of Romania.

[78] Based on the settlement negotiated with the EU, the United Kingdom could contribute further to the EU budget or grant non-repayable assistance to the new EU Member States.

[79] This settlement would have taken effect if the United Kingdom had remained in the EU.

[80] Comprising net inflows from "compensation of employees" and "workers' remittances from abroad" in the balance of payments.