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Brexit Sensitivity Index 2019: Who Has The Most To Lose?

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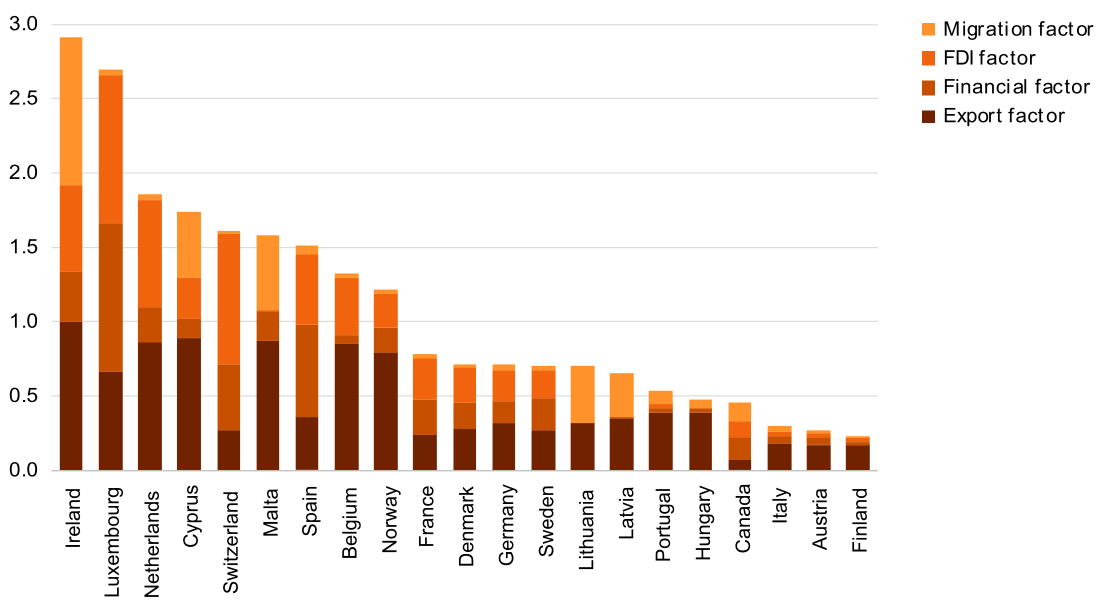
S&P Global Ratings' latest survey of 21 countries most exposed to Brexit lists Ireland, Luxembourg, and the Netherlands as the economies most susceptible to any trade and migratory aftershocks.

Brexit Sensitivity Index (BSI)



Data Sources: U.K. Office of National Statistics, BIS, Eurostat, European Central Bank, S&P Global Ratings, United Nations Department of Economic and Social Affairs.

Our Brexit Sensitivity Index (BSI) measures goods and services exports to the U.K., bidirectional migrant flows, financial sector claims on U.K. counterparties on an ultimate risk basis, and foreign direct investment (FDI) in the U.K. (excluding FDI claims attributed to special purpose entities, see Appendix). The BSI is the sum of these four data points all normalized and converted into a scale from 0 to 1. The higher the sum, the greater the exposure.

We first published our BSI on June 9, 2016, two weeks before the U.K. national referendum on whether the country should leave the EU. Since then, we have modified our methodology for calculating two of the four BSI factors, so that the data more accurately reflect financial linkages between European economies and the U.K.

What's Changed Since 2016?

Nine of the 10 countries with the greatest exposure to Brexit in 2016 are still in that group today, although there has been a reshuffling in the rankings. Perhaps the most notable change is that the Netherlands has moved up four places to become the third most vulnerable economy. Between year-end 2015 and year-end 2018, Dutch exports to the U.K. increased by nearly 0.6% of GDP, and Dutch banks still carry high exposures to U.K. counterparties.

For the 2019 BSI, we have included Portugal for the first time. Its ranking of 16 indicates relatively low exposure, stemming from low FDI and financial sector claims on the U.K., despite significant export and migratory exposures.

The other key difference we've observed is the contrasting approaches larger European banking franchises are taking toward their U.K. exposures. Compared with end-June 2016, the banking systems of Belgium, Germany, Ireland, and Switzerland have cut their exposures to U.K. counterparties--a trend in place long before Brexit was contemplated. In contrast, since the U.K. referendum, banking systems in the Netherlands, France, and Spain have increased their U.K. business, when measured on an ultimate risk basis.

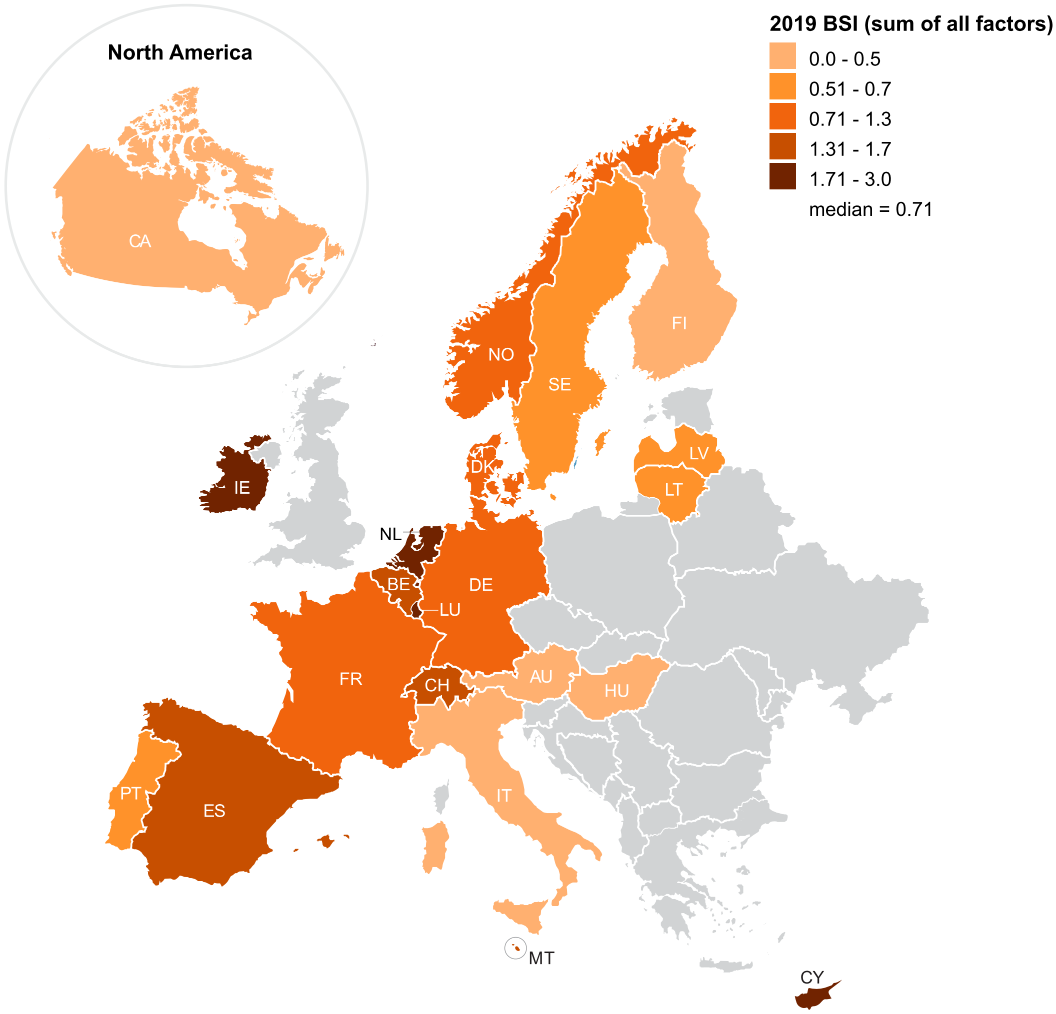
At the same time, the financing of the U.K.'s large external deficits has shifted away from FDI toward portfolio equity and debt [see the U.K. Office of National Statistics (ONS) third-quarter 2018 Balance of Payments report]. This indicates to us that, during 2018, concerns about the consequences of Brexit for the U.K. have already led to a weaker global and European appetite to make long-term investments in the British economy. This is something to watch, in light of the U.K.'s current account deficit of 5% of GDP, the second highest in the world in absolute terms.

The BSI: How Things Stand In 2019

Of the 21 sovereigns most exposed to Brexit, only two (Canada and Switzerland) are not EU members, and one (Canada) is not European.

2019 Brexit Sensitivity Index

2016 Rank	2019 Rank
Ireland	Ireland
Malta	Luxembourg
Luxembourg	Netherlands
Cyprus	Cyprus
Switzerland	Switzerland
Belgium	Malta
Netherlands	Spain
Spain	Belgium
Norway	Norway
Sweden	France
France	Denmark
Germany	Germany
Denmark	Sweden
Lithuania	Lithuania
Latvia	Latvia
Canada	Portugal
Finland	Hungary
Hungary	Canada
Italy	Italy
Austria	Austria
	Finland



Countries not drawn to scale. Data Sources: U.K. Office of National Statistics, BIS, Eurostat, European Central Bank, S&P Global Ratings, United Nations Department of Economic and Social Affairs.

Scores Above The Median

1. Ireland (BSI 2.9; 2016 Ranking: 1)

The 2.9 result for Ireland is more than 4x the 0.7 median, implying significant reverberations in the Irish economy should the U.K. leave the EU, particularly should it do so without a formal agreement that includes a transition period. Ireland's 499-kilometer border with the U.K. encourages vigorous trade in merchandise and services, as well as substantial migratory flows between the two countries. At 8.5% of GDP, Ireland exports more goods and services to the U.K. than any other sovereign on the index. Deep supply chains extend between Ireland and Northern

Ireland, not least in agro and food processing. Indeed, Northern Ireland is the U.K. region with the closest trade links with Ireland, making up around 15% of total trade.

Another byproduct of Ireland's location is the large bidirectional immigration between it and the U.K. The sum of Irish residents in the U.K. and vice versa totals 16.7% of Ireland's population, according to data from the ONS and the U.N.'s Department of Economic and Social Affairs. That figure is twice that of the next largest bidirectional migratory figure, namely 8.35% for Malta, and far exceeds two-way migratory flows from southern European countries such as Spain (1% of Spain's population), the seventh most vulnerable nation on our BSI.

Ireland's financial sector's exposure to the U.K. is the fourth highest of all 21 economies surveyed, reflecting the size of Irish banking subsidiaries operating in the U.K. Yet financial sector claims are down compared with that in 2016, as the Irish banking system continues to reduce its U.K. footprint.

Given all of these connections with the U.K., there is little doubt that a no-deal Brexit would represent a sizeable shock to Ireland's small open economy. Nevertheless, we would expect that Ireland's highly flexible economy would reorient trade toward even larger trading partners, such as the remaining EU countries and the U.S. We also think that Ireland is well placed to attract some of the FDI displaced from a post-Brexit U.K., should U.K.-based financial subsidiaries and branches lose their coveted EU passporting rights, which currently enable them to sell financial services in the EU market.

2. Luxembourg (BSI 2.7; 2016 Ranking: 3)

Luxembourg's sizeable claims on U.K. financial institutions, and high exports (many rebooked via Luxembourg for tax purposes) explain its position as the second most vulnerable country. To measure Luxembourg's FDI claims on the U.K., we used ONS data, excluding claims by special purpose entities (SPEs), which we estimate make up over 95% of Luxembourg's FDI in the U.K. SPEs, while legally resident in Luxembourg, are controlled by foreign parents; their purpose is to enable foreign companies to issue debt, and retain earnings including royalties in the most tax-efficient way possible.

As a consequence of the export and capital flows connected to these SPEs, Luxembourg's BSI probably overstates its vulnerability to Brexit. Nevertheless, as a small open financial services center that uses its sovereignty to operate as a financial conduit for many of the world's largest companies, Luxembourg is vulnerable to any effects that the U.K.'s departure from the EU might have on its vast financial and business services sectors.

3. Netherlands (BSI 1.9; 2016 Ranking: 7)

Over the past three years, the Netherlands' relative exposure to Brexit increased as a result of several factors:

- Significant exports of goods and services to the U.K., of 7.3% of GDP in 2018 versus 6.7% of GDP in 2016 (ONS data), the third highest after Ireland and Malta.
- Substantial inbound FDI (netted for SPEs) into the U.K., based on ONS estimates.
- On an ultimate risk basis, Dutch banks' increased claims on U.K. counterparties, up 24% to 11.5% of GDP since the referendum vote on June 23, 2016. This is the fourth highest exposure as a share of GDP among the 21 economies in the survey. It also contrasts with declines in U.K. counterparty exposures in Belgium, Germany, Ireland, Switzerland, and Malta since the U.K.'s

national referendum.

For the Netherlands, export exposures (ONS data) may be overstated due to high re-exports and royalty payments. However, these confirm just how open the Dutch economy is, with its large transport and maritime sectors. The Netherlands remains the largest maritime freight transport country in Europe, home to the three largest ports by volume on the continent.

4. Cyprus (BSI 1.7; 2016 Ranking: 4)

With its large tourism, auditing, and financial sectors, and historical connections to the U.K., Cyprus remains close to the top three economies most exposed to Brexit. Cyprus hosts a large population of U.K. pensioners, as well as two military bases, technically a British Overseas Territory that accounts for 3% of Cyprus. Also, a large portion of Cypriot nationals live and work in the U.K. We estimate that annual remittances of Cypriot nationals resident in the U.K. to Cyprus amount to around 0.2% of Cyprus' annual GDP. This is a substantial figure, albeit below that for Hungary (0.3% of GDP), Lithuania (0.4% of GDP), and Latvia (0.6% of GDP).

Cyprus is no stranger to external shocks, having managed to retain much of its business services sector and to recover economically from the 2012-2013 financial crisis and sovereign default. Even so, Brexit could create headwinds for its economy, given the importance of migratory, export, and financial links between the two countries.

5. Switzerland (BSI 1.6; 2016 Ranking: 5)

Switzerland's exposure to the U.K. is primarily via sizable FDI holdings and large financial sector subsidiaries and branches in the U.K. These entities book trading positions and engage in wholesale funding operations with U.K. counterparties. Compared with 2016, the Swiss financial sector's claims (on an ultimate basis) on U.K. counterparties have declined by 14%, although the downsizing of Swiss financial operations in the U.K. predates the Brexit referendum.

Nevertheless, at an estimated 21.7% of GDP, Switzerland's financial sector exposures to the U.K. remain the third highest after Spain and Luxembourg (compared with the second highest in 2016). Other links to the U.K. economy are more modest. Switzerland's direct exports of goods and services represent an estimated 2.3% of GDP versus the 3% median for the 21 economies on the BSI; bidirectional migration is minimal at 0.4% of the Swiss population compared with the 0.6% median.

Although we did not include a currency risk channel in our metric, we note that the Swiss franc, along with all of the Nordic currencies, is vulnerable to flight-to-quality appreciation pressures in the event of a no-deal Brexit, in our opinion.

6. Malta (BSI 1.6; 2016 Ranking: 2)

Like Cyprus, Malta exports a substantial amount of tourism and business services to the U.K., and has a large population of resident U.K. national pensioners. Malta's financial claims on the U.K. are, moreover, larger than Cyprus'. However, excluding SPEs, Malta's inward FDI into the U.K. is essentially zero.

7. Spain (BSI 1.5; 2016 Ranking: 8)

Of all the economies whose GDP exceeds €1 trillion, Spain stands out as the most exposed to Brexit. This is chiefly a consequence of Spanish banks' ownership of large U.K. retail banking franchises. We measure the exposure of a country's banking system to U.K. counterparties on a consolidated, ultimate risk basis, using Bank of International Settlements (BIS) data. Using this metric (which includes Spanish commercial bank subsidiaries' balance-sheet exposures), Spain's financial claims on the U.K. amount to 30% of Spanish GDP, the second highest after Luxembourg. Had we used a non-consolidated estimate of cross-border funding instead, Spain's financial claims on the U.K. would have been considerably lower.

Most of Spain's financial sector business in the U.K. comprises self-funded retail banking rather than wholesale and trading businesses, in contrast to those of Germany, Switzerland, France, and most of the other economies in this survey, excluding Ireland. This, however, arguably makes it more sensitive to any economic fallout from a no-deal Brexit, should that include prolonged weakness of the real economy, including the labor market.

Given the large Spanish financial franchises in the U.K., as well as large investments in telecoms, insurance, and infrastructure concessions, Spain's FDI exposure to the U.K. economy is also substantial, at 4.7% of GDP. This is the highest of all economies in our BSI with GDPs larger than €1 trillion. We estimate that about one-sixth of Spain's total outbound FDI is in the U.K., a figure that has roughly doubled since 2006.

Spain's exports to the U.K. have increased, by an impressive 0.3% of its GDP, to 3.1% of GDP since we last published the BSI, and is higher than that of other large member states, including Germany. However, it is considerably lower than the trade exposures of smaller more open economies like Ireland, the Netherlands, Cyprus, Malta, and Norway. Migratory flows between Spain and the U.K. are large in absolute terms but, at around 1%, are less important than the percentage figures for Ireland, Cyprus, Malta, and the Baltics.

8. Belgium (BSI 1.3; 2016 Ranking: 6)

As a small open economy, Belgium's BSI of 1.3 indicates relatively high exposure versus the 0.7 median. Since 2016, Belgium's export exposure to the U.K. has increased to 7.2% of GDP from 6.8%. By comparison, its FDI claims on U.K. residents have declined to 3.8% of GDP from 5.6%, largely due to retrenchment from financial services and London. At the same time, it is noteworthy that, like Germany and Switzerland, the size of Belgian financial institutions' risk exposures to U.K. counterparties has reduced considerably, although (also like Germany and Switzerland) this trend of derisking predates the U.K. referendum.

9. Norway (BSI 1.2; 2016 Ranking: 9)

Norway's relatively high 1.2 BSI measure comes down to its gas exports to Britain, which we expect would not be affected by the U.K.'s departure from the EU. Norway is not a member of the EU, but is part of the European Free Trade Association.

The other economies we assessed are either close to or below the BSI median of 0.71.

The Others

While we think the Nordic currencies are vulnerable to further appreciation pressures should the U.K. leave the EU on April 12 without a formal deal, their trade, migratory, financial, and FDI exposures are average (Norway is the exception).

For the Baltics, we anticipate that Latvia and Lithuania (Estonia less so) would be affected by Brexit via the large number of nationals working in and sending remittances from the U.K. (estimated by Eurostat at 0.6% of GDP for Latvia and 0.4% of GDP in 2017 for Lithuania). Other Baltic exposures are negligible. No Baltic country is a net creditor, thus reducing the region's vulnerability to a currency or balance-of-payments shock connected to Brexit.

The U.S. isn't in the top 20 since the vastness of its economy means its U.K. exposures are relatively small, though large in absolute terms. Canada's only financial claims total an estimated 7.2% of GDP (down from 10.5% in the 2016 BSI) versus 8.1% of GDP for the median.

Portugal's exports of goods and services to the U.K., at 3.2% of GDP, and bidirectional migratory flows are larger than Spain's. But Portuguese banks and private sector have little in the way of claims on the U.K. economy.

What Our BSI Reveals

Our index does not reflect the potential political and market aftershocks of Brexit. Rather, it distills the current real and financial economic links to the U.K. economy, the world's fifth largest, while also indicating which sovereigns might be more exposed to an unwinding of the U.K.'s standout macro feature: its current account deficit of 5% of GDP.

As a major provider of equity and debt financing to the U.K., the Euro area is also the largest single investor in the U.K. Any change in the nature of the U.K.-EU relationship will have significant implications for Europe, but an even larger effect on the U.K., the only current EU member that we have not included in our BSI Survey.

Appendix

BSI = Exports of goods and services to the U.K./GDP + consolidated financial sector claims on the U.K. on an ultimate risk basis (BIS data, % of GDP) + Inward foreign direct investment in the U.K./GDP (ONS data, excluding FDI attributed to special purpose entities) + Bidirectional migrants as a percentage of the population.

- The population = a country's nationals resident in the U.K. + U.K. nationals resident in that country, divided by the country's population (UN Department of Economic and Social Affairs (2015).

- Sources: Trends in International Migrant Stock: Migrants by Destination and Origin (UN database, POP/DB/MIG/Stock/Rev.2015; population data from Eurostat)].

- SPEs have been netted against inward FDI data to remove third-party debt from equity.

This report does not constitute a rating action.