October 2016

What To Do With the UK?

EU perspectives on Brexit

Edited by Charles Wyplosz

A VoxEU.org Book

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Foreword

The negotiating table is almost set for Britain's exit from the European Union. In recent months, the Brexit debate has been primarily focused on the UK's future position within Europe. Little has been discussed about how this decision will affect the remaining 27 member states. With a preliminary date of March 2017 chosen to invoke Article 50 of the Lisbon Treaty, now is the time to begin formally discussing the challenges that both the UK and EU will face during negotiations.

Gathering the opinions of 25 authors from 15 different EU countries and Switzerland, this eBook discusses the major issues that face different countries in the wake of the vote for Brexit. These include questions of trade, foreign direct investment, labour mobility, the supremacy of the European Court of Justice, EU budget contributions and a host of other policies that may bring disruption to the negotiating process. The question of a 'hard' or 'soft' Brexit is likely to be a conflict-inducing matter for member states. For some, a hard Brexit would cause further damage to their post-crisis economies. For others, it would ensure the continuing legitimacy of the EU as an entity.

This eBook hopes to shed light on the beginning of the UK's long process of withdrawal from the European Union. It aims to gather the diverse array of views and create some consensus around the best way to approach the process, as the final agreement will need to be agreed upon collectively.

CEPR is grateful to our Policy Director, Charles Wyplosz, for taking the initiative to collate and edit this eBook. Our thanks also go to Simran Bola and Anil Shamdasani for the excellent and swift handling of its production. CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for an exchange of views on this crucially important topic.

Tessa Ogden
Chief Executive Officer, CEPR
October 2016

Introduction: Cycling backwards

Charles Wyplosz[1]
The Graduate Institute, Geneva and CEPR

For decades, Europe was about integration. Following the British referendum, the main issue now is disintegration. There was a time when the prevailing view of European integration was the ‘bicycle principle’: you must keep moving forwards; if you stop, you fall off. Cycling backwards is arguably much more difficult. This stunning change may be one reason why governments do not seem to have given much thought to what they would do in case the British people chose Brexit. They must now confront a highly complex and radically new negotiation. Hundreds of thousands of pieces of legislation, rules and regulations have become obsolete overnight. Pretty much like with an organ transplant, all these vessels must now be cut off and reconnected somehow because, one way or another, Britain – or what remains of it – will continue to be deeply integrated with its former EU partners.

Following highly emotional reactions, hopefully the time of rationality has come. The British and EU27 governments face two negotiations. First, the divorce proceedings will start when Britain invokes Article 50 (by the end of March 2017); the proceedings are required not to exceed two years, unless prolonged by a unanimous decision. Second, they will have to negotiate under Article 218 on all aspects of the future relationship between the UK and the EU as a whole. The EU27 currently does not intend to start the second negotiation before the first one is concluded.

From the EU27 side, the task is doubly complicated. Each government must decide what it wants and what it could be ready to concede. Then all 27 governments and the European Parliament must negotiate among themselves what their collective

1 I am grateful to Richard Baldwin for comments and to Roel Beetsma, Franc Klaassen and Rutger Teulings for permission to use tables that they initially prepared for their own contribution.

position will be for the second step, namely, negotiations with the UK. Importantly, any agreement must be approved unanimously by the 27 member countries and also by the European Parliament. This is an extremely tall order of requirement.[2]

This book is an effort to contribute to the extraordinary challenges that lie ahead. It focuses on economic issues and on the negotiating positions of the EU27 countries. I have asked leading economists from a large number of countries[3] what, in their view, their own country's strategy should be. The objective is not to dwell on the millions of thorny detailed issues that will come up, but instead to focus on the big picture. Each country has its own interests to protect, and possibly new ambitions, that are quite conceivably different from what other countries will want. Intentionally, there is no British contribution in the book. That requires another book, many other books in fact. Indeed, CEPR researchers have already contributed an eBook on the topic (Baldwin 2016).

Unsurprisingly, the responses are diverse. One reason is that the potential impact of Brexit varies from one country to another. Another reason is that the view of what the EU stands for, or *should* stand for, is not the same from one country to another. All sorts of historical and geopolitical issues pop up. A key ingredient of the Jean Monnet method was to avoid dealing with this set of issues, including the ultimate destination of the integration trip. What appeared then to be a brilliant strategy is now hitting back. Ambiguity can only take us so far…

The authors were asked what, in their views, the negotiation strategy of their own countries on economic matters could/should be. They were given free rein to structure their contributions and choose their topics. Most start by laying out the facts: the importance of trade, foreign direct investment and labour mobility for their countries.

2 To make matters even more complicated, the second negotiations are unlikely to be completed by the time the EU will have to decide on its Financial Framework for 2021-2028.

3 Contributions come from the 15 following EU countries: Austria, Belgium, Finland, France, Germany, Greece, Hungary, Ireland, Italy, the Netherlands, Poland, Portugal, Slovakia, Spain and Sweden. I also requested a contribution from Switzerland given this country's de facto integration into the EU and the current challenge posed by its own 2014 referendum that imposes restrictions to labour mobility. The chapters are presented in alphabetical order of the countries described by the authors.

Then come all sorts of important considerations ranging from domestic politics and history, to views on the EU and the role of principles. This chapter is an attempt to summarise the rich set of contributions.

Trade is not always the big issue

Table 1 shows how important direct trade is for the individual EU27 countries. Several facts stand out. First, the UK market is very important for some (usually small) countries, but much less so for others. The stakes, therefore, are not the same. Second, as shown by László Halpern in the chapter on Hungary, indirect trade may be more important than direct trade in some cases. This is one aspect of the new 'value chain' form of trade. Third, British exports to many countries are negligible or small for the UK. This would seem to suggest that the UK will not be very concerned by a trade agreement. This would be misleading. As a large country, the UK is relatively closed but, as a whole, the EU27 absorbs about half of its exports. Conversely, the UK is a relatively small market for the EU27 as a whole, though not for all individual countries. Of course, this is a narrow consideration, but one that may weigh in the mind of negotiators. Finally, as noted in some chapters, Britain tends to import industrial goods and to export services. If the final agreement were to treat the UK as just another third-party country, WTO rules would apply by default. These rules imply heavy tariffs for traditional industries, including agro-industrial products, which could hit some countries hard. In addition, this specialisation means that trade disruption would have redistributive effects along the lines of traditional trade models.

Table 1 Direct trade links with the UK

Country	Exports to the UK		Exports from the UK	
	€ billions	% of exporter's GDP	€ billions	% of UK GDP
Austria	4.36	1.7	2.20	0.1
Belgium	31.74	7.3	15.99	1.1
Bulgaria	0.59	1.7	0.48	0.0
Croatia	0.21	0.9	0.19	0.0
Cyprus	0.12	4.3	0.51	0.0
Czech Republic	7.53	4.5	2.67	0.2
Denmark	5.37	3.3	3.15	0.2
Estonia	0.33	2.2	0.30	0.0
Finland	2.78	1.9	1.85	0.1
France	32.13	2.1	24.49	1.6
Germany	89.25	3.5	41.81	2.8
Greece	1.08	1.3	1.21	0.1
Hungary	3.58	3.7	1.76	0.1
Ireland	15.28	14.1	22.97	1.5
Italy	22.46	1.6	11.59	0.8
Latvia	0.54	2.9	0.30	0.0
Lithuania	1.03	3.4	0.37	0.0
Luxembourg	0.74	10.1	0.30	0.0
Malta	0.15	9.1	0.52	0.0
Netherlands	47.48	7.6	23.98	1.6
Poland	12.08	3.3	4.98	0.3
Portugal	3.35	2.7	1.72	0.1
Romania	2.38	1.8	1.36	0.1
Slovak Rep.	3.76	5.2	0.61	0.0
Slovenia	0.54	1.5	0.28	0.0
Spain	18.72	2.4	12.17	0.8
Sweden	9.07	3.2	6.08	0.4

Note: This table was prepared by Roel Beetsma, Franc Klaassen and Rutger Teulings as part of their contribution to this book. It has been moved here to avoid repetitions in other chapters.

Sources: Exports in billions are obtained from the IMF (2016a). They are presented in current (i.e. 2015) euros by converting local currency into euros against the average exchange rate of 2015. Exports as a share of GDP are calculated by multiplying total exports as a share of GDP, both numbers obtained from the IMF (2016b), by exports to the UK as a share of total exports, both numbers obtained from IMF (2016a).

Foreign direct investment matters in some cases

For many smaller countries, foreign direct investment (FDI) in either direction is negligible, as shown in Table 2. In others, though, it is very important and usually flows both ways. Luxembourg, Ireland and the Netherlands receive from and send to the UK considerable amounts of FDI. Part of these flows may relate to tax optimisation, which stands to divide EU27 countries. Another part, though, reflects value chain trade. It is noteworthy that for some of the largest countries (France, Germany, Spain) FDI *from* Britain largely exceeds FDI *to* Britain, suggesting that British firms subcontract production to these countries. Keeping these flows open may well be an important objective for the EU27.

The City of London

It is well understood that a key objective for the UK will be to maintain the supremacy of the City of London. Passporting rights, which allow financial institutions registered in one country to operate in all other EU countries, are the key element here. Some large countries (France, Germany, Italy) consider that scale matters and that they stand to gain some of the business that the City would lose if its passporting rights are revoked. These considerations matter. With well-established links to the City and a tradition of providing international financial services, some smaller countries (Ireland, Luxembourg, the Netherlands) also expect to benefit from an end to passporting rights for the UK. These views are incompatible. If scale matters, we should expect much of the City's business to migrate to just one place, not to be scattered among many countries. This realisation could work against a united front. Besides, financial firms may develop strategies that allow them to keep most of their activities, especially the most lucrative ones, in London.

Table 2 Accumulated foreign direct investment in and from the UK, 2014

	Accumulated investment in the UK		Accumulated investment by the UK	
Country	€ billion	% of investor's GDP	€ billion	% of UK GDP
Austria	2.87	0.87	1.22	0.05
Belgium	31.8	7.93	13.6	0.60
Bulgaria	0.01	0.02	0.17	0.01
Croatia	--	--	0.28	0.01
Cyprus	4.61	26.5	0.65	0.03
Czech Republic	0.01	0.01	2.08	0.09
Denmark	8.37	3.21	8.71	0.39
Estonia	--	--	0.15	0.01
Finland	1.85	0.90	1.30	0.06
France	94.3	4.41	47.4	2.10
Germany	62.1	2.13	29.5	1.30
Greece	0.24	0.14	1.93	0.09
Hungary	-0.01	-0.01	1.11	0.05
Ireland	17.0	8.82	41.9	1.85
Italy	5.51	0.34	12.3	0.55
Latvia	--	--	0.13	0.01
Lithuania	--	--	0.08	0.00
Luxembourg	97.8	200	134	5.93
Malta	0.79	9.70	--	--
Netherlands	218	32.9	147	6.52
Poland	0.14	0.03	6.19	0.27
Portugal	0.58	0.34	3.14	0.14
Romania	0.01	0.01	1.05	0.05
Slovakia	0.00	0.01	0.29	0.01
Slovenia	0.01	0.03	--	--
Spain	56.7	5.44	20.2	0.89
Sweden	12.0	2.77	22.4	0.99

Note: This table was prepared by Beetsma et al. as part of their contribution to this book. It has been moved here to avoid repetitions in other chapters.

Sources: Foreign direct investment data are from the Office for National Statistics (2015a,b), all in 2014 pounds and converted into euros using Eurostat (2016b) data. GDP data are from Eurostat (2016a).

Labour mobility is the big issue

Free labour mobility and the ban on discrimination against foreign nationals hailing from the EU constitute one of the four freedoms that – along with the mobility of goods, services and capital – are considered a fundamental pillar of the EU. Prior to the referendum, the British government asked for some exemptions concerning both the right to settle in the UK and the treatment of EU citizens regarding welfare services. By and large, this request has been rejected. Prime Minister Theresa May considers that popular opposition to this freedom played a critical role in the Brexit referendum. The UK government is now duty-bound to reject this obligation, one way or another.

This is likely to be the most complicated part of the negotiations. It involves a matter of principle: can one of the four freedoms be jettisoned, or even simply made relative? For a number of the contributors, the answer is a straightforward "no". Others note that migration is a hot political issue in most countries and argue that the answer might not be so black and white. In fact, the issue is quite complicated. To start with, some countries are net receivers of EU migrants, while others are net issuers (see Table 3). Furthermore, immigrants can come from the EU or from the rest of the world, and the mix is very different from one country to another. It might seem that Brexit only concerns intra-EU migration, but then comes the Schengen agreement. Once they are registered in any EU country, people are free to move to any other EU country, except Ireland and the UK since these two countries have an opt-out from the Schengen agreement. The national debates about migration are shaped by these distinctions, which naturally leads to diverging views. This matters a lot for the negotiations.

Furthermore, a significant number of British citizens live in EU27 countries, where they contribute to economic activity as workers or retirees. Tourists from the UK are conspicuous in many Southern European countries, but also elsewhere. A few contributors also mention the importance to their countries of student mobility, noting that British universities attract many foreign nationals (this is noted in the cases of Austria, Finland, France and Slovakia).

Table 3 Citizens from EU27 in the UK and vice versa, 2015

Country	EU27 citizens in the UK		UK citizens abroad	
	Number	% of population of emigration country	Number	% of UK population
Austria	21,698	0.3	11,013	0.02
Belgium	29,142	0.3	27,335	0.04
Bulgaria	51,875	0.7	5,329	0.01
Croatia	9,029	0.2	670	0.00
Cyprus	84,815	9.7	40,547	0.06
Czech Republic	41,605	0.4	4,795	0.01
Denmark	24,972	0.4	18,556	0.03
Estonia	9,361	0.7	487	0.00
Finland	14,325	0.3	6,898	0.01
France	149,872	0.2	185,344	0.29
Germany	322,220	0.4	103,352	0.16
Greece	39,700	0.4	17,679	0.03
Hungary	56,166	0.6	6,980	0.01
Ireland	503,288	10.7	254,761	0.39
Italy	151,790	0.3	64,986	0.10
Latvia	66,046	3.4	1,148	0.00
Lithuania	116,861	4.1	3,301	0.01
Luxembourg	2,092	0.4	6,559	0.01
Malta	31,758	7.6	12,046	0.02
Netherlands	68,489	0.4	49,549	0.08
Poland	703,050	1.8	34,545	0.05
Portugal	98,967	1.0	17,798	0.03
Romania	89,402	0.5	3,124	0.00
Slovak Republic	67,781	1.2	4,890	0.01
Slovenia	2,298	0.1	578	0.00
Spain	91,179	0.2	308,821	0.48
Sweden	35,055	0.4	24,950	0.04

Note: This table was prepared by Beetsma et al. as part of their contribution to this book. It has been moved here to avoid repetitions in other chapters.

Sources: Population data re from UNCTAD (2016) and migration data are from the United Nations (2016).

The positions taken by the contributors reflect these contradictory aspects. They all recognise that labour mobility is a make-or-break issue. Most consider that it is simply non-negotiable as a matter of principle. The countries from Central and Eastern Europe are also extremely keen to preserve the rights of the large numbers of their citizens who live in the UK. However, a few contributors call for a more pragmatic approach and suggest various temporary opt-out clauses (Austria, Greece, Sweden) or some more permanent arrangement (France). Migration, it is sometimes noted, is a live issue in many countries, and domestic political considerations may well interfere with the negotiations.[4]

The European Court of Justice

In his contribution on Belgium, Paul de Grauwe focuses on the vocal British rejection of the legal supremacy of the European Court of Justice, including in matters concerning the four freedoms. It is argued that this issue cannot be separated from the Single Market since it ultimately settles relevant disputes. Experience with the European Economic Association and EFTA confirms that the issue is real and serious. This may well be another make-or-break issue.

Third countries

The EU comes with some baggage in the form of countries with special arrangements. Along with the EU countries, Iceland, Lichtenstein and Norway are part of the European Economic Association (EEA). In practice, these three countries have nearly the same arrangements as the EU countries, including full access to the Single Market and contributions to the EU budget, albeit without decision power. Switzerland rejected EEA membership through a referendum and reached its own parallel agreements with

4 The Schengen agreements are rarely discussed, which is logical since the UK has opted out. Some contributors note that the agreements are in trouble anyway and may have to be rethought. The Polish contribution fears that Brexit will weaken the opposition to a common asylum policy.

the EU. The most important difference is that Swiss financial institutions do not have passporting rights. Norway and Switzerland are sometimes mentioned as possible templates for the UK.

Of interest is that, in 2014, Switzerland decided by referendum to break away from the labour mobility agreement. Since then, it has been involved in difficult negotiations with the EU regarding the transposition into law of this decision. Given the prominence of the labour mobility issue for the UK, a chapter is devoted to the case of Switzerland in which Simon Evenett examines the linkages between the now parallel negotiations between the EU and Switzerland and the UK.

History and politics

Brexit is a major political event. It challenges the idea of bringing all of Europe into a 'common house', which could now unravel. Maybe to a surprising degree, many contributions refer to Britain's own history and role not just in Europe, but also in individual country experiences over the centuries.

Historical links with Britain loom large. George Alogoskoufis notes that the UK has been a key contributor to Greek independence and security for over two centuries. Rui Peres Jorge and José Tavares argue that Portugal and the UK form "the oldest strategic alliance in the European continent", with an emphasis on trade that will not escape readers of David Ricardo. Several Northern countries only joined the EU after Britain did, and this was not a coincidence. Miroslav Beblavý and Vladimír Bilčík remind us that most Eastern and Central European countries remember Britain championing their membership to the EU. Dariusz Rosati adds that Poland shares with Britain a strong attachment to NATO and welcomes its support against threats from Russia, a view likely to be shared strongly by the Baltic States and other Eastern European countries. Alan Barrett and Edgar Morgenroth observe that Ireland fears the resurgence of its long-troublesome border with Ulster and is attached to shared cultural roots, the result of secular population movements, common language and education. Luis Garicano considers that the case of Gibraltar will matter greatly for Spain. On the other side, de Grauwe considers that historically, Britain always has endeavoured to limit the power of the continent and will want to use the negotiations to further this goal. All these considerations obviously matter, even though Britain's opt-out from Eurozone and Schengen membership has already led to some estrangement from its former *protégés*.

The fear that other countries may be tempted to follow Britain and leave the EU is another important issue. This is currently shaped as the choice between a 'hard Brexit' and a 'soft Brexit', that is, between the deep severance of economic and political links on the one hand, and a quasi-membership associated with mutual concessions on the other. Countries with deeper economic ties, as shown above, are less willing to support a hard Brexit, as are countries that share some historical or worldview kinship with the UK.

Other contributions (Finland, Slovakia and Sweden) note the role played by the UK in promoting a liberal economic order in Europe. They express concern that Brexit will leave their countries in a weaker position as the largest countries could challenge this order. The Visegrad countries, which feel dominated by the core members of the EU, voice a similar concern. They have regarded the UK as a natural ally and worry that its withdrawal will make their position more difficult. Indeed, the often-mentioned suggestion that Britain should not be offered an easy arrangement for fear of triggering more withdrawals, or a 'Europe *à la carte*', is particularly relevant for the Visegrad concerns. Several contributors believe that a Brexit will lead the Visegrad countries to forge common positions, which would isolate them.

Contributions to the EU budget

Unsurprisingly, the countries that are net recipient of EU funds (Greece, Poland, Slovakia) worry about the implications of Brexit, as does Austria (a net donor). Indeed, the UK has been a net contributor, which means that its withdrawal will reduce net transfers to a number of countries. At the same time, most contributions from the largest countries do not even consider payments to the EU to be an important issue.

Conclusions: What kind of Brexit?

Much of the current public debate contrasts a ‘and a ‘soft’ Brexit . The British government has stated that it is seeking a hard Brexit, meaning a complete withdrawal from the web of links that bind it to the EU. Many EU27 governments have also publicly signalled a preference for a hard Brexit. This means that the negotiations would start from a clean slate, in contrast to the negotiations for a soft Brexit, which would start from the existing arrangements and seek to change those that the UK sees as incompatible with the referendum. This way of presenting the negotiations can be seen in many ways.

It can be a negotiation strategy. Starting from a clean slate instantly frees the UK from all its previous commitments and puts the focus on what it wants (“Brexit means Brexit”). From the EU27 standpoint, a hard Brexit establishes that the UK cannot expect any preferential treatment relative to any other non-EU country (“out is out”). Thus each side of the negotiating table starts from far out, presumably hoping to force the other side to walk more than half of the way.

Another interpretation is that EU27 countries want a hard Brexit as a matter of principle. They are unwilling to provide bespoke treatment because it would contravene international agreements built up over decades. They are also concerned that soft treatment of the UK would encourage other countries to seek special arrangements, a process that could unravel the EU as we know it.

Yet another possibility relates to domestic politics. In virtually every EU country, Eurosceptic political parties are on the rise, sometimes even forming part of a governing coalition (in Finland and the Netherlands, for example). These parties consider Brexit as vindication and hope to capitalise on the event to grow further. Pro-European governments, on the other hand, are keen to make Brexit very painful for the UK if only to demonstrate to their electorates that Euroscepticism is a dead end.

Finally, a variety of vested interests may influence governments. Some fear being on the losing end and call for mutual concessions. Others believe that they stand to benefit from a hard Brexit. A key example is the hope that the City of London will lose a significant part of its lucrative business, which will migrate to create a new global financial centre elsewhere.

Whatever the motivation, a large number of contributors support a hard Brexit. The list includes those writing about Belgium, Finland, Germany, Italy, Hungary and, possibly, the Netherlands. Other contributors, who resent a strategy that they see as a sort of Nash equilibrium that hurts everyone, favour a soft Brexit. This list includes contributors from Greece, Portugal, Spain and Sweden. The remaining contributors do not take a firm stand, adopting a more nuanced, case-by-case view. France could even be ready to trade some of its positions on Brexit against concessions by other countries (Germany is mentioned) on intra-EU arrangements.

Table 4 Positions on key issues

	Willingness to be flexible on:			Kinship on liberal views	Concern about budget contribution
	Trade	FDI and financial services	Labour mobility		
Austria	Yes	Yes	Some		Yes
Belgium	No	No	No		
Finland	No	No	No	Yes	
France	No	No	Yes		Yes
Germany	No	No	No		
Greece	Yes	Yes	Yes		Yes
Hungary	No	No	No		
Ireland	No	Yes	No		
Italy	No	Some	No	Some	
Netherlands	No	Some	Yes	Yes	
Poland	Yes	Yes	No	Yes	Yes
Portugal	No	Yes	No		Yes
Slovakia	No	Yes	No	Yes	Yes
Spain	Yes	Yes	No		
Sweden	No	No	Yes	Yes	

Source: Author's own interpretation of contributions to this book.

Table 4 summarises this diversity of opinions. At the risk of oversimplification, the first three columns present my own interpretation of the contributor's views on how flexible their countries are willing to be on the three core issues of trade, FDI and labour mobility. The fourth column indicates whether the contribution mentions kinship with the UK in promoting a liberal economic order, and the last column does the same for concerns about the loss of the British contribution to the EU budget. Beyond the lack of unanimity, the table shows that the countries that share a liberal economic order orientation with the UK are typically more prone to displaying some flexibility on the Single Market rule, especially when they are also concerned about the British contribution to the EU budget.

Clearly, the EU27 countries have a lot of work to do among themselves before negotiations start (which may delay the negotiations). Another way of looking at this is that the British negotiators may have some scope for exploiting disagreements. Of course, it matters a great deal that the largest countries (France and Germany, and maybe Italy too) are set to be inflexible. Experience shows that these countries often carry the day, but will it happen again this time? The Brexit vote is unsettling the EU. The art of cycling backwards may shake old habits and trigger resistance from the smaller countries. In addition, domestic politics – as reported in the cases of Austria and Belgium – or idiosyncratic national considerations – such as Spain's preoccupation with Gibraltar and the Visegrad countries' tendency to rebel – could upset the old tradition. It may prove hard to reconcile Germany's determination to reject the ultimate British request for *extra-wurst* ('special sausage') treatment and Sweden's hope of 'Brentry' (bringing Britain back to the EU). The fact that any agreement requires unanimity and approval by the European Parliament heavily favours the status quo.

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About the author

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1 Brexit: Austria's negotiation stance

Michael A. Landesmann and Robert Stehrer
The Vienna Institute for International Economic Studies (wiiw)

Importance of economic relations between Austria and the UK

A recent analysis using up-dated information from the World Input-Output Database (WIOD) [1] shows that in 'value added' terms, Austria is dependent on exports to the UK – directly and indirectly – to the value of 1.2% of its GDP (Stehrer 2016). This calculation, based on 2014 data, combines domestic value added embodied directly in Austria's exports to the UK with Austria's value added contribution to exports from other countries to the UK through international supply chains of intermediate inputs.[2] The UK ranks seventh among Austria's export partners in value added terms, with a share in Austria's value added exports of slightly below 4%.

In gross output terms, the UK accounts for about 3.2% of Austrian exports,[3] making it Austria's tenth most important trading partner in goods trade (Holzner 2016). In services exports, the UK ranks fifth with a share of 4%. On the import side, less than 2% of Austrian imports come from the UK (which is ranked 13th among Austria's import partners); however, the UK is Austria's third most important import partner of services, accounting for 4.7% of total services imports.

1 The analysis relies on an updated preliminary version of WIOD released in 2016.

2 For the EU27 as a whole the same calculation would lead to EU27 value added exports to the UK accounting for about 2% of total EU27 value added.

3 Here and in the following we refer to data for the year 2015.

Turning to foreign direct investment, the share of Austria in the UK's total inward FDI stock from the EU27 is less than 1%. From Austria's perspective, the UK accounts for 3.5% of total Austrian outward FDI stock, ranking it seventh among Austria's FDI destinations.

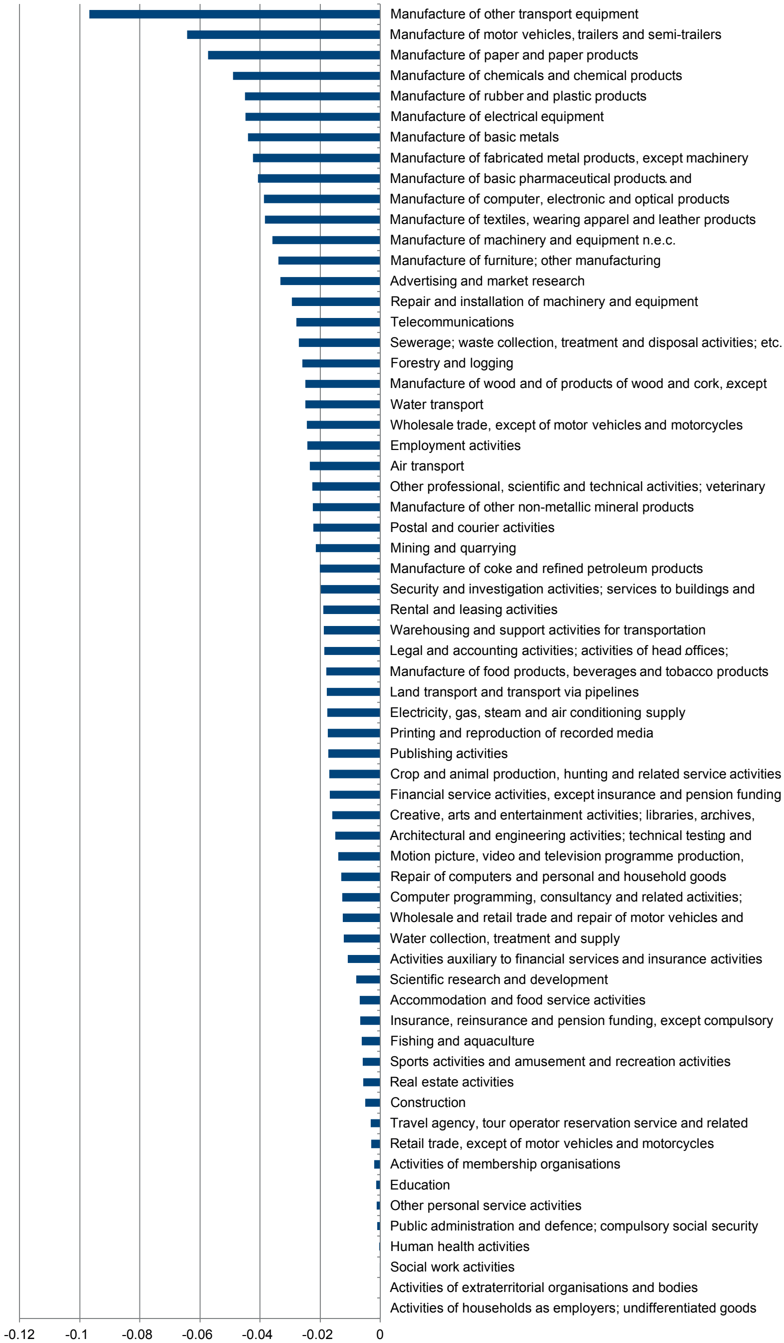
Finally, the number of people with Austrian citizenship who live in the UK is around 22,000 (representing 0.25% of the Austrian population), and about 11,000 persons from the UK reside in Austria (representing 0.13% of Austria's population).

To estimate the impact of Brexit on Austria's GDP using the above information on direct and indirect trade linkages with the UK, we ask two questions. First, what would be the impact of a one-year fall in the UK's GDP by 2%, taking into account not only the direct effect on EU27 exports to the UK but also the induced effects of the negative impact of reduced trade flows on other countries' GDP? Second, what would be the more sustained effect if UK GDP growth is one percentage point lower over a three-year period than under a 'no Brexit' scenario?

Again using WIOD data for 2014, our estimates are as follows. A one-year fall in UK GDP by 2% would reduce EU27 GDP by about 0.05%. A one percentage point lower growth path for the UK over a three-year period would lead to a fall in EU27 GDP of about 0.2%. For Austria the impact would be 0.15%. We should emphasise that this is a pure trade impact that does not take into account the impact through other channels such as a reorientation of FDI and of migration flows, or the impact of Brexit on the general investment climate in the EU.

The above analysis is derived using a model based on disaggregated industry data, so the impact on individual industries can also be calculated (see Figure 1). We can see that for Austria, the industries most affected would be transport equipment, motor vehicles, paper and paper products, chemicals, electrical equipment, metals, etc. In this exercise, the impact on financial and business services is only partially captured, as many economic linkages in these areas happen through 'modes' other than the direct exports and imports of such services, such as through the operations of Austrian companies directly in the UK market. Such linkages are not covered in this exercise.

Figure 1 Effect of a fall in UK GDP by 1% on value added of Austria's industries



Source: WIOD preliminary release 2016; own calculations.

Possible stance of Austria in the forthcoming Brexit negotiations

The political situation in Austria is one in which a rather shaky 'Grand Coalition' between the Social Democrats and the People's Party, which had ruled Austria for most of the post-war period, is currently in power. The expectation is that these two main parties will not achieve a joint absolute majority of parliamentary seats in the next parliamentary elections, and hence a change in the composition of government is likely. The party that is now leading in the polls is the Freedom Party, a right-wing, Eurosceptic and anti-immigration party. The Freedom Party consistently polls over 30%, while the other main parties each poll in the low-to-mid 20s. The pressure on the main parties from the Eurosceptic party is thus strong, with two quite contrasting possible reactions.

The current coalition could take a hard stance to indicate that a decision to leave the EU, or even to initiate a referendum in this direction (an idea that the Freedom Party launched but then withdrew), would involve significant costs for a country that follows this path. In this case, Austria would take a rather inflexible position with regard to the full acceptance of the four freedoms as a quid pro quo for a favourable trade agreement with the UK after Brexit.

Alternatively, factions of the two ruling parties might try to appeal to EU-sceptic parts of the electorate and come up with a scenario in which Austria could gain from some weakening of the four freedom principle, in particular regarding adjustments to the freedom of movement of labour and non-discriminatory access to the social welfare system by EU migrants. Sections of the governing parties might also express quite differentiated views on areas such as a joint approach to refugee and asylum policies, the further deepening of the Single Market in services, and EU trade deals. All in all, in the current political context, Austria can no longer be counted as one of the core EU countries that puts joint action by EU partners above what would be perceived as beneficial to its own position in the current national political process.

Nonetheless, the impact on Austria's position of Germany's policy stance in EU and international matters is traditionally strong, although Austria has taken an independent stance in some areas (on the closure of the Balkan route quite recently, for example, and the very hard line it takes regarding any support at the EU level for nuclear power generation).

What about economic interests?

Austria has been a major beneficiary of the Single Market, as well as of the 2004 and 2007 enlargement process. It is a core member of what is now termed the 'central European manufacturing core' (Stoellinger 2016), which represents the cross-border regional agglomeration of manufacturing activity in Germany, Austria and the central European new member countries. Austria therefore has a vested interest in an integrated market and also in free access to main export destinations, especially for industrial goods. Adherence to EU standards greatly facilitates such production and trade integration, and this would be reflected in Austria's position in negotiations with the UK. In areas of industrial production and trade with the UK, we expect Austria to insist on as strict a compliance with EU standards as possible under the trade agreement finally reached in the negotiations.

On the issue of trade in services, which will be an important concern of the UK in the forthcoming negotiations, Austria is no way a 'rival hub' to London as a financial and business services centre, although it has developed strengths in these areas during the phase of its integration with adjoining central and eastern European economies. We would rather expect that Austrian businesses would be interested in relatively unrestricted access to the City of London, which provides essential services, and similarly would support granting the UK relatively smooth access to EU markets. We would think that in this area, Austria would take a rather 'soft' line in the negotiations with the UK.

Austria is an important tourism destination for UK citizens, who rank fourth in terms of total nights spent in Austria. From this perspective, Austria would not want to project an image of a difficult opponent in the forthcoming negotiations with the UK.

Another issue is any quid pro quo arrangement regarding a possible contribution by the UK to the EU budget. First of all, Austria will be interested in the UK fulfilling its full budgetary obligations as long as it is a member of the EU, and also during a transitory period if the UK still remains a member of the Single Market during that period. After that, any concessions which the UK might want to negotiate in terms of preferential access to the market, mutual recognition arrangements, and so on might have to be bought by concessions by the UK on continuing to contribute to the EU budget, or on its participation in certain policy areas. We expect that the negotiations on budgetary issues will be quite hard and Austria, as a significant net payer, would want to take a strong stance in this respect.

Migration is of course a ‘hot topic’ in Austria and, if the UK had continued to be an EU member, one could have easily imagined that Austria would have been amongst the countries that would have been in favour of adopting an ‘emergency clause’ to allow temporary periods of restrictions on intra-EU mobility. Concern over migration flows from new members was always high with both the first and second rounds of eastern enlargement – during which Austria used the full seven-year restriction – and this will continue to be the case with any further rounds of enlargement (such as the one with the western Balkans). Similarly, Austria might be one of the countries that would support a tightening of access by migrants (including intra-EU migrants) to social benefits (along the lines of that granted to David Cameron before the Brexit vote). However, we do not necessarily expect that Austria would lobby in this direction in conjunction with negotiations with the UK. This could change if a shift in the governing coalition takes place while the negotiations with the UK are still ongoing (there is talk of a possible early election before the mandatory date in 2018).

The areas in which Austria would be very keen to maintain close relations with the UK are European student exchange programmes, access by Austrian students to UK universities, and the UK’s participation in EU research activities. Traditionally, the UK has been an important destination for Austrians studying abroad and for student exchanges, and Austria would be very interested in keeping this channel as open as possible and also in keeping down the costs for Austrian students benefiting from it. Any preferential access for EU students to UK educational facilities will thus be strongly supported by Austria, and we expect that in this area there would be general agreement amongst all of the EU27.

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2 Which Brexit negotiating strategy for the Belgian government?

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In this chapter, I first analyse the question of the negotiating strategy the Belgian government *should* take vis-à-vis the UK government in the process of achieving new trade relations with the UK. Second, I discuss which strategy the Belgian government *is likely* to take.

The negotiating strategy of the Belgian government should be based on the idea that it is in the interest of the country to maintain a strongly integrated EU. This implies that the UK government should be confronted with a clear choice. Either the UK adopts a model like the Norwegian one, or it stands alone and negotiates new trade agreements with the EU and about 50 other countries (or groups of countries) in the framework of the WTO rules. The Belgian government must make it clear that there is nothing in between these two choices. There can be no 'special deal' with the UK.

If the UK accepts a Norway-type model, it will retain full access to the Single Market. In that case, there are no obstacles for British goods and services in the EU and for EU goods and services in the UK. But the price the UK pays in this model is the free movement of EU citizens in and out of the UK and acceptance of the rules on standards, health and safety that are decided in Brussels, without being involved in the decision-making process.

It is very unlikely that the UK government will accept this model. In fact, in her speech at the Conservative Party conference of 2 October, Prime Minister Theresa May made it very clear that the British government wants the UK to "take back control over its borders, its laws and its money". She announced two important principles that will guide future negotiations. First, the UK government will establish full control over immigration to the UK. Second, the jurisdiction of the European Court of Justice (ECJ) in the UK will end when Brexit is finalised.

It is clear that the second principle in particular makes it impossible for the UK to remain in the internal market, for the following reason. The Single Market is based on a system of common rules governing the health and safety of goods and services, competition and norms and standards. The European Court of Justice oversees the application of these rules in all countries, and therefore has jurisdiction in these countries. The Court therefore plays the role of referee to ensure that the common rules are applied correctly. The Single Market can only work if member states accept in advance the authority of the referee. By rejecting the jurisdiction of the European Court of Justice, or any other foreign court, the UK disqualifies itself from the Single Market.[1]

All this implies that there is very little choice left for the UK government, and the Belgian government should make this clear. The UK will have to negotiate a trade agreement with the EU, like any other sovereign country. This is the case with Canada and the US today. Negotiations with these countries are difficult and drag on for years. This will also be the case for the UK. It has chosen full sovereignty and refuses to accept a supranational authority. It should be treated as such.

Britain may try to reach a 'special deal' with the EU in which it would maintain the right to introduce controls over immigration and sovereignty on the application of Single Market rules. This is the 'intergovernmental' approach, and it is the dream of the UK authorities. It would take the form of an arrangement in which Britain retains a veto on any new decision from Brussels regarding the rules of the Single Market, while enjoying the benefits of the Single Market.

1 Pisani-Ferry at al. (2016) have argued recently that the free movement of persons is not an essential ingredient of the Single Market. They propose that the UK could remain in the Single Market while imposing some limitations on the free movement of persons. This may be true. However, the refusal of the UK to accept any jurisdiction of the European Court of Justice (or any other foreign court) by itself is sufficient to disqualify the country from membership of the Single Market.

The reasons why the Belgian government, or any other EU member state government, should not accept being dragged into negotiating a special deal with the UK are obvious. When the UK joined the EU in 1974, its main strategy was to prevent the Union from becoming too strong. The UK political elite decided that this could best be achieved from inside the Union. Now that the UK is departing, the century-old British strategy remains the same – i.e. to weaken the forces that can make Europe stronger. The UK can achieve this by insisting on a special deal between it and the EU whereby the UK maintains the benefits of the Union while not sharing in the costs. Such a deal, if it comes about, will signal to other member countries that by exiting they can continue to enjoy the benefits of the Union without the costs. In addition, such a deal would reinforce the inter-governmental approach in EU decision making. Such a prospect would fatally weaken the EU. This would certainly not be in the long-term interests of a country like Belgium.

Unfortunately, the long term is rarely a guide in policymaking. Short-term interests are more likely to prevail, including in Belgium. Mercantilist pressures are likely to be very important. Trade between Belgium and the UK is quite unbalanced. In 2015, Belgian exports to the UK amounted to €31 billion, making the UK Belgium's fourth largest trading partner (after Germany, the Netherlands and France). At the same time, Belgium imported only €17 billion from the UK, resulting in a positive trade balance of €14 billion with the UK. As a result, the political pressure from the Belgian export lobby to accommodate the desires of the UK government is likely to be strong. In addition, by far the largest part (close to 80%) of Belgian exports to the UK are generated in Flanders. This creates a potential political split along linguistic lines over the question of the Belgian government's negotiating stance towards the UK government, with Flemish politicians more likely to pursue an accommodating stance, and French-speaking politicians more prone to following the French government's hard stance in the Brexit negotiations. Which of the two will prevail is hard to predict. Belgian politics is full of surprises that have much to do with a double political cleavage – one along linguistic lines, and the other along the right-left axis.

In a way, Belgium is a microcosm of what can happen at the EU level. The need for two linguistic groups to pursue common policies creates permanent tensions that arise from simultaneous centrifugal and centripetal forces. During the last decades, the centrifugal forces have dominated the centripetal ones. The Brexit negotiations risk reinforcing the centrifugal forces. However, they do not have to lead to this outcome if Belgian policymakers succeed in taking a long-term view of the interests of the country.

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3 What should and will Finland make of Brexit?

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The outcome of the June referendum was a major disappointment for Finns interested in EU and foreign affairs, with the exception of a small minority that detests the supranational EU and hopes Brexit will be a harbinger of its unravelling. The disappointment relates to three factors.

First, the Finnish economy does not need any additional negative shocks as it struggles to recover from a long recession. Brexit can potentially trigger a severe shock that would also affect Finland. Second, Brexit is bad news for the Single Market and the market-oriented policies of the EU, which Finland considers to be very important. This is because the UK's departure will diminish political support for a well-functioning internal market and a market-oriented approach to regulation in general. Third, Brexit will weaken the political clout of the EU, which Finland joined primarily in order to be in the right European club. In this regard, security is at least as important as the promotion of European values (human rights, democracy, rule of law, environmental sustainability, etc.). The detrimental effects of all these aspects would obviously be greatly compounded should Brexit lead to a chain reaction of other countries seeking to exit the EU.

These three aspects also determine the Finnish national interests with regard to the Brexit outcome and the process itself. The direct impact of Brexit on the economic, political, social and cultural interactions between Finland and the UK is less important than the indirect effects through the impacts on other countries, EU institutions and common policies. This is because the bilateral links between Finland and the UK are not particularly strong by European comparison, and because the diverse interests of the EU27 require difficult compromises that are likely to be better reached when the future orientations of the EU27 are also on the table. [1]

Bilateral links are not exceptionally strong and do not need special protection

Table 1 Importance of the UK for Finland, selected aspects

Variable	Indicator	2015 or the latest
Export of goods	% of all exports	5.2
Export of services	% of all exports	6.4
Import of goods	% of all imports	3.2
Import of Services	% of all imports	6.7
FDI to Finland	% of all FDI to Finland	4.0
FDI from Finland	% of all FDI from Finland	2.1
Banks' foreign borrowing from the UK	% of banks' total foreign borrowing	11.4
Non-financial sector foreign borrowing	% of sector's all foreign borrowing	2.1
Finns living in the UK	% of Finnish population	0.2
Britons living in Finland	% of Finnish population	0.1
British tourists to Finland	% of all foreign tourists (overnighting)	8.8
Finnish tourists to the UK	% of all trips (overnighting) abroad	3.9
Finnish degree students at UK universities	% of all Finnish degree students in another EU country	29.4

The UK has traditionally been an important market for the Finnish forest industry, fostering tight links between the Finnish business community and Britain. Nevertheless, given the widening of the industrial base of Finland and globalisation, the UK's share of Finland's exports of goods has declined and settled at around 5%. The UK now ranks seventh among Finland's export markets after Germany, Sweden, the United States,

1 The need to discuss broader issues about the future EU27 simultaneously with the Brexit arrangements is reinforced if the UK's exit from the EU requires a technical amendment to the Treaty on European Union. The need to agree on the reallocation of seats in the European Parliament and on the EU budget also speaks for more comprehensive negotiations than those focusing on the Brexit terms alone (Fabbrini 2016).

the Netherlands, China and Russia. Britain's relative position is broadly the same with regard to exports of services and imports of goods and services. UK trade is thus less important for Finland than for other EU countries on average, and in particular for countries such as Germany, France, Spain, the Netherlands, Belgium and Sweden.

Foreign direct investment (FDI) from the UK is not very large either, at 4% of all FDI to Finland, and FDI from Finland to the UK represents only 2% of all outgoing FDI. Still, the subsidiaries of British companies account for some 9% of total employment by foreign subsidiaries in Finland, and subsidiaries of Finnish companies in the UK account for some 5% of total employment by all subsidiaries of Finnish companies abroad.

As for other countries, the City is more important for the Finnish financial system in relative terms than the UK is as an export market or place of non-financial business operations. According to BIS data, over 10% of foreign bank claims on Finnish banks stem from the UK; the same is true for derivative contracts. The City is also important in terms of human contacts for financial market actors, and the Finnish corporate governance model is closer to that of the UK than it is to those of Germany or France. For the non-financial sector, however, the UK banks are a minimal source of financing, at some 2% of all foreign liabilities.

The UK is not a significant destination for emigration from Finland. Only around 10,000 Finnish citizens are residents in the UK. This represents 4% of all Finns living abroad and 0.2% of the Finnish population. Migration from the UK to Finland is even less significant, with some 5,000 Brits living in Finland. Britain plays a bigger role in tourism – around 9% of all foreign tourists in Finland came from Britain in 2015, while 4% of Finnish foreign travel was to the UK.

On the other hand, together with Sweden, the UK is the most popular place for Finnish university students to study abroad. Almost 30% of all Finnish students studying for a degree in another European country do so in the UK. In this regard Finland is rather typical of the EU, where the unweighted average of the UK share in foreign (European) studies is slightly over 30%.

UK researchers, research institutions and innovation-orientated companies are also important collaborators for Finnish actors in research. For example, the UK ranks second after Germany in collaborative links for Finnish researchers in the EU's Framework Programme 7. Similarly, the UK ranks second after the US as a destination for post-doctoral researchers taking a position abroad.

A simulation analysis incorporating the negative effects of Brexit through uncertainty, trade and the associated exchange rate movements, but without exceptional political turbulence, suggests that the initial negative impact on growth for Finland will be of roughly the same order of magnitude as the EU overall, implying a fall in growth of between 0.2 and 0.3 percentage points in 2017. The longer-term growth effects for Finland will obviously depend on the basis on which future relations with the UK are arranged. However, in all scenarios considered, the impact on Finland's GDP is very small. It could be even marginally positive, as Finland could gain shares in some markets where the UK loses them.[2] Should Brexit lead to a paralysis and a process of unravelling of the EU, the macroeconomic effects on Finland, as on other EU member states, would be of course much more severe.

All this implies that while Finland naturally should seek to protect its bilateral interests, their importance is in general no greater, and in some areas smaller, for Finland than for other countries of the EU27. In relative terms, maintaining the best possible access to higher education and research institutions in the UK, as well as the associated free movement of students and the highly educated, are of particular interest to Finland.

The priorities: Integrity of the Single Market and security

As a small peripheral economy, Finland's prosperity is very much dependent on its access to foreign markets, resources and knowledge. This implies that maintaining the integrity of the Single Market, and preferably deepening it with regard to services and public procurement, is of great importance. Therefore, it is not in Finnish interests to

2 The simulations were carried using the National Institute's Global Econometric Model (NiGEM) on standard assumptions about the effects of different trade arrangements between the UK and the remaining EU members (WTO, free trade agreements, EEA) (see Lehmus and Suni 2016).

allow Brexit to lead to cherry picking by individual member states on various aspects of the Single Market. Giving the UK privileged access to the Single Market in, for example, financial services or in general without a commitment to the free movement of people and a contribution to the budget, if ever accepted by other member states, would definitely lead to similar demands by many other states. This would obviously be detrimental to the effective functioning of the Single Market.

This economic argument against compromising on the integrity of the four freedoms is reinforced by the associated potential centrifugal political consequences. If a leaving country can retain many of the economic benefits without the responsibilities that come with EU membership, it obviously strengthens the hand of the political forces in other countries that support leaving the EU. This could result in further separations or additional special arrangements, which could dramatically weaken the cohesion of the EU. The EU's capacity to formulate strong unified positions and to act decisively on them would diminish. In particular, the EU would become less of a bulwark against destabilising geopolitical manoeuvers, such as the Russian activities in Ukraine. This would represent an obvious loss for Finland.

On the other hand, the same economic and broader political arguments speak in favour of keeping the UK as close to the EU as possible even after Brexit, on the condition that this can be done in a way that strikes a reasonable balance between responsibilities and benefits. Thus, a European Economic Area (EEA) arrangement would be economically ideal for Finland. Given its likely unacceptability to the UK, allowing some control of immigration would not be a problem for Finland, as long as it is balanced, for example, by a significant contribution to the EU budget (and does not restrict the mobility of students and researchers, which is unlikely to become problematic anyway given the UK's own interests). Thus a solution along the lines of the 'Continental Partnership' proposed by Pisani-Ferry et. al (2016) could make sense from the Finnish perspective, assuming it does not lead to a chain reaction.

It would also be in the Finnish interests to keep the UK involved in security policy collaboration with the EU as much as possible. Given that the UK has resisted efforts to strengthen the EU's defence capabilities, potentially at the expense of NATO collaboration, Brexit may in fact allow this aspect of EU integration to become stronger than has been possible so far. This suits Finnish interests very well.

What positions is Finland likely to take?

Early indications suggest that the Finnish government is indeed emphasising the importance of keeping the Single Market as intact as possible and is seeking to expand the EU's security policy role and capacity. While any talk of 'punishing' the UK has been explicitly rejected, the government has underlined the integrity of the four freedoms, and will most likely put more emphasis on maintaining maximum unity of the EU and limiting the risk of further disintegration than on reaching an amicable agreement with the UK. The government has also taken a positive view towards Franco-German proposals for strengthened defence cooperation.

At the same time, the government must also define its position on the EU's post-Brexit future. A widely accepted view in Finland, shared by the government, is that the vote for Brexit is further evidence of a lack of political support for institutional reforms of the EU that would transfer powers from national governments and parliaments to the European Commission or any other EU-level body. This concerns fiscal powers and resources in particular. A Eurozone treasury or Eurobonds would not meet with any more understanding now than in the midst of the Eurozone Crisis. The lenient approach taken by the Commission and the Council towards France, Spain, Portugal and Italy with regard to their Stability and Growth Pact commitments is taken as proof that the existing arrangement cannot guarantee fiscal prudence. In the short term, these examples in fact offer a relief to the government. They make it very unlikely that Finland – with positive general government net financial assets and a history of solid creditworthiness – would be penalised even if it will most likely fail to meet its Medium-Term Objective (MTO) and debt criterion in the near future. The institutional conclusion is not a call for tighter rules or enforcement mechanisms. Instead, the failure of the strengthened Stability and Growth Pact is much more likely to be seen as a call for stronger market discipline.

On the other hand, the Finnish government appears to accept that safeguarding financial stability requires the completion of the banking union and would also benefit from a capital market union. It is therefore likely to support the plans to set up a European Deposit Insurance Scheme (EDIS), provided the risks of the participating countries' banking systems have first been put on an equal footing. Similarly, the government is likely to support the harmonisation of the corporate tax base and measures to reduce the scope for tax evasion, as well as the creation of an effective EU insolvency procedure. Going forward with these projects is in line with the Finnish tradition of emphasising practical implementation of decisions taken over general declarations on new grand plans.

An interesting political aspect of the Finnish reaction to Brexit is that the anti-EU, anti-immigration party, the True Finns, is apparently unable to capitalise on the anti-EU sentiment reinforced by the Brexit vote in the same way as somewhat similar political forces have done in many other European countries. While many in the rank and file of the True Finns party greeted the Brexit vote as an affirmation of a widely spread anti-EU sentiment in Europe, the leadership is bound by its position as part of the government of Finland. Given that the party holds the positions of both foreign and defence minister, it must give substantial weight to aspects of security policy. This works against taking hostile positions to deepening EU-level cooperation in these fields, even if it means more powers at the EU level, and makes an anti-EU stance less credible in general.

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4 Brexit the French way: Regulation, tax, and politics

Laurence Boone and Ano Kuhanathan
AXA

In many ways, the reasons behind the Brexit vote find many sympathisers in France: a rejection of the EU, which appears to many as a bureaucracy with higher administrative burdens than those of its member countries and which is incapable of delivering growth and employment; a lack of any perceived benefit from the Single Market; disapproval of the way the EU is handling the refugee crisis; the perception of an open space with no border controls which is prone to insecurity; and a desire to repatriate some legislative power. Even though Britain has always been less engaged in the European political project, French citizens share these frustrations. But the reasons for France's disenchantment with Europe go beyond that. The French see the EU as an entity that is unable to cope with the perceived downside from globalisation – a place where competition is not fair and where institutions lack political oversight.

For these reasons, the French position on the Brexit negotiations will likely focus on the desire to preserve or increase France's competitiveness, while seeking to attract businesses that could enhance its international position for trade in goods and services. On the freedom of movements, France's position is more ambiguous. It will want to preserve the production chain, which for certain industries is intimately linked to the UK, but also to limit the movement of posted workers, a significant political issue in France. In addition, its own difficulties in coping with the issue of migration may play a role in the negotiations. Finally, France may trade some negotiating objectives against concessions by other EMU countries concerning social considerations and further integration such as a common budget, albeit small, although it is unlikely to be at the centre of the future discussions.

Despite a lack of competitiveness, bilateral economic ties are mostly in favour of France

Whatever the competitiveness metric, France tends to perform poorly against the UK. The well-known Global Competitiveness Index from the World Economic Forum ranks countries based on various factors such as the reliability of institutions, infrastructure, education or innovation. In the 2015-2016 report, France is ranked 22nd overall and the UK 10th. France is behind the UK in almost all areas, but according to the WEF the gap is most significant when it comes to labour market efficiency (flexibility and use of talents) and technological readiness (adoption and diffusion of technology). On competitiveness, France is much lower than the UK, especially on corporate taxation. International firms are better off setting up shop in the UK. According to the *World Bank Doing Business* 2016, a firm pays much more tax when based in Paris than in London (see Table 1).

Table 1 Summary of tax receipts as a proportion of corporate profit for France and the UK

Tax or mandatory contribution	France	UK
Corporate income tax	0.5	19.2
Employer paid – payroll tax	6.1	-
Employer paid – social security contributions	47.3	-
Environmental tax	-	0.1
Labour tax	-	11.2
Municipal business tax	-	1.3
Real estate tax	1.8	-
Tax on insurance contracts	-	0.1
Territorial economic contribution (CET)	7	-
Vehicle tax	-	0.1
Total tax rate	62.7	32

Source: Doing Business 2016, World Bank.

At the same time, the trade and investment ties between France and the UK are rather strong and mostly in favour of France. The UK is the 5th largest export market for France, representing 7.1% of its exports. It is also the 8th largest source country, representing 3.9% of French imports. The French market share in the UK is twice as high as its global market share. The UK accounts for the largest French bilateral trade surplus, with €12.1 billion in 2015 (0.5% of GDP). The French food and wine industry accounts for almost 25% of the total surplus. The rest of the trade relationship is mostly intra-industry trade focused on automobiles, car parts, pharmaceuticals, aircrafts and aerospace-related goods. France is also the 3rd largest foreign investor in the UK, with investments totalling around 4.8% of GDP in 2014. Conversely, British investment is important in France, at about 2% of GDP in 2014. The UK is the primary European country in which French firms operate, with 359,000 employees and 3,074 subsidiaries based there, and it is second only to Germany in terms of turnover at €113.2 billion in 2014. This large presence of French firms in the UK stems not only from the strong ties between the two countries, but also from the difference in tax policy mentioned above, currently reinforced by EU rules of exemption on withholding taxes on the payment of dividends and interest between parent and subsidiary.

As a result, France will pay particular attention to tax policy arrangements with the UK. It will want to prevent any further harm to its competitiveness. Any attempt by the UK to use taxation to compete with the EU runs the risk of creating tensions in the negotiations.[1]

London, the symbol of France's battle against British exceptions and regulatory arbitrage

The UK has always promoted the concept of differentiated integration. It has not adopted the euro, it has wanted to limit the scope of the banking union, and it opted out of Schengen. Recently, the House of Commons Treasury Select Committee has launched a survey on Solvency II, which could be interpreted as a sign that the UK wishes to use regulation to attract financial firms.

France will likely be opposed to granting access to EU facilities if it is perceived that there is 'unfair competition' on the grounds of tax or regulatory matters. It will oppose any measure that could allow regulatory or tax arbitrage for the British financial

1 "France hits out at UK plan to cut corporate tax", *Financial Times*, 11 July 2016 (available at https://www.ft.com/content/77a20970-474c-11e6-b387-64ab0a67014c).

industry, of course, but also for any other sector where access to the Single Market will be granted. This could include, for example, regulation for utilities such as energy, the digital industry (France is particularly cautious on data privacy), and transportation. Conversely, France will likely try to attract financial services to Paris.

First, any opt-out from regulation while granting access to the financial Single Market for the UK would be seen as a retreat from the objective of harmonisation of financial regulations. In Paris' view, a harmonised competition and regulatory framework is key for both market integrity and financial stability, which also benefits London. Second, during the last negotiations on supervision, the UK sought to limit European authorities' oversight and sought a flexible regime for relationship with third parties. Yet, differences in the implementation of the single rule book would likely be viewed as a way of granting some advantage to the City. As such, France will consider that it is incompatible to both grant access to the continental financial market and to exempt the UK from full European supervision of the implementation of the single rule book. In the absence of a deal on supervision, France would emphasise that the euro is the 'currency of the union', question the principle of non-discrimination of currency, and could insist on repatriating clearing houses on the continent. Such a relocation would be considered essential for financial stability reasons, as the Eurosystem carries credit and liquidity risks related to trade clearance.

Conversely, France is already taking steps to attract those financial firms that would seek to leave London. As the number of French employees in the City has grown larger over the past decades, and brain flight is a significant political issue, the French authorities will likely try to attract firms that doubt that a good deal can be reached. Indeed, the French banking authority (ACPR) and financial market supervisor (AMF) have already taken measures to attract British financial firms.[2] In order to simplify and speed-up procedures, both authorities are offering English-speaking contacts to guide UK-based applicants. They are also accepting documents in English that have already been submitted to the British supervisors. Beyond anecdotal evidence, there is no evidence that these steps have had any material impact so far, at least up until Theresa

2 "The ACPR and the AMF are simplifying and speeding up licensing procedures in the context of BREXIT", Press Release, 29 September 2016.

May announced when Article 50 would be triggered. In addition, France may wish to look at the regulatory framework for the Fintech industry, with a view to repatriating some of this activity to the continent.

The human puzzle: Calais migrants, French workers and UK pensioners

The issue of labour mobility is a complex one for France as it combines a lack of job opportunities for some workers (with lower or no qualifications) with more attractive wages and careers for qualified workers. Officially, nearly 150,000 French citizens live in the UK; including students, the number is closer to 300,000. The number of UK citizens living in France is also around 150,000. Among the French living the UK, 25-40 year-olds are the dominant group, while about a third of Britons living in France are over 65. Importantly, most French who work in the UK did not move for fiscal reasons – a typical 35-40 year-old household with two children ends up with the same level of taxation as in France, but with less social services. They move because job opportunities are more numerous and less dependent on initial educational background. France could have to cope with the return of these workers if they were denied the permission to stay in the UK. This situation has always been the Achilles' heel of the political debate in France, especially because qualified French students are actively sought by the financial sector.

The issue of labour mobility is made even more complicated by two additional reasons. First is the question of migrants and refugees, which is equally sensitive in the UK. Second, the issue of posted workers has attracted significant attention in the public debate. France has no official objection to the freedom of movement, but it has recently objected to the growing use of posted workers. It received the 2nd highest number of posted workers in the EU in 2014.[3] It considers that low-qualified European migrants compete directly with local workers for jobs in some sectors, such as construction and domestic services. In these sectors at least, France could be tempted to limit the freedom of movement. It would be highly regrettable if France were to use the Brexit

3 See http://ec.europa.eu/social/BlobServlet?docId=15194&langId=en.

negotiations to attempt to restrict the freedom of movements. However, since other countries could well support such an attempt, politicians might be tempted. It would be more helpful to review the Posted Workers Directive, with a view to introducing a fairer set-up for those workers that move around the EU on behalf of their firms. For example, posted workers working in France (or any other country) could be submitted to the same labour regulations, including the minimum wage and social contributions. This would restore the level playing field.

The small town of Calais has become an infamous symbol of migration, yet this has nothing to do with the EU**.** The *Le Touquet* agreement, which is pivotal to the UK's immigration control framework, is built on the premise that the UK can better control migrants wishing to cross the Channel on French territory (and vice versa, although this is much less relevant). Given the sensitive political debate around refugees and immigration, France could be tempted to seize the opportunity of the Brexit negotiations to reopen this agreement, even if it is bilateral and not part of any EU Treaty.

Accounting for political considerations: French demands for more social EU support and possibly EU deepening

Unlike the UK, since the beginning of the EU, France has been pushing towards institutional integration, the promotion of a 'European social model', and further integration such as a common budget, albeit small. These discussions came to a halt with the French 2005 referendum that rejected the ratification of the Lisbon Treaty. In 2005, the country was nearly equally divided between those believing in 'more Europe' and those signalling that Europe was inefficient in addressing their concerns. Today populism and Euroscepticism are growing in France across the political spectrum, but much more vocally on its extremes.

Yet, a new government could decide to be more forceful in promoting both the European social model and deeper economic integration. France has constantly argued in favour of completing the banking union, but also supports a European budget to finance investment and a European unemployment insurance. In Paris' view, Europe is currently very asymmetric, with more integration on the economic and banking side than on the budgetary and social sides.[4] A union that is seen as caring more about the people could turn around public opinion and revive the European construction. Even though an ambitious federal budget will not be part of the Brexit negotiations, France could use these negotiations to press its demands, such as the completion of the banking union or an enlarged Juncker Plan. France and Germany have long disagreed on the macroeconomic framework. France wants more common budgetary measures, including the issuance of debt to support investment. It also seeks more flexibility in the fiscal rules to deal with low growth. German puts more emphasis on structural reforms and debt restructuring, and is highly reluctant to consider any form of debt mutualisation. It would probably not be a good negotiating strategy to mix Brexit and EU discussions, but Brexit should lead to a redefinition of the EU project, including the Eurozone.

Conclusion: Expect a hard stance towards the UK in some sectors

France is likely to seek to include the UK in a comprehensive free trade zone to maintain easy access to the UK markets, but with a view to safeguarding its own competitiveness. This is particularly challenging as France would likely suffer most, in the short term, from a hard stance in the negotiations. Yet, the French authorities will be particularly mindful of tax competition, freedom of movement, as well as financial regulation and supervision in order to avoid fiscal, social and regulatory dumping. As the UK is likely to stand firm on immigration control and financial supervision, the negotiations with France will presumably be difficult.

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4 "François Hollande: 'Ce qui nous menace, ce n'est pas l'excès d'Europe, mais son insuffisance'", *Le Journal du Dimanche*, 19 July 2015.

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5 If you really want to go – Germany and Brexit

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The 11 June 2016 issue of the leading German news magazine, *Der Spiegel*, was extraordinary. On the cover it bore a Union Jack and a plea: "Bitte geht nicht – warum wir die Britten brauchen". To make sure that the other side of the Channel also got the message, it was repeated in English: "Please don't go – why Germany needs the British". The Brexit-related articles were all bilingual. The cover price in pounds was slashed and the cover story read much like a love letter to British and their "culture and talent for being cool".

The *Financial Times'* reaction was dismissive; it disqualified the appeal as an unusual attempt to sway public opinion ahead of the Brexit referendum. The reaction of the *The Times* was harsher: the title page read "Germany's EU threat to Britain", referring to *Spiegel's* interview with the German finance minister. When asked about Britain's chances of leaving the EU but not the Single Market, Wolfgang Schaueble, in an eerie early echo of what became Theresa May's favourite slogan, had said "Out is out".

This journalistic episode may seem trivial, but it reflects on key aspects of Germany's relationship with the British and their desire to leave the EU. Many in Germany feel closer to the UK than to other European countries. Moreover, they are well aware that the UK is an important economic partner but that it has often been a difficult political partner, frequently asking for and obtaining special treatment (to use the German colloquial term, '*Extra-Wurst*' – a special sausage). Nevertheless, the prevailing view was that the British would choose to remain in the EU not only because of a well-understood common interest, but also because of narrow self-interest. Instead, on 24 June, they decided to leave and in the process probably ask for a very big *Extra-Wurst*.

Initial German reactions to the Brexit decision

In Germany, the Brexit vote divided decision makers into two camps. In the first camp were those – like Vice-Chancellor Sigmar Gabriel, head of the SPD and member of the grand collision – who exclaimed that it was "a bad day for Europe" but also that it constituted a chance for a new start for the EU. Germany should play a more active role in shaping a Union that is closer to the concerns of people. In other words, the focus should be on deepening integration (where necessary), preserving the union of the 27, and minimising political fallout from Brexit negotiations on other EU members. Prolonged divorce proceedings and special deals with the UK would not be in the interest of the EU.

In the second camp were those, like Chancellor Merkel, who called for remaining calm, not rushing to conclusions, and giving the UK time to build a new government and make up their mind on how to approach the imminent divorce. In contrast to the first camp, they thought that the lesson was that the direction of "ever closer union" was being rejected (not only in the UK) and that this was not the time for further integration. But this camp was also keenly aware of the potential chain reactions that might be ignited by concessions to Britain and has always declared that if Britain wished to maintain membership of the internal market, then it would have to accept free movement of labour, paying into the EU budget and observing current and future Single Market regulations. The German government was also firm in stating that there would be no pre-negotiations before Article 50 was triggered (which obviously would have weakened the position of the EU), and this position was shared across the EU27. Thus official and public Brexit discussions were put on hold until the UK had time to regroup.

After some hesitation, the British prime minster has now made two significant announcements: she has set a date for the formal start of negotiations (promising to trigger Article 50 in the first quarter of 2017), and she has declared that regaining control over immigration is non-negotiable. This raises two questions. First, is the UK really so different in terms of immigration? Second, is there any scope for a compromise on free mobility?

Is the UK disproportionally affected by immigration from the EU?

Table 1 shows that the answer to the first question is no. Out of a total population of 64 million, 2.4 million EU citizens live in the UK, that is 4%. They make about half of the total foreign population of the UK. These shares look very similar for Germany – 4% of the resident population (3.2 million) moved from other EU28 states, and the total foreign population is somewhat higher than in the UK. Both countries are very close to the EU28 averages. Therefore, there seems to be little ground for claiming a special situation in the UK.

In fact, the share of EU28 movers in the resident population in Belgium, for instance, is almost double the UK figure. And Switzerland, where movers from the EU28 make up about 15% of the population, would also have better grounds for claiming to be disproportionally affected by immigration into its labour market.

Table 1 shows stocks, but how about flows? Has the UK recently been flooded by workers from the EU (and EFTA)? While the UK has been highly attractive for recent movers of working age, so too has Germany (Figure 1). In both countries, the largest group of new movers has been from Poland, followed by Romania. It is worth restating that labour migration has predominantly been into employment. In fact, the employment rate of newcomers from the EU is typically higher than the employment rate of the resident populations, and the UK is no exception here (Canetti 2014, p. 21-22) Rather, Germany is the exception – EU newcomers to the country have slightly lower employment rates than nationals. In addition, the recent inflow of refugees from the Middle East has largely been concentrated in Germany. Based on numbers, it would appear difficult to explain to Germans (and to other EU members) why the UK should receive special treatment.

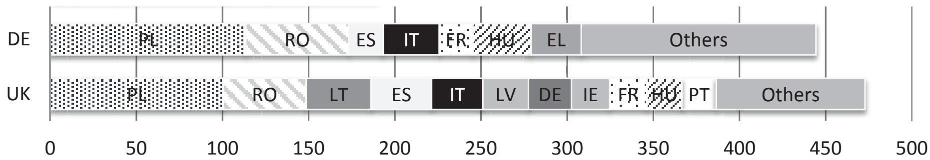
Table 1 Shares of EU28 and non-EU migrants

Country of residence	EU28 movers in % of total population	Foreign population in % of total population	EU28 in % of foreign population	EU28 movers (thousands)	Foreign population (thousands)	Total population (in thousands)
Germany	4%	10%	42%	3,259	7,696	80,620
UK	4%	8%	49%	2,421	4,930	64,100
EU 8	3%	7%	41%	14,032	34,089	505,170
Belgium	8%	12%	70%	380	544	4,591
Switzerland	15%	24%	64%	1,219	1,901	8,039

Note: Shares of EU28 movers and foreign population in total population, and absolute numbers (in thousands).

Source: Canetti et al. (2014), Tables 2 and 3; own calculations.

Figure 1 New EU28/EFTA movers of working age



Note: New EU28/EFTA movers are defined as EU or EFTA citizens of working age (15-64) who have been living in the UK or Germany for up to three years as of 2013.

Source: Canetti et. al (2014), Figure 8.

Can there be a compromise on free labour mobility?

On the British side, there is certainly the hope that in the end there will be a deal preserving almost full access to the Sngle Market, including passporting rights, while regaining the freedom to limit labour mobility.

On the face of it, free labour mobility may seem less important than the other three freedoms of movement, namely of goods, services and capital. After all, until recently the free movement of labour in the EU was partially restricted at least for the recent accession countries. After accession, a phased seven-year transition process allows other EU member states to apply limits to workers from the new member. During the last phase (years five to seven after accession), such restrictions may only be applied in case of serious disturbances in their labour market and after having notified the European Commission. Bulgaria and Romania joined the EU in 2007, and while some of the other EU countries granted free movement for labour immediately, others used the full transitional period. But by the end of 2013, these transitional arrangements were terminated and full labour mobility extended to Bulgaria and Romania. At present, there remain only some restrictions for workers from Croatia, which joined the EU on 1 July 2013 (Canetta et al. 2014). Such transition arrangements where only meant to give labour markets time to adjust to new entrants, to increase flexibility and smooth the path to full integration. They were not meant to be long-run solutions.

Nevertheless, one idea might be to simply extend the phase III accession regime indefinitely and grant countries the right to restrict labour mobility in the case of serious disturbances in their labour market. Pisani-Ferry et al. (2016) suggest that temporary restrictions of labour mobility might be an acceptable price to pay for sustaining deep economic integration with the UK (and possibly other countries on the outer rim).[1]

However, for the EU the costs of compromising on labour mobility may be very large. This is certainly the case for the Eurozone – full labour mobility is one of the preconditions for optimality of a common currency and a key adjustment mechanism for asymmetric shocks. One of the main arguments for the US being a more robust currency area than the Eurozone was the strong response of labour mobility to negative employment shocks within the US. Newer evidence, however, suggests that after the Global Crisis this is no longer true – labur mobility in response to unemployment has been higher in Europe than in the US. Jauer et al. (2014) estimate that in Europe, up to about a quarter of any asymmetric labour market shock was absorbed by migration within a year. Admitting restrictions on labour mobility would thus severely weaken the architecture of the common currency. This cannot be in the interest of Germany or of present and prospective Eurozone partners. Rather, it is in their common interest to share a robust common currency and immunise against shocks, both foreign and homemade.

Looking beyond the common currency area, the cost of compromising on labour mobility could also be very high. Presumably, restrictions would operate with quotas that would be selective based on country of origin (and possibly other criteria, such as education and qualifications). If these were admissible inside the EU, they would create first- and second-class European citizens, which could lead to constant acrimony between members. It would certainly serve as a force for further disintegration and undermine key promises of membership of the EU – namely, prosperity and opportunity.

1 They propose a Continental Partnership (CP), starting between the UK and the EU7 and involving "participation in selected common policies consistent with access to the Single Market; participation in a new CP system of inter-governmental decision making and enforcement; contribution to the EU budget; close cooperation on foreign policy, security and, possibly, defence matters".

The corrosive effect of a compromise with the UK might not be limited to the economic realm, since it could open the door for nationalist parties everywhere to also demand special treatment on all sorts of issues. This is the last thing the EU needs.

What is Germany's self-interest?

The imminent Brexit negotiations have the potential to give rise to toxic disputes within the EU27. This would be the case if individual countries seek to gain market shares in special sectors, or to pursue short-term political victories at the expense of others. Germany's enlightened self-interest cannot be confined to short-term cost-benefit calculus for specific goods or sectoral relative advantages. In the long run, Germany's prosperity is inseparable from the success of Europe and the Eurozone. As the bloc's largest economy, it has great impact but is also highly exposed to Europe. Thus its priority has to be to preserve the EU and the Eurozone, and to avoid corrosive, possibly divisive or even destructive compromises with a country that wants to leave.

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6 Greece and the upcoming Brexit negotiations

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For a number of years after 2010, most commentators believed that Greece would be the first country to leave the Eurozone, and possibly the EU. European solidarity and the will of the Greek people to remain in the European family has so far averted 'Grexit', despite a close call in July 2015.

Now Brexit is before us, and Greece, among others, is called upon to form a position concerning the post-Brexit EU-UK relationship.

There are two possible outcomes of the Brexit negotiations. One is a 'hard Brexit', in which Britain leaves the Single Market, abandons the 'four freedoms' – the free movement of people, goods, services and capital – and resorts to a kind of 'fortress Britain' in which there will be a significant reduction in the volume of trade of goods and services between Britain and the EU. The second possible outcome is a 'soft Brexit', in which Britain remains in the Single Market, retains the *acquis communautaire*, and accepts mainly cosmetic restrictions to the free movement of people.

The question that arises for Greece is whether it should push for a hard Brexit, or whether it should aim for a negotiation that would make it possible for Britain to accept a soft Brexit.

In this, Greece should balance political and economic considerations, as well as the possible contagion effects that would be generated if Britain were to be perceived as having secured an outcome in accordance with its own objectives.

The political background between Greece and the UK

Britain is an important trading partner for Greece, but not as important as the longstanding close historical political ties between the two countries would have led one to believe.

It was in London that the two 'independence' loans were raised in 1824 and 1825, even before the creation of the Greek state, with the aim of helping finance the Greek war of independence against the Ottomans. It was through the 1827 Treaty of London that the three Protecting Powers (Britain, France and Russia) agreed on the autonomy of Greece from the Ottoman Empire, and intervened in the war of independence, leading to the creation of the modern Greek state in 1828. It was through a protocol signed at the London Conference of 1832, between Bavaria and the Protecting Powers, that Greece was declared an independent kingdom, free of Ottoman control, following the assassination of Governor Kapodistrias. It was on a British warship that King Otto, the first king of modern Greece, arrived in Greece in 1833, and it was on a British warship that he fled in 1863. It was at the urging of Britain that Greece adopted a more democratic constitution in 1864. It was through London finance houses that Greece was contracting its foreign loans throughout the 19th century. The close political relationship continued through the first half of the 20th century, culminating in the post-1944 British intervention to secure that Greece did not become a communist state.

The impact of a hard and soft Brexit on trade, tourism, migration, the EU budget and the European economy

Economic ties between Greece and the UK are not as deep or as strong as the history of their political ties and the size of the UK economy would suggest.

Exports of goods and services

Britain is only the sixth largest market for Greek exports, accounting for exports of $1.28 billion in 2014, or 3.8% of total Greek exports of goods. Turkey (13% of Greek exports) is the top export market for Greece, followed by Italy (9.3%), Germany (6.8%), Bulgaria (5.0%) and Cyprus (4.9%). France (2.6%) follows the UK in 7th place, followed by Romania (2.4%) and Spain (2.1%).

Almost half of the exports of Greece to the UK are chemical products (such as pharmaceuticals and beauty products), metals (such as copper pipes and aluminium plating and foil), foodstuffs (such as processed fruits, nuts and vegetables), and machines (such as insulated wire, telephones and broadcasting equipment). Animal and vegetable products (cheese, yogurt, grapes, etc.) are also important exports of Greece to the UK, as are minerals, textiles and plastics. In many ways, the exports of Greece to the UK have the same general structure as total Greek exports (see Table 1).

Table 1 The structure of Greek exports in 2014

	Greek exports to the UK	Total Greek exports
Chemical products	16.0%	8.4%
Metals	15.0%	12%
Foodstuffs	12.0%	7.9%
Machines	11.0%	7.4%
Animal products	9.5%	4.3%
Vegetable products	9.2%	5.3%
Minerals	8.6%	36%
Textiles	5.9%	4.7%
Plastics and rubbers	4.8%	4.3%
Other	8.0%	9.7%

Source: Observatory of Economic Complexity, MIT Media Lab.

Does this mean that Greece would find it easy to find other markets in the case of a hard Brexit? Not at all. The UK is a significant export market for Greece, and would be hard to replace. Greek export markets are generally quite small, and it would not be easy for Greek exporters to redirect these exports to other developed economies or other markets. Thus, based on bilateral trade considerations, Greece should opt for a soft Brexit, as this would imply the least damage for Greek exports.

This argument is reinforced if one considers third markets in Europe. Greece does not compete with the UK in third markets in Europe, as the structure of Greek and British exports is quite different. As there is little intra-industry trade between Greece and the UK, there are also very limited overlaps between Greek and UK exports in third markets in Europe. Thus, Greece stands to gain very little from the gap that would be opened in these markets in the case of a hard Brexit. The gap would be filled by other industrial economies, such as Germany, France, Italy and the Netherlands, who compete with Britain in similar export markets.

Tourism

A second important export market for Greece is tourism. Of the 23.6 million tourists that visited Greece in 2015, 2.4 million came from the UK. The UK is the second largest tourist market for Greece, almost on a par with Germany (2.8 million in 2015).

It is hard to establish direct links between Britain's participation in the Single Market and tourism. However, if the Brexit negotiations resulted in a hard Brexit, with further negative effects on the value of sterling and a prolonged slowdown for the British economy, then one could anticipate a significant reduction in British tourist arrivals in Greece, with strongly negative effects on the Greek economy.

Table 2 Tourist arrivals in Greece by country of origin, 2014 and 2015 (millions)

	2014	2015
Germany	2.459	2.810
UK	2.090	2.397
Bulgaria	1.535	1.901
France	1.463	1.522
Italy	1.118	1.355
Poland	0.589	0.754
Serbia	0.986	0.728
Romania	0.543	0.540
Russia	1.250	0.513
Europe	19.477	20.716
Asia	1.412	1.515
America	0.890	1.095
Oceania	0.205	0.212
Africa	0.049	0.062

Source: National Statistical Authority of Greece

It is important to note that a rise in arrivals from Britain and Germany between 2014 and 2015 more than compensated for the significant drop of arrivals from the Russian Federation (see Table 2). However, it is hard to contemplate how the gap from a significant drop in the number of British tourists in Greece would be filled.

Thus, in the light of considerations based on tourism, which is Greece's major export industry, Greece should again adopt a negotiating position in favour of a soft Brexit, as this would have minimal effects on the value of sterling and growth in the British economy, and would help maintain the strong tourist flows to Greece.

The EU budget

A third consideration is the EU budget. Britain, is a net contributor of about €7 billion in 2014 to the EU budget, despite its rebate. In the case of a hard Brexit, Britain will pay nothing into the community coffers. In the case of a soft Brexit, the EU could negotiate a reduced contribution, as has happened with Norway. This will still be significantly less than the current UK contribution, but would still better than in the case of a hard Brexit.

Given that Greece, unlike Britain, is a net recipient from the EU budget, to the tune of €5 billion in 2014, it stands to lose a lot in the case of a hard Brexit. Thus, it should again go for a soft Brexit.

Migration

A fourth consideration concerns migration. Both Greece and the UK are host countries for migrants from the rest of the Europe. However, following the 2010 crisis, migration from Greece has grown significantly, including migration to the UK. This has helped lessen social tensions in Greece and allows young Greeks to maintain and improve their human capital. The hope is that when the Greek economy eventually recovers, they might be able to return to Greece and contribute to the recovery.

In addition, many UK citizens have chosen Greece as the country where they reside during their retirement, contributing indirectly to the economy.

Thus, migration issues also suggest that Greece should adopt a negotiating position that would lead to a 'soft Brexit', as in that case the impact on the bilateral movement of people between Greece and the UK will face the least possible negative disruption.

Macroeconomics

A final consideration concerns the different macroeconomic effects of a soft and hard Brexit. A hard Brexit is bound to be a major shock for the European economy, and is thus much more dangerous for the recovery of Greece from the 'great depression' that was forced upon it by the 'sudden stop' of 2010. Most analysts expect a recovery in the next two to three years, but this prediction is based upon a smooth path for the economies of Greece's trading partners in Europe. If this path were to be disrupted by a hard Brexit, the Greek recovery would be put in grave danger as well.

Thus, the macroeconomic effects of a hard Brexit on the European macroeconomy, and the dangers for the recovery of the Greek economy, is an additional reason for why Greece should be aiming at a soft Brexit.

Conclusions

These are in my view the five most important considerations for Greece in the forthcoming Brexit negotiations: trade, tourism, the EU budget, migration and macroeconomics.

Based on these considerations, the negotiating position of Greece should be conducive to a soft Brexit.

Of course, Greece should also balance the main counterargument against a soft Brexit during the actual negotiations. This is none other than the potential domino effect on other countries, who may be tempted to follow the British path. As a result, the concessions made to Britain in order to secure a soft Brexit should be at the minimum.

In any case, this is bound to be a hard and drawn-out negotiation into uncharted territory. All EU countries should stand ready to react to new developments, but they should also stand ready to 'call Britain's bluff', as Britain stands to lose much more than the EU in the case of a hard Brexit.

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In addition to his political and academic posts, he has served as a consultant to a number of international institutions, including the European Commission and the World Bank. He has also been a Research Fellow at the Centre for Labour Economics of the London School of Economics (1981-82) and CEPR (1985-1999). During 1992-1993 he served as Chairman of the Council of Economic Advisors of Greece.

7 Economic consequences of Brexit strategy for Hungary

László Halpern
CERS-HAS and CEPR

Potential effects of Brexit on the Hungarian economy

Direct trade between Hungary and the UK has been quite modest, which means that one should not expect a significant impact of Brexit on the Hungarian economy, whatever the effect on its volume. The UK's share in Hungarian exports was 4.3% in 2015, and only 1.7% of Hungary's total imports came from the UK. Hungary has a modest share of the UK's trade – 0.3% of exports, and 0.8% of imports. The main Hungarian export products to the UK are nuclear reactors, boilers, machinery and mechanical appliances; electrical machinery and equipment; vehicles other than railway or tramway; and optical instruments. The main UK export products to Hungary are pharmaceutical products; nuclear reactors, boilers, machinery and mechanical appliances; electrical machinery and equipment; vehicles other than railway or tramway; and optical instruments.

However, Hungary's trade-induced losses due to Brexit are estimated to be relatively large in spite of these low shares in direct trade, with Breinlich et al. (2016, p. 131) estimating the losses at 0.3% of GDP. In relative terms, this is larger than the losses for (in decreasing order) the Czech Republic, Sweden, Germany, Poland, Slovakia, Finland, France, Portugal, Austria, Romania, Spain, Italy, Slovenia and Greece, but less than the losses for Ireland, the rest of EU (smaller countries taken together consisting of the Baltics, Bulgaria, Cyprus, Luxemburg, Malta), the Netherlands, Belgium and Denmark. The same study estimates that the trade effect on UK GDP will be in the range of 1.3% to 2.8%, depending on the scenario. Under an optimistic scenario, the UK is assumed to negotiate a Norway-like deal and tariffs remain at zero, but non-tariff barriers increase to one quarter of the reducible barriers faced by US exporters to the

EU. The authors further assume that the UK will not benefit from additional intra-EU integration, through which non-tariff barriers will fall 20% faster than in the rest of the world. They also factor in a 17% reduction in the UK's fiscal contribution to the EU (the same as Norway), a saving of 0.09% of UK GDP. Their pessimistic scenario supposes that the UK and the EU impose MFN tariffs on each other. Non-tariff barriers increase to three-quarters of the reducible barriers faced by US exporters to the EU. Further, the UK is excluded from additional EU integration, through which non-tariff barriers are assumed to fall 40% faster than in the rest of the world. In this scenario, they assume that the UK will save 0.31% of GDP on its fiscal contribution to EU budget. UK exports to the EU will fall by between 11% and 31% in the short run, and the long-run effects will be larger at somewhere between 25% and 44%. In the two extreme scenarios, EU exports to the UK will fall by between 10% and 29% in the short run, and by between 27% and 38% in the long run.

The second-round effects, however, are more important than the direct effects. They come from the fact that Germany is far more important to Hungary than the UK is. Germany's shares of Hungarian trade are 30.3% of exports and 23.5% of imports. (More or less the same is true for Slovakia although with somewhat lower trade exposure to Germany; countries in a similar position are also exposed to the second-round effects). Hungarian trade with Germany is large and may affect UK-German trade. One third of German exports to the UK consist of vehicles other than railway or tramway, a product group that represents a quarter of Hungarian exports to Germany. Product-level case studies might offer some insights into the conversion rate – that is, the extent to which Hungarian exports to Germany affect the German exports to the UK. Unfortunately, we do not have adequate case studies, but it is highly probable that Hungarian exports to Germany do in turn generate German exports to the UK.

Export and import transactions are especially linked to each other when exports and imports take place within the same firm or along the same supply chain. This suggests that the bulk of the economic effect of Brexit on Hungary via the trade channel may come not from the direct trade flow, but rather from second-round effects via Germany. If Germany trades less with the UK after Brexit, this will have a larger effect on Hungarian welfare than the loss due to the decrease in direct trade between UK and Hungary.

FDI from UK to Hungary has been quite volatile. For example, its share in overall inflows was 16% in 2012-2013, but was close to zero in 2014. Up to 2014, the UK's share in the stock of FDI in Hungary was 3.8%. The UK is the seventh largest investor in the country, and it mainly invests in the retail, telecommunications and professional services sectors. The largest companies in Hungary that are owned either fully or partly by UK investors are Tesco, Shell, Unilever, Glencore, Vodafone, Invitel, British American Tobacco Hungary, Imperial Tobacco Hungary, Reckitt Benckiser, and GlaxoSmithKline.

The UK is the second most popular destination (behind Germany) for Hungarian emigrants working abroad. According to official statistics, after Hungary's EU accession, the number was slightly below 40,000 until 2010. In the following six years their number increased rapidly, with an annual inflow of more than 20,000 in each year. These emigrants are younger, more skilled and more educated than the median Hungarian employee or job seeker. More specifically, two subgroups can be identified: skilled workers, and employees with a higher education. One quarter of these work in hotels and restaurants, and their share is significantly larger than that from other member countries joining the EU in 2004 or later. The share of health and social workers among Hungarians working in the UK is also significantly higher than for these countries. The share of workers in the manufacturing and building industry is lower, however, and is very similar to that of the EU15.

A large increase in foreign remittances – reaching 3.2% of Hungarian GDP in 2014 – can be explained by this increase in emigration. The UK was the fourth largest source country behind Germany, the US and Canada, with around €360 million.

Main elements of Hungary's strategy for Brexit

It is obvious that Brexit will have non-negligible consequences for Hungary through all three channels – trade, labour and capital. Although it may seem that the welfare loss due to trade is not significant, it is not its estimated magnitude in itself that should generate major concern. Its overall effect may be larger due to second-round channels, and this is why the Hungarian negotiating partners should attach high importance to the trade chapter.

Trade and labour movement issues will be linked during negotiation, as there seems to be no easy compromise between the positions of the UK and the EU. If the UK prefers a free trade agreement (FTA) with discretionary regulation of labour movement from the EU, and the EU insists on the Single Market – i.e. an FTA must go hand-in-hand with free movement of EU labour – it is hard to foresee a compromise.

Hungary has benefitted from a UK labour market that has welcomed highly skilled and highly educated immigrants. The UK labour market holds great value in the eyes of Hungarian job seekers abroad, and there is no close substitute in the EU on such a scale. It will take some time for potential migrants to react to new rules of entry into the UK labour market. However, as the negotiation will last for a while, assuming the push factors still dominate, potential migrants will have enough time to acquire the skills necessary for an alternative target country. According to the literature on the welfare effects of migration on source countries, well-designed domestic policies are the appropriate answer to the potential emigration outflow.

If, as can be assumed, the trade and labour markets will be tied to each other in the negotiations, two main broad options emerge: free labour movement with a custom union, or discretionary labour regulation with tariffs and non-tariff barriers. If the 'free' option is impossible for political reasons, then the negotiations will be over the parameters and the conditions of the departure from free trade. The UK seems to have a hard stance on labour, but it should be ready to give up much more in terms of free trade to achieve discretionary labour measures, as the trade-induced losses are highly asymmetrical between the UK and the EU. Any significant departure from free trade will be accompanied by new, additional financial market barriers. The above estimations do not deal with the effect of increasing frictions in financial flows between the UK and the EU – their effect on welfare might be as negative as that of new tariffs and new trade barriers.

A few countries may even see some short-term gain from reduced access to the UK labour market, as fewer skilled and highly educated emigrants leave their countries. These are mostly countries from the EU8 – especially Bulgaria, Hungary Poland, and Romania. However, any short-term welfare gains in the labour market will be exceeded by the losses through the trade channel. In addition, the short-term labour market gains might not even be realised if the new UK labour regulations do not dampen the emigration push factors in Hungary and in other central and eastern European countries. And the short-term effects – if they exist at all – will doubtless evaporate in the long run. Therefore, it is important for the Hungarian negotiators to understand that their eventual reluctance to join the EU's hard stance on the trade front will not be compensated by the welfare gain on labour. This is why the Hungarian strategy should take into account that any concession on labour market regulations will have consequences for the trade channel. It should be clear that any bartering over the labour market for trade concessions might have a negative overall effect on Hungarian welfare.

The Hungarian long-term interest is to take advantage of trade with UK, be it direct or indirect. It follows that Hungary has a strong interest in allying itself with Germany over trade. However, the large EU countries will take a hard stance on the potential trade-off between trade and labour deviations from the free option. Their initial readiness to swap deviations from the free option in trade and labour might be significantly different from that of Hungary, which is comparable to that of countries with similar trade and labour exposures to UK (such as Slovakia, the Czech Republic and Poland). However, if these countries together with Hungary make efforts to impose their negotiating position – that is, appearing ready to accept the UK's hard stance on labour – on others, then the overall trade-related welfare outcome might be in jeopardy as a harder stance on trade will be the unavoidable final outcome. As the final agreement should be unanimously voted on, any serious disagreement between the EU15 and the EU8 may provide an additional argument in favour of a two-speed EU.

The Brexit negotiation will be instrumental in the future of the EU, and economic considerations will certainly be heavily influenced by more general issues on the EU agenda. Hopefully it will become clear to the participating countries that disintegration would be costly, and that significant welfare losses are unavoidable. It may serve as a disciplinary device to deter other countries from even considering exit.

What is required?

According to the UK's Department for International Trade, the benefits for UK businesses exporting to Hungary include English being accepted as a business language, a western-style business culture, over £28 billion EU funding between 2014 and 2020, and the

UK ‘brand’ being viewed positively. The strengths of the Hungarian market include its strategic location in the heart of Europe, a well-developed transport network, an open economy, good infrastructure and communications, and its investment incentives. Hungary ranks 54th in the World Bank’s *Ease of Doing Business* report, but the report places Hungary 110th in terms of protecting investors. Despite Hungary’s increasingly westernised business culture, UK companies can encounter difficulties there, including bureaucracy, corruption, language difficulties (especially for smaller companies and outside Budapest) and legal barriers in public procurement. Obviously, these difficulties have nothing to do with Brexit and their removal should have a positive effect on both trade and FDI with all countries.

Whatever the final outcome of the UK-EU negotiations, Hungary will surely remain popular among British stag parties and ‘ruin bar’ visitors, and Hungarian dentistry services will still be used extensively by British patients. Whatever the overall impact of this on Hungarian welfare, however, it will not compensate for the potential loss from falling UK-EU trade.

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8 Ireland and Brexit

Alan Barrett and Edgar Morgenroth
Economic and Social Research Institute and Trinity College Dublin

Introduction

Ireland's relationship with the UK is unique among EU member states. It has historical and cultural links which differ in nature from those between any other EU member states and the UK. It can be argued that these historical and cultural links are also stronger compared to other EU member states. Ireland is the only EU member with a land border with the UK, and has a more intensive trade relationship with the UK. There are significant migrant flows between the two countries and a single electricity market has operated on the island of Ireland since 2007. Given these factors, it is not surprising that Ireland would prefer the status quo of free trade and free movement between the EU and the UK to be maintained.

In this chapter, we will discuss the trade and migration implications for Ireland of Brexit, with a view to identifying the core concerns of the Irish government in advance of Brexit negotiations. In our concluding remarks, we will also touch on the issue of the border between the Republic of Ireland and Northern Ireland. While this brings us into the realm of politics, the economic implications of any perceived distraction to the peace process are potentially significant for Ireland, and more so for Northern Ireland itself.

Trade

Ireland kept strong economic connections with the UK after independence, and at the time when both the UK and Ireland joined the EU in 1973, 55% of Irish merchandise exports were destined for the UK and 50% of imports came from the UK (Morgenroth

2015). Since then Ireland has significantly diversified its trade and the share of both services and merchandise trade with the UK has been steadily declining. However, the UK still accounted for 17.2% of total trade (merchandise and services imports and exports) in 2014, making it the single most important individual trading partner for Ireland, just ahead of the United States (17.1%)[1].

The degree to which free trade can be maintained depends on the degree to which the UK wants to deviate from current EU rules. For example, if the UK wanted to deviate from current rules on state aid then, under free trade, some UK firms would have an advantage over EU firms, including Irish ones. This would amount to unfair competition, which would not be in the interest of the EU. It is likely that the UK government will seek to change both the regulatory environment for UK firms and the openness of the UK to free movement of workers from the EU, which makes changes to free trade more likely.

While the aggregate trade numbers give an indication of the overall exposure of Ireland to an introduction to trade barriers, they hide the significant heterogeneity of trade relations with respect to types of firms, sectors, products and regional exposure, which are important in identifying key sensitivities for Ireland.

While the Irish economy is one of the most open in the world, a large share of Ireland's exports is due to the significant presence of foreign multinational corporations (MNCs) in the country. For industrial products, MNCs account for 90% of Irish exports, with the rest accounted for by indigenous firms. However, indigenous firms are far more exposed to the UK market with 43.5% of their exports being destined for the UK, while for MNCs the share accounted for by the UK is just 10.6% (Barrett et al. 2015).[2]

The vast majority of MNCs are exporting firms and operate in advanced sectors, but a significant share of indigenous firms are active in more traditional sectors such as food and beverages, or basic engineering. These more traditional sectors tend to be more dependent on the UK market. For example, almost 78% of exports of wearing apparel, 70% of wood and wood products and 62% of non-metallic mineral products

1 The rest of the EU is significantly more important for Irish trade, accounting for 35.8% of total trade in 2014.

2 The numbers are based on the Central Statistics Office's Census of Industrial Production 2012.

are destined for the UK. In relation to merchandise trade, it is also notable that Irish trade is remarkably concentrated in a small number of products (Barrett et al. 2015). For example, just over 7% of Irish merchandise exports to the UK consisted of packaged medicines and 4% were boneless beef. Finally, trade intensity with the UK is greater along the (economically lagging) border with Northern Ireland.

Overall, the concentration of merchandise implies that indigenous firms in more traditional industries and firms located close to the border are more exposed to the imposition of trade barriers. Importantly, traditional industries – and in particular, food products – attract the highest rates of tariff under the WTO rules. For example, boneless beef – which is the second most important merchandise export to the UK – would be subject to a tariff of 12.5% plus €303.5 per 100 kilogrammes, which for trade in 2015 would have resulted in an average tariff of almost 60%. In 2015, almost 50% of all boneless beef exported from Ireland was destined for the UK. Overall, Ireland would be harder hit by a WTO regime than other member states given the nature of the products traded, and would therefore aim to avoid a WTO scenario (Lawless and Morgenroth 2016).

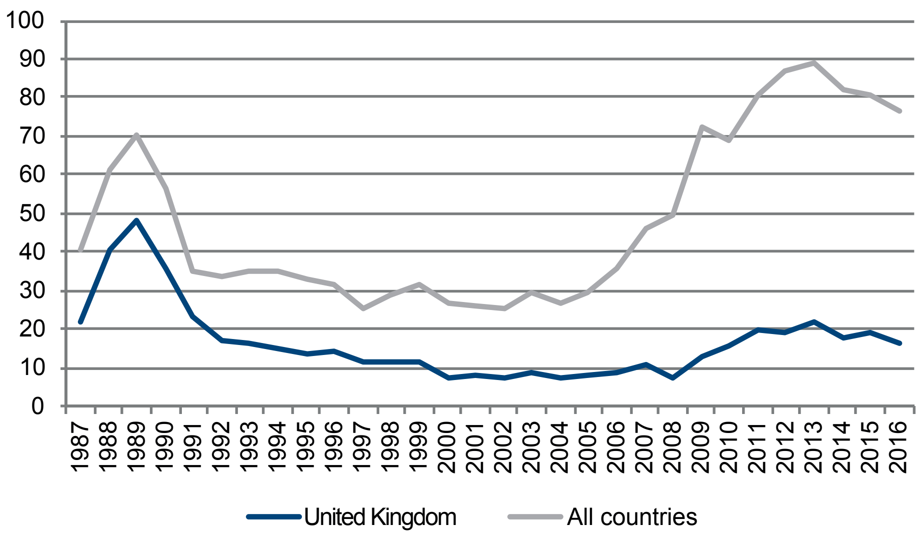
Almost 20% of Irish services exports are destined for the UK but, as in the case of merchandise trade, there are significant differences in the dependence on the UK across subsectors. For example, almost 80% of Irish transport services exports go to the UK, and for Irish financial services exports the UK (32.8%) is a more important destination than the rest of the EU combined (32.1%). The latter shows the close integration of the International Financial Services Centre in Dublin with the City of London, while the former is related both to trade-related transport and the provision of aviation services. The trade in financial services between Ireland and the UK is facilitated by the passporting of financial services within the EU. While a loss of the passporting rule might lead to reduced trade in financial services between Ireland and the UK, it might also lead to the relocation of the affected companies from the City of London to the EU. Given the range of location advantages present in Ireland, this might actually have a positive effect.

The focus of trade impacts tends to be on exports, but imports also need to be considered. Ireland is more dependent on the UK for merchandise imports than for merchandise exports. This is due to the heavy reliance of Ireland on energy imports from the UK (mainly natural gas and fuels) and retail products. In relation to the latter, it is noteworthy that UK retailers have a very significant presence in the Irish market, there is a preference for some UK-produced retail products in Ireland, and many products wholesalers based in the UK serve both the UK and Irish market, as the Irish market is too small. Trade barriers would result in higher prices and would thus have an inflationary impact.

Migration

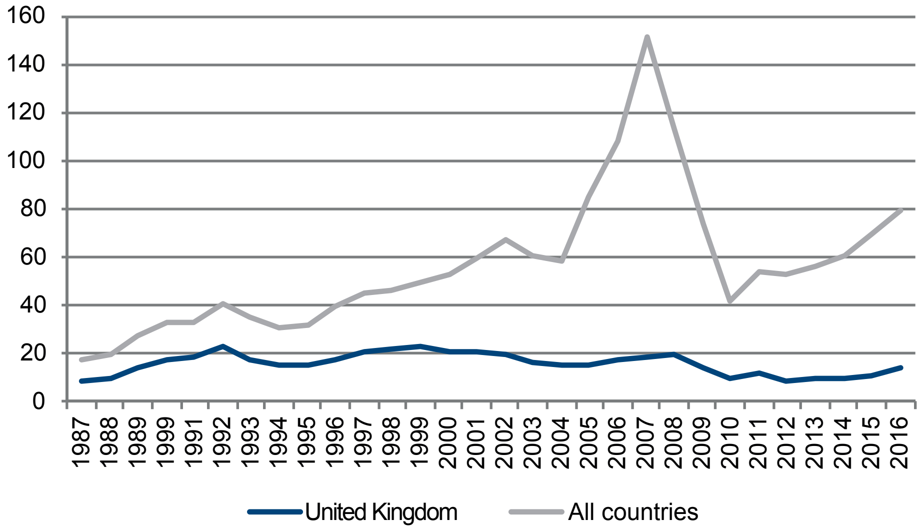
Migratory flows between Ireland and the UK have been a key feature of the demography and economics of the two islands for centuries, so it is unsurprising that the possibility of restrictions on free movement raises significant issues. These issues will be best understood if some context is provided, so we will begin this section by providing some data on population flows to and from Ireland. In Figure 1, we show emigration from Ireland over the period 1987 to 2016 – we show all emigration, and that which flowed specifically to the UK. In Figure 2, we provide the corresponding figures with respect to immigration.

Figure 1 Emigration from Ireland, 1987 to 2016 (in thousands)



Source: Central Statistics Office

Figure 2 Immigration to Ireland, 1987 to 2016 (in thousands)



Source: Central Statistics Office

Focusing first on Figure 1 (emigration), it can be seen that the proportion of emigrants from Ireland going to the UK has decreased over time. In 1987, over a half of Ireland's emigrants were bound for the UK, but this has fallen to 22% in 2016. There are two reasons for this relative decline. First, going back to the late 1980s, almost all emigrants from Ireland were Irish nationals. However, following the inflows of non-nationals into Ireland in the 2000s (Figure 2), almost 60% of 'emigrants' from Ireland in 2016 were not Irish nationals. Many of these non-nationals would have been returning to their countries of birth. Second, some emigration from Ireland due to the Great Recession was to countries which were somewhat insulated from the worst effects, such as Australia.

In spite of the relative decline of the UK as an emigration destination, flows to the UK doubled during the Great Recession and were sizeable. When one considers that there are about two million people employed in Ireland, the total outflow to the UK of 98,000 from 2010 to 2015 is clearly significant. These figures suggest that the UK labour market played an important role during the Great Recession in absorbing some of the labour which would otherwise have remained unemployed in Ireland. This role has been identified in many papers over many years (for a review, see Barrett 2005). Before leaving Figure 1, it is also worth noting that there was a steady stream of emigration from Ireland to the UK during the years of Ireland's economic boom, although at a lower rate. This flow reflects the fact that many Irish people chose to migrate to the UK even when jobs were plentiful in Ireland, often for reasons of professional development. This professional development was possible partly because of the shared legal, linguistic and other institutional features of Ireland and the UK, which meant that human capital accumulated in the UK could be recognised, and rewarded, in Ireland (Barrett and Goggin 2010).

Looking briefly at Figure 2 and immigration, we again see a pattern of decline in the relative importance of the UK. In the earlier period, much of the immigration into Ireland was return migration of former Irish emigrants, many of whom were returning from the UK. But by 2016, 17% of immigration into Ireland was from the UK, made up of returning Irish, UK nationals and third-country nationals.

The high rates of migratory movement between Ireland and the UK have led to a situation where almost 400,000 people who were born in the Republic of Ireland were resident in the UK in 2011. Similarly, almost 230,000 UK-born people were resident in Ireland in 2011. As can be expected, this leads to high level of short-term movement between the two islands. By way of illustration, about 40% of overseas trips to and from Ireland relate to the UK.

These high levels of movement have been prompted by a range of push and pull factors over the decades (such as economic swings), and throughout the period since Ireland's independence in the 1920s, the movement has been facilitated by a remarkably liberal migration regime referred to as the 'common travel area', or CTA. Under this arrangement, Irish and British citizens have always been allowed to move between the islands and to settle for work purposes. The maintenance of the CTA has been a core principle for all Irish governments. Ireland and the UK jointly opted out of the Schengen arrangement in 1995, with the EU granting the opt-out partly in recognition of the Ireland-UK CTA.

Turning now to Ireland's needs from the Brexit negotiations, the maintenance of free movement between the islands has been identified by the Irish government as a core demand. As discussed above, the free movement that has existed since independence has been an important source of labour market adjustment for Ireland. Without the

UK as an emigration destination, Ireland would likely see more internal labour market adjustment to economic shocks. While emigration from Ireland might disperse to other locations, the cultural and linguistic links with the UK continue to make it an attractive destination for Irish emigrants.

The maintenance of free movement between Ireland and the UK has received a sympathetic ear from many sources, including from within the UK government. However, it remains unclear how the UK itself will restrict free movement from the rest of the EU but not from Ireland, if free movement with Ireland is to be maintained.

Conclusion

It should be clear from the discussion above that the Irish and British economies are closely linked through trade and migration. By extension, any disruption to the ease with which goods, services, capital and labour move between the islands is likely to have negative economic consequences. For this reason, the Irish government has already made clear its hope that Brexit will have a limited impact and that arrangements such as UK access to the Single Market will continue. Failing this, the Irish government will look for formulae to be devised whereby the unique circumstances of Ireland can be accommodated.

In making its case, the Irish government will point to the Northern Ireland peace process and the importance of the continued normalisation of relationship within Northern Ireland, on the island of Ireland and between Ireland and the UK. With regard to the island of Ireland, a situation has evolved since the signing of the Good Friday Agreement in 1998 whereby the border between north and south is essentially non-existent for most practical purposes. This is in stark contrast to the situation in the 1970s, 1980s and into the 1990s, when there was a significant security presence at the border. The possible recreation of the border for the purposes of customs or passport checks is generally understood to be a negative development and adds to the argument for creative solutions to be found if Brexit results in trade or migratory barriers.

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9 An Italian perspective on the forthcoming Brexit negotiations

Stefano Micossi and Riccardo Perissich
ASSONIME; Council for United States and Italy

At the moment, the only certainty in the forthcoming Brexit negotiations is ... uncertainty. The British prime minister has announced her intention to formally notify the intention to leave the Union at the latest in March 2017, but the likely content of the British opening position will remain unknown for several months to come. We also don't know when the negotiations will start, since after receiving notification the European Council will have to agree on a mandate to its negotiators. Therefore, all we can do at this stage is set out our hypotheses on the likely shape of the British negotiating position and discuss, in this context, what the Italian interests and reactions might be.

The economic impact of Brexit

A cursory look at the trade statistics indicates that the static impact of Brexit cannot be very large (Table 1). The UK is a net importer of goods from the EU (with which it has a large deficit of about 4.8% of GDP) and a net exporter of services to the EU (with a surplus of around 1% of GDP). At least initially, restrictions on access to the Single Market might worsen both, but the exchange rate depreciation might offset this to some extent. However, as noted by Gros (2016), for a number of years now the UK's trade flows have increasingly been diverted to the rest of the world. This is especially the case for services, where the country has developed a very large surplus.

Table 1 UK trade with the EU and the World, 2015

	Total trade			Trade in goods			Trade in services		
	Exports	Imports	Balance	Exports	Imports	Balance	Exports	Imports	Balance
World									
£ million	508,767	547,441	-38,674	283,282	409,719	-126,437	225,485	137,722	87,763
% of GDP	27.2	29.3	-2.1	15.2	21.9	-6.8	12.1	7.4	4.7
EU									
£ million	222,433	290,969	-68,536	133,524	222,992	-89,468	88,909	67,977	20,932
% of GDP	11.9	15.6	-3.7	7.1	11.9	-4.8	4.8	3.6	1.1

Source: Office for National Statistics.

Table 2 Trading and financial relationships between the UK and main EU countries (% of GDP)

	Trade (goods and services, 2014)		Portfolio investment (stocks, end of 2015-Q2)		Direct investment (stocks, end of 2014)	
	Exports	Imports	Assets	Liabilities	Assets	Liabilities
Italy	1.7	1.1	3.9	6.8	1.3	2.2
France	2.5	1.9	11.1	12.7	4.9	2.2
Germany	3.4	2.1	6.5	8.8	2.8	0.7
Spain	2.9	1.8	3.2	7.2	6.0	1.7

Source: Banca d'Italia Economic Bulletin No. 3, July 2016.

In Table 2, we report the trading and financial relationships of the four largest EU countries with the UK. Again, the numbers are small. Germany stands out for relatively large merchandise (export) flows, and France for large portfolio investments, but altogether it is difficult to see any earthquake in sight. The numbers for Italy are tiny on all three dimensions (trade, portfolio investment and direct investment).

The long-term effects might be more substantial to the extent that Brexit elicits new patterns of direct investment – for example, if Japanese car manufacturers move their plants to an EU location (possibly in Eastern Europe), or financial traders (clearing in euros) abandon the City for Frankfurt, Amsterdam or Paris (see Lannoo 2016). Some of this investment might well be attracted also to Milan, whose Borsa Italiana is owned by the London Stock Exchange Group. However, while public and private actors in the EU are positioning to take advantage of Brexit, any conclusion on the eventual effects would be highly speculative at this stage.

Timing

The reason the UK government has not yet formally notified its intention to exit from the EU is quite obvious: they first need an in-depth evaluation of possible approaches to Brexit, without which they simply can't define their opening shots in the negotiations. An important constraint here is that the UK government will not want the UK to participate in the next elections for the European Parliament, to be held in June 2019. On this, Article 50 of the Treaty on the European Union (henceforth, "Article 50") provides that "the Treaties shall cease to apply to the state in question from the date of entry into force of the withdrawal agreement" (para. 3) or, if an agreement cannot be reached, two years after the notification of the intention to exit. Notification by May 2017 would normally ensure that Brexit happened before the next European parliamentary elections.

After receiving the notification, the European Council will have to agree – by a qualified majority – on a mandate for the EU negotiating team, and then seek the consent of the European Parliament under the procedural rules for international agreements (Article 218 of the Treaty on the Functioning of the European Union). This may take some time, in view of the electoral cycles that will then be under way in France and Germany.

However, while this may delay the negotiations, it will not alter the deadline set by Article 50. A strong incentive for both contracting parties to accelerate the negotiations will be provided by the desire to put an end to the current state of uncertainty, which is paralysing investment decisions on both sides of the Channel.

Italian attitudes towards the UK

Let us note at the outset that Italy has been a strong supporter of British membership of the European Community since the early days. The motivation for this has been twofold. The first is a long tradition of friendship that, with the exception of the Second World War, goes back to the UK's support for the Risorgimento. The second is that Italy hoped that Britain could provide a welcome balance to the dominance of the Franco-German partnership. Despite several attempts on the Italian side, this strategy has always led to disappointment; Britain, despite some polite noises, never really took any notice.

The fact is that, apart from being uneasy with the role of France and Germany, Britain and Italy have very few common interests – the most important of which are probably that both countries are strongly pro-US and are attached to NATO. One of the rare moments when the two nations were aligned against France and Germany was when Berlusconi decided to side with George W. Bush and Tony Blair and support the war in Iraq. Another area where the interests of both countries have been often aligned is trade, and the UK's diminished influence on the ratification of the EU-Canada Comprehensive Economic and Trade Agreement (CETA)[1] and the now-frozen TTIP negotiations will be sorely felt by Italy.

Despite all this, Italy was forthcoming during David Cameron's attempts to negotiate conditions for continued UK membership of the EU, and the vote in favour of Brexit has been met with regret and dismay.

1 CETA has already been agreed upon by negotiators, but its ratification has been called into question by the EU's decision to subject its entry into force to ratification by all member states. Thus, the proposal will have to be approved by 38 national and regional assemblies, as prescribed by national procedures for the ratification of international treaties. The Italian government has been a strong advocate of immediate ratification of the agreement.

It should also be noted that, in recent years, Italy has once again become a country of emigration. It is estimated that between 60,000 and 100,000 young Italians have moved abroad every year in recent years to seek employment opportunities, mainly to other parts of the EU. Moreover, about 600,000 Italians are working in Britain.

What negotiations?

There will be two parallel negotiations: one to extricate Britain from all relationships with EU institutions and policies, the other to define the new trading and investment relations between the UK and the EU (including the new arrangements for the circulation of workers). The first negotiation – the 'exit' negotiation under Article 50 – does not involve difficult questions of principle. It mainly concerns the interruption of payments flowing between the EU's budget and the UK, the treatment of UK personnel by EU institutions (including pension claims), the splitting up of common properties of EU institutions (buildings and the like), and the relocation of the two EU agencies located in London (the European Banking Authority and the European Medicines Agency).

The important negotiation of course is the second one, which is akin to a comprehensive trade and investment agreement and is likely to take several years. On this, Article 50 only makes an oblique reference to the effect that exit negotiations will take account of the "framework" for the future relationships between the exiting country and the EU, but the European Council has ruled out explicitly any dialogue in this domain as long as the intention to exit has not been formally notified.

EU legislation, as well as standing trade agreements negotiated between the EU and third countries also on behalf of the UK since 1973 (numbering over 140), will cease to apply to the UK upon exit (as has been mentioned), but not before. One unpleasant implication is that, until exit takes its full effect, not only must the UK continue to apply existing EU rules and Treaties (under the control of the Commission and the European Court of Justice), but it also cannot formally start separate trade and investment negotiations with third countries (since the power to negotiate trade agreements on behalf of its members belongs exclusively to the EU).

There is hardly therefore any room for the UK to try to divide EU members and seek separate settlements with some of them. There is one area, however, where Brexit can elicit fresh divisions between remaining member states, and that is the common budget. Assuming that "Brexit is Brexit", all UK payments to and from the EU budget would lapse. Since the UK is currently in a sizeable net creditor position (by about €7 billion per year), a decision would have to be taken on how to allocate this net reduction in revenues. Table 3 shows how the net contributions of some creditor countries would be affected, under the assumption that spending levels are not modified (based on estimates by Nùñez Ferrer and Rinaldi 2016). The extra burden would not be enormous, but neither would it be negligible, especially for Germany and France. With the prevailing budgetary stringency in most countries, it is perhaps more likely that the missing UK contribution will lead to a reduction in spending, with loud complaints from recipients.

Table 3 Total contributions and net balances to the EU budget for selected countries, 2014 (billion euros)

	Total contributions	Net balance*	Δ contributions with UK out**
Austria	2.9	-1.3	0.5
France	21.0	-7.5	1.5
Germany	29.1	-17.7	2.6
Italy	15.9	-5.2	0.8
Netherlands	8.4	-6.4	-0.1
Sweden	4.3	-2.6	0.4
United Kingdom	14.1	-7.1	-
EU28	133.0	-4.4	7.1

Note: *computed as the difference between total EU expenditure in the member states and total contribution to the EU budget by member state, including adjustment for the British rebate and for Justice and Home affairs.

Source: European Commission and ** Nùñez Ferrer and Rinaldi (2016).

The UK's likely position

The discussions will be shaped by the type of relationship that the UK will chose to have with the EU. Should Britain go for a 'hard Brexit', abandoning the Single Market altogether, the negotiations will be relatively simple as we shall have to discuss how to disentangle existing links, discuss a trade pact, and maybe discuss other issues that are not central to the functioning of EU institutions, such as cooperation on security.

If, on the other hand, Britain wants some form of participation in the Single Market (either tailor-made or following an existing model), two critical issues will be at the centre of the negotiation: the free movement of people, and the extent to which EU regulations will be applied by the UK. The latter question is as important, if not more so, than the former.

The cornerstone of the Single Market is the common set of rules that allow the free circulation of goods, capital, services and people. To retain full access to the EU market, Britain would have to agree to respect the rules decided by EU institutions and, equally important, the authority of the European Court of Justice. A return to full sovereignty for the UK parliament was one of the main motivations for the vote in favour of Brexit; and indeed Prime Minster May has now indicated that she wants the UK to become a "fully independent sovereign country", a clear sign that she will aim for a clean break from the Single Market.

Of course, the UK may choose to negotiate full access for some sectors (for instance, financial services), but the problem of principle would remain. International trade negotiations also provide for mechanisms to recognise, on a case-by-case basis, the 'equivalence' of national rules. This could be helpful in some cases, and it has been suggested that it could be a second-best alternative if agreement on the 'passport' for financial services proves impossible. However, the experience of the discussions with the United States regarding the TTIP suggests that, in practice, what would be negotiated would not be a convergence of the regulations, but rather the transparency and – as far as possible – the convergence of the regulatory processes. As far as the EU is concerned, its institutions would remain the sole judges of the degree of equivalence, posing again a possibly insurmountable political problem to the UK electorate.

Resistance from the EU side to weakening the integrity of the decision-making process is likely to be even stronger than in the case of the free circulation of people. Italy is sure to take a strong stand against any concession on this question.

On the free movement of labour

On the issue of free movement of labour, Pisani-Ferry et al. (2016) have argued that this problem belongs to the 'political' dimension of the EU and is not an integral part of the Single Market. As a consequence, in the framework of a negotiation exclusively focused on the economic relationship with a non-member, the EU may well consider granting concessions that were refused to David Cameron last year. It has also been suggested that, given the tensions that exist in many countries over the issue of migration, Brexit could provide an opportunity to change existing EU policies. We believe this approach to be utterly wrong for a number of reasons.

The Schengen Area and the free circulation of EU citizens are easily confused, but they are not the same thing. The Schengen agreements – later incorporated into EU law by the Amsterdam Treaty in 1997 – abolished internal border controls between the member states (with opt-outs by the UK and Ireland) and established a common external border to the EU, supplemented by common visa controls and police cooperation (also applied by Iceland, Norway and Switzerland). The Council wants now to strengthen this construction with a common border and coast guard.

Many ongoing discussions, and tensions, between the member states in the European Council are centred on the issue of the effective control of the common external border against migrants from third countries, terrorists, drug traffickers, and so on. The condition for saving Schengen from oblivion is re-establishing effective border controls vis-à-vis third countries; this was successfully done on the eastern border by closing the Balkan route to migrants, but it has yet to be achieved on the southern border. France and Austria are threatening to reintroduce border controls because they do not want to receive migrants who land in Italy and that Italy would like to see move north. In this respect, it can be said that while Schengen also has an economic dimension, it is a 'political' project, of which the UK has never been part.

The principle of the free circulation of people, on the other hand, is an integral part of the Single Market and applies to all EU countries, irrespective of whether they are part of Schengen or not. It is not difficult to see that, without the free movement of people, the freedom of establishment and the freedom to provide services across borders are nullified. The City is well aware of this – and for this reason has advocated maintaining free circulation for qualified people after Brexit, without which their ability to operate on the continent would be crippled. But there is more – under Article 3 of the Treaty on the European Union, freedom, security and justice form a central part of EU citizenry, and the four freedoms appear as an inseparable political right.

By and large this right – the free circulation of EU citizens – is not called into question in the EU apart from in the UK, where over three million EU citizens are currently working and residing. In Italy, for example, there are close to one million Romanian citizens but there has been practically no negative reaction among the public, apart from in response to the very specific problem of the Roma community. We are all aware that there may be cases of abuse of social security or labour laws; however, the jurisprudence of the Court of Justice can take care of most of these problems and, if necessary, the rules can be adapted.

For these reasons, as well as in order to protect the interests of Italian citizens that wish to work or study in the UK, we fail to see why Italy should show flexibility in response British demands on this score. The free circulation of EU citizens is one of the foundations of the Union; by weakening it, we would endanger the entire construction, as well as undermine the support of those who still want a stronger and more integrated Europe (and possibly political union) to emerge from the current convulsions. Concessions in this area would also further compromise the already tense relations with the eastern European member states.

Conclusion

Looking at the forthcoming negotiations, Italy can therefore be expected to be helpful, but there will be strict limits to its flexibility. The main concern will be that uncertainty surrounding Brexit does not impinge on pressing intra-EU and intra-Eurozone questions.

Broadly speaking, Italy will attach a high priority to preserving the integrity of the basic principles that govern the EU (including the institutional balance) and to the possibility of the Eurozone integrating further.

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10 The Dutch position in the Brexit negotiations

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Possible Brexit models

By and large, there are four conceivable outcomes of Brexit (Busch and Matthes 2016). One is the 'Norwegian model', in which the UK has to comply with the EU regulations – implying uninterrupted freedom of movement of goods, services, capital and persons – and continues to contribute to the EU budget, but has no say in EU policies. Accepting free movement of people would go against what the 'Leave' camp thought they were voting for in the referendum, while the remaining EU members are unlikely to accept a Norwegian model without free movement of people to avoid setting a precedent. The 'Switzerland model' restricts the free movement of people, but also impedes free trade with the EU. The 'Turkey model' is a customs union with tariff-free movement of manufactured and processed agricultural products, but no free trade in services. Finally, there is the fall-back of common WTO membership of the UK and the rest of the EU. In this case, all four freedoms of movement would be impaired. The UK would have to renegotiate trade agreements with non-EU countries, as well as the conditions of its WTO membership. Under the Switzerland model, contributions to the EU budget would be limited, while under the Turkey and WTO models, they would come to an end. The economic consequences of Brexit for the Netherlands are highly dependent on the model that prevails.

1 We thank Audrie van Veen and Charles Wyplosz for comments on an earlier version of this article. Any potential remaining errors are our sole responsibility.

Direct economic consequences for the Netherlands

Without knowing the eventual outcome, we can form an idea of the magnitude of the economic interests at stake for the Netherlands, and in comparison with other the rest of EU countries, so as to assess which countries' interests are most congruent with those of the Dutch. We will do so for trade in goods, foreign direct investment, and migration.

From Table 1 in the introduction to this book, we see that exports from the Netherlands to the UK amount to around €47 billion, or 7.6% of Dutch GDP. The Netherlands ranks fourth among EU members in exports to the UK as a fraction of GDP (behind Ireland, Luxemburg and Malta). Relative to their size, these countries export substantially more than the large EU economies. Among these, with exports of 3.5% of GDP, Germany has the strongest interest in keeping the trade channel with the UK open; the shares of France, Italy and Spain are also non-negligible. Regarding UK exports, the Netherlands accounts for almost €24 billion, or 1.6% of British GDP. This is on a par with UK exports to France, but less than exports to Germany. In terms of shares of GDP, bilateral trade relations between individual EU countries and the UK seem more important for the former than for the latter. Still, the sum of all UK exports to the EU amounts to over 12% of UK GDP, indicating that the UK has a substantial interest in preserving free trade with the EU.

As shown in Table 2 of the introduction, the accumulated foreign direct investment (FDI) of the Netherlands in the UK amount to €218 billion, more than those of France and Germany together, and almost one third of Dutch GDP. Accumulated UK FDI in the Netherlands amounts to 6.5% of UK GDP, again more than in France and Germany together. These high numbers may be partially explained by tax planning schemes of international companies. Still, the UK and the Netherlands have a strong mutual interest in keeping barriers to direct investments in each other's economies as low as possible.

The largest bone of contention to the UK voters is the free movement of workers across the EU. There is a feeling on the side of many British citizens that foreigners steal their jobs and abuse the welfare system. Whether this is true or not, Brexit may cause a backlash against the free movement of workers. What could this mean for the Netherlands? Table 3 in the introduction reports the number of migrants from other EU countries in the UK. The total number is about 2.9 million, or 4.4% of the UK's total population of almost 65 million. Among these, the Polish make up the largest share with slightly over 700,000, followed by the Irish (500,000) and the Germans (about 320,000). For Ireland, this amounts to a substantial share of its population (10.7%). The number of Dutch living in the UK is about 68,000, which is only 0.4% of the Dutch population. The total number of UK citizens living in other EU countries is about 1.2 million, or 1.9% of the UK population. The largest group (around 308,000) is formed by those who live in Spain, followed by Ireland (about 250,000) and France (about 185,000). The number of UK nationals living in the Netherlands is close to 50,000, which is only 0.1% of the UK population. Overall, therefore, bilateral migration flows between the UK and other EU countries are rather unbalanced, although the scale of the imbalance is rather small for the Netherlands. Furthermore, most UK citizens living in Spain and France are retired, and these countries would not like to see them leave because of their spending in the local economy. The issue of immigration indicates a further imbalance between the UK and the rest of EU. For the Netherlands, the overall interest in maintaining free movement of workers to and from Britain is comparatively small. From the perspective of the UK, one might ask to what extent the immigration problem can be solved by leaving the EU. The total number of foreigners living in the UK is about 8.5 million, so the fraction of foreigners from the EU is 34%. Surely, the bulk of the UK's immigration 'problem' cannot be solved through Brexit.

Indirect consequences for the Netherlands

The previous section gave an idea of the potential order of magnitude of the direct economic consequences of a disruption in the economic relationship between the Netherlands and the UK. The indirect consequences of a breakdown of this relationship are much harder to assess. The Netherlands generally supports free trade and competition – there exists no culture of protecting specific professions. In this regard, the Netherlands and the UK tend to be allies in the European political arena. On issues such as the financial transactions tax, their views also tend to be aligned. With the departure of the UK from the EU, the Netherlands will lose an ally when it comes to promoting the functioning of markets and uninterrupted trade and investment. The centre of gravity of who determines EU economic policies will inevitably shift to the countries that are less eager to promote the free functioning of markets, and the Netherlands' trade and financial relationships with the remaining EU members and with countries outside the EU may become weaker.

Other considerations

The pensions industry and other financial industries

While most EU pension systems are dominated by a pay-as-you-go pillar, in which current workers finance the benefits of the retired, the UK and the Netherlands feature substantial savings held by pension funds. According to EIOPA (2016), 85% of all EU pension savings are in defined-benefit plans. The UK accounts for 48% of total EU savings in defined-benefit plans, and the Netherlands is second with almost 40%. Of the total EU savings in defined-contribution plans, the UK accounts for 65% and Italy for almost 20%. Total Dutch pension savings amount to roughly twice its GDP, with the vast majority of the savings held by pension funds executing defined-benefit plans. The pension fund sector is therefore of substantial importance to the Netherlands, and its interests in the European arena have generally been strongly aligned with those of the UK's pension fund sector.

There appears to be rather little understanding on the side of European policymakers of the nature of pension funds and the plans they operate. In fact, there is a latent pressure to extend the supervisory framework for the insurance sector to pension funds. While pension funds have up to now been exempted from Solvency II, the chances that pension funds will eventually be shifted under Solvency II will no doubt increase with the exit of the UK as a protector of the pension fund industry. The consequence would be that pension funds would have to reduce the riskiness of their asset portfolios at the cost of reducing investment returns, which would eventually lead to an expected reduction in pension benefits.

It has been suggested that the Dutch financial sector could benefit from Brexit and the presumed exodus of business from the City. This may be too optimistic. Over the past decade, the Dutch financial sector has been shrinking, and it is still shrinking. Activity migrating out of London and headed for the European continent might prefer to settle in Frankfurt, or even Luxemburg or Paris, from which it can service the entire

EU. These places have a larger concentration of financial sector activities, making it easier, for example, to attract specialised employees and maintaining relationships with other relevant parties in the financial sector. The Dutch financial sector may benefit somewhat from the creation of new subsidiaries of parties operating in the City. However, we would expect these to mainly service local demand, such that of British and other foreign firms servicing the Dutch market.

Mergers and acquisitions

There is a rich history of successful collaborations between UK and Dutch companies, with important examples being the world players Royal Dutch Shell and Unilever. More recently, in 1999, the Dutch steel company Hoogovens and British Steel teamed up to form Corus (which was taken over by Tata Steel in 2007). From the side of British Steel, an important reason for the merger was the enhanced proximity to its customers on the European continent. History suggests that trade barriers caused by Brexit may be partly overcome through cross-border mergers of UK and Dutch companies. Such mergers would allow UK companies easy access to the EU. Its proximity to both the UK and central Europe may thus benefit the Netherlands.

Avoiding precedents and a Europe à la carte

Much of the above suggests that it is in the interest of the Netherlands not to take too tough a position towards the UK in the negotiations over future trade and investment relations. Nevertheless, the Netherlands shares the common interest of the remaining EU countries in avoiding the UK setting a precedent for other countries to leave the EU, or for the extraction of all kinds of concessions in order not to leave. A 'Europe à la carte', in which countries only subscribe to the EU arrangements they like while avoiding those they do not like, is to be avoided. Populism is on the rise almost everywhere in

Europe, and giving the UK an easy way out may send the wrong signal that a country can have all the benefits of the EU without having to contribute to its budget or having to follow certain common rules.[2]

What position should the Netherlands take in the Brexit negotiations?

It is clear that the Netherlands has a substantial economic interest in maintaining the freedom of movement of goods, services and capital between the UK and the rest of EU. In fact, it shares these interests with the UK, as well as with the other relatively small, highly open economies in the northwest of Europe. Dutch interest in maintaining the freedom of worker movement seems less vital. Moreover, while a large fraction of the eastern Europeans in the UK are manual workers, Dutch workers in the UK are on average highly qualified and would, therefore, find it easier to overcome migration barriers. The Norwegian model, with complete freedom of movement of people, will not be acceptable to the UK, while a 'Norwegian-minus' model without freedom of movement of people will be unacceptable to most of the rest of EU. An important reason for this is to avoid setting a precedent of a 'Europe à la carte'. This issue should surely weigh relatively less heavily for the Netherlands and the other small, open north-western European economies. They may do well to team up and try to jointly push for a solution that comes as close as possible to a 'Norwegian-like' model. This model not being acceptable to the UK, there may possibly be a solution with some (restricted) freedom of labour movement. For example, freedom of movement might be differentiated across sectors and across qualifications, so that it would be relatively easy for highly qualified workers to work in the UK. What we have in mind comes close to the 'Continental Partnership' proposed by Pisani-Ferry et al. (2016), in which the members of the Continental Partnership subscribe to all freedoms except the free movement of workers, contribute to the EU budget, and are consulted before new EU legislation is

2 The UK is a net contributor to the EU budget. Based on the assumption that the net contribution of the UK would be spread across the remaining EU countries in proportion to their stakes in the 2014 EU budget (see http://europa.eu/european-union/index_nl), we estimate the additional contribution of the Netherlands at 195 million euros, if the UK were to drop out of the EU budget completely. Proportionally to GDP this is a very limited amount. However, it will give populist parties additional ammunition to stoke anti-EU sentiment.

enacted but have no formal say in its design. Our version of the Continental Partnership would complement this with targeted freedom of labour movement, although it is likely that this proposal will face strong opposition from eastern European countries who are afraid that the sectors in which their citizens are mainly working would be restricted. It should be understood that the UK itself would be hurt much more than any *individual* country in the rest of EU by a breakdown of its economic relationships with the EU. Hence, its negotiating position may be quite weak. The Continental Partnership would mean a concession by the UK in terms of influence over EU legislation. However, its main reservation towards EU membership – namely, unrestricted freedom of movement of workers – would be solved.

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11 Poland–UK relations after Brexit: Suggested priorities for negotiations

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Introduction

Brexit will affect Poland in many ways, including bilateral trade, foreign investment, movement of people, transfers from the EU budget, and cooperation in security and defence areas. Technical negotiations on the divorce conditions will be conducted by the European Commission within the mandate given by the European Council. This means Poland will have to negotiate on two levels: first, it will try to secure its interests in the process of preparing a common EU negotiating position, which involves negotiations with other EU member states; second, it will have to closely monitor the negotiation process with the UK to ensure that the outcome is acceptable. This requires a thorough assessment of the current links between Poland and the UK in all areas in order to identify strategic Polish interests and risks implied by Brexit.

The rest of this chapter is organised in three parts. First, I discuss the status quo in major segments of Poland-UK relations, and identify key exposures. Second, I suggest a possible 'road map' for Poland's position for Brexit negotiations. Third, I present main conclusions and recommendations.

The status quo

While the modalities of the future structure of relations between the EU and the UK are uncertain and will be the outcome of long negotiations between the two parties, Brexit will surely affect all areas of bilateral Poland-UK relations that fall within the competences (exclusive or shared) of the EU. The most relevant ones cover trade in goods and services, foreign investment, movement of people, and payments from the EU budget, as well as some selected issues from the area of common foreign and security policy and the area of common policy of justice and home affairs.

Trade in goods

Table 1 Poland's merchandise trade with the UK, 2014

Trade flow	€ million	Per cent of total exports/ imports
Exports to the UK	10,567.4	6.4%
Imports from the UK	4,360.5	2.6%
Trade balance	6,206.9	-

Source: Poland's Central Statistical Office.

The UK is the third largest export market for Poland (after Germany and the Czech Republic), accounting for 6.4% of total exports of goods, and the eighth largest source of Poland's imports (after Germany, China, Russia, Italy, the Netherlands, France and the Czech Republic), with a share of 2.6% of total imports of goods (see Table 1). The total value of Polish exports to the UK in 2014 was €10,567 million, which is equivalent to some 2.5% of GDP and is almost 2.5 times greater than Polish imports from the UK (at €4,360 million). This large trade surplus makes Poland relatively more dependent on exports to the UK than on imports from the UK. Consequently, Poland is more vulnerable to any restriction on access to the British domestic market after Brexit. By contrast, Poland's respective share of the UK's foreign trade is much smaller. Poland is 12th largest exporter to the British market and the 21st largest importer from the UK, with the value of British exports to Poland equivalent to only 0.2% of the UK's GDP in 2014 (less than a tenth of the respective figure for Poland). This asymmetry in the relative export weights makes Poland's negotiating position *vis-à-vis* the UK much weaker.

Table 2 Poland's trade with the UK, 2014 (by CN sections)

		Imports (€ mln)	Exports (€ mln)	Imports (%)	Exports (%)
1	Live animals, animal products	189	499	4.33	4.72
2	Vegetable products	35	232	0.80	2.20
3	Fats and oils	18	12	0.41	0.11
4	Prepared foodstuffs	192	949	4.40	8.98
5	Mineral products	107	295	2.45	2.79
6	Products of the chemical industry	1,093	720	25.06	6.81
7	Plastics and rubber and articles thereof	353	532	8.09	5.03
8	Raw hides and skins, articles thereof	26	17	0.60	0.16
9	Wood and articles of wood	4	300	0.09	2.84
10	Pulp of wood, paper, paperboard and articles thereof	102	195	2.34	1.85
11	Textiles and textile articles	215	124	4.93	1.17
12	Footwear, headgear etc.	14	15	0.32	0.14
13	Articles of stone, ceramic product, glass	42	317	0.96	3.00
14	Pearls, precious stones and metals, articles thereof	21	409	0.48	3.87
15	Base metals and articles thereof	248	509	5.69	4.82
16	Machinery and mechanical appliances, electrical and electrotechnical equipment	873	3,039	20.02	28.75
17	Transport equipment	656	1,499	15.04	14.18
18	Optical, photographic, measuring, checking instruments, etc.	127	128	2.91	1.21
19	Arms and ammunition	2	7	0.05	0.07
20	Miscellaneous manufactured articles	44	771	1.01	7.29
	Total	4,360	10,567	100.00	100.00

Source: Poland's Central Statistical Office.

The structure of Polish exports is dominated by machinery, electrical and electronic equipment (accounting for 29% of the total), agricultural products and foodstuffs (16%) and transport equipment (14%) (see Table 2). These three categories, together with chemical products, account for more than two thirds of Polish exports to the UK. Assuming the UK leaves the Single Market (and the customs union) and falls back to WTO rules on trade with the EU, the sectors that are likely to suffer most will be agriculture and – to a lesser extent – car manufacturing, low-processed products such as chemicals, plastic and rubber products, and wood and paper products.

On the import side, machinery, electrical and electronic equipment, as well as transport equipment, account for 35% of the total, followed by chemicals (25%). The increase of the import costs after Brexit will likely be rather negligible, and may affect primarily traditionally 'sensitive' products such as foodstuffs, textiles and cars.

Trade in services

The UK is the third largest purchaser of services from Poland (after Germany and Switzerland), accounting for 6.6% of total Polish exports of services, and the second largest exporter of services to Poland (after Germany) with a share of 8.2% of Polish imports. The total value of Polish exports of services to the UK in 2014 was €3.04 billion, almost €1 billion more than the value of imports (at €2.15 billion). In terms of shares of total Polish exports to the UK, telecommunication and informatics services accounted for 23%, professional services for 20%, transport services also for 20%, and other business-oriented services for 10%. On the Polish imports side, 'other business-oriented services' accounted for more than half of (mostly accounting and consulting). Somewhat surprisingly, financial services play a relatively minor role in Polish imports from the UK (less than 20%, at under €400 million). Brexit is likely to reduce Polish exports of services in areas such as transport, construction and finance, but since their actual value is relatively small, the overall impact on those sectors in Poland will not be substantial.

Foreign direct investment

According to the National Bank of Poland, the value of UK FDI in Poland in 2014 was €5.9 billion, which represented only 3.4% of the total FDI stock (€171.7 billion) registered in the country. Among the largest British investors are Tesco Plc (retail trade), Imperial Tobacco, GlaxoSmithKline (pharmaceuticals), British Oxygen Corporation (industrial gases), Aviva Plc (insurance), Bates Ltd (transport and storage), Cadbury Schweppes (foodstuffs) and Shell Overseas Holdings Ltd. (oil products). A recent trend is to move auxiliary departments of medium and large British firms, such as accounting or HR, to Poland (i.e. offshoring). A considerable part of direct investment goes to real estate. Interestingly, UK financial firms have not invested much in Poland (except for Aviva). Among the 20 largest Polish banks, there is no bank with a dominant share of British capital.

Outward FDI by Polish companies in the UK is much smaller in volume, but is growing fast in terms of numbers. According to estimates by the British-Polish Chamber of Commerce, there are already some 40,000 small firms established in the UK by Polish citizens, mostly by those residing in the UK. Brexit is not likely to affect these existing firms, but it could provide incentives to increase the number of investments, both inward and outward, to circumvent potential restrictions imposed on bilateral trade.

Movement of people

Large immigration from other EU member states was one of the key factors behind the UK's decision to leave the EU. It is estimated that there are around 3.6 million EU citizens living in the UK, more than 80% of whom will have permanent residency rights by the time the UK is likely to leave the Union in early 2019. The remainder – more than 600,000 people – will probably be offered an amnesty and the right to stay permanently. Polish citizens represent the largest group among those migrants, totalling some 900,000 (of which some 110,000 were born in the UK). Their resident status will probably be maintained after Brexit, although for some the severance of trade and economic ties between the UK and the EU may provide an impulse to return to Poland. The Polish government will certainly strongly insist on protecting the right of Polish migrants. By contrast, it will not be that interested in securing further unrestricted access to the British labour market after Brexit, because economic migration from Poland is definitely not a priority.

Although the UK is not part of the Schengen area or of the common asylum policies, Poland could count on indirect support from the British for its resistance against expanding EU competences with respect to migration and asylum policies. Both countries (together with some other Central European countries) share a very sceptical view of *Wilkommen Politik* and strongly resist joint responsibilities and any automatic rules of receiving and reallocating refugees. Brexit will certainly weaken the position of 'refugee sceptics' within the EU.

The EU budget

In the 2014-2020 Multiannual Financial Framework, Poland is the largest recipient of EU money, both in absolute terms and net of its own contribution. In 2015, it received €13,358 million from the EU budget and paid in €3,718 million, thus benefitting from a net transfer of €9,640 million (or around 2.3% of Polish GDP). The UK is the second largest net payer into the EU budget; its net contribution in 2015 was €10,751 million (after the 'British rebate'), or 7.4% of the total annual EU budget for that year. Brexit will certainly reduce the EU budget, though probably only after 2018. The impact on Poland's net position will depend on how successful the Polish government is in safeguarding the current level of transfers. In the most likely case, with the necessary cuts induced by Brexit being spread roughly proportionately across all budgetary lines, the loss will be about 7-8% of the current level. However, if cohesion policies bear the brunt of the expenditure cuts, the net loss for Poland may be substantially larger. If the UK negotiates a 'Norway-type' deal with the EU, Poland's losses will be smaller.

Political cooperation

The UK has been an important political partner for Poland in the EU. As far as economic policies are concerned, both countries share a similar vision of economic liberalism and free trade, combined with a reluctance to allow Brussels more sway in economic, an especially tax, matters. In the area of foreign and security policy, the UK and Poland have been dedicated supporters of NATO and of close transatlantic ties with the US and

Canada. Both countries also have been ready to take a more assertive stance towards Russia, being in favour of reacting more decisively to Russia's aggressive policies against Ukraine and in the field of energy supplies. With the UK leaving the EU, Poland is likely to lose an important ally in vital areas of common European policies.

Suggested negotiation priorities for Poland

- The relatively high share of the UK in Poland's exports and the large trade surplus makes Poland relatively more dependent on exports to the UK than on imports from the UK. Consequently, Poland is more vulnerable to any restriction on access to the British domestic market after Brexit. This calls for negotiating for relatively easy access to the UK market for EU exports, which would have to go with full reciprocity.
- Amongst exports, agriculture, transport equipment and low-processed products should receive special attention in negotiations. If import quotas are negotiated, Poland should secure sufficiently large shares to minimise the impact of Brexit. Concessions in other areas may be considered to achieve this goal.
- Since Brexit is likely to reduce Polish exports of services in areas such as transport, construction and business-oriented services, negotiators should safeguard those exports to the extent possible. But since their actual value is relatively small, the overall impact on those sectors in Poland will not be substantial, and there is no need to offer substantial concession in exchange.
- No substantial risk seems to exist with respect to FDI. In this area, more is at stake for the UK, so Poland could consider specific concessions in exchange for better market access in other areas.
- In the area of free movement of people, Poland will concentrate on protecting full resident rights for Polish citizens living in the UK, in particular including unrestricted access to social and public services, and social security guarantees. By contrast, Poland will not insist on maintaining unrestricted access to the British labour market after Btrexit.
- Brexit will reduce the EU budget, and transfers to Poland will be reduced. This negative impact can be mitigated if the necessary budgetary cuts do not affect

cohesion policies (unlikely), or if a 'Norway-type' agreement between the EU and the UK is signed, with UK contributions to the EU budget maintained to some extent (again, not very likely).

- In the area of foreign and security policy, Poland will be interested in cultivating the existing strong ties with the UK. It may propose enhanced cooperation between the EU and the UK to maintain the current balance between diverging priorities within the EU (especially between southern and northern member states) and to better promote its national security interests after Brexit.

Conclusion

No one knows what form the divorce contract between the UK and the EU will ultimately take, and the negotiations are likely to last even after early 2019. This allows some time to reflect on the modalities and implications of possible solutions. As of today, taking into account the potential impact of Brexit on trade, investment, movement of people, the EU budget and political cooperation, Poland should be in favour of a rather 'soft' Brexit, with the UK retaining access to the Single Market and remaining open to exports from EU countries – including Poland – and contributing to the EU budget.

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12 The path to Brexit: The view from Portugal

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Brexit: The preliminaries

The somewhat unexpected vote in favour of the United Kingdom's exit from the European Union introduced a time of uncertainty and risk. The almost unanimous consensus is that immigration – rightly or wrongly – as well as the economic misfortune of the less well-off were catalysts for the surprising result. These are likely to be guideposts for the UK's politicians in the process of negotiation leading to Brexit. Add to this context the clear opposition to the principle of Brexit emanating from important regions such as Scotland and the capital city of London, and we end up with what is likely to be a long, complex, convoluted, and halting process of severing ties from the core of the EU policies.

The Brexit negotiations are likely to be long and protracted, taking place over a period of several years, possibly a decade or more. The economic fundamentals, we believe, may change in the meantime. Perhaps more importantly, some of the political determinants of the Brexit vote are volatile. Brexit negotiations, if pursued to the full, imply a rather wide range of negotiations of new agreements with non-EU countries and international bodies on trade of goods and services, capital flows, and – possibly – labour movement. The UK parliamentarians are not necessarily enthusiastic about committing the effort and acumen necessary to unravel these many, diverse sets of new agreements. In sum, the UK government, we believe, has not been given a strong mandate – rather, it has been given a weak mandate to pursue a substantial decision. The uncertainty of the process makes an examination of individual EU countries' likely positions with regard to the negotiations that will lead to Brexit particularly relevant.

It is unclear which EU institution(s) – the European Council, the European Commission, or both – will lead the negotiations. The deal must first be agreed by the Council of the European Union. If, as is probable, the deal on the future relationship is a ‘mixed nature agreement’, meaning that it affects both EU competences (e.g. on trade policy) and member state competences (e.g. on foreign policy), then it will require the unanimous support of Council members. The deal must also be approved by a simple majority vote of the European Parliament. It must then be ratified by all 27 member states, again bringing to the fore the relevance of anticipating, as far as it is possible, the individual stances of the different countries on the issues.

The negotiation issues include the degree of access to the Single Market in goods and services the UK will be afforded, with the key issue of financial services; the freedom of movement of people and workers; and the degree of adherence to EU laws, as well as the remaining role the UK may play in influencing those decisions. The EU conceding access to the Single Market in exchange for allowing only minor changes to the free movement of people is a possible outcome.[1] The relevance of financial services for the UK may also be a strong bargaining point for the EU. On security, and in light of common NATO membership and the state of affairs regarding security and terrorism issues, it is unlikely that either the EU or the UK would be interested in lowering the current level of cooperation. However, mapping each country’s trade-offs across different policy areas is nonetheless crucial for the complex negotiations to come.

Portugal, the UK, and the four freedoms

The four freedoms implied by the Single Market rules may have unequal bearing on Portugal’s stance in the Brexit process. The most prominent realities are the traditionally strong commercial ties between Portugal and the UK, as well as the significant number of recent Portuguese immigrants in the UK. The importance of British tourists to

1 Some UK politicians have indicated that they would attempt to secure a high degree of access to the Single Market in goods and services, but maintain limits on free movement of people. European leaders have said that access to the Single Market “requires acceptance of all four freedoms” of the EU, including freedom of movement of people. Other member states will be keen to protect the rights of their citizens to live and work in the UK (Munro 2016).

Portugal is also key. Less relevant, but nonetheless significant, will be the discussions on the free movement of capital and on financial market access, which is a key topic for the British government and the EU.

The UK is Portugal's fourth most important trade partner, after Spain, France, and Germany. More interesting, alongside Germany, Poland, Spain and Belgium, Portugal has a significant trade surplus with the UK, both in goods and services.[2] According to the Banco de Portugal, Portugal ran a significant €5 billion current account deficit with the EU in 2015, amounting to 2.7% of GDP.[3] Bilateral trade with the UK registered a surplus upwards of €3 billion, rivalled only by Portugal's surplus with France.

This is a particularly important aspect for Portugal, traditionally a deficit country that recently experienced a painful loss of access in other traditional markets while also grappling with one of the highest levels of external indebtedness among developed countries.

The role of the UK as a client for Portuguese exporting companies is unequivocally important: it ranks top as a client for services (€3.7 billion in 2015, around 15% of total services exports); fourth as an importer of goods (€3.5 billion, around 7% of total exports); and fourth again when goods and services are considered together (€7.2 billion, around 10% of total exports). In this ranking, Britain is behind only Spain, France and Germany. The UK is also a relevant seller to Portuguese companies and consumers, ranking 6th in imports of goods in 2015 (after Spain, Germany, France, Italy and the Netherlands), and second as a provider of services.

Regarding tourism, a few days in the Algarve, in the south of Portugal, are enlightening as to the numbers of British residents and their influence in the sector, both as customers and entrepreneurs. Locally, English is a second language, used from menus to real estate adverts. Not surprisingly, Portugal runs a surplus in the tourism balance of trade of €1.6 billion, representing 13% of the total surplus in services registered in 2015.

2 As recently highlighted by the IMF (2016).

3 This was just slightly compensated by the trade flows with the rest of the world. In 2015, Portugal registered a current account surplus of €755 million.

While tourism has always been important, it has gained a renewed relevance in the last few years as the country strives to return to a sustainable growth path. Tourism is probably the only significant economic sector that is growing at close to double digit rates. Illustrating the centrality of tourism, and in the wake of the debate on its possible impact on cities, Lisbon's mayor has recently echoed the prevalent feeling in the country: "I have no idea what it means having too many tourists [in Lisbon]".[4]

The above highlights the importance of the free movement of goods and services to and from the UK for Portugal. Any unnecessary regulations, paperwork and clearance procedures, new duties and taxes, or higher costs of shipping and handling will be a major concern from Portugal's point of view.

On a different front, Portuguese negotiators will monitor closely the implications of Brexit for the free movement of people. This follows naturally from the significant role tourism plays, as highlighted above, but goes well beyond that to the large number of Portuguese living in Britain, which has grown significantly in the last five years in the wake of the economic and financial crises.

The most recent data show that Portugal has 219,000 permanent residents in the UK, more than double the 2011 figure. Portuguese has become the fifth most represented foreign nationality in the UK. Those who have moved to the UK are mostly the young and skilled, the vocal and the political. The top four nationalities are more or less conspicuously present in the UK's political debate: Poland with 916,000, India with 362,000, the Republic of Ireland with 332,000, and Romania, with 233,000 (Office for National Statistics 2016). As a percentage of its own population, immigrants from Portugal are no less relevant than Polish and Romanian immigrants are to their home countries.

While emigration from Portugal in the last years has included more skilled workers, there is still a relatively high number of less-skilled Portuguese workers that could be dramatically affected if the current rules of movement for non-EU citizens were to be applied without changes. Currently, according to the Portuguese government, about one

4 "Fernando Medina: Não sei o que é ter turistas a mais", *Jornal de Negócios*, 27 September 2016.

third of the Portuguese in the UK do not fulfil the criteria for non-EU citizens to be given a visa to work in the UK – that is, a minimum income of €24,500 per year, a college education and fluency in English. Taking both permanent and temporary residents into consideration, the number of Portuguese nationals in the UK may have reached as many as 500,000. The UK was the favoured destination of Portuguese emigrants between 2012 and 2015, with as many as 20-30,000 Portuguese migrating each year to the UK.[5]

Portugal has a long tradition as a labour-exporting country, which is reflected in its attitude towards migration. According to the latest European Commission Eurobarometer survey,[6] 66% of the Portuguese population have a positive attitude towards immigration from other EU countries, which compares with an average of 58% for the EU. Furthermore, 45% have a positive attitude towards immigration from countries outside the EU, compared with 34% for the EU; and 83% support the right for EU citizens to live in every member state of the EU, compared to 71% across the EU. This immigrant-friendly mind set of the Portuguese is likely to add to the relevance of the free movement of people in the local political debate around Brexit.

Out of the four freedoms, we believe the free movement of capital will play the least important role from the Portuguese point of view. The recent crisis resulted in significant foreign disinvestment in the country, particularly between 2011 and 2013, with the trend starting to reverse since then. Average annual British foreign direct investment (FDI) net flows between 2010 and 2015 amounted to only €30 million of investment in Portugal, although in 2015 the UK was the second largest investor with €500 million. Data on foreign ownership of firms in the country[7] suggest there are around 400 British companies in Portugal (accounting for about 0.1% of the total number of companies), which are responsible for 16,000 jobs (around 0.4% of total jobs) and €5 billion of annual turnover (1.5% of total turnover).[8] UK portfolio investment data show signs of mild disinvestment flows between 2010 and 2015, but significant investment in 2015.

5 Observatório da Emigração: Países de Destino, accessed 28 September 2016.

6 Standard Eurobarometer 85, July 2016, questions QB4.1, QB4.2 and QB6.1

7 "Negócios britânicos em Portugal valem 16 mil empregos. E agora?", *Dinheiro Vivo*, 16 July 2016. The background data come from the Informa D&B database, part of the Dun & Bradstreet Worldwide Network.

8 Considering 2014 values published by the Banco de Portugal.

The UK presence is far from irrelevant, as Portugal urgently needs to attract more FDI and external financing to reduce its unemployment rate and grow its output. The UK has a significant stock of investments in the country. According to the Banco de Portugal, the total value of the UK's FDI amounts to €7.7 billion, or 7% of the total FDI stock in Portugal. The UK nonetheless lags behind the Netherlands, Spain and the Luxembourg, at €20 billion each of FDI stock.[9] Perhaps more importantly, there is a secular tradition of innovative English entrepreneurial activity in the country, dating at least as far back as the successful establishment of the Port region as the first wine region in the world.

Future budgetary relations between the remaining member states might also play a role in the negotiations. As a net contributor to the EU budget, the UK's exit will either imply less money for the net recipients, such as Portugal, or more money from existing or new net contributors, among which Germany France and Italy stand out.[10]

It is interesting to identify with which countries Portugal is likely to align in each of these four economic freedom areas; the table below does just that.

	Trade	Capital		People
		FDI	Portfolio	
Countries Portugal is most likely to align with	Countries with intense trade ties with the UK, while exhibiting a surplus	Countries with weak to mild ties with the UK	Countries with weak to mild ties with the UK	Countries with a high number of immigrants in the UK
	Germany, Poland, Spain, Belgium	Italy, Greece, Finland, Austria.	Austria, Hungary, Cyprus Slovenia, Latvia, Lithuania, Czech Republic and Poland	Poland, Ireland, Germany, Romania

9 Foreign Portuguese investment in UK in the end of June of 2016 amounted to €1.4 billion, or 2.5% of the total investment.

10 A report from the German Finance Ministry leaked to the press estimates that with the UK's exit, Germany's share of the EU's GDP would increase from 21% to 25%, meaning an extra €4.5 billion per year in 2019 and 2020 in net contributions, rising to a total of around €20 billion ("Germany's EU budget bill may rise 4.5 billion euros after Brexit: report", Reuters, 10 September 2016).

The Political economy of Portugal´s response to Brexit

The approach of political actors in Portugal to evolving Brexit negotiations will be determined not only by economic factors, but also by a number of distinctly political economy factors. We should be clear that our strongest belief is that, as the UK and the EU navigate towards Brexit, Portugal will be a *soft* negotiator. In other words, we expect Portugal's stance to be accommodating rather than contentious, and respectful of the conflicting interests of both sides of the table. The reasons for holding such a belief stem from the political impulses that characterise Portugal's political establishment and voters, namely:

1. *A yearning for the Centre.* The political mainstream in Portugal is adamantly pro-European, with the centre-left to right-wing political parties that represent a stable section of about 80% of the electorate very keen to maintain access to the European core and to be at the forefront of new policies. Even among the left-wing parties currently supporting the socialist government, there is a tacit agreement to comply with the EU's budgetary rules and to not seriously question the Portuguese commitment to EU policies.
2. *Risk aversion.* Natural anxieties over reverting to a traditionally more isolated and peripheral position in the ensemble of Europe – Europe's 'periphery' – will fuel a risk-averse attitude towards European policymaking. This may make Portugal keen to align with the major actors in the EU, while at the same time being wary of any confrontational stance towards 'deviant' countries. From Portugal you can expect no inclination whatsoever to make Brexit more of a divorce than a friendly separation. EU governments might adopt a tougher stance out of fear that a seemingly generous Brexit deal might lead to local referendums. If, for this or any other reason, negotiations become problematic and Germany and France more contentious, Portugal is likely to comply reluctantly with the dominant EU stance. In addition, Portugal is likely to favour the Council as the actor to lead the Brexit

negotiations, which approaches giving veto power to each country and thus avoids endpoints with significant idiosyncratic costs to Portuguese economic and political interests.[11]

3. *An emphasis on people.* In spite of its recent experience as an immigration country, Portugal views itself – and rightly so – as fundamentally a labour-exporting country. This reflects the country's secular experience of movement of labour to Brazil and the United States since the early late 19th and early 20th centuries, and, more recently in the 1960s and 1970s, massive emigration to France, as well as to other European countries. From the UK government's point of view, free movement of highly educated workers would probably be welcome, in contrast to that of less-skilled workers. From the Portuguese side, free movement of both high- and low-educated workers is important, as well as tourism. This is an area where Portugal has little leverage, besides staying true to the Single Market principles encompassing all four freedoms. Any attempts to restrict the movement of people between the EU and the UK will likely meet very strong opposition from Portugal. The possible unwanted return of these professionals – or at least a substantial number of them – is a possibility the mainstream political parties will want to avoid at all costs, given its political consequences.
4. *An eagerness for trade-offs.* Portugal is likely to contribute to the Brexit negotiations with a pragmatic, cool-headed attitude that will emphasise trade-offs and mutually beneficial outcomes. The UK will likely look for support for a context that keeps London as the central financial hub of Europe. While this is a source of potential division in Europe – with Paris, Frankfurt, Amsterdam and even Dublin potentially fighting for the spoils – it is an area in which Portugal has little to lose, and will thus be inclined to play with several players. With the possible, but unlikely, exception of issues related to contributions to the EU budget, we believe governments and parties will likely trade access to EU resources and losses in goods, services, and capital for a reasonable outcome on movement of labour. While restrictions in the movement of goods may hurt, forced movement of workers would be politically disastrous.

11 Munro (2016) suggests it is likely the "27 member states will play a crucial role in informal negotiations on the future UK–EU relationship".

5. *Old alliances.* Lastly, the UK and Portugal form maybe the oldest strategic alliance in the European continent, with trade a salient issue. While mostly symbolic, it carries a political weight for its salience among the voters and politicians.

All things considered, Portugal would likely accept an EFTA-type agreement in which free movement of people is not at stake, such as in the current EU agreement with Switzerland. A simple bilateral free trade agreement with the UK – the most likely outcome if the UK insists on rejecting free movement of people – will not be favoured by Portugal. In this case, Portugal is likely to negotiate a specific, bilateral deal concerning the movement of people.

In sum, Portugal's negotiating stance will likely reflect its yearning for continued access to the core of European prosperity and resources, as well as and presence at the forefront of EU policy; its aversion to being sidelined and focus on access to the EU core; a focus on freedom of movement of labour as opposed to goods, services and capital; and an emotional attachment to the UK, which is traditionally seen as a fellow country facing the North Atlantic, rather than a strange, menacing, or even diverging political entity.

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13 Slovakia and Brexit: A gentle approach to tough love

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Background[1]

The United Kingdom has been an important reference point for Slovakia's dealings with the EU. In the early half of the last decade, Bratislava viewed the UK as a champion of EU enlargement. The UK strongly supported EU accession of post-communist states and ranked consistently high among the top foreign investors in Slovakia. Its decision to open the country's labour market to new member states in May 2004 reinforced the UK's friendly image.

The UK also played an important role in the EU's launch of its European Neighborhood Policy, which helped structure new political relations between Slovakia and its biggest neighbour, Ukraine, and began to spread the EU's economic and geopolitical order beyond the club's eastern border, thus anchoring Slovakia in the West more firmly.

In the latter half of the last decade, the positions of the two countries began to diverge institutionally as a result of Slovakia joining Schengen in 2007 and adopting the euro in 2009. Policy preferences have also shifted. Since the onset of the financial and debt crises in 2010, the UK has become tougher on labour migration. Equally, it has been playing a less visible role in the EU's neighbourhood.

1 This section draws on a series of blog posts written for the LSE in the run-up to the Brexit decision in June 2016 (see http://blogs.lse.ac.uk/europpblog/2015/11/11/european-views-on-the-uks-renegotiation-germany-greece-slovakia-and-the-eus-institutions/ and http://blogs.lse.ac.uk/brexit/2016/06/14/preparations-for-a-brexit-v-views-from-belgium-hungary-latvia-slovakia-and-sweden/).

Despite this, Slovakia, as a small open and trade dependent economy, has for years shared the UK's broad push for a liberal economic order. Slovakia's interests following the UK's recent decision to leave the EU will be to improve the single market and foster clear and equitable trade and investment policies.

The negotiating process

This will be no easy task, as the public debate on Europe in Slovakia – and more broadly on the continent – has been increasingly divisive. At the same time, the UK's departure from the EU offers an opportunity for Slovakia to strengthen its domestic consensus on future relations with Brussels and to solidify its regional alliances within the EU. Otherwise, Slovakia and its EU partners in central Europe, especially from the Visegrad group, are likely to be marginalised within the Union because of a number of already existing divisions among EU member states.

In practical terms, this means that Slovakia has to be clear about its specific preferences in the run-up to talks on a future EU-UK settlement. We identify the country's most important sectoral interests below. Moreover, while negotiating the terms of Brexit will depend heavily on the UK's preference for the degree of dissolution from existing EU order, whenever possible Slovakia should emphasise an orderly and step-by-step approach towards any final deal between Brussels and the UK. Predictable rules and agreements, rather than unruly power and sudden breaks from the status quo, are likely to serve Slovakia's interests better.

In short, Slovakia should favour a managed disruption of the EU as a result of Brexit. While being tough with respect to its own red lines, Bratislava should attempt to spread over time the costs tied to losses from any cuts to EU freedoms in the UK. One way to do this would be an initial agreement during the Brexit talks that the final state of neighbourly relations between the EU and the UK will take shape gradually. Just as enlargement policy uses the logic of accession talks and transition arrangements for sensitive sectors prior to fully fledged membership of a new EU state, the UK's dis-association could be carefully managed and implemented in steps agreed upon during detailed negotiations. To put it bluntly, the interests of Slovakia's citizens and industry would be served better should Brexit be a softer and more amicable event.

A hard and unpredictable Brexit would not only create far greater risks in terms of direct bilateral economic and political losses vis-à-vis the UK, but could also have spill-back effects on the EU itself. Since its EU accession, Slovakia has been keen to underscore and preserve the principle of equal treatment of both citizens and member states across the EU. If the UK were to suddenly end the free movement of labour from the EU, this might create additional political pressure for protective labour market and business measures across the remaining EU member states. It is strongly in Slovakia's interest to prevent additional deterioration of EU freedoms and the creation of new dividing lines within the EU.

Strategic interests

Since EU accession, Slovakia has been striving to solidify its place in the Union's political core and to help preserve the EU's broader political cohesion against the backdrop of growing economic and political problems across the region. Brexit might herald a new era for Europe, an era marked by disintegration.

A hard and chaotic Brexit could challenge Slovakia's preference for the EU's future as much as it could undermine the strength of the EU's liberal economic voice. In anticipating intra-EU talks on future EU-UK relations, we argue that Slovakia should have strong interest in minimising both political and economic damage, but most of all unintended consequences of the UK decision to leave the Union.

From an economic policy point of view, it is the four freedoms – free movement of labour, capital, goods and services – and the relative importance attached to each of these by national governments that exert the most powerful influence on their negotiation strategies and objectives. The free movement of labour will be the biggest preoccupation for the Slovak government, with free movement of goods an important second. Free movement of capital and services are likely to be a distant joint third.

Free movement of labour

Nearly 1.8% of Slovak nationals live in the UK (although this represents only 0.14% of the UK population). Table 1 contains more details including developments during the last five years. The final column shows that there are between 85,000 and 93 000 Slovaks living in the UK, depending on how they are counted.

Table 1 Slovak population resident in the UK

	2011	2012	2013	2014	2015
UK population born in Slovakia – ranking among countries	31st	32nd	40th	32nd	28th
Size of UK population born in Slovakia	61,000	61,000	52,000	75,000	85,000
UK population with Slovak nationality – ranking among countries	19th	21st	23rd	19th	16th
Size of UK population with Slovak nationality	64,000	66,000	55,000	79,000	93,000

Source: Slovak Migrants in UK – data for 2015 by Office of National Statistic in United Kingdom, Population by Country of Birth and Nationality Tables (all datasets) at http://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/internationalmigration/articles/populationbycountryofbirthandnationalityreport/2015-09-27.

Given the small size of Slovakia's population (5.4 million), the resulting number is not very important for the UK but it is huge for Slovakia, and the UK thus has a special position in that, together with Ireland, it is Slovakia's non-neighbour with the most Slovaks. To give an anecdotal example, otherwise sparsely used Bratislava airport offers flights to five destinations in the UK (Birmingham, Edinburgh, two in London and Manchester) compared to one destination each in Germany and France. At the same time, the number of UK nationals living in Slovakia is negligible and heavily concentrated in the managerial/professional classes.

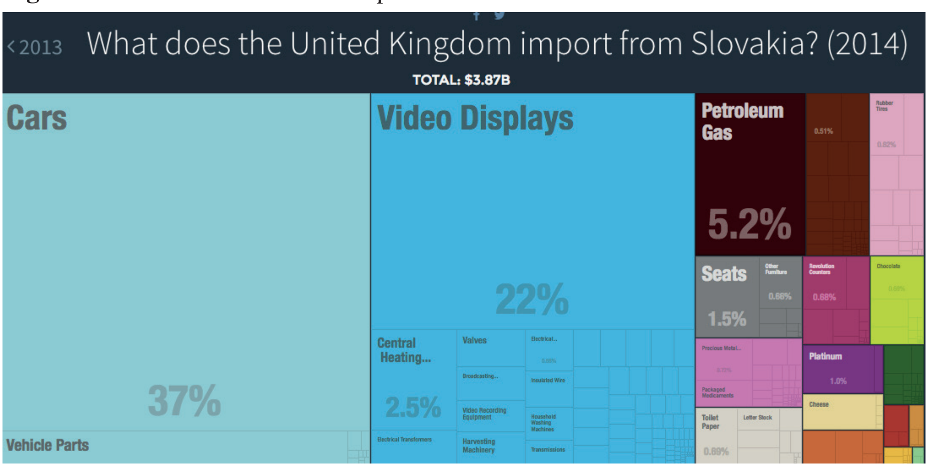
The UK is also an important destination for Slovak students. For example, they make up 0.2% of the UK's graduate students, which is a significant number given the disparity in populations (OECD 2016)

Retaining full rights for existing migrants, as well as minimising the limits Brexit places on future flows, is therefore vital for any Slovak government. After the recent EU summit of heads of governments in Bratislava in September 2015, Slovak Prime Minister Robert Fico declared that the whole Visegrad Four group (the Czech Republic, Hungary, Poland and Slovakia) will veto any Brexit agreement that limits the rights of EU citizens to work in the UK (Reuters, September 17, 2016)

Free movement of goods

The UK is Slovakia's eighth largest export market, accounting for 5% of exports. As Figure 1 shows, two items dominate exports – cars and screens – together accounting of nearly 60% of the total. These figures are in line with the Slovak position as the number one producer of cars per capita in the world and also an important producer of various screens. These goods are produced by local plants of multinationals – namely, Volkswagen, Peugeot-Citroen, Kia, Samsung and Sony.

Figure 1 Structure of Slovak exports to the UK



Source: MIT Atlas of Economic Complexity.

Preserving open access for its manufacturing exports will therefore also be very important for Slovakia. This is reinforced by the fact that Slovakia is also linked to the UK through intermediate countries – namely, Germany and the Czech Republic – to which it exports as part of multinationals' global value chains. These two countries alone account for a third of Slovak exports and have important markets in the UK.

There is an additional, important and delicate issue. In 2015, the Indian-owned British carmaker Jaguar Land Rover announced a €1.5 billion investment in a car production plant near the Slovak city of Nitra, its first in Europe outside the UK. The plant should start shipping cars in 2018 (300,000 annually) and will represent a major expansion of the already massive Slovak car industry both in terms of volume and value added (Ministry of Foreign Affairs 2016). There were rumours following the Brexit referendum that the investment will be put on hold due to uncertainties about the future, but these claims were discounted by the company. For economic reasons as well as prestige, the investment is of huge importance to the current government and if the company had Brexit-linked needs, they would likely be treated very seriously. However, it is not known whether there are any.

Free movement of services and capital

Financial services are nearly irrelevant to the Slovak position on Brexit, as the whole Slovak banking sector is foreign owned – primarily by Italian (Intesa and Unicredit) and Austrian (Raiffeisen and Erste) banks. There are no major British banks in Slovakia and there is only limited outsourcing of services in the financial sector or opportunity to grab business from the City.

Slovakia is a member of the Eurozone and thus also has presence in the ECB. For that reason it is, *ceteris paribus*, likely to support a push for the relocation of certain types of operations (e.g. clearing) into the Eurozone proper following Brexit, but this is not a major priority.

On the other hand, the UK is a major provider of foreign direct investment for a country whose economic model over the last 20 years has been dominated by foreign investment. However, unlike the German, French or Italian investments, which have a large presence in the manufacturing sector, UK investments are mostly in the service sector (from Tesco, Shell, etc.) with little strategic importance or value added. Tesco, the largest investor, is gradually withdrawing from Slovakia following a change of strategy.

It is therefore unlikely that these would be major concerns for the Slovak government in the Brexit negotiations.

Conclusion

Both economically and politically, continued unfettered access for Slovaks to the UK labour market and for Slovak-produced cars and electronics to the UK goods market will be priorities for any Slovak government in the Brexit negotiations. At the same time, the Slovak government has a very high degree of flexibility with regard to the interests of the British financial services industry. Slovakia's strategic interest is in helping to preserve a predictable and workable rule-based economic and political order in Europe. In this sense, for the future of the European project and Slovakia's place within it, the process of Brexit itself will be as important as the contents of the final EU-UK arrangements.

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14 How will Spain negotiate Brexit? Preserving a tangled web

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Brexit was a bombshell in Spain, its impact surpassing that of the general election which the country itself was holding three days later. Spaniards were stunned, worried about both the political and economic implications. Indeed, according to a Bertelsmann study of public opinion in large European countries, Spain was the country most against Brexit, with 64% of Spaniards declaring their position against it (De Vries and Hoffman 2016).

Unlike in other countries, the worry does not extend to a potential contagion of Spain's politics. Among the mainstream political parties only one, Podemos, has flirted with Euroscepticism (it once advocated leaving the euro, as the Communist Party, one of its allies, still does). In fact, Spaniards have historically been among the strongest supporters of the European integration project (as well as among its main beneficiaries). As of 2016, 74% of Spaniards would vote 'Remain' if a similar referendum were held in Spain (De Vries and Hoffman 2016). However, Spain is worried about the future, and there is generalised concern about what Brexit may mean for Spain and for Europe. There are several reasons for this.

1 In the interest of full disclosure: I am a Spanish citizen, my kids leave in Holland, and my job is in London. Thus my life will be directly affected by the negotiations which are the object of this chapter, as will the lives of many other UK and European residents. Even though the author is in charge of economic, industrial and innovation policy for the Ciudadanos Party in Spain, the analysis presented here is undertaken in a personal capacity as an academic observer and LSE professor. None of what is here written should be taken to be the position of the party or a recommendation of what it should do; it most emphatically is not. I thank Carles Casajuana, the previous Ambassador of Spain to the UK, for a useful conversation and Jesús Fernandez Villaverde for comments on the first draft. All errors are my own.

First, the UK-Spain relationship is *the* picture perfect illustration of the economic and political benefits that the EU, and the Single Market, can bring about, as I show in the next section – large flows of people in both directions, as British retirees seek out Spain's quality of life and Spanish youth seek jobs and education in the UK; a peaceful, workable non-solution to the Gibraltar question, one of the most intractable territorial disputes left in Europe; large flows in trade of goods and services in both directions; and very large foreign direct investments by companies from both countries in the other. Untangling this web, as a hard Brexit would require, would be very costly to companies and workers all over Spain (and, of course, the UK). This economic cost is a particular concern given that the country is just coming out of a brutal economic crisis and levels of unemployment are over 20%.

More broadly, Spain wants a strong Europe. All political parties in the Spanish parliament are in favour of strengthening the Union, including deepening the Eurozone towards a fiscal union, common border and security policy, immigration policy, and so on. Spaniards worry that Brexit may be the beginning of the unravelling of a European project that has been a crucial pillar of Spain's return to democracy and prosperity.

Finally, Spaniards' worry also has a more local angle, as the referendum has potential – albeit unclear – implications for the regional dispute in Catalonia. A growing minority of Catalans have been agitating for independence for Catalonia. The way Europe deals with a potentially independent Scotland's likely accession request in the aftermath of Brexit is being closely followed in Spain, even though all parties acknowledge the crucial differences between the constitutional and legal status of Scotland and Catalonia.

In spite of these worries, some in Spain see opportunities in Brexit. Most notably, the Spanish government sees Gibraltar as a colony of the UK on Spanish soil. There is unconcealed glee in the Spanish conservative government about the broad support that remaining in the EU has commanded in Gibraltar, and many in government see a unique opportunity to solve an issue that has enormous symbolic value to many Spaniards. Spain will also fight to attract the financial service industry and manufacturing jobs that may abandon the UK post Brexit.

A highly integrated market: The four freedoms in action

As we pointed out above, Spain is one of the clear success stories of the European integration project, and the Spain-UK relationship in particular features a highly integrated market, with benefits from trade widely spread among the entire population. Spanish and UK citizens have taken advantage of the four freedoms that are basic to the Single Market: free movement of goods, services, people and capital.

Free movement of people has resulted in huge bilateral migration flows. Migration will be the crux of the negotiations, as it was the key driver of the Brexit vote and limiting freedom of movement within the EU is likely to be the one request by the UK that is most difficult for the EU to accept.

And yet the picture of bilateral flows between Spain and the UK could not be further from that painted by the 'Brexiteer' politicians Boris Johnson, Michael Gove and Nigel Farage. In fact, Spain has quite an unusual position among European countries in that the balance of immigration is 'favourable' to the UK – many more Brits choose to live in Spain than Spaniards in the UK.

In the age of EasyJet, the estimates vary hugely, but Eurostat estimates that 306,000 UK-born citizens have Spanish residency. However, if one also counts those who live for part of the year in Spain, the figure reaches a stunning one million full- and part-time residents, according to a study by the Institute for Public Policy Research (Finch 2010). On the other side, official Spanish Statistical Institute (INE) estimates suggest that 102,498 Spaniards live in the UK, although again the true number is likely much larger.[2]

The potential issues at stake that must be sorted out in negotiations for all of these citizens are many. From access to health care, to housing and work permits, to visa-free travel, Brexit may change it all, and according to multiple press reports, it appears to be a source of anxiety and even anguish, particularly for less mobile UK pensioners in Spain.

2 On the other hand, in the last (2011) census, 79,814 Spanish-born residents were recorded in England and Wales.

The freedom to trade goods and services has resulted in large bilateral flows and a substantial trade surplus for Spain. The most recent data (released by ONS in March 2016) show that Spain exported goods and services to the UK worth a total of £24 billion in 2014 and imported £14.8 billion.[3] Thus Spain had a bilateral trade surplus of £9.2 billion, well over 1% of Spanish GDP (depending on the volatile exchange rate). After Germany (which had a £25 billion surplus), this is in absolute terms the largest positive imbalance with the UK of any country in the EU, and the fourth largest worldwide after Germany, China and Norway.

This overall surplus is composed of a surplus in the trade of both goods and services. The UK is the fourth largest market for Spain's goods and services, accounting for 7% of the total. In terms of goods trade, the UK is particularly important for the exports of transport equipment (20%), machine tools, chemicals, metals, mining, and vegetables.

The large services surplus is due mostly to tourism. The UK is the main buyer of Spain's tourism, with 15.8 million British tourists visiting Spain in 2015 and the UK accounting for 21.1% of total tourism income (Greenwood 2016).

Thus it is hard to overstate the risk that a 'hard Brexit' would pose, through trade, for Spain's economy. No country is more vulnerable than Spain to the trade disruption, given the trade surplus (in GDP terms), and no country has a greater interest in the softest of Brexits. There is a large downside for both countries from any disruption to all of these flows – and no conceivable upside – from the negotiations. All that remains to ask is how bad will the damage be.

Freedom of capital movement has resulted in enormous FDI flows. According to a recent report (Greenwood 2016), the UK is the main destination for Spain's FDI, accounting for 14% of the total outflow. This outflow has been directed particularly towards finance, telecoms and electricity. Spain has the largest investment in the UK's financial services of all EU countries, and is second worldwide after the US, through two of the largest Spanish banks (Santander and Sabadell). Almost one out of every five pounds of foreign investment in the UK's banking sector is represented by these two

3 See www.ons.gov.uk/businessindustryandtrade/internationaltrade/adhocs/005436annualimportsandexportsofuktradebycountryfrom1999to2014.

Spanish banks (17%, according to Greenwood 2016). Both banks have huge exposure to the UK through their affiliates, with these affiliates accounting for around a quarter of their assets and profits in Q1 2015.

The flow in the opposite direction is also large. The UK is the fifth largest investor in Spain, focusing on telecoms and tobacco (Greenwood 2016).

In sum, the relationship is a clear success for the UK-led project of a European Single Market, and one that will be expensive for both parties to unravel. For the UK, the highest human and economic cost will be from unravelling the freedom of movement (with significant potential losses to large UK contingents of residents in Spain). For Spain, the main potential vulnerabilities are in trade and FDI flows.

For both, potentially enormous vulnerabilities derive from potential financial and macroeconomic turbulence as the new steady state is reached. This has the potential to be a really nasty transition.

Spain's priorities

Spain has three priorities, which are not necessarily compatible.

1. The politics: Preserving the Union

As one of the most pro-European countries, Spain is committed to preserving and deepening the Union. This obviously suggests that Spain will support the European Parliament involvement and the European Commission's leadership in the negotiations, avoid obvious bilateral discussions (quiet discussions, one imagines, must be always taking place), and push for an arrangement that falls neatly into existing categories – that is, EEA or Switzerland, or if not, Canada. Thus political considerations would lead us to expect Spain to militate strongly against intermediate 'soft' solutions such as that proposed by Pisani-Ferry et al. (2016).

2. The economics: Preserving the tangled web of the four freedoms

The economics point in quite a different direction. As we have seen, the UK-Spain relationship is a very tangled web indeed, with large benefits to both parties, and, in trade of goods and services, particularly to Spain. To disentangle it would involve massive costs. A hard Brexit is emphatically not in the interest of either the UK or Spain. The economics (unlike the politics) suggest that Spain would be likely to militate against any disruptive Brexit and look for middle of the road solutions. However, this pragmatism is unlikely to extend to all British aspirations. In particular, Spain has a very recent memory of large outward migration flows (throughout the period of the dictatorship) that have recently been revived again with the crisis, and it will be extremely difficult for the government to accept a limitation to the freedom of movement.

3. Gibraltar: A potential make or break issue

Gibraltar, a small peninsula with large strategic value, was lost by Spanish after its capture in 1704, during the War of Spanish Succession, by an Anglo-Dutch fleet and was ceded to Britain by the Treaty of Utrecht in 1713. After multiple wars and sieges, it has become a highly succesful enclave within the EU with a high degree of self-government. The status of Gibraltar, officially a colony, is nevertheless contentious, as is the status of its airport, which was built on land that the Treaty of Utrecht set as neutral territory.

The management of this dispute has been greatly facilitated in the context of the EU. The border between Spain and Gibraltar was only reopened in 1985, and since then trade and people have flowed freely between the two territories. Gibraltar has become the second richest territory in the Union.

The current Spanish Minister of Foreign Affairs, José García-Maragallo, has stated clearly – and his position has been echoed by the Spanish Permanent Representative to the United Nations on a recent meeting on decolonisation – that after Brexit a new understanding must be found, and that it must involve co-sovereignty of the UK and Spain over Gibraltar. In his words, "they will have to choose between British outside the Union or Hispano-British inside the EU". Only co-sovereignty will allow Gibraltar to have the treaties apply to it.

In the solution the Spanish government is pushing for, Gibraltar citizens would preserve access to the European Single Market, obtain both nationalities, and conserve a large degree of autonomy. Spain and the UK would be jointly in charge of defence, foreign affairs, border control and immigration. Crucially, the Spanish flag would fly on Gibraltar.[4]

How much of an obstacle this issue – tiny in terms of welfare for the two countries, but with huge symbolic value – may pose in the negotiations remains to be seen, but it is sure to have a considerable weight in them.

What can we expect Spain's negotiating position to be?

From the perspective of its commercial, investment, and migratory interests, Spain could be willing to accept a soft Brexit, that is, a modified EEA with some governance mechanism for the participation of the UK in joint decision making.

However, Spain has been adopting a low profile in the international arena for many years now, and its Europeanism suggests that it is highly unlikely to deviate from the position taken by France and Germany, and will thus demand that the Commission leads and the Parliament has a say in the negotiations, once Article 50 is invoked. Spain will likely be a disciplined soldier on the European side, and demand that access to the Single Market continues to require a commitment to all four freedoms, and most notably to freedom of movement of people inside the Union.

A potential stumbling block is Gibraltar. Everything we have heard from the Spanish government up till now suggests that it is unlikely any deal in which Gibraltar retains access in any form to the EU will be reached that does not involve joint (Spanish and British) sovereignty over the peninsula.

4 For a good description of the positions of Spain and Gibraltar on these issues, see the article by Andrés Machado in *El Mundo*, "Picardo repica a Maragallo: Ni en cuatro años ni en 4000 ondeara la bandera Española en Gibraltar", 6 October 2016.

The Gibraltar issue highlights the likely result of the negotiation between the EU27 and the UK – the UK's death by a thousand cuts. Every country involved in the bargaining has veto power, and every one of them is likely to have a shopping list – some issue that is important enough to block progress. For the Poles it may be freedom of movement, for the Irish it may have to do with Northern Ireland. The ability of the UK government to resist these demands, with the clock ticking, simply does not seem to be there.

As a result, the UK is likely to find itself, at the end of these two years, with a very bad deal. By the time 27 countries have finished putting together their "Yes, but what about Gibraltar?"-like objections, the pro-Brexit politicians will either have to start explaining to voters the distance between the fantasy they invented and the reality, or be prepared to back off from Brexit.

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15 Preparing for Brentry – after Brexit: A view from Sweden

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Sweden joined the EU in 1995 after a major financial crisis in the early 1990s. At that time, EU membership helped the country improve its economic performance and contributed to two decades of rapid economic growth and rising exports. The UK is a key economic and political partner to Sweden in the EU. It is Sweden's fifth largest trading partner in goods, second largest trading partner in services, and the third largest investor in Sweden.[2] Politically, Sweden and the UK have often formed coalitions to push for market-oriented reforms to enhance the EU's economic performance (Keading and Selck 2005, Hayes-Renshaw et al. 2006).

Brexit puts this close partnership at risk, with clear negative economic and political consequences for Sweden. Limiting the damage from Brexit by keeping the UK as close as possible to the EU is clearly in the interest of Sweden. In our view, Sweden should work for a happy divorce that lays the foundation for a remarriage. In other words, we hope that Brexit will be followed by 'Brentry' – the return of the UK to the Union in the future.

Specifically, Sweden should aim to keep the UK in the common market and to maintain as close political links with the UK as possible. A 'hard' Brexit should be avoided. We believe this is possible by offering the UK, as well as all other member states, the

1 We have received constructive comments from many, in particular Jan Frydman, Oskar Grevesmühl, Arne-Jon Isachsen, Magnus Jerneck and Geoffrey Wood. The usual disclaimer holds.

2 Source: Statistics Sweden

explicit right to impose well-defined and temporary restrictions on the free movement of labour. Naturally, the right to limit migration comes coupled with the obligation for the UK to honour all of its other obligations, including paying into the EU budget.

We arrive at this proposal because migration was one of the key issues in the UK referendum campaign.[3] The referendum outcome was sufficiently close that the result could easily have been the opposite had the UK been allowed to impose controls on the flow of EU migrants that were perceived as effective by the electorate. The UK population has grown by almost 8% in a decade, mostly from immigration. Public concern about migration has increased with the rising number of migrants, and it has been a major political issue in several recent general election campaigns (Cowley and Kavanagh 2010, 2015).

People's concerns about migration are not unfounded. Empirical research shows that the effects of migration on the host country are seldom unequivocally favourable. Often some parts of society gain from migration while others lose, at least in the short run. Migration of skilled labour can contribute greatly to economic growth by filling vacancies, bringing in new ideas, or helping firms to open up new export markets. Migration can also cause negative effects such as lowering social trust (Alesina and La Ferrara 2002, Putnam 2007), reducing wages, and putting pressure on housing and public services.

In terms of skills, roughly half of EU migrants to the UK are highly skilled (Nickell and Salaheen 2015). EU migration has greatly benefited some parts of the UK – such as the London area – greatly, contributing to their economic success (McWilliams 2015). In other areas the effects have been the opposite, with a heavy pressure on wages, housing and public services. The EU referendum in part reflected the split between communities that have benefitted from migration and those that have suffered.

The UK is not the only EU member for which EU migration is a crucial political issue. A recent Eurobarometer survey found that 45% of respondents in Italy hold a negative or very negative view of EU migration, the same level as in the UK. In France and

3 http://lordashcroftpolls.com/2016/06/how-the-united-kingdom-voted-and-why/

Germany the level is lower, but is still high at between 30% and 40%. In the European elections in 2014, political parties calling for restrictions on migration scored victories across large parts of the EU, coming out on top in Denmark and France.

In Sweden, labour migration from eastern European countries has sparked a debate about the undercutting of labour contracts. A recent inflow of roughly 4,000 beggars from Romania and Bulgaria has also caused a major debate on EU migration.[4,5] Addressing public worries about migration is not just in the interest of the UK, but of the whole of the EU. Failing to deal with migration, when it is a major political issue in many countries, is bound to undermine public support for the EU.

The key question in the Brexit negotiations will most likely be whether an escape clause concerning the free movement of labour is possible. Such a safeguard clause should be viewed as a temporary opt-out. Permanent opt-outs already exist, which suggests that temporary measures should be consistent with the EU Treaty. The UK currently has several opt-outs, including on the common currency and the Schengen area, to name just two. Of course, a complication in this case is that the free movement of people is one of the 'four freedoms' of the EU, while other areas of EU cooperation, such as the common currency, are not.

Still, the negative effects on some parts of the EU of rapid migration must be addressed. Migration was not an issue when the European project was launched in the 1950s. In fact, according to Article 3 of the Lisbon Treaty, the aim of the EU is to "work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress". With wages declining and public services under pressure, the freedom of movement of labour runs the risk of being in conflict with the goals of social progress and full employment, at least in the short run and at least in some parts of the EU.

4 http://www.svt.se/nyheter/inrikes/dubbelt-sa-manga-tiggande-eu-migranter-senaste-aret

5 http://www.svt.se/nyheter/inrikes/svenskarna-for-tiggeriforbud

Our solution to the UK's concern over the level of migration is simple. We recommend a *temporary* escape clause – not a *permanent* opt-out – concerning the free movement of labour, which any member state can invoke *when and only when* it can prove to the Commission that EU migration is directly harming a significant part of domestic society. These restrictions should be temporary, explicitly stating an exact time limit. In addition, the country imposing the restrictions should be obliged to implement measures to remove the restrictions on EU migration within the limited time. The right to temporary restrictions on migration should thus be clearly linked to direct action addressing social bottlenecks.

In the case of the UK, a temporary restriction on the entry of unskilled labour for, say, a five-year period would reduce the downward pressure on wages and give local authorities time to address pressures on housing and public services in the affected regions.[6] A return to the free movement of labour should follow thereafter.

An objection to our proposal is that it is impossible to allow all 28 member countries escape clauses from all parts of EU cooperation. This is a valid objection, especially when it comes to one of the four basic freedoms. However, our proposed escape clause is in line with Article 112(1) of the EEA Agreement, which states "[i]f serious economic, societal or environmental difficulties of a sectorial or regional nature liable to persist are arising, a Contracting Party may unilaterally take appropriate measures under the conditions and procedures laid down in Article 113".

In addition, there is a precedent for limiting free movement across the Union. The free movement of capital, which is also one of the four freedoms, was restricted during both the Cypriot financial crisis in 2013 and the Greek financial crisis in 2015. In these two cases, an escape clause from the fundamental right to move capital from one EU country to another was restricted as part of a programme to strengthen and support the euro. We are calling for a similar escape clause for labour to diminish the risk of a break-up of the Union.

6 https://mainlymacro.blogspot.se/2016/09/immigration-and-experts.html

Our bottom line is simple. Sweden should suggest that the negotiations following the UK activating Article 50 should focus on keeping the UK as close to the EU as possible and within the common market, while giving the UK (and other member states) the right to impose temporary and well-defined restrictions on the flow of unskilled EU migrants. During the time of the restrictions, the UK should make necessary preparations such that the restrictions on migration could be lifted in the short term. In exchange for response to access to the common market and the ability to limit some of the flow of migration, the UK should accept all EU regulations and trade agreements with external partners, and should and contribute to the EU budget.

Our proposal is constructive, oriented towards finding a solution to the problems created by Brexit. In addition, it sends an important signal to citizens across the EU that the Union is based on important principles, but is sufficiently flexible to address temporarily widespread public concerns when these are at odds with the principles. We believe such a signal would help to rebuild trust in the European project across the whole Union.

The UK referendum result was a close one. A breakdown of the Brexit vote demonstrates that younger voters strongly favoured UK membership of the EU. Looking into the future, this suggests that support for re-joining the EU is likely to grow in the future. From a Swedish point of view, 'Brentry' would be the most beneficial long-term outcome of Brexit. Our proposal is designed to facilitate such a return of the UK to the EU and to induce other EU members to remain within the Union.

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16 Has Brexit cast a shadow over Swiss foreign economic policy?

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"We are discussing with Switzerland, we have Britain in mind, because these questions are interlinked."
Jean-Claude Juncker, President, European Commission, 19 September 2016[1]

The United Kingdom is not the only European nation experiencing strained relations with the European Union. Switzerland, a landlocked country almost entirely surrounded by EU members, has been on a potential collision course with the European Union ever since the Swiss population voted in 2014 for immigration restrictions. In fact, as will be argued below, Swiss relations with the EU have been deteriorating for nearly a decade, with stronger signals of dissatisfaction from Brussels concerning the current arrangements that integrate Swiss society and its economy with its neighbours.

When a majority of British voters favoured Brexit, the concern immediately arose that potential future EU-UK negotiations would cast a shadow over EU-Swiss relations. Indeed, as the quotation at the start of this chapter shows, EU officials have drawn links between these negotiations, essentially implying less room to manoeuvre to meet any Swiss demands. More generally, these developments raise the question addressed in this chapter: In what ways has or will Brexit influence the conduct of Swiss foreign economic policy?

Although longstanding economic interests and constitutional considerations will play their part, the answer to this question will depend on timing and triggers, practical matters that many analysts tend to overlook. It is argued here that, as a result of very

1 http://www.politico.eu/article/eu-switzerland-stuck-on-immigration-free-movement-single-market-europe-migration/

recent developments, the likelihood of a rupture in Swiss-EU relations over immigration restrictions in early 2017 has diminished significantly. However, over the medium term, given Brussels' irritation with current EU-Swiss bilateral arrangements, much depends on whether the EU is prepared to risk a schism with another neighbour. Moreover, Brexit opens up other medium and longer term opportunities and challenges for Swiss foreign economic policy that are discussed here.

Resolving the impasse over immigration restrictions

Constitutionally speaking, the Swiss government is supposed to implement within three years the immigration restrictions that the Swiss populace voted for on 9 February 2014. Following that vote the European Commission has taken a robust and fairly consistent line insisting that Switzerland stick to its international commitments, thus allowing the free movement of EU citizens into Switzerland. As then-EU commissioner Laszlo Andor remarked, "*Pacta sunt servanda*. A deal is a deal, and selective implementation or even 'cherry-picking' is not an option" (Andor 2014).

Until this summer there appeared to be little prospect of resolving this impasse. The Swiss federal government proposed a safeguard clause for immigration in March 2016 but this was amended by a committee of the Swiss parliament. Subsequently, on 2 September 2016 the Political Institutions Committee of the National Council proposed introducing preferences during hiring for Swiss nationals and foreign residents of Switzerland.[2] The expectation of proponents of this measure is that it will reduce immigration by between 5,000 and 10,000 persons per year. This proposal has now been approved by one chamber of the Swiss parliament.

Perhaps, as a result of the omission of restrictions on immigration in the latest proposal, Jean-Claude Juncker stated on a visit to Zurich in September 2016: "I'm more optimistic than I was in the past weeks – it's all moving in the right direction…We moved closer on some points. That the government wants to privilege Swiss employees on the jobs

2 https://www.parlament.ch/de/services/news/Seiten/sda-spk-n-2016-09-02.aspx

market is o.k. for me if it takes place in the framework of mutual recognition."3 Juncker indicated, however, that there were unanswered questions and that the final proposal would have to be approved by a joint Swiss-EU commission.

An interesting question is whether the Brexit vote and expected future negotiations on the terms of the UK's departure from the EU led to a hardening of the EU position with Switzerland on free movement – and whether, in response, Switzerland sought an alternative measure that did not directly curtail free movement. It is possible to point to numerous statements by EU officials before the Brexit vote calling on Switzerland to respect free movement if it wanted to retain access to EU markets. Moreover, Brexit or no Brexit, time was running out for the Swiss government to find a solution before the February 2017 implementation deadline. While it is not evident that Brexit played a definitive part in shifting the Swiss position, it would seem rash to draw the opposite conclusion.

While the near-term threat to Swiss-EU relations has diminished, it should still be remembered that the second chamber of the Swiss parliament must still approve this proposal. Moreover, should this proposal generate a sufficiently strong adverse reaction from enough Swiss voters then it may well be put to a vote. There is, therefore, some residual uncertainty.

One other development is worth noting. In her first speech to the Conservative Party conference in October 2016, UK Prime Minister Theresa May made clear that ending the free movement of persons was a first-order priority of her government in future negotiations with the EU. Mrs May stated:

> *I know some people ask about the "trade-off" between controlling immigration and trading with Europe. But that is the wrong way of looking at things. We have voted to leave the European Union and become a fully-independent, sovereign country. We will do what independent, sovereign countries do. We will decide for ourselves how we control immigration. And we will be free to pass our own laws…We are not leaving the European Union only to give up control of immigration again. And we*

3 http://www.bloomberg.com/news/articles/2016-09-19/juncker-eyes-swiss-specific-immigration-deal-despite-brexit

are not leaving only to return to the jurisdiction of the European Court of Justice.[4]

With this statement there is a now significant difference between the Swiss and UK government positions on free movement of persons with the EU. The current Swiss proposals would, if the statement above is to be believed, be unacceptable to London and therefore would not form a template for a future EU-UK deal. This implication may draw some of the tension out of the remaining Swiss-EU negotiations to overcome the impasse over immigration restrictions.

The institutional architecture of EU-Swiss relations[5]

At present EU-Swiss relations are governed by a set of 120 bilateral agreements covering a wide range of matters. Critically, as far as the Single Market is concerned, unlike members of the European Economic Area such as Norway, Switzerland does not have to automatically translate into its national laws every regulation promulgated by the European Commission. Switzerland is only obligated to enact and enforce ‘equivalent’ regulations. The associated lack of legal certainty has long vexed the EU.

Every two years the European Council reviews its relations with Switzerland. The published Council conclusions, while couched in traditional diplomatic language, have signalled growing frustration and impatience on the part of the EU. These concerns are longstanding, as the following excerpt from the December 2008 conclusions make clear:

> *Given the EEA judicial framework does not apply, the Council is concerned with an inconsistent application of agreements between the EU and Switzerland, and calls on Switzerland to fully implement those agreements* (European Council 2008, p. 7).

Well before the immigration vote in 2014, the position of the European Council had hardened:

4 http://www.independent.co.uk/news/uk/politics/theresa-may-conference-speech-article-50-brexit-eu-a7341926.html

5 This section of this chapter draws upon Evenett (2016).

> *In full respect of the Swiss sovereignty and choices, the Council has come to the conclusion that while the present system of bilateral agreements has worked well in the past, the challenge of the coming years will be to go beyond that system, which has become complex and unwieldy to manage and has clearly reached its limits. As a consequence, horizontal issues related to the dynamic adaption of agreements, an independent surveillance and judicial enforcement mechanisms and a dispute settlement mechanism need to be reflected in EU-Switzerland agreements.* (European Council 2010, p. 7).

In conclusions drawn in its meeting on 20 December 2012, the European Council was prepared to state that, in its view, negotiations with Switzerland concerning its further participation in the Single Market had reached a "stalemate" (European Council 2012, p. 5). In this regard the Council felt it had to make the following remark:

> *…the Council notes that by participating in parts of the EU internal market and policies, Switzerland is not only engaging in a bilateral relation but becomes a participant in a multilateral project. All in all, [the desired] institutional framework should present a level of legal certainty and independence equivalent to the mechanisms created under the EEA Agreement* (European Council 2012, p. 6).

The most recent, pertinent conclusions of the European Council, issued on 16 December 2014, state clearly the direction in which the EU would like to see its institutional arrangements with Switzerland evolve:

> *The Council reaffirms that by participating in parts of the EU's internal market and policies, Switzerland is not only engaging in a bilateral relation but becomes a participant in a multilateral project. It has taken note of the reconfirmation by the Swiss Federal Government in December 2013 of its attachment to a sectoral approach. The EU believes that an ambitious and comprehensive restructuring of the existing system of sectoral agreements would be beneficial to both the EU and Switzerland. A precondition for further developing a bilateral approach remains the establishment of a common institutional framework for existing and future agreements through which Switzerland participates in the EU's internal market, in order to ensure homogeneity and legal certainty in the internal market* (European Council 2014, p. 7).

Clearly, the EU is dissatisfied with the current institutional architecture of EU-Swiss relations. Although this dissatisfaction predated the Brexit vote, looking forward the question arises: To what extent will Brexit cast a shadow over any EU-Swiss negotiations on these matters?

In principle, the European Commission could take the view, as it did during discussions on immigration, that it will negotiate with Switzerland taking account of its likely future negotiations with the UK. In so far as this limits EU negotiating flexibility, then Switzerland may feel it has little choice but to settle on terms more conducive to the EU.

However, unlike the case of immigration restrictions, the timing and triggers are different. On timing, assuming that the UK government does indeed invoke Article 50 before the end of March 2017 (as Mrs May announced at the recent Conservative Party conference), then supposing that no serious negotiations between the EU-UK take place before the formation of the next German federal government in September or October 2017, there will be no more than 18 months before the negotiating mandate expires.

Given that the EU negotiators are likely to convince themselves that they will have the maximum leverage over their British counterparts towards the end of the two-year interval (during the last quarter of 2018 and first quarter of 2019), unless London capitulates, the probability that any wide-ranging deal of this complexity, including the type of institutional architecture the EU prefers, is concluded is tiny.

The expectation, then, is that the UK will leave the EU in March 2019 without a deal with Brussels. At that point, unless a timetable for talks is agreed, there will be no further triggers to bring a subsequent EU-UK negotiation to a close. Also, the inevitable brinksmanship in the run up to March 2019 is likely to leave bad blood and it cannot be ruled out that the EU and UK will not commence negotiations on a regional trade agreement until the middle part of the next decade.

What does this timetable mean for Switzerland? Should the federal government want to negotiate a new institutional arrangement with the EU – and it is far from clear that it does – then any Brexit-related UK-EU talks would cast a shadow over any EU-Swiss negotiation until only March 2019. After that, the prospect of a EU-UK deal would seem so remote that the argument that the EU must negotiate with Switzerland with an eye to their talks with the UK will lose a lot of force. In which case, the EU negotiating position towards Switzerland might become more flexible.

Another Brexit-related consideration is that the European Commission, in its zeal for institutional homogeneity and seeing a threat to its *modus operandi*, provokes a confrontation with Switzerland. This seems unlikely, however, as it would almost certainly require EU member state approval – and Switzerland would learn about this soon enough to mount a diplomatic counter-offensive.

Furthermore, the European Commission could barely afford a rupture with another neighbour with whom it engages in significant amounts of commerce. As Lady Bracknell said in Oscar Wilde's *The Importance of Being Earnest,* "To lose one parent, Mr Worthing, may be regarded as a misfortune; to lose both looks like carelessness." Paradoxically, then, Brexit may have reduced the likelihood of Brussels confronting Bern over the current set of bilateral agreements.

Medium term opportunities and challenges raised by Brexit

After the UK leaves the EU, other opportunities to advance Swiss commercial interests arise.

As soon as the UK leaves the EU it will be able to negotiate regional trade agreements with third parties. Given the strength of commercial ties between Switzerland and the UK, one option that could be explored in Bern is whether a Swiss-UK regional trade agreement would advance its commercial interests. With the UK's exit from the EU, in the absence of such an agreement, in principle London and Bern would raise tariffs up to the respective MFN applied rates. Such disruption to trade would be undesirable. Beyond trade in goods, as two advanced industrial economies, Switzerland and the UK would have a range of other commercial interests that could benefit from liberalisation and codification in a regional trade agreement.

Other implications might follow from an aggressive UK strategy towards regional trade agreements. Ongoing EU negotiations with third parties may be hampered, if not stalled outright, by the UK's exit. US officials have expressed concerns about the value of a Transatlantic Trade and Investment Partnership (TTIP) that does not include the UK. Should the odds lengthen on the conclusion of TTIP, then the risk of associated trade diversion harming Swiss commercial interests diminishes.

Conversely, to the extent that the UK signs trade deals with third parties, Swiss export interests may be affected adversely, although the degree will depend considerably on the details on any such accords. Indeed, should the UK and US eventually sign a regional trade agreement, or even an enhanced bilateral investment treaty, then Swiss commercial interests in that key North American market would be implicated.[6]

As seems likely, the UK will leave the EU in March 2019 without a comprehensive trade agreement in place. Should this come to pass, the City of London would lose its passporting rights. Given that Swiss access to the EU market in financial services is restricted in some respects, London and Bern could join forces to propose a financial services sector deal to the EU, creating a pan-European financial space.[7]

Even more ambitiously, Switzerland and the UK might want to align with other centres of financial services – such as Hong Kong, and Singapore – to negotiate with the EU. Naturally, larger coalitions are harder to manage. Still, the point remains that a sectoral approach to financial services might advance both Bern's and London's interests.[8]

Lastly, should the anticipation or reality of the UK leaving the EU prove sufficiently unsettling to the business community in the UK, then the possibility that London engages in far-reaching competitiveness-improving reforms should not be ruled out.

6 I thank Frédéric Payot for encouraging me to think further about the potential consequences of an aggressive UK policy towards regional trade agreements.

7 Given the relative size of their financial sectors, arguably such cooperation may enhance Swiss leverage more than UK leverage. Indeed, the UK may conclude that the additional leverage from such a bilateral approach to the EU is not worth the cost of aligning and coordinating negotiating positions. I thank Michael Meier for encouraging me to think more about such matters.

8 Switzerland is a party to the ongoing Trade in Services Agreement (TiSA) negotiations, which include financial services. To date there have been 20 rounds of negotiations. According to the European Commission report on the latest round (conducted in September 2016) as far as financial services were concerned "some difficult questions could still not be resolved" (see http://trade.ec.europa.eu/doclib/docs/2016/october/tradoc_154990.doc.pdf). Should the TiSA negotiation be concluded successfully to Switzerland's satisfaction, then a joint approach with the UK to the EU might become moot.

Whether or not such reforms are based on free market principles or, as Prime Minister May seems to prefer, a state-led industrial strategy, then firms based in the UK could end up competing more effectively with Swiss rivals.

Some have referred to the prospect of the UK becoming "Switzerland on Steroids." One need not go that far to recognise that within two and a half years Switzerland will face a sizeable competitor on the periphery of the European Union. Foreign investors seeking to be close to the EU, but not in it, will soon have a wider range of options. In turn, pressure will build on Switzerland to strengthen its competitiveness. The latter is already impressive but competitiveness is by its nature a relative concept. A UK that gets its act together could over the medium to longer term become a stronger rival to Switzerland in the global quest for capital, ideas, and talent.

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With Britain's exit from the European Union edging ever closer, so too are the negotiations. So far the focus has been on the future position of the UK. Now the time comes for the remaining 27 member states to understand the implications for them, and establish a strategy for the European Union.

This eBook gathers the opinions of 25 authors from 15 of these member states, and from Switzerland. They not only look at the different challenges that will face the UK, but also the EU27. Amongst the challenges are labour mobility, trade, the City of London, foreign direct investment, the European Court of Justice and EU budget contributions.

The seemingly likely outcome of a 'hard' Brexit is also causing tensions between EU countries, with some expected to benefit from it and others to lose. This eBook is a way of discussing the potential issues facing different members when it comes to negotiating with the UK.

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