The Other Side June 30, 2016

Repercussions of BREXIT

The UK is currently the fastest growing major economy in the European Union. After the results of the referendum, and the uncertainties created by BREXIT, it is questionable how long this growth momentum will last: most economic analysts, including the International Monetary Fund, had earlier forecast adverse repercussions of a divorce from the European Union. After last Friday, the British Prime Minister, who has announced his intention to leave in the next few months, must now be ruing having called the referendum: as recently as February he had negotiated for Britain, an ‘opt out’ from the commitment to ‘ever closer union’ incorporated in the Treaty of Rome (1957) which was the starting point of the European Project. David Cameron then thought that this ‘opt out’, along with some other changes on economic/financial issues, was a very satisfactory package and he was confident of winning the June referendum.

Many are worried about the repercussions of the divorce and, over the week-end, some 3 mn people have signed a petition requesting Parliament for a second referendum on the issue. This is unlikely and it looks like England and Wales will have to live with BREXIT, negotiating the detailed terms of the separation; Northern Ireland, and particularly Scotland, both currently part of the United Kingdom, may well separate from the UK to remain within the EU, the former perhaps after merging with its southern neighbour, the Republic of Ireland.

The financial services industry, which has made London as the world’s premier international financial market, may well migrate some activity to Frankfurt, Hong Kong and Singapore. No wonder ‘the City’ voted heavily in favour of remaining within the EU, while much of the traditional heartland of British mining and manufacturing industry, was for BREXIT: the last three decades of Anglo Saxon economic ideology has given far greater priority to the prosperity of the financial services industry, than to the real economy which used to create reasonably well paid jobs for a large number of people. One result has been that income inequalities have grown rapidly, and the relatively worse off are naturally opposed to the immigration policies of the EU. Their worry is that the ‘outsider’ will compete for the low-paid jobs: the dislike of the immigrant is even more when she is from a different ethnic group.

Chances are that BREXIT will have far greater economic repercussions on the UK than on the Union. Not that BREXIT will have no impact on the EU: it may well lead many countries in the euro zone to seriously review the cost/benefit of the single currency, which has imposed very significant and material restrictions on their sovereignty. Perhaps the condition which has had the biggest impact on growth and employment is the holy cow of fiscal austerity: while Greece’s GDP has dropped 30% since the crisis of 2010, Spain and Portugal have got one more year to bring their deficits down to the prescribed limits. Italy continues to suffer from large unemployment and a major problem of bad debts for its banking industry. In many countries from Austria to France to Netherlands, extreme right wing parties are gaining strength, also because of the immigration policies. Polls suggest that a majority of the population in Italy and France desire a UK-type referendum on the EU/single currency – though the latter does not have any ‘opt-out’ provision.

Perhaps the biggest immediate impact of the result of the referendum has been on the currency markets. The British pound had dropped 12%, which is not much of a surprise, before recovering a little. The Japanese yen has appreciated very significantly and is currently quoted around JPY 102 per $; the exchange rate was over JPY 110 a month back. The appreciation of the yen makes it even more difficult for Japan to come out of the deflationary trap of the last couple of decades.

BREXIT may not have much of a direct impact on the Indian economy. However, one comment of the Bank of England Governor, quoted in the Financial Times editorial post referendum, should be of interest to our policy makers. He said that the UK has become dependent on the “kindness of strangers” to finance its current account deficits. Obviously he was referring to the portfolio capital inflows which have become increasingly important for balancing the books. The Bank of England’s Financial Stability Report of July 2015 reported that UK’s net International Investment Position is a negative 20% of GDP; ours not much different.

A.V.Rajwade (avrajwade@gmail.com)