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Institute of South Asian Studies
National University of Singapore
29 Heng Mui Keng Terrace
#08-06 (Block B)
Singapore 119620
Tel: (65) 6516 4239 Fax: (65) 6776 7505
www.isas.nus.edu.sg
http://southasiandiaspora.org

Brexit and an Uncertain World: Some Implications for South Asia

This paper continues the story the author began telling in his first paper on the subject of Brexit,[1] the voters decision on June 23 to answer the question posed in a referendum whether the United Kingdom should stay in European Union which it joined in 1973. The voters opted to leave. A total severance of relations may not occur but the uncertainty created by the vote will have very negative consequences in finance and investment.

Shahid Javed Burki[2]

Confidence and uncertainty are two variables that worry all economists when they reflect about the future. Since they are difficult to quantify, they don't make into their equations and the models they work with. That notwithstanding, both figure prominently when economists reflect on Britain's future following the Brexit vote? It is not only the United Kingdom that would be affected but also the European Union. In fact there are likely to be consequences for the entire world economy.

1 Shahid Javed Burki, Two 'Brexits' – The First, 70 Years Ago, ISAS Brief No. 440 – 8 July 2016, available at www.isas.nus.edu.sg

2 Mr Shahid Javed Burki is Visiting Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He can be contacted at sjburki@nus.edu.sg. The author, not ISAS, is liable for the facts cited and opinions expressed in this paper.

How will Brexit play out in the drama the script of which is still being written? The political dust raised by the referendum of June 23 will take time to settle down. Much has already happened. Prime Minister David Cameron has left office and has been succeeded by the new leader of the Conservative party Mrs Theresa May who appears to follow a hard line on Brexit. Boris Johnson, the former mayor of London and a colourful advocate of the exit move from the European Union, decided not to take part in the contest for succession to David Cameron.

The impact of Brexit on party politics in Britain has been quite significant. The Labour Party has been convulsed. The majority of its backbenchers have rebelled against Jeremy Corbyn the party's leader. They voted against him but were not able to persuade him to resign his position. He has, since, been re-elected. Those who voted for Britain's exit did not think that they were producing a major earthquake in British politics but that is precisely what has happened. Political uncertainty always has negative economic consequences and that will be the case with the Brexit move.

It is hard not to be pessimistic about the future. The immediate effects of Brexit will flow almost entirely through financial markets. The British pound was hit badly, losing 7.6 percent in two days in its value expressed in American dollars. Major currency pairs just don't do that. Since 2012, the average daily move in the pound-dollar exchange rate was only 0.35 percent. The two day movements in the rate after the Brexit move was 21 times the historical average – it was indeed an earthquake. Converting the UK national income at the depreciated rate resulted in the country losing to France its ranking as the world's fifth largest economy, after the United States, China, Japan and Germany. "The world's central banks, normally the first responders in times of economic distress, are poorly positioned to help," wrote Neil Irwin in an assessment for *The New York Times*. "The Bank of England faces an extraordinarily knotty situation. It simultaneously must plan for a possible recession caused by the Brexit uncertainty and for higher inflation because of the drop in the currency and outflow of capital. It can fight one problem but not both at once."[3]

Foreign banks with large operations in London are thinking about their future. Even Deutsche Bank, the symbol of German banking but only nominally based in Frankfurt uses London as a base for investment banking and trading. It began to think about moving these operations out of the UK capital. Several American banks are similarly disposed. The extent of their presence in London may change as a result of Brexit. A day before the Brexit vote, Jamie Dimon, chief executive of JP Morgan Chase said that if the vote was in favour of leaving the European Union, up to a quarter of the bank's 16,000 employees in Britain might need to move. A day after the vote, he warned in a staff memo that "in months to come, we may need to make changes to our European legal entity, structure, and the location of some roles."

While finance is the first sector likely to be affected, longer-term consequences will flow from what happens to the flows in investment capital. Uncertainty is bound to influence the amount of foreign direct investment that flows into Britain. Before Brexit, Britain was the favoured destination of this type of capital. With Europe having been integrated into one large market, most manufacturing and technology companies based their activities on their read of comparative advantage. For instance, Airbus produces wings in Broughton, a manufacturing town in Britain, and employees 15,000 people in the country plus tens of thousands additional employees working for various suppliers to the aircraft manufacturing company. "This is a lose-lose result for both Britain and Europe," said Thomas Enders, the Airbus chief executive.[4] Most Airbus aircrafts use Rolls Royce engines made by an iconic British company but now owned by Volkswagen. If tariffs were re-imposed as a result of the British planned to exit the European Union, it would not be worthwhile for Airbus to manufacture large parts of its aircrafts in Britain.

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[3] Neil Irwin, "Points of departure: Sketching what the future holds for Europe and the global economy," *The New York Times*, June 25, 2016, pp. B1 and B3.

[4] The Jamie Dimon and Thomas Enders quotes are from Jack Ewing, Points of Departure: Companies ponder as Britain exits E.U.," *The New York Times*, June 25, 2016, pp. B1 and B3.

The "exiters" seem not have realized how integrated is the European automobile industry. Britain imports more automobile products from Germany than anywhere else. The country's is Germany's third largest customer for German exports, after the United States and France. BMW, Mercedes and Volkswagen account for half of the cars sole in Germany. Foreign companies but not only those in Europe have helped keep alive automobile manufacturing in Britain. Mercedes and Rolls Royce are generally regarded iconic British cars but both are owned by Volkswagen. Nissan has pumped close to 4 billion pounds since the 1980s into building a world-class factory in Sunderland in northeast England. In 2015 it produced 475,000 vehicles, about a third of Britain's total automobile production. About 55 percent of this output was exported to Europe.

All the assessments that have been made to reflect on what Brexit will bring to Britain and Europe, little attention has been given to relations between it and some of its former colonies. For the last several years some of the large Indian companies have acquired assets in Britain. Tata now owns Jaguar and Land Rover cars in Britain. It worked hard to revive both brands that had lost a great deal of the appeal and lustre because of problems with quality. The cars are selling once again in both Europe and the United States. Tata is also Britain's largest steel producer.

The Indian expatriate community is deeply involved in developing the IT sector in Britain. Many work in Facebook and Google; both have sizeable operations in Britain though for tax reasons they are headquartered in Ireland and the Netherlands. Google employs 1,000 engineers, many Indians and Pakistanis, across Britain working on global products like its search engines and Android operating system.

The main conclusion to be drawn from this analysis is that the Brexit move was poorly thought-through. Apart from the adverse consequences in the areas of finance and manufacturing, it will also impact on the supply of manpower to Britain, particularly those with the skills the British educational system and its demographic situation are not producing in the required numbers. The impact on South Asian immigration of Brexit stands in need of urgent attention. South Asia will be affected more than the countries in the European continent or the Middle East since it sends people with different levels of skills. Most of the recent migrants to Britain have been people skilled in finance and technology. Reducing their number will have consequences for South Asia.

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