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EXECUTIVE BRIEFINGS
POLITICS AND ECONOMY: BRITAIN

Adit Jain, IMA India
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An island nation again

I remember vividly a meeting of Britain's Young Conservatives in Oxford, in the summer of 1987, where Margaret Thatcher, then Prime Minister of the United Kingdom, addressing a group comprising mostly of students, proudly declared that the rose on her lapel was the Rose of England. What remains embedded in my mind was the fact that the audience responded to her remark with a standing ovation lasting four minutes. Such patriotism, usually reserved for Trooping the Colours on Remembrance Day or a rugby match against France, is uncommon at political meetings. After years of Labour Party misrule, trade union militancy and self-defeatism, Britain had finally emerged from the shadows under a reformist Conservative administration. Young people were proud to be British again.

Over the years, however, the balance of power transitioned from Whitehall to Brussels – the headquarters of the European Commission. Policy formulation on things as irrelevant as the size and composition of a sausage, to more pertinent ones concerning immigration or judicial interpretation of laws were made by bureaucrats with scant interest in the emotions of local communities. The perceived interests of Europe over-shadowed those of its member states, or so the British felt.

What finally triggered the referendum on Brexit, called by David Cameron the current British Prime Minister and leader of its Conservative Party, was the issue of immigration. Initially from Poland and subsequently from newer member states of the European Union, people migrated to Britain in search of employment. It was unfortunate enough that British jobs were going to meagrely paid immigrants, but the fact that unemployed migrants had access to tax-payer funded dole was infuriating. Moreover, the benefits of EU membership appeared limited to the greater London area and the home-counties where the rich and successful live. The rest of England did not gain as much. Clearly, Mr Cameron miscalculated the magnitude of frustration amongst the British people. On the 23rd June they cast their vote, in defiance of the establishment, choosing to leave the common market. As such things go they voted with their hearts rather than their minds, creating an appalling environment of economic uncertainty not only for Great Britain but also for the European Union and the world at large. In doing so they rejoiced in their new found 'independence' without sufficient comprehension of what may follow.

Britain's membership to the EU allows its businesses tariff free access to the world's second largest economy – the bulk of Britain's exports are to the EU – but more importantly, London serves as Europe's financial capital. London, the fifth largest metropolitan economy in the world, comprises a quarter of British output and much more of its growth. Without access to Europe's financial services market it will shrivel in status. But apparently that wasn't an argument convincing enough to alter voting patterns in the shires and rural England.

In the short term, the pound will remain impulsive and under downward pressures. Within a couple of days following the exit vote, it was on the receiving end of a bear hammering, falling to a 30 year low. The euro too fell, albeit somewhat less than the pound, whilst the dollar and yen made significant gains. This trend is likely to continue until there is clarity on the exit process, which may take as much as two years or longer. Capital will flow from equities to bonds and yields will fall as bond values rise. However, countries such as India that are less exposed to Britain, blessed with strong market fundamentals, have low deficits and moderate inflation, should recover quickly. The United States Federal Reserve may offer dollar swaps to some economies to tide over short term liquidity issues. The Bank of England has also promised to ease liquidity through a quantitative easing programme of GBP 250 billion together with a cut in interest rates. It has room for both measures and, hopefully, the sophistication to curb volatility, reduce speculation and set suitable expectations. In many ways it is the most important player in the unfolding drama.

Over the next few months, the United Kingdom will engage in discussions with the European Union to plot the exit process. It will seek a trade agreement initially with its erstwhile European partners and subsequently with a host of other nations and trade blocks. Until then, global markets will remain volatile as positive and negative news regarding the exit process comes into the public domain. Gyrations in the markets are therefore likely. Additionally, there is considerable political uncertainty ahead – firstly on account of Mr Cameron's departure (an early election may happen) and secondly, because the principal opposition Labour Party, is also going through an internal revolt. Many Labour MPs are said to be infuriated with its leader Jeremy Corbyn's half hearted effort to campaign against Brexit. Thirdly, there is unambiguous opposition to the exit process from Scotland, whose citizens had voted to stay in. Nicola Sturgeon, First Minister of Scotland and Head of the Scottish National Party, thinks that the Scottish Parliament can block the deal (or at least Scotland's part of it). However, this is constitutionally not possible. But Ms Sturgeon will demand another Scottish independence referendum and this time she might actually win. Because of all these factors, markets will remain edgy.

From a business standpoint, the main worry is the impact that Brexit will have on Britain's ability to access the common-market for goods and services. Many manufacturing companies (e.g. automotives) have set up sizeable capacities in Britain with a view to service the entire EU region. If their access to those markets is curtailed, or their ability to hire cheap labour from the EU reduced, they will have to cut back on further investments in Britain or even worse relocate capacities to the continent. Some predictions suggest that UK growth could fall by as much 1.5 percentage annually if it exits the EU, but those are based on simplistic and generalised assumptions. Nevertheless, it would seem that some impact on long term growth is unavoidable.

More worrying from the European perspective are strategic and security considerations. Whilst Brexit supporters would argue that military cooperation is based on the North Atlantic Treaty Organisation, where Britain will remain a member, European integration has in fact been the main reason for peace in the continent for 70 years. Britain's military leadership provided an important anchor towards this process. There is do doubt that without Britain, Europe will be pushed into a weaker position in international negotiations either on trade or strategic matters. But more worrying in the nearer term is the agony that other countries may follow suit. Nationalist political parties and the far-right which are anti European Union (such as Marine Le Pen's Front Nationale in France; Geert Wilder's Dutch Party for Freedom; Law and Justice Party in Poland; Freedom Party in Austria) have previously been on the fringes of European politics. They are now becoming centre stage. They will, in the least, strongly influence policy formulation if not determine it. The British vote has inspired them and terrified the establishment. It is hard to say how things will evolve but the European ideal of 'ever closer integration' will take a back seat at least for now. In the extreme case, nationalism may spread across Europe.

But Britain too, out of Europe, will be weaker. Its influence on global matters has greatly reduced since the Thatcher years, when the European project first spread beyond the boundaries of France, Germany and Italy. A British Prime Minister today is unlikely to enlist the enthusiastic response Mrs Thatcher received at the Oxford meeting of the Young Conservatives in 1987. Some might even wonder whether Britain is an idea whose time has gone.