DHĀRANA

INTERNATIONAL JOURNAL OF BUSINESS FROM BHARATIYA VIDYA BHAVAN'S M. P. BIRLA INSTITUTE OF MANAGEMENT, BENGALURU

Vol.11, #1 (2017) pp 15-20 ISSN 0974-0082

Impact of Brexit and India's Preparedness: A Perspective

M.R. Shollapur & Shridevi V. Patted*

Abstract

Britain's decision to withdraw from the European Union on June 24, 2016 ceasing its long affiliation since January 1, 1973 has sent shockwaves across the globe. The markets have collectively reacted sharply leading to turbulence especially in financial markets. The investors are found dumping stocks and risky assets opting for safe heaven assets. The earnings outlook of corporate entities has taken a beating. The Indian companies which have their business contacts and locations in Britain and Europe are feeling the pinch of Brexit. However, our regulators are of the opinion that the nation is ready to handle the eventualities of Brexit. Against this background, this paper intends to examine the pros and cons of Brexit and India's preparedness in handling the same. Narrative approach is adopted in discussing the issues pertaining to the impact of Brexit and India's preparedness.

Keywords: *Economic Unification, Monetary Union, Euro Zone, Regional Cooperation, Market Turbulence, Safe Haven Assets.*

Introduction

he early roots of regional economic cooperation in eneral and the unification of Europe in particular can e traced back to the Treaty signed at Paris on 18 April 951. Under this treaty, six countries came forward to stablish European Coal and Steel Committee (ECSC). hey include Belgium, France, Italy, Luxembourg, the letherlands and then Federal Republic of Germany. he same six countries later signed the Treaty of Rome on 25 March 1957 to create the European Economic Community (EEC). The EEC acted as a forum of economic cooperation facilitating free market of goods, manpower and capital. New members joined the EEC over time: Denmark, Ireland and UK (1972), Greece (1979), Spain and Portugal (1986). With the Maastricht Treaty (1992), the European Economic Community has been renamed as European Union (EU). The Maastricht Treaty had laid down certain conditions for joining

Professor and Director, Siddaganga Institute of Technology, Tumakuru 572 103 & Assistant Professor, Government First Grade College, Tyamagondlu 562 132.

the union. The prospective member countries had to achieve low inflation rates, low long-term interest rates and a stable exchange rate so as to become members of the union. In addition, the public debt and current budget deficits should not exceed 60% and 3% of country's GDP respectively. The EU emerged as a regional economic integration in Western Europe by removing all the barriers to the free flow of goods, capital and people. The increase in its membership from the original six to twenty eight indicates a converging trend towards regional cooperation.

In spite of the increasing membership and the efforts of economic unification by the EU over time, the seeds of disintegration in the union are sown with the Brexit. There is a need to ponder over its repercussions especially on trade, investment and corporate performance across globe. It is a matter of greater concern to examine its impact on India as well and also to ensure India's preparedness in handling the consequential crisis. The study is organized into five sections. The second section discusses the raison *detre* of Brexit. Third section describes the impact of Brexit on trade, investment and financial markets and corporate performance. Fourth section discusses India's preparedness in handling the impact of Brexit. Last section concludes the discussion.

II. The Britain's Exit: *raison detre*

The undertones of those who favored 'leave' and 'stay' are insightful. The leave won decisively with 52% of the votes. Mostly the old voted to leave and the young voted to remain. Those who lost their jobs to the advances in technology and global trade poured out their grudge by voting out. Those who saw their future in growing collaborations in research, and the rise of new businesses as well as disruptive new companies that are transnational in their funding, work force and markets voted to stay. In nutshell, Britain's decision to exit from the E.U. has political, economic and socio-cultural undertones. These are summarized hereunder:

- Britain had troubled relationship with EU since the beginning. The ministerial governance of the European Parliament was detrimental to the interests of the British. It even felt that the bureaucratic regulations affected its innovation and competitiveness. The proponents of Brexit even felt that being a member (EU involves giving up some control over its own affair
- Britain faced the menace of huge immigran especially from the Eastern and Southern Europ that put heavy pressure on its housing and oth services. There is a general feeling that Europe cou not properly handle the migration crisis. Millions (Syrian fleeing their homes made their way to Europ Britain found that the East European immigran were affecting their jobs. Traditionalists upset by th ever growing presence of the foreigners in their mid: with their own uniforms, food, clothing and in som cases religion voted to halt and reverse migration.
- Being in the EU had direct financial burden in term of its contribution to the European budget. Wherea Britain paid £ 13 billion to EU, it could receive only 4.5 billion in 2015. In addition, Britain found itself th being dependent on Europeans led to disappearing (its own industries.
- A widening disparity among the members of th EU was disappointing. Two countries that share th same currency led to two spectacularly unequal live in the same monetary union. For instance, Greece ha 25% unemployment level whereas Germany had onl 4%. Similarly, the percentage of public debt to GD was 177% in Greece as against 71% in Germany. Th former Governor of Bank of England observes th 'the monetary union has created a conflict betwee centralized elite on the one hand and the force (democracy at the national level on the other.'
- Of late, Britain felt that its doors lie open to terrorist attacks by remaining in the European Union due t the open border mandate of the European Union.

Against these compelling reasons, the United Kingdo decided to exit from the EU to seek its own way. Wit its exit from the EU, Britain can be free from the E rules and regulations. As a consequence, Britain woul be privileged to establish its own trade agreement It would regain control over its borders and chec immigration that would result into more jobs to loc people. It may also result into hike in wages that woul benefit its native working class. It would also get fishin rights around its coasts.

rexit also puts Britain to political and economic ardships. Politically, Britain will have to give up its ıfluence in Europe and retreating itself from the lobal power networks. Back at home, Britain will see new Prime Minister by September 2016 which will ırther escalate the uncertainty. Ms. Theresa May /ho is to succeed Prime Minister David Cameron had ıdicated for invoking Article 50 of the EU's Lisbon reaty. It deals with the formal procedure for leaving ıe EU. Negotiations on the future relationship cannot egin until it starts the divorce proceedings. From ıe economic angle, UK's status as one among the iggest global financial centres will be dismissed ıereby affecting the national governments of Britain. ı addition, its status as major investment banking hub /ould be damaged as some business would shift to the uropean Union. As a result, Britain would face weaker rowth and investment prospects. It would need to romote its own agreements of trade among various ountries including the U.S.

Il. Impact of Brexit on trade, investments, inancial markets and corporate sector

ıt the global level, the impact of Brexit can be seen n trade and investments and turbulence in financial ıarkets. Its impact is already felt on the exports, ṃports, investment and financial markets. In addition, ıdian companies including banks are being also ffected. The overall impact of Brexit is summarized in he following paragraphs:

'. *Impact on trade*

ƚrexit affects the overall economy of the EU in general ınd trade and investment in particular. Many countries onsider Britain as the gateway to free trade with the est of the nations of the EU. Brexit may reduce the ırospects of Britain's trade with the EU and thereby ead to a sustained drop in GDP and loss of jobs. It s also feared that Britan's tax revenues may drop as ompanies that do large amounts of business with :urope may shift their bases back to the EU. Brexit ıuts fuel to the fire as the foreign firms operating in he EU would be compelled to relocate their European ıperations elsewhere.

'he Global Counsel has brought out a report entitled "BREXIT: the impact on the UK and the EU" (2015). This report has found that Brexit would severely impact the trade and investment channels of the UK. It is also feared that there would be regulatory divergence affecting trade volumes and reducing the attractiveness of the UK for investment. This would impact on European businesses in the UK and supply chains involving UK firms. The report also observes that other member nations such as Netherlands, Ireland and Cyprus are also exposed to Brexit. Each of these countries has strong links with the UK in respect to trade and investments. In few cases, there is an intimate alignment even in policy terms. This is found especially between the UK on the one hand and the Netherlands and Irelands on the other hand.

From India's point of view, currency fluctuations might undermine India's export of goods and services to the UK. For locals in the UK, imports have already become 10% expensive due to currency devaluation. This along with further devaluation could trigger curb in spending, leading to a fall in trade. Since relations between India and Britain are good, the latter may focus on emerging markets like India to make up for the deficit in trade and investment. Further, Indian companies which are not exporting to Europe are not affected.

2. Impact on investments

The UK attracts the maximum amount of FDI in the EU. With Brexit, the UK loses the status of 'gateway to Europe' that, in turn, would diminish its attractiveness in general and the investment from the rest of the E.U. in particular. As a result, the corporate headquarters hitherto set up in the UK may quit. In addition to European nations, the US too, which is one among the largest investors in the UK, consider the UK as a gateway to free trade with the European Union. Brexit jeopardizes the US access to market. A survey by the British Americans Business has favored that 70% of its members thought that Brexit would damage their operations and future investments. The IMF is of the opinion that the reduction in investment would decrease economic growth up to 5.6% over the next three years.

Further, uncertainty causes certain things that are bad for developing countries. It poses much more difficulty

in accessing capital. India, for instance, losses its access to Europe and UK will not be an alternative destination for India's FDI as before. On the other hand, Britain may woo Indian companies in the form of tax incentives, enabling regulations and other financial enticements. Amidst this dilemma, India needs to forge its ties with other countries within the EU such as Netherlands, France, Germany, etc. The current values of British pound offer an appealing rationale for foreign investors to buy properties in the UK. The lower prices and devaluation of the £ together would prompt Indian investors to acquire assets in the UK. Further, London continues to be a favourite destination for India's property buyers.

3. Turbulence in financial markets

Brexit creates a whole bunch of financial, economic, political and geopolitical uncertainties. Primarily, there are uncertainties with regard to Britain's future relationship with the EU, and its access to the European markets. It has heightened market uncertainty in particular, leading to an aversion to invest in equities now. The markets have reacted sharply to the referendum results with the £ falling to its lowest since 1985. It is losing value against currencies of major economies. Other major currencies that have also shown volatility include the Euro which has seen its worst fall against $. Consequently, there will be considerable caution and lower confidence on spending and investment in the short run. The US too experienced nervousness as the Dow Jones index opened 200 points down. Interestingly, the Asian markets remained resilient on 27 June 2016 after the sell-off on 25 June 2016. India was not an exception. However, currencies could not bear the assault as the £ crashed to 31 year low. Similarly, China's Yuan plunged to the lowest since 2010. Amidst this assault on currencies, gold is being considered as a safe asset. Gold has remained as a powerful asset as its prices surprised investors with a sharp rally on Friday, the 24 June 2016.

The Indian equity market has reacted negatively to the Brexit news on 25 June 2016. The BSE Sensex fell as much as 1091 points (4%) before recovering to close 2.2% lower. The 30 share Sensex fell 2.24% to 26397.71 as turmoil gripped global markets on Brexit. The Nifty of the National Stock Exchange ended the da at 8088.60 down 181.85 points or 2.20%. Rupee initial weakened past 68 a dollar. Gold moved up 4.28% 1 $1,310 an ounce while the US 10 years yield ascende to 1.56%. Similarly, the prices of commodities lik oil swelled on the back of the dollar rise. Thus Brex caused a crash in stocks and currencies, especially i emerging markets such as India. This tends to prom investors offload stocks and risky assets such a emerging market currencies and bonds and fly to sa haven assets like gold, the yen and the dollar. As result, billions of dollars may flow out of India.

The stock market indices on 27 June 2016 ende unchanged over 25 June 2016, after dangling betwee gains and losses. This status quo was prompte as investors kept to the sidelines, confused by th implications of Brexit. The sensex rose 5 points 1 close at 26,402.96. The rupee closed at 67.94 pe dollar, almost unchanged from 25 June 2016 as Centr Bank intervention helped the currency rebound fro low. Institutional activity in the stock market wa unenthusiastic with foreign and domestic investors ne selling shares worth Rs. 146 crores and Rs.147 crore respectively.

4. Impact on corporate sector

In the light of uncertainty, corporate sector is puttin the investment plans on hold. With the slowdown i borrowing, every bank operating in the UK will probab be hurt. This is evident in case of British banks suc as Barclays and Royal Bank of Scotland whose share plunged to the lowest level since financial crisis. Bot the Barclays and Royal Bank of Scotland (RBS) incurre losses on 27 June 2016, falling between 9% and 14% Barclays shares fell more than 17% for the secon straight day and RBS plummeted as 26% in Londo trading. Analysts downgraded Barclays – RBS an Lloyds Banking Group cutting their earnings outlook The average share price estimate of three bank dropped more than 13% in the next two days. The U went through two downgrades from triple A to doubl A.

For India, Europe is the second largest market for India IT-BPM industry. A number of Indian companies hav operations in UK which generate a substantial portio

f revenues from European Union in general and UK ı particular: Tata Motors (35%), Bharat Forge (40%), Motherson Sumi (55%), Mahindra (CIE) and Tata Steel :0%). Similarly, a number of Indian exports to the UK enerate a good amount of revenue: Balakrishna Inds i5%), I.T. Companies (20-30%), Cumins India (4%), nd VA Tech Wabag (32%). The revenues of these ompanies are going to be affected. In the backdrop f India's exposure to the UK and Europe coming nder pressure, the EPS estimates of stocks like TCS, CL Technologies, Maruti Suzuki, Tata Motors, Tata teels and Balkrishna Industries have been cut. On 7 June 2016, Bank of America downgraded TCS) underperform from 'buy', cutting its target price) Rs. 2450 from Rs. 2750. Deutsche Bank, on the ame day, significantly increased underweight on IT ervices. This was due to the apprehension that the ector is negatively affected from the double blow of ross-currency headwinds and revenue volatility. Thus, ıe Indian IT companies would come under pressure n account of Brexit. The immediate impact could be een through a weaker Euro and Pound versus the ıdian rupee. Further, many European companies have ostponed their software spending before the Brexit. is hoped that this impact will get reflected in second uarter's earnings which will be reported in July 2016. is felt that minor disappointment can cause about -10% price changes in post-earnings announcements.

/. India's preparedness

is true that Indian stocks suffered at the behest of olatility in global financial markets. Further, the fears ertaining to the dollar's strength has weakened ıvestors' confidence. The Finance Minister has ghtly said that 'We are well prepared to deal with hort term and medium term consequences of Brexit'. ıdia's preparedness is reflected through the following ıdicators:

- Sound macroeconomic fundamentals
- Comfortable external position
- Rock-solid commitment to fiscal deficit
- Declining inflation
- Healthy reserve position
- Better growth forecast
- Integrated working together of the Government, RBI as well as other regulators
- Lower exposure to the external sector as compared to many other countries
- India is not a significant commodity exporter
- Low short term external debt
- RBI's assurance of liquidity support for both Re & $
- Government support to Indian firms
- Expectations of robust monsoon rains
- Ambitious reforms such as early passage of GST, medium term development goal being 8-9%

As an economy, we are greatly insulated and sure to grow by 7.6%. There will be a revival in the rural demand due to forecast of robust monsoon rains. Further, it is expected to calm down food prices. It gives enough cushion to withstand the pressures of Brexit. A few advantages are perceived as well. For instance, with migration from mainland Europe drying up, Britain would be able to accommodate migration from India due to its English speaking population. Moreover, we have historical and cultural ties with them. The devaluation of Pound will surge in leisure tourism to Britain and UK. Further, it will serve as a destination for higher education. Also there is time for making adjustment and try to see how things work better.

V. Conclusion

Europe is not yet fully recovered from the series of financial crisis that have been rolling countries such as Greece and Italy. In addition, a time has now come to Britain to unwind its four decades of increasingly close relationship with the European Union. Terms on which the UK would be trading with E.U. in future is not yet known. Most players don't know how things are going to play out. This is the first time that a country is leaving the EU. So no historical benchmark is available to fall back upon. Above all, withdrawal is not going to happen overnight. As it will take at least two years, there will be a lot of time for making adjustments and try to see how things work better. It can be concluded that the UK's decision to exit the EU has increased greater stress and turbulence in the markets and thereby casting a shadow over the global economy. Thus, there is a fear of global recession led by the UK.

The repercussions of fallout will emerge in next 5-10 years. However, it is difficult to predict now.

References

1. Amiti Sen, (2016). 'Brexit may speed up India - UK free trade pact'. *Business Line,* Dt. 01-07-2016, p.13.
2. Berlin, (2016). 'European lawmakers urge a speedy Brexit', *The Hindu,* Dt. 27-06-2016-p.14.
3. Bloomberg, (2016). 'Brexit: Gold rally seen reducing Indian imports to 7 year low', *Business Line,* Dt. 01-07-2016-p.18.
4. Brian, W., & Alex, H., (2016), 'The UK's EU referendum: All you need to know.' http://www.bbc.com/news/uk-politics-32810887, 24-06-2016.
5. Clive Crook, (2016). 'Will UK re-do Brexit?' *Business Line,* Dt. 01-07-2016, p.01
6. Eun & Resnick, (2011), *'International Financial Management,'* TMH, 4th Ed, 2011.
7. ET Bureau, (2016). 'Brexit pounds global markets'. *The Economic Times,* Dt. 28-06-2016, pp.1
8. Gregor Irwin, (2015). *'Brexit: The impact on the UK and the EU',* GC Global Counsel, June 2015.
9. Jeff Madura, (2012). *'International Corporate Finance,'* Cengage Learning, 10th Ed, 2012.
10. Jim Zarroli (2016), 'How Will Brexit Affect London's Status As A Global Financial Center?. http://www.npr.org/2016/06/27/483665241/how-will-brexit-results-affect-londons-status-as-a-global-financial-center, Dt. 27-06-2016.
11. John Pilger, (2016). 'Why the British said no to Europe', *The Hindu,* Dt. 28-06-2016, p.8.
12. Justin Tallis, (2016), 'EU referendum: What are th pros and cons of Brexit?' 'http://www.thewee co.uk/brexit-0 Dt. 27-06-2016.
13. Mark Mobius, (2016). 'Long – term view c emerging markets not altered by Brexit', *Busine: Line,* Dt. 27-06-2016, p.11.
14. Nayanima Basu, (2016).'Post-Brexit, UK and Indi can move ahead on the trade deal' *'Business Lin* Dt. 01-07-2016, p.4.
15. Neil Irwin, (2016), 'How Brexit will affect the glob economy, now and later'. http://www.nytime com/2016/06/25/upshot/how-brexit-will-affec the-global-economy-now-and-later.html?_r=0 . D 24-06-2016.
16. Nilesh Jasani, (2016). 'Brexit has the potenti to lead to Market Turmoil'. *The Economic Time Money Matters,* Dt. 01-07-2016, p.11.
17. Patrick Gillespie, (2016). 'How Brexit impacts th U.S. economy'. http://money.cnn.com/2016/06/24 investing/brexit-impact-on-american-globa economy/. Dt. 24-06-2016.
18. Peter S. G. (2016), 'Turbulence and uncertaint for the market after 'Brexit' http://www.nytime com/2016/06/25/business/international/brexi financial-economic-impact-leave.html?, Dt. 23-06 2016.
19. Rajesh, M., (2016). 'Cos with Europe exposure fac downgrade risk after Bexit'. *The Economic Time* Dt. 28-06-2016, p.9.
20. Sanchit Kumar (2016). 'Brexit effect: Indian equit may defy global shivers', *The Hindu,* Dt. 27-06 2016, p.15.
21. Surojit Gupta, (2016). 'India emerged from Brex crisis relatively well', *The Times of India,* Dt. 01-07 2016, p.19.