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BREXIT: IMPACT ON THE INDIAN ECONOMY AND STOCK MARKET

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ABSTRACT

One of the hugely anticipated major economic events "BREXIT – Great Britain's referendum to exit from the powerful European Union" happened in June 2016. This certainly marked the materializing of a global event risk in today's world. BREXIT has certainly taken many by surprise and was unexpected by most quarters of the world financial markets which was evident from the immediate negative reaction mostly driven by the sentiments. Post which, developments have been more in line with broader market consensus as policy makers have expressed their willingness to extend full support to the economy. UK's Bank of England has already loosened its monetary policy and is probably going to do more in the coming days to avoid any unnecessary collateral damage. Sensing that the growth of the economy will be impacted, the UK government could also go in for a more pragmatic fiscal policy in days to come. Markets have remained broadly stable and have reacted on expected lines with adequate capital making its way towards safe haven assets. The initial reaction in the markets was of shock and resulted in steep declines in the equity markets and strengthening of the USD. However, since then the level of risk aversion has reduced and equity markets across the globe have done well along with a rise in price of most sovereign bonds. Still, the true ramifications of Brexit will take months, to become apparent. While there are a number of possibilities that can play out in the coming months, it is important to take a step back and gauge the impact on the Indian economy and stock markets through its linkages with UK and the broader EU economy. This paper attempts to find the impact of Brexit on the global economies and stock markets, with a special focus on India.

KEYWORDS: Brexit, Stock Market, Economy, Investors

INTRODUCTION

EMERGENCE OF EUROPEAN UNION

The European Union is an economic and political partnership among 28 European countries. In order to avoid going to war and to improve the economic cooperation with each other, these countries formed the EU after the World War Two. Since then, these countries treat their association as a one market, allowing goods and people to trade around. To facilitate the same, they traded with a single currency "Euro", which was used by around 19 member countries. As per estimates, the EU GDP is worth more than $18,000 billion and a population of more than 500 million and is considered to be the biggest economy in the world.

BREXIT

BREXIT is an abbreviation for "British Exit". This refers to the UK's referendum to exit from the European Union. This referendum is a vote by the citizens of UK to give a Yes or No answer to a question. Supporters of Brexit believe Britain is being held back by the EU, which they say impose too many rules on business and charges billions of pounds a year in membership fees for little in return. Moreover, they feel that Britain must reduce the number of people coming to Britain to live and work and also to take back full control of their borders. On June 23rd, 2016, the people of Britain voted for the Brexit from the EU, which is considered a historic referendum. Withdrawal from the EU has been a right under Article 50 of the Treaty on European Union of EU member states since 2007.

ARTICLE 50 – THE LISBON TREATY

The formal and legal process for any country to withdraw from the EU comes under Article 50 of the Lisbon Treaty. The Government of the country wishing to withdraw from the EU must formally notify the European council of its intention to leave the EU, which triggers a two-year process for the remaining EU members to negotiate alternate arrangements between the leaving country and the EU. During these two years, EU laws continue to apply for the leaving country as in the past. In case of an agreement is not reached at the end of the two years, EU rules and rights stops applying to the leaving country, unless the remaining EU members unanimously decide to extend the negotiation period. However, as of now, Article 50 has not yet been triggered, and it is unclear as to when exactly it will be triggered. Governments are not legally obligated to trigger Article 50 immediately, and in the case of the UK, it is likely that Article 50 will be invoked by the new Prime Minister after due course of internal discussions. The UK may need some time to create a strategy and deduce which aspects of the EU are the most important to it from an economy perspective and from a more populist point of view. However, it is widely perceived that the newly appointed Prime Minister would trigger the Article 50 is likely to be triggered in 2017 at the earliest.

TRADE RELATION BETWEEN INDIA-UK-EUROPEAN UNION

The UK and the EU are both important trading partners for India. According to Ministry of commerce data points, UK-India bilateral trade was valued at USD 14.02 billion in FY16, and EU-India trade (including UK) was valued at USD 88.56 billion in FY16. Further, exports to the UK and the EU were worth USD 8.83 billion and USD 44.62 billion, whilst imports were worth USD 5.19 billion and USD 43.94 billion, respectively. Trade deals and negotiations were being discussed even before the referendum took place. The UK used to be India's third biggest trading partner 15 years ago; today it is its 12th. Also, the UK is one of the seven countries with which India has a trade surplus. Negotiations with the EU are currently being held regarding the Free Trade Agreements, which will likely provide a boost to bilateral trade between nations.

Table 1

Indian Merchandise Trade in FY16 (in USD Billion)	
UK Exports	3.4%
EU Exports	17.0%
Total Exports	USD 262 billion
UK Imports	1.4%
EU Imports	11.5%
Total Imports	USD 380 billion

Source: Ministry of Commerce and Industry, India

While the bilateral trade relationship between UK and India is dominated by goods, services also form an important part of the equation. As such, the trade in services has declined over the last five years as India exported around USD 6.8 billion and imported around USD 3.16 billion in the calendar year 2011. However, since then imports have increased to USD 3.5 billion while exports have declined and stand at approximately USD 3.9 billion for the calendar year 2015.

Table 2

Year	Exports (in USD Billion)	Imports (in USD Billion)
2009	5.4	2.8
2010	5.9	3.3
2011	6.8	3.2
2012	5.9	3.3
2013	3.9	3.2
2014	4.6	3.6
2015	3.9	3.5

Source: Office for National Statistics, UK

BREXIT IMPACT ON UK ECONOMY

Since the referendum, the pound fell to its lowest level since 1985 and triggered a major political shuffle in UK. Emergency steps are now being taken to calm the economic turmoil after the historic pound fall. Britain has lost its top AAA credit rating. The central bankers however feel that the market and economic volatility can be expected as this process unfolds and has initiated interest rate cuts and other measures aimed at saving the country from slipping into recession. However, economists feel that the Brexit vote is good news for exporters who have struggled with the high value of the pound. Moreover, Brexit would mean that Britain will no longer contribute billions of pounds a year towards the EU's budget.

IMPACT OF BREXIT ON INDIA

Brexit may impact businesses in two possible ways:

- **Currency Weakening:** The GBP is likely to remain weak and may depreciate versus the USD as the UK is a current account deficit economy. As such, it needs investment flows to fill the gap. This weakening is likely to affect companies that earn in GBP
- **Growth Impact:** The impact of the BREXIT vote will be felt over the coming years, and there is likely to be a slowdown in growth of the UK economy. This slowdown may not only be limite to the UK but also to the EU region as uncertainty on future prospects is likely to hold back investments for businesses and consumption for households.

INDUSTRY WISE IMPACT DUE TO BREXIT

Consumer & Industrial Products

This sector is vast and has a huge amount of exposure to the UK economy. Negative shocks to growth could have repercussions for the sector. For example, following the BREXIT vote, Indian auto stocks lost almost 10% of their values as a number of the companies get a major share of their revenues from the UK and EU. The UK accounts for almost 4% of all auto exports and the EU accounts for almost 16% of auto exports. Manufacturing units based out of UK will see their profitability erode due to the lower value of the GBP.

- **The Travel and Tourism sector:** This sector will also likely be largely affected by the BREXIT as it directly affected by currency fluctuations. As such, it could get a boost as the UK economy gains competitiveness via a weaker currency.

- **Garment Sector:** This sector has a large exposure to the UK and is the top export to the UK. Indian garment exporters have witnessed some slowdown in demand and could see lower levels of sales due to a slowdown in growth.
- **Energy & Resources:** UK-India bilateral trade of boilers, machinery, and mechanical appliances was worth USD 1.4 billion in FY16 and is both the second largest import, and export of India with the UK. Given the BREXIT, no major uptick in global demand is expected. Research suggests that every USD 1 drop in crude prices is estimated to amount to savings of around USD 1 billion in India's oil import bill and could help the downstream companies.
- **Financial Services:** Financial services, banking and real estate are among the largest service sectors in the UK, which are directly affected by the currency fluctuations. These sectors could endure some negative effects as businesses could hold up decisions to invest further on account of ambiguity in trading rules between the UK and the EU. This can cause Indian firms to reassess their operations in the UK and move investment and ties someplace else, which in turn could also affect the flow of Indian personnel to the UK.
- **Life sciences & Health care:** India's pharmaceutical sector has significant exposure to the UK, as it exported USD 0.46 billion to the UK and a total of USD 1.51 billion to the EU. Mid-to-large tier pharmaceutical companies have exposure to the UK economy and a hit to demand in the UK and the EU is likely to have negative effects on profit and sales.
- **Technology, Media and Telecommunications:** India's IT sector has a huge presence in the UK, and therefore is one of the most vulnerable sectors in terms of how BREXIT plays out. Many IT companies have their EU headquarters in the UK and use the country as a gateway for business across the EU. Indian IT companies might witness operating-profit margin pressure as the EUR and GBP weaken against the USD. Shares of many Indian IT companies fell following the result of the referendum.

BREXIT IMPACT ON INDIAN STOCK MARKET

A day after the BREXIT referendum, on 24th June, the Indian stock markets reacted by steep decline in the main indices. The Sensex opened lower by 635 points and went down by 1091 points before bottom fishing brought some stability. Even as the index recovered 486 points form the day's low, it still close the day with a deep cut of 605 points or 2.24%. Brexit took the market by surprise as most opinion polls where suggesting that Britain will vote to remain in the EU. Britain's exit from the EU is a huge event and will haunt the global economy in the coming months. The immediate impact of Brexit is an increase in risk aversion when it comes to investing. Among the global currencies, only the Japanese yen and the US dollar appreciated. Currency depreciation will further increase risk aversion and put pressure on the weak Asian currencies. However, market watchers believe, long-term investors need not worry about Brexit. Since India's economy is doing well from a long-term view, there is nothing to worry. Investors should not bother too much about such events. Indian markets should perform better compared to most other emerging markets and also the developed markets.

CONCLUSIONS

Brexit might lead to different scenarios and these may have varying impact on India. We have considered a few of them below:

- **European Economic Area (EEA) Model:** The EEA was formed in 1994 and serves as a bloc that gives non-members of the EU access to the single market, providing free movement of goods, services, people, and capital among the EEA. Further, EEA membership allows for free trade within the area, however since they are not necessarily members of the monetary union, they are free to set their own external tariff and independently negotiate their own trade deals with countries outside the EU. In the scenario that the UK decides to become a member of the EEA, this could possibly be advantageous for India in terms of trade. In particular, the UK would have the liberty to set its own external tariff and independently negotiate the trade deals with countries outside of the EU. As such, trade deals negotiated between the UK and India could provide for huge potential for improvement and close collaboration in terms of trade.
- **Swiss Model:** In case of Swiss model, where Switzerland does not come under the EU or the EEA, instead it has a sequence of bilateral treaties that have been negotiated with the EU government their relationship. AS such Swiss access to the single market in services is restricted, which in the UK's case could complicate matters. Further, given the fact that the UK can choose where it wants to have an agreement on trade, there would be higher uncertainty. Overall, while access to the single market remains, it has more restrictions that could have some repercussions for Indian businesses.
- **WTO:** The WTO is the primary body that administers international trade between its 161 member nations. If the UK fails to remain economically integrated (via the EEA or EFTA), its trade between the EU and the rest of the world will be governed by the laws of the WTO. In this scenario, the UK would have the liberty to set is own tariffs on imports, and would not be bound to the EU's regulation and gain the freedom to choose its own economic policy and regulations, which could potentially be beneficial for India. Further, if the UK and India manage to finalize an FTA, this would give UK-India trade a boost.
- **The Canadian Model: Comprehensive Economic and Trade Agreement (CETA):** The CETA scenario involves leaving the single market, wherein the UK would negotiate a preferential trade agreement with the EU. In the CETA model, Canada is given preferential access to the single market and most trade tariffs are eliminated. On the downside, Canada will have to undergo rules of origin requirements wherein they will need to prove that the goods are made in Canada, which proves to be very costly for firms and businesses. In this scenario, UK will gain preferential access to the single market and most trade tariffs would be eliminated with the exception of some sensitive food items including eggs and chicken. The UK would be free to negotiate deals with India without intervention from the EU. A number of Indian businesses currently enjoy exporting to the EU through UK without paying any tariffs. In this scenario, since UK would have preferential access to the single market, India would still be able to use it as a gateway to the EU.

The EU as a body has had success stories. It has been largely relevant in removing barriers to the movement of people, capital and trade which has in turn made the powerful EU economies more powerful. However, global headwinds in the form of increased competition from emerging economies particularly China and India makes one rethink their strategy. The EU has a choice of looking inwards or outwards in embracing these forces of globalization. An expansion of the EU to more eastern European economies or creating a political union may not be viable options at this stage. Several trends go against a more federal view of the union, some of which are supported by the view that the EU is more bureaucratic than it perhaps needs to be. A rethink of EU strategy in looking at lesser centralized regulation and leaving more to the member economies may help. Embracing globalization and bringing in newer ideas of research, education, training, technology, cross-border infrastructure, etc. from India and other similar emerging economies may help support the union's weaker members. This will benefit India positively offering greater opportunities to penetrate newer EU markets with lesser regulations, reduced barriers and greater vigor. At this juncture, it is almost futile to say that BREXIT implies uncertainty, but that is an aspect most economies and corporates would have to deal with. The way forward will be volatile and can possibly be subject to changing political equations in the EU and UK itself. While it is will be beneficial for both the parties to resolve the situation as fast as possible, the reality may be different. Given these circumstances, Indian companies can expect some hit to their UK businesses as overall growth in the country slows in the immediate short run. A weaker currency will also mean that any repatriation of profits from the UK region to the pre-BREXIT era. However, in the mid of long run, if the forces of globalization play themselves out well, an event such as BREXIT may turn out to be positive for India, bringing it closer both to the EU and the UK.

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