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Implications of BREXIT

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Brexit

Sumon Kumar Bhaumik
Chair in Finance
University of Sheffield, UK

Background

The United Kingdom (UK) first applied to join the European Union (EU) – what was then the European Economic Community (EEC) – in 1961[1]. It eventually joined the EEC on January 1, 1973, and this decision to join was ratified by a referendum in 1975; 65 per cent of the votes were in favour of continued membership of EEC. However, there was opposition to EEC membership among prominent members of both the Conservative (Tory) and Labour parties, and it is often argued that divisions within the Tory party about continued EEC membership was a key reason for the end of Margaret Thatcher's tenure as Prime Minister.

The EU, on the other hand, continued down the path of further integration, with the adoption of the Maastricht Treaty in 1992, which led to the introduction of the Euro (common) currency – initially only for accounting purposes and later replacing sovereign currencies – in 1999. Successive Labour governments during the 1997-2010 period were largely EU-friendly, but steered clear of joining the Eurozone, arguably on account of the imperfections in the design of the common currency area.[2]

However, strong pockets of opposition to EU membership remained within the Tory party, over issues such as (net) contribution to the EU – about £8.5 billion in 2015, changes to laws and regulations at the EU level that eventually influenced law making and regulations in the UK, and ratification of the Lisbon Treaty in 2008.[3] Subsequent to the crisis in Greece, Italy and Spain, opposition to the EU was also visible among centre left political activists who strongly disagreed with EU's prescription of fiscal austerity for troubled economies. Finally, both the Tory and Labour parties were pressured by the rise of the strongly euroskeptic UK Independence Party (UKIP) whose share of votes rose by 9.5 percentage points between 2010 and 2015.[4]

The pressure to call an "in-out" referendum increased after the Tory party entered the government, in partnership with the strongly pro-EU Liberal Democrats, in 2010.[5] However, the coalition partners could not agree on an EU Referendum Bill, and a referendum instead became a part of the Tory party's election manifesto for the 2015 elections. After the Tory party came to power in 2015 with absolute majority in the House of Commons, the date of the referendum was set for June 23, 2016.

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[1]For a detailed discussion, see How did we get here? *A brief history of Britain's membership of the EU.* http://www.europeanfutures.ed.ac.uk/article-3278. | [2]De Grauwe, P. (2013). Design failures in the Eurozone: Can they be fixed? *LSE 'Europe in Question' discussion paper series.* Downloadable from http://www.lse.ac.uk/europeanInstitute/LEQS%20Discussion%20Paper%20Series/LEQSPaper57.pdf. | [3]For example, see *Protecting human rights in the UK: The Conservatives' proposals for changing human rights laws,* Downloadable from https://www.conservatives.com/~/media/files/human_rights.pdf. | [4]Source: http://www.bbc.co.uk/news/election/2015/results | [5]Source: http://www.bbc.co.uk/news/uk-politics-15390884

Campaign and Outcome

The campaign for the so-called Brexit referendum was as intense as it was unsavoury. The UK government and the Labour opposition broadly backed the Remain (within EU) campaign, but prominent members of both parties – most (in)famously Boris Johnson, the former Mayor of London – campaigned for Leave. True to its raison d'être, the UKIP campaigned to leave the EU. While the Remain campaign largely focused on reports and studies that highlighted downside economic risks of Brexit,[6] the Leave campaign was largely focused on immigration from EU countries on account of the freedom of movement of labour among member countries, sovereignty of the UK Parliament over EU laws, and net contribution to the EU budget (as captured by the now infamous £350-million-a-week-for-NHS campaign slogan).

On June 23, voters in the United Kingdom (UK) voted in favour of Brexit by a relatively small margin; just about 52 per cent of the people who voted, i.e., roughly 37 per cent of the electorate, voted in favour of Leave. There were visible regional divides. While the majority of Scottish and Northern Irish voters voted in favour of Remain, most regions of England and Wales voted in favour of Leave. Data also highlights other patterns,[7] namely, Remain voters were likely to be more educated, on average, and more likely to live in areas whose residents are professionals. By contrast, Leave vote was more likely to dominate in low income areas and in areas where large number of residents do not hold passports. Some scholars have suggested that while Brexit may, in part, reflect disaffection of voters who did not benefit from globalization and the aggregate economic growth it delivered, the decision to vote Leave may well has been driven by deeper cultural factors, across income groups.[8]

Even though pre-referendum polls suggested that it was a close race, the outcome nevertheless came as a shock to many. It led to a political upheaval within the Tory party, with the Cameron-Osborne wing of the party getting replaced by Theresa May, the new Prime Minister, and prominent Brexiters such as David Davies, Boris Johnson and Liam Fox. The official line taken by the (new) government is that "Brexit means Brexit" which leaves much scope for speculation. However, there is an emerging consensus that as the UK government prioritizes control of immigration and as the EU countries harden their stance about the link between freedom of movement and access to single market, the so-called Hard Brexit – a complete opt out of the EU, including the customs union – is a possibility.[9] [10]

Economic Impact – Short and Long Term

Since the June 23 referendum, the most visible impact of the pro-Leave vote has been on the exchange rate of the pound sterling. The spot exchange rate of the pound vis-à-vis the US dollar has declined from 1.5729 (USD per GBP) on June 23 to 1.2227 on October 11. Over the same period, the effective exchange rate of

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[6] For example, see *Brexit 2016: Policy analysis from the Centre for Economic Performance at the LSE.* Downloadable from http://cep.lse.ac.uk/pubs/download/brexit08_book.pdf. | [7] Source: http://blogs.ft.com/ftdata/2016/06/24/brexit-demographic-divide-eu-referendum-results/ | [8] For example, see *It's NOT the economy, stupid: Brexit as a story of personal values,* http://blogs.lse.ac.uk/politicsandpolicy/personal-values-brexit-vote/. | [9] Source: http://www.bloomberg.com/news/articles/2016-09-28/-hard-brexit-looms-as-28-red-lines-turn-deeper-shade-of-scarlet. | [10] For a discussion of the political rationale for Hard Brexit, see: Rostowski, J., *The political logic of hard Brexit* (October 10, 2016), Project Syndicate, https://www.project-syndicate.org/commentary/hard-brexit-theresa-may-by-jacek-rostowski-2016-10.

the pound has declined from 87.763 to 73.8789 (January 2005 = 100).[11] The pressure on the pound is driven by both large current account deficit, which rose from 5.7 per cent of GDP in Q1 of 2016 to 5.9 per cent in Q2,[12] and by continued uncertainty about post-Brexit arrangements.

An optimistic view of this phenomenon is that the sharp decline in the exchange rate of the pound would stimulate exports that would both address the current account problem and stimulate growth. The more cautious view suggests that on account of weak external demand and internal market frictions that hinder reallocation of resources within the economy, trade gains from the depreciation of the pound may be limited.[13] At the same time, worries remain about how the depreciation of the pound would translate into inflation, and how the global bond market would react to the downside risk of holding pound-denominated assets.[14] Inflation is likely to weaken consumer spending that has been held up since the referendum.[15] A rise on yield of gilts, on the other hand, would make it more expensive for the government to finance its fiscal deficit that was expected to be 2.9 per cent of GDP at the time of the 2016-17 budget and which may increase further in the "new phase" of the economy.[16]

As the impact of Brexit on the currency market plays out, the main issues that the UK government, indeed the political class and policy makers, have to grapple with, are as follows:

- Immigration: The popular wisdom that has emerged in the aftermath of the June 23 referendum is that the Leave vote is, to a significant extent, a vote against the kind of migration levels that the UK has experienced over the past two decades, and its perceived impact on local employment, wages and pressure on services such as social housing. While evidence suggests that the impact of immigration on local employment and wages is limited,[17] reducing the flow of migrant labour to the UK has de facto become the central post-referendum issue. This has three important implications. First, reduction or reversal of flows of skilled labour in certain sectors such as health could adversely affect public services such as NHS. Second, inadequate access to skilled labour could adversely affect productivity growth in the UK, which already lags behind those of countries such as the USA and Germany.[18] Third, any adverse impact on growth in the short to medium run would adversely affect the fiscal position of the government.

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[11]Source: Bank of England | [12]Source: Office of National Statistics, http://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/balanceofpayments/aprtojun2016. | [13]Eichengreen, B., *Brexit and the Pound in your pocket,* Project Syndicate (September 13, 2016), https://www.project-syndicate.org/commentary/small-uk-export-boost-since-brexit-vote-by-barry-eichengreen-2016-09. | [14]For example, see *Gilt Yields Climb as Pound Falls,* Wall Street Journal, http:// www.wsj.com/articles/gilts-sold-off-as-weak-pound-weighs-1476098654. | [15]For data on consumer confidence levels, see http://www.gfk.com/en-gb/insights/report/uk-confidence/. | [16]Source: *New Chancellor Philip Hammond to Scale Back Austerity,* Financial Times, https://www.ft.com/content/db1b6304-492a-11e6-b387-64ab0a67014c. | [17]For example, see: [1] *Immigration, the European Union and the UK labour market,* Centre for Economic Performance, LSE, http://cep.lse.ac.uk/pubs/download/pa015.pdf; [2] Devlin, C. et al. (2014). Impacts of migration on UK native employment: An analytical review of the evidence, Occasional paper 109, Home Office and the Department for Business Innovation and Skills, Downloadable from https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/287287/occ109.pdf. | [18]Bhaumik, S.K. (2011). Productivity and the economic cycle, BIS Economics paper no. 12, Department for Business Innovation and Skills, Downloadable from https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32108/11-772-productivity-and-the-economic-cycle.pdf.

- Type of Brexit: As mentioned above, the rhetoric of "Brexit means Brexit" does not reveal much about the post-Brexit trade arrangements of the UK. The options include, among others, the so-called Norway, Swiss and Canadian models, named after the agreements these countries have with the EU.[19] The key issues are the extent to which the EU would grant access to the coveted single market,[20] given the red lines that the UK may have about free movement of labour within the Union, and the related issue of passporting rights to UK financial services firms and the extent to which the UK would be able to influence the relevant rules and regulations as a non-member state.[21] The supporters of Hard Brexit argue that, once free from the customs union, the UK would be able to strike trade deals with other countries of the world such as the USA, Canada and the emerging market economies. However, experts, businesses and overseas investors remain worried about the impact of loss of access to the single market,[22] as highlighted in the extraordinary intervention by the Japanese in the post-referendum Brexit debate,[23] whereby the UK would have to operate under the fallback position of World Trade Organisation (WTO) rules.[24] [25]
- Interim Policy Paradigm: On August 4, the Bank of England's Monetary Policy Committee reduced the bank rate by 25 basis points, from 0.5 per cent to 0.25 per cent, and extended its scheme to purchase UK government bonds by £60 billion.[26] The sharp depreciation of the pound since has implications for the ability of the Bank to sustain interest rates at this level should the depreciation continue unabated. More importantly, there is now very little room for monetary policy to stimulate the economy should there be pronounced adverse impact of Brexit on the real sector,[27] largely by way of the impact of the uncertainty about the post-Brexit settlement on business investment. At the same time, any slowdown in the economy is likely to have an adverse impact on the government's fiscal position,[28] reducing the government's ability to pursue expansionary fiscal policy aggressively. Nevertheless, there is an emerging consensus that to mitigate the impact of the uncertainty on the private sector, the government should plan for a fiscal stimulus while the cost of borrowing is low, and the government has signaled that it is considering

[19]Armour, J., *Brexit to the European Economic Area: What would it mean?* (July 19, 2016), https://www.law.ox.ac.uk/business-law-blog/blog/2016/07/brexit-european-economic-area-what-would-it-mean. | [20]For more information about the single market, see *The EU single market: How it works and the benefits it offers,* Financial Times, https://www.ft.com/content/1688d0e4-15ef-11e6-b197-a4af20d5575e. | [21]For details about "passporting", see http://www.bankofengland.co.uk/pra/Pages /authorisations/ passporting/default.aspx. | [22]Emmerson, C. et al. (2016). The EU single market: The value of membership versus access to the UK, Institute for Fiscal Studies, Downloadable from https://www.ifs.org.uk/uploads/publications/comms/R119%20-%20The%20EU%20Single%20market%20-%20Final.pdf. | [23]Source: http://www.mofa.go.jp/files/000185466.pdf | [24]See *Facts behind the claims: Trade rules,* The UK in a Changing Europe, http://ukandeu.ac.uk/facts-behind-the-claims-trade-rules/. | [25]See also *Trade and investment implications of Brexit,* Note prepared by the World Bank Group Trade & Competitiveness Global Practice (July 11, 2016). Downloadable from http://documents.worldbank.org/curated/en/ 177291468937534200/ pdf/107118-REVISED-PUBLIC-TradeandInvestment-Implications-of-Brexit-note-docx-July-14-REVISED-clean-AO.pdf. | [26]Source: http://www.bankofengland.co.uk/publications/Pages/news/2016/008.aspx. | [27]Estimates of monthly GDP growth estimates of the UK can be viewed at http://www.niesr.ac.uk/monthly-gdp-estimates. | [28]Emmerson, C. (2016). Brexit and the UK's public finances, Institute for Fiscal Studies. Downloadable from https://www.ifs.org.uk/uploads/publications/ comms/r116.pdf.

limited fiscal stimulus as required.[29]

Looking Ahead

There is far too much uncertainty about the long term impact of Brexit on UK's economy. The key issue is that all UK governments will have to act in the interest of all UK citizens who are unlikely to have voted for policies that would reduce their standards of living, and those of the future generations, and the majority of whom would arguably make trade-offs between key Leave issues such as immigration and access to the single market.[30] While rhetoric is perhaps unavoidable in politics, real politik requires careful negotiations, and abdication of hard ideological positions. To quote Dr. Robin Niblett of Chatham House: "The politicians who will lead the UK out of the EU must guard against allowing a yawning gap to emerge between their political rhetoric and the realities facing Britain outside."[31]

[29]See *U.K. treasury chief hints at post-Brexit fiscal policy revamp*, The Wall Street Journal, http://www.wsj.com/articles/u-k-treasury-chief-hints-at-post-brexit-fiscal-policy-revamp-1473348329. | [30]Source: http://www.independent.co.uk/news/uk/ politics/ brexit-bmg-poll-hard-soft-theresa-may-david-cameron-eu-referendum-a7340641.html | [31]Source: https://www.chathamhouse.org/expert/comment/brexit-reality.

Brexit: A New Chapter in The United Kingdom's History

Souvik Gupta[1]
Economist
The International Monetary Fund (IMF)

Introduction

On June 23, 2016 the United Kingdom (UK) voted, in a referendum, in favour of leaving the European Union (EU), a relationship that started more than four decades ago. Belying many pollsters, the "leave" campaign gained a simple majority with nearly 52 per cent of the ballots cast in their favour. The relatively close call and a surge in the "leave" momentum in the run up to the referendum reflected divided opinions. In the end, England and Wales voted predominantly in favour of leaving the EU, while the younger and the higher educated voters chose to remain within the EU.

The referendum does not mean that the UK has already exited the EU, commonly known as Brexit (i.e., Britain's exit). Although the June referendum reflects the will of the majority of voters, its outcome is not legally binding. The ruling leadership has, however, publicly announced its willingness to respect the verdict of the referendum. Withdrawal of EU membership will involve invoking the Article 50 under the Treaty of Lisbon, which requires that the UK will have to negotiate and conclude a new arrangement with the EU within two years from its notification to withdraw from the union, unless an extension is granted unanimously by other member countries. The UK government is yet to notify its intention to withdraw from the EU. Withdrawal of EU membership does not preclude future possibility of rejoining the bloc. The new leadership in the UK under Prime Minister Theresa May, who took office in July 2016, faces the task of overseeing the process of exiting from the EU.

What is the EU?

Emerging from the ruins of the Second World War, economic integration and cooperation was sought to promote peace and harmony in Europe. In the early post-war days, the European Coal and Steel Community was formed in 1951. The European Economic Community (EEC) came into force in 1958 with six founding members, including France and Germany. The UK joined the EEC in its first phase of expansion in January 1973, along with Denmark and Ireland. Over the years, this union has emerged as a large single market and an important contributor to global economic prospects, attracting other European countries to join. The EU currently has 28 member countries, including the UK. As the union got bigger the cooperation also expanded into other policy areas, involving migration, health, product standards, business

[1]The views expressed here are those of the author and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

competition, justice, security, climate and environment and so on. In recognition of its expanded role, the EEC was renamed as the EU in 1993. A single currency, the euro, was launched in 1999 and it is currently the official currency in 19 member countries of the EU, including the six founding members. The UK, however, opted out of this monetary union, known as the euro area, and maintained its own currency. The EU was awarded the Nobel Peace Prize in 2012 as it "for over six decades contributed to the advancement of peace and reconciliation, democracy and human rights in Europe."

The UK's Economic Relationship with the EU

Over the past half a century, the EU (outside of the UK) accounted for, on average, a little more than a quarter of global economic output. Though in recent years this share has fallen somewhat, reflecting ongoing economic difficulties in parts of the union, the ex-UK members of the EU still constitute a large single market. As a result, ties with the EU has benefitted the UK economy via tariff-free access to the single market, investments from the other EU countries, and access to non-EU markets around the world through the EU's free trade agreements (FTAs). The EU is the UK's largest trading partner. The UK's special access to the EU on business services, known as "passport", particularly supported the rise of its financial services industry and emergence of the City of London as one of the leading financial centers in the world. Indeed, the financial services industry plays an important role in the UK economy, now contributing about 8 per cent of its economic output and more than a quarter of its services exports. Overall, empirical studies find evidence of net benefits accruing to the UK economy from its EU membership through greater competition, more efficient resource allocation, and a rise in productivity.

Why the Referendum?

Despite the economic gains from its access to the bloc, an undercurrent was gaining momentum against the growing EU rules and regulations, including those on labour migration and contribution to the EU budget, which many in the UK interpreted as interfering with sovereignty and national interests. Against this backdrop, Prime Minister David Cameron promised to hold a referendum on EU membership during his 2015 re-election bid. However, the more conservative fraction of his ruling party and the UK Independence Party carried forward the "leave" campaign and led it to victory. Prime Minister Cameron has since resigned from his position and also recently relinquished his membership to parliament.

What Lies Ahead?

A decision by the UK to withdraw from the EU has political and economic implications for the UK itself and also for the EU and the rest of the world. However, currently there is considerable uncertainty on how these will play out, particularly given the lack of a precedence of similar political decision in size, scope, and complexity. In the extreme, the process will not only involve negotiating a new arrangement with the EU, but potentially establishing several new bilateral treaties with the rest of the world, both of which could call for monumental efforts.

The UK is one of the affluent and politically influential members of the EU. Economists currently believe that the macroeconomic impact of this separation will be larger for the UK itself, than for the EU, and will crucially depend on the nature of the new engagement. But there is considerable uncertainty about the form of the eventual engagement as the political process of negotiating has not yet started. A prolonged negotiation could further exacerbate this uncertainty, holding up investments and impacting productivity. There are also concerns about the future of the EU workers in the UK and vice versa.

At present three types of relationships exist between the EU and a non-EU country. Each of these choices has its own pros and cons, with varying economic, financial, and political implications.

- A relationship under the European Economic Area (EEA), which currently comprises all EU states, Iceland, Liechtenstein, and Norway. It includes abiding by most EU rules, contributions to the EEA grants, tariffs on trade in some of the products, and no access to the EU's FTAs;
- A bilateral arrangement with the EU, like those with Switzerland, Canada or Turkey. These arrangements have limited tariff-free trade, no access to the EU's FTAs, some adoption of EU rules (Switzerland, for example, has agreed to free movement of people), no general provision for a "passport" access, and the possibility of lower contribution to the EU budget (Switzerland contributes, but Canada does not; while Turkey receives some EU funding); or
- Trade arrangement under the World Trade Organization, which is the default outcome for the UK should negotiations on a new arrangement with the EU fail. It will imply conforming to the international agreements and standards, no tariff-free or "passport" access to the EU, and no contribution to the EU budget.

In the first few days after the referendum, volatility in the global financial markets rose in response to what was a negative surprise. However, major stock markets and currencies have recovered since then with the exception of the British pound, which has remained close to its lowest level since the late 1980s against the U.S. dollar. Post referendum, very little hard economic data are available yet for the UK, but survey responses indicate a slowdown in investment intentions, while retail consumption has held up as yet. However, most economists expect a more substantial slowdown over the medium-to-long term. Prior to the referendum, the UK Treasury had estimated that "the UK would be permanently poorer if it left the EU", with adverse consequences for employment, public finances, and public services. After the referendum, the IMF has lowered its forecast for the UK's economic growth in 2017. To mitigate the adverse macroeconomic and financial impacts, the Bank of England has already lowered its key policy interest rate and announced other supportive measures.

The global economy could be impacted by Brexit too, particularly if there are significant negative spillovers on the EU economies and/or global financial stress rises. The uncertainty over Brexit, in addition to other global factors, could contribute to the near-term global economic growth falling short of current expectations. Over the longer term, with structural factors like population aging and a slowdown in global investment and productivity already weighing on the future growth potential in many economies, multilateral efforts should focus on the benefits of global integration and structural reforms to support economic growth. But the gains from globalization and technological changes need to be better shared by strengthening economic policymaking and implementing them more effectively.

Conclusion

Brexit is a momentous change in the architecture of the EU with implications beyond the bloc. Economists predict that Brexit will have an adverse macroeconomic impact on the UK over the medium-to-long term. In this context, policymakers have a key role to play in helping to reduce uncertainty about the process and objectives that will guide negotiations between the UK and EU. We hope that the British and European authorities will work collaboratively toward a smooth and predictable transition.

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Understanding BREXIT

Sudipa Majumdar
Senior Lecturer in Business
Middlesex University Dubai

After World War II, there was movement to create unity between Germany and France, which led to the formation of the European Coal and Steel Community (ECSC) and the European Economic Community (EEC), formed in 1951 and 1957 respectively by the 6 countries - Belgium, France, West Germany, Italy, Luxembourg and the Netherlands. These countries formulated policies to ensure political and economic solidarity and interdependence amongst them. It was not until 1973 that the United Kingdom (UK) joined the EEC; after they witnessed the strong post-war recovery and the powerful alliance among the EEC nations.

The European Union (EU) was established under its current name in 1993 following the Maastricht Treaty and the latest major amendment, the Treaty of Lisbon, came into force in 2009. By 2016, the EU became a "single market" allowing goods and people to move around as if the member states were one country. It has its own currency, the Euro (which is used by 19 of the member countries), its own parliament and also its policies on the environment, consumer rights and allows free movement of goods, capital, services and people between member states.

UK and the EU

UK and the EU have gone through various stages of relationship with the EU. In the initial years, when UK wanted to join the EEC, their entry was vetoed twice by the French President Charles de Gaulle who accused Britain of having links with the US. Even after their entry in 1973, there was a growing divide when Margaret Thatcher openly opposed the move towards formation of a single currency. "Black Wednesday" was one of the lowest points in UK's relationship with Europe when the Chancellor of the Exchequer Norman Lamont announced Britain's withdrawal from the Exchange Rate Mechanism on September 16, 1992 and UK did not accept the single currency, the Euro. In the last decade, John Major and Tony Blair tried to patch things up but the Euro crisis stalled all prospects of Britain adopting the single currency.

The Euro crisis deepened the need to address the shortcomings of European integration and European Monetary Union (EMU). Finally, the European Union Referendum Bill was introduced to the House of Commons in May 2015 on whether the UK should remain a member of the EU and it was subsequently enacted in December 2015. As per the provision of the Act, Prime Minister David Cameron promised to hold a referendum on UK membership in the EU on June 23, 2016 and he went forward with the vote.

Prime Minister Cameron was the chief among those who wanted the UK to remain an EU member as he believed that upon an exit, the UK's GDP would be 6.2 per cent lower and families would be worse off to the tune of about US$ 6,200 a year. His “Remain” camp argued that the UK is “stronger, safer and better off in Europe” since British jobs and trade were tied to the EU and that the EU adds billions of dollars to the British economy every year and they were supposed by the big businesses for whom staying in the EU made it easy to move money, people and products around the world. More than 250 celebrities signed a letter in support of remaining, stating: "From the smallest gallery to the biggest blockbuster, many of us have worked on projects that would never have happened without vital EU funding or by collaborating across borders….. our global creative success would be severely weakened by walking away." In contrast, the right-wing Independence Party was the strongest in arguing that the UK should exit the EU and wanted to be free of EU regulations. According to the "Leave" camp, the EU imposed too many rules on business and charged billions of pounds every year in membership fees for little in return. Leaving the EU would keep the British taxpayers' dollars to spend on their own healthcare, education and security.

Finally, on June 23, 2016, voters were concerned with: "Should the United Kingdom remain a member of the European Union or leave the European Union?". This was the first vote of its kind in the history of the economic and political bloc in its modern form. "Britain" and "Exit" were combined and became the shorthand name for June 23 referendum, in which a majority of Britain voted to exit the EU, which was driven by a range of motives including sovereignty, governance, immigration as well as economics and trade.

Brexit and Its Short-Term Impact

It is not easy to assess the short-term economic impact of Brexit, because official data are published with a long lag. The first official estimate of GDP growth in the third quarter will not come out until late October. But other available indicators and estimates definitely give us a hint as to how the British economy has fared.

The strongest impact was on the exchange rate - as predicted, the pound fell by one-tenth against the dollar within a week; less so against the euro. However, there is little evidence that the currency depreciation had resulted in increased market share in exports, particularly for a country like Britain which competes mainly on "non-price" factors such as quality and customer service. But, the fall in the value of the pound increased the cost of imports for manufacturers - input prices faced by manufacturers rose significantly, the most dramatic rises came in the cost of imported food materials (rose 10.2 per cent) and the price of imported metals (rose 12.4 per cent). One sure beneficiary of cheaper sterling has been the UK's tourism sector, as a weaker pound made Britain a cheaper destination for overseas tourists. According to estimates by travel analytics, flight bookings to the UK rose 7.1 per cent after the vote.

Many economists prior to the referendum had predicted an immediate and significant impact on the UK economy and dip in consumer confidence, should the country vote to leave the EU. In complete contrast, there has only been a slight drop of 0.4 per cent in GDP in the July-to-September quarter. Further, in the few weeks following the vote, UK consumers continued to spend more than before and retail figures went up in the supermarkets. According to the British Bankers' Association (BBA), there have been 168 million credit card purchases in July; retail sales volumes rose by 1.4 per cent in July. There was also a boost to sales from tourists with a peak in sale of luxury goods such as jewellery and watches, made cheaper by the weak pound.

Annualized inflation went above the Bank of England's 2 per cent target. The Consumer Prices Index (CPI) rose 0.6 per cent in July though it was largely due to higher fuel prices and not as a fallout of Brexit. Prices are expected to rise in the coming months as the full impact of the weaker pound is felt which would result in cost-push inflation. The drop in the UK currency makes imports more expensive, hence the retailers and manufacturers are likely to pass on those higher costs to end consumers.

The Bank of England undertook some major steps to boost the UK economy. It cut interest rates from 0.5 per cent to 0.25 per cent - it was the first reduction in the cost of borrowing since 2009 and took UK rates to a record low. The Bank also announced a huge extension of its quantitative easing programme that could pump an extra £170bn into the economy, and a £100bn scheme to force banks to pass on the low interest rate to households and businesses. One effect of the interest rate cut was the fall in yield on government bonds. First, in uncertain times people look for relatively safe investments, such as government bonds and the fall in yield adds to the uncertainty. Second, it worsened the pension funds deficit because as bond yields fall, it reduces the incomes pension funds get from their investments.

UK has been a major recipient of Foreign Direct Investment (FDI) with an estimated stock value of over £1 trillion, about half of which come from EU member countries, according to UK Trade and Investment. After Brexit, the trade platforms between UK and the EU have become uncertain and a drop in foreign investments is expected until the tariff and non-tariff barriers become clearer with new trade agreements.

There were big falls in stock markets in the UK and around the world on June 24, but they recovered within a week. In the last week of August, the FTSE 100 index of UK blue-chip companies was about 8 per cent higher, helped by overseas earnings that will benefit from the fall in the value of the pound. The domestically focused FTSE 250 index of mid-sized companies was also up by 5 per cent.

The Future of UK

At this point of time, the UK economy seems quite steady and stable after the initial shock of the Brexit vote, although the value of the pound remains near a 30-year low. The Bank of England is hoping that its expansionary monetary policies will stave off recession and stimulate investment and Theresa May, the new Prime Minister, has also made encouraging promises about a fiscal stimulus. The EU is likely to ensure that Brexit occurs smoothly since most member states had a trade surplus with the UK and could not afford to lose access to UK markets which offered the EU countries a net trade surplus worth £70bn.

The fall in the value of sterling resulting in cost-push inflationary pressures would lead to adverse effects on small and medium sized businesses as their trade relation with the EU remains uncertain. The fall in gilt (UK government bonds) interest rates coupled with inflation will increase the amount that the government has to pay on loans, creating further pressure on public finances as debt interest will be higher. Companies are already putting off big decisions on capital spending or recruitment, given the uncertainty about the future of the economy. The foreign investment scenario will also worsen as UK lost its top AAA credit rating, which would make government borrowing costlier and more difficult.

At this juncture, however, economists are only making intelligent guesses regarding the future of UK. For the UK to leave the EU, it has to invoke an agreement called Article 50 of the Lisbon Treaty. Theresa May has declared that she will not commence the process before the end of 2016, and the UK will have another two years to negotiate its withdrawal, by December 2018. The terms of Britain's exit will have to be agreed by 27 national parliaments and the UK will continue to abide by EU treaties and laws for a few more years. This indicates that though the UK voted on June 23, 2016 to leave the EU, we have to wait until 2019 to understand the real implications of Brexit and its economic impact on the UK and the rest of the world.

Brexit and India – Are We Missing Something…?

Soumyatanu Mukherjee & Rudra Sensarma
Assistant Professor & Professor
Indian Institute of Management Kozhikode

Introduction

The 'Brexit' referendum on June 23, 2016 has opened up a Pandora's Box not only regarding the futures of Britain and the EU, but also for the integrated global market as a whole that comprises South Asian developing countries like India or China. Many commentators have argued that the referendum result is a positive for India and it will boost UK-India trade. While today, some may feel optimistic at the immediate consequence of a 20 per cent drop in the pound that has made travel and the costs of studying in UK universities cheaper for now; the question remains: should we really rejoice? Rather, for India, Brexit may turn out to be another piece of depressive news from the global economy.

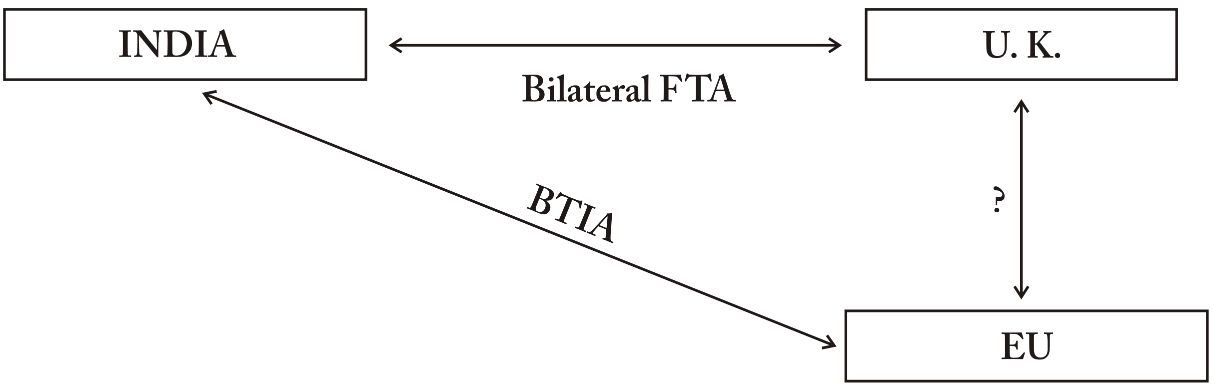
So far as long-term economic implications are concerned, after the Brexit, UK's first priority would likely be its largest potential trade partner, namely the EU. Yet some commentators have claimed that Brexit will benefit India. What we show later is that it may not be true. The new trade secretary of Britain, Liam Fox, is advising the Prime Minister, Theresa May, to pull out of the EU Customs Union. The reason is to allow the British Government the freedom to sign separate trade deals with other countries, including India. However, just the possibility of having a new trade deal with the UK after the completion of Brexit should not necessarily be good news for India. Because, once the UK is out of the EU Customs Union, they will need to choose from a number of alternative agreements with the EU that may, in turn, adversely affect India's trade with the UK and at least some of the major Indian companies operating in the UK. In this article, we explain the likely alternative agreements that UK may enter into with the EU. Moreover, we discuss the implications for trade, migration and investments between India and the UK.

Implication for India's Trade

Given that bulk of India's trade is with the EU rather than the UK, with the former accounting for approximately 13 per cent of India's world trade, India should worry about the fate of its Bilateral Trade and Investment Agreement (BTIA) with EU. However, at the same time, UK is the largest importer of India's exports in Europe [UK contributed 3.37 per cent share of India's overall exports in 2015-16, surpassing the 2.7 per cent figure for Germany][1]. Therefore, regardless of any bilateral free-trade agreement (FTA) between UK-India and EU-India, we need to explicitly consider the potential 'threat' of binding "rules of origin" (ROOs) that either of the UK or the EU may face while exporting to the other. These rules demand to

[1] India's bilateral trade with Britain was worth $14.02 billion in 2015-16, out of which $8.83 billion was in exports and $5.19 was in imports (Source: Ministry of Commerce & Industry, Department of Commerce).

ascertain, for instance, that the British exports to the EU were actually produced in the UK and thus eligible for duty-free treatment. This is particularly relevant in our context since many of the Indian products exported to UK and EU are essentially 'middle products', for instance, motor vehicles parts that go into assembly and manufacture of a motor vehicle in an automobile factory in the UK. Therefore, post-Brexit, we need to determine what would happen to the UK-EU bilateral trade relationship, since that could potentially dampen the demand for India's products in the UK and/or the EU.



Therefore, we need to explore what possibilities the UK has,[2] viz. a) To join the European Economic Association (EEA) and continue to be a part of the Single Market, like Norway; b) To negotiate bilateral deals providing partial access to the Single Market, like Switzerland; c) To sign a free trade agreement with the EU, like Canada; d) To trade with the EU under WTO rules, as the US currently does.

Recent research shows that among these four options, it is more likely that from the UK's perspective, the first option – namely the 'Norway option' is the least bad alternative (and the UK-EU Customs Union won't be materialised), equivalent to a 1.3 per cent fall in Britain's income per capita [Dhingra & Sampson (2016)]. However, if this option materialises, then although the recognition of UK product standards would become valid for exports to all EU markets ('mutual recognition'), the UK exports would be subject to the 'rules of origin'. Hence, all intermediate trade from India to UK would be taxed, as well as the exportables produced by Indian companies in Britain, when they would be exported to the EU. Exactly similar logic would be applicable for the EU exports to the UK. As a result, not only will India lose markets for some of its exports to the EU and UK, but also the Indian companies in the UK and EU may experience a slowdown after Brexit.

On top of this, it would also be unrealistic to assume that Britain, after Brexit, will relax its regulations (non-tariff barriers) with India, when tariffs are already quite low. Moreover, the Brexit turmoil would be felt in the EU as well, in several facets – particularly, with respect to the future structure of the EU and the Eurozone. Therefore, economically unstable EU and Britain, being major trade and investment partners of India, would definitely have repercussions on India, even in the long-run.

[2] Dhingra, S. and Sampson, T. (2016). 'UK-EU relations after Brexit: What is best for the UK economy?' in: Baldwin, R. E. (Ed.) Brexit Beckons: Thinking ahead by leading economists, Vox.EU.org., http://voxeu.org/article/uk-eu-relations-after-brexit-whats-best-uk-economy

Impact on Immigration

Let us now move on to the impact on the Indian immigration to the UK. From the current political scenario, it seems highly probable that the Theresa May government will settle on the so-called 'EEA minus option' in the future immigration system (Portes 2016[3]). This implies that while free movement between the EU and Britain would not continue like the present scenario, Indians (and other non-EU nationals) would still not be treated at par with EU nationals, with a considerable bias towards the latter.

Another possibility is that the UK would impose some restriction on work-related migration and those would presumably be more severe for the Indians and other non-EU citizens.

A third possibility is that the UK would impose no specific constraints relating to occupation or skill level for the EU nationals, but would simply restrict the issuance of new National Insurance numbers to the EU nationals, with a monthly or annual ceiling. But then once that ceiling would be reached, any further EU national looking for work in the UK would have to apply through the system that currently applies to Indians and other non-EU nationals. Hence, the EU nationals would not be prevented from travelling to or living in the UK, but they would not be able to work legally unless they fulfil requirements similar to those applicable for non-EU nationals.

Given the above, it is really difficult to assert now which of these three possibilities will be realized after Brexit actually takes place. Indeed, there is no reason to simply believe that Brexit would lend itself to the third possibility, opening the door for Indians to work in the UK.

Investments

Finally we discuss the prospects for business investments. India is the third largest source of FDI into UK while UK is the third largest source of FDI for India. The inward FDI from Britain will continue to flow depending on the business climate in India. However Indian investments into Britain depend on the motivation of the investing companies. If their aim is to serve the British market then the investments will mirror the growth prospects of the British economy. However those Indian companies who set up a base in Britain as a gateway to the European market will now rethink their decision and may want to reduce their exposure or recall their plans of investing or expanding. Several hundred Indian companies including behemoths like Tata Motors operate in Britain creating hundreds of thousands of jobs. Some of them may shift to a European location or at least move a part of their operations there. Of course the UK would not like to lose out on Indian investments and can therefore be expected to make themselves a more attractive destination by offering less regulation and tax incentives which would be possible now since they are unencumbered by EU rules. But whether that will be enough to compensate for the slowdown of investments due to loss of access to the European market depends on Britain's post-Brexit arrangement with EU (which option they choose out of the four identified earlier) and is something that we will see unfold over the coming years.

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[3] Portes, J. 2016. 'Immigration – the way forward' in: Baldwin, R.E. (ed.) Brexit Beckons: Thinking ahead by leading economists; Chapter 12, VoxEU.org Ebook, CEPR Press.

Brexit: Voting Pattern and Lessons from the Outcome

Sanjay Banerji
Professor of Finance
University of Nottingham Business School, Nottingham, United Kingdom

The voting patterns behind the recent referendum in UK not only exposes a sharply divided nation regarding her relationship to EU but it also reveals a rainbow coalition among people cutting across economic classes, geographies and political values. On the aggregate, 52 per cent people voiced for 'leave' from the Union and voted in favour of the 'Brexit' while 48 per cent were in favour to remain within the Union (shortly called "remainers" and the other known as "leavers"). But a close look at the disaggregated data of voting by different age groups, educational background, political opinions and geographical regions show a pattern of unanimity of opinions among people with very different economic, cultural and political attributes. A large number of people who voted in favour of the leave campaign would hardly agree with one another on other social, economic or political agenda due to their innate differences.

One could start with some plain facts: The largest gains for "leave" campaign supporters came from both East and West Midlands and the North East segments of the country where almost 58 per cent of the people voted in their favour. On the other hand, similar percentage voted in favour of the "remain" campaign in places like London and Scotland.

The original idea to "leave" European Union was mooted by members of a section of the conservative party who had thought that ultra-bureaucratic mechanisms of the EU along with its overreaching and arcane laws in many spheres are curbing individual freedom and business potentials of UK. They were also unhappy over how these laws and implementations had budget implications determining net transfer of funds between EU and UK. With them joined members and sympathizers of a Nationalist party called UK Independence party, also known as UKIP who viewed large scale migration from EU countries undermining British heritage and culture and solution to this problem lies in unilateral withdrawal from the EU. Mostly influential in rural and suburban areas and scattered all throughout England, the latter formed the core group behind the call of Brexit along with the section of the conservative party members who thought that it was bad economic union. The final results naturally show that the campaign for leave won handsomely in places known for UKIP strongholds. For example, the places like Boston or Castle point where 70 per cent of the electorate expressed their desire to leave in the referendum on EU, had also voted for the party UKIP which aggressively espoused the cause for isolation from all foreigners including Europeans in last election.

However, these two groups together did not have the number needed to force a Brexit unless supported by broad segments of other people in the whole population of the electorates. Places like West midlands (Nottingham, Leicester) where in many pockets and segments, leavers won by a comfortable margin also have a large population belonging to those descendants who migrated on a large scale from Indian subcontinent and West Indies in the post second world war period. At that time, the country torn and devastated by the war casualties, had a scarcity of labours and workers from outside were allowed to migrate to perform labour-intensive and manual jobs which were vacant in the post war era. In terms of cultural, economic and political aspects, they were quite different from both conservative and the ultra-nationalist forces, yet they had voted together in favour of 'Brexit'.

The leave vote, surprisingly has also garnered support in regions like Northeast England traditionally known as stronghold of Labour party which holds relatively liberal social views unlike right wingers. However, in some Northern councils and authorities, where the labour party traditionally wins elections at the national and local levels, the leave proponents had received more than 70 per cent of the votes in the referendum. The majority of this people were white working class males concentrated mostly in areas with either traditional or declining industries located in places such as Durham, Sheffield (known as coal belt or heavy industry, machinery sectors) which are traditional bastions of Labour party that in general subscribe to a socially liberal policy and outlook as opposed to UKIP or conservative parties. Although ideologically different otherwise, it is estimated that the leave campaigners won ¾th of places in conservative party/UKIP stronghold and also 70 per cent in the areas known as labour constituencies.

The voting patterns emerged from different analysis sum up the emergence of a coalition strongly favouring 'Brexit' primarily consisting of: (a) older generation of white working class people subscribing either conservative political views or having an ultra-nationalist outlook; (b) people living in the areas of traditional or declining industrial belt; (c) descendants of Asian and African immigrants who came to UK country 40-50 years ago.

To emphasize again, the members within these four groups in many aspects were not at all similar on any measures capturing social, economic and political attributes. For example, those who rally behind UKIP tend to be older white people and socially, culturally, they tend to be more nationalistic (as their party name and abbreviations overly suggest) and share few similarities with either descendants of immigrant families in East midlands or working class people from North east England. Yet they became ally to the cause for break-up of UK from the European Union with a conviction that leaving the union would be both good for both individual and collective benefits.

To understand why such radically different groups came together for a common cause, a cursory glance of the history of the Union could be helpful. The European Union in its initial form was a product or outcome of two major wars fought by European nations. In the end, architects of the Unions, namely, major political leaders of the European nations, realized the futility of wars and found that tying up nations via own business interests is the most credible path to peace and prosperity. Just like any other family firms, members connected via business interests, do not force a break up, it was also presumed that huge gains from trade from free mobility of labour, goods and services across the countries would bring economic prosperity which will be the source of sustenance for durable and long lasting peace. No nation would dare a break up as its costs (being in autarky) would exceed the gains from being partners of trade and commerce uninterrupted by tariff or restrictions to mobility of labour.

Of course, there were naysayers who had a considerable following in UK. While the six nations including France, Italy and Germany signed the treaty of Rome in 1957, Britain had walked out. Later in 1963, UK was willing to join the nascent common market but was vetoed by De Gaulle who accused Britain of harbouring “deeply rooted hostility" to the Union. Finally, came 1973 and Britain joined the European Common market (EEC) and had it ratified by a referendum in 1975 with two- third majority voted in favour of entry into the EEC.

Ironically, the biggest support for joining EU came from all segments of conservative party members who thought entry to the EEC is a panacea to economic maladies that engulfed Britain. The time was different. In mid-seventies, Britain was a sick country in Europe with high inflation, unemployment rates and falling levels of productivity with innovations reaching at nadir. The militant trade unionism together with declining industries (coal etc.) and falling exports had already placed UK behind average EEC countries. So, joining a trade bloc like EEC was not just for economic necessity but a question of survival.

The next twenty years saw a period of prosperity, growth (and of course peace) for both UK and the Union. While in 1975 Britain's growth rate was more than 2 per cent less than the average growth of Germany, Italy and France, it got equal in 1982 and maintained an average of a 1.5 per cent lead upto very recent period. Britain became 5th largest economy in the world and her financial sector achieved a height only comparable to that of New York. In the meantime, the world economy during last thirty years also experienced an unprecedented increase in the scale of globalization which also contributed to Britain's wealth accumulated in trade in goods and services with EU as well as with other nations.

However, whether local (with EU) or global, international trade also creates its winners and losers. It is well known that trade brings efficiency in production via specialisation where countries concentrate in sectors where they are relatively more efficient. The other side of the coin is the force of global competition which also causes withering away of inefficient (high cost) industries. Though in an idealized set up, gains would tend to outweigh losses so that those who lost out in worldwide competition can, on principle, be compensated by an appropriate redistribution policy. The reality is of course very much complicated and redistribution policies are seldom properly designed by the Government.

Thus, while the Britain's financial and service sectors flourished but higher wage rate and related costs also decimated the traditional industries and much of those activities, especially in manufacturing and heavy industries, got shifted to China and other places where the similar product could be manufactured with a lower cost. In fact, relocation of such industries over last thirty years made China a giant economic powerhouse. In UK, on the other hand, displacement of workers in those declining sectors made their skills redundant as they went out of favour with markets' likes. All of a sudden, global trade made technical expertise accumulated in sectors like heavy industries, manufacturing and coal became obsolete and had an adverse impact on prevalent economic activities in vast areas of the country and regions specialized in such industries. New Castle, Durham, Sheffield, Manchester and other cities received the hardest blow. Even the diamond cutting industries, an age old profession in parts of London, had all their business literally shipped to China. On the other hand, London and her surroundings experienced huge growth due to influx of skilled people in finance, insurance and other quality intensive service sectors. The Government taxed these businesses and redistributed the surplus in other parts of the country that suffered from the onslaught of globalization but no systematic effort had been made to retrain the workers of those failing sectors so that they could acquire new skills that were readily marketable.

Empirically, the substantial part of the support for leave campaign came from those who were out of work (59 per cent) than those were in employment (45 per cent). Also, low skilled people supported the cause for leave (75 per cent) as opposed to those with higher qualification and skill (27 per cent). Hence, it is not a wonder that repeated warning of worse economic consequences of the Brexit issued by the proponents of the 'remain side' fell to deaf ears in areas with declining wage rates in sectors decimated by the forces of globalization [Financial Times (2016)]. This argument of adverse economic impact was based on lower volume of business and trade as a consequence of fallout with EU, failed to impress these people because they were already losers from trade and the government initiative was not enough to prepare them for newer kind of service economy.

In the meantime, EU had expanded from her original 7 to 28 member nations. The newer members also came from ex-Soviet bloc countries and many of them were economically impoverished with historically low wage rates and poor standard of living. With their entry in EU, the weakest economic sections started migrating to other rich EU nations including the UK. Mostly economic migrants, they took advantage of free mobility of labour within the EU countries and joined in the less skilled service sectors and spread from London to Midlands over the years. As long as a country experiences economic prosperity, competition in the labour market via increased migration from outside does not threaten the interests existing labour force within a country because overall size of the pie was enough for everyone.

It all ended with 2007 financial crisis followed by great recession and a harsh government budget that increased the pains of adjustment in the labour market by trimming expenditures in key areas like job training programme for the displaced workers. The new migrants from the Eastern Europe thus posed a serious threat to people with relatively low or moderate levels of skills. Many of them had either lost jobs due to relocation in other parts of the world and they had not been able to acquire new marketable skills either due to the fact that they had poor savings to maintain themselves or were too old to learn a new skill required for re-entry into modern labour market. Many such people living from Midlands to Northeast, including the descendants of old immigrants fell into this category. Thus expansion of the size of EU and consequent migration heightened conflict between new and old immigrants and call for Brexit resonated well to the latter. This fact is also borne out by an empirical study that finds a statistically significant positive relationship between the places of recent (last 10 years) immigration influx and the likelihood of voting for the leave agenda.

The studies also confirm the negative relationship between wage growth, level of skill, level of income and the probability of vote towards leave [Goodwin and Heath (2016)]. To sum up, original supporters of the Brexit won because they had been able to muster support from the various heterogeneous groups where a large section was affected by lower wage rate either due to displacement of their skills from globalization or increased competition from immigration from the newly inducted countries within European Union. From economic point of view, the outcome in the referendum is thus due to trade-off between product market benefits and heightened frictions in the labour market accompanied by both expansion of EU and globalization of trades which went hand in hand in the last few decades.

So, what are the lessons to be learnt from this social experiment? First, it is not enough to offer subsidy to the falling sectors but a greater initiative by the government was needed to equip the displaced workers with adequate marketable skills and training. This is the case of a market failure because it is of no interest for firms to do the job for their future workers.

Second, there is an optimal speed of integration. Expanding the EU's size from 7 to 29 was perhaps too quick. Such decision should be subject to a detailed cost benefit analysis, possibly in the same manner that a conglomerate firm does before deciding upon a new acquisition. Finally, the Government, should do a fact check regarding its own credibility before abruptly announcing a major shift of the policy. Recent studies show that level of trust with the Government is at its nadir. In 2014, a study prepared a questionnaire that asked "what is the percentage of British politicians who care for their country?" [Jennings (2016)]. The respondents answered 8 per cent. The same figure was 28 per cent in 1972 and was 35 per cent in 1942. Certainly not a great time for ruling politicians to call a referendum which in a way also measures their level of credibility.

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International Management Institute
Kolkata

International Management Institute Kolkata
2/4C, Judges Court Road
Alipore, Kolkata 700027
Telephone: +91 33 6652 9664
website: www.imi-k.edu.in