Financial Contagion Inevitable: Courtesy- Brexit

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***Abstract* -** The decision of exiting the European Union by UK has certainly changed the face of Britain and the other member states. There has been rise in the voters across the Union for favoring the freedom of internal markets in goods, services and labor. Brexit will not only increase the highlight on the movements between the euro nations but also led to the preeminent influence on the credit arrangements between nations. This paper thereby investigates the possible factors affecting the credit possibilities as well as the contagion effects on European Economy post Brexit.

***Keyword* - Brexit, Credit risk, European Union, UK**

INTRODUCTION

European Union's future is based on the UK referendum which could give new meanings to the world largest single market and will produce major effect on the key developed economies (UK and EU member states) for many decades. Many years back in 1973 when UK joined EU with the strength of being the fastest growing regional association, its aim was to gain economic co-operation and integration which included the setting up of single commodity market and customs union. Current development of UK leaving EU has increased the environment of uncertainty among the world but economist are trying to find the ways in which both the countries should react in the case of leaving UK.

Former Prime Minister of UK Sir Edward Heath (1970-1974) announced that one day UK will rise and gain over the market share of European economy but this transition is going to take its own course of action which will make UK more efficient and competitive. Now, after 43 years UK is deciding whether to leave or stay in EU. On the other hand EU has grown up to be the mere political club where the union is divided into the monetary power making them more fragile and vulnerable. UK was doubtful about the intention of EU form the first day it joined European economic Committee as a sole aim of EU was to create even a closer and tighter platform for the countries to trade and transfer. This was the reason UK's first two applications of joining EU was declined as UK's intentions were different. Former Chancellor of UK Nigel Lawson argues that as they were not aware of EU's intention, UK has to take this political decision for its own growth and development to face the competitive world [1]. Although both the countries agree that this decision will have some economic consequences. British government had announced that the UK and European agreement settlement will take place by the 23rd June, 2016 which will also include the renouncing of UK's referendum on EU's membership [2].

UK and EU has to confirm upon the new deal arrangements where UK will be leaving the Union but future trade and transfers from EU will be amended which will safe guard the migrants from Eurozone charges and increase their welfare by creating a national political parliament. Moreover the major threat to the single commodity market platform created by the union has to be minimized. Although British government has ordered the cabinet ministers to vote in order to remain in EU but as the referendum date nears ministers have started campaigning to leave EU officially. The exit of Britain from European Union has been named as the "Brexit".

EU is facing the issue of major member state leaving the union for the first time since its incorporation. Prime Minister David Cameron has committed to bring a new referendum in the light where UK will not be a part of EU's political clout but it will continue to make new trade arrangements and negotiations [3]. Britain's exit is highly uncertain as the polling to remain in EU is far from assured. The large percentage of effect from Brexit will be on the households, companies and investors. Both of the opinions, the break of ties with EU and the uncertainty of the decision is threat to the businesses in UK and EU.

Emergence of Brexit

United Kingdom took decision of leaving European Union on 24th June 2016. This has impacted the other member states drastically leaving an imprint of long term depreciation in the development of the country. This decision was against the market forecast as the voters were assured of the uncertainty.

In the fall of 2015 the referendum Bill was passed stating that UK wants more control over the migrations and also limits the power of EU over the trade and transfers of UK. The amendments and negotiations to the new referendum bill were discussed over a period of time. On June 24th 2016 this bill put forward a question to the ministers of UK "whether UK should be a part of EU or not?"In 2016 and 2017 the polling process of European Economic Community (EEC) started. The combined votes of liberal states were not enough to form a blocking minority in order to stop the UK's decision. According to the enactment of Article 50 of the Treaty on European Union, if any member country willing to leave the union has to win its decision by majority of votes of the other member states[4]. Moreover it will take period of 2 years for all the mandatory obligations for withdrawal to be completed. This would bring further weakness in the Government and would force the prime minister to resign. This will also have an effect on the economy's credit environment as well as the directions of the government policies would also change.

After 2 years i.e. in 2019, UK and EU is expected to decide upon the trade agreement to be followed which will support the country's new economic and political decision. UK will be free to adopt any type of trade agreement but EU has to be more cautious as new arrangements might hurt the sentiments of the other member states.

The future of the new monetary relation between EU and UK is uncertain as it might yield both positive and negative returns for the market players. The market and political dampening effect will be best seen in the central Europe in around 2018 when the trade will be insufficient to support the economic growth of the member states as the major portion of the EU budget was contributed by UK[5]. The UK's decision to leave EU has impacted the stock markets and affected the relative earnings of companies and investors. The remittances and funds of EU will bring upon a weaker growth and development.

In the wake of current financial conditions the EU markets will suffer the volatility not only in the arrangements of funds but also the employment opportunities which were created by UK abroad[6]. This will create a differential factor in the market. In the near future it will possibly create further downward pressure on the economic growth of the member states of EU.

BREXIT AND CREDIT RISK

Credit Risk has been the major reason for the failure of the world greatest banking regulations which includes Basel III norms. Credit risk threatens the profitability and survival of the banks in the major economies. The alarming rates of credit risk were observed during dollarization of 2009, where most of the businesses became insolvent. Credit risk directly effects the lending and borrowing cycle of the economy therefore shaking the whole credit cycle of the economy.

Brexit has led to the leakage in the European Union credit cycle. With the exit of Britain, EU has to face major changes which not only included political changes but also financial, structural and institutional changes. Brexit puts a large amount of pressure on the credit risk of the European Union's member states. These effects can be channelized into the following:

Trade

The trading partners of European Union are highly dependent on the market demand by UK. UK is an important market for EU in terms of trade and transfers. The member states of EU buy more from UK than UK buys from them due to which there are huge bilateral trade deficit between the states. Currently, UK has £70Million of trade deficit with other countries in goods and services. The trade deficit of UK with other 27 countries has grown at the rate of 0.6%equivalent of the GDP of EU 27 countries (The 27 EU countries are: Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain and Sweden).Although UK accounts for only one sixth of the total EU exports but EU accounts for nearly half of the UK exports. In 2015 the total exports in goods and services to EU was £360million [7]. This Trade Deficit has led to the imbalances in the current account of the countries. In order to settle this trade balance, countries took credit loan for the increased amount of British Pound after the Brexit. This has impacted the budget of countries which were engaged in the trade of goods and services through international supply chains offered by UK.

"Countries are more likely to trade with the countries which are geographical closer and viable" [8], the trade mechanism created by EU on this principle has been damaged but the effect on trade might be insignificant in future as UK and EU will negotiate on the terms and conditions of a more liberal trade that would be beneficial for all countries. The adoption of credit risk aversion technique such as investing in the safer instruments and booking the profits for the short term will also facilitate slow growth of Exports in Future [9].

FDI

Member states of EU has large amount of Investments in UK which will be affected after the exit of Britain from EU. UK has decided to pull off the foreign investments in the country which means high adjustments for those have invested vigorously. EU has been successful in attracting

FDI for Energy, retail and wholesale trade. With the loss of UK the attractiveness of EU for FDI has been reduced as the technological advancements and job creation platforms were provided by UK.

Labor

Brexit was the result of the huge migrations from other states to UK which decreased the minimum earnings of the UK citizens. UK provides a restriction free business opportunities and free labor movement making it favorable for many firms to operate. The restrictions on labor will be damaging for EU to a great extent as UK provides the large amount of labor force required for the business. Brexit has forced the business managers to redefine their business models which mean the loss of jobs. Moreover the migration of labor from EU to UK has pulled down wages and also put downward pressure on public services.

There are significant effects on the states which provide the large source of migration to UK such as Poland. It would impact hugely on supply of labor, skills and remittances. But if the migrants get deflected to other states there will be indirect impact on the public services.

The main hazard for the other member states of EU is that UK limitations has increased resentment towards immigration in the member states of EU, both because of ricocheted migration and how UK strategies impact on the laws and policies debated elsewhere. Balloting shows concerns are already high in several states[10]. However, there is one important difference between the UK and other member states. In the UK the contentious issue is intra-EU immigration, whereas elsewhere it is mostly extra-EU immigration.

Financial

Brexit will impact the liquidity, insolvency and cost of the monetary services in Europe if it challenges London's competitive situation. This would be expensive for trades and households through Europe. Most of the European financial institutions have major processes in London which would be exorbitant to transfer. European bank exposure to the UK is calculated at $1.7tn in total [11]. It would be costly for European financial institutions to relocate wholesale banking activity away from London. London is important not only for European nation but also worldwide banking institutions. Yet, London's global position could be impaired if majority of European business transfer following Brexit. Rivalry between businesses borne out of new blockades to trade with London might be unsettling and inflated. Along with the loss of the credit ratings of EU businesses which were earlier regarded as AA+ businesses are now reduced to AA rating[12]. Businesses in Europe would also lose due to higher charges and less liquidity. London was geared to meet the world demand not only the Britain alone therefore; it cannot remain an isolated Island for a longer period of duration.

This was seen for the first time in past 30 years that the purchasing power of London was equal to the purchasing power of New York which is 40[13]. This was the result of the decreased interest rate on the investments which impacted the purchasing power of the individuals. Currently individuals are investing in European bonds rather than the stocks because bonds provide the best retirement funds and assured return.

Trade Policy

The EU open and liberal trade policy will be because of UK impact. More than any other state, UK has put political weight on trade agreements. The EU will have less impact on the partner fortrade negotiations if the UK would not be a part of the EU. The EU's high trade priorities include Economic Partnership Agreement with Japan and The Transatlantic Trade and Investment Partnership (TTIP) with the US. The EU 27 external trade is about 15% of the international trade compared to 4.3% for the UK. The UK has supported a relaxing agenda for the EU. The EU may turn out to be a rougher negotiating partner which will be better to extract a good agreement in absence of UK. While some businesses would want new trade therapies and regard trade therapies as an authentic means to hostage partial competition, this would detriment consumers and firms that rely on imported products, particularly from emerging markets. It also risks a protectionist response in Europe.

International Policy Influence

The Policies have a large amount of impact on the credit risk of the economy. Recently EU has cut down the bank rates which fueled the growth of bonds more than the stocks. It is expected that the rates will be hiked twice before the end of this year[14]. Due to this the banks has starting buying the corporate debt and deflate the interest rate in the economy to the level of New York. After the political decision of Brexit the stock indices of EU fell and pound was devalued by 0.5% [15]. There is large amount of damage to the political relationship between the countries which will affect the trade trust relationship and financial services (lending and borrowing) especially Germany. This will continue in short run in order to averse the credit risk whereas in the long run, balance sheet of the Euro countries will be affected combining with the depreciation of currency and slower growth rate of exports.

Budget

UK is the largest contributor to EU budget[16]. The gap generated would need to be fulfilled by the higher contributions from the other member states. Many economies may have to suffer the budget cuts in order to bridge the gap. The higher spending in the economy may facilitate the liquidity in the monetary cycle of European Union. The renegotiation of the Multiannual Financial Framework[17] will impart the amount of effect on the countries as the nations which absorb high amount of EU funds are likely to be more affected than the others. Countries might need to increase the share budget by 5.8% [18]. This will bring negative impact on the credit cycle of the economies as the government spending will reduce and individuals are highly likely to save more than to spend more unlike in past.

CONCLUSION

The majority of the impact from Britain's Exit [19] can be categorized into three ways which are not taken into account in the above mentioned factors:

Uncertainty

The Brexit has imposed an environment on uncertainty where all individuals, companies and investors are worried about the impact of the decision on the world's economy as a whole. The new arrangement of trade which is to be decided upon levies huge dead weight with it. This new relation will define the face of the world's strongest and largest single consumer market.

Political Dynamic

The new dynamics of politics between the members states of EU will be decided upon which implies the redistribution of power among them. This will damage the trust and confidence between the states which was built over a period of time. The major states such as Germany and France will be most affected due to Brexit. It could either bring them together or increase the differences between the member states.

Contagion

Brexit will cause a spillover effect in the whole world as the other states will try to make them more noticeable and viable for the new trade relationships. The new trade policies which can be either more liberal or tighter for EU will have a far reaching effect on the developed economies.

The member states having strong credit relations with UK will be most affected which includes Cyprus, Netherlands and Spain. They share a trustworthy trade relationship with UK which might be broken after the new trade regulations enforced by EU. The countries with direct investment in UK will be following an upward trend in the credit risk situations as the interest yield will be declining. Currently, Scotland has 2, 00,000 migrants from England while UK has 4, 00,000 scots living in England who will be facing severe policy changes as UK wants to minimize migrations[20]. EU will lose its position in the world market and will face severe damages for the loss of share globally[21].

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