A major consequence of Brexit is that the financial centre of the euro area (EA) – the City of London – has decided to cut regulatory ties with the euro area as a whole. The City’s role in banking and investment finance in the EA was always an anomaly, made possible primarily by the creation of the Single Market in financial services. The UK government shaped EU legislation in favour of banks that reside in London and use the City as a gateway to the Continent. This was not economic nationalism, since it favoured above all transnational banks, and it was not protectionist since the idea was to foster financial liberalisation in all EU Member States. Rather, it was an exercise in ‘economic patriotism’ (Clift & Woll 2012, 308–9, Morgan 2012): the idea was to champion free trade in a sector in which the national economy has a comparative advantage. However, economic nationalism has fought back, notwithstanding the rhetoric of ‘Global Britain’.

This chapter focuses on the likely effects of Brexit on the EA. What changes are in the offing for a currency area that is abandoned by its major financial centre? The chapter makes three claims in particular: (1) some of the business currently transacted in London will go to the EA, which is a mixed blessing; (2) the EA’s regulatory approach will become more attuned to the financial institutions and political preferences prevalent in Continental Europe; and (3) the euro will remain permanently stronger vis-à-vis the British Pound.
Relocation of financial services

The City will certainly lose in relevance for European finance and seems to be resigned to this, although not without lobbying the government for favours. A study by Bruegel assumes, at this stage inevitably arbitrarily, that about 30 per cent of wholesale banking in Europe will relocate from the City to the continent, which would leave London still hanging onto a sizable share of 60 per cent of the European banking industry (Sapir et al. 2017, 5–6). Both the British government and officials in continental Europe have threatened one another with ‘competitive’ taxation and regulation of banks if they stay or move, respectively. It beggars belief that such open threats of a race to the bottom should be issued on both sides of the Channel: not even ten years have gone by since the biggest financial crisis in post-war history broke out, caused, inter alia, by lax standards and regulatory enforcement. The only silver lining in this is that supervisors, like the member of the Bundesbank’s Executive Board responsible for financial supervision, and the Governor of the Central Bank of Ireland, have come out publicly against such archaic offers to transnational finance (Dombret 2017; Sapir et al. 2017, 6).

The reason for the declining relevance of London as a gateway to mainland Europe is that banks stand to lose their ‘passporting’ right. This is the ability to use a banking licence issued in one Member State to do financial business anywhere else in the EU. Passporting could be substituted by so-called equivalence, by which a bank proves that the jurisdiction from which it has its licence covers all the areas and is as strict in its regulation of the various areas as the EU. But such equivalence decisions cover only the wholesale business, not retail. And they are not permanent: they come under scrutiny each time there is legislative change in one of the two jurisdictions. Besides, the EU has been reluctant to afford US banks such equivalence, which makes it unlikely that it will treat UK banks any more leniently ten years down the line. ‘[T]he prospects for EU market access through the UK look rather dim’, as Andreas Dombret (2017) from the Bundesbank put it.

It is unlikely that the EU-related parts of the City’s business and the accompanying jobs will all relocate to a single new centre inside the euro area, such as Amsterdam, Dublin, Frankfurt or Paris (which are the four most frequently mentioned). In fact, some financial business may not go to the EA at all. There is anecdotal evidence that some US banks may relocate to places like Warsaw instead, because they do not trust that the
EA will survive; again, this is made possible by the Single Market and the passport it gives to any and all banks that are incorporated as headquarter or subsidiaries in another Member State. Other US banks may reduce their presence in Europe altogether and relocate to New York, the City’s old rival in international finance.

Anglophone observers are always quick to portray any change as yet another nail in the coffin of the euro project. But such speculation demonstrates a rather short memory of the history of European monetary integration. At the height of the crisis in 2008–9, there was a consensus, reaching the echelons of high finance, central banking and supranational regulatory bodies, that financial markets had become too prolific in generating phony assets and that they had become too interconnected and too self-absorbed for their own good, let alone for the good of the rest of the economy (e.g. Bernanke 2016; Turner 2015). If Brexit can contribute to the shrinking of an oversized financial system in the EA, then it may well turn out to be a net benefit for every economy. Political and market pressure will make this hard to resist, though, proving again how hard it is to contain boom–bust cycles and ‘excessive financial elasticity’ at the national level (Borio 2014).

Relocation of the financial sector to the EA is a mixed blessing from another point of view. It reduces the scope for risk sharing. The Irish bailout in 2011 illustrated how this worked when the UK was still a member of the EU. Banks headquartered in the UK were the largest creditors of Ireland; according to the Bank for International Settlement they were exposed to the tune of around €160 billion on an ultimate risk basis and also held large claims on Spain (around €98 billion). The UK government offered to guarantee €3.8 billion of the €85 billion rescue package for Ireland. A meeting at the Treasury came to the conclusion that this was the best and cheapest insurance it could get for banks for which the British taxpayer would otherwise have been potentially liable. This implicit insurance premium of around 4.5 per cent looked particularly attractive after the UK had performed three years earlier the biggest single bank bailout in history. The rescue of the Royal Bank of Scotland had cost the British taxpayer £113 billion (around €138 billion) by 2013 (HM Government 2014c: para 3.14), costs that were still accumulating by 2017. It was in the EA’s interest that the UK financial system was not destabilised even more, as this could have unleashed flight from the pound, a flight that only various central bank swap arrangements would have prevented from turning into a full-on currency crisis, and which would have contributed to the nervous breakdown of markets. The risk sharing also works the other
way round. To the extent that British banks with international exposure were rescued by the British taxpayer, the bailouts also stabilised banking systems across the continent. Any relocation of banks will reduce such risk diversification. To make up for it, the overall risk level needs to be brought down by ensuring a smaller, less leveraged and better regulated financial system.

**Refocusing the regulatory approach**

With the creation of the banking union that came into effect in 2014, the ECB has become the developed world’s largest financial supervisor, measured by the banking assets under its purview. The Single Supervisory Mechanism has the responsibility for the licensing and supervision of all euro area banks, but supervises directly only around 130 ‘Significant Institutions’, representing 85 per cent of all bank assets in its jurisdiction. For the rest, it delegates supervision to national authorities and merely supervises their practices. Since financial regulation is no longer national, or even European, the ECB will in future make its voice heard through international fora, such as the G20 and the Basel Committee. Even before the banking union was agreed in June 2012, the European Commission was pro-active in pre-empting US financial regulation and opted for setting standards so as to prevent having to follow standard setting by others (Moloney 2010, 1342–3). To the great dismay of hedge fund managers, it regulated their business. Some of them subsequently became the biggest funders of the Leave campaign.

Even before the crisis, financial re-regulation set the EU on a collision course with the UK. Some of this seems to have been a chosen path: indeed, the Cameron administration apparently preferred litigation to negotiation, as these examples attest to.

- The UK challenged the Financial Transaction Tax (C-209/13 UK v Council): the UK wanted the Court to annul the introduction of the tax under enhanced cooperation because it deemed it to be costly for non-participating countries, since the tax would be levied on any transaction in which one party is from any of the 11 participating countries. The UK lost the case.
- The UK government also took other EU legislators to court (C-270/12 UK v European Parliament and Council) regarding the prohibitions of short-selling and other aspects of credit default swaps. The UK disputed whether the newly created European Securities Market
Authority had the authority to conduct interventions in financial markets that would suspend, temporarily, the short-selling of financial instruments or buying of credit default swaps if the orderly functioning of markets so requires (notably a downward spiral of asset prices). Again, the UK lost the case.

- The UK government wanted the capping of bankers’ bonuses annulled (C-507/13 UK v European Parliament and Council). It disputed that the EU has the right to restrict the variable element in the remuneration of ‘material risk takers’ in financial institutions. The UK dropped the case after the Advocate General delivered his opinion that the case should be dismissed by the Court.

The dilemma for the UK government is now stark: as soon as the UK wants to act on its preferences, or has to give in to the lobbying of hedge funds and bonus-seeking bankers, equivalence of UK and EU financial regulation becomes a distant prospect.

A test case may soon arise, namely that regarding the jurisdiction of central counterparties. This multi-billion currency business is to clear claims and liabilities arising, mainly, from trillions of derivatives. These clearing houses emerged as a consequence of financial re-regulation after the crisis of 2008–9. The international regulatory community at the G20 level agreed to reduce shadow banking and the risk of over-the-counter derivatives, the latter being the main activity of central counterparties. Over-the-counter means that these financial instruments are not traded on an exchange but between two market parties; so if one side fails to meet the contract this may trigger a liquidity crisis for the other party, and because the sums involved are so huge, this can easily spread across the market. Clearing houses can reduce this risk since only net payments have to be met by each party, and the central counterparty itself acts like a mutual insurance fund in that it can meet the obligations of the failing party out of the ‘margins’ it requires each party to pay. An additional problem may arise, however, if the clearing house – that tends to hold open positions overnight that are in the order of one billion euros – has a currency mismatch (i.e. not enough funds in the currency that the failing party was supposed to deliver). Hence, central bank cooperation is required.

In 2011, the ECB announced that central clearing in euros has to happen in its jurisdiction. The UK government challenged this requirement as discriminating under Single Market rules. The Court case T-496/11 United Kingdom of Great Britain and Northern Ireland v European Central Bank (ECB) was decided in the UK’s favour: the Eurosystem Oversight Policy Framework was annulled on the ground that the ECB
referred to ‘securities’ for which the central bank has no mandate. This wording can easily be changed. The ECB kept a brave face and sent a signal of cooperation shortly before the referendum, entering immediately into a formal swap agreement with the Bank of England that would give the latter unlimited access to euros. But it is not clear that this is the last word. Andreas Dombret, the Bundesbank’s supervision tsar, was quoted as saying that euro-clearing can stay in the UK only if its authorities comply with the European Market Infrastructure Regulation (Marsh 2017).

Strengthening of the euro vis-à-vis the pound

The breadth and depth of the financial system are vital determinants of an exchange rate. We should expect the euro to strengthen permanently vis-à-vis the pound sterling as the role of the City of London diminishes and international financial regulation reflects continental European preferences more strongly, as argued above. This may help to recalibrate trade (im)balances between the two currency areas, although UK services exports to mainland Europe will likely be adversely affected by Britain exiting the Single Market. The negative effect on UK’s export of services will be muted by the fact – well-established in the economics of intra-industry trade between advanced economies – that the competitiveness of core export industries in advanced economies depends less on costs (as determined by the exchange rate) than on strong brands, innovation and logistics.

It is hard to say how this will play itself out when it comes to the euro area’s internal imbalances. The following table shows the UK’s main trading partners and the UK net trade balance in goods and services for 2014.

As Figure 13.1 shows, the UK has a deteriorating trade balance with the EU as a whole. At the beginning of 2016, the main EU trading partners of the UK were, on the import side (and in order of magnitude): Germany, China, the US, the Netherlands and France; and on the export side: the US, Germany, France, the Netherlands and the Irish Republic. Three out of five main importers, then, and four out of five main export destinations, are in both the EU and the euro area. A strengthening of the euro vis-à-vis the British pound would rebalance trade with strong trading nations in the euro area. On the whole, this would be unproblematic and arguably beneficial for both sides.

A further consideration, however, is whether the transition to a stronger effective (trade-weighted) euro will have an additional disinflationary effect on the EA economy. This would be problematic, since
it is the opposite of what the euro area economy needs to bolster its recovery. Low growth and low inflation (even deflation in some sectors) make already onerous debt burdens more difficult to serve leading to a surge of non-performing loans. The plight of Italy, with its conservative banking system that had not financed a bubble that burst, is a warning sign of how debt may become unsustainable in an environment of low growth and low inflation.

**Unlikely changes**

Having enumerated the three most likely changes that will follow British withdrawal from the EU, it is worth pointing out two possible changes that are not very likely. The first concerns the potential for a breakdown in central bank coordination. While central bank cooperation may be affected by the UK’s withdrawal, the crisis management of 2009–10 showed that central banks have become quite accustomed to coordinating their rescue operations effectively. Indeed, this has been the case ever since the breakdown of the Bretton Woods system in the 1970s. In 2009–10 a network of swap lines prevented currency attacks on Eastern European currencies, while a swap line between the Bank of England and the ECB supported Irish banks exposed to net...
claims in pounds sterling. These were made into a standing arrangement between six central banks in October 2013: the US Federal Reserve, the ECB, the Bank of England, the Bank of Japan, the Swiss National Bank and the Bank of Canada (also called the C6). The cost-effective prevention of currency crises in open economies is in the interest of all countries trading with, and investing in, each other; this will not change with the UK’s withdrawal from the EU.

A second unlikely scenario is a wholesale decline in the perceived value of EA membership. The threat of currency crises makes it unlikely that other countries’ desires to seek or maintain euro area membership will be affected by the UK’s withdrawal. Even at the height of the crisis, Baltic countries joined the EA: Estonia in January 2011, Latvia in 2014 and Lithuania in 2015. This was, moreover, not because there existed overwhelming popular support for membership or pressure on them to join. Rather, policymakers in these countries realised that EA membership would make their economies less exposed to current account crises and less dependent on the goodwill of foreign central banks. The cross-border payments system, TARGET, eliminates foreign exchange constraint and provides insurance against a sudden stop of trade finance (Schelkle 2017, Chapter 9). Furthermore, the Single Supervisory Mechanism now protects them against the ring-fencing of liquidity by supervisors in other euro area countries. For these small economies, giving up the exchange rate does not mean losing a policy instrument, since they would have to follow the moves of the ECB anyhow. The peripheral Member States of the EU do not have the advantages of the UK, which is an old financial power with an established reputation that it will not default on its foreign debt, and hence they are unlikely to take any cue from the UK’s withdrawal.

In sum, Brexit is likely to have negative effects on the EA. Contrary to what some policymakers seem to think about those trying to attract parts of the City into their jurisdiction, the relocation of financial services into the monetary union may well turn out to be a cost for these jurisdictions. Contingent liabilities for this crisis-prone sector will increase and the relocation will reduce risk sharing between the two currency areas, although by how much is hard to predict. Other effects, such as that on financial regulation in the EA and on trade with the UK, are more ambiguous and probably of second-order relevance.