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'Diverging Capitalisms?' series

Brief No. 1

The impact of Brexit on the City and the British economic model.

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This Brief is the first of a series drawing on the project 'Diverging Capitalisms? Britain, the City of London and Europe' led by FEPS, Policy Network and SPERI, which aims to consider the changing nature of the British economy, its place within the European economic space and the consequences of a possible Brexit. The findings presented here take the analysis developed as part of the workshop entitled 'Diverging Capitalisms, Part 1: The City after the crisis' held in London in April 2016 as a starting point, and seek to read this in the light of the results of the recent Brexit referendum.

In this Brief we consider the impact of Brexit on the City, focusing on two key aspects of the debate: the tensions between the City and democratic politics, and the challenges for the future of the City posed by the vote on 23 June for Britain to leave the European Union (EU).

Background

- Some time in the next few months the new British Government is widely anticipated to declare formally its intention to leave the EU by invoking Article 50 of the Treaty of Lisbon;
- When it does so, it will have just two years to negotiate a formal exit agreement. Whether the negotiations over a new relationship within the European Union can start in parallel, how much time they would take and whether there is scope for a transition period is unclear;
- Crucial to that relationship will be its implications for the City of London, which will be striving to secure the 'passporting rights' that would allow it to continue to provide financial services from Britain in EU member states;
- Given both the substantial surplus in financial services that Britain currently enjoys with the EU and the contribution of the City to British GDP, the implications for the success of the British economy in the decades to come could scarcely be higher;
- In the balance of the negotiation will also be the British government's tax policy. Suggestions that the corporate tax rate could be cut down to 15% as a way to boost British competitiveness after Brexit have not gone down well in European capitals.

The City Meets Democratic Politics – Helen Thompson, University of Cambridge

The City of London has lost in British political life for the first time since the 1930s. No one has benefited more for the past three decades from the free movement of capital within advanced economies and the free movement of labour within the EU than the City. It has hitherto achieved this success without any serious challenge from within democratic politics because the three principal British-wide political parties held a consensus that the economic distribution of advantages and disadvantages wrought by these policy parameters was the centre ground of national politics.

Under the surface, however, the pressure on this consensus has been bubbling in the democratic polity since at least 2005 when a Labour government, having apparently unthinkingly decided to eschew the transition arrangements on the free movement of labour for the accession of eastern European states into the EU that every other large EU state adopted, was re-elected on just 35 per cent of the popular vote with significant working class defection into non-voting. The financial and euro zone crises then began to bring the pressure to the breaking point marked by Brexit. At home after the 2008 crash the distributional winners of policy were once again the financial sector and asset holders, not least as a result of quantitative easing. This success in a political context in which banks were toxic only fuelled voter anger that before the referendum could not be politically realised under either the British electoral system or whilst the Labour party was determined by one means or another to make itself unelectable. Within the EU Britain's non-membership of a euro zone that lacked until far too late a lender of last resort turned Britain into an employer last of resort for the economically dysfunctional and politically rotten currency union. As migration to Britain from the periphery of the euro zone increased from 2012 so UKIP's political fortunes rose and Prime Minister David Cameron's difficulties within the Conservative party mounted.

The euro zone crisis also posed deep problems for the City itself by politicising, in France in particular, London's position as the offshore centre of euro-trading. As the European Central Bank (ECB) and the French and German governments pushed for some regulatory leverage over London's euro trading, they created a Euro-sceptic critique of the power structure of the European Union and left the City dependent on the European Court of Justice to uphold the principle that non-euro states should not be discriminated against within the Single European Market (SEM). Ironically, the City's political problems since the onset of the euro zone crisis within the EU also created the political space for Boris Johnson as Mayor of London to establish his euro-sceptic credentials within the Conservative party against a Prime Minister who never sounded anything like as convincing when he was threatening a British exit to secure a meaningful renegotiation either to protect the City or secure concessions on the free movement of labour.

When the campaign came what had become a catalogue of democratic political weaknesses for the City were laid bare. On a matter in which the vital interests of a significant number of City's firms were at stake the City's fate was always going to be at best marginalised from the terms of political debate. In a contest in which the Leave campaign made the free movement of labour and democratic sovereignty the centrepiece of its assault on Britain's EU membership, the Remain campaign was never going to triumph by asking voters to consider jobs in American investment banks in Canary Wharf. But the City's political problems were exacerbated by the extreme fear tactics adopted by the Remain campaign. Much of 'Project Fear' was directed at voters who were already the losers in the distributional conflicts in which the City had triumphed and who simply did not have sufficient stake in an economy based on ongoing free movement of labour and capital to be easily frightened by a future that already felt bleak. Telling these voters to fear the reaction of financial markets was an invitation to return the answer that they would take the chance the referendum finally gave by switching democracy from its parliamentary to plebiscitary form of standing up to the markets, literally and figuratively, by doing nothing more than voting to exit a political union for which they have long had little liking and now understood as structurally institutionalising their economic and political weakness.

The question now for the City is whether it can recover its political position sufficiently to dictate the terms of Brexit. In a number of ways it starts in a much better position than over the referendum because there is no longer a political mechanism for the majority of English and Welsh voters to express their preference over what they want, even supposing that there was anything like a unitary will among these voters now the binary choice of the referendum is removed. The City's direct access to the political class and the assumption across most of the Conservative party, the Liberal Democrats and the vast majority of the parliamentary Labour party that access to the Single European Market must prevail is once again its asset. Indeed, the non-Corbynite part of the Labour party appears in the aftermath of the referendum much less uneasy in its embrace of the City's concerns than it has hitherto been since the 2008 crisis because the City is the part of the British economy that appears most immediately exposed to turbulence and the relocation of jobs. Whilst the Labour party has some very good electoral reasons to prioritise securing concessions on the free movement of labour in the Brexit negotiations, there is no evidence, at least of yet, that the centre left of the party is willing to sacrifice its European commitment and having as close to the SEM aspects of membership of the EU as is possible to embrace the economic and political grievances of the working and lower middle classes.

In this sense the domestic political struggle for the City is far from lost. Something that looks like the European Economic Area and includes 'passporting rights' would leave the City in much the same position as it enjoys now. Within the political fault-lines around the euro zone, however, the old status quo cannot be restored. London as the offshore centre of the euro zone is now even more of a political provocation to the French and there is much less reason for the European Court of Justice to exhibit caution in its judgement in relation to matters of the relationship between euro trading regulation and the Single European Market. Nonetheless, the euro zone is much less politically secure than it was before the Brexit referendum. If and when the euro zone descends into its darkest crisis yet the City of London stands to gain as a safe haven and Brexit may well look much less like the national economic risk than is currently supposed. In this sense the City's reinvention of itself internationally in the face of its last domestic political defeat may yet be repeated.

Brexit: A Real Challenge for the Future of the City – Leila Simona Talani, King's College, London

The vote in favour of Brexit cast by British citizens on 23 June opens new questions about what model British capitalism will be following in the future.

If globalisation did not pose any a real challenge to the City of London, Brexit might indeed make it more difficult for the City to fully gather the benefits of financial globalisation. Scholarly interventions have demonstrated that globalisation could have indeed increased the bargaining power of the City inside the national polity, as its economic position is very likely to improve in the future thanks precisely to globalisation. This will be the case no matter which definition of globalisation we take into account, and regardless of whether the analysis is carried on at the macro or at the micro level.

Starting from a quantitative definition of globalisation, at the macro level this implies a trade-off between national monetary autonomy and stable exchange rates. As exchange rate stability is necessary for trade liberalization, countries will need to renounce their macro-economic autonomy and integrate their monetary policy-making through global agreements and institutions.

However, the decision by the UK government not to join the European Monetary Union (EMU) demonstrates that, in the trade-off between the stability of the exchange rates and autonomous monetary policy, some countries, and especially some domestic actors (notably the City of London), might still prefer the latter. The reasons for this are many. Primarily, financial services have everything to gain from being able to set interest rates at a higher level than the other financial centres and to keep the level of domestic regulation under control as this represents a relevant competitive advantage in attracting short- and very short-term capital. Moreover, unstable exchange rates may and do actually signify a substantial source of revenues for the City of London. Finally, the City of London is most likely to be one of the main winners of financial speculative practices.

From the micro point of view, when adopting a factorial approach globalisation favours capitalists and skilled labour and therefore, undoubtedly the City of London. Furthermore, if an interest group is able to credibly threaten to leave the country, its bargaining power increases. As a consequence, globalisation reduces the capacity of the government to disregard the preferences of the most mobile factor, which is capital and financial capital in particular, increasing the negotiation and political power of the owners of such capital: the City of London.

Finally, adopting a sectoral instead of a factorial kind of analysis, to the extent to which the City remains competitive internationally, with a high degree of openness of the markets, it will improve its position not only with respect to labour but also with respect to industrial capital.

From the qualitative point of view, around-the-clock access to financial markets all over the globe does not threaten the geographical allocation of financial power. This has remained surprisingly stable and concentrated in three centres: New York, London and, to a more limited extent, Tokyo. This concentration is unparalleled in any other kind of industry and it is also extremely durable. London is the most successful of these centres and its position has certainly been strengthened by its ability to attract expertise and highly valuable skills from all over the globe, including the EU. This resulted in a virtuous circle, which made London more and more attractive to highly skilled labour and this, in turn, favoured the concentration of financial services in the British capital. Brexit most likely will revert this dynamics making London less attractive to highly skilled labour from the EU and thus also limiting the concentration of expertise and knowledge, which represents such a valuable competitive advantage for the City of London.

Moreover, Brexit can offset also other benefits of globalisation, as it will undermine the ability of the City to have full access to EU markets without discrimination. This would be particularly true if the EU decides to go ahead with the Capital Markets Union, not only because the City is unlikely to be allowed to take part in it, but also because not being in the EU could mean the imposition of barriers to the free movement of capital outside the EU. To a certain extent, the planned merger of the London Stock Exchange and Deutsche Börse might have some important consequences, but it remains to be seen what will be the terms of the final agreement between the two stock exchanges.

If it is true, as the analysis above has shown, that the City thrives on the liberalisation of financial markets, having barriers imposed by the EU as a consequence of Brexit would represent a major blow on the hegemonic position of the City in the international context. Moreover, it remains to be seen if a stand-alone UK will be able to negotiate the same trade conditions as the EU when it comes to international trade agreements, such as, for example, TTIP.

Maybe, at this point, the pragmatic adaptation, relaying uniquely on the power of the Bank of England and the HM Treasury, will not be enough to guarantee the best possible treatment to the British financial sector internationally. Maybe this is the reason why, overall, the City would have preferred Britain to remain in the EU.

Summary of Key Points

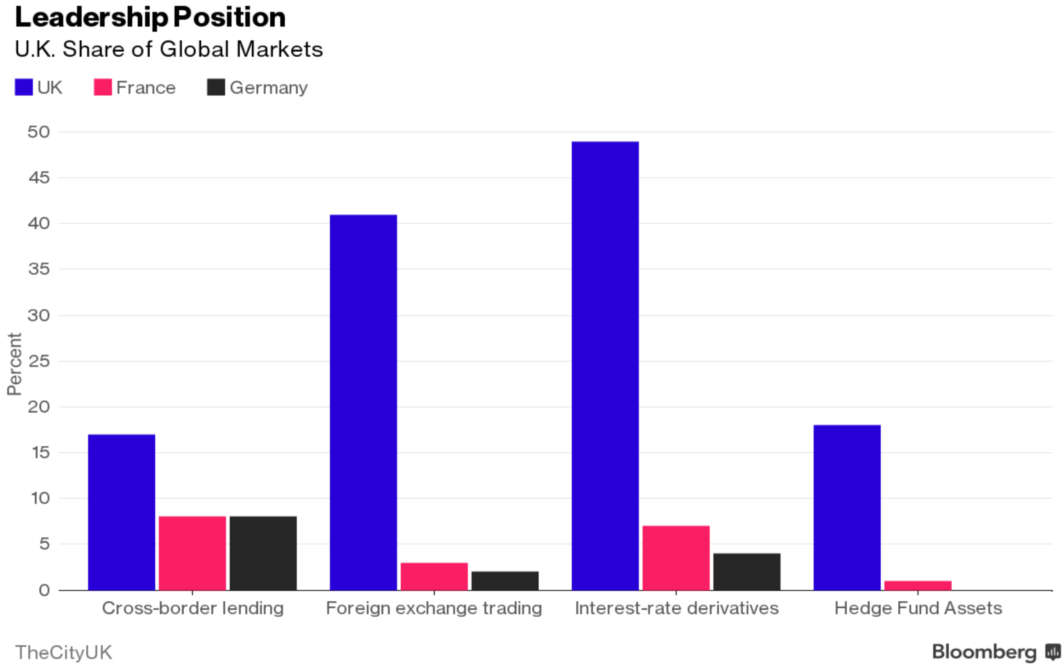
- Before the EU referendum, the City of London benefited hugely from access to the European Single Market. For example, in 2013 Britain ran a £19.9 billion surplus in financial services with the EU. The City is home to 35% of the EU's wholesale financial activity, 78% of its foreign exchange turnover, and 74% of over-the-counter derivatives trading (City UK).

- However, throughout the 2000s broad swathes of the British population felt they had not benefited from the EU's Single Market to the same extent. In the post-2008 context, large sections of British society experienced stagnant living standards. They also felt powerless to control immigration. These problems intensified after 2005 and after 2012 when EU immigration to Britain increased markedly.

- During the EU referendum campaign, the Remain campaign's message about economic uncertainty struggled to counteract the Leave campaign's claim that it could win back 'control' over Britain's borders and political system. In part this was because much of the population felt they did not benefit from the status quo and partly because it was difficult to build support around a campaign that Brexit might 'hurt the City'.

- Now the EU referendum has passed, the City is in a position to advance its interests once again and shape the post-Brexit environment. It is likely to push for 'passporting rights' which would mean it would continue to have access to the Single Market in financial services.

- However, it is worth bearing in mind that the euro zone itself is highly vulnerable to a future economic downturn. In this context, the City could become a 'safe haven' for investors fleeing instability within the Single Currency area.



Source: Bloomberg http://www.bloomberg.com/news/articles/2016-02-19/what-would-brexit-really-mean-for-firms-in-london-s-city-q-a

- The City of London remains one of the world's leading financial centres at the present moment.

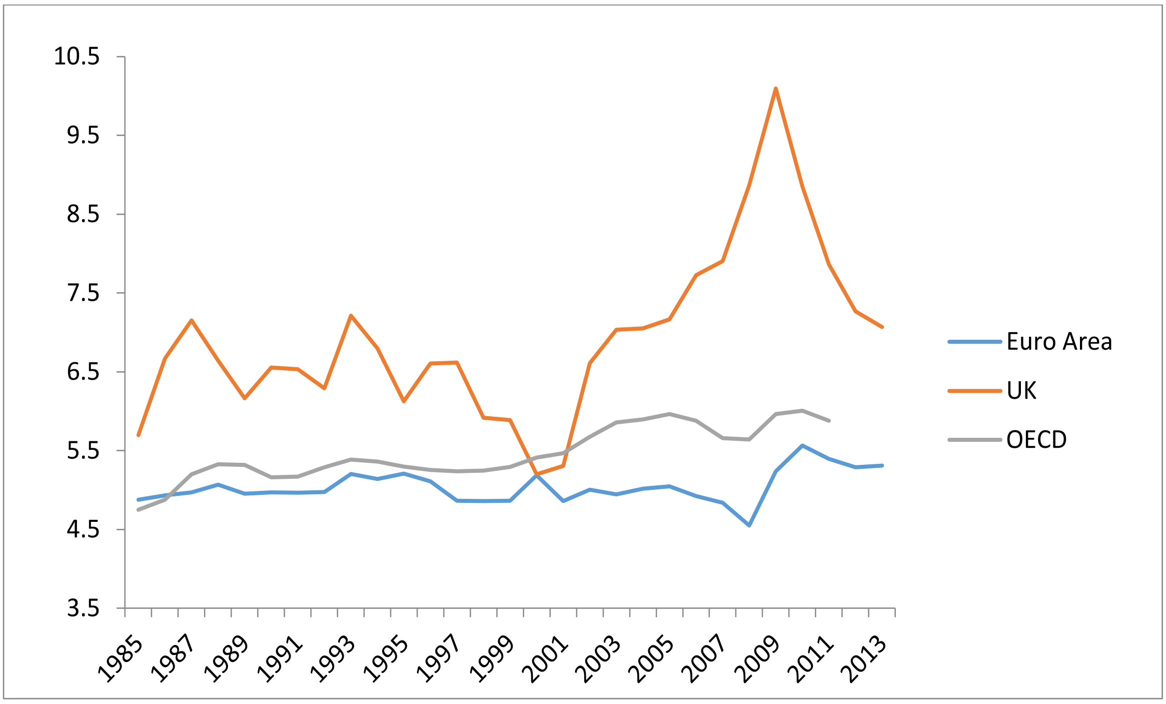
- During the 2000s, the British government's choice to not join the euro did not harm the City of London. Indeed, since the introduction of the euro and up until the 2008 financial crisis, the size of the financial sector in the UK increased from 5.5% of GDP to 10% of GDP. In contrast, the financial sector in the euro area remained at around 5% during this period.

- However, this position is potentially threatened as a result of the Brexit vote in the EU referendum. In particular, the City's status may come under threat if it cannot continue to access the EU's Single Market in financial services

- In addition, in the post-Brexit environment the UK government will have to negotiate new trading arrangements with non-EU countries. This could result in higher tariff and non-tariff barriers for City firms depending on the details of the arrangements which are arrived at.

- As such, the status of the City looks very uncertain in the months and years following Britain's choice to leave the EU.

Value Added By Financial Sector % GDP



Source: OECD http://www.oecd.org/economy/financial-sector-must-promote-inclusive-growth.htm

Conclusion

- The City is at the core of the British dilemma over Europe because it is the power engine of the British economy. Over the past decades, Britain's growth has relied to a large extend on foreign capital and the export of financial services – the condition for which was to accept free movement of people. British voters' decision to leave the EU shows that they are ready to pay the economic price for regaining some control over immigration. The next few years of negotiations will test the solidity of this choice. As the backlash against immigration and free markets is widely shared across the EU, the odds are that Britain will manage to legitimise its demand for new migration rules and the price to pay might not be as high as predicted.

- The likely loss of 'passporting rights' would make business in the EU more complicated for London-based financial firms, but it does not mean the end of the road for the City. By opening subsidiaries in EU member states, British firms will be able to keep a foot in the Single Market. Moreover, under the principle of 'equivalence', financial firms based in third countries will have partial access to the EU's Single Market (for instance, under the incoming MiFID II and MIFIR regimes). However, this will be conditional upon Britain continuing to apply the EU's existing and upcoming legislative body without any change, and to political goodwill – French financial markets representatives will press French government to be ruthless with the City. Britain will need to display a lot of goodwill and cooperative spirit.

- The City can also count on the new British government's determination to protect what it sees as a key element of its prosperity. If access to the Single Market is to be seriously damaged, Britain intends to remain an attractive place for foreign capital by other means. Suggestions that the corporate tax rate might be cut down to 15% confirm the fear in some EU continental countries that Britain will become an aggressive tax haven at its borders. Whether this is realistic given Britain's fragile fiscal situation is questionable, but this will in any case provide the British government with a significant leverage tool in the upcoming negotiations with the EU.

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