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EU economic governance after Brexit: Governing a disintegrating Europe.

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This Brief is the second 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 Brexit. The findings presented here take the analysis developed as part of the workshop entitled 'Diverging Capitalisms, Part 2: Brexit and new EU economic governance' held in London in October 2016.

In this Brief we provide new insights on how fragmented political and economic interests, both internationally and intra-nationally, have been shaping EU economic policy-making in the wake of the global financial crisis, the Eurozone crisis and the UK's referendum on EU membership.

Summary

- Though often characterised as an 'awkward partner' in Europe, when it comes to questions of financial regulation since the crisis Britain is better understood as at times a 'foot-dragger', at times a 'fence-sitter' and even at times a 'pace-setter'.

- The UK has consistently dragged its feet on questions of EU financial services regulation in protecting City interests; it has been a more constructive fence-sitter on questions of banking union, supporting the idea as part of a wider strategy to deal with the problem of sovereign debt within the Eurozone; and it has been a pace-setter on questions of capital market union, animated as it has been by the idea that the City might acquire a greater share of a more liberalised financial market in Europe.

- Brexit presents Britain with a new set of challenges – it must surely strive to retain its privileged access to EU financial markets whilst, at the same time, being forced to give up its role in shaping the ways in which they are regulated. These are difficult imperatives to juggle and if the British government gets this wrong there is a danger that a significant share of the City's current business will be relocated elsewhere in Europe.

- The ongoing crisis of the Euro area continues to pull European capitalisms apart. Brexit is just the latest stage in that ongoing process.

- The way in which the May administration has tied its hands with respect to the City, privileging in its terms the interests of 'ordinary working families' over those of the banks, threatens to deal a severe blow to Britain's European financial market access.

- The likelihood is that the City will become a rather less significant financial centre for the monetary union and the wider European economy to which it will no longer belong in quite the same way.

Background

- Since 2008, Europe has been beset by economic crises. The global financial crisis was followed by the sovereign debt crisis in the Eurozone, and growth remains geographically and socially uneven.

- Variegated national and intra-national interests have become more pronounced in this context, and the European Union has been struggling to make relevant decisions addressing increasingly socially and politically fragmented constituencies. It has been a time of simultaneous institutional integration and disintegration.

- The UK is likely to trigger Article 50 – the process by which it will leave the EU – in the spring of 2017. The divorce process is expected to take two years, but the negotiation of a new UK-EU relationship is expected to face significant hurdles which could hold back other EU initiatives in the meantime. What Brexit will mean for both the UK and the economic governance of the EU remains unclear and depends on the future UK-EU relationship in financial services. Both sides face strategic dilemmas between economic and political rationales.

European Union Financial Regulation, Banking Union, Capital Markets Union and the UK

Lucia Quaglia (University of York)

When the EU reformed its framework for economic and financial governance after the international financial crisis and the sovereign debt crisis three policy areas stood out: financial regulation, which was significantly revised in the wake of the international financial crisis; banking union, which was the EU's response (or to be precise, the Eurozone's response) to the sovereign debt crisis; and capital markets union, which was the EU's attempt to revamp financial activities and the real economy after two consecutive crises. The UK has been a key player in these post-crisis reforms, albeit in different ways and with varying intensity. The (at times considerable) British influence was geared towards the attainment of preferences that were shaped by domestic politics and political economy, first and foremost, the interests of the financial services industry and the City of London.

The UK was mostly a foot-dragger (with important exceptions) in post-crisis EU financial services regulation, resisting measures, such as rules on hedge fund managers and the financial transaction tax, which were very burdensome for the financial industry, especially the City. The main exceptions were banking rules on capital requirements, resolution and structure.

The UK was a constructive fence-sitter on banking union: it was by and large supportive of this project as a way to tackle the sovereign debt crisis in the euro area by severing the 'doom-loop' between the instability of the banking sector – which had to be bailed out in the majority of euro area countries – and the

fragility of public finances, which were becoming unsustainable in some countries. However, the UK did not want to be part of banking union, which was mainly seen as a solution to euro area problems. Moreover, the joining of a banking union would have implied the supranationalisation of banking supervision, which was politically unacceptable in the UK.

The UK was a pace-setter on capital markets union, at least compared to other member states. It had the most to benefit from the financial liberalisation promised by the project, given the diversity of its financial sector and, in particular, the high concentration of wholesale market activity, private equity and hedge funds. At the same time, UK policy-makers were concerned that capital markets union would also involve new EU regulation and further centralisation.

The UK faces a 'dilemma' in the Brexit negotiations on finance. If the UK loses membership of the single financial market, parts of the financial industry based in the UK will relocate to the EU in order to continue to benefit from passporting across the EU. If UK retains membership of the single market, the UK will have to continue to comply with EU financial regulation on which it ceases to have a direct say. The EU also faces a Brexit dilemma on finance. Any 'special deal' for the financial services sector in the UK is politically unpalatable for the EU. It would be the kind of 'pick and choose' approach that so far has been ruled out by the EU. At the same time, the City is by far the main financial centre in Europe, so there might be incentives to retain it in the single market. Furthermore, many continental banks, insurers, securities dealers, etc operate in London. For both the EU and the UK, it will be a challenging circle to square.

The Integration and Disintegration in the European Union

Waltraud Schelkle (European Institute, London School of Economics)

The prolonged crisis of the euro area has strengthened centrifugal forces in the EU. For the first time in the union's history, a member state has decided to leave the EU, based on an in-out referendum. Even so, we have witnessed a series of sovereign bailouts in the EU that make all IMF bailouts pale in comparison as well as the creation of a banking union within two years. The story of post-crisis Europe is one of astonishingly rapid and far-reaching steps of institutional integration while centrifugal political-economic forces are on the rise.

Any European country, whether in or out, has to deal with the inherent tensions between honouring international commitments and responding to the demands of domestic constituencies. This constitutes not only a political dilemma but also a strategic opportunity for policymakers. Yet David Cameron's administration was surprisingly inept in exploiting the opportunity, despite holding a favourable initial position.

An example that can illustrate this is the creation of a banking union from the German and the UK point of view. Before the crisis, keeping supervision, resolution and deposit insurance as national responsibilities was part of Germany's attempt to keep monetary and fiscal policy strictly separate. But these national responsibilities

contributed directly to the fragmentation of banking during the crisis, as well as to the negative feedback loop between banks and sovereigns, transmitted through banks' holdings of government bonds. Hence, when a banking union became unavoidable, amidst an escalating crisis, Germany was confronted with a dilemma: how could it help to maintain the euro area and prevent fiscal exposure to other member states' failing banks?

The June 2012 European Council decided to introduce a banking union amidst dangerously rising risk premia on Italian and Spanish bonds. In a backroom deal, the heads of the four biggest euro area member states also gave ECB President Draghi the green light for his 'Do whatever it takes' speech (Draghi 2012) before he proposed this to the ECB Governing Board. This speech marked a watershed that turned a virulent into a latent crisis.

But the sudden stop of financial panic also allowed Germany to backtrack on promises to agree to a deposit insurance guarantee or some fiscal backstop to the single resolution mechanism. The 'Do whatever it takes' speech worked too well. Inadvertently and unintentionally, Draghi allowed the German government to respond to domestic political opposition to further integration since the euro area's existence was no longer at stake. The reassuring steps toward a banking union and the ECB acting as a conditional lender of last resort to sovereigns helped to sustain disintegration in fiscal terms.

Somewhat surprisingly, the British government did not stop the move towards banking union. The UK wanted to see the troubled currency union stabilised and accepted 'the remorseless logic' towards closer integration, as finance minister George Osborne put it. Contrary to earlier German wishes, the ECB was put at the helm of banking supervision. Supervision of its banking system by a supranational authority was unacceptable even though the UK had just abolished its own pre-crisis supervisor. More astonishingly still, the UK government asked for remarkably little in return for the split of the single market in financial services that the banking union implied. The escalation of the euro area crisis made a hard-nosed British government panic, given the exposure of the City.

Even without Brexit, the permanent split of the single market would have deprived future UK governments of a lever vis-à-vis the financial system in the UK. Banks are domestically unpopular and created huge costs for the Treasury but are too important for the UK economy as a major source of well-paid jobs. Against this background, it is noticeable how the new UK Prime Minister, Theresa May, has signalled to the City that she will not fight the City's corner in the Brexit negotiations. Her pledges to care more about 'ordinary, working-class families' than the 'wealthy' is an act of public hands-tying. She told the financial services industry that the constraint from 'Brussels' has been replaced by the constraint that potential UKIP voters represent to her government. But the City will remain a (diminished) financial centre of the monetary union to which it does not belong. Hence, the UK's political dissociation from the EU will weaken the City domestically only to the extent that there is an ever present nationalist challenge.

Conclusion

- The tension between political responsiveness and economic interests has defined European integration since its very beginning. However, the global financial crisis and the Eurozone debt crisis have taken pressure on national governments to another level. Playing the 'two-level game' of EU and national politics has become extremely perilous.

- In this new context, integration and disintegration are taking place in parallel. Centripetal forces – call it survival instinct – urge Eurozone members to get their act together. Yet the dominance of intergovernmental decision-making, and the very limited and conditional solidarity which has emerged from the Eurocrisis, signal the impracticability, for the time being, of greater centralisation and cross-border transfers. This casts dark clouds over the future of the euro. Meanwhile, centrifugal forces have pushed non-euro outsiders like Britain to reconsider their membership of the EU.

- It remains to be seen how far the current politicisation and resulting turbulences will affect EU market integration in the long run. The British government might threaten to set up a tax and regulatory haven on the EU's doorstep if it does not get sufficient access to the single market, especially in financial services. This will make it difficult for the EU-27 to ignore British views completely. On paper, the most sensible outcome remains getting back to the principles enshrined in the agreement struck between David Cameron and 27 heads of states and governments in February 2016: to allow both sides to take different directions while preserving the integrity of the single market and strictly forbidding discrimination or special treatments. Yet it might take some time to return to such a conciliatory tone.

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