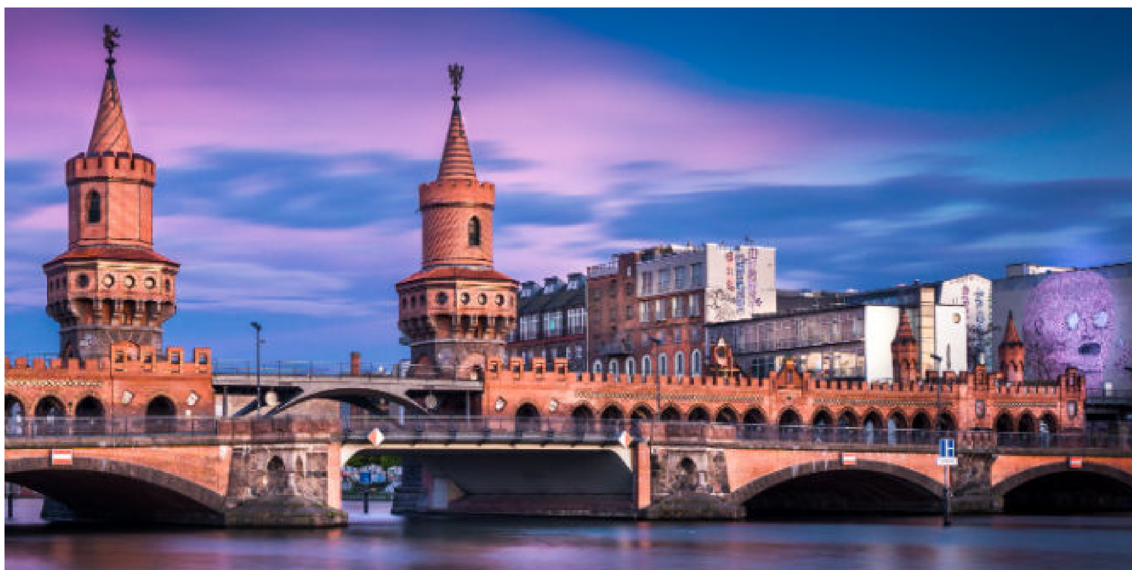
Continental Breakfast 13: Brexit's lasting effects on the EU

The departure of the UK will have lasting effects on the European Union, which will be felt for years to come. ***Marcel Hadeed (LSE)*** *reports on a lunchtime event on 1 October, 2018 jointly hosted between LSE and the Hertie School of Governance, Berlin. Where do we stand six months ahead of the British withdrawal from the EU? How do perspectives in Berlin and London differ? And what implications do we expect for three areas that have sparked controversy in the negotiations: economic governance, the financial sector and free movement?*

How might Brexit change EU economic governance?

The overall influence of the UK on the EU's economic governance is hard to assess. It helped shape forms and norms of regulation, including the social realm. It introduced a pro-market approach into the single market and argued for a "lighter touch" on regulation – emphasising the need for efficient resource allocation and cutting red tape.

Brexit will shift the balance of power in the EU. Not only for the Franco-German engine, whose intentions were set out in the Meseberg declaration, and which loses a powerful opponent to its integrationist tendencies – but also for the balance between the EU's North and South. Without the UK, the fiscally conservative camp loses its blocking minority on legislation, which will facilitate the establishment of new fiscal resources. France and Spain have already announced their common support for new fiscal resources dedicated to Eurozone stability. Brexit could also facilitate the creation of a "southern bloc" pushing for more investment and/or redistribution. It is conceivable that this would act as a catalyst to address the outstanding issue of divergence.



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An open question will be how the process of accession to the euro will develop. The exit will reduce the size of the non-euro bloc by 50 percent in GDP terms. Without the UK, 85% of EU GDP is produced within the euro area. Furthermore, the non-euro countries are left without a blocking minority in the Council as the UK, which constitutes 12.85 percent of the EU's population, leaves. Legislation that is more closely aligned to the needs of the euro might accelerate accession, especially if shared fiscal resources were realised.

Brexit will also provide a window of opportunity to do away with "corrections" in the EU budget, better known as rebates. Defending them will become harder in the future and the Commission's proposal for the upcoming Multiannual Financial Framework already includes the phasing out of remaining corrections for Germany, the Netherlands, Austria and Sweden.

Brexit will also have an impact on labour migration, as Germany will become the biggest beneficiary of skilled labour migration from the CEE members, as well as trade and investment, although it might prove a sideshow to the effect of the US reorientation on trade.

What is the impact on EU financial markets of the City of London leaving the EU?

Brexit will lead to a partial migration of banking business from the City of London to the EU27 with Frankfurt, Paris, Dublin and Amsterdam being the biggest projected recipients. London will also lose some of its attractiveness for US banks as an entry point into the single market. Paris is reportedly a preferred replacement destination for the future. Financial regulations will also be more suitable to the needs of continental Europe, for example by shifting away from capital requirements as a metric for stability.

A question yet to be decided is how open or closed the EU's financial markets are going to be for UK firms and banks. Having hoped to attain a principle of equivalence when dealing with the single market, the UK is now focusing on attaining "reciprocal recognition". This will mean reduced market access.

One of the biggest risks of Brexit for the EU and the UK banking sectors is reduced risk-sharing. Risk-sharing is achieved by diversification of risk portfolios. In simple terms, the more countries banks have in their debt portfolio, the more resilient they are to economic downturns in particular countries, as only a fraction of their debt fails to be serviced. British banks formed an integral part of European banking activity and were highly exposed in Ireland and Spain. Not only did the British government participate in the Irish bailout – thus contributing directly to financial stability – but EU member states also benefited from the bank bailouts in the UK.

Another way of risk sharing is via swap arrangements between the two central banks. Swap arrangements allow central banks to freely exchange currencies. When funding markets in one currency area deteriorate, outside access to that currency can become limited. Swap arrangements let central banks acquire this currency to lend it to its domestic banks. This ensures stable funding and investment. Currently, the Bank of England and the ECB have a standing swap arrangement, but depending on the ongoing negotiations, this might change. Limited access to euro liquidity in the UK or pound liquidity in the euro area can present a serious risk to financial stability.

A source of friction in the negotiations concerns the financial stability mandate of central banks in the aftermath of the financial crisis. It dictates the clearing of derivative contracts that had accumulated before and during the financial crisis in order to reduce over-the-counter (OTC) business. OTC transactions are non-standardized and can create undetected risks – assets chiefly implicated in the financial crisis of 2008 were all traded in OTC markets. Clearing by so-called central counterparties has become a lucrative, yet risky business that both the ECB and the Bank of England want to supervise because they may be called upon as lenders of last resort. Currently, a lot of euro clearing is done in the City of London, but the ECB, which had lost a court case on that matter in 2015, has already proposed legislative amendments to establish its competence over clearing in euros, which it views as of "systemic importance". Cooperation between the two central banks may become more fraught.

What is the impact of Brexit on free movement?

Migration soon became a central issue of the referendum campaign with a consensus emerging, despite much evidence, that free movement of people was a crucial and disruptive issue.

Free movement therefore became part of David Cameron's renegotiated deal with the EU. Interestingly, after the lost referendum made the deal obsolete, the proposed changes were dropped and no longer discussed. A debate on intra-European migration that was so pronounced in the UK was not taken up in other EU capitals. Being left alone by politics, the only changes to the principle of freedom of movement of people where induced by the ECJ. In its rulings in the Dano and Alimanovic cases, it upheld restrictions in access to social benefits to intra-European migration.

This lack of political debate was likely due to the refugee crisis shifting away the focus from intra-European migration. It occupied much attention also from those parties that are critical of EU migration, thereby taking the issue off the political agenda. However, given the persistent socio-economic divergence within the EU, intra-European migration is likely to persist and with it the political forces opposing it. The issue is thus likely to reappear on the political agenda.

This post represents the views of the author and not those of the Brexit blog, nor the LSE.

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