Leaving the EU will be detrimental for the future of the City

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The City's growth is not endogenous, it has coincided with the achievement of the European single market. In the past 20 years London managed to adapt as a bridgehead for foreign, mostly US, financial institutions' operations all over the EU (banks, institutional investors and fund managers, and ratings agents). ***Karel Lannoo****, one the participants of the first* LSE Commission on the Future of Britain in Europe, *claims that it is doubtful that this would remain the case if the City ceased to be an EU financial centre.*

Anyone who has recently visited the City will realize that London has become the New York of Europe. With its dazzling and ever-changing skyline, it is apparent for all to see that the British capital is booming, probably more than any other European financial centre. At the same time, however, there is a risk that the city's extraordinary transformation will deceive UK citizens into thinking that the growth is endogenous, based on genuine internal strengths, and to overlook the external dimension of it, above all in a European context. This is especially dangerous in light of the forthcoming British referendum on EU membership.

London's predominance as a financial centre in the EU is a fairly 'recent' phenomenon, and its growth over the last two decades has coincided with the achievement of the single market, which allows for the free movement of capital and the free provision of goods and services throughout the EU. Each country was allowed to develop in its own area of comparative advantage. Germany specialized in manufacturing and cars, London, and also other parts of the UK, specialized in finance and business services. This led to a huge transformation, and those who lived in the City at the end of the 1980s would hardly recognize it today.

Back in the 1960 and 1970s, depending on the indicator used, London was on a par with Paris as a financial centre. London was more international and more market-based, whereas the size of banking assets and the contribution to GDP was higher in France. Financial sector employment was similar in both centers until about 20 years ago. London's big bang and UK labour market reforms, the nationalizations in the early Mitterrand years and later the single market and the prospect of monetary union changed all this. London managed to adapt as a bridgehead for foreign, and most importantly US, financial institutions' operations all over the EU.

City of London arms on a saddle blanket. Photo by RodolphRodolph. CC BY-SA 3.0

Looking at the components of the City as a financial centre today, the single most important group probably consists of US-domiciled financial institutions, banks, institutional investors and fund managers, and ratings agents. Their presence in the City is clearly related to the free provision of services all over the EU, a facility that has been further enhanced in recent years. A change in the UK's position within the EU will rapidly have a negative impact on this freedom, and thus have immediate consequences for US banks. This latter effect will have a direct economic implications for the UK, as this group is the most competitive compared to the other components, the UK banks, other European banks as well as other foreign banks.

Moreover, the City plays a pivotal role for US banks in arbitraging between both single markets. The City provides the critical mass and infrastructure for transactions as a global financial centre, as an alternative to the US or Asian centres. When the US Commodity Futures Trading Commission and the US Exchange Commission introduced rules governing swap execution facilities (SEF) in the US at the end of 2013, euro interest rate swap transactions moved almost overnight to London. It is doubtful that this would remain the case if the City ceased to be an EU financial centre.

From a market development perspective, closer association with Banking Union would provide additional protection for the UK. As one of the few EU countries, the UK's exposure to its banks has grown since the financial crisis. The country's total banking assets stand over 5 times its GDP, more than the double that of the EU average. Opting in into the single supervisory mechanism (SSM), and even more the single resolution board (SRB) and fund (SRF), not to mention the European deposit insurance scheme, would provide the UK with a much larger backstop, and possibly better supervision. But this suggestion is clearly taboo.

A large financial centre like the City requires a large single market and/or requires openness towards other economies. But those voting on the UK referendum may not necessarily be aware of the importance of this interconnectedness, and what it means for the UK economy. Large parts of British public opinion, especially when confronted with threats from abroad, seem to prefer isolationism as the best way forward. This will be detrimental for the future of the City.

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