

The Euro Area: Staying the Course through Uncertainties

Report on the Panel “Addressing the Impact of Brexit” at the
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Conference Report



BREXIT – views from a high-level discussion on the eve of what was thought to be Britain’s exit from the EU

By David T. Llewellyn, Loughborough University

On March 29th the UK was originally scheduled to leave the EU. While, subsequent decisions by the UK Parliament meant that this did not happen according to schedule. It was timely that a high-level panel discussion at the conference “The Euro Area: Staying the Course through Uncertainties”, which took place on April 29th, 2019 was devoted to a consideration of BREXIT, given its wider repercussions for the EU and the euro area in many respects. The panel covered a number of issues of relevance beyond the day-to-day BREXIT news.

Brexit has to be seen in a broader historical context...

Professor David T. Llewellyn (a former President of SUERF) outlined the tortuous procedures in the British government and Parliament which, at the time of the conference, had produced a stalemate. The issue needs to be seen in a historical context in that there has been a long-standing difference in perspective between the UK and the Continental view of European integration. The UK has viewed the EU as essentially an economic project whereas the Continental view has given as much, if not more, emphasis to the political dimension about which the UK has been more resistant. David Llewellyn argued that a central problem had been that, while the referendum had produced a narrow majority in favour of exiting the EU, no indication had been given as to the precise nature of the exit or what exit model was envisaged. At various times, the UK Parliament has discussed and voted upon eight alternative models ranging from what had been termed the *Common Market 2.0* model (the softest form of BREXIT) to exiting without a deal and defaulting to World Trade Organisation rules (at the other end of the spectrum). Llewellyn argued that the BREXIT debate was a mess and had proven to be

inconclusive with no majority emerging in Parliament or government for any of the alternative models including the deal that had been negotiated by the Prime Minister and which had been rejected three times in Parliament.

... and as a case study for decisions about insufficiently specified alternatives

The wide range of alternative models highlighted that, what might have appeared at the time of the referendum to be a simple choice for the electorate, the final decision would actually involve a complex set of economic and political trade-offs. The speaker also indicated that, in various ways, much of the debate was irrational not the least because the original debate at the time of the referendum was conducted in the absence of sufficient information about the consequences of whatever decision would be made. It is for this reason that there has evolved in the UK in some quarters a campaign for there to be a second referendum now that the implications of an EU exit are clearer and more information has become available. Llewellyn argued that, at the time of the conference, it was not at all clear what would eventually emerge with two extreme models (amongst others) both being possible: a revocation of Article 50 with the result that the UK would remain a member of the EU and, at the other extreme, a decision to leave without a deal and defaulting on WTO rules which, the speaker argued, was the most extreme model of BREXIT and would be the worst of all the possible outcomes. The economic impact of BREXIT would depend crucially upon which model would be adopted.

Brexit is a case study of the effects from populism

Minouche Shafik (Director of the London School of Economics) addressed three issues: the underlying causes of BREXIT in the context of the broader global issue of populism, the short-term contingency planning of the Bank of England, and the future long-term relationship between the UK and the EU. Regarding the underlying causes of the vote for BREXIT, this should be viewed in the broader context of global populism which has two key characteristics: anti-elitism and anti-pluralism. These focus on a narrow concept of “the people” and a narrow view of who represents the will of the people: those who are not “the people” are viewed as being against the people and this includes, for instance, the judiciary and independent central banks. The speaker argued that this is dangerous to democracy as it is anti a more pluralistic approach to interpreting the “will of the people”. There have been two drivers of this trend in the UK: economic insecurity (most especially in the post-crisis) period, and a feeling of there being a clear threat to identity as societies become more diverse in several dimensions such as religion and ethnicity. Ms Shafik argued that these trends were an important driver of the vote in the UK to leave the EU. The issues are complex and cut across conventional party political divisions. The divisions now are more to do with social conservatism versus social liberalism and is undermining the political system in the UK. However, the speaker argued that leaving the EU would do little, if anything, to address these underlying factors that led to a narrow majority to leave the EU.

Have markets fully priced in BREXIT? Which form of BREXIT?

Regarding the role of the central bank, following the vote the markets were focussed on sterling and the Bank of England had been successful in implementing measures (such as the enhanced provision of liquidity) to stabilise sterling in the foreign exchange markets. Regarding the future, the speaker judged that the markets have priced in a soft BREXIT outcome and that there will not be substantial implications for monetary and financial stability because of the forward planning measures of the Bank of England.

BREXIT may strengthen the view that Europe should develop as “concentric circles”

The third strand in the presentation was the future relationship between the UK and the EU in the broad context of how the EU is likely to evolve. Regarding the status of the euro zone, it is necessary to complete the project by further infrastructure measures regarding monetary union, banking union and capital market union. Minouche Shafik argued that there were some countries (perhaps Denmark, Sweden, and some countries in Eastern Europe) who would probably never join the euro project. The speaker suggested that we should view the future evolution of Europe in terms of concentric circles with a core, an outer core, and a third core of countries. Different frameworks are needed and it will be necessary to be explicit about the implications for each circle, the relationships between the three circles, and the “rules of engagement” between them. It will be necessary to clarify the framework of concentric circles in a way that will allow Europe to provide leadership in the world economy.

For a small country like Ireland, euro participation has many advantages

The third speaker, **Sharon Donnery** (Deputy Governor of the Central Bank of Ireland), began by signalling that the Central Bank of Ireland (CBI) has a broad mandate. Turning firstly to the significance of “the euro at 20” (the central theme of the conference) the speaker noted that for a small open economy such as Ireland, the benefits of the euro certainly outweigh the costs. The availability of euro system liquidity (in the period 2007-2009) provided an important buffer by replacing private funding with central bank funding. It was suggested that cross-border liquidity flows were not available to those other European countries that retained their own currencies but had significant foreign currency liabilities. Although their ability to devalue might have advantages in some circumstances, its immediate impact was to further exacerbate balance sheet problems in relation to foreign currency debts.

Among EU countries, Ireland is affected the most by BREXIT

Turning to the potential impact on Ireland of a possible BREXIT, the speaker noted that, given the close trading and other relationships with the UK, Ireland would be the country most affected except for the UK itself. Although the Irish economy is now far more diversified than in the past, the UK remains an important market for certain sectors and regions. The CBI analysis suggested that BREXIT could reduce the growth rate of the Irish economy by up to 4 percent in the first year. This would come about through a combination of heightened stress in financial markets, a depreciation of sterling, reduced investment by firms, lower consumer spending, and disruption at ports and airports. There were additional complications associated with deep supply-chain linkages.

The Central Bank of Ireland prepared for BREXIT very comprehensively

Given its wide range of responsibilities, the speaker indicated that the CBI had made every effort to ensure that the financial system has the necessary resilience to avoid financial stability risks in the event of a no-deal scenario. There had been engagement with financial firms focussed on ensuring that all necessary steps have been taken to mitigate the risks to their customers and businesses. No blueprint had been provided by the Central Bank as it is for firms themselves who must be responsible for their own plans in the context of their own risks. The speaker emphasised that, given the international nature of the Irish financial sector, the CBI cooperated closely with European partners. Various public authorities had put in place various measures to mitigate specific financial system concerns.

The UK is a close friend, ally and neighbour and its absence from the EU will be missed. The UK will remain a strong financial centre although some fragmentation around different centres will emerge. The speaker concluded that, during the BREXIT negotiations, there has been strong unity between members of the EU and that this suggests the future is bright for both the EU and the euro.

While the trade channel is important, financial and confidence effects from BREXIT may be more relevant

Recognising that, in the words of the song of the 1960s, “Breaking up is hard to do”, **Cecilia Skingsley** (Deputy Governor of the Swedish Riksbank) focussed on four issues: the economic consequences of BREXIT, the continuity planning, what can be learned from the issue, and what needs to be done by other countries. In Sweden, around 50 percent of GDP is related to foreign trade with six percent of exports going to the UK. This means that Sweden will be directly affected through the trade channel as the UK exits the EU. However, it would be the aggregated effects through financial markets, general confidence and spill-over effects from other trading partners that would be the main concern. On the assumption of an orderly BREXIT, the Riksbank’s base-line forecast is for a gradual slowdown in growth of the Swedish economy with a series of interest rate rises to maintain the inflation target. However, the Bank must be prepared for a more serious outcome and for monetary policy to be able to adjust to this. Regarding continuity planning, the Riksbank takes a similar view to most other EU countries and there have been extensive discussions with partner countries most especially with regard to funding conditions. In the event of a “no deal” outcome, it is imperative that the London clearing house remains open for foreign banks for another twelve months.

What to learn from BREXIT for other EU countries? Policies resonating better with the population

Regarding what can be learned from the experience, the speaker argued that BREXIT has not turned out to be the starting point leading to a SWEXIT. Support for membership of the EU has grown to an all-time high of 60 percent. However, this should not be interpreted as a strong support for joining the euro or getting further into a more political union. The BREXIT challenge also underlines the importance of developing policies that resonate with the greater part of the electorate. It would seem that the sovereignty issue turned into a pressure-cooker in British politics which led eventually to the referendum result. The sovereignty issue should have been addressed earlier and in a different way than through a referendum. The speaker emphasised, however, that developing policy that resonates with the population should not be confused with populism: It is more about defusing pressure within a policy area that otherwise builds up over the long term.

Non-integration is not the answer!

In conclusion, the speaker suggested that Sweden needs to rethink its role in the EU and what it wants to achieve. Staying outside international areas of cooperation and the banking union is a sure way to minimise influence over issues that have to be adopted in any case. With respect to the banking union, this is currently under consideration in a public enquiry process which will deliver results later this year. It remains an open question whether Sweden will join the Banking Union. A second issue is that the corporate sector will have good reasons to express an elevated mistrust of the public sector for some time to come. Corporations are complex with small margins operating in a competitive world. It is likely that we will see changes in global value chains with less of the just-in-time model. Countries with prudent institutions and gradual policymaking will benefit from this development.

Conference presentations are available at:

www.suerf.org/paris2019