Forging a new future between the UK and the EU

Key findings of a conference jointly organized[1] by SUERF and De Nederlandsche Bank

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Conference Report

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Brexit marks an unprecedented event in European history. While the United Kingdom has often been portrayed as holding back Europe, in has in effect in several key areas been on the forefront, notably pushing for deregulation, flexibility and deeper market integration. Moreover, when it comes to finance, London has a long history as Europe's main financial centre. To study implications from Brexit, the event brought together thought leaders from policy making, academia and industry. The conference focused on three themes: First, the future relationship between the EU and the UK in terms of trade arrangements, the impact of Brexit for the provision of financial services in the EU by UK financial firms, and broader implications of Brexit for the EU's role in the global financial system as well as for the euro's role as an international currency. Second, the rise of regional or spatial divergence and inequality, its reasons and possible countermeasures. Third, strategies to achieve the energy transition and the role of the financial sector and central banks in facilitating this transition.

1. The fixing of the date for Brexit has created clarity but many issues remain open – the EU and the UK will also in future share many interests and should maintain alliances

Klaas Knot, President, De Nederlandsche Bank warmly welcomed the opportunity of this joint event with SUERF. In his opening remarks he reflected on **"Interests and alliances"** between the EU and the UK. Overall, he offered an optimistic view on the future relationship between the UK and the EU, based on the shared interests and current and possible future alliances. Nations do not only have own interests but also many common ones. The EU and the UK continue to face very similar challenges and

[1] The conference was designed and organized by Jakob de Haan, De Nederlandsche Bank and SUERF, Ernest Gnan, OeNB and SUERF, Michala Marcussen, Société Générale and SUERF, and Yael Selfin, NIESR and SUERF.

opportunities. Achieving a deep post-Brexit trade deal, which includes financial services, is a key theme for 2020. A hard Brexit at the end of 2020 remains a possibility and could cut deep into foreign trade, much as if Britain were to leave the EU without a deal. Given the complexity of the issues, less than a year time for negotiations to achieve a Brexit deal is very short. In economic terms there may be little difference between a no-deal Brexit that could have occurred on 31 January, and a hard Brexit that could still occur at the end of 2020. This would happen if the EU and the UK were unable to agree on a timely trade deal and if no agreement could be reached on extending the transitional period beyond 2020. Trade between the EU and the UK may drop by an average of 20% in the years after a no-deal Brexit and even if a trade deal were agreed by end-2020 it is unclear whether it would cover the important services sector. From a central banker's and financial stability perspective, a deep and comprehensive trade-deal, including services, would be preferable. Whether this will be possible will depend on how far the UK is willing to align with EU regulation post-Brexit, notably in financial services. This should, however, in practice not be so difficult, given that much of EU post-crisis financial regulation has significantly been shaped by the UK, and since it is in the interest of the City of London to provide financial services in continental Europe also after Brexit. The Netherlands and the UK also share interest in dealing effectively with climate change, as evidenced by both the DNB's and the Bank of England's early and major involvement in the Network of Central Banks and Supervisors for Greening the Financial System.

2. Brexit is a lose-lose situation for both the City of London and continental Europe in terms of their roles in the global financial system

An important topic linked to Brexit concerns **implications for London and Europe with regard to their future role in the global financial system**. The topic was introduced by with a keynote speech by **Luis de Guindos**, Vice-President, European Central Bank, on **"Europe's role in the global financial system"**. Brexit has important implications for the EU financial system, most notably for capital markets, as London, though likely to remain an important global financial centre, will become less integrated with EU markets and firms. In the past, the EU has heavily relied on the City of London to provide financial market clearing and investment banking services, as well as advisory and financing services related to securities issuance, M&A and syndicated lending. The EU post-Brexit therefore needs to step up efforts to develop its domestic capital market capacities, given that non-bank finance has strongly increased in continental Europe since the GFC. The European Commission has therefore set up a high-level forum to develop the next Capital Markets Union Action Plan. Completion of European Banking Union becomes more urgent post-Brexit.

The contours of the future EU-UK relationship in financial services are still uncertain. The EU will need to balance the benefits of continued integration with the UK financial system against potential risks to financial stability, consumer and investor protection, a level playing field and the integrity of the Single Market. It should be ensured that the United Kingdom and EU Member States do not engage in a race to the bottom on regulation. If the UK were not to remain a member of the EU Single Market, it would move away from a fully-integrated relationship underpinned by the EU's single rulebook and single passport for financial services, and would rely instead on the EU's equivalence framework for third countries. For some types of financial activities, e.g. central clearing, this allows third country financial service providers to serve EU clients provided a number of strict conditions are met. There is, however, not automatic right for equivalence. By contrast, other kinds of financial activities, such as certain bank lending and deposit-taking activities, are not covered by third-country regimes and so can no longer be provided from the UK, but will need to be provided from within the EU. These considerations are already leading to the relocation of financial firms from the City of London to Germany, Ireland, the Netherlands and France. This is observed in banking, asset management and insurance, trading platforms, exchanges and the fintech sector.

David Miles, Professor, Imperial College Business School, in a second keynote speech on **"The City and the EU after Brexit; some (mainly pessimistic) thoughts"** drew a pessimistic picture regarding the impact of Brexit on financial services cross-border trade. London has been the place where a high proportion of financial services central for European stock, bond, derivatives and forex markets as well as many banking services are provided from. Over time, other financial centres could in principle take over these functions, but probably less efficiently and with transition costs. EU (UK as a rule-taker, preservation of the "pure" EU Single Market, no regulatory race to the bottom) and UK (outcomes based approach, a sort of enhanced equivalence, autonomy of law and rule making) negotiation positions are quite far apart for now. Considerations of net benefits in terms of economic welfare and non-economic factors (such as European security) seem of secondary nature. In Miles' reading, the UK in fact partly has tougher financial regulation than the EU (or would have preferred to have it); it views EU financial regulation and supervision rules shaped by national interests. In his view, the EU has made Brexit negotiations more protracted and the UK leaving more likely. He called for a more sympathetic and pragmatic line on financial services in the interests of both the UK and the EU but was pessimistic on whether this might happen. If no constructive agreement were found, the negative impact on the UK economy would according to Miles be moderate (around 0.75% of GDP). The move of financial sector employees from the City of London to continental Europe would render housing in London cheaper and on the continent more expensive. More financial firms on the continent would imply that smart young people would go into finance instead of science, medicine etc. It may be questioned whether these effects are considered desirable in continental Europe.

A panel, chaired by **Jakob de Haan**, further elaborated on **"The international role of the European financial system" and on the future possible role of the euro as an international currency**. **Lorenzo Bini Smaghi**, Chairman, Société Générale noted that **Europe is divided on whether it wants a stronger role in the international financial system and for the euro**. There will be no European Capital Markets Union without a safe asset and completion of the European Banking Union.

Iain Begg, Professor, London School of Economics and Political Science, gave a presentation on "London, the euro and the international role of the European financial system". A stronger international role of the euro needs a clear political wish for it among European leaders, the completion of EMU, of European Banking Union and European Capital Markets Union, as well as the creation of a European safe asset. Furthermore, an important incoherence will continue to **hamper a stronger global role of the euro**: For one thing, national priorities continue to dominate approaches to euro area governance. Notably, the conflict between calls for risk sharing versus calls for risk reduction remains unresolved. For another, divergent national economic developments inhibit common action while compliance with EU rules and processes remains unsatisfactory. Furthermore, a stronger global role of the euro would likely meet with resistance from the US and with competition from China. The **EU globally leads the protection of private data (GDPR)** - this may benefit (EU as standard setter forcing others to comply, extending influence on data) or hamper (competitive disadvantage relative to large US tech firms) the EU's role in global financial markets.

Richard Portes, Professor of Economics, London Business School, offered his thoughts on the "International role of the **European financial system: a macro-prudential perspective**". He emphasized the importance of global and domestic financial cycles and the vulnerability of individual countries to capital flows. Structural global imbalances and search for yield may generate vulnerabilities. Macro-prudential policies are potentially very powerful. But they should incorporate global developments and spillovers in their underlying analysis and design. Financial institutions generate, transmit and are affected by global financial risk. The EU has major systemically important banks and non-bank financial intermediaries. Macro-prudential monitoring in the EU should attach

importance to monetary developments in core economies and the global financial cycle. At the same time, the EU's macro-prudential policies should bear their own spillovers clearly in mind. Against this background, Portes argued in favour of Counter-Cyclical Capital Buffers for exposures to third countries, in order to increase resilience to external developments. Due to leakages and spill-overs from macro-prudential policies, stronger cross-border coordination should be considered. He concluded by wondering whether more centralized EU macro-prudential policies might strengthen the international role of the EU's financial system and whether the EU might take the lead in developing and implementing a macro-prudential toolkit for global non-bank financial intermediaries.

Phil Wooldridge, Head of Financial Markets, BIS gave an overview of the "International role of the European financial system through the lens of the BIS' Triennial Survey". The latter is conducted every three years since 1986 and provides a unique snapshot of activity in opaque foreign exchange and over the counter (OTC)derivatives markets by collecting data from 1300 dealers in 53 countries on instruments, currencies, counterparties, maturities and execution method. The 2019 survey shows that OTC markets continue to grow both in interest rate derivatives and foreign exchange trading and are propelled by offshore trading. Foreign exchange turnover is strongly influenced by rules on offshore trading. Clearing helps contain derivatives trading volume. London is the global centre for offshore foreign exchange trading.

Lorenzo Bini Smaghi

Richard Portes

Phil Wooldridge

Iain Begg

Andy Haldane

3. **Regional inequality is an increasing concern and may contribute to populism and anti-EU sentiment; underlying reasons are complex, and so are policy measure to address it**

A topic which is gaining increasing attention not least because it may contribute to the rise of populism and supported the vote for Brexit by the British electorate is **inequality among regions** within countries and across the EU. **Andy Haldane**, Chief Economist, Bank of England and Chair of the Government's Industrial Strategy Council, introduced the topic with his keynote speech on **"Spatial inequality"**. Economic development and growth differ vastly within countries. Politics is well advised not to neglect this. It is not straightforward to identify metrics to gage whether a region is doing well or badly. Wealth, health and happiness are possible examples for different metrics, which yield vastly different results in terms of rankings. For instance, London, among the most productive and richest regions in Europe, ranks low in terms of wellbeing (life satisfaction), not least due to long commuting times. Across UK regions, the level of productivity, while positively correlated with education, disposable income, life expectancy, employment and voter turnout, is negatively correlated with rooms per person, perceived social network, life satisfaction, and homicide rates. Besides the level of the various indicators, also their dynamics are relevant. Within cities like London, divergence in various indicators of wellbeing such as health can differ vastly across areas in close vicinity. **To gage citizens' well-being, complex needs need to be identified**. These include transport and connectivity, schools and education, shopping and social places, jobs and skills, money and finance, and housing and shelter. Middle England fares badly in terms of education levels, jobs and skills, as well as productivity levels. By contrast, some remote rural areas score very well in terms of social infrastructure. **Regional disparities are increasingly recognized as important also in economics**. This is reflected in recent endeavors to construct less aggregated heterogeneous agent and highly disaggregated agent-based models. The availability of microdata and the computational ability to deal with them opens new avenues for economic research which should be actively pursued, to define, e.g., "optimal policy areas" and the role of local versus national strategies.

A panel chaired by **Yael Selfin**, Chief Economist, KPMG, Research Fellow, NIESR, and SUERF, elaborated on **how to tackle (regional) inequality**.

Joaquim Oliveira Martins, Deputy Director, OECD, supplemented Haldane's analysis in a presentation on **"Tackling regional inequality in the UK"**. The productivity divergence in the UK between frontier (mostly Greater London) and lagging regions widened strongly in the 15 years up to the outbreak of the Global Financial Crisis (GFC), then remained roughly stable and widened again since 2015. In France divergence happened mostly in the post-2007 half-decade. By contrast, Germany experienced marked convergence in productivity across regions, with frontier regions roughly stagnating since 2000, while lagging regions gained 25% in productivity since 2000. In Poland, both frontier and lagging regions experienced strong productivity gains, which went hand in hand with marked convergence across regions. There are **two polar policy approaches to address regional divergence**: a) compensating lagging regions and promoting labor mobility. This does not work in the long run, leads to the "geography of discontent" and the "revenge of places that don't matter". The UK has such a compensatory model. b) Adopting a place-based approach for regional productivity developments. The required development of tailored strategies is in practice quite demanding, and is too complex to be handled centrally alone. Partnerships between central government and partial delegation to the local level, allowing for local capacities and for experimentation, seem promising. A **national spatial productivity strategy** should aim to benefit from agglomeration economies, notably in services, in large and dense urban areas. Developing the tradable sector plays a key role for productivity catching up. For remote rural areas smart specialization may be the way to go.

Anthony Venables, Professor of Economics, Oxford University, observed that cities' productivity premium hinges on agglomeration effects, and a focus on tradable goods. It is hard to get out of downward cycles for cities mostly producing non-tradables. **Most conventional regional policies are not helpful.**

Zsolt Darvas, Senior Fellow, Bruegel, gave a presentation on **"EU wide income inequality and regional development"**. Net after taxes and based on individual data across the entire EU, and based on the Gini coefficient, income inequality in the EU has been falling since 1988 (with the exception of a temporary slight increase between 2010 and 2012). This trend is driven by developments across and within EU countries: Income convergence reduced EU28 income inequality, while within-country inequality increased until 2012 and stabilized thereafter. This contrasts with the US, where after tax and social transfer-income inequality has continuously increased since 1980 until now. Comparing economic growth across regions should correct for initial conditions. Controlling for them, Darvas isolated "unexplained" growth and found that good growth performance is spread across countries (there are rather successful regions in 21 of the 28 EU countries), while bad performance is more concentrated (in half of the EU countries). Greece is special in having suffered particularly severely after 2008. While being generally rather skeptical on the overall effectiveness of the EU's cohesion policy, Darvas found that the best performing regions have EU cohesion projects with longer durations, clear priorities, an inter-regional focus, a high proportion of non-research NGOs, academia or the private sector (as opposed to public sector entities) among beneficiaries, more national (as opposed to regional or local) management, and higher total as well as per capita Cohesion Fund funding.

Charles Goodhart, Emeritus Professor, LSE, and SUERF Fellow, followed up with a presentation on "Regional inequality". In his view, **regional inequality is caused by a combination of demography, globalization and technology**, whose effects were not sufficiently offset by policy. As demography is reversing, globalization is waning, and policy might improve, the worst might be over and the key question is which effects technology might have in the future. The working age population in CESEE and China is going to decline in the decades to come and its rate of increase is going to fall in India and Asia excluding China. Dependency ratios in developed economies are going to worsen over the next two decades, more so in Japan and Germany than in the US and the UK. Trade union density has been falling in developed economies since the 1980s, depressing wage developments. The education gap in wages has accumulated since 1980, more so among men than among women.

Zsolt Darvas

Joaquim Oliveira Martins

Anthony Venables

4. Climate change: a topic both relevant for the EU and the UK post-Brexit

Dirk Schoenmaker, Professor, RSM, Erasmus University Rotterdam, and SUERF Fellow opened the debate with a keynote address on **"Financing the low-carbon transition"**. For successful energy transition, you need to link the activities needed for the energy transition and their financing. **Coordination** between public and private actors needs to be improved. A **step-wise** approach is needed to scale-up green finance. Particularly in the initial experimental high-risk phases of transition projects the public sector needs to involve itself actively. Development banks such as the EIB have an important role to play. As projects mature, the private financial sector can take over and the public sector can retreat. Outdated energy systems need to be phased out starting with cutting subsidies, pricing in externalities and stricter regulation. A combination of taxing high-carbon activity and support for upcoming sustainable energy is needed. Those affected most by the energy transition need help. On the finance side, brown sectors need to face higher financing costs and even exclusion from certain sources of finance. Over time, this will lead to optimization and ultimately to a phasing out of these industries. De-carbonization so far is by no means on its way. As things stand, the role of fossil fuels will further increase by 2025 globally, reach a plateau by 2030 and only slightly decline by 2040, while the role of renewables will increase only slowly. The energy transition needs to overcome both societal and financial hurdles. International, national and subnational actors need to be involved, in public administration, the financial and corporate sectors and in civil society. The gap between small entrepreneurs with more skills than funding and large investors with more financing than skills needs to be overcome through a **tiered system of financing**. The "**icebreaker model of blended finance**" involving financial investors and social investors; debt, equity, grants and technical assistance; and both financial and non-financial forms of return is a promising avenue. This approach also makes it possible to reflect important non-financial returns in business case evaluations. Schoenmaker concluded with eight recommendations for national, sub-national governments and the financial sector to pursue this route.

A panel chaired by **Michala Marcussen**, Group Chief Economist, Société Générale, and SUERF Vice President, elaborated further on the topic of climate change. **Dirk Schoenmaker** opened the panel with a presentation on "Greening Monetary Policy": The ESCB's secondary objectives cover the support of climate protection. This must and can be without interference with the primary object of price stability, and with the aim of market neutrality. A greening of central bank frameworks should, in order not to impair the monetary transmission mechanism, observe two principles: first no adjustments in the asset mix, in currency denomination and maturity; second, keeping the list of eligible assets as broad as possible to minimize distortionary effects on markets. In line with these principles, rather than categorically excluding certain brown assets or focusing exclusively on assets with the best green scores, Schoenmaker proposed that central banks should "**tilt** their **portfolios towards low carbon assets**", i. e. overweight green assets in their portfolios and operations. This would lower financing costs for green firms and help create a critical mass of green investors. Central banks should, however, refrain from financing specific projects or follow sectoral targets; this is for government to do.

Aerdt Houben, Director Financial Markets, De Nederlandsche Bank agreed that **central banks can support greening the financial system** by 1. adjusting monetary policy operations, 2. climate transparency requirements on financial firms, 3. own reserve investment policy, 4. supervisory policies. **Heather Gibson**, Director, Economic Analysis and Research Department, Bank of Greece, explained that climate change and decarbonization involve high "Knightian" uncertainty. Returns from green finance need a long-term perspective. Central banks must make sure their assets and collateral price in climate risk appropriately.

Heather Gibson

Dirk Schoenmaker

Aerdt Houben

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Overall, the conference highlighted that while the final decision on Brexit has created clarity, many open issues remain for the time being. Given the complexities and strongly opposing positions, negotiations for the Brexit deal will be difficult to complete by end-2020; a hard Brexit can therefore still not be ruled out at end-2020. Brexit notwithstanding, important challenges such as (regional) inequality and climate change will remain burning issues both in the UK and the EU and need to be urgently addressed. Central banks are currently (re)defining their roles in climate protection but it is clear that their role can only be an accompanying one, while the bulk of measures need to be taken by governments, through regulation and taxation. While obviously not being able to provide full answers, the conference brought together policy makers, the financial sector and academic researchers helping them to identify urgent and controversial issues and to achieve an overview and a synthesis of views on the topics discussed. SUERF thanks members of the scientific committee, speakers and the DNB as hosting institution for their dedication in enabling this event, as well as event participants for their many important points raised and the lively discussion.

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About the authors

Jakob de Haan is Head of Research of De Nederlandsche Bank and is also Professor of Political Economy, at the University of Groningen. He has been Scientific Director of SOM, the graduate school and research institute of the faculty of Economics and Business of the University of Groningen. He graduated at the University of Groningen, where he also received his Ph.D. He has published extensively on issues like public debt, monetary policy, central bank independence, political and economic freedom and European integration. He is member of the editorial board of Public Choice, and European Union Politics, editor of the European Journal of Political Economy, and has been President of the European Public Choice Society. De Haan has been visiting professor at the Free University Berlin (2003/4), Kiel Institute (2002, 2010), and the University of Munich (1999). He is also research fellow of CESIfo and since May 2018 President of *SUERF – The European Money and Finance Forum*.

Ernest Gnan is Head of the OeNB´s Economic Analysis Division. Dr Gnan is also member of the European Central Bank´s Monetary Policy Committee and expert member of the Austrian Fiscal Council. Since 2006, Dr Gnan has also served as Secretary General of SUERF. Since 2005, he has been lecturer at the University of Vienna, and since 2006 lecturer at the Austrian Academy of Accountants.

Michala Marcussen assumed the role of Société Générale's Group Chief Economist in September 2017 and leads a team of over 30 economists and sector engineer's in her role as Head of Economic and Sector Research in the Risk Division. She is a member of Société Générale's Group Management Committee and has been with the SG Group since 1994. With over 30 years of experience in the financial industry, she is a frequent commentator in the economic debate. Michala Marcussen holds a Master of Science in Economics from the University of Copenhagen and is a CFA charterholder. Michala is also Vice President of *SUERF – The European Money and Finance Forum*.

Yael Selfin is Chief Economist at KPMG in the UK. Her research centres on the impact major issues including Brexit and other geopolitical events are likely to have on the economy as well as on individual businesses. Prior to joining KPMG in 2014 she worked at two independent economic consultancies as well as at PwC for over 14 years, where she set up and led their Macro Consulting business, as well as oversaw their international economic research. She has a BSc in Economics from UCL and did further studies in Advanced Econometrics at LSE. She also has a Chartered Accountant qualification.