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ON THE EU AFTER BREXIT

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Brexit

Great uncertainty still surrounds the likely course of the UK government regarding its future relations with the EU. On this, for the time being, Ms. May has no mandate, and her government needs time to evaluate the different scenarios. For this reason, Article 50 may not be invoked for some time—most people think not before the year's end or early next year. However, I see no purpose in toying with the idea that Brexit will not happen–an unlikely development that would tear apart the broken tapestry of British politics even more.

The European Council has thus far only taken a stand on procedure. Article 50 negotiations for extricating the UK from the EU and the negotiations on a new relationship will have to remain separate, with the former preceding the latter. While Ms. Merkel has stated that "there is no reason to be nasty," she was clear on there being no room for "cherry picking". In all likelihood, the Council will not take any initiative until the notification is received.

Uncertainty is probably the single most important variable in determining the immediate cost of Brexit to the British economy—especially its impact on investment. However, after some initial overshooting, it now appears that financial markets are not overreacting.

The greatest challenge for Ms. May is preserving the success of the UK's giant financial services industry, which grew thanks to access to the Single EU Market and the euro. These are two factors that turned London into Europe's financial centre, home to the vast pan-European market for equity, bonds, and derivative-based hedging products. Thanks to the EU's freedom of movement of capital, services, and people, financial service providers and direct investors used London as the gateway for accessing the vast EU Internal Market. Financial services also are a major source of the UK's trade surplus with the rest of the world (£ 72 billion) and the EU (£ 19 billion), which help reduce the large deficit in its balance of payments (4 to 5% of GDP). It should be stressed that, in this area, freedom of movement for

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people is quintessential to the freedom to provide services, as the two can hardly be separated.

Most important will be the future of cross-border banking services. There are 489 foreign banks registered in London, of which 183 are from the EU. Will they be allowed to continue operating from London into the EU markets under the same rulebook as today, or will they be forced to set up separately capitalized subsidiaries to operate within the EU? Or, will they simply move their activities to the Continent if London loses its unfettered access to the EU? Should the UK lose Internal Market (IM) access, the repatriation of euro clearing of securities trades would probably be unavoidable, with significant loss of activity for the City.

Trade relations with the EU in manufacturing are also very important for the UK (about half of their total trade is with the EU). Should they lose their IM access, they might have to confront the EU external tariff (e.g. 10% tariff for cars), pushing global manufacturers to relocate within the EU.

Against this background, there are two main camps within “Leave.” On the one hand, the “liberal” leavers stress the need to aggressively open up the British economy to the rest of the world, with the aim of making the UK akin to a giant Singapore or Hong Kong. On the other hand, the “protectionist” leavers advocate protecting low income earners and curbing migration.

As far as we can tell, Teresa May might lean in the latter direction. As home secretary, she was tough on migration even at the expense of the economy. For instance, she supported limiting visas for fee-paying university students and showed great reluctance to guarantee the status of the three million EU citizens living in the UK. She even claimed, at one point, that, under Labour, the asylum system had been “just another system of getting here to work.” She has also shown a worrying tendency to meddle in markets–for example, by suggesting limits on foreign takeovers of British firms, as well as stronger limits on managers’ pay and worker participation in company boards. She also seems to favour some kind of “industrial policy.”

Clearly, the UK will face a trade-off between maintaining market access to the EU and curbing immigration of EU workers. If new restrictions on EU nationals already working in the UK are sought after, then the exit negotiations will also involve some sour components on the future status of approximately two million British citizens who work and reside in the EU. If the UK decided to exit the EU Internal Market, then it might have to renegotiate trade relations not only with the EU, but also with some 142 countries that were concluded under the EU umbrella. As these negotiations would take time, and Article 50 negotiations must, in principle, be concluded within two years from notification of the intention to exit (an extension is possible but requires unanimity in the European Council), then the UK might, at some stage, find itself out in the cold with only the protection of World Trade Organization (WTO) rules.

A way out might exist. Former prime minister and chancellor of the exchequer Gordon Brown recently suggested that the UK could leave the EU but remain a member of the European Economic Area, which currently includes EU members along with Norway, Iceland, and Lichtenstein. The EEA provides for the IM’s Four Freedoms, while leaving out the Common Agricultural and Fisheries Policies. The EEA Treaty also contains a safeguard clause (Article 112) whereby a member state may suspend part of the EEA freedoms when faced with extraordinary economic disturbances. In this manner, the UK may obtain the “emergency break” for migrants from the EU without losing access to the IM, which it had sought without success in the negotiations with the EU last year (although other EEA members are allowed to retaliate, per Article 114 of the Agreement).

However, EEA membership has the unpalatable feature of requiring the UK to obey EU laws and contribute to the EU budget, while losing all ability to influence EU decisions—a deficit that may become especially unsavoury for banking legislation.

What is next for the EU and the eurozone?

The damage inflicted by Brexit on the EU has three main dimensions. The first is the loss of an important neighbour, economic partner, financial centre, and defence and security player, as well as a key go-between with the United States. Damage limitation would perhaps be easier on security and defence issues, where common interests remain very strong and popular opposition is not significant, than on the economic front, where the legacies of the electoral campaign will weigh heavily on the UK government, limiting its freedom to manoeuvre in the upcoming negotiations. The blow is especially hard on Germany, which always found in the UK steady support on key policies, from austerity to sanctions on Russia to the refugee deal with Turkey and, in general, to Germany's liberal economic policies.

The second (potential) damage is the risk of political contagion. Brexit represents the first strong anti-integration shock since World War II, and anti-integration movements and parties in Europe are already seizing the occasion to raise the volume of anti-EU campaigns. The evidence that the door may be open for exit could feed anti-EU sentiments, which are already running strong because they reflect a strong undercurrent of anti-globalization sentiments that have been building up for some time in all advanced countries. The general perception is that not only has the EU failed to respond to its citizens' requests for protection and security, it also unduly constrains national governments from acting freely in their search for solutions. The popular rejection of trade deals (CETA, TTIP) and a wave of anti-EU referenda (Denmark, the Netherlands, Hungary) are clear signals of a general rejection of integration policies that can hardly be underestimated.

Thus, it is not surprising that there is little appetite in member states and amongst the larger public for new initiatives for institutional reform (treaty changes). However, unless the EU shows some ability to respond to popular demands for policies more responsive to the predicaments of the working class, notably, but not only, in the peripheral countries, the EU may not withstand the brunt of the coming electoral cycle (Austria first, and then the Italian referendum on constitutional reforms in October, French presidential election in the Spring, and German general elections in September).

Which brings me to the third potential damage of Brexit. The sense of urgency in EU capitals is turning into a push to find intergovernmental solutions, and, hence, the emerging tendency is to weaken common institutions rather than strengthen them. This is most visible with migration policies, where German impatience with the baroque decision-making procedures in the Council, the resistance by many member states against the implementation of common decisions, and the weakness shown by the Commission in enforcing common decisions have already led to strong public statements to the effect that governments are ready to take matters into their own hands if the Commission fails.

Similar trends are emerging in the domain of common economic policies, where there has been little progress in bridging the different national approaches in a climate of growing mistrust in common institutions.

To an important extent, popular discontent in many countries still suffering high unemployment and burgeoning areas of poverty and social exclusion reflects failed economic policies, i.e., failure to protect the losers from globalization and to provide reassurance and security in the face of strong migratory flows. The relationship between core and periphery within the EU is badly strained by low growth, on one hand, and very low interest rates on the other. The former is a promise that the plight of those suffering from acute deprivation will not be tackled; the EU is seen more as an obstacle to addressing these perceived wrongs, with its strict budgetary and state aid rules, than a source of help. Additionally, interest rates are expected to remain low for a long time, leaving little prospect for decent incomes for savers and threatening the very survival of the financial industry in high savings countries.

Moreover, in Germany and other 'core' countries, low interest rates are seen as a consequence of the European Central Bank's expansionary monetary policies–economic nonsense, as they are, first and foremost, the consequence of excess savings. This perception may one day limit the ECB's ability to respond to a new idiosyncratic shock hitting one of its members, as was the case in 2010-12. Thus, even the ECB's ability to cope with a new sovereign crisis may be weakened.

In reality, it should be self-evident (but isn't, unfortunately, in some member states) that these strains cannot be tackled unless the issue of growth can find greater room in the EU economic agenda. Public investment needs to be increased throughout the EU, and if budgetary conditions make it impossible to so at a national level, then a large European investment programme financed by the EU through common bonds should be an option. Given the low interest rates, this would not entail any net increase in overall public debt, provided the money is deployed for projects with adequate returns. The refusal to use bond financing for public investment is, of course, a mistake on purely economic grounds, since it means that the current generation is asked to finance projects with returns stretching into a distant future, for which future generations may well be asked to contribute.

Meanwhile, market opening in the IM in the key network utility services (telecom, transport, and energy), and in services in general, have stalled, depriving the EU economy of valuable opportunities for private investment and higher incomes from valuable new services.

Worrying trends are also emerging in economic governance, where we have been witnessing a tendency to reduce cooperation in the management of common economic policies and to let risk management revert to individual member states, even to the point of envisaging automatic debt restructuring for countries in need of financial assistance. There is a loss of confidence in common institutions, which is driving requests to bring policy management into intergovernmental fora (e.g., bringing the European Stability Mechanism under the control of national governments, at the expense of the Commission, which is increasingly seen as too lenient when enforcing budgetary and economic discipline).

It is necessary to recognize that all attempts to put economic policies on autopilot are bound to fail; the solution to the present predicament is not greater decentralization with automatic adjustment, but, rather, greater centralization of decision-making with broader discretionary powers. In this context, the notion of creating a EU minister of finance, who is endowed with true executive powers to implement and enforce common economic policies, has been raised again in a joint note by the central bank governors of France and Germany but has not yet been pursued. This would be a much preferable direction for change, to the extent that it could simultaneously bring about greater credibility and the necessary flexibility in the implementation of common economic policies.

Finally, let me touch briefly on the issue of the European Monetary Union and the Banking Union. Here, too, the recent trend has been one of paralysis and bitter disagreement. The Economic and Financial Affairs Council (ECOFIN) has gone as far as publicly announcing that negotiations on a cross-border deposit insurance (the European Deposit Insurance Scheme) are frozen until a sufficient amount of risk reduction in the banking systems of member states is achieved. In practice, the Italian government managed to block active consideration by the ECOFIN of measures to encourage the reduction of the sovereign debt exposure of its banks, and, as a result, the negotiation on EDIS has stalled.

EDIS, however, is needed to protect the eurozone from severe liquidity crises hitting the banking system as a whole in one country, which, given the current fragile state of many banks, would have been a highly desirable feature of the EMU. Thus, the ECOFIN announcement may play out as a notice to investors that the field is open to fresh speculative attacks on peripheral banks (and sovereigns); investors may now only be waiting for a trigger to coordinate expectations and start the run. The Italian referendum on constitutional reform in October may provide that trigger. Should it be rejected by voters, the country may be thrown into a new phase of political instability and ineffective government.

Once again, the Council has failed to find sufficient common ground to provide EMU institutions with adequate arrangements for risk sharing, and the system remains exposed to a fresh "bad shock". On this, I would like to recall an important feature of functioning federal monetary unions, which is very well illustrated in American history.

The key point is that a federal monetary union requires a no-bailout rule for sub-federal governments, which the EU has in its Treaty but was circumvented de facto during the sovereign debt crisis and must be credibly restored. It is important to realize that the no-bailout rule entails sub-federal sovereigns becoming risky paper, subject to the risk of insolvency and restructuring. However, fractional reserve banking systems cannot function without safe assets for banks to hold as liquidity reserve. In the US, ever since Alexander Hamilton's "assumption" of state debts after the War of Independence, this safe asset is supplied by the federal government.

The EMU cannot function without such a safe asset, which would need to be issued by a European institution. This function could perhaps be played by the ESM, which is emerging as the candidate for wielding the EMU's fiscal power. Once the EMU possesses its own debt instrument, the ECB can use it to guide financial market conditions; it could also be utilized to manage the common aggregate fiscal policy, once one can be agreed upon by the EU Council.

In sum, a functioning EMU cannot escape, in the end, adequate risk sharing arrangements (which does not necessarily entail transfers other than the transfer of risk amongst member states). This will not be feasible without strict budgetary discipline and the no-bailout rule for sovereigns. However, once this is in place, the system would also require a common bond to simultaneously provide the safe assets that banks need to function and the risk sharing the financial markets demand in order to have full confidence in the EMU. Once we get there, there will be no more bad shocks threatening the survival of the EMU and the system will be financially stable.