The EU after Brexit
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Brexit

Great uncertainty still surrounds the likely course that the UK government will take regarding the future relations between the UK and 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 notification may not come for some time, most people think not before year-end or early next year. However, I see no use of toying with the idea that Brexit will not happen: it is a distant possibility, and would tear apart even more the broken tissue of British politics.

The European Council has so far only taken a stand on procedure: Article 50 negotiations for extricating the UK from the EU and the negotiations on a new relation will have to remain separate, and the former precede the latter. Merkel has added that “there is no reason to be nasty” but that there will be no “cherry picking”. In all likelihood the Council will not take any initiative till the notification is received.

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

The greatest challenge for Ms. May is to preserve the success of the UK’s giant financial services industry – which grew up out of access to the Single EU Market and the euro. These are the 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 freedom of movement of capital, services and people, financial services providers and direct investors used London as the gateway for access to the vast EU Internal Market. Financial services also are a major source of trade surpluses with rest of the world (£ 72 billion) and the EU (£ 19 billion) in the context of large deficits in the rest of the BOP (5% of GDP). It should be stressed that in this area freedom of movement for people in quintessential to freedom to provide services, 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

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Internal Market (IM) access, then the repatriation of euro clearing of securities trades would probably be unavoidable, with significant loss of activity by 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 confront the EU external tariff (e.g. 10% tariff for cars) – pushing global manufacturers to relocate within the EU.

Against this background, two main strands in the "leavers" camp: on one hand those who stress the need to open up aggressively the British economy to the rest of the world, so as to become a sort of giant Singapore or Hong Kong (the "liberal" leavers); on the other hand those that stress the need to protect low income earners and curb migration (the "protectionist" leavers).

From what we see, Teresa May my rather lean in this latter direction: as home secretary she was hard on migration even at the expense of the economy – for instance by limiting visas for fee paying university students, or showing great reluctance to guarantee the status of the 3m EU citizens. She even claimed at some point that under Labour the asylum system had been "just another system of getting here to work". She has also shown a worrisome tendency to meddle with markets – for example by suggesting limits to foreign takeovers of British firms, stronger limits to managers' pay, and even workers participation in company boards. She seems to favour some kind of "industrial policy".

Clearly, the UK will confront 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 the (about) 2m Britons working and residing in the EU. If the UK decided to exit the EU IM, 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, by requires unanimity in the European Council), then the UK might at some stage find itself out in the wild with the only protection of the WTO rules.

Some way out may be available. Former PM and chancellor of the exchequer Gordon Brown has recently suggested that the UK could leave the EU but remain a member of the EEA (currently including EU members and in addition Norway, Iceland and Lichtenstein) – which comprise the IM Four Freedoms, and leave out the Common Agricultural and Fisheries Policies – and thus be allowed to utilize the safeguard clause existing in the EEA Treaty (Article 112) whereby a member state may suspend part of EEA freedoms in the presence of extraordinary economic disturbances. In this manner, the UK may obtain the "emergency break" of migrants from the EU without losing access to the IM – as it had sought without success in the negotiations with the EU last year (but then other EEA members are allowed to retaliate, Article 114 of the Agreement). Brown also suggested that the UK could seek some arrangement similar to that enjoyed by Lichtenstein – which permit some permanent restrictions on entry of foreign workers, but apply to a very small country in rather special circumstances.

However, EEA membership has the unpalatable feature that the UK would continue to obey EU laws, and contribute to the EU budget, while losing all ability to influence EU decisions; a situation that may become especially unpleasant for banking legislation.

What next for the EU and the eurozone

The damage inflicted upon the EU by Brexit has three main dimensions. The first one is the loss of an important neighbour, economic partner, financial centre, and defence and security player, as well as 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 freedom of manoeuvre in the coming 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 refugees 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 WWII, and anti-integration movements and parties in Europe are already seizing the occasion to raise the noise 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, while the general perception is that not only the EU has failed to respond to the quest for protection and security of its citizens, but that it constrains unduly national governments' freedom of action 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.

It is thus not surprising that there is little appetite in member states and amongst the large public for new initiatives of institutional reform (treaty change). However, unless the EU shows some ability to respond to popular demands for policies more responsive to the predicaments of the working classes, 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 institutional reforms in October, France 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 them rather than make them stronger. This is most visible with migration policies, where German impatience with the baroque decision-making procedures at 27, the resistance by many a 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 effects that “governments are ready to take matters in their hands in case the Commission didn’t manage”.

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 swelling areas of poverty an 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 migration flows. The relation 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 plights of those that those suffering from acute deprivation will not be tackled; and the EU is seen more as an obstacle to address these plights, with its strict budgetary and state aid rules, than a source of help. And low interest rates are expected to last for a long time, leaving little prospect of decent incomes for financial 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 ECB expansionary monetary policies – economic nonsense, they are first and foremost the consequence of excess savings – which however may one day come to limit the ability of the ECB to respond to a new idiosyncratic shock hitting one of its members, as in 2010-12. Thus, even the ability of the ECB to cope with a new sovereign crisis may be weakened.

In reality, it should be self-evident (but it isn’t, unfortunately, in some member states) that these strains cannot be tackled unless the question of growth can find greater room in the EU economic agenda. There is a need to increase public investment throughout the EU – and if budgetary conditions make it impossible to do it at national level, then it should be possible to consider a large European investment programme financed by the EU with of common bonds. Given the low level of interest rates, this would not entail any net increase in overall public debts, provided the money was deployed for projects with adequate returns. The refusal to use bond financing to finance public investment is of course mistaken on purely economic grounds, since it means that the current generation is asked to finance projects with returns stretched 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.

Worrisome 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 risks management reflow 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.

the ESM, under national governments' control, at the expense of the Commission, increasingly seen as too lenient in enforcing budgetary and economic discipline).

There is a need to recognize that all attempts to put economic policies on automatic pilot are bound to fail – that the solution to the present predicaments does not lie in greater decentralization with automatic adjustment, but greater centralization of decision-making with broader discretionary powers. In this context, the question of creating a EU minister of finance endowed with true executive powers to implement and enforce common economic policies has been raised – among others, in a joint note by the central bank governors of France and Germany – but not yet pursued. It seems to me this would be a much preferable direction for change, to the extent that it could at the same time bring about greater credibility and the necessary flexibility in the implementation of common economic policies.

Finally, let me touch briefly upon the issue of EMU and banking union. Here too the recent trend has been one of paralysis and bitter disagreement. The ECOFIN Council has gone as far as to announce in public that negotiations on a cross-border deposit insurance (EDIS) are frozen until a sufficient amount of risk reduction in the banking systems of member states can be 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 result the negotiation on EDIS has stalled.

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

Once again, the Council has failed to find sufficient common round 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 by American history.

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

EMU cannot function without such a safe asset, which therefore would need to be issued by a European institution – a function that perhaps could be played by the ESM, which is emerging as the candidate fiscal power of EMU. Once EMU posses its own debt instrument, this could be utilized by the ECB 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 other transfers than the transfer of risk amongst member states). This will not be feasible without strict budgetary discipline and the no-bail out rule for sovereigns; but once this is in place, the system also require a common bond to provide at the same time the safe assets that banks need to function and the risk sharing the financial markets demand to have full confidence in EMU. Once we get there, there will be no more bad shocks threatening the survival of EMU and the system will be financially stable.