Philip R Lane: The European financial system after Brexit

Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, at Reuters Newsmaker Event, London, 28 October 2016.

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Good morning! I can think of no better location to speak about the implications of Brexit for the European financial system than here in Canary Wharf.

Before I turn to my main topic, let me briefly mention a few points in relation to the near-term implications of Brexit. First, while the economic and market reaction to Brexit has been relatively orderly so far in the UK and the rest of the EU (in part due to the monetary accommodation provided by the Bank of England and the easing of yields across Europe), the transition towards the phase of active UK-EU negotiations that will begin in Spring 2017 may trigger a more substantial re-assessment of post-Brexit economic prospects. In particular, if the momentum in the negotiations is in the direction of a more severe form of Brexit, this may damage consumer and investor confidence. While the effects might be qualitatively similar in both the UK and the wider EU, it is likely that the impact will be asymmetric, in view of the relative size of the UK and EU economies.

Second, the large movement in the Sterling-euro exchange rate represents an important stabilising mechanism by which the equilibrium real exchange rate depreciation associated with the downward shift in the relative economic prospects for the UK is partly attained through a step adjustment in the currency. It also shifts the financial terms of trade, with UK owners of foreign-currency assets enjoying a valuation gain. While incumbent foreign holders of Sterling assets have suffered a valuation loss, the decline in Sterling may entice new foreign investors attracted by the decline in the relative price of UK assets. Finally, in relation to the exchange rate, it is important to keep in mind that the recent depreciation of Sterling against the euro is in the wake of a sustained appreciation phase between early 2013 and the middle of 2015.

Third, the extensive linkages between the UK and Ireland mean that Irish economic performance is especially sensitive to shifts in UK output levels and the Sterling-euro exchange rate. Accordingly, the Central Bank of Ireland has adjusted its 2017 growth forecast from 4.2 percent to 3.6 percent. The scale of this revision shows the material impact of Brexit on the Irish economy; at the same time, the Irish economy is far more diversified today than in the past, so that Brexit is just one factor among many in determining overall economic performance. Still, we view Brexit as a major downside risk for the Irish economy and will be closely monitoring developments in the UK economy as the full impact of Brexit takes hold.

Let me now turn to the primary goal of my speech, which is to discuss the potential implications of Brexit for the configuration of the European financial system, with a primary focus on the euro area. If the UK-EU negotiations deliver an agreement that effectively preserves the single passport for UK-resident entities selling into the EU, the net impact of Brexit on the structure of the European financial system might be quite minor. However, in scenarios in which UK-resident firms are no longer treated as equivalent to EU firms for regulatory purposes, it is likely that significant migration of financial activity from the UK to the EU will occur.

In particular, it is plausible that a larger fraction of trade in euro-denominated financial instruments will take place inside the euro area, with ancillary implications for the location of financial lawyers, professional services firms, central counterparties, clearing services and settlement services. In order to more easily meet regulatory requirements, there may also be shifts in the organisation of the banking groups. In addition, we may expect to see non-EU banks looking to set up subsidiaries in the EU and EU-resident banks possibly converting UK branches into subsidiaries.

In the post-Brexit environment, it is unlikely that financial activity will cluster in a single location in the euro area, since no individual location offers a close substitute to London. An open question is whether the decentralisation of the European financial system will impose significant efficiency costs. Once a location is established as a dominant financial centre, there are many self-reinforcing factors that help it to maintain a hegemonic position. Most obviously, a deep labour market for financial-sector workers and a localised stock of intangible financial knowledge are highly attractive both for new financial firms and new entrants to the labour market.

However, if a shock fundamentally disrupts this equilibrium configuration, it does not follow that a new dominant location will inevitably emerge, since there also countervailing factors that work against the concentration of activity in a single location. This point is especially relevant in the context of the euro area, given the diverse characteristics of its main financial centres. Moreover, the decentralised nature of the eurosystem, with monetary operations largely executed through the national central banks, may also facilitate a multi-polar financial system in the euro area.

The capacity of a decentralised financial system to deliver the potential gains from a single market in financial services can be supported in several ways. First, the Single Supervisory Mechanism is an important pillar for an area-wide banking union, with a common supervisory regime led by the ECB, with local implementation in partnership with national regulators. A robust banking union also ultimately requires a common European deposit insurance system and the full financing of the Single Resolution Fund.

Second, the Capital Markets Union (CMU) agenda now takes on greater urgency, in order to enable deeper and more liquid markets in euro-denominated instruments. This is essential if the euro area is to reap the benefits from a more balanced financial system, in which equity and bond markets offer an alternative to banks in intermediating funds between savers and investors. The CMU agenda is quite demanding in terms of the range of the individual components, such that it will require considerable commitment among policymakers to make sustained progress.

Third, in any new long-term relationship between the UK and the EU, it is quite likely that there will be very extensive ongoing UK-EU trade in financial services, with associated high levels of bilateral financial flows. Moreover, a substantial proportion will take the form of intra-firm transactions, through the internal markets of globally-significant financial institutions. Internal trade within these institutions can be highly valuable as a mechanism to deliver international risk sharing. However, effective regulation of these firms will require continued collaboration between UK and EU regulators (in partnership with other global regulators). Similarly, the role of large, complex financial institutions in the international financial system calls for ongoing cooperation among the major central banks in underpinning the liquidity of international markets.

Finally, let me emphasise that the locational decisions of financial firms within the euro area should not be driven by regulatory considerations. Rather, a common regulatory system and a genuine single EU-wide market in financial services should allow firms to concentrate on the relative merits of alternative locations in relation to the standard factors identified in the economic geography literature. In the coming years, the analysis of these locational decisions promises to be a major research field for economists and financial geographers.