Sharon Donnery: Brexit and global capital markets

Remarks by Ms Sharon Donnery, Deputy Governor (Central Banking) of the Central Bank of Ireland, at Chatham House, London, 23 March 2017.

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Introduction

It is a pleasure to be invited to Chatham House to discuss Brexit and global capital markets.[1]

In my remarks today, I would like to first turn to history to better understand the emergence of centres for capital. I will then touch on what Brexit may mean for the 'City of London' as a global market for capital. Finally, I will address some of the potential macroeconomic implications of the UK's decision to leave the EU and exit the Single Market, for both the UK and Irish economies, and for Ireland as a location for financial services.

History of centres for capital

The fortunes of centres for capital change. Take the example of a world-leading commercial and financial centre of the past: Venice. Venice rose in status because it was able to make full use of its location, servicing important trading routes between Europe and the East. By the fourteenth century markets for debt, and secondary markets for debt, equity, and mortgage instruments existed.[2] Their development was accompanied by financial innovations such as bankruptcy laws distinguishing illiquidity from insolvency; double-entry accounting; deposit banking; and a reliable medium of exchange – the Venetian Ducat.[3] However, the emergence of alternative trade routes with the discovery of the New World and Vasco de Gama's voyage to India endangered the economic supremacy of the Italian city.

The Venetians were not blind to the changing geopolitical landscape. To retain its importance as a leading trading and financial centre, Venice encouraged the excavation of Suez Canal, but without success.[4] Moreover, Venice failed to modernise its naval force, which was not equipped to navigate in oceanic waters. The Mediterranean soon lost its importance as European trade re-routed to the oceans, signalling the decline of the fortune of the Italian city and the advent of new opportunities for the Atlantic powers.

Subsequently, the Netherland's economic prominence led to Amsterdam becoming the world's leading trading and financial centre, from the end of the sixteenth century. However, the Napoleonic Wars, French Occupation and relegation in terms of the financing of international trade and issuing foreign loans, led to a decline in its status as a 'capital of capital'. It could not compete or adapt to competition from new centres such as London or Paris.[5]

Turning to London, the need to finance successive wars – the Spanish War of Succession, the Austrian War of Succession, and the Seven Years War – gave rise to a financial revolution in the eighteenth century. The establishment of the Bank of England – although private at the time – enhanced the state's opportunity to borrow, and led to the establishment of a genuine capital market which attracted savings, and where joint-stock companies and government securities were traded.

London consolidated its position as a leading international financial centre in the nineteenth century following Britain's expansion as the dominant player in the world economy after the Napoleonic Wars. Productivity gains from technological innovations (such as mechanisation of textiles, use of coal in the metallurgical industry and use of steam) during the industrial revolution further enhanced its position as an already great trading and colonial power.[6]

Brexit and global capital markets

The City's international pre-eminence developed over 250 years. Agglomeration benefits in terms of labour and scale reinforced the City's attractiveness.[7] The UK now receives the second largest FDI inflows in the world and the largest in the EU. Over half of the stock of UK FDI is in financial services. Most financial transactions in the EU – three quarters of the hedging activity, more than three quarters of the FX activity, half of the lending and half of the securities transactions – take place in the UK, irrespective of where the counterparties are based.[8] In this context, it is fair to say that both central banks and firms must grapple with sizeable and specific issues associated with Brexit.

Broadly speaking, it is not unreasonable to assume that much of this FDI is predicated on UK access to the Single Market, and a portion will be diverted to other Member States when Britain leaves. However, estimating the impact of Brexit on the geography of international financial centres is complex. In this regard, research undertaken by staff at the Central Bank of Ireland shows location decisions of non-bank financial FDI are driven by the very same factors that are traditionally regarded as determinants of investment decisions in more traditional sectors of the economy.[9] Specifically, the research finds that barriers between the home and host, market size, regulation and taxes, as well as other traditional gravity variables such as sharing a common border, currency, language and legal system have an impact on firms' location decision. These results are interesting given the perception that this sector is very footloose and not tied to a specific geographic location.[10]

In addition, the importance of factors other than taxation in driving non-bank FDI location decisions mitigates concerns that FDI in the non-banking financial sector simply flows to low tax locations or to those with less stringent regulation. The same results hold when looking at research on bank FDI.[11]

Some more specific challenges for firms to grapple with include, what will happen to the existing passport regimes and whether third country equivalence can be relied upon in a post-Brexit scenario. In these cases, the potential solutions which might be arrived upon vary depending on the applicable legislative requirements. In other words, what this means for European financial services will depend on the sector and firm type.

What is important is that regardless of where an entity seeks to relocate, firms should expect a rigorous assessment of the applicable regulatory standards and intrusive ongoing supervision of their activities. Regulatory authorities in the EU operate as part of the European System of Financial Supervision (ESFS) and, as such, should apply European legislative requirements in a uniform manner. A commonality of approach will be very important to ensure that the risk of regulatory arbitrage is mitigated and any financial stability risks which could arise as a result of a diminution of regulatory standards are avoided. ECB Banking Supervision, the EBA, ESMA and EIOPA have critical roles in supporting consistent and coherent financial supervision and the effective implementation of the rules in the financial sector across the EU and across sectors. We are confident that location decisions will be driven by factors such as infrastructure, skills, legal framework, and cultural factors, rather than any regulatory 'race to the bottom'.

The potential macroeconomic impact of Brexit

We now know Article 50 will be triggered next week. Although the short-term risks of Brexit were overestimated by some, it is important that we do not underestimate the risks over the medium and longer term.

Estimates of the potential long term economic cost of a UK departure from the EU range from a relatively limited impact (with an orderly departure and a reasonable transition period) to the potentially very damaging prospects of a so called 'hard Brexit'. Under such a scenario goods trade between the UK and the EU would be subject to tariff and non-tariff barriers leading to a significant decline in trade volumes. With the UK outside the Single Market and without passport rights, trade in financial services would be adversely affected. Moreover, incentives for businesses both domestic and foreign to invest in the UK would also be undermined.

The UK's revealed preferences, set out in broad strokes in the government's recent White Paper, seems to plot a middle course between a soft and hard Brexit extremes. However, the devil will be in the detail which will only become clear in the negotiations that will follow. More recent history – in Hong Kong or Singapore, for example – suggests that the dominance of international centres of finance is driven by global factors, rather than national economic developments. The international nature of the City suggests London's resilience as a global capital market will be less reliant on the state of the British economy post-Brexit.

Brexit is likely to see some relocation of financial services to Dublin. Authorisation-related activity in Ireland has continued to increase including queries from banks, markets firms, queries regarding payments and electronic money, and insurance authorisations. To date, these have largely been exploratory. For example, in the case of Ireland, the semi-annual growth rate of the number of Irish resident investment funds since the UK referendum in June-2016 to Decemeber-2016 stood at 3.13 percent. This is close to the longer-term trend seen since December-2012. This may serve as evidence that, to date, there have not been significant location spillover effects. In the main, firms are waiting until Article 50 is triggered before taking concrete decisions on activity and location.

Taking a long term perspective, while the UK remains a very important market for Ireland, the UK share of Irish exports has been on downward trend for decades, matched by an upward trend in the share off exports going to rest of the EU. Prior to Irish accession to the EU, the UK accounted for over 50 per cent of Irish exports. This has fallen to under 20 per cent for services and under 14 per cent for goods exports. By contrast, the EU, excluding the UK now accounts for close to three times the volume of goods exports to the UK and around twice the volume of services exports to the UK. This trend is unlikely to be reversed and is more likely to become more pronounced following the UK's departure from the EU.

Conclusion

The decision to leave the EU will impact significantly on the trading arrangements between the UK and EU, with effects also for investment and capital flows and potentially the structure of European financial markets.

Although, some European jurisdictions will potentially see considerable change in light of the UK's exit, what is not anticipated is for a 'new London' to emerge. Given more recent technological developments, it is unclear whether agglomeration effects are as important as they once were. The answer to that question will contribute to determining the extent to which financial services will fragment across a number of European cities.

The rise and fall of Venice and Amsterdam shows that what determines the fortunes of 'capitals of capital' depends on their ability to cope with external shocks and global developments and ultimately their ability to adapt to the changing landscape of history. The future importance of the 'City of London' will therefore depend not only on the agreement between the EU and the UK, but also on how London will position itself in the post Brexit world.

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[1] I would like to thank Mark Cassidy, Donata Faccia, Micheál O'Keeffe, James O'Sullivan, and Terry Quinn for their contribution to my remarks.

[2] See for example Puga, D., & Trefler, D. (2014). International trade and institutional change: Medieval Venice's response to globalization. The Quarterly Journal of Economics, p. 768.

[3] Ibid.

[4] See Grygiel, J. J. (2006). Great powers and geopolitical change. JHU Press, pp. 51-87.

[5] See Cassis, Y., & Collier, J. (2010). Capitals of Capital: The Rise and Fall of International Financial Centres 1780-2009. Cambridge University Press, pp. 09-15.

[6] Ibid.

[7] See Ball, M., & Sunderland, D. T. (2002). An economic history of London 1800-1914. Routledge, p.335.

[8] See for example Wright, W. (2016). The Potential Impact of Brexit on European Capital Markets: A Qualitative Survey of Market Participants. New Financial.

[9] See Davies, Ronald B. and Killeen, Neill (2015). Location Decisions of Non-Bank Financial Foreign Direct Investment: Firm-Level Evidence from Europe, Central Bank of Ireland Research Technical Paper No.4.

[10] Ibid., p.5.

[11] Claessens, Stijn, and van Horen, Neeltje (2014). Foreign banks: Trends and impact. Journal of Money, Credit and Banking, 46(s1), pp.295-326.