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essays

Britain, Europe and the City of London: Can the triangle be managed?

By Philip Whyte

★ Relations between the UK, the EU and the City of London have become more fraught since 2008.

★ A common belief across Europe is that tensions across the Channel partly reflect British resistance to regulating financial markets. This belief is mostly mistaken.

★ The UK and the continent are being prised apart by British euroscepticism and the eurozone crisis. There is a growing chance that the UK will leave the EU after 2015.

★ The future of the City of London will therefore be shaped not just by the emerging regulatory environment, but also by Britain's uncertain relations with the rest of the EU.

Introduction

The City of London, the British government and the EU co-exist less harmoniously than they used to. Before the global financial crisis, British governments could casually assume that what was good for the City was good for the UK and the rest of Europe. Britain's membership of the EU was widely seen as a boon for the City, not least because non-EU firms saw London as a bridgehead to the European market. The EU's efforts to remove barriers to trade in financial services were supported by the UK and the City. And while some EU member-states resented the fact that Europe's largest financial centre was physically located outside the eurozone, British governments could plausibly claim that the City was a European asset whose success was vital to the region's prosperity.

Since the financial crisis, however, the triangular dynamic between the UK, the City of London and the EU has changed in important ways. The UK has discovered, or relearned, that it has a comparative advantage in a sector whose excesses can have a ruinous impact on the 'real economy'. Attitudes to the City elsewhere in the EU have also become more jaundiced. Not only has the global financial crisis revived old suspicions about 'Anglo-Saxon financial capitalism', but some continental European politicians now see in the City of London a nest of malevolent speculators bent on destroying the eurozone. Finally, while the City finds itself under siege from stricter regulations at UK and EU level, the often awkward relations between the UK and the EU have become more fraught than ever.

This essay explores the sometimes paradoxical way in which relations between the City, the UK and the EU have changed since 2008. It argues that differences over financial regulation, or the UK's historically protective attitude to the City, play a fairly marginal role in explaining why relations between the UK and the rest of the EU have become harder to manage. Occasional spats over regulation have flared up across the Channel. But the reason is not – as is often claimed elsewhere in Europe – that the British do not want

Centre for European Reform
14 Great College Street
London SW1P 3RX UK

T: 00 44 20 7233 1199
F: 00 44 20 7233 1117
info@cer.org.uk / www.cer.org.uk

to regulate and supervise financial markets as strictly as others. Britain has changed markedly since 2008. In some areas, the UK finds itself at the hawkish end of the European debate on financial regulation. The years of 'light touch' Anglo-Saxon financial regulation are over.

If the Channel has widened since 2008, the reason is overwhelmingly political rather than regulatory. The UK's regulatory environment for financial services has become more 'continental' than it used to be. But British politics have not. Politically, Britain is drifting away from the continent. Domestic pressures are building for the UK to loosen its ties to the EU.[1] Meanwhile, the eurozone's member-states are being forced to contemplate deeper integration – including the establishment of a 'banking union' – to prevent their shared currency from unravelling. The future of the City of London, it follows, is being determined by more than changes to the regulatory environment in the UK and the EU. It is also being influenced by Britain's increasingly uncertain relations with the rest of Europe.

[1] *David Rennie, 'The continent or the open sea: Does Britain have a European future?', CER report, June 2012.*

The UK and the City since the financial crisis

Britain's attitude to the City of London is more complicated than it used to be. Before the global financial crisis, a number of assumptions informed official British policy mind-sets. These were that a large and vibrant financial sector was key to the success of a modern market economy; that the City, by dint of its history, had a special aptitude for providing such services (to the UK and the rest of the world); that the City made a vital contribution to British jobs, tax revenues and export earnings; that promoting London's status as a financial centre should be a key objective of policy (alongside the pursuit of monetary and financial stability); and that policy-makers should, so far as possible, refrain from doing anything that might damage London's competitiveness as a financial centre.

It would be wrong to claim that all these assumptions have been abandoned since 2008. The British government is not committed to chasing financial activities and institutions out of London – however keen it is to diversify the economy, and however angry the British public is with financiers. But if some of the old assumptions live on, they do so in attenuated form. The Financial Services and Markets Act 2000 required the Financial Services Authority (FSA) to have regard to the City's competitiveness as a financial centre when discharging its tasks. This is no longer the case. Delivering financial stability now takes clear priority over the City's competitiveness. And supporting the City's status as a financial centre is no longer seen as the task of a supervisory authority.

At the same time, official attitudes have become sharper, less complacent and more enquiring than in the past. The FSA's chairman, Lord Turner, has questioned whether all financial instruments and activities are "socially useful" – and suggested that some parts of the financial system have swollen beyond their optimal size.[2] The Bank of England's director for financial stability, Andrew Haldane, has argued that outsized salaries and bonuses in the sector have not resulted from skill (or 'wealth creation'). Instead they have been the product of excess leverage and rents created by market failures – such as the implicit state subsidies enjoyed by 'too big to fail' banks and 'agency problems' which have allowed banks' employees, rather than their owners, to harvest most of the gains.[3]

[2] *Adair Turner, 'How to tame global finance', Prospect, August 27th 2009.*

[3] *Andrew Haldane, 'The $100 billion question', Bank of England, March 30th 2010.*

The UK's regulatory framework, meanwhile, has become much tougher – with banks, which had to be rescued with taxpayer money, bearing the brunt of the clampdown. The thrust of the new rules has been to increase banks' resilience by forcing them to meet much stricter capital and liquidity requirements; and to try and make it possible for banks to fail if they run into trouble. Banks are being required to draw up recovery and resolution plans (otherwise known as 'living wills') setting out how they can be restructured or wound up if they run into difficulty.[4] And the coalition government has chosen broadly to follow the recommendations of the Vickers Commission, which in time will force banks to ring-fence their retail banking arms from their trading and investment banking operations.

[4] *Andrew Gracie, 'Resolution through the lens of corporate restructuring', Bank of England, June 5th 2012.*

The supervisory structure that administers these new rules is also being revamped. The FSA, which has supervised the City since 1997, is set to be abolished. A newly-created Financial Conduct Authority will take over responsibility for monitoring compliance with conduct of business rules, while responsibility for supervising financial firms is being transferred to a Prudential Regulatory Authority inside the Bank of England (the central bank). In addition, a new Financial Policy Committee, also housed inside the central bank, has been set up to bridge the gap between monetary policy and 'microprudential policy' (or the supervision of individual firms). The purpose of the FPC is to monitor how individual and systemic risk interact (so-called 'macroprudential policy').

Finally, the financial sector has been targeted by changes to the tax system. The motives for such changes have not always been consistent – sometimes they have been to assuage public anger, and sometimes to tackle a perceived market failure. The previous government introduced a one-off tax on bank bonuses, raised the top rate of income tax from 40 per cent to 50 per cent, and introduced a levy on bank debt (in effect, an ex ante tax on the risk that banks pose to financial stability). Britain's current government did not renew the tax on bonuses and recently reduced the top rate of income tax to 45 per cent. It has also strongly opposed EU proposals for a financial transactions tax (FTT). Set against this, however, the coalition government has kept – and increased – the levy on bank debt.

In short, the regulatory, supervisory and tax framework in which banks and other financial firms operate in the UK is very different to that which prevailed before the financial crisis. The overwhelming majority of these changes have been domestically generated: few have resulted from foreign pressure; many were adopted in the UK before they were elsewhere; and some go further than many countries elsewhere in the EU are prepared to contemplate. It follows, first, that the City of London's competitiveness is being determined as much by measures adopted in the UK as by those passed in Brussels; and, second, that it is wrong to describe the UK, as continental European politicians sometimes do, as a recalcitrant country that must be cajoled by others to regulate its financial markets.

Cross-Channel regulatory differences: Rhetoric and reality

How has the regulatory response at EU level differed from that in the UK? Early in 2009, the UK[5] and the EU[6] published separate official reports into the causes of the financial crisis, and the lessons to be drawn. The reports came to very similar conclusions. They agreed, among other things, that the crisis was caused by excess leverage; that prevailing supervisory assumptions had suffered from a fallacy of composition (they had wrongly assumed that what made sense for individual firms made sense for the financial system as a whole); and that the crisis had revealed flaws in the design of the EU's single market that could be rectified in one of two ways – 'more Europe' (greater supervisory integration at EU level), or 'less Europe' (making foreign banks operate via subsidiaries in host countries).

[5] *Financial Services Authority, 'The Turner Review: A regulatory response to the global banking crisis', March 2009.*

[6] *Jacques de Larosière, 'Report of the high-level group on financial supervision in the EU', February 25th 2009.*

Given the quarrels which have since flared up across the Channel, three points are worth bearing in mind. First, much of the EU's regulatory agenda overlaps with the UK's. The centrepiece of the EU's regulatory agenda – the latest Capital Requirements Directive (CRD IV), which will implement the Basel III agreement into EU law – will not force British banks to hold more capital than they are already required to in the UK. The UK had no reservations about introducing a levy on bank debt, as the Commission recommended in 2010. And in a number of areas, EU initiatives have actually followed a British lead: the Likanen group, which is examining whether financial stability can be enhanced by reforming the structure of banks, is effectively an EU version of the Vickers Commission.

Second, where disagreements across the Channel have arisen, these have not necessarily been because the British have been hostile to tougher regulation per se. On CRD IV, the UK has actually been at the hawkish end of the European debate on regulation, arguing for a strict interpretation of Basel III and for the freedom of individual countries to apply tougher capital adequacy requirements than the internationally agreed minima. The UK's disagreements with the Commission and Germany on the bank levy did not centre on the levy itself (which it was happy to introduce), but on the uses to which the revenues raised should be put. And Britain's efforts to amend the Alternative Investment Fund Managers (AIFM) Directive should not be mistaken for opposition to regulating 'shadow banks'.[7]

[7] *Paul Tucker, 'Shadow banking: thoughts for a possible agenda', Bank of England, April 27th 2012.*

Third, despite its traditional neuralgia about sovereignty, the UK has agreed to greater supervisory integration at European level. It is a full participant in the European Systemic Risk Board (ESRB), a new body set up under the aegis of the European Central Bank (ECB) to conduct macroprudential surveillance at EU level. And it participates fully in the new European Supervisory Authorities (ESAs) which have been established to improve co-ordination between national supervisors. What has made this new architecture just about palatable to Britain is that it falls short of creating a single EU supervisory authority. It is a more modest edifice that tries to square the need for greater supervisory effectiveness with the hostility of sovereignty-conscious countries such as the UK to federal-looking bodies.

So why have disputes periodically flared up across the Channel? Part of the explanation is that many on the continent attribute the global financial crisis to 'unregulated Anglo-Saxon financial capitalism'. According to this view, the task following the crisis is two-fold: to extend the perimeter of regulation so that as few entities as possible are left unregulated; and to get the British to regulate and supervise financial markets the way other EU countries do so. Although other EU countries were guilty of similar failings as the UK, this is a view that the UK has found hard to counter. So countries like France and Germany have been able to push some favoured hobby horses; and friction has arisen between a 'rules-based' continental approach and a 'judgement-based' British one.

Despite large areas of overlap, therefore, differences of emphasis have emerged which have sometimes left the UK looking isolated. As a result, the UK has found itself on the receiving end of two accusations. When it has expressed reservations about some EU measures, other EU countries have portrayed it as being unwilling to learn the lessons of the crisis and of defending the interests of the City. This has been the case, for example, with respect to the AIFM directive and the EU's mooted financial transactions tax (FTT), both of which were proposed by the Commission under political pressure from France and Germany. However, when the UK has adopted a more aggressive approach than other countries – as it has done with respect to banks – it has faced accusations of unilateralism.

For many on the continent, the UK remains what it has always been: difficult, unilateralist, too protective of the City and hostile to regulation and European co-operation. To British ears, however, such complaints have often sounded self-serving. Continental politicians have played to their domestic galleries by attacking 'Anglo-Saxons' (and the 'speculators' they supposedly harbour and fail to regulate). Yet they have glossed over their own countries' part in the crisis (poor lending by over-leveraged banks) and shown a lack of urgency in tackling the problems highlighted. For example, most EU countries have been far slower than Britain in recognising the under-capitalisation of their banking sectors; and few have been as aggressive in tackling the problem of 'too-big-to-fail' institutions.

British suspicions of continental motives have been fed by two other factors. One is the belief that other EU countries will blithely sign up to measures that do not necessarily do much to promote financial stability but which affect the UK disproportionately. The usual example cited in this context is the EU's proposed FTT (which, because of the City of London's scale, would affect the UK more than any other EU member-state). Another is the nagging British suspicion that some continental demarches conceal protectionist motives. The European Central Bank's insistence that clearing houses which handle "sizeable amounts" of euro-denominated business should be located in the eurozone is seen in this light – and was referred by the UK to the European Court of Justice in 2011.

British euroscepticism and the eurozone crisis

Relations across the Channel have also been destabilised by the interaction of two other factors: increasing euroscepticism in Britain and the crisis in the eurozone. Events came to a head at the EU's fractious summit in December 2011, when Britain vetoed the EU's proposed fiscal treaty on the grounds that it had failed to obtain from its European partners special 'safeguards' for the City of London. Oddly, given the contempt in which financiers are currently held, the British public seemed to applaud the move. However, it also infuriated the rest of the EU. Not only did the UK appear to be linking two issues that were largely unrelated, but the UK was also widely perceived to be subordinating the interests of the eurozone to those of the City – at a time of existential crisis for the former.

There can be little doubt that the eurozone crisis has reinforced a tendency across Europe to see the UK as politically unhelpful at best, and at worst actively unfriendly. The UK attracts resentment because it does not belong to the eurozone; because it exhorts eurozone countries to sign up to arrangements it would not countenance for itself; because it showed no solidarity with the rest of Europe by participating in the bail outs of Greece and Portugal (though it did contribute bilaterally to that of Ireland); and because talk among Conservative eurosceptics and parts of the media of exploiting the crisis to repatriate powers from Brussels sounds like the rhetoric of a hostile country (the UK, it suggests, has a greater interest in loosening its ties with the EU than in the survival of the eurozone).

The eurozone crisis has also deepened negative perceptions of the City. Two complaints are often heard on the continent. The first is that since Europe's largest financial centre is located outside the eurozone – and in the EU's most eurosceptic member at that – financial markets "do not understand Europe".[8] The second is that unregulated 'Anglo-Saxon speculators' are a malign force bent on destroying the euro. In short, because financial markets are concentrated in London, they are less well informed, less regulated

[8] *Alain Frachon, 'L'euro et les méchants Anglo-Saxons', Le Monde, June 22nd 2012.*

and more hostile to the eurozone than they would otherwise be. (By implication, if Paris or Frankfurt were more dominant, the crisis would be less acute because financial markets would have a better understanding of the eurozone's institutional advances since 2010.)

To British ears, many of these complaints sound like wild conspiracy theories. The City of London does not march to the tune of the British government or, for that matter, the eurosceptic media. The British government has no intention of joining the eurozone, but nor does it want it to break up (given the catastrophic economic shock this would inflict on the British economy). The eurozone is not a victim of malignant external forces like 'Anglo-Saxon speculators', but of its own institutional design flaws – as deposit withdrawals from banks in many of the zone's 'peripheral' economies attest. As for the outcome of the eurozone crisis, it will not be decided by the British government or the City of London, but by continental European policy-makers in Berlin, Frankfurt, Paris, Brussels and elsewhere.

But if continental complaints have often been over-wrought, in one respect at least they have been justified: the UK has not sounded like a friend at a time when the eurozone faces an existential threat. It is one thing to argue, as the British government has done, that the UK should not participate in the bail out of the indebted eurozone peripherals. (Why, it asks, should a highly indebted country such as the UK be enlisted to help compensate for a 'solidarity deficit' in a currency zone to which it does not belong and which in any case runs a current-account surplus with the external world?). However, it is quite another to argue, as some parliamentarians on the Conservative backbenches have done, that the UK should actively seek to exploit a profound regional crisis to advance eurosceptic ends.

The pressure exerted on the British prime minister by eurosceptics at home has been, and remains, intense. In October 2011, 81 members of David Cameron's own party (the Conservative Party) defied his orders by voting in favour of a parliamentary motion which called for a referendum on the UK's continued membership of the EU. Although the motion was defeated, this was only thanks to the votes of the pro-EU Liberal Democrats (the other party in the governing coalition) and a majority of the opposition Labour Party. The parliamentary vote represented the biggest rebellion in Conservative ranks since 1993 – and left eurosceptics with unsated appetites. When Mr Cameron went to the EU summit in December 2011, therefore, he was under immense pressure to show 'bulldog spirit'.

Although Mr Cameron told his party this was not the right time for the UK to try and claw back powers from the EU (as many in his party are demanding), he felt obliged to offer eurosceptics something in lieu. His answer was to ask for a protocol that would provide 'safeguards' on the City of London. (The protocol was not, as President Sarkozy claimed at the time, an attempt to exempt Britain from EU financial regulation. One of Cameron's demands was for the UK to be able to regulate the City more strictly than the EU, not less). However, the City was not really consulted. Some in the Square Mile loudly welcomed Cameron's move. But many others were quietly furious at having been turned into poster children for British euroscepticism and feared this would weaken their influence in Brussels.

When Cameron vetoed the proposed EU treaty in December 2011, his move was applauded by an increasingly eurosceptic public at home. But it achieved nothing at EU level. Most of the EU's 27 member-states went ahead and signed a new treaty anyway. The UK secured none of the safeguards it had sought. And the veto cost the UK a lot of goodwill. Political bridges have admittedly been repaired (to some extent) since December 2011. But the veto has also created a profoundly negative impression of the UK which could have lasting political consequences. Three views of the UK are now common across Europe: that it is unreliable and unconstructive; that it is an active distraction from solving the region's worst crisis since World War Two; and that it appears to be heading for the EU's exit door.

Can Britain co-exist with an integrating eurozone core?

When the UK's Turner Review spoke of a choice between 'more Europe' and 'less Europe', it was referring to the flaws that the financial crisis had exposed in the design of the EU's single market. The eurozone crisis has since exposed another flaw in Europe's architecture: the structural instability of a currency that is shared by fiscally independent countries which are individually responsible for backstopping their banking systems. Because states and banks interact very differently in such a currency union than they do in a fully-fledged federation like the US, the eurozone is prone to banking and sovereign debt crises in some of its constituents; and the advent of such crises can provoke 'death spirals' in which the financial frailties of sovereigns and 'their' banks feed on and amplify each other.[9]

[9] *Philip Whyte, 'The eurozone and the US: A tale of two currency zones', CER insight, November 21st 2011.*

The creation of the ESAs and the ESRB (see above) was largely designed to resolve some of the design flaws of the single market. But neither the ESAs nor the ESRB are answers to the design flaws of the eurozone (their establishment has actually been followed by an intensification of the crisis). The root of the problem is that exchange rate risk inside the currency union has not really been abolished because its members have been reluctant to pool the costs of their shared currency. The result is that the political and economic stresses to which crisis-hit countries can be exposed are so great that their continued membership is called into question – resulting in capital flight from the countries concerned. Investors and depositors are therefore flightier inside the eurozone that they are within the US.

If confidence in the irreversibility of the eurozone is to be restored, therefore, the currency union will need to go well beyond the 'Larosière reforms' which set up the ESAs and the ESRB. It needs to be underpinned by a fully-fledged 'banking union'. Ultimately, such a union would need to consist of a number of pillars: a common deposit protection scheme (perhaps funded by an ex ante levy on banks); a collective, region-wide regime for restructuring and, if necessary, recapitalising ailing banks; a joint authority to supervise financial institutions across the currency union; and, to eliminate currency risk altogether (and hence banks' vulnerability to the fiscal position of the individual state in which they are domiciled), a common debt instrument ('Eurobond') for the currency union as a whole.[10]

[10] *Simon Tilford and Philip Whyte, 'Why stricter rules threaten the eurozone', CER essay, November 2011.*

In June 2012, the President of the European Union, Herman Van Rompuy, submitted a report to the European Council in which he recommended a number of reforms along these lines. Among other things, the report proposed what it called an "integrated financial framework" – another term for a banking union – consisting of "a single European banking supervision and a common deposit protection insurance and resolution framework". The report left a number of details deliberately vague. Among these was whether all banks, or just the largest, should be covered by the new regime; and who should supervise them (the European Central Bank or the European Banking Authority?). However, the report did express a preference that the new framework should cover all EU countries.[11]

[11] *Herman Van Rompuy, 'Towards a genuine economic and monetary union', European Council, June 12th 2012.*

All this leaves the UK in an awkward position. The British government has already made it clear that it has no intention of joining an EU banking union. It agrees that such a union is necessary to restore faith in the long-term viability of the eurozone (because it follows what the UK's chancellor of the exchequer, George Osborne, has called the "remorseless logic of monetary union"). But the government insists that Britain, though home to the region's largest financial centre, should not participate in such a union because the country does not belong to the eurozone. In short, the UK argues that a common banking union is a necessary corollary of a shared currency, but not of the EU's single market. Eurozone countries should therefore form a banking union, but without British participation.

On paper at least, there is no reason why an integrating eurozone core should not be able to co-exist with the remaining members of the EU-27. It is quite possible to sketch a blueprint in which a eurozone banking union is embedded in a broader EU framework. Thus, banks incorporated in the eurozone could be supervised by the European Central Bank, while banks incorporated in the UK would be supervised by the soon-to-be formed Prudential Regulatory Authority. The regulatory framework for the whole of the EU would be set by EU-27 bodies, not eurozone ones. And the European Supervisory Authorities would continue to perform many of their current functions, such as mediating between the various supervisory authorities and intervening to settle disputes when these arise.

However, the UK is worried about three practical difficulties. The first is whether the integrity of the single market at 27 can be maintained in the face of an eurozone 'core' that is becoming ever more closely integrated. Although the UK believes that it can in theory, it worries that in practice a eurozone 'caucus' could emerge in the EU-27 which would effectively set rules affecting financial services over which the UK has little influence. A second British worry is that a eurozone core could adopt measures that discriminate against non-eurozone countries – as the ECB has already done in relation to clearing houses handling euro-denominated transactions.[12] A final concern for the UK is the risk that banks and other firms could decide of their own will to relocate to an integrating eurozone core.

[12] *Nick Clegg, 'Be alive to the risks and rewards of a banking union', Financial Times, June 26th 2012.*

A fully-fledged European banking union will not emerge overnight – if it ever does. Properly conceived, it entails far more than sharing sovereignty: it also means sharing the costs of bank rescues and depositor protection. It is, in other words, an integral feature of a full fiscal union. For that very reason, it raises the same difficulties for certain eurozone countries as the idea of common debt issuance (mainly because it is seen as just another call on the credit standing and generosity of creditor countries inside the currency zone).

Even so, it is possible that an embryonic banking union (or 'union lite') will emerge, with the first step seeing the transfer of supervisory functions to a European-level body. And a 'banking union lite' could still pose many of the above-mentioned problems for the UK.

A triangle under increasing strain

Relations between Britain, the EU and the City of London have, then, become more difficult to manage than they were before the financial crisis. The reason is not, as is sometimes supposed elsewhere in Europe, because the aftermath of the crisis has exposed an age-old conflict between a continent that wants to regulate financial markets and a recalcitrant Anglo-Saxon island that does not. If a commitment to regulating financial markets tightly is a mark of continental identity, then the UK is undoubtedly more 'continental' that it used to be. The principal reason that the triangle has become harder to manage is that the UK seems determined to loosen its relations with the EU – and may even be set to leave the EU altogether – at a time when the eurozone has to integrate further if is to survive.

(i) The UK – an angry and less influential country

The UK is not the country it was five years ago. In ways that are not always appreciated elsewhere in Europe, general attitudes towards the City of London have become less accommodating than they were before 2008. Taxpayer bail-outs of over-leveraged, 'too-big-to-fail' banks; inflated pay levels (reflecting excessive leverage, economic rents and, in a few cases, outright criminality); repeated mis-selling scandals; and the country's worst economic downturn since the Great Depression have combined to transform attitudes towards the City in official circles and among the general public. Almost no-one in officialdom any longer believes that there is a necessary identity of interest between the City of London and the British state. And 'bankers' are widely reviled by the broader public.

At the same time, the UK has turned more hostile to the EU than it has ever been since it joined in the 1970s. According to the latest Eurobarometer poll, just 17 per cent of British respondents express trust in the EU, and only 13 per cent say they have a broadly positive image of the EU.[13] Opinion polls by YouGov show that only 10 per cent support greater integration; 33 to 40 per cent want a repatriation of powers; and 23 to 29 per cent want to leave the EU altogether. A large majority of British voters now want a referendum on the EU. In a three option referendum, 15 per cent would vote to stay in the EU as is, 47 per cent to renegotiate the terms of membership, and 28 per cent to leave. In a straight in-out referendum, some 50 per cent of Britons would vote to leave and just 25 per cent to stay in.[14]

[13] *European Commission, 'Standard Eurobarometer 76', Autumn 2011.*

[14] *YouGov, 'Public opinion on Europe', October 23rd 2011.*

Britain, then, is an unhappy country. So far, its disaffection has produced a clearer sense of what the country wants from the City of London than what it can realistically get from the EU. The UK wants a financial sector that does not socialise its losses, that is less captured by the narrow pecuniary interests of its employees, that is subject to the discipline of the market-place, and that works harder to restore that intangible feature without which the market system cannot work: trust. Britain's policy towards the EU, by contrast, is less clear that many in the UK seem to think. The government is about to carry out an audit of the EU's competences, with a view to drawing up a 'shopping list' of powers that might be repatriated – and using the list as the basis for renegotiating the terms of the UK's membership.[15]

[15] *George Parker, 'Hague to review EU law', Financial Times, July 11th 2012.*

Although this exercise chimes with public opinion, it places the UK in an odd position. On the one hand, it is exhorting other countries to integrate further to save the eurozone. On the other hand, it wants to loosen its relations with the EU, while obtaining special 'safeguards' for the City of London and the single market. To other EU countries, this list of demands seems contradictory – and perhaps even delusional. The UK wants others to sign up to arrangements it would not dream of agreeing to itself; to opt out of EU policies it dislikes; and to be given special reassurances in the areas it values. In short, the UK wants an integrating core to which it does not belong to respect the integrity of the single market, even as the UK contemplates opting out of some of its provisions (such as employment rules).

Britain's prime minister says that he does not want to leave the EU, but to renegotiate Britain's membership with the EU and put the reformed relationship to a referendum. He may struggle to get what he wants. A renegotiation of the terms of British membership may not be on offer. Other EU countries will point out that the single market rests on a complex series of bargains from which the UK cannot exempt itself. If the UK cannot live with these, they may argue, it should leave the EU. Meanwhile, pressure for an in-out referendum is building at home. Voters want one. It may be the only way to quell divisions within the

Conservative Party and see off the threat of the UK Independence Party (UKIP). And the other parties may feel they have no option but to commit themselves to holding one.

Eurosceptic monomania is having an unhealthy influence on Britain's policy towards the EU. Britain's current policy towards the EU is being determined overwhelmingly by political pressures at home rather than developments in the rest of Europe. Yet the EU faces two radically different futures: one in which the eurozone saves itself by integrating further, and another in which it fails to do so and falls apart (with all sorts of unpredictable consequences for the EU itself). Although the two outcomes present the UK with very different choices, British policy could end up being the same either way. If the eurozone does fall apart, the UK will attract accusations that it helped sabotage the currency – and risks being a marginal player when it comes to shaping the post-crisis European order.[16]

[16] Gideon Rachman, 'Blackmail cannot be UK's Europe policy', Financial Times, July 2nd 2012

(ii) Europe – a self-inflicted crisis and the British problem

The eurozone is struggling with a political and economic crisis of its own making: its members created an institutionally flawed currency union which has proved hopelessly ill-equipped to deal with the aftermath of a financial crisis. But this is not how everyone sees it. Some believe that the eurozone is the innocent victim of a financial crisis that originated in the US. And some resist the conclusion that the eurozone is institutionally flawed. Policy-makers need to be clearer-eyed. The old continent played an active part in the genesis of the crisis (European banks were as highly leveraged as their counterparts in the US, and invested their money just as badly). And the eurozone has struggled to deal with the aftermath of that crisis because it is a very different monetary union to the US.

The survival of the eurozone is almost certainly incompatible with its current state of institutional limbo. Up until recently, the hope was that the eurozone could extricate itself from its crisis if it 'Europeanised' German discipline. But the attempt to restore confidence by strengthening rules (and compliance with them) has failed to allay fears about the prospects for the eurozone's long-term survival. To do that, member-states need to commit themselves to deeper fiscal integration. At present, the eurozone has acquired some of the form but little of the substance of a proper fiscal union. Properly conceived, such a union entails a willingness to share the fiscal costs of a common currency – be it in the form of joint debt issuance, or a common deposit protection scheme for the eurozone banking system.

Although there is growing recognition of all this at EU level, there is a reluctance to accept it at national level. It is not hard to see why. A fiscally decentralised monetary union has turned out to be economically unstable and politically dysfunctional. But it is also an institutional configuration that most closely reflects political realities at national level: the reason the eurozone is fiscally decentralised is that solidarity is weaker across European borders than it is within them. The problem for some national leaders is that they do not have a democratic mandate to do what is necessary to make the currency union work better. So they face a tragic dilemma: either they correct the flaws but turn the eurozone into something they said it would never be; or they accept the risk that it will unravel.

The outcome of the eurozone crisis will not be determined by the UK or the City of London. Even so, the 'Anglo-Saxon world' may provide a convenient scapegoat to cornered European politicians. The belief that the eurozone is the victim of Anglo-Saxon speculators is so commonplace that in some quarters it passes for a truism. As François Hollande told a French audience in January, "*la finance, c'est l'ennemi*" (particularly, he might have added, when it is in London). Some EU leaders have periodically intimated that the eurozone will not survive if the City is not tamed – a belief that partly explains their support for an EU FTT. But the eurozone crisis has nothing to do with Anglo-Saxons; and the difficulties posed by the City are really no different for Europe than they are for the UK.

Europe does not have a problem with 'Anglo-Saxons'. It has a problem with Britain. And this problem is not primarily with the UK's attitude to financial regulation, which has changed markedly since 2008. It is with Britain's growing hostility to and disengagement from the EU. If the eurozone becomes a more integrated monetary union, one challenge will be to ensure that it and the EU-27 can continue to co-exist. In theory, this should not be impossible (even if the price is greater institutional untidiness). But the UK poses a huge challenge. It wants safeguards for financial services, even as it seeks to repatriate powers in areas like employment law and contemplates restricting the free movement of labour to prevent an influx of migrants from crisis-hit eurozone countries such as Greece.[17]

[17] Jim Pickard, 'Cameron vows to bar Greek influx', Financial Times, July 3rd 2012.

So a secondary question to that of the eurozone's survival is how far other EU countries will be prepared to go in coming years to accommodate British euroscepticism. One view in Britain is that the country enjoys leverage because others do not want it to leave the EU.[18] This is true, but only up to a point. It is one thing to argue that other countries value Britain's traditional contribution to the EU. But it is quite another to claim that their patience is unlimited. The truth is that Britain has lost a huge amount of goodwill, even among its traditional allies. The question a growing number of EU countries are asking is: why bend over backwards to accommodate a country that is so ill-disposed to all things European, and that currently seems intent on heading for the exit door?

[18] *Jo Johnson, 'Britain must defend the single market', CER essay, June 2012.*

(iii) The City of London – despised and under siege

Since late 2008, the City of London has been under siege from a flood of new rules in the UK and the EU. On the back foot politically, the Square Mile has struggled to frame a convincing story in its defence. Its apologia has tended to rely on a number of general claims: that the financial sector plays a critical role in a market economy; that excessive regulation will raise the cost of capital, so hitting economic growth (and shareholder value); that pay levels in finance simply reflect the cost of employing wealth-creating talent and are not therefore excessive; that the City should be cherished as a 'European champion' (in the same way as the German car industry or the French luxury goods sector); and that if the regulatory climate becomes too hostile, financial firms and activities will move elsewhere.

Not all of these claims are wrong. Some largely blameless entities have been caught up in the regulatory clampdown, potentially adding needless costs to consumers of their services. Anyone who doubts the importance of the financial system to the wider economy need only look at what happens to economic activity when banks are impaired, as has been the case in much of Europe since 2008. Nevertheless, the widespread belief among City participants that they are the victims of crude populism and 'banker bashing' is as self-indulgent as it is false. If planes fell out of the sky, one would expect their manufacturers to carry out a painful self-examination, tackle the problem, and take public criticism on the chin. The City has not given outsiders the impression that it has done any of these three things.

Some of the claims advanced in the City's defence, moreover, have been strikingly inapt. Making money is not the same thing as creating wealth (tidy fortunes were made in the 'noughties' by people who misallocated capital on an epic scale). Higher capital requirements are not necessarily incompatible with economic growth or shareholder value; what they do conflict with is non-risk adjusted banker pay.[19] It is no surprise that the City attracts less admiration than other European champions: its activities produce potentially enormous negative externalities; too many of its participants are blissfully indifferent to these; and, as an industry, the financial sector appears to attract a disproportionate share of people who have difficulty doing anything that gets in the way of their personal enrichment.

[19] *Robert Jenkins, 'Let's make a deal', Bank of England, July 10th 2012.*

The City is not a monolith. It employs many honourable firms and people who have been unfairly tarnished by the excesses and scandals of recent years. But like it or not, banks and financiers more generally are now widely despised and mistrusted in the UK and the rest of Europe.[20] The City of London, meanwhile, is acquiring an unwanted reputation as a centre of market irregularities (such as the Libor fixing scandal) and trading disasters. A financial centre will not remain competitive for long if doubts take hold about the integrity of its markets and its participants.[21] Regulatory enforcement should help to tackle the City's reputational issues. However, a change in the City's broader culture may be elusive without further changes to incentives and tougher sentencing policies for criminal offences.

[20] *Martin Wheatley, 'Rebuilding confidence and trust in banks and bankers', Financial Services Authority, May 4th 2012.*

[21] *John Kay, 'Not on my watch: applies to banks and the navy', Financial Times, July 3rd 2012.*

How the current uncertainties in Britain's relations with the EU are resolved will also shape the City's future. Eurozone countries may be about to establish an integrated banking union without British participation – or not. The eurozone could unravel – or not. And the UK may be embarking on a course that ends in its departure from the EU – or not. Contrary to a widely-held view in Europe, the City is not eurosceptic: there is no settled 'City view' on what Britain's relations with the rest of Europe should be. After the December 2011 summit, some in the City welcomed the UK's isolation. But many others resented having been used by the eurosceptic cause.

Conclusion

It is tempting to gauge relations between the UK and the rest of the EU by reference to disagreements over individual items of financial regulation. For people of a certain disposition on either side of the Channel, doing so has certain advantages. British eurosceptics can tell themselves that the City is threatened by ill-intentioned continentals, while the latter can tell themselves that 'unregulated Anglo-Saxon financial markets' pose a threat to the survival of the eurozone. This essay has argued that both sets of claims are mostly nonsense. The future of the City is being determined as much by measures in London as in Brussels. And the outcome of the eurozone crisis will be decided by continental policy-makers – not by Britain's eurosceptic government or the City of London.

There are two factors that are prising Britain and the continent apart: the eurozone crisis and British euroscepticism. If the eurozone is to survive, it will have to integrate further. This may or not happen. But if it does, the euro outs, and the UK in particular, have legitimate concerns about what this would mean for the EU-27. The UK wants to ensure that a more integrated eurozone core does not threaten the integrity of the single market. It worries that a tighter core could caucus inside the EU, subjecting the 'outs' to rules they had not shaped; and that it might encourage the ECB to try and force certain firms and activities to be located in the eurozone rather than London. Against this backdrop, strong EU institutions would be needed to look after the interests of the EU-27 (and the UK).

But the UK has exhausted a lot of goodwill. And it will struggle to persuade others to take its concerns seriously. The problem is not just that Britain's soft power in Europe has been damaged by eurosceptic rhetoric in parliament (the indifference of some British eurosceptics to the fate of the euro has been widely noted on the continent). It is also irritation at the timing and content of the British government's agenda on the EU, as well as uncertainty over its eventual outcome. Britain's determination to review the terms of its EU membership is seen as an unhelpful distraction at a time when the region is in crisis. It has been likened to complaining about a neighbour's intruding hedge while their house is on fire; and it is in any case seen as a prelude to the UK's eventual exit from the EU.[22]

22 *Alex Barker, 'Eurozone disquiet at great British sideshow', Financial Times, July 3rd 2012.*

How looser relations (or a full divorce) between the UK and the EU would affect the City is bitterly contested. British eurosceptics argue that the City would benefit, because it would be freed from EU legislation it does not like, and better placed to win new business from faster-growing emerging markets.[23] But this may be a little too glib. For one thing, the regulatory environment in the UK is less accommodating to the City than it used to be. For another, access to the European hinterland remains a key attraction for firms located in the UK. If the UK loosened its relations with the EU or left altogether, some banks might choose to relocate to the continent. The City could also become vulnerable to protectionist measures in Europe and to more restrictive immigration policies in the UK.

23 *Stephen Booth et al, 'Continental shift: Safeguarding the UK's financial trade in a changing Europe', Open Europe, December 2011.*

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Philip Whyte is a senior research fellow at the Centre for European Reform
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