

Europe's odd man out

Paul Wallace examines the impact of Brexit on the ECB, looking at how the UK's departure will strengthen the EU central bank and how it might affect London's financial status

Since the UK's vote to leave the European Union last June, the consequences for London as a financial centre have been much discussed. In contrast, little attention has been paid to the impact on the European Central Bank (ECB). Yet, precisely because London is in effect the financial capital of Europe's monetary union, Brexit will reshape the central bank at the eurozone's heart in Frankfurt.

First, the UK's departure from the EU will rupture the institutional relationship between the ECB and the Bank of England (BoE), still a heavyweight central bank largely because of London's financial pre-eminence. When the ECB was conceived at the Maastricht summit 25 years ago, the intention was that monetary union would encompass the whole of the EU, even though the UK and Denmark secured opt-outs. That has remained a policy goal even as the EU has expanded from 12 member states to 28. As a result, the ECB is owned not just by the 19 national central banks in the eurozone, whose governors sit together with the executive board on the governing council that sets monetary policy, but also by the other nine members of the EU that retain their own currencies.

Each of the 28 central banks has a capital share ("key") in the ECB determined by its country's economic and demographic weight, making the BoE notionally one of the main owners. But the central banks that do not belong to the monetary union pay in only a tiny proportion (3.75 per cent) of their subscribed capital to help cover the ECB's running costs. The keys that actually turn, determining in particular risk-sharing and the apportionment of monetary income, are based on fully paid-up capital, which comes from the eurozone central banks. Even so, this institutional tie between the ECB and the BoE remains significant and will be severed once the UK leaves the EU.

At the formal level, the BoE will no longer take part in meetings at the ECB. These take place every three months for the general council, which handles relations between the 19 "ins" and the nine "outs". Chaired by Mario Draghi, the ECB's president, this body is much less powerful than the

governing council and the executive board. Still, it remains a useful forum for the central banks outside the eurozone, and its status as the ECB's third decision-making body reflects the importance to the ECB of maintaining links and cooperation with them.

The UK's departure will also tip the regulatory balance. In particular, it will strengthen the ECB's clout in new macroprudential arrangements covering the whole of the EU. These seek to prevent a re-run of the 2008 financial crisis by stymying credit excess and are overseen by the European Systemic Risk Board (ESRB), established at the end of 2010. The ESRB is already heavily influenced by the ECB since its board is chaired by Draghi and its secretariat is staffed and financed by the central bank. One current constraint is that Mark Carney, governor of the BoE, is second only to Draghi on the ESRB's board. Once the UK leaves, the ESRB will lack this counterweight from outside the eurozone.

“*The UK's exit will tilt the economic balance of power further towards the inner eurozone club*”

The British departure will tilt the economic balance of power further towards the inner eurozone club and away from the eight remaining "outs", a diverse set of countries that includes Sweden as well as Denmark but comprises mainly nations such as Poland and Bulgaria that joined the EU in the past decade or so. Before Brexit, the outs had a strong champion in the UK since it alone made up 17.5 per cent of the EU economy while together their share was nearly 30 per cent. But once the UK leaves, the eight remaining outs will account for less than 15 per cent of the EU-27's output. That will make them more likely to adopt the euro (as all but Denmark are in any case supposed to do) to secure a place at the top table.

If Brexit precipitates a rush of new eurozone members, the power of the ECB's executive board, which includes Draghi and the vice-president, will increase further. A new voting system on the governing council started in 2015, which gave the six board members – who are appointed by eurozone leaders – permanent voting rights. In contrast, the remaining 19 governors have to share a fixed tally of 15. Four of these are reserved for the governors from the five countries with the biggest economies and banking sectors, leaving 11 to be shared by 14 at present – and rising as the eurozone expands.



Mario Draghi, chairman of the ECB. Source: ECB

A more powerful ECB with a stronger executive board is also likely to flex its muscles more in financial markets. Until recently, it seemed that a flashpoint could be the City of London's central counterparties (CCPs), which handle massive amounts of euro-denominated derivatives each day. The ECB demanded in 2011 that the business be based within the eurozone, arguing that this was essential if it were to be able to ensure the smooth operation of euro payments.

In 2015, European judges rejected this location requirement in a case brought by the UK government, ruling that the ECB did not have the legal authority to impose such a condition on the

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CCPs. Should the ECB now wish to press the point – which is not a given, as the article by Richard Metcalfe [see page 29] examines – the central bank is more likely to prevail once the UK has left the EU.

A more immediate concern for the ECB is what might happen if the Brexit negotiations founder in acrimony, forcing a “cliff-edge” departure in the spring of 2019 with no transitional arrangements to ensure a smoother change. Both the UK and the eurozone economies shrugged off the Brexit vote despite the immediate jolt to confidence. But that was in large part because of the delay in turning the referendum result into

reality. Even Michel Barnier, the EU's chief negotiator, has expressed his concern about this risk to financial stability arising from the City's prominence.

There are various ways in which the ECB and the BoE could cooperate to maintain financial stability if Brexit turns out to be disorderly. The most potent is through central bank swaps, allowing the BoE to provide euro liquidity to banks within London. Central banks have long-standing, informal networks. So, for example,

even though the direct institutional relationship between the BoE and the ECB will cease, they will continue to take part regularly in meetings at the Bank for International Settlements in Basel where global standards for international banks are formulated.

One thing that will not change at the ECB is its working language, which has been English from its inception in June 1998 and, indeed, before that at the European Monetary Institute, a transitional body set up in 1994. This reflects the status of English as the world's lingua franca, especially in finance and economics.

Likewise, the ECB may find that London's status as a financial centre is surprisingly resilient. When the UK stood apart from the single currency project at Maastricht, there were fears that the City would lose ground. Helmut Kohl, the then German chancellor, believed that pressure from the City would swiftly lead to a change of heart. Instead London thrived, demonstrating the strength of the “cluster effect” that causes financial activities to concentrate in one location.

Although the ECB will become stronger as a result of Brexit, it will remain a supranational central bank that lacks a corresponding state. The odd man out among central banks may find that it is stuck in an odd relationship with an offshore financial centre. ■



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