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**The causes and future consequences for the City of London after Brexit**

A Thesis in Business

By

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## I. Introduction

After forty-three years of membership, 51.9% of the United Kingdom electorate voted to "leave" the European Union on June 23rd, 2016. The decision has been referred to as "Brexit", short for "British exit". The referendum, called by Prime Minister David Cameron, had a national turnout of 72.2%, with results that revealed sharp national divisions. With a year until the official day Brexit, on March 29th, 2019, the UK and EU have to sign a trade deal that will establish the fundamental structure for the future relationship between the island and the rest of the continent. While the long-term consequences for the UK remain unclear, one thing is certain, the EU wants the negotiations to be a painful process for Britain. Its officials fear that a good Brexit deal for Britain will inspire other member states to exit, attempt to negotiate similar agreements, and thus lead to the disintegration of the EU.

The first chapter of this thesis provides a timeline of the major events leading up to the UK's exit from the European Union and a description of who is involved in the negotiations as well as the political and economic interests of the British government and the European Union. The second chapter examines the factors that contributed to the victory of the "leave" vote in the UK referendum. The Brexit vote was the result of Britain's historical relationship with Europe, the 2008 financial euro-zone crisis, and the rise of populist euro-skeptic parties in recent years.

The third chapter explores the financial consequences for the City of London after Brexit by drawing comparisons between the potential consequences of a "Hard Brexit" and a "Soft Brexit". My thesis defends that the City of London will continue to be Europe's financial capital but if Britain undertakes a "hard Brexit", UK firms will lose passporting rights and the ECB will claim the relocation of clearing houses, causing the City to lose a significant part of its financial business. I rely on a variety of secondary academic and journalistic materials, on academic and policy conference talks I attended, and on and interviews I conducted with financial professionals in the City of London and with staff members of the European Commission and Parliament in Brussels for my sources.

## II. The Brexit Timeline

In the wake of the historic “Brexit” vote, Theresa May replaced David Cameron as leader of the Conservative party and Prime Minister on July 13th, 2016. Despite being a “remain” supporter during the UK political campaign, Theresa May insisted that the will of the British electorate to leave the EU had to be respected, “The country voted to leave the European Union, and as prime minister I will make sure that we leave the European Union”. Assuming the Prime Ministry at one of the most turbulent times in recent political history, Theresa May promised to negotiate the best term for British departure from the EU, “No deal is better than a bad deal”. The Prime Minister provided several clues in what she wants to achieve from the Brexit process in speeches at the Conservative Party conference in October 2016 and at Lancaster House in January 2017[1].

On March 29, 2017 Theresa May invoked Article 50, a clause in the EU’s Lisbon Treaty that outlines the steps to be taken if a country seeks to leave the bloc. She became the first EU head of government to invoke the exit treaty. The Prime Minister wrote to Donald Tusk, Chair of the European Council, notifying him of Britain’s decision to withdraw. A two-year period began in which the UK and the EU must negotiate the terms of the exit and establish a future economic and political relationship. During this transition period, the UK will remain in the single market

[1] Renwick, Alan. (January 2017). *The process of Brexit: What comes next?* UCL European Institute.

and customs union. The UK will officially cease to be a member of the EU at midnight on March 29th, 2019[2].

The two-year negotiations will proceed in three phases. First, negotiations over the rights of EU citizens in the UK and UK citizens in the EU, over the divorce bill to terminate British membership, and over the status of the Northern Ireland border will be pursued. If the European Council were to decide there is "sufficient progress" made on these issues by October 2018, the EU will authorize to start the negotiations over a transitional arrangement (second phase) and a trade deal (third phase) between the island and the EU27[3].

The key players in the "Brexit" negotiation for the UK are David Davis, Sarah Healey, Oliver Robbins, and Tim Borrow. David Davis was appointed by Theresa May to be the Secretary of State for Exiting the European Union and is Britain's principal negotiator in Brussels. As Brexit secretary, he is leading the talks on what Britain wants from the negotiations and is working closely with the European Parliament to ensure that the process is completed in the two-year period. Davis played a key role in getting Article 50 passed in the British Parliament. Sarah Healey, the director general of David Davis's department, is the second in command in the Brexit negotiation. Oliver Robbins, Theresa May's Europe adviser, is trusted by her, having served in the Home Office when she was Home Secretary. Oliver Robbins will help craft the future economic and political relationship with Europe. Finally, Tim Barrow, Britain's ambassador to the EU, has "overall" responsibility for the UK's departure from the EU. His job consists in ensuring that Britain's policies are clearly explained to EU member states[4].

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[2] Renwick, Alan. (January 2017). *The process of Brexit: What comes next?* UCL European Institute.
[3] (August 2017). *Brexit: At-a-glance guide to the UK-EU negotiations*. BBC News.
[4] (June 2017). *Brexit: The people who are negotiating*. BBC News.

On the other side of the Brexit negotiating table, is Michel Barnier, the European Commission's chief negotiator and a French national. Michel Barnier, described by the Telegraph as "the most dangerous man in Europe[5]", is a tough negotiator as he has insisted that Britain will have to accept the four freedoms "without expectation or nuance" if they want to retain access in the single market. The former French Foreign Affairs minister, Sabine Weyand, was picked as deputy chief negotiator. According to Jean Claude Junker, Weyand is "the Commission's best and brightest". She studied at Cambridge in the 1980s and has more than twenty-three years of experience in trade relations at the Commission itself. Didier Seeuws, Mr. Barnier's right hand man in the talks, heads the Council's task force for Brexit negotiations. Seeuws has experience in negotiating trade deals and an exhaustive knowledge of the workings of Brussels. Donald Tusk, President of the European Council since 2014, must keep Europe's leaders united as they negotiate Britain's exit. The former Polish Prime Minister, has put all his efforts to keep the waters calm in Brussels by stating "what doesn't kill you makes you stronger". Guy Verhofstadt, a Belgian Member of the European Parliament (MEP) and former Belgian Prime Minister, will play a crucial role when the European Parliaments gets to vote on the final Brexit deal[6].

While the priority of the British government is to negotiate a trade deal, the EU leaders clearly stated they would not start the second phase of the negotiations without first solving the three key issues of the Article 50, which are the rights of EU citizens in the UK and UK citizens in the EU, the divorce bill to terminate British membership, and the status of the Northern Ireland border after Brexit. On December 2017, EU leaders agreed to move to the second stage

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[5] Waterfield, Bruno. (February 2010). *Michel Barnier: the most dangerous man in Europe?* The Telegraph.
[6] (June 2017). *Brexit: The people who are negotiating*. BBC News.

of the Brexit talks, as Jean-Claude Juncker informed public that the UK had made "sufficient progress" in the key negotiating issues. First, Theresa May agreed that her government would continue to pay into the EU budget until December 31, 2020, stating that "The UK will honor commitments we have made during the period of our membership" (Theresa May, Florence Speech on September 22nd, 2017). While the British House of Lords argued that the UK was not legally obliged to do so, they agreed that in order to secure a favorable trade deal, the UK's commitment to pay was politically necessary. The UK's financial settlement will be between £35 and £39 billion. Second, the EU27 and the UK have agreed to protect the rights of EU citizens in the UK and UK citizens in the EU. A joint document said both EU citizens and UK nations can continue "to live, work or study as they currently do under the same condition as under Union law[7]". Third, the two sides promised to ensure that there would be no hard border between Ireland and Northern Ireland and to uphold the Belfast agreement. However, Michel Barnier recently noted that a hard Brexit border with Norther Ireland is not "unavoidable" if the UK decides to leave the single market and customs union, "A UK decision to leave the single market and to leave the customs union would make border check unavoidable[8]".

The UK desires a close trading relationship with the EU, even as it seeks to leave the single market and the customs union, negotiate deals with non-EU countries, and end its subservience to the jurisdiction of the European Court of Justice. However, Michel Barnier has no interest in offering the UK a good Brexit deal, for he seeks to dissuade other member states from seeking similar arrangements which could lead to the disintegration of the European Union.

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[7] (December 2017*). Brexit: The rights of EU citizens in the UK and Britons in the EU*. BBC News.

[8] Bienkov, Adam and Payne, Adam. (February 2018). *Northern Ireland border checks are now "unavoidable" after Brexit.* Business Insider

His “fear that other EU27 states will copy the Brits and start asking for special deals is greater than the fear the impact a “Hard Brexit” could have on the EU[9]”. There exist several paths for the UK after Brexit, ranging from a highly disruptive exit without agreement, a “Hard Brexit”, to a smoother path that sacrifices control to remain in the EU single market, “a Soft Brexit”. The UK Parliament and the EU Parliament will have to approve a deal by 11pm on March 29th, 2019, the day that Brexit will officially take place[10].

A breakdown in the talks could occur at any time due to Theresa May’s weak and divided government. Since the general election, in which the Conservative party lost an overall majority in the UK Parliament, there has been open disagreements between its members over the goals and strategies of the negations. The Prime Minister surprised the UK public in calling for early elections in June 2017 to, as she argued, successfully navigate the country though Brexit negotiations. May sought to form a new government to guarantee “certainty and stability for the years ahead”. She believed that the move would strengthen the Conservative government’s hand in the negotiations with the EU. On June 9, 2017, UK citizens and residents woke up to news that the election had resulted in a hung parliament. The Conservative party won 318 seats, eight seats short of a majority and had to enter a coalition government with the Democratic Unionist Party of Northern Island (DUP). The loss of its majority led to a loss of confidence and credibility in May’s ability to govern. “She can’t continue [longer term] because her credibility is shot, not just at home but abroad[11]” and "The PM called this election because she wanted a

[9] Cooper, Charlie. (March 2017). *What the EU27 wants from Brexit.* Politico.
[10] Hunt, Alex and Wheeler, Brian. (March 2018). *Brexit: All you need to know about the UK leaving the EU*. BBC News
[11] John, Tara. (June 2017). *The UK Election Has Produced No Clear Winner.* Times United Kingdom.

mandate. Well, the mandate she's got is lost Conservative seats, lost votes, lost support and lost confidence[12]".

## III. The causes of Brexit

### i. The Weight of History

The Brexit vote was the result of Britain's awkward historical relationship with its neighbors on the European continent. Beginning with The Hague Congress in 1948, in which hundreds of European statesman and prominent citizens met to discuss the construction of a more peaceful and prosperous Europe, Britain encouraged its European neighbors to build, but decided to remain outside of any European political or economic organization. In the early 1950s, as Belgium, France, Germany, Italy, Luxembourg, and the Netherlands initiated plans to develop a European common market and quasi-Federalist political institutions, Britain rejected any participation in the creation of a "United States of Europe". The economic success of the Unites States had provided a compelling argument for the benefits of a common market and the creation of a new Europe assured many Europeans that they would benefit from the increased security and social progress that would follow from economic and political integration, where trade restrictions would be abolished, capital and labor would move freely across borders, and fiscal and monetary policies would be harmonized. But, the UK rejected a Federalist-style European government and common market, fearing that it would lose its "special" political and military relationship with the United Sates, its advantageous trade relationship with its Commonwealth partners, and have its industries subjected to low wage competition. The

[12] Chappell, Bill and Doubek, James. (June 2017). *Theresa May Promises 'Certainty' After Queen Approves plan to Form Government*. NPR News.

founding nations decided to continue with their plans of building a powerful central institution without Britain.

The 1950 declaration by French foreign minister, Robert Schuman, proposing the unification of the French and German coal and steel industries, had invited other Western European countries to join in. Britain rejected the invitation, its political and business leaders seeing themselves as stewards of an imperial power and managers of an economy with a per capita GDP that was almost a third larger than the average of the six founding members. Britain's financial elite wanted the Pound Sterling to remain a global currency and refused to give up monetary sovereignty. Some British leaders saw the Schuman Plan as a "deliberate and concerted attempt to oblige us to accept the United States of Europe"[13].

The 1957 Treaty of Rome created the European Economic Community (EEC) and the European Atomic and Energy Community (EURATOM), a common market in goods, capital, services, and labor across its member states. Its drafters saw it as a step towards an "ever closer union". The six founding member states experienced spectacular rates of economic growth during the following years. Britons watched as their European neighbors surpassed them in economic performance. In the late 1950s and 1960s, UK's economy grew at a lower annual rate (2.7%) than West Germany (7.8%), Italy (5.8%), and France (4.6%)[2].

The poor economic performance of the UK relative to "The Six" provoked its Prime Minister, Harold Macmillan, to approach the leaders of the EEC about joining. Macmillan's famous 1960 speech "Winds of Change" signaled a turning point in Britain's history, marking the end of the UK's role as an imperial power. Britain finally applied for EEC membership in

[13] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc.

1962, two years after Macmillan drafted a document known as a “Grand Design”, a plan for Britain’s future foreign and economic policy that showed a “strong desire to play a full part in the development of European institutions”[14]. The UK was willing to accept a common external tariff and a common agriculture policy. French President Charles de Gaulle vetoed Britain’s first application for membership, believing that the British government lacked a real commitment to European integration. De Gaulle thought that Britain’s domestic industry had to “evolve further” to be compatible with economies of the “The Six”. De Gaulle also vetoed a second UK application in 1969 because he was concerned that Britain’s close relationship with the US would give America too much influence in European affairs.

After Charles de Gaulle’s resignation in 1969, his successor, President George Pompidou, agreed to meet with the then British Conservative Prime Minister Edward Heath to negotiate conditions for a new British application. Heath wanted Britain to join the EEC as he believed that membership would allow it to regain its economic vitality, “This will enable us to be more efficient and more competitive in gaining more markets not only in Europe but in the rest of the world”[3] (Edward Heath, January 1st, 1973). Britain had to accept the Community’s existing intergovernmental institutions, regulations and policies, including a mandated contribution to the EECs budget and an adjustment of its legislation regarding the agricultural sector to conform to the EEC’s Common Agricultural Policy.  Britain became a member of the European Economic Community in 1973 and, in a 1975 referendum, the UK electorate voted by a 2 to 1 margin to remain part of it.

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[14] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc.

Eleven years after the UK's admission to the EEC, tensions exploded over its contributions to the EEC budget. In 1984, Prime Minister Margaret Thatcher claimed that Britain's required payments to the Community budget exceeded the amounts and value of the services and agricultural subsidies it received in return. She colorfully asserted that she wanted "her money back". Thatcher wanted to re-negotiate Britain's contribution to the Community. Four years later in 1988, in her famous "Bruges Speech", she broadened her criticism of the EEC, claiming that it had become an unwieldy, inefficient and overly powerful bureaucracy. In it, she rejected the idea of "a European super-state exercising a new dominance from Brussels"[3] (Thatcher, September 21st, 1988). Observers of British affairs noted at the time that "Europe has been a toxic issue in British politics, not just because it caused division between parties, but also deep divisions within the parties"[15]. The Eurosceptic wing of the Conservative party rejected the idea of a supranational government, the abolishment of border controls, and the adoption of a social market model of capitalism. Its leaders refused to surrender national sovereignty, to pursue the Schengen agreement on travel across borders, and to subject British business to European regulations. Euroscepticism over greater European economic, political, and social integration had become rooted in Britain a little over a decade after it joined the EEC.

"Black Wednesday" marked the beginning of the UK's separation from Europe. The European Exchange Rate Mechanism (ERM), launched in 1979, was introduced to reduce exchange rate volatility and achieve monetary stability within Europe. It was a precursor to economic and monetary union, a preparation for the introduction of the Euro on January 1st, 1999. Initially, Britain refused to join, even after the other members had proposed a special band, allowing the Pound wider fluctuations around the hybrid ECU (a weighted average of the value

[15] Wilson, Sam. (2014). *Britain and the EU: A long and rock relationship.* BBC News.

of its member states' national currencies). However, in 1990 Britain decided to join the ERM, intending to keep its currency above 2.7 Marks to the Pound as a measure to curb its domestic inflation. But, in 1992 the UK was forced out of the ERM, as increasingly diverging inflation rates between the UK and Germany, and conflicting interest rate polices between the Bank of England and the Bundesbank put the Pound Sterling and the broader ERM under pressure. "Black Wednesday" was one of the lowest points of the UK's relationship with its European partners. The UK Treasury estimated that the loss from that day was around $3.14 billion. According to a banking official from Bank of England interviewed in London, "Black Wednesday" was the precursor to Brexit. He argued that "You can draw almost a straight line between September 16th, 1992 and June 23rd, 2016, from Sterling's ejection from the ERM to the referendum conceded by David Cameron that saw Britain vote to leave the EU"[16].

In the 1990s and early 2000s the UK refused to adopt the Euro, to surrender its rights to control its own borders, and to turn the single market into a social market. Britain negotiated an opt-out of the monetary union created by the Maastricht Treaty. The Treaty laid the foundations for a single currency, the Euro. The idea was to create a currency that would reduce exchange rate risk and compete against the American dollar in world currency markets. The Euro promised gains in price transparency, lower inflation, and the facilitation of trade and investment by removing the uncertainties associated with exchange rate fluctuations. The Treaty established a set of convergence criteria to ensure that those countries which joined had stable and low inflation rates, sustainable public debts, reasonably low interest rates, and minimal exchange rate fluctuations against the currencies of their partner states. Britain was not committed to joining a single currency for it was unwilling to lose control of its fiscal and monetary policies. The single

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[16] Official of the Bank of England. (2017, October 12). Personal Interview.

currency was adopted on January 1st, 2002 by twelve countries, but not by the UK. Its launch and early success led to a half decade of "Europhoria", as the states that adopted it prospered economically.

The Maastricht Treaty transformed the European Communities into the European Union, a name change that reflected the evolution of the organization from an economic union into a political union. The Treaty granted the European Parliament more powers, and European officials and expert observers expected that 80% of all future legislation affecting EU citizens would be made in Brussels and Strasbourg. A growing Eurosceptic movement in the UK refused to give up national sovereignty to a more powerful European government. As Margaret Thatcher had warned in her 1988 Bruges speech: "We have not successfully rolled back the frontiers of the state in Britain, only to see them re-imposed at a European level, with a European super-state exercising a new dominance for Brussels"[17]. The UK government had also demanded an opt-out from the Schengen Agreement in 1995, a treaty and set of conventions that abolished internal border checks and international border controls and established common visa policies among its member states. Britain thus stayed out of what became known as Europe's Schengen Area, retaining its own policies on Visas and continuing to maintain customs checkpoints between itself and its European partners.

The Brexit vote is thus a product of a long and complicated relationship between Britain and Europe. From its belated entrance in 1973 to an organization that had already been shaped by its founding six members, to David's Cameron decision to call a referendum on continuing its membership in 2016, the UK has never been comfortable belonging to the EU. It has been unable

[17] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc.

to recast EU institutions and policies according to its vital interests and has been unwilling or incapable of adapting to them. The UK has always had a different view of its role in the world and has faced great difficulties in shifting from being a dominant imperial power to being one of a community of nations. Britain found itself opting out of significant parts of the Maastricht Treaty, of the Schengen Pact, and of the Euro. Euroscepticism became an increasingly dominant political tendency after "Black Wednesday" and finally led to David Cameron's decision to call for a referendum.

### ii. Economic Reasons

The recent financial crisis which began in the United States and spread around the world, and the subsequent Eurozone crisis contributed to the Brexit vote. Europe had enjoyed a long period of rapid economic growth in the late 1990s and early 2000s, but in 2008 the good times ended[18]. Greece entered a recession, Ireland's three major banks became insolvent, Germany's economy slowed down dramatically, and Spain's economic activity plummeted due to the significant exposure of its banks to its collapsing real estate sector[19]. Deficit and debt levels among European governments rose dramatically as tax revenues fell and state expenditures rose as European economies entered recession[20]. Bond yield spreads between trade surplus and trade deficit countries and between those with different levels of government debts and deficits skyrocketed. In October 2011, Sir Mervyn King, the Governor of the Bank of England referred

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[18] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc.
[19] European Commission. (2009). *Economic Crisis in Europe: Causes, Consequences and Responses*. Directorate-General for Economic and Financial Affairs.
[20] European Commission. (2009). *Economic Crisis in Europe: Causes, Consequences and Responses*. Directorate-General for Economic and Financial Affairs.

to it as “the most serious financial crisis at least since the 1930s, if not ever”[21]. The debt crisis generated a series of political conflicts between the UK and the rest of Europe and the recession led to a crisis of confidence in the European economies and the Euro, "Majorities or near majorities in most nations now believe that the economic integration of Europe has actually weakened their economies."[22]

The European sovereign debt crisis started in 2009 when Portugal, Ireland, Italy, Greece, and Spain were unable to refinance their government debts. The failure of their financial systems saddled their governments with huge debts as each attempted to save their insolvent banks. These debts threatened the Eurozone with catastrophe as the states found it increasingly difficult to service them. The contraction in Europe’s economy caused rises in unemployment, in government deficits and debts, and in bond yields spreads, as skepticism towards the future economic and political stability of the euro-zone became widespread. Between 2008 and 2009, EU unemployment rose by 6 million. The jobless rate in Spain, Greece, and Italy reached more than 20%. The government deficits of the sixteen Eurozone nations went from 0.6% of their GDP in 2007 to 6.3% of their GDP in 2009. Britain’s deficit reached 11.5% of its GDP (far higher than the 3% guideline laid down by the Stability and Growth Pact). The Stability and Growth Pact (SGP) was created to enforce fiscal responsibility among the Eurozone member states to preserve the value of the Euro. The SGP obligates each country to maintain an annual budget deficit of no greater than 3% of GDP and a national debt lower than 60% of GDP. By

[21] Kirkup, James. (October 2011). *World facing worst financial crisis in history, Bank of England Governor says*. The Telegraph.
[22] Waterfield, Bruno. (May 2012). *Increasing ‘crisis of confidence’ in the EU.* The Telegraph.

2010, Portugal, Ireland, Italy Greece, and Spain had all violated the pact and their sovereign debts were approaching junk status according to international credit rating agencies[23].

The European Central Bank was at first reluctant to take serious action in response to the crisis, i.e., to dramatically lower its lending rate and expand liquidity. The European Council and Commission created a Financial Stability Facility with contributions from the Eurozone's member states which could offer loans to illiquid banks and governments.  Eventually, the ECB relented, lowering its lending rate and commencing a quantitative easing (QE) program to support private and sovereign bond markets, and stimulate private lending, investment, production and employment. Despite the somewhat successful attempts by the ECB, the European Commission and the European Council to end the Eurozone crisis and promote economic recovery, critics of the Euro system grew ever louder and more numerous. They argued that the ECB's policies were not optimal for all the countries in the Eurozone, favoring Germany and some northern European states to the detriment of the southern and peripheral countries. The ECB and the other EU institutions still lack the policymaking flexibility and cannot simultaneously serve the interests of an "EU split between a core group of highly developed, flexible, well-educated, environmentally conscious nations, and an outer fringe of poorer, less well-equipped, inadequately educated, and inflexible countries"[24].

Meanwhile, as chaos broke out in the Eurozone states, a similar crisis was taking place in the UK. In January 2008, the share prices of Barclays and the Royal Bank of Scotland decreased by more than 9% and the FTSE 100 index plunge by more than 5%. Housing prices fell by 10%

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[23] Gambill, Gregory. (2011). *The Greek Sovereign Debt Crisis and Potential Implications for other Sovereign Nations.* United States of America: University of Connecticut.
[24] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc. p. 220

from January to December 2008, and many retail chains went out of business, including MFI, Woolworths, and Blacks. In the fourth quarter of 2008, the UK's GDP fell by 1.5%[25]. Then, in September 17, 2008, Lloyds TSB announced a £12 billion deal to take over Britain's biggest mortgage lender, the Halifax Bank of Scotland (HBOS). HBOS had suffered huge losses from underwriting subprime mortgages. The event touched off the worst financial crisis Britain has experienced since the 1930s. The FTSE 100 suffered one of its worst single day drops in its history. The British economy suffered greatly from the crisis due to its oversized financial sector. Numerous scholars debate whether London's financial center boost or harms the UK economy. A report from the Organization for Economic Co-operation and Development (OECD) argues that countries with bigger banking sectors suffer weaker growth and worse inequality[26], "Even when the financial sector is not collapsing into the arms of the state, a large finance sector is a debilitating drain on an economy"[27]. The relocation of banks and clearing houses after Brexit could be helpful to Great Britain in the long run as the financial sector would scaled down, allowing the expansion of other sectors of its economy including manufacturing and other non-financial services.

In 2009 the Bank of England undertook an aggressive and pro-active approach to provide support to the financial industry and prevent a generalized run on bank deposits. It injected massive amounts of liquidity (£75 billion over three months) into financial markets to support the banks. Simultaneously, the Bank of England considerably decreased interest rates to a record

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[25] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc.
[26] Stewart, Heather. (June 2015). *OECD: large banking sectors widen inequality and slow growth.* The Guardian.
[27] Stewart, Heather. (June 2015). *That's why the country's in such a state: too many bankers.* The Guardian.

low of 0.5%[28]. The initial reaction of the UK government, as well as other Western governments, was to cut taxes and increase spending. Gordon Brown, the British Prime Minister from 2007 to 2010, led the charge as reported in British Guardian, "the evidence suggests that the last Labour prime minister is in with at least half a shout of keeping the world economy afloat in 2008-2009, and an excellent claim of having saved the UK[29]". In April 2009, Gordon Brown chaired the London G-20 Summit in which the participating governments pledged to do all they could to restore confidence, growth, and jobs, strengthen the financial system, and promote global trade and investment by rejecting protectionism. With monitoring by the IMF, the G-20 agreed to make available more than $1 trillion to support the countries' economies[30].

A year into the crisis, a new Conservative-led British government engineered a dramatic U-turn in fiscal policy. The new government led by David Cameron adopted a major deficit reduction plan that imposed a harsh austerity program of massive spending cuts. The austerity measures slowed down the economic recovery and generated a populist move among many Britons with poisoning attitudes towards elites, immigrants, and the EU. On the other hand, the Bank of England continued its astonishingly expansionary monetary policy. In October 2011, it resumed its "Quantitative Easing" program and pumped another £75 billion into the financial system, increasing the QE budget to £275 billion, as it faced warnings of a "double-dip recession[17]".

Simultaneously, Europe concentrated in stabilizing the Euro, as the bailouts of debt-laden members pushed the currency union to the verge of collapse, creating macro-economic

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[28] Allen, Katie. (January 2015). *Quantitative easing around the world: lessons from Japan, UK, and US.* The Guardian.
[29] Chakrabortty, Aditya. (February 2012). *Gordon Brown did not save the world, but he saved the UK.* The Guardian.
[30] Portes, Jonathan. (April 2009). *The outcome of the London Summit*. CEPR' Policy Portal.

regulations as well as programs to promote economic growth[31]. The Eurozone member states created the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). The EFSF was a temporary mechanism to assist Ireland, Portugal, and Greece. It was replaced in 2013 by the ESM. Both organizations provided financial assistance programs for Eurozone states and banks facing liquidity crises. The ECB maintained historically low interest rates and provided loans of €1 trillion to its member banks to maintain their liquidity.

The British and US economy rapidly recovered from the financial crisis due to the quick and proactive policies of the Bank of England and the US Federal Reserve. The US recession ended in June 2009 and achieved its pre-recession GDP level in the middle of 2010[32]. The British recession also ended in the middle of 2009, but it did not reach its pre-recession level of GDP until 2013[33]. The Eurozone experienced a double dip recession and did not recover its pre-recession GDP until the start of 2015[34]. recession. Therefore, on July 26, 2012, the European Central Bank announced the change of its monetary policy stance, signaled by the famous remark of its President, Mario Draghi: "We are ready to do whatever it takes to preserve the single currency[35]".

[31] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc.
[32] U.S. Bureau of Economic Analysis. (March 2018). *Real Gross Domestic Product [GDPC1]*. FRED, Federal Reserve Bank of St. Louis.
[33] Eurostat. (March 2018). *Real Gross Domestic Product for United Kingdom*. FRED, Federal Reserve Bank of St. Louis.
[34] Eurostat. (March 2018). *Real Gross Domestic Product for Euro area (19 countries).* FRED, Federal Reserve Bank of St. Louis.
[35] Wigglesworth, Robin and Groom, Brian. (July 2012). *ECB 'ready to whatever it takes'*. Financial Times.

In many ways, the 2008 financial crash and the euro-zone crisis put "a time-bomb under the sustainability of Britain's membership of the EU"[36]. The Eurozone failed to deliver growth and promote stability. The crisis had a huge impact on the economic growth, the labor market and employment, and the fiscal budgetary positions of the member states[37]. The struggle to resolve the Eurozone's problems, including its high and increasing unemployment rates and its member states' huge government debts, distracted Europe from achieving its long established economic and political objectives[38]. The 2008 financial crisis created distrust among Europe's populations of supra-national institutions. The European Union suffered a dramatic fall in its credibility[39].

The 2008 financial crash and the Eurozone crisis exacerbated economic inequalities between the core and peripheral states of the EU which heightened longstanding British euro-skepticism[40]. In the half decade after the European monetary union was created, most of its member states experienced good rates of economic growth with inflation rates within the ECB's targets[41]. However, when the financial crisis hit, the ECB's initially tight monetary policy and its promotion of austerity-type national fiscal policies arguably contributed to chronic economic stagnation and high unemployment among its southern and peripheral member states. The national austerity measures urged on by the European Commission and Council, and promoted

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[36] Thomson, Helen. (2017). *Inevitability and contingency: The political economy of Brexit*. The British Journal of Politics and International Relations. p.446
[37] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc.
[38] Lanchester, John. (October 2016). *The failure of the Euro*. The New Yorker.
[39] Muro, Diego and Vidal-Lorda, Guillem. (June 2014). *Mind the Gaps: The Political Consequences of the Great Recession in Europe.* London School of Economics.
[40] Merler, Silvia. (March 2017). *European identity and the economic crisis*. Bruegel.
[41] Gilbert, Mark. (2011). *European Integration: A Concise History.* United Kingdom: Rowman & Littlefield Publishers, Inc.

by the ECB, helped to create a clear division between some of the core member states (primarily Germany) and some of the peripheral member states (primarily Greece), whose experience of the crisis was decidedly different due to the imbalances between their economies. Media, government, and economic elites in the former argued that "citizens in the north cannot be faulted for not wanting to pay for the economic errors or misdeeds of the south, they do not a sense that they "owe" those in the south anything in the name of a shared European identity"[42]. Some observers argue that different policy choices by the European Commission and Council, by the ECB, and by the national governments themselves could have ameliorated the crises and ended it sooner. Whether or not this would have required resource transfers from the richer to the poorer members' states is an open question about which many officials, scholars and informed observers give different answers[43].

Before the Brexit referendum, the UK had the fastest growing economy among all major European countries and an unemployment rate below Germany's. Its annual economic growth in 2016 was 2.2%. In the three months leading up to the July 2016 EU referendum Britain's economy grew by 0.6% due to the performance of its industrial, retail, healthcare, and car manufacture sectors. Industrial production had jumped by 2.1%, the manufacturing sector had risen by 1.8%, and every other sector was expected to keep growing in the following quarters. The chancellor, Philip Hammond, claimed that UK's economy was fundamentally strong, "We enter the referendum from a position of economic strength[44]". However, even if Britain had experienced healthy growth rates, the 2008 financial crisis had made Brexit an inevitable event.

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42 Merler, Silvia. (March 2017). *European identity and the economic crisis*. Bruegel.
43 Debating Europe. (June 2017). *Is it fair that rich EU countries pay for the development of poor EU countries?*
44 Paterson, Owen. (October 2016). *We will enter Brexit negotiations from a position of strength.* Prospect.

The failing Euro and Eurozone monetary and fiscal policies as well as the tensions between its core and periphery countries put the UK's membership at risk and influenced the "Brexit" vote.

### iii. The Demographic Divide in Britain

The EU referendum brought to the surface deep divisions in voter attitudes based on income, education and living standards in Britain. Regions with low GDP per capita, large proportions of un-skilled workers with low levels of education, and a large percentage of people over the age of 65 were more skeptical of the EU and voted "leave". On the other hand, regions that had benefitted the most from immigration, trade, and globalization voted strongly in favor of remaining in the EU. Robert Peston, a British journalist, presenter and political editor of ITV News, argues that globalization has not worked for everyone as it has accentuated the gap between college educated white collar professional workers and non-college educated blue collar workers and/or members of the lower middle classes. The referendum results illustrated the demographic and economic division of the country over Brexit[45].

Surveys on the Brexit vote indicated that perceptions of immigration played an important role in how people voted, and that differences in age, education, social class, geographic residence, and wealth heavily influenced those perceptions[46]. A total of 36% of 18 to 24-year-olds, 81% of 55 to 64-year-olds, and 83% of those aged 65 years old and older participated in the vote. Dorling and Stubbs attributed the low turnout rate for the young to high student debt levels, low wages, precarious housing situations, and discontent with increasing levels of

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[45] Peston, Robert. (October 2017). *UK and EU Politics, Economic Prospects, and the Future of the City.* Société Générale Annual Equity Derivatives Conference. London, United Kingdom.
[46] Dorling D., Stuart B., Stubbs. J. (2016). *Brexit, inequality and the demographic divide*. London Schools of Economics.

inequality. Those young people who voted tended to hold more socially liberal views and to have more positive perceptions of immigration. Older people turned out in greater proportions and numbers, perhaps because they didn't face the challenges of their younger cohorts. Also, older voters tended to have more conservative views, to hold less positive opinions on immigration, and to associate the EU with decreases in their wages and living standards. The East coast areas scored the highest anti-EU votes as they have the UK's highest pensioner population.

Differences in education levels between UK voters also played an important role in how they voted[47]. Voters with higher levels of education and areas where residents had proportionately more college degrees voted in favor of the EU, as they perceived that access to the EU's single market offered them significant economic and social benefits. A total of 44% of voters with a university degree or an equivalent qualification voted to "remain" in the EU. Two-thirds of the population of the city of London have bachelor's degree and they voted to "remain". In the London borough of Wandsworth, the London suburb of Richmond, and city of Cambridge, where half of the populations have higher education qualifications voted by a two to one margin to "remain" in the EU. Only three of thirty-five geographical areas where more than half of the residents had a university degree voted to "leave" the EU--- these included South Bucks, West Devon, and Malvern Hills. Finally, residents with no formal qualifications or whose education ended in secondary school voted 56% to "leave" and 33% voting to "remain".

Differences in social class, wealth and residence were key dividing lines in the EU referendum[48]. High income areas of the UK where the nation's wealth is heavily concentrated,

[47] Dorling D., Stuart B., Stubbs. J. (2016). *Brexit, inequality and the demographic divide*. London Schools of Economics.
[48] Dorling D., Stuart B., Stubbs. J. (2016). *Brexit, inequality and the demographic divide*. London Schools of Economics.

such as the South East, the South West, and most of London voted to remain in the EU. There was a strong positive correlation between the regional centralization of wealth and the vote to "remain". Lower and middle-class areas with high levels of semi-skilled and unskilled workers voted to "leave". The poorest areas, hit hardest by the financial crisis of 2008, voted to leave. These included Wales, Sunderland, and Yorkshire. A total of 62% of the voters of Blaenau Gwent in Wales with the highest working-class population in Britain voted to leave.

Finally, the regions that have benefited most from immigration and trade voted most strongly in favor of "remain", while regions where people felt more threatened by immigration voted to "leave"[49]. Older and lower income people disproportionately voted to "leave", having more negative views on immigration and the influence of the European Union institutions. People residing in less wealthy areas perceive immigration as a threat to British national identity and as the reason for declining wages, shortages of housing, and a degradation of public services. A poll conducted two weeks before the referendum showed that voters overestimated the size and impact of immigration. Respondents thought that EU citizens made up 15% of the total UK population, whereas the actual figure is 5%. People in London, the South West, and the South East, all wealthier areas, have more positive views of migration (45%, 35%, 35%), contrary to those in the North West, the Northeast and the Midlands (32%, 29%, and 30%). Meanwhile, areas where a higher percentage of the population were born outside the UK voted to "remain"; for example, the city of London, where immigration is massively higher than the rest of the country, had a 60% vote to "remain".

[49] Dorling D., Stuart B., Stubbs. J. (2016). *Brexit, inequality and the demographic divide*. London Schools of Economics.

The EU referendum results exposed divisions between a highly qualified population that is comfortable competing in the international labor market and enjoys the cultural diversity that comes with immigration, and a "left-behind" Britain that has not benefited from globalization. Brexit signifies a rejection of globalization, as a large percentage of the UK population has not benefited from the advantages of global free market capitalism. According to Robert Peston, globalization hasn't worked for everyone in Britain[50]. The people that have gained from globalization are the one percent of the advanced capitalist nations and the growing middle classes of the rapidly developing Asian nations who've experienced increases in income and wealth. Many people across the UK do not believe that a globalized economy is working for them as they observe and experience increasing inequality, growing poverty rates, and stagnant wages. Unskilled and semiskilled labor displacing technological innovation and increasing competition from low wage labor in the developing world has led to job insecurity and stagnant wages among the middle and lower income classes of Britain and increases in the income and wealth gaps between them and the economic elites. The unbalanced British economy exhibits deep national geographical inequalities which contributed to Brexit.

### iv. The rise of political extremist groups and euro-skepticism

The vote for Brexit was led by a populist, anti-elite, and anti-system political movement at a time when euro-skepticism was on the rise in the UK. Historically, populists have promoted the disruption of the existing social order by supporting ordinary people against privileged elites and "the establishment". A prominent current example of a pure populism is the Italian Five Star

[50] Peston, Robert. (October 2017). *UK and EU Politics, Economic Prospects, and the Future of the City.* Société Générale Annual Equity Derivatives Conference. London, United Kingdom.

Movement led by Beppe Grillo, who in 2009 claimed that "the elite is corrupt" and asked Italians "to vote for me". Modern populist parties reject economic integration, free markets, and liberal values[51]. Over the past decade, Western democracies have experienced the rise of anti-system political movements that seek to completely change their current economic, political, and social systems[52]. According to Jean-Claude Juncker, the president of the European Commission, European nations are facing "galloping populism[53]". A populist political party, the United Kingdom Independent Party (UKIP) was prominent in the Brexit campaign and influenced the UK electorate to vote "leave" advocating the disengagement from the European Union.

Euroscepticism is a doctrine that criticizes Europe's economic, political, and social effectiveness. In Britain and in Europe more widely the movement gained increasing momentum in the early 1990s. France, an original founding member of the EU, narrowly approved the Maastricht Treaty with only 51% of the vote in favor. The result of the referendum, known as the "petit oui" and the Danish "No" vote on June 1992 caused the greater prominence of an overt Euroscepticism in Europe[54]. British Euroscepticism as a political movement has its roots in 1973, at the beginning of Britain's membership of the European Economic Community, but since the 2008 financial crisis, Britain has experienced an explosion of populist Euroscepticism.

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[51] Hopkin, Jonathan. (June 2017). *When Polanyi met Farage: Market fundamentalism, economic nationalism, and Britain's exit from the European Union.* The British Journal of Politics and International Relations.

[52] Convery, Alan, Peterson, John, and Wincott, Daniel. (September 2017). *Brexit: causes and consequences*. The UK in a Changing Europe. The British Journal of Politics and International Relations.

[53] Ellyatt, Holly. (September 2016). *Europe faces 'galloping populism', Junker warns in State of the Union address. CNBC* News.

[54] Bilefsky, Dan. (April 2016). *Voting on European Integration: A Long History of Skepticism*. The New York Times.

Historically, populist movements have appeared during economic crises. After sixty years of political dominance the center-left and the center-right democrats are in retreat[55]. The popularity of Eurosceptic opposition parties grew after the Great Recession of 2007-2009 as EU polices failed to increase economic growth[56]. The deep recessions, huge deficits, and increasing unemployment rates that plagued most EU member states panicked large segments of their populations who increasingly called for radical solutions to their problems. As Josh Elboim, former director of equity derivative sales at Société Générale notes, "Since the 2008 financial crisis, wealthy individuals have recovered but the other part of the population hasn't, and they feel like they have been left behind[57]".

The recent populist, anti-establishment surges on the Right are responses to the dramatic refugee crisis in Europe, and on the Left to the economic and political failures of European and national institutions[58]. Right-wing populist parties -- Britain's UKIP, the French Front National, and Germany's Alernative für Deutschland -- refuse to transfer more sovereignty to Brussels and decry immigration from either the new Eastern European member states of the EU or refugee and migration inflows from the Middle East and North Africa. SYRIZA in Greece, Podemos in Spain, the Bloco de Esquerda in Portugal, and La France Insoumise in France are left wing parties that have demanded dramatic reforms in EU institutions and policies but have not, for the most part, called for an exit from the European Union[59]. The rise of Eurosceptic and extremist

[55] Jordan, Jason. (October 2017). *The Resurgence of Populist Nationalism in the West.* Drew University Conference. Madison, New Jersey.
[56] Jordan, Jason. (October 2017). *The Resurgence of Populist Nationalism in the West.* Drew University Conference. Madison, New Jersey.
[57] Josh Elboim, Interview in London
[58] The EEAG Report on the European Economy. (2017). *"Economic Policy and the Rise of Populism – It's Not So Simple"*. CESifo, Munich. pp. 50–66.
[59] The EEAG Report on the European Economy. (2017). *"Economic Policy and the Rise of Populism – It's Not So Simple"*. CESifo, Munich. pp. 50–66.

political groups have spread across the continent. In Finland, the Finns Party led by Timo Soini, which some observers call a populist party and others a traditional ultra conservative party, gained one fifth of the vote in 2015 election. In Spain, Podemos, characterizes itself as a Left wing Populist party, collected a third of the national votes in the 2015 election. In Greece, the support for both sides of the political spectrum has dramatically increased, and in the Netherlands, the party for Freedom, characterized as right wing, populist, anti-Muslim immigrant, Eurosceptic, and led by Geert Wilder, has received large levels of support. The UK's referendum has empowered anti-European movements across the continent[60].

In the UK, concerns about immigration and terrorism, growing mistrust of European Union and domestic mainstream political elites, and fears of globalization and rising inequality inspired the recent wave of populism. In the aftermath of the accession of ten states to the EU in 2004, and a second accession of two states in 2007, the UK received increasingly large numbers of immigrants from the new member states. According to the Office for National Statistics, between 2015 and 2016, immigration from countries that joined the EU in 2007, Romania and Bulgaria, increased by 19,000[61]. A further 48,000 people came from the eight countries that joined the EU in 2004-- Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Latvia, Lithuania, Estonia[62]. According to Marek Okolski, the movements were a response to demographic and economic factors in these countries as well as a "hidden shortage of labor in some sectors in the UK[63]". Notably, the recent huge waves of refugee migrations from the

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[60] Ser, Kuang. (July 2016). *After the UK, which nations are more vulnerable to an anti-EU revolt?* PRI's The World.
[61] Office for National Statistics. (February 2017). *Migration Statistics Quarterly Report: Feb 2017*.
[62] (May 2017). *Reality Check: Migration to the UK. BBC* News.
[63] Okólski, Marek. (November 2014). *Polish Emigration to the UK after 2004; Why Did So Many Come?* Central and Eastern European Migration Review. p.11-37

Middle East and North Africa to continental Europe, did not impact Britain, as it is an inaccessible island state. In an interview by Edward Alden, James McBride states "The irony is that the country that was least affected by the refugee and migration crisis is the one where we've seen the most consequential political backlash[64]".

UK political extremist groups promoted the idea that leaving the EU was the only solution to out-of-control immigration and terrorist attacks. While Jonathan Portes, a professor of economics and public policy at King's College London, demonstrates that there is little relationship between wages and immigration in the UK[65], the United Kingdom Independence Party argued that restricting labor migration to the UK would reduce the unemployment rate and maintain the wages of British citizens. The concerns about immigration are not only related to its effects on employment, wages, and economic and social inequalities, but also to the belief that immigration is threatening Britain's culture and national security. The terrorist attacks in major European cities before the UK Referendum allowed populist parties to counter the argument that the EU made Britain a safer place. They claimed that open borders and free movement of people implied the free movement of terrorists across the continent. As Peter Foster editorialized in The British Telegraph daily newspaper following a series of Terrorist attacks in Brussels, "On days like today, the very phrase "European security" sounds like a bad joke"[66]. Populist parties used the terrorists' attacks as a key plank in their Brexit political campaign, arguing that being in the EU would not keep Britain safe from terrorist atrocities. However, it is important to emphasize

[64] Alden, Edward. (June 2016). *What Brexit Reveals About Rising Populism. Greenberg Center for Geo-economics Studies.* Council on Foreign Relations.
[65] Portes, Jonathan. (July 2017). *Why you're wrong if you think clamping down on immigration from Europe will help low-paid British workers.* The Independent.
[66] Foster, Peter. (May 2016). *Brussels attacks: Terrorism could break the EU and lead to Brexit.* The Telegraph.

that homegrown terrorism inspired by the Islamic State poses the dominant threat to the national security of the UK. Soeren Kern's report references the study of Hannah Stuart "Islamist Terrorism: Analysis and offences and Attacks in the UK (1998-2015*)*", which explains that young British males and females have been the most prevalent offenders in recent years, "The threat to the UK remains from homegrown terrorism and is heavily youth- and male-oriented with British nationals prevalent among offenders[67]".

UKIP emphasized in their campaigns that bringing back control from Brussels to London would solve all the UK's economic and immigration problems. Their slogan "Take Back Control" meant that the UK needed to regain its ability to take decisions and pass its own laws. They argued that the UK should not accept EU's supremacy and the rulings of the European Court of Justice. UKIP's political campaign criticized European integration and called for a return of the supremacy of British Nation State.

The Conservative Party and the Labour Party, the oldest UK political parties, have dominated British political life since the early 20th century[68]. Before the Brexit referendum, the Conservative party, while united in support of free markets, private enterprise, a strong military, and "traditional social values", was divided over Britain's relationship with Europe. Most party members were in favor of a revision of Britain's membership in the EU but did not wish to hold a referendum on it. Two-thirds of the Conservative members wanted to remain part of the EU. However, once the vote was held and the British electorate voted to leave, Conservative Prime Minister David Cameron, who had led the "Remain" camp, resigned from office and the party's

[67] Kern, Soeren. (March 2017). *Homegrown Terrorism is Top Threat to UK*. Gatestone Institute International Policy Council.
[68] Profile: The Conservative Party. Election 2010. BBC News.

official position was reversed. Cameron's successor, Theresa May, who had supported "Remain", was charged with negotiating an exit from the EU.

The British Labour Party, whose Parliamentary members had been divided on membership in Europe until the 1980s, became increasingly pro-European in the late 1980s and 1990s. This, however, only emerged after Neil Kinnock's election as a party leader in 1983, followed up by Tony Blair's pro-Europeanism[69]. The major democratic socialist party in the UK, led by Jeremy Corbyn since September 2015, started showing a clear division after the EU referendum. In April 2017, the party reached historically low polling numbers (25%) as traditional Labour voters started moving towards the Conservatives who they believed were more supportive of Brexit[70]. The Labour Party was divided between nationalist Eurosceptic and pro-European MPs. Two thirds of the Labour party supporters voted to "remain"[71]. The Conservatives no longer enjoyed the Parliamentary majority they had since 2015 after the June 2017 general election. Brexit became more complicated that anyone would have expected[72].

Finally, the United Kingdom Independence Party (UKIP), founded in 1993 in opposition to the Maastricht Treaty, slowly seeing its poll ratings and its voting percentages (although not its Parliamentary seats) in UK elections rise, experienced one triumph after another in European elections[73]. Two years before the referendum, the party gained 27% of the popular vote in the European Parliament elections due to the UK's increasing Eurosceptic sentiment. This marked

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[69] Dimitrakopoulos, Dionyssis. (September 2015). *The Labour Party and the EU*. The UK in a Changing Europe.
[70] Dimitrakopoulos, Dionyssis. (September 2015). *The Labour Party and the EU*. The UK in a Changing Europe.
[71] Ashcroft, Lord. (June 2016). *How the United Kingdom voted on Thursday… and why*. Lord Ashcroft Polls.
[72] Grose, Thomas. (June 2017). *Brexit Negotiations Just Became a Lot Harder for the UK*. US News.
[73] McIntyre, Sophie. (May 2017). *How many seats did UKIP win?* Independent.

the first time in history that a non-mainstream party, different from the Conservative and Labour parties, won the European elections[74].

Instead of a normal political campaign, the EU referendum campaign was framed as "pro-establishment versus-anti-establishment", "pro-immigration versus anti-immigration", "nationalists versus internationalists". The "leave" campaigns of UK populist political parties, including UKIP, the Labour Party, and the Conservative party, successfully undermined the "remain" political campaigns. The official leadership and most of the Parliamentary members of the Conservative, Labour, and Liberal Parties, and the other minor parties in the UK Parliament took a "remain" position. Only UKIP, a large number but still a minority portion of Conservative MPs and a smaller number of dissident Labour MPs took a "leave" position. While the "remain campaign" was warning the UK electorate about all the future potential economic consequences of Brexit, populist groups questioned the "remain" campaign leaders' honesty and changed the focus of the economic issue into immigration. The populist and anti-system movement increased voter hostility towards Europe, arguing that the "Remain" campaign was attempting to frighten the electorate to vote for the status quo. According to a member of the Bank of England, the UK citizens that voted "leave" wanted a change in government and rebelled against the current system, "In David's Cameron government cabinet more than 60% of his cabinet went to private schools and was involved in the Panama papers[75] scandal"[76].

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[74] Wintour, Patrick and Watt, Nicholas. (May 2014). *UKIP wins European elections with ease to set off political earthquake*. The Guardian.
[75] The Panama Papers are 11.5 million leaked documents that detail how the rich and powerful use tax havens to hide their wealth. The files were leaked from one of the word's more secretive companies, a Panamanian law firm called Mossack Fonesca.
[76] Official of the Bank of England. (October 2017). Personal Interview.

In addition, UKIP and the leadership of those parts of the Conservative party that supported "Leave" were able to influence the electorate by changing the focus of the campaign from economic towards immigration issues. Their campaign claimed that the negative economic consequences of "Brexit" highlighted by the "Remain" camp were vastly exaggerated. They received favorable coverage by leading tabloid newspapers and by parts of the mainstream broadsheet press. Press coverage of immigration tripled in the ten last weeks before the EU referendum. The Daily Mail, the Daily Telegraph, and the Daily Express each repeatedly published front page articles on the "problems of mass immigration" before the referendum. During the last four weeks before the vote, more than half of the articles in these papers discussed the economic, social and political burdens of immigration. More than 98% of the articles published during this time portrayed negative images of Albanian and Turkish immigrants. They used dramatically exaggerated metaphors to describe the migrations, like the opening of the "floodgates" or the arrival of the "waves" of foreigners, or the "flocking" and "swarming" of refugees. The "Leave" campaign emphasized that the only way to reduce migrant numbers was to leave the Union. They promised to increase the UK's border forces and introduce a "one in, one out" immigration system to track illegal immigration and reduce net migration to zero[77].

The "Leave" campaign effectively used digital communication, mainstream media, and social media to swell its vote. While the "remain campaign" paid little attention to social media, the more populist "leave" campaign used emotional appeals and clear messaging on it to influence the electorate. Millions of people were mobilized through the Internet to vote for

[77] Maidment, Jack. (June 2017). *UKIP manifesto for General Election 2017: Key Points, policies and summary.* The Telegraph.

Brexit. Their populist message dominated the most popular social media platforms like Facebook, Twitter, and Instagram, and #IVoteLeave became a trending hashtag. The media campaign influenced millions of voters that did not have strong opinions on “Brexit”. UKIP’s propaganda messages that EU membership contributions cost Britain 14.5 billion pounds per year, that EU regulations cost it another 33.3 billion per year, that the UK should take its democracy back to “control its destiny”, determine its own laws and sign its own trade dals with the rest of the world, was very effective in swaying voters.[78]

v. Conclusion

The Brexit vote was the result of Britain’s awkward historical relationship with its neighbors on the European continent. Britain decided to remain outside of the European political and economic integration process until 1973. After it joined, the country became an awkward partner that had to adapt its legislation to the already established organization and found itself opting out of significant parts of the Maastricht Treaty, the Schengen Pact, and the Euro. The 2008 financial crisis and the subsequent Eurozone crisis also influenced the Brexit vote. The failing Euro and rising critics towards the EU put Britain’s membership at risk and generated a dominant Eurosceptic political tendency. UKIP campaigned against European integration at a time when Euroscepticism was on the rise. It successfully influenced the UK electorate to vote “leave” by promoting a populist campaign against the establishment’s political parties. The following chapter will discuss the financial consequences for the City of London after Brexit by drawing comparisons between the potential consequences of a “Hard Brexit” and a “Soft Brexit”.

[78] Pearson, Allison. (June 2016). *Sir James Dyson: ‘So if we leave the EU no one will trade with us? Cobblers…’.* The Telegraph.

## III The Economic Consequences of Brexit for the City of London

### i. The City of London as the financial hub of the European Union: A Brief History

The Global Financial Center's Index of 2007 lists London as the most competitive financial center in the world, ahead of New York and other major cities across the globe[79]. For the past three hundred years it has been a primary location for the trading of international financial assets. The largest shares of international bank lending, foreign exchange turnover, and cross-border trading in equities and bonds occur in the City of London. How did it become the financial hub of Europe and a major international financial center? The City's success and prosperity has long been associated with an openness and liberal attitude towards foreign business, international trade and foreign investment. The growth of the Eurodollar and then the Eurobond market are the major reasons for the development of London as a major European financial center[80].

The more recent success of the City of London as a major international financial center was achieved as result of economic developments and public policy decisions made after WWII. Post-war Europe received $13 billion of financial aid under the U.S. Marshall Plan to facilitate its recovery from WWII. The aid only partly alleviated widespread dollar shortages in Western Europe in the late 1940s and early 1950s, as Europeans lacked sufficient productive capacity to meet domestic demand and used Marshall funds and other credit to purchase American goods. The situation changed in the mid-1950s as the US increasingly ran large balance of payments

[79] (March 2007). *The Global Financial Centers Index*. City of London.
[80] Burk, Katherine. (March 1992). Witness Seminar on the Origins and Early Development of the Eurobond Market. Cambridge University Press. P.67

deficits with its European partners. U.S. trade deficits with and U.S. multinational companies' investment in Europe transformed European dollar shortages into dollar gluts.

The Glass-Steagall Act passed by the US Congress in June 1933, and Regulation Q introduced by the US Federal Reserve in August 1933, both part of the New Deal reforms of the US financial system, imposed various restrictions on commercial and investment banking. The former segregated the two forms of banking to preclude the use of commercial bank deposits from financing risky equity investment, believed to have worsened if not initiated the 1929 Wall Street crash and subsequent depression. The latter, imposed interest rates ceilings on bank deposits to prevent commercial banks from competing for them in attempts to take on higher return but riskier loans. In the mid-1950s, much of the increasing flow of dollars to Europe, a result of rising US trade deficits with and US F.D.I in Europe, were not channeled back to the United States, where the interest rates they could earn on US Treasury securities or in US bank deposits were quite low. Dollars were increasingly retained outside of the US to escape the operational controls imposed by the US central bank. Michie and Mollan note that "the restrictions imposed by the Federal Reserve promoted a regulatory escape by large American banks seeking to sidestep New Deal regulation and take advantage of London's burgeoning offshore business[81]".

Eurodollars initially escaped the strict regulations imposed by the Federal Reserve Board in the US, but why was the business moved to the City of London? The major competitive advantage of the City of London was a lax regulatory environment. It became an attractive destination for US dollar deposits in UK and later in the UK branches of US banks as they could

[81] Green, Jeremy. (December 2015). *Anglo-American development, the Euromarkets and the deeper origins of neoliberal deregulation*. Cambridge University Press.

earn higher interest rates in Britain than in America. In 1955, UK banks started offering exchange deals and liquidity programs that allowed investors to earn interest rates in their credit deposits. US banks were restricted in providing interest rates to investors due to the strict regulations imposed by Regulations Q[82]. At first, this was a mechanism for channeling American deposits into the British economy since Midland switched funds into sterling as an alternative form of currency. This was accomplished by recycling Eurodollar deposits as loans to companies and governments outside the UK[83]. Banks in London bid for funds by paying a slightly higher rate and then re-lent them back at rates just below US rates. Then, Banks slowly created Eurodollar accounts and by April 1963, the London offices of American banks accounted a third of all UK's banks overseas liabilities[84]. The Eurodollar market in London grew from $1.5 billion in 1959 to $50 billion in 1970[85].

London attracted most of the Eurodollar business due to the higher interest rates in the UK, the self-regulation permitted by the British authorities, and the changes in access to the forward exchange market. The major competitive advantage of the City was the regulatory environment which combined tight money in the domestic economy with relative freedom in international finance. The innovations of the Midland Bank led to the opening of numerous US bank operations in London as American bankers sought to take part in the new market. The growth of the Eurodollar market combined with the laissez faire environment prompted the

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[82] Ferguson, Niall. (May 2009). *Siegmund Warburg, the City of London and the financial roots of European Integration.* p. 369
[83] Ferguson, Niall. (May 2009). *Siegmund Warburg, the City of London and the financial roots of European Integration.* p. 369
[84] Michie, R.C and Mollan, S.M. (1992). *Networks and Clusters: The City of London as a Global Financial Center since 1870*. Durham University and York St John University. p.1
[85] Ferguson, Niall. (May 2009). *Siegmund Warburg, the City of London and the financial roots of European Integration.* p. 369

invasion of American, Swiss and other foreign banks to the City of London. The number of foreign banks increased from 51 to 129 between 1962 and 1970. More than 75% of the money in London's banking system came from abroad[86]. The number of funds handled by foreign banks in London grew from 263 million to 12-billion-pound sterling between 1957 and 1969[87]. The Eurodollar market moved from being dominated by British banks to one dominated by the branches of American banks in London. As Catherine Schenk wrote, "Moorgate, where many US banks found premises, became known as 'America Avenue'"[88]. The Eurodollar market quickly became the key advantage to allow the City of London develop into the financial hub of Europe as well as one of the world's largest international capital markets headquartered in London[89].

The rise of the Eurobond market between the mid-1950s and 1970s was another breakthrough in the history of London's development as a major financial center. Initially, Eurobonds were dollar denominated bonds issued in Europe rather than in the US, as non-American investors who sought to borrow dollars were required to go through a complicated underwriting syndicate on Wall Street. Eurobonds were a form of medium or long-term financing. In the 1960s, the architects of the Eurobond market, Siegmund Warburg and his associates in the City of London, made a conscious effort to re-establish the City of London as an international financial center. Siegmund Warburg, a prominent German-born English banker,

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[86] Michie, R.C and Mollan, S.M. (1992). *Networks and Clusters: The City of London as a Global Financial Center since 1870*. Durham University and York St John University.
[87] Michie, R.C and Mollan, S.M. (1992). *Networks and Clusters: The City of London as a Global Financial Center since 1870*. Durham University and York St John University.
[88] Schenk, Catherine R. (2010). *The Regulation of International Financial Markets from the 1950s to the 1990s.* University of Glasgow. p.3
[89] Schenk, Catherine R. (1998). *The Origins of the Eurodollar Market in London: 1955-1963*. Department of Economic and Social History. University of Glasgow. p. 224-228

played a crucial role in founding the Eurobond market in the 1960s. The successful financier envisioned his creation as enhancing his companies' profits, but mainly as way to rebuild London's pre-war position as an international financial center.

The birth of the Eurobond market took place on July 1st, 1963 with the first Eurobond issued by Autostrade, an Italian motorway construction company. It issued $15 million in Eurobonds through a London banking institution, Julius Strauss, who sold part of the issue to its Swiss clients. Strauss invented the name "Eurobond" to replace the term "foreign loan in dollars" as he wanted to expand the "Europeanisation" of the market[90]. The Eurobond market grew because of its tax-free status and ease of trading. In 1963, $4.8 billion in Eurobonds were issued in the UK. In 1972 the total was $17.5 billion, and from 1978 through 1983 the total was $165.6 billion. Eurobonds have grown to be one of the world's "biggest and freest sources of long-term public funds"[91], comprising 90% of international bond issues today.

Ten years after another significant development took place in the City of London. In 1986, Margaret Thatcher's government initiated the "Big Bang" reform, which revolutionized London's financial industry. The agreement between the London Stock Exchange and the British government transformed London's securities market, making it "globally competitive"[92]. The Financial Times described the "Big Bang" as a "City Revolution". To this day, it is considered one of the Conservative party's signature policy reforms, laying the foundations of what became Europe's primary financial center. It generated a wave of mergers and acquisitions, ending the

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[90] Burk, Katherine. (March 1992). *Witness Seminar on the Origins and Early Development of the Eurobond Market.* Cambridge University Press. p.69

[91] Ferguson, Niall. (May 2009). Siegmund Warburg, the City of London and the financial roots of European Integration. p. 379

[92] Bellringer, Christopher and Michie, Ranald. (2014). *Big Bang in the City of London: an intentional revolution or an accident?* Financial History Review. p. 132

separation between those firms who traded equities and those who advised investors. In addition, the reform opened the London stock market to competition from international banks as it abolished minimum fixed commissions on trade and allowed foreign firms to own UK brokers. Coupled with the reforms of the London Stock Exchange was the Thatcher government's abolishment of foreign exchange controls in 1986. British investors gained full access to foreign exchange which removed major barriers to their participation in international investment. London Stock Exchange members were permitted to act in a "dual capacity" as both brokers and dealers. London's attractions as a global financial center was reflected in its foreign exchange market, where daily turnover between 1973 and 1979 rose from $4 billion to $25 billion[93]. All these changes were accompanied by the creation of the Securities and Investments Board in 1985 (eventually reorganized and renamed as the Financial Services Authority in 1997), a regulatory body for the City's financial services industry. FSA was eventually abolished and replaced between 2010 and 2012 due to its failure to adequately anticipate and deal with the 2008 financial crises[94].

The UK's relationship with Europe also played an important role in the development of the City of London as a financial center. The past forty years of membership in the European Economic Community (EEC), the European Communities (EC), and the European Union (EU), as well as the evolution of the single market, furthered the growth and development of the City of London. Access to the European single market strengthened the City's global role by increasing its ability to attract overseas firms and to spur a more efficient allocation of capital. Although the UK stayed out of the process of European Monetary Union (with a brief exception

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[93] Michie, R.C and Mollan, S.M. (1992). *Networks and Clusters: The City of London as a Global Financial Center since 1870*. Durham University and York St John University. p.12
[94] (April 2013). *UK financial regulation overhauled.* BBC News.

during its participation in the Exchange Rate Mechanism which ended catastrophically in 1992), EMU contributed to the City's growth. EMU represented a major step in the integration of EU economies, involving the coordination of economic and fiscal policies, a common monetary policy, and culminating in a common currency. In principle, by reducing currency volatility, reducing the costs of doing business across borders, and decreasing inflation and interest rate differentials between its members states, it should have enhanced European economic growth and stability, which should have redounded to the benefit of the City of London[95].

In 1989 London's foreign exchange market accommodated 200 billion pounds of transactions in major international currencies, including the dollar, yen, and the mark. In the 1990s 288 banks had a main branch in the City of London. Over 70% of them were heavily involved in the Eurobond market that had an annual turnover of 1,200 billion pounds. London also became the financial center for wholesale banking activity in securities and bond trading. The London Stock Exchange had an annual turnover of $1,815 billion and $4,170 billion in domestic and international equities, respectively in the 2000s[96]. In 2018, the City of London hosts 90% of international bond issues and is one of the world's biggest sources of long term public funds.

The City of London owes its success to many factors, not just because of Britain's membership in the EU. Brexit will not alter entirely the status quo of London as a global financial center, as the City has a competitive advantage over its European partners in a wide range of financial activities. But, policymakers in Frankfurt, Paris, and Dublin will seek to

[95] Levitt, Malcolm. (November 2012). *The City and EMU*. Off-course, the financial crisis of 2007-9 and the resulting economic crisis in Europe has exposed the fragility of these arrangements.
[96] Michie, R.C and Mollan, S.M. (1992). *Networks and Clusters: The City of London as a Global Financial Center since 1870*. Durham University and York St John University. p.13.

capitalize on attracting those financial sectors, especially the banking industry and the clearing houses that are the most vulnerable to a "Hard Brexit"[97].

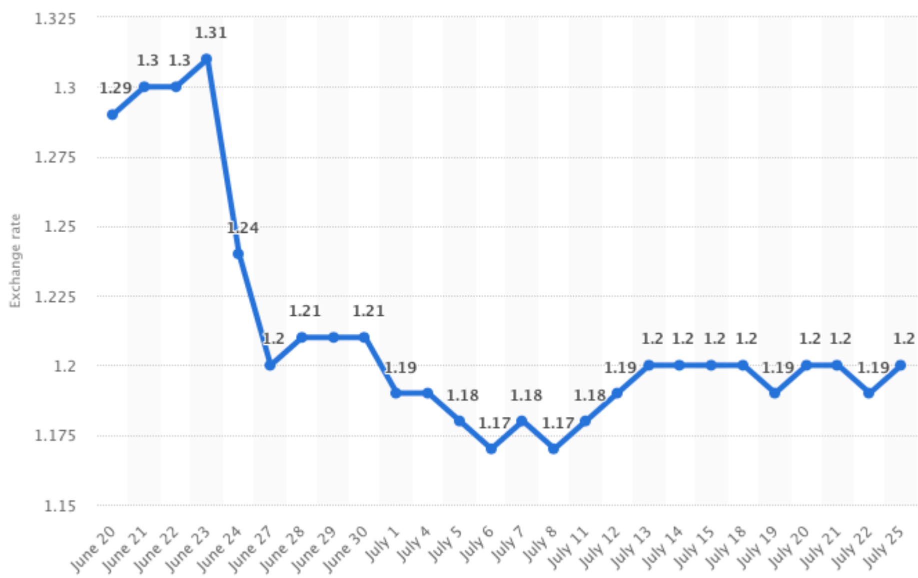
i. The Short-term Effects of Brexit in Financial Markets

On Friday June 24th, 2016, the day after the UK voted to "leave" the EU, the pound Sterling fell by 8% against the dollar, 11% against the Yen, and 5.8% against the Euro[98]. The value of the Sterling slumped to a 31-year low of currency markets and was one of its biggest one-day loss in history[99]. The collapse eclipsed the chaos that occurred during Black Wednesday in 1992 when the UK left the Exchange Rate Mechanism. Britain's benchmark stock index, the FTSE 100, plunged by more than 500 points, a 9% decrease at the opening, but gradually recovered during the day as companies in the index generate 70% of their revenues outside the UK. The FTSE 100 closed 3.2% lower. The FTSE 250, the index for mid-cap companies with sterling-denominated revenues, fell 12% at the opening and finished 7.2% down. British stocks lost $125 billion in value, equivalent to 15 years' worth of Britain's contributions to the EU budget. Banking shares declined the most. RBS, Barclays, and Lloyds Banking Group shares declined by up to 30% of their market value when markets opened. The 10-year UK Gilt yield fell to a record low of 1.02%, a decline of 35 basis points, as investors reallocated their wealth towards safer assets[100].

[97] SPERI Global Political Economy Brief No. 6. (2017). *Frankfurt, Paris, and Dublin: Post Brexit Rivals to the City of London?* The University of Sheffield. Page number?
[98] Mackenzie, Michael and Platt, Eric. (June 2016). *How global markets are reacting to UK's Brexit vote.* Financial Times.
[99] Allen, Katie, Treanor, Jill and Goodley, Simon. (June 2016). *Pound slumps to 31-year low following Brexit vote.* The Guardian
[100] Mackenzie, Michael and Platt, Eric. (June 2016). *How global markets are reacting to UK's Brexit vote.* Financial Times.

Graph 1: The FTSE 100 performance post-Brexit[101]


Graph 2: Post-Brexit currency exchange rates of the Pound Sterling (GBP) against the Dollar (USD)[102]

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101 *The FTSE 100 performance post-Brexit*. Investing.com

102 *Post-Brexit currency exchange rates of the Pound Sterling (GBP) against the Dollar (USD).* Guardian Graphic.

Graph 3: Post-Brexit currency exchange rates of the Pound Sterling (GBP) against the Euro (EUR) June to July 2016[103]


European markets also plummeted the day after the Brexit vote. The Euro Stoxx 600, a major index of stocks across the European continent, fell by 7%. The German DAX fell by 6.8%, France's CAC fell by 8%, Ireland's ISEQ fell by nearly 8%, and the Italian FTMIB and the Spanish IBEX fell more than 20%. European banks suffered severe losses as the Euro Stoxx Bank plunged 18%, its worst ever drop. In addition, the prices of gold and silver increased by 5% and over 8% as investors looked for the safety provided by the precious metals."[104]

International markets also came under heavy pressure following the Brexit vote. The American S&P 500 stock index dropped by 3.6%, its biggest one-day drop since August 2015. The financial and technology sectors suffered heavy declines, with bank stocks falling the most. The 10-year Treasury rate fell more than 30 basis points to 1.40%, its lowest point since 2012,

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[103] *Post-Brexit currency exchange rates of Pound Sterling to Euro*. Statista. The Statistics Portal.
[104] Martin, Will. (June 2017). *The day after Brexit: Remembering a chaotic day in markets a year ago.* Business Insider.

although it rose again to 1.56% when the U.S. markets closed. Japan's Nikkei 225 fell 7.9%. Hong Kong's Hang Seng index also declined, led by the drop in the shares of HSBC and Standard Chartered which plunged by 10%. Australia's ASX Index fell by 3.2%[105].

The Governor of the Bank of England, Mark Carney, tried to reassure the markets by stating that the central bank will "not hesitate to take additional measures as required as those markets adjust and the UK economy moves forward, including 250 billion pounds of additional liquidity it can provide to the markets."[106] The Bank of England cut interest rates to a record low, and restarted a quantitative easing program.

A year after Brexit, the UK's political and economic future was still fundamentally uncertain. The UK's economic growth rate of 1.5% in 2017 placed the country at the bottom of the G7 group. Official forecasts by the Organization for Economic Cooperation and Development predicted weak economic growth for the UK though 2019, arguing that Brexit would weigh heavily on Britain's economic performance. The OECD advised Britain to secure a transition deal with the EU27 instead of a hard Brexit which remained a "major risk" to the UK's economy. It called for "maintaining the closest possible economic relationship between the United Kingdom and the European Union (which) would further support economic growth[107]".

The pound did not fully recover from the Brexit shock into 2018, due to uncertainty about the results of the final deal to be negotiated between the UK and EU. The value of the pound fell dramatically against the Euro and the Dollar in late 2016 and early 2017, trading around 10% to

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[105] Mackenzie, Michael and Platt, Eric. (June 2016). *How global markets are reacting to UK's Brexit vote.* Financial Times.
[106] Connington, James. (January 2018). *The FTSE 100 has hit record highs in 2018 – does the 'January effect' mean it will keep going?* The Telegraph.
[107] Giles, Chris. (November 2017). *OECD predicts weak economic growth for UK due to Brexit*. Financial Times.

15% below its pre-Brexit vote levels. When the Bank of England cut its policy rate from 0.5% to 0.25% in August 2016, the Pound came under severe pressure. In October 2016, when Prime Minster Theresa May pledged to invoke Article 50, beginning the official negotiations with the EU for Brexit, the Pound crashed by 6%, falling to $1.1819, its lowest level since 1985. Fears of a “Hard Brexit” were blamed for the fall. However, beginning in early 2017, the Pound began to recover against the dollar. In January 2018, the Pound had its best month since the Brexit referendum, rising 6% against the Dollar to $1.40 approaching its pre-Brexit level[108]. The Pound reached its highest level since the Brexit vote after the Christmas holidays as traders believed that the UK could achieve a better Brexit deal[109].

The steep drop of the Pound, especially against the Euro in late 2016 and early 2017, helped drive UK inflation rates higher[110]. In 2017, the rate increased to 2.7%, reaching its highest level since April 2012. The purchasing power of UK consumers fell, as imported goods became more expensive due to Sterling’s weakness. Higher UK consumer prices were not matched by higher wages and the British household sector faced a serious budget squeeze. Three months after Brexit, earnings growth fell by 1.5% and real wages fell by 0.5%. The UK savings rate hit a 53-year low in the first quarter of 2017 and households borrowed more to maintain their levels of consumption. Finally, UK house prices declined after Brexit and remained under pressure due to the slowdown in the UK economy and high inflation[111].

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[108] *Graphics Currency: GBP to USD.* XE.com

[109] Partington, Richard. (January 2018). *How has the Brexit vote affected the economy? January verdict.* The Guardian.

[110] Partington, Richard. (January 2018). *How has the Brexit vote affected the economy? January verdict.* The Guardian

[111] Partington, Richard. (January 2018). *How has the Brexit vote affected the economy? January verdict.* The Guardian

Interestingly, most UK financial stocks quickly recovered from the Brexit shock. The companies listed in the FTSE 100 Index earned approximately 75% of their revenues from sales outside of the UK. Sterling's weakness helped boost their exports out of Britain, and their foreign currency earnings were similarly boosted when translated into Sterling. On January 12, the FTSE 100 and the FTSE 250 indexes hit records highs, gaining 2.5% and 1.5% in one month.

### ii. The Impact of Different Trade Deals on the City of London: A Soft or Hard Brexit?

The European project sought to create one territory without borders, tariffs and other trade barriers and regulatory obstacles for the free movement of goods, services, capital, and labor (known as the "four freedoms") among its member states. It led to the largest international single market in the world, reducing business costs and increasing of businesses efficiency. The introduction of a common currency and the harmonization of standards for both goods and services facilitated the development of free trade among its members. By 2017, the EU accounted for 16.5% of the world's imports and exports, with more than 60% of that trade resulting from transactions between its member states[112].

The European Union is Britain's largest trading partner. More than 40% of the demand for UK services and 46% of the demand for UK manufactured goods comes from its European partners. The UK's level of trade integration with Europe is so high that the nature of the post-Brexit trade agreement will have a huge impact on the country's economy. The UK can attempt to undertake a variety of different arrangements with the EU. Britain can either remain part of a customs union, join the European Economic Area (EEA), enter into a Swiss-style trade

[112] Armour, John. (2016). *Brexit and Financial Services.* London School of Economics.

relationship, sign a Free Trade Agreement (FTA), or operate under World Trade Organization (WTO) rules. As for now, the relationship between the UK and the EU has not changed, and the UK will remain a full member of the EU until the day it formally leaves[113].

According to Société Générale's chief UK Economist, "The UK will be economically worse off outside the EU under most trade scenarios. The key questions for the UK is: how much worse off?[114]" Under the most optimistic scenario calculated in a study conducted by the London School of Economics (LSE), the UK will experience an ongoing decline of 1.3% in yearly GDP by remaining part of the customs union[115]. On the other hand, under the most pessimistic scenario, which implies a EU-UK trade deal under WTO rules, the LSE predicts losses of 2.6% of GDP[116]. In addition to considering the hit on UK's productivity, Oxford Economics, Price Waterhouse Coopers, and the British Treasury models predict a total GDP loss as large as 6.3% to 9.5% in the indefinite future[117]. The consensus view between trade economists is that the more significant the trade barriers, the worse the economic damage will be.

The first scenario above, continued membership in the European Economic Area (EEA) also known as the "Norwegian" option, would minimally disrupt UK-EU economic relations. Britain would maintain its full access to the single market but have no say over EU trade policy (i.e., "regulation without representation"). The UK would continue to have access to the single market via passporting rights[118], but would have to abide by whatever the remaining EU

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113 The Article 50. The Lisbon Treaty. Educational Evaluation and Policy Analysis (EEPA).
114 UK Economist of Société Générale. (2017, October 12). Personal Interview.
115 HM Government. (April 2016). *HM Treasury analysis: the long-term economic impact of EU membership and the alternatives*. p.69.
116 HM Government. (April 2016). *HM Treasury analysis: the long-term economic impact of EU membership and the alternatives.* p.69.
117 HM Government. (April 2016). *HM Treasury analysis: the long-term economic impact of EU membership and the alternatives*. p.7.
118 This concept will be later expanded upon.

members agreed between themselves and continue to make contributions to the EU budget. This "best" optimistic scenario would lead to a 0.5% loss of GDP according to the LSE reports, which is equal to the UK's current contribution to the EU's budget.[119] Theresa May refuses to negotiate a "Norway type of deal" as her position has called for an end to Britain's legal subjection to the rulings of the European Court of Justice, the application of the four freedoms allowing for the free movement of individuals into Britain, and the financial contributions to the EU budget. A looser alternative to joining the EEA would be a customs union deal, like the one that Turkey has negotiated with the European Union. It would allow tariff free trade between the UK and the EU but would not allow the UK to negotiate its own trade deals with non-EU countries.

The UK could also negotiate a "Swiss" style deal. Switzerland is a member of the European Free Trade Association (EFTA). Switzerland's economic and trade relations with the EU are mainly governed through a series of bilateral agreements. The country is required to adopt some of the European Union regulations in exchange for accessing part of the EU's single market. While Switzerland must respect the free movement of people due to the bilateral Agreement on the Free Movement of People (AFMP), it is not part of the EU Customs Union[120]. Switzerland has a "weak voice" in trade negotiations with the EU and has no influence over EU Regulations or Directives. In addition, if Switzerland were to break a single clause in any of the numerous bilateral agreements that make up their trade deal with Brussels, the whole economic relationship comes tumbling down[121]. The Swiss-EU trade agreement offers a compromise

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[119] Springford, Tilford, McCann, Whyte, and Odendahl. (April 2016). *The economic consequences of leaving the EU. The final report of the CER commission on Brexit 2016*. Center for European Reform.
[120] European Commission Website. Trade Policy of Switzerland.
[121] McTague, Tom (October 2017). *Brexiteers fear 'Swiss Trap' trade deal*. Politico.

between sovereignty and economic integration. This outcome is considered a “middle way between two extremes”.

A European Economic Area membership, a customs union, or a “Swiss” type deal would give the UK partial access to European markets. In return it would give the UK limited power in trade negotiations with third countries, would require it to comply with the free movement of labor from EU member states, would obligate it contribute to the EU budget, and would mandate it to adopt EU’s rules. However, these types of deals would not address the reasons why UK citizens voted to “leave” the Eurozone, rejecting as they did the four freedoms, the regulatory alignment imposed by the EU, and the financial contributions to the European budget.

Mr. Michel Barnier, the European Commission’s chief Brexit negotiator, has stated that the UK’s deal with the EU will be “along the same lines as the ones signed between the EU and countries like South Korea, Japan, and Canada[122]”. If the UK were to sign a Free Trade Agreement (FTA), it would be able to set its own trade policies with non-EU countries, but it would preclude almost all trade tariffs between it and the EU. The EU-Canada Comprehensive Economic and Trade Agreement (CETA), which took seven years to negotiate and ratify, does not oblige Canada to pay into the EU budget, to abide by the EU’s four freedoms, and to obey ECJ rulings.

A CETA type agreement is attractive to the current British government, but Mr. Barnier has clearly stated that “It is not, and will not, be possible for a third country to have the same benefits as the Norwegian model but the limited obligations of the Canadian model[123]". While

[122] Stone, John. (December 2017). *EU says final Brexit deal will be along same line’s as agreements with Canada, South Korea and Japan.* Independent.
[123] European Commission. (September 2017). *Speech by Michel Barnier in front of the Committees of Foreign Affairs and the Committees of European Affairs of the Italian Parliament*.

the Norwegian deal would offer Britain full access to the single market, it would require it to contribute to the EU budget, to accept the majority of European legislation, and to allow the free movement of European citizens into the country. The Canadian model offers preferential access to the EU single market without the obligations of a Norway type agreement. The CETA deal eliminates nearly all tariffs on the goods trade with the EU without obligating Britain to accept workers from across the EU or to pay into the EU budget[124]. However, the CETA deal would not give the UK financial services sector access to the EU market. Banks chartered in Britain would have to get passporting rights to access EU clients. Mr. Barnier has explained that no other EU-free trade agreement has yet covered financial services, suggesting that the City of London will be "left out in the cold"[125]. The UK government is considering this type of deal as it seeks to end its contributions to the EU budget, to regain greater control over EU immigration, and reassert its sovereignty over its own regulations. But while Theresa May hinted at her preference for it in her Florence speech, it does not guarantee that UK financial firms will secure passporting rights[126].

If the UK and EU do not reach a deal during the transition period which lasts until March 2019, then they will have to operate under World Trade Organization (WTO) rules[127]. Under this scenario, the UK would not be able to adopt trading arrangements that currently exist between the EU and other countries. It would have to negotiate its own agreement with the EU. The UK will no longer have access to the EU single market and be part of the EU Customs Union. Tariffs and other trade barriers admissible under the WTO would automatically go into effect in all trade

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[124] EU referendum. (June 2016). *Five models for post-Brexit UK trade*. BBC News.
[125] Stone, John. (December 2017). *EU says final Brexit deal will be along same line's as agreements with Canada, South Korea and Japan.* Independent.
[126] Henley, Jon. (September 2017). *Theresa May's Florence speech: key points*. The Guardian
[127] Dhingra, Swati. (September 2017). *No deal – the WTO option.* The UK in a Changing Europe.

between the UK and the world. A “no deal” will significantly disrupt UK-EU economic relations. The Center for Economic Performance estimates that the “no deal” scenario would reduce the level of the UK’s trade with the EU by 40% over ten years, causing a reduction of 3.5% of GDP[128].

The UK is in a weaker negotiating position visa vi the EU as its exports to Europe account for a greater percent of its total exports and GDP than Europe’s exports to the UK[129]. If Theresa May insists on restricting the right of EU citizens to live and work in the UK, on ending her government’s contributions to the EU budget, and rejecting the authority of the European Court of Justice (ECJ) over UK laws, then, according to Mr. Barnier, it will lose the benefits of the single market. Barnier notes that “this is a legal reality. It simply draws the logical consequence of the UK’s decision to take back control”. Theresa May is coming under increasing pressure to state where she stands on Britain’s future trade agreement. European authorities seem to have a clear view for the economic side of their partnership, “We’ll be working on the basis of a free-trade agreement along the same lines of what we negotiated and signed with Canada, South Korea, and Japan”, Mr. Barnier told reporters in Brussels.

[128] Breinlich, H., Leromain, E., Novy D., Sampson T. (November 2017). *The Brexit Vote, Inflation, and UK Living Standards*. Center for Economic Performance.
[129] Full Fact Team. (November 2017). *Everything you might want to know about the UK’s trade deal with the EU.* The UK’s Independent Factchecking Charity.

Table 1: Possible Brexit Scenarios

| EEA Member "Norwegian Option" | Bilateral Agreement "Swiss Model" | Free Trade Agreement "Canada Model" | No deal "WTO terms" |
|---|---|---|---|
| • Application of the four freedoms<br>• Application of EU regulations under ECJ<br>• Access to Single Market with passporting rights<br>• Contribution to EU budget | • Application of the four freedoms<br>• Access to Single Market by adopting some EU regulations<br>• No access to Customs Union<br>• No influence over EU regulations | • No application of the four freedoms<br>• No influence over EU regulations<br>• Market access depending on the shape of the FTA deal | • Only WTO terms applied<br>• No application of the four freedoms<br>• No access to Single Market or Customs Union<br>• No contribution to EU budget |

### iii. The Long-term Consequences for the City of London After Brexit

Despite opting out of membership in the Eurozone, the City of London has become the European Union's largest financial center. Like Wall Street in the United States and Hong Kong in China, it has become the point of reference for financial services in Europe. The UK hosts 48.9% of the world's interest rate over-the-counter (OTC) derivatives, 40.9% of its foreign exchange turnover, and 20% of its global equity markets. London is home to 358 banks and numerous insurance companies, hedge funds, specialized finance providers, and fin-tech companies. Its financial industry has drawn law firms, ratings agencies, data vendors, consulting and auditing firms. London possesses the largest stock exchange in the EU and has the most developed derivative market and clearing settlement institutions[130].

The City of London is extremely important for the UK's overall economy, generating 7%

[130] European Parliament. (December 2016). *Brexit: The United-Kingdom and EU financial services.*

of the UK's GDP and employing more than a million workers (i.e., 3.4% of the UK's total workforce). The City of London is Britain's largest exporter. In 2014, the UK ran a notable trade surplus in financial services (£27 billion) with the EU but the country ran an overall deficit with the EU. More than 25% of UK financial services exports are with the European Union[131]. The financial services industry contributed 245 billion Pounds to the UK economy in 2015, accounting for 7% of the total output[132]. In 2016, the UK financial services industry contributed 71.4 billion Pounds in taxes, an equivalent to 11.5% of total UK government taxes. The trade arrangement the UK will agree to with the EU will determine the economic future of the City of London and Britain.

The UK can either position itself as an international financial center with low regulations to gain more global business or remain part of the EU legislation and adapt a similar trading model to the current one. A "soft" Brexit means that the UK will leave the EU but will remain a member of the EEA enjoying the access to the single market. A "hard" Brexit signifies that the UK will rely on WTO rules due to the absence of a free trade agreement with the EU. The key issue is whether the UK wants to remain part of the single market accepting the "four freedoms" and the authority of its supranational institutions or join the international community.

After the UK referendum, economists developed various long-term scenarios to estimate the direct effects of Brexit for the City of London. Numerous studies show that Brexit will cause a steep drop in the UK's GDP, i.e., cause a severe recession and a long run decline in the level of potential output, whereas a few studies posit net long run gains from deregulation and enhanced

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[131] Cimino-Isaacs Cathleen and Lu Zhiyao. (July 2016). *UK-EU Trade and Foreign Investment.* Peterson Institute for International Economies.
[132] London Assembly. (July 2016). *Regional GVA estimates for London by different geographies, 1997-2014.*

productivity. However, in financial services, researchers agree that "the most favorable Brexit scenarios for the City are those in which the UK never leaves the single market[133]" as the UK has "much to lose and little to gain from leaving the EU". Will the City of London remain the center financial hub despite Brexit? What are the long-term consequences for the financial capital of the EU?

If the UK were to leave the single market, the City of London may lose up to £18 billion in revenue and up to 30,000 jobs[134]. Oliver Wyman's 2016 study estimates that these account for about 15% of financial sector revenues and 4% of employment in the City of London[135]. Price Waterhouse Cooper's research estimates a loss of £14 to £20 billion in revenue and 70,000 jobs[136] and Ernest and Young estimates an 18% loss of revenue and 7% to 8% drop in employment (83,000 jobs)[137]. As of February 2017, 361,000 people work in the financial and professional business services sector in London and generate almost £47 billion in economic output[138]. However, Brexit will not entirely alter the status quo of London as a global and European financial center, as the City has a competitive advantage in numerous financial areas against its nearest rivals in the European Union.

The following analysis reflects the relative importance and possible effects of Brexit in the different financial subsectors operating in the City of London. If the UK were to leave the

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133 Veron, Nicolas. (2017). *Brexit: When the banks leave*. Bruegel. p.1
134 Djankov, Simeon. (February 2017). *The City of London after Brexit*. London School of Economics.
135 Oliver Wyman. (2016). *The Impact of the UK's exit from the EU on the UK-based financial services sector*. Marsh & McLennan Companies. p.5
136 Price Waterhouse Coopers. (April 2016). *Leaving the EU: Implications for the UK financial services sector.* p.4
137 Ernst & Young. (2016). *Brexit – What next for Banks?* p.6
138 (February 2017). *City of London Jobs.* ONS. Business Register and Employment Survey.

European single market and operate under WTO regulations, UK firms would lose "passporting rights" and the ECB would demand the relocation of clearing houses to the member states of the Eurozone. Banking and Euro-clearing activities are the most likely financial subsectors to relocate to the European continent as a result of Brexit. London's insurance, asset management, and auxiliary services will suffer less from Brexit.

A. Passporting rights

One fifth of global banking activity takes place in the City of London. There are over 250 foreign banks in London, more than in New York, Paris, and Frankfurt. The most important subsector of the industry is retail and business banking, which offers savings and checking accounts, mortgages, personal loans, and debit/credit cards, accounting for 55% of the sector's revenues and 82% of its employees. The second largest banking subsector is sales and trading, one of the key functions of an investment bank that covers activities related to buying and selling securities and other financial instruments, accounting for 30% of the banking sector's revenue and 11% of its employment. Investment banking (this subsector raises financial capital to underwrite deals for corporations) and private banking or wealth management (this subsector provides professional services including investment advice, accounting, tax services, and retirement planning to high net worth individuals) account for 10% and 5% of banking revenues respectively. The retail and business banking subsector services the domestic economy, less than 1% of its business comes from Europe. However, the private banking and wealth management subsector is primary international, as two-thirds of the revenues are generated by services for foreign clients. Similarly, the investment banking subsector makes more than 14% of its global investment revenues internationally. The private banking and investment banking subsectors depend heavily on European and international activity.

Around £3,570 billion assets are held by major UK banks, such as HSBC, RBS, Barclays, and Standard Chartered. More than 80% of revenues in the UK banking sector is not dependent on EU "passporting" rights because of the importance of the domestically focused retail and banking subsector. However, 20% of the revenues (£25 billion pounds) from UK business banking comes from the EU. Those UK sectors reliant on EU markets will face an increase in their operating costs because of the need to reorganize their operations and to open subsidiaries in the EU. On the other hand, the 250 international banks located in London, which hold £1,730 billion assets, have headquartered their main European operations in the City. In case of a "hard Brexit" these banks will need an extra license to do business in the EEA market. Goldman Sachs, JP Morgan, Citigroup, Morgan Stanley, Bank of America Merrill Lynch are examples of US investment banks that use EU "passports" to do business across the Eurozone. Nineteen percent of the revenues of European banks that have operations in London, such as Deutsche Bank, BNP Paribas, Société Generale, ING, and UniCredit, come from the UK[139].

If the UK does not secure membership in the EEA (a Norway-type deal), many of its financial firms will lose their passporting rights which allow them to service clients across the EU without obtaining licenses to operate in individual countries. The EU has legislated a network of Directives and Regulations that permit the firms of its member states to operate in all EU countries by having one license in one-member state. Passporting rights are extremely valuable to financial companies for they can avoid the costs of gaining approval to operate in

[139] Shoenmaker, Dirk. (2017). *The UK Financial Sector and EU integration after Brexit: The Issue of Passporting*. Bruegel.

each individual EU country. However, passporting rights are only granted to firms headquartered in the member states of the EEA. Leaving the European Union means that third-country rules will apply to firms based in the UK. The UK will have to negotiate individual bilateral agreements to allow its financial services firms to have access to the markets of each member of the EEA. According to Karel Lanno, negotiating this "special deal" will be "a long and difficult process of persuading the EU of the importance of a global financial center for the European economy[140]".

While Brexit offers a few positive advantages to the UK's financial sector, less burdensome regulation and greater freedom in negotiating trade and investment arrangements with the rest of the world, researchers agree that "the most favorable Brexit scenarios for the City are those in which the UK never leaves the single market[141]". Will the City of London remain the center financial hub despite Brexit? What are the long-term consequences for the financial capital of the EU? If UK firms were to lose their passporting rights, significant parts of the UK banking and trading sector will move to the European continent to serve their EU clients. On October 19th, 2017, Lloyd Blankfein, CEO of Goldman Sachs, twitted "Just left Frankfurt. Great meetings, great weather, really enjoyed it. Good, because I'll be spending a lot more time there. #Brexit". This marked the first time that a major US financial firm signaled the relocation of its European operations away from London. As of today, March 2018, more than 10% of the City's businesses have already decided to leave[142]. HSBC, UK's largest international bank has announced that they will move 1,000 jobs to Paris. UBS will relocate between 1,000 to 5,000

[140] Lannoo, Karel. (September 2016). *EU Financial Market Access after Brexit*. CEPS Policy Brief. p.8
[141] Veron, Nicolas. (2017). *Brexit: When the banks leave*. Bruegel. p.1
[142] Veron, Nicolas. (2017). *Brexit: When the banks leave*. Bruegel. p.2

jobs, and Goldman Sachs will reduce their operations by half (3,000 jobs). European banks have also started moving their subsidiary operations back home. Oliver Wyman's study estimate that one third of EU banking businesses will relocate, causing an £8 billion loss per annum[143] and Price Waterhouse Cooper's 2016 study estimates 70,000 to 100,000 job losses by 2020 in the financial services sector[144].

More than 69% of revenues in London wholesale banking business uses EU passport rights to access European markets. The private banking and investment banking activities heavily rely on European markets, need to have passport rights to operate in the EU and are more at risk from a "Hard Brexit". These sectors are more reliant on pass-porting rights as a majority of their revenues come from EU clients. London has a special advantage in these lines of business due to the localized nature of relationships between skilled labor, customers, and suppliers that help firms achieve innovative solutions, develop new markets, and attain more efficient wats to deliver services and products to client. International banks and European banks have branches in London to access the whole European market. Major UK and foreign banks will have to apply for a license in the EEA to keep doing business in the EU. The relocation of banks from London to one of the member states of the EEA or EU will be followed by a similar outmigration of consulting, legal services, and auditing companies[145].

Studies indicate that Frankfurt, Paris, Dublin and/or Amsterdam will become host to 30,000 jobs that will move out of London. Frankfurt, currently ranked as the EU's second most

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[143] Oliver Wyman. (2016). *The Impact of the UK's exit from the EU on the UK-based financial services sector*. Marsh & McLennan Companies. p.3
[144] Price Waterhouse Coopers. (April 2016). *Leaving the EU: Implications for the UK financial services sector. Page??*
[145] Batsaikhan, Kalcick, Schoenmaker. (2017). *Brexit and the European financial system: mapping markets, players and jobs*. Bruegel.

competitive financial center, will benefit from being the site of the European Central Bank (ECB). Frankfurt currently employs 74,700 financial workers and has an emerging fintech industry. But some observers note that "Germany should not delude itself that it can become in a short time the new financial center of Europe[146]". Paris, one of the largest financial centers in the EU, hosts four of the ten largest banks and has the second largest insurance market. The French capital employees 330,000 employees in the financial sector but has relatively high tax rates and relatively strict financial regulations. Dublin, deeply integrated in the UK's economy and the EU, has recently developed a five-year plan to increase jobs in the financial sector by 10,000 as it currently has 35,500[147].

Despite the future relocation of banks and financial services firms, studies show that Brexit will not lead to the loss of London's status as Europe's financial capital. However, there is clear evidence that policymakers in Frankfurt, Paris, and Dublin will seek to capitalize on Brexit. The City of London hosts the largest number of headquarters of top companies and financial institutions. The UK financial sector trade balance is greater by a factor of 10 than the export surpluses of the financial sectors of the other major European cities. The tax revenues from the City of London are more than 100 times greater than Frankfurt's. In addition, the UK hosts more assets, capital, and services than does Frankfurt, Paris, and Dublin. The City has a leading role in forex and interest rate OTC derivatives turnover. Finally, an advantage that will remain despite Brexit is the "economies of agglomeration" in the City of London. Economies of agglomeration is an economic term that refers to the benefits that come when firms and people are located near

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[146] SPERI Global Political Economy Brief No. 6. (2017). *Frankfurt, Paris, and Dublin: Post Brexit Rivals to the City of London?* The University of Sheffield.
[147] SPERI Global Political Economy Brief No. 6. (2017). *Frankfurt, Paris, and Dublin: Post Brexit Rivals to the City of London?* The University of Sheffield.

one another together in cities and industrial clusters. Most of large euro-area banks have a substantial presence in London and 90% of the EU turnover of the largest US and Swiss investments banks are in the UK. The intense concentration and clustering in being located in the premier European financial district and one of the three global international financial centers alongside New York and Tokyo provides numerous advantages for companies[148]. The proximity to customers, skilled labor and professional workers are some of the benefits of a London location. In addition, being located close to competitors and support services generates greater knowledge. The address has become an invaluable brand in both a national and international context.

B. Euro-clearing houses

The City of London is the global base for clearing foreign exchange transactions. The clearing house business is a major reason why the City of London is the financial hub of the EU. Clearing houses are financial institutions that facilitate the exchange of payments, securities, and derivatives transactions. Clearing houses stand between the transacting parties to reduce trading risks. Clearing houses, such as the London Clearing House and the Deutsche Borse Group, stand between two parties in a deal and are responsible should one of the traders default on a payment. Clearing houses have grown and become increasingly important since the 2008 financial crisis, as they have helped stabilize financial markets and increased the efficiency of their operations. A Djankov notes, "prior to the crisis, derivative transactions created a complex, opaque, and dangerous, web of exposures that helped turn a shock into a panic[149]". On top of reducing the

[148] Taylor, Peter. (February 2003). *Financial Services Clustering and its significance for London*. Manchester Business School.
[149] Djankov, Simeon. (February 2017). *The City of London after Brexit*. London School of Economics.

risks in the markets, clearing houses have also reduced the costs of complex financial transactions by matching buyers and sellers. To provide transparency and information to policymakers and supervisors, clearing houses must follow the regulations imposed by the European Market Infrastructure Regulation (EMIR) which ensures that the information in all derivative transactions is reported to the European Securities and Markets Authority (ESMA).

The City of London is the world's dominant location for clearing derivatives contracts denominated in Euros. Three quarters of the Euro-denominated business is cleared by houses in London, which provide 83,000 jobs and £80 billion per year in revenues[150]. In comparison, Paris accounts for 11% and Frankfurt for 7% of the Euro-denominated business. The UK has the largest over the counter (OTC) Euro-foreign exchange market and the largest OTC interest rate derivatives market in the world. The UK is the market leader in Euro-denominated transactions. Around €1trillion of foreign-exchange contracts are cleared in London every day. The three major clearing houses in the UK are CME Europe, the London Clearing House LCH Group, and the London Metal Exchange Limited. The London Clearing House clears 50% of interest rate contracts and 95% of the OTC interest rate swaps, for a total of €747 billion traded daily.

The ECB has been concerned for a long time with the "development of major Euro financial market infrastructures located outside the Euro-area[151]". It formed a Eurosystem Oversight Policy Framework to regulate and monitor clearing house operations[152]. In September 2011, the UK government argued at the General Court in Luxembourg that the Oversight Policy Framework should be canceled as the ECB lacks the competence to impose those type of

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[150] Moore, Charlie. (June 2017). *Brussels wants to grab London's euro trade after Brexit, but what is a clearing house and why do they matter?* This is Money.
[151] Batsaikhan, Uuriintuya. *Brexit and the UK's Euro-denominated market: the role of clearing houses.* Bruegel.
[152] ECB. (July 2011). *Eurosystem Oversight Policy Framework*. European Central Bank.

requirements in the EU as it violates the "freedom of establishment", the "freedom to provide services" and the "freedom of capital in the single market". After four years of legal battles, the General Court ruled in favor of the UK as the court defended the "no discrimination" argument of the single market. However, if Britain were to leave the European single market, the City will no longer operate under EU regulations and Brussels will no longer have control over how clearing houses in the UK are policed. Clearing houses operations are considered systemically important and if a UK clearing house were to fail it would have huge implications for the EU.

After the Brexit referendum, the European Commission and the European Central Bank argued for the relocation of Euro clearing services to the Continent to protect the European financial system. They fear that after March 2019, the UK will loosen the regulation of London's clearing houses by changing the risk management models they use and by reducing their liquidity requirements. The European Commission has undertaken an aggressive campaign for greater control of the Euro clearing market. It has proposed to give the European Securities Markets Authority more power to enforce new regulations and to reduce systemic risks of future non-EU clearing houses. The European Commission has also planned to force the transferring of all clearing houses that have "specifically substantial systemic risk" to the EU to "have a say on some decisions taken by third-country authorities[153]". The proposal to relocate such businesses would considerably affect the London Clearing House (LCH), the largest Euro-denominated clearing house in the world, which clears over 90% of Euro-denominated derivatives. The former CEO of the LCH, Xavier Rolet, stated that moving out of the City would be highly damaging to

[153] Weber, Alexander. (November 2017*). UK's Bid to Retain Euro Clearing After Brexit Gains EU Allies.* Bloomberg.

business of the LCH, noting that "It's going to be complete chaos. This has not been properly thought through"[154].

According to Valdis Dombrovskis, Vice President of the European Commission and the Commissioner for the Euro and Social Dialogue[155], the Euro clearing issue is one of the most important threats to the City, "As we face the departure of the largest EU financial center, we need to make certain adjustments to our rules to ensure that our efforts remain on track.[156]" Oliver Wyman's study shows that if the UK undertakes a "hard Brexit", the City will lose more than half of the business in this sector to its competitors, a total of £78 billion and 100,000 jobs[157]. The fragmentations caused by the relocation of one clearing house to multiple locations would lead to less financial stability and greater risk. The Financial Times described the relocation of clearing houses as being "detrimental" and "in no one's interest" because having multiple headquarters will increase business costs. The alternative to relocation is the intensive cooperation between UK and EU authorities[158]. UK regulators have clearly stated that they prefer stricter supervisions in London than relocating the Euro clearing derivatives activities inside the bloc. Andreas Dombret, a member of the executive board of the Bundesbank noted that this would "obviate the need for a large-scale relocation of clearing business, at least from an economic standpoint[159]."

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[154] Batsaikhan, Kalcick, Schoenmaker. (2017). *Brexit and the European financial system: mapping markets, players and jobs*. Bruegel.
[155] European Commission. Valdis Dombrovskis. Vice-President (2014-2019).
[156] (June 2017). *London could lose EU euro clearing role*. BBC News.
[157] Oliver Wyman. (2016). *The Impact of the UK's exit from the EU on the UK-based financial services sector*. Marsh & McLennan Companies.
[158] Moore, Charlie. (June 2017). *Brussels wants to grab London's euro trade after Brexit, but what is a clearing house and why do they matter?* This is Money.
[159] Comfort, Nicholas. (November 2017*). Bundesbank Says Brexit Deal Could Keep Swaps Clearing in London.* Bloomberg.

C. Asset Management, Insurance, and Auxiliary Services

The City of London controls 45% of all European financial assets (£6.9 trillion). A total of 18% of them are the assets of EU clients and 15% are the assets of non-EU clients. Asset management accounts for 11% of the City's revenues and 5% of is employment, which represents 85,000 jobs. The assets under management come from pension funds (£1.9 trillion), insurance funds (£960 billion), commercial property managers (£480 billion), private wealth managers (£417 billion), hedge funds (£254 billion), and private equity funds (£210 billion). The City of London is the largest center for hedge funds and private equity funds in Europe. A total of 800 funds in London manage 85% of Europe's hedge funds assets[160].

More than 25% of UK asset management revenues come from EU businesses, a total of £6 billion. UK asset managers may need to set up subsidiaries across Europe to manage investment funds more efficiently as investment activities will become more expensive and complex for clients in the UK. Oliver Wyman's study estimates that one third of EU funds in London will relocate, representing £2 to £3 billion[161]. In addition, UK private equity funds, Blackstone, Carlyle, BC Partners, and Advent have announced plans to relocate to Ireland or Luxembourg to continue to be able to do business in the EU after Brexit. In 2016, private equity deals for UK based companies were significantly lower than in 2015. The transition period has

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[160] Djankov, Simeon. (February 2017). The City of London after Brexit. London School of Economics. p.8.
[161] Oliver Wyman. (2016). *The Impact of the UK's exit from the EU on the UK-based financial services sector*. Marsh & McLennan Companies.

created a hold-off investment period due to the uncertainty of the negotiations between the UK and EU[162].

The UK's insurance industry is the largest in Europe and the third largest in the world. London is the world's leading market for internationally traded insurance and reinsurance. More than 600 insurance companies operate in the City of London, providing 20% of the City's annual revenue (£41 billion out of £200 billion in 2016[163]). It employs 325,000 people, 30% of the employment in the financial industry. This sector will not be affected should the UK leave the single market. Djankov notes that "75% Insurance services in the UK are provided through subsidiaries rather than branches requiring a passport to operate[164]". Brexit will not raise costs appreciably in this sector. The only exception will be Lloyd's of London, who serves clients across the EU and uses the passport system (11% of Lloyd's business is directly reliant on passporting), through Solvency II, which covers all types of insurance.

## IV. Conclusion

The Brexit vote was the result of Britain's awkward historical relationship with its neighbors on the European continent. Britain decided to remain outside of the European political and economic integration process until 1973. After it joined, the country became an awkward partner that had to adapt its legislation to the already established organization and found itself opting out of significant parts of the Maastricht Treaty, the Schengen Pact, and the Euro. The

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[162] Szary Wiktor and Sylvers Eric. *Faced With Brexit Questions, Firms Hold Off on U.K. Investment.* The Wall Street Journal.
[163] Djankov, Simeon. (February 2017). *The City of London after Brexit*. London School of Economics. p. 8
[164] Djankov, Simeon. (February 2017). *The City of London after Brexit*. London School of Economics. p.7

2008 financial crisis and the subsequent Eurozone crisis also influenced the Brexit vote. The failing Euro and Britain's weakened position in the European single market put its membership at risk and generated a dominant Eurosceptic political tendency. UKIP campaigned against European integration at a time when Euroscepticism was on the rise. It successfully influenced the UK electorate to vote "leave" by promoting a populist campaign against the establishment's political parties.

The more recent success of the City of London as a major international financial center was achieved as result of economic developments and public policy decisions made after WWII. The growth of the Eurodollar and the Eurobond markets in London, and the UK's membership in the EU were the major reasons for the development of the City as a major European financial center. As one of the most competitive financial centers in the world, it faces numerous challenges after Brexit. The immediate consequences of the "leave" vote was a fall in the Pound Sterling against other major world currencies, and a big shock in the UK's and Europe's financial markets. However, the future long-term consequences will depend on the trade deal agreed between the UK and the EU. The UK can either remain part of the single market, accepting the "four freedoms" and the authority of the European supranational institutions. or join the international community and rely on WTO rules. While London will continue to be Europe's financial capital, if Britain undertakes a "hard Brexit", UK firms will lose passporting rights and the ECB will claim the relocation of clearing houses, causing the City to lose a significant part of its financial business.

As of March 2018, it is far from clear how things will develop. The Brexit process is "more complex than first moon landing[165]" as there is no clear roadmap for this unprecedented negotiation. It may become even more difficult and complicated because Theresa May's government could soon collapse[166]. As noted by Robert Preston, "The people that negotiate today may not be the people that negotiate in six months". The Prime Minister is facing a revolt from inside her cabinet over her plan to keep UK regulations aligned with the European Union after Brexit. Boris Johnson and Michael Gove have expressed "genuine fears" that she is trying to force through a soft Brexit[167]. In addition to the weakness of Theresa May's government, in January 2018, Buzzfeed News leaked a government report that predicted an economic hit from Brexit. This confidential document that was meant to be shown only to Theresa May and David Davis, suggested that the UK will be worse off under the three possible post-Brexit scenarios, a comprehensive free trade deal, single market access, or no deal at all. The report said that Britain's national growth would be 8% lower under a no deal scenario, around 5% lower with a free trade agreement, and about 2% lower with single market membership over a 15-year period[168]. The Scottish National Party minister and spokesman, Stephen Gethins, remarked "This is highly embarrassing for Theresa May."[169]

The uncertainty and complexity of the negotiations leaves a lot of questions unanswered.

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[165] Oltermann, Philip. (October 2017). *Brexit 'more complex than first moon landing', says academic study.* The Guardian. Berlin, Germany.
[166] Peston, Robert. (October 2017). *UK and EU Politics, Economic Prospects, and the Future of the City.* Société Générale Annual Equity Derivatives Conference. London, United Kingdom.
[167] Savage, Michael. (February 2018). *Theresa May faces revolt of leading Tory donors*. The Guardian.
[168] Mason, Rowena. (January 2018). *Brexit would damage UK growth, says leaked cabinet report.* The Guardian.
[169] Mason, Rowena. (January 2018). *Brexit would damage UK growth, says leaked cabinet report.* The Guardian.

Will the UK be able to reach an agreement on a future trading partnership with the EU before March 2019? Will Theresa May's leadership be replaced by another candidate that will negotiate the UK's Brexit deal? Will the EU allow the UK to have the best of both worlds, access to the single market that covers the areas of financial services without following European regulations? What type of agreement is necessary to maximize gains in this negotiations for the UK and the EU?

This thesis has focused on the impact of Brexit on the City of London. But, the UK vote to leave the EU will also have a profound impact on the other members states. On top of the Brexit negotiations, the European Union currently faces numerous political and economic challenges, such as the rise of populist political parties with Eurosceptic sentiments, the high unemployment rates in its peripheral states, the Greek debt crisis, the ongoing migrant and refugee flows, and the heightened terrorism threat. What is the future of the European Union after Brexit? Will there be a domino effect with other countries calling referendums to leave the European Union? Will this eventually lead to its disintegration?

The EU heads of state met in Rome on March 25th, 2017 to celebrate the 60th anniversary of the Rome Treaty and reflect on the future of the European Union. For the first time in sixty years, its most ardent supporters worry about its continued existence. But some, however, believe that Brexit offers opportunities to intensify political and economic integration in order to transform the block into a more cohesive entity. A joint statement by the Heads of the State on the occasion March 2018 meeting of the European Council read, "We have united for the better. Europe is our common future"[170]. Peter Ide Kostic, Administrator in the Secretariat of the European Parliament, believes that the future of Europe looks better without the UK, "The EU is

[170] European Council. (February 2018). *Political reflection on the future of the European Union*.

already moving forward. Countries want to work together to achieve goals like more military cooperation, more regulation, bigger EU budget, and closer integration, which were impossible with the UK in the European Union. For example, now that Brexit is over, and we have to move on, countries have decided to contribute with a higher percentage of their GDP to the EU budget[171]". Justina Lasik, Policy Coordinator at the European Commission also believes that the EU is moving ahead with a positive agenda.

While the long-term consequences for the European Union are unclear, one thing is certain, the EU wants the negotiations to be a painful process for the UK. Its officials fear that a good Brexit deal for Britain will inspire other member states to exit, attempt to negotiate similar agreements, and thus lead to the disintegration of the EU. European leaders are intending to force the UK to have a "hard Brexit" to ensure that other countries in the block are not tempted by any favorable deal to hold their own referendums. Lasik notes that "The union needs to ensure that no other country leaves. Through these negotiations the EU needs to make the case that no country is better off outside the EU. On top of the negative economic consequences in the short term, the EU cannot give a good trade deal to Britain. In the current EU discussions, we are not concerned about Brexit anymore, we are concerned about the future of the EU. Therefore, we need to think ahead and focus on the future financial framework[172]". The president of the European Commission launched a white paper outlining five possible scenarios for the EU after Britain formally withdraws in 2019. The scenarios ranged from a do-nothing approach to a full-blown federalism approach, but Mr. Junker stated that there will be a sixth scenario "Scenario 6:

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[171] Peter Ide Kostic. (October 2017). Personal Interview.
[172] Justyna Lasik. (October 2017). Personal Interview.

Sustainable Europe for its citizens", for the future of Europe after Brexit that will save the European Union.

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