Radical Options for Scotland and Europe

ROSE BRIEFING 39
6 April 2021

BRITAIN AND EU AGREE 'MEMORANDUM OF UNDERSTANDING' ON FINANCIAL SERVICES

An agreement not to agree

On Friday 26 March the Treasury issued the following statement:

'Technical discussions on the text of the Memorandum of Understanding, which was agreed in a Joint Declaration on Financial Services Regulatory Cooperation alongside the Trade and Cooperation Agreement, have now been concluded. Formal steps need to be undertaken on both sides before the Memorandum of Understanding (MoU) can be signed but it is expected that this can be done expeditiously. The MoU, once signed, creates the framework for voluntary regulatory cooperation in financial services between the UK and the EU. The MoU will establish the Joint UK-EU Financial Regulatory Forum, which will serve as a platform to facilitate dialogue on financial services issues.'

A draft of the memorandum, seen by the FT, said the forum's activities should include "reducing uncertainty" and "identifying potential cross-border implementation issues" (Financial Times 27 March). It represents a minimal level of agreement and simply commits Britain and the EU to twice yearly meetings to review developments in a UK-EU Financial Regulatory Forum. According to the Financial Times, it 'falls short of legally binding cooperation'. The Forum would instead seek to avoid 'unnecessary incompatibilities' but leave 'each side free to develop its financial system as it sees fit'. This leaves investment managers in London, handling $10T dollars in investors' cash, free to deregulate away from EU rules, to heighten risk margins and hence (at least on a good day) profits. In fact this divergence has already begun. A little earlier in March the House of Lords Committee reviewing EU-UK rules recorded the relaxation of regulations on the supervision of stock purchases and a shift to 'self-regulation'. The EU Commissioner for Financial Services commented 'you can't have divergence and equivalence' (*Financial Times* 26 March).

Effectively Britain and the EU have agreed not to agree and to allow regulations to diverge. The mainly overseas investment companies in the City of London have been concerned with what they saw as increasingly obstructive EU financial regulations and in particular the creation of a European Capital Markets Union (CMU) designed to overcome the fragmentation of EU investment markets between Paris, Frankfurt, Milan and Amsterdam – all much smaller than London. There appears to have been an agreement on both sides that failure to agree detailed regulations for financial services should not be allowed prevent the signing of Agreement on goods and other services as secured in December 2020.

There has been no agreement on 'equivalences' and some minor trades (dealing in EU based shares and currencies) have seen some business shift to Amsterdam. The objective of the City of London was to maintain regulatory freedom for the investment of its capital funds – which far exceed those held by investment companies in the EU and which still give the mainly US, Swiss and Japanese investment companies in London the power to dominate EU capital markets, mergers and takeovers.

EU CENTRAL BANK SIGNALS SLOWER EU GROWTH AND HIGHER INFLATION

The recent intensification of the coronavirus (COVID-19) pandemic has weakened the near-term outlook for euro area activity but not derailed the recovery. Despite extended and more stringent containment measures, activity in the fourth quarter of 2020 declined by significantly less than expected in the December 2020.'

Given the uncertainty about the progress and effectiveness of vaccination two scenarios were given in the report.

'The mild scenario envisages a more successful roll-out of the vaccines, allowing for a phasing out of containment measures by the end of 2021, while faster learning effects limit the economic costs. In this scenario, real GDP would rebound by 6.4% in 2021, reaching its pre-crisis level in the third quarter of the year, with inflation rising to 1.7% in 2023. In contrast, the severe scenario envisages a strong intensification of the pandemic, with new variants of the virus also implying a reduction in the effectiveness of vaccines, leading governments to maintain some containment measures until mid-2023 with substantial and permanent losses to economic potential. Under this scenario, real GDP would grow by just 2.0% in 2021 and would not reach its pre-crisis level within the projection horizon, with inflation at only 1.1% in 2023.'

On inflation the report indicates a sharp upturn. 'Overall, HICP inflation is expected to rebound sharply from 0.3% in 2020 to 1.5% in 2021, peaking at 2.0% in the last quarter of 2021.'

RISE IN EXPOSURE OF EU BANKS TO GOVERNMENT DEBT

EU banks' exposure to government debt has been rising during the pandemic and in Spain has reached a level approaching that in 2011-12. In France and Italy the level of exposure substantially exceeds that in 2011-12. A senior analyst at the Deutsche Bank has expressed concern for the longer-term consequences for the solvency of both banks and for the respective governments – as in 2011-12 – and the dangers this poses to the Euro as a uniform currency that cannot be differentially devalued. Germany remains substantially less exposed than in 2011-12.