



## Critical review

## The geo-politics of Brexit, the euro and the City of London

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## ABSTRACT

In this review, we call for more engagement with the geo-political dimension of the finance economy that epitomises the 21st-century capitalist order within the European Union. Using the example of financial clearing and settlement, key processes in global trade and finance mechanisms in which London leads the world, we discuss the entangled political and economic dimensions in the shadow of Brexit to come, and its potential impact on the City's complex financial ecosystem. The aim here is not to consult the crystal ball and predict London's future as a financial centre. Yet, euro clearing is of geo-political relevance: if the UK leaves the EU, euro clearing would be taking place outside of the ECB's regulatory space of intervention. This can become highly problematic, as the nominal euro sums involved in a major crisis are immense. We believe that these processes illustrate the pressing need to engage with finance's geo-economics and geo-politics in more depth, both empirically and conceptually.

## 1. Introduction

Finance's significance to economies, societies, states and households has considerably increased over the last decades. The most visible manifestation of finance's major production spaces are financial centres, i.e., urban concentrations of firms in the financial sector engaged in cross-border business; and Clark's (2005: 99) view that "[M]oney flows like Mercury" is an apt reminder of the core characteristics of finance. Money quickly gravitates around money itself because financial capitalism values money and finance in its own right; if disturbed, however, money swiftly re-pools elsewhere. There is no doubt that the financial industry enjoys little popularity due to its previous excesses; nonetheless, there is much at stake for London and its post-Brexit financial ecosystem, up to now a major growth-generating engine for the UK's entire economy. Recent contributions by Bachmann and Sidaway (2016) linked the marginal public Brexit vote with a relentlessly growing inequality and uneven development in the UK, a diagnosis fostered significantly by the works of and the UK's economic policy focus on London's finance centre.

Clearly, London's City will not simply fold up and rebuild elsewhere. Yet, the shock waves of pre-Brexit around the landscape of Europe's financial centres – others vying already for large pieces of London's financial pie – invites financial geographers to take on the challenge of analysing this process in a laboratory-like situation that will unfold over the years to come. Such an ambition ties in with an aspiring geographical research program recently formulated by the *Global Network of Financial Geography* (FinGeo). Scholars in this network, which

encourages heterodox thinking, seek to grasp finance in its complexity and across established disciplines. This critical review takes up this challenge. It focuses on one of London's least considered financial industries, that is, the clearing and settlement of financial transactions. Illustrating the financial geographies of Brexit, we thus hope to stimulate a more theoretically grounded debate on the complex production systems of global finance itself. So far, much work has scrutinised how London's financial hub has grown over time in both economic and competitive terms, including, among other, by attracting new finance activity (Clark, 2000; Pryke, 2007), managing structural changes in finance over time (Langdale, 1985; Hall, 2007), and constituting organisational power relationships across space (Jones and Search, 2009; Waite, 2017; Wójcik, 2013). Yet, such illustrations of expansion and clustering processes contrast analyses that focus on Brexit-induced political and economic developments of separation and disentanglement, which are the spotlight of this review.

Focussed research on the geo-economics and geo-politics of financial production systems is still lacking across disciplines. Hazardous episodes like Brexit may force financial economic systems to transform more quickly and with much higher costs than previously anticipated, and reshuffle the spatial landscape of financial production accordingly, also with far-reaching impacts on the debt and equity markets that help financing states and the corporate world alike.

The remainder of this review contextualizes, first, London's international financial centre (IFC), then presents some core political and economic workings of euro-denominated clearing activities, before discussing points of intervention on how financial geography could

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contribute to better comprehend the economic architecture of 21st-century financial capitalism.

## 2. City firms and Brexit

City firms plug into a tight web of international financial value chains (Coe et al., 2014; Dörry, 2015), which help with creating new forms of credit, new ways of increasing liquidity and novel methods of offsetting risks, many of which come with prolonged and artificially complex chains of financial intermediation. Financialisation, intermediation and arbitrage exploitation are parts of a lucrative fee-generation machine, which has attracted an army of bankers, lawyers, accountants and other finance-related professionals (Bezemer and Hudson, 2016; Kay, 2016). Finance contributed 44% to the UK's entire exports, totalling £225bn in 2015 (The Economist, 2017), thus underlining the immense importance of this sector to the country's gross domestic product, if not adding always to value creation in the true sense. Yet, clearing is important as it technically aids each commercial trading activity.

Few places in the world have been able to wield as much power in the world's financial system as London. Indeed, the City's influence rests upon its anchored financial institutions, themselves deeply rooted in the global circuits of financial capital (Allen, 2010). Moreover, few IFCs, such as London, have successfully set trends in the past, while the capacities of the large majority of financial centres are primarily based on their ability to copy and follow. Now, the UK is filing for divorce from the common European market and, presumably, cutting some of its close trading ties forged over four decades. If proceeded, Brexit will be the centre-stage a power play of unprecedented geo-political scale and economic importance over the coming years, and may reshuffle the attuned interests of the world's financial landscape, shaped and led by London's City and New York's Wall Street for decades.

Brexit-sides, the UK and the remaining EU 27, find themselves caught in a curious situation: The City of London is disproportionately important for the remaining 27 EU member states. This may explain the EU's recent positioning towards a 'fair' but worse-than-remain Brexit-deal (Rossbach, 2017; finanzen.net, 2017). To date, the EU's economic well-being depends heavily on UK-based financial services: 40% of Europe's assets under management and 60% of Europe's capital markets business are held by UK-based banks. These banks further "provide more than £1.1tn of loans to the other EU member states" (Boffey, 2017), and give the UK quite a bargaining chip at the Brexit negotiation table. Yet, the geo-political situation is also unique: London, the EU's largest IFC, encounters the EU, the world's second largest financial market. London's finance industry is further of high strategic importance to the UK keen to access the EU single market. The financial services sector contributed 11% (£66.5bn) of the UK's total tax income (PWC, 2015), and together with related professional services generated an annual trade surplus of £71.9bn in 2015 (TheCityUK, 2016). The EU market thrives, among other things, on reciprocal agreements between states, so-called 'passporting'. Passporting accepts the other members' regulatory standards, and allows banks, asset managers and other finance companies to choose freely their country of domiciliation.

It all poses important tensions on its own. Yet, the remainder of this review revolves around the *two currencies-one market* taxonomy, i.e., how to manage the politically highly sensitive, yet economically tremendously lucrative euro currency business outside the euro area in London.

Best to start with some definitions: world trade activities of all kind rely on clearing and settlement. The world's reserve currencies, such as the euro, play a major role in international trade, whether by paying for traded goods and services, by issuing or trading euro securities, or by hedging foreign exchange risk with euro derivatives. Euro securities are securities deposited outside the jurisdiction of a national (or the European) central bank. Derivative contracts in any currency permit investors, governments and banks to speculate, to hedge risks, and to

invest under conditions of fickle interest rates and currency markets. Trading creates debit and credit positions between two or more market participants; clearing comprises the time until these bi- or multilateral transaction obligations are settled. Hence, clearing requires intermediaries like clearing houses that eliminate transaction-related settlement risks. What then is the Brexit-related challenge for London? We argue that it is what would equal a collapsing *Jenga* tower when losing too many vital pieces, just as clearing is for London's financial ecosystem.

According to The Economist (2016: 27), "many Brexiteers are unfazed by bankers' threats to decamp. They say that as finance goes global, passporting will no longer matter. ... [London's] competitors are New York, Singapore and Hong Kong." Indeed, some investors cheer a world full of new opportunities; yet, financial markets had gotten visibly nervous when facing the political *uncertainty* engendered by these opportunities. Less optimistic observers argue that soon the tide could turn against the City's remarkable fortunes of recent decades. Financial heavyweights, such as HSBC, Goldman Sachs, UBS, and some large asset managers have already started relocating parts of their core business from London to rival, EU-based IFCs to guarantee continuous access to the continent's financial market. Among the most attractive bidders for London's finance expertise are Dublin, Frankfurt, Luxembourg and Paris. Others, however, may join soon.

Alongside Wall Street, the City of London embodies the archetype of Anglo-American financial capitalism. Yet, unpredictability and uncertainty – the nemeses of finance – are now coming even on home turf in the shape of political decisions, including UK's Brexit vote but also fears of increased market protectionism in anticipation of general elections held in key European countries later this year. Economic systems of finance react to political uncertainty. Overlaps with observations by economic geographers, namely Martin and Sunley (2006:407), caution, "major shocks cause system-wrenching change". Yet, their intervention covers primarily *techno-economic* evolution and not political 'gambling' processes for city-regions by and between nation states.

## 3. The geo-economics of euro clearing are geo-politics

To the untrained eye, London's finance sector looks like a monolith. In reality, banking, lending, speculating, clearing, hedging, trading, consulting, auditing, insuring and many more are highly specialised financial activities performed by equally specialised service-providers that include investment banks, asset managers, hedge funds, insurers, lawyers and auditors, retail banks, stock exchanges, clearing houses, and the like. Just like a natural ecosystem, as famously outlined by Jane Jacobs (1969), London's financial ecosystem contains numerous synergistic relationships between these specialised (often indeed primarily wealth accumulating) activities that make the City a highly dynamic whole. Indeed, London's largely heterogeneous finance sector is similar to a "composite system" (Martin, 2010), built on matching processes that innovatively combine existing activities across companies and sectors in order to create new activities that generate income, as the novel blending of finance with technology (FinTech) exemplifies.

Still, even the most competitive financial system needs market access, and it is at this point, where geo-economics transitions into geo-politics. For London's financial eco-system to continue to thrive depends fundamentally on the negotiation outcomes with the EU. London's clearing industry makes an interesting case. The market for global derivative trading is huge and vastly dynamic. Over-the-counter (OTC) single currency interest rate derivatives account for its largest chunk, of which euro-denominated transactions are the lion's share. They amount to 1.336tn US\$, which is almost double that of USD-denominated transactions (0.776tn US\$). London by itself not only handles the biggest volume of US dollar clearing outside the US, it also dwarfs its Eurozone-based competitors Frankfurt and Paris in clearing euro derivatives with figures amounting to 928tn US\$, 88tn US\$ and

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