The City of London In a New Geopolitical Order

By Brunello Rosa

Among the world’s financial hubs, the City of London is most in search of a new identity that would allow it to adapt to an evolving geopolitical scene. Global financial hubs tend to be the key financial center of the country, region or continent they are based in: New York is the most important financial center for the Americas, as Hong Kong, Tokyo and Singapore are the key hubs for their respective geographical locations in Asia. But being the most important financial center for Europe does not seem to be enough for the City. Why is that?

On the one hand, the City’s geographical position between the Americas and Asia gives it the advantage of enjoying trading hours that overlap with a portion of Asian markets’ trading and most of the American trading day. London’s time zone supremacy (epitomised by the role of the Greenwich meridian as an international benchmark) has allowed the City to become the world’s most important center for currency trading, and therefore to elevate itself from the ranks of “simple” regional hubs. On the other hand, the City is the most important center for transactions of a currency (the Euro) which does not belong to the country where it is located, and towards which it has always expressed a high degree of skepticism, mostly deriving from the identification of that currency with the Franco-German axis that dominates Europe.

The City suffers a “cognitive dissonance” as a result, deriving on one side from being perfectly aware that it is the greatest beneficiary of the combined effect of Thatcherite deregulation of financial services and the creation of the Euro (which has led all the major European financial institutions to transfer their trading desks to London); but (on the other side) absolutely reluctant to remain anchored to a continent (and its Machiavellian institutions) it does not feel to belong to, and to which it remains attached for mere economic and financial opportunistic reasons. Hence, London’s continuous search for a (new) role in the global geopolitical order.

Figure 1: Foreign Banks’ Branch Assets as a Proportion of Total Banking Assets (selected EU countries)

Source: RGE, CER, BoE

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2 This paper was presented at the Conference “The City of London and the Future of the British Economy”, organized by the City University of London, on 5 November 2014. A previous version of this article appeared – in Italian – in LIMES, La Rivista Italiana di Geopolitica, 10 October 2014 (http://temi.repubblica.it/limes/anteprima-di-limes-1014-impero-londra/67417?photo=8).

3 Not just north America but also south America, as the saga of the Argentinian “tango bonds,” staged in New York, proves.

4 There’s no need to remind that after Germans, the French is the population that British people feel more distant from themselves (even after the belated entente cordiale).
The EU Referendum Will Free London...To Become More of a Prisoner?

The EU has changed significantly since the UK joined the European community in 1973. The UK’s intentions have been that Europe should have remained just a single market—which would have benefited a free-trade, insular power such as the UK. Because of that, the UK has always been extremely present in the single market, but openly absent at institutional level⁵, as clearly demonstrated by the decision to veto the inter-governmental treaty that established the “fiscal compact” in 2012, or in the position of vehement opposition to the appointment of Jean-Claude Juncker as President of the EU Commission in 2014⁶.

However, this stance of opportunistic ambiguity by the UK can not be maintained forever and, in fact, EU partners are now asking more insistently that the UK start assuming its fair share of responsibilities in the alliance. Partly in response to that, the Liberal-Conservative government has put on the referendum on EU membership to be held by the end of 2017, if the Conservatives win the May 2015 general elections. Without specifying what would happen otherwise, the Conservative leadership has said it will be happy to campaign to remain in the EU, if—by that time—enough powers have been repatriated (especially labour mobility and social benefits for immigrants).

*What could be the benefit for the City deriving from the UK leaving the EU?*

The propaganda in favour of Brexit suggests that the UK would finally re-acquire the regulatory sovereignty that Brussels’s “perfidious bureaucrats” are intent on stripping via a plethora of directives and regulations on financial services. But the so-called “trilemma” of international economics could cause a serious headache to those in favour of Brexit as a way of regaining sovereignty. According to this “trilemma,” it is impossible for the following three conditions to materialize at the same time: financial stability, increased internalization of trades and regulatory sovereignty – if you pursue two of them, you need to give up the third.

Now, since the City definitely wants to increase its role of intermediation of international trades, and – at the same time – does not want to give up the prospect of increased financial stability (especially after the devastating consequences of the financial crisis started in August 2007), it is obvious (given the “trilemma”) that the City needs to be less demanding in terms of regulatory sovereignty. But even if – for some magical reasons – the City found itself in the position of transcending this trilemma, Brussels’ bureaucracies have already made it clear what would be the consequences of a Brexit for the City of London.

According to the new Directive on Financial Services (MIFID II), financial institutions from non-EU countries (so-called “third countries”) willing to offer their services to EU citizens would necessarily need to open a branch within the EU borders, and prove that the regulations of the country of origin are “equivalent” to the EU’s. This equivalence would be certified by the EU’s European Securities and Markets Authority (ESMA).

Therefore, if the UK left the EU, it would become a “third country”, and its financial institutions willing to approach EU citizens would need to open a branch within the EU and “hope” that ESMA would consider the UK’s new regulation (derived from regained sovereignty) as “equivalent” to the EU’s. Even if the UK had already lobbied hard to make sure that this equivalence does not mean “line-by-line” but rather “equivalence of prudential principles,” it is unlikely that ESMA would consider as “equivalent” a set of rules less restrictive than those of the EU. With the paradoxical result that the City will ultimately campaign to make sure that the government has adopted regulation conforming as closely as possible to EU principles, and in so doing de-facto giving up the just-regained (supposed)

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⁵ Even the choice by the UK (and imposition to the rest of the Union) of Lady Ashton as High Representative for Foreign Policy and Security derives from the same attitude. The lack of a strong political weight by Lady Ashton has meant that every country has conducted its foreign policy in isolation, effectively what the UK wanted to do, thus boycotting the possibility by the Union to develop a common foreign policy.

⁶ Although Cameron has been “compensated” for the choice of Junker as President by the appointment of Sir Jonathan Hill as Commissioner for Financial Stability, Financial Services and Capital Markets Union.
regulatory sovereignty, without even the possibility of intervening/interfering in the EU’s decision-making process, as it is currently the case.

**If Europe Disappoints, Why not Look at China, Islamic Finance and Global Markets?**

If the idea of breaking the chains with Europe means finding itself “more of a prisoner” than before, perhaps another possibility exists. The road ahead has been somehow indicated by the Bank of England’s new governor. Speaking in occasion of the 125th Anniversary of the Financial Times, Mark Carney, incumbent president of the Financial Stability Board and with previous, long experience in Goldman Sachs, has depicted a scenario in which, by following current trends, in 2050 the assets of the UK banks could be 9 times UK’s GDP, even abstracting from the contribution of foreign banks based in London and of the “shadow banking system.” While many would consider this as a terrifying scenario, Carney said, he would suggest to look at it as a serious perspective and proposition, if adequately regulated.

*Figure 2: Total Assets of UK Monetary and Financial Institutions (Number of Times GDP)*

![Graph showing total assets of UK monetary and financial institutions](image)

*Source: RGE, Haver*

In order to gain the position of a global financial super-hub, and potentially that of world financial capital, the City of London has been making an effort to attract Chinese and Islamic finance, both in rapid expansion.

Regarding Chinese finance, after agreeing the creation of “swap lines” between the Bank of England (BOE) and the People’s Bank of China (PBOC), allowing the BOE to provide liquidity in renminbi in case of necessity, the cooperation has increased further, with Chinese banks allowed to open their branches in the City with simplified procedures, while remaining mostly regulated by Chinese authorities. Subsequently, it has been decided that China Construction Bank could become the first London-based clearing house for renminbi transactions in the UK. Finally, the UK government has recently issued its first renminbi-denominated bond (for RMB 3bn, around £ 0.3 billion). As one can see, these are all manifestations of the efforts made by China (and the UK) to allow the renminbi to become a “more international” currency, a key step for China to become a global super-power in the next few years.

The potential revenues from these agreements could become huge in coming years, as recently proved by the flotation at Wall Street of the e-commerce portal Alibaba, which has soon risen above the market capitalization of some of the banking giants that have mediated Alibaba’s flotation; the largest IPO in American history.

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On the other hand, Islamic finance is probably still in its infancy (see charts below), but the recent launch of the “sukuk” bond in the UK in June 2014, the first in the Western world, shows the growth potential of this branch of activity, especially thanks to the gigantic flow of liquidity coming from oil-exporting countries where Islam is the prevailing religion.

8 “Sukuk” (Islamic) bonds generate returns to investors without infringing Islamic law (that prohibits riba or interest). Sukuk represents undivided shares in the ownership of tangible assets relating to particular projects or special investment activity.
The Bank of England Is Getting Ready For Global Central Banking

Given these developments, the BOE has radically changed its approach to “liquidity insurance,” i.e. the supply of liquidity in case of necessity of a bank or other financial institutions. When Mervyn King was Governor of the BOE, the idea prevailed of limiting counterparts’ “moral hazard” by only conceding liquidity insurance at punitive rates, in order to avoid financial institutions assuming excessive risks in the conviction that – in the worst case – there would be the central bank ready to backstop them. This approach, perhaps correct in theory, proved disastrous in practical terms, as proved by the bank run on Northern Rock in August 2007.

Carney’s arrival has completely changed this approach: not only liquidity insurance is provided at much more favourable rates, but the number and types of counterparts is likely to be increased in the next few years, in order to eventually include also central counterparts (CCPs) and broker-dealers. The setting of a very generous (initial) leverage ratio of 4.05% (the 3% minimum set up by Basel III accords, plus the 1.05% supplementary buffer for systemically important institutions), is another incentive for large financial institution to settle in the UK and grow its size. Finally, the BOE Chief Economist Andy Haldane has recently spoken about the possibility of “managing global finance as a system,” a clear indication of the new global reach the BOE is looking at.

The objective is clear: the City is trying to diversify its offering in order to be sure of being able to play a major role in international transactions even if Euro-denominated trades were to dramatically decrease as a consequence of either the UK’s decision of leaving the EU, or the break-up of the euro-area.

The City gets ready for new geopolitical scenarios, where the EU might not exist anymore.

The City’s desire and attempt to loosen its ties with Europe might not be solely driven by the search for higher and more diversified sources of profits, or increased regulatory sovereignty. Actually, it could be part of a hedging strategy from actors that observe the rapid evolution of the geopolitical scenario in a direction that is unfavourable for the EU, which might cease to exist, in its current form, over a finite time horizon.

In effect, “united” Europe, conceived as the largest experiment in human history of creating an area of perpetual peace, freedom, prosperity, democracy and social protection, is in this moment under siege from all fronts: migrants fleeing war and poverty from North Africa; the continued political-military instability in the middle East (with at least three open fronts: Syria, Israel/Palestine and Iraq) and the pressure from the North-East deriving from the Russian-Ukrainian crisis. In such a delicate moment, European countries should try to stick together to defend the values they hold dear. Instead, deep fault lines are opening within Europe: populism, nationalism and separatism are appearing as forms of extreme reaction to the perpetuation of a status quo that the German leadership considers as an acceptable (or even desirable) outcome and that is, instead, perceived as a form of “zombification” by the populations of those countries subject to the rules deriving from the German approach.

These external and internal pressures risk destroying Europe in just a few years: with the EU having promoted the creation of transnational macro-regions, the EU of nation states is collapsing under the weight of the (tragically imperfect) mechanisms of regulation of the single currency, only able to reignite anti-euro populism (such as that of Marine Le Pen in France, and Alternative Fur Deutschland in Germany). Europe could save itself by promoting the (painful) birth of transnational macro-regions; but this process cannot happen under a leadership that only aims at preserving unsustainable equilibria; with forms of regionalism tending to morph into separatism, with explosive potential, as the Scottish Referendum has just proven.

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9 The Bank of England has launched, on November 5th 2014, the application process for CCPs and Broker-Dealers to access the Sterling Monetary Framework. For details, see http://www.bankofengland.co.uk/markets/Pages/money/documentation.aspx.
10 The record of the FPC meeting setting up the ratio can be found at: http://www.bankofengland.co.uk//publications/Pages/Records/fpc/2014/141031.aspx
I would personally attach a 40% probability to the EU not existing in its current form in the next 10 years, with the euro-area also having a different shape, as a consequence or the cause of the reshaping of the EU. And here is the point: let’s project ourselves “fast forward” 10 years into the future, and assume that the EU does not exist anymore, or not in its current form. If the City hadn’t, in the meanwhile, prepared for this eventuality, and only remained anchored to the role of major financial center of Europe, it would be simply a victim of the events. But British people, being pragmatic and little inclined to sentimentalism, feel the need to start preparing for a future in which every nation state (or what will be left of it) will have to re-invent its role in the world.

If this scenario materialized, the steps taken today to diversify its offering (and clientele) would continue to allow the City to play a major role in a completely changed geopolitical landscape. A geopolitical environment where the ties with China and Islam, together with the “special relationship” with the US and the geographical location at the centre of Europe would continue to allow London and its City to remain the “table” where all the most important economic and financial “cards” are played.

Therefore, with its possible referendum on EU membership, the UK could become the detonator of this geopolitical scenario that it is currently fearing, and against which it is taking its legitimate precautions.