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French plot to topple City of London is foolish bluster

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The sun rises on the City of London

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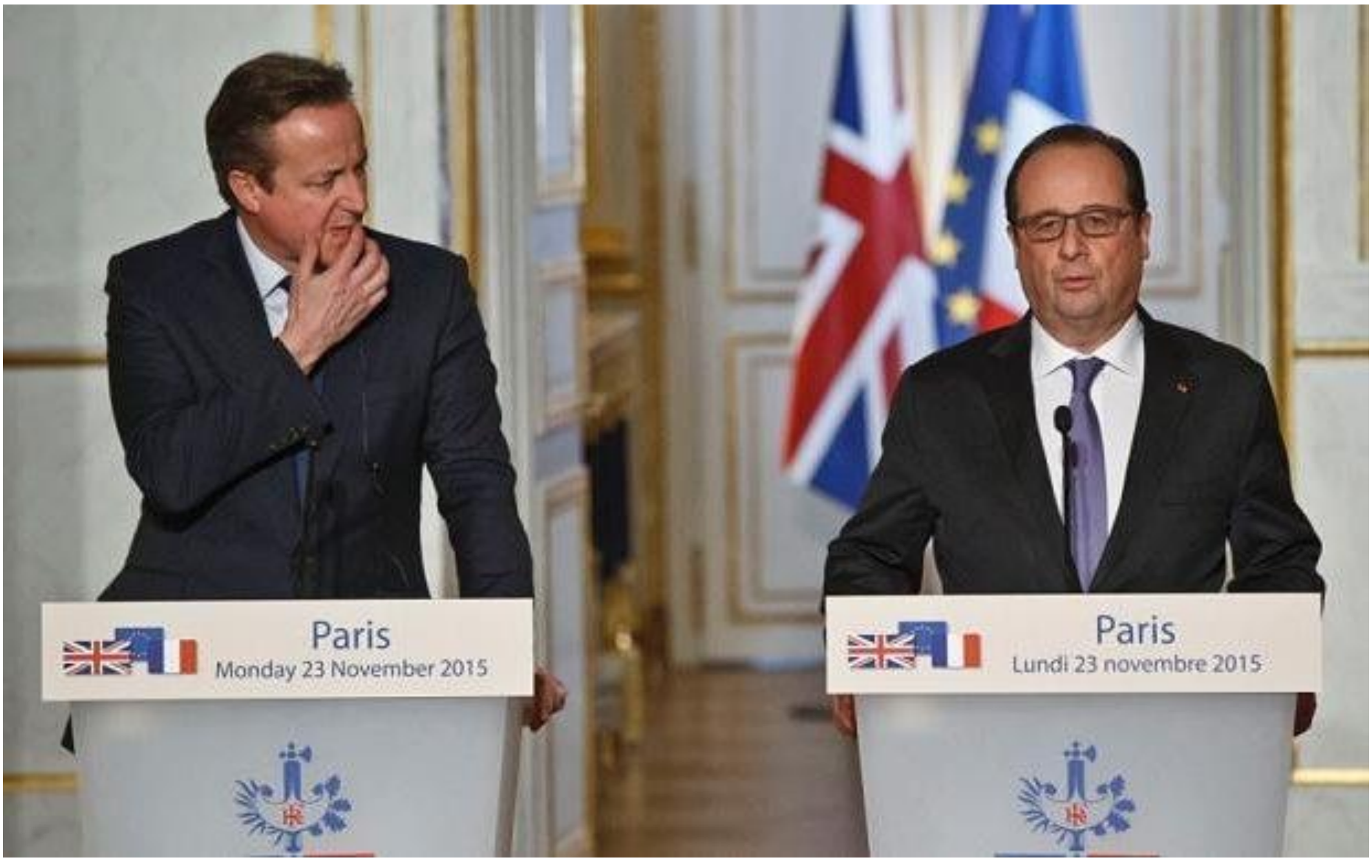
French leaders are openly plotting to peel off large chunks of the City's financial industry as soon as Britain leaves the EU. This might prove much tougher than they imagine.

The plans conflict with far more important economic and strategic objectives of the EU, and some of the stated intentions violate existing EU law.

France is rolling out the red carpet for putative refugees from Canary Wharf, hoping to capture the lion's share of the estimated €600bn to €1 trillion market for clearing in euro-denominated transactions. Some German officials are also eyeing the City, but more discreetly.

"There is a power play going on. It is very clear France and Germany will do everything they can to damage the City and get the business for themselves," said Professor Athanasios Orphanides, a former member of the European Central Bank's governing council.

"But I don't think anybody can kill the City that easily. The EU itself is so messed up right now and the eurozone is so fragile that any shock could tip them over the edge, and when it happens it is going to be non-linear," he said.



David Cameron (left) and Francois Hollande

French President François Hollande has been notably combative, telling Les Echos that Britain will lose its vital right to commercial passporting “completely” the moment it steps out of the club. This clashes head on with France's parallel policy of intimate defence ties with Britain.

He has also stated categorically that Europe will stop the City carrying out clearing operations in euros, adding for good measure that the Referendum result is irreversible. It is almost as if he welcomes the result for his own internal motives within the French political system.

Prof Orphanides, now at the Massachusetts Institute of Technology, said neither Paris nor Frankfurt have the skills or outlook to run an international financial centre of global scale.

"Whatever they try to do, they'll end up shooting themselves in the foot and driving the businesses out Europe. The EU regulations are so costly that I think the City could actually see long-term benefits from leaving," he said.

The City is ranked number one in the Global Financial Centres Index, ahead of New York, Singapore, Hong Kong, Tokyo, and Zurich. None of the EU's other hubs come close. Luxembourg is 14, Frankfurt is 18, and Paris lags far behind at 32, behind Calgary or Dalian in China.

The great unknown is whether London's incumbency advantage is 'sticky' in the fluid world of global finance. Chris Cummings from the industry lobby TheCityUK says it is hard to replicate a deep and established market.

"No major financial institution is leaving. They have gone 'long' London. People have families here and it is their centre of gravity, and there are big regulatory costs to moving," he said.

It is hard to see how a French socialist government facing a revolt from its own left-wing base can offer the kind of tax rates and operational freedom needed to lure away the City's star players.

President Hollande's assertions assume that Britain and the EU do not agree on the European Economic Area, or a hybrid variant dubed 'EEA-plus". This Norwegian model safeguards passport privileges for financial services.

They also assume that Britain cannot secure a sui generis arrangement under the international practice of “equivalence”, as some City leaders propose. Since the UK’s rules for clearing houses are the same as EU rules, it would be a hostile step to deny it.

The EU itself would face a headache if it tried to do so, since it would then lose easy access to the City's crucial market for dollar clearing. "London is the financial foundation of the EU economy," said Mr Cummings.

Nor it is clear whether the EU can shut down the trading of euro securities in London even if it tried. “Nobody is worried about remnimbi clearing in London; nobody is worried about dollar clearing in London, why is this such a big deal?” said Barclays chairman John McFarlane.

John McFarlane

Mr McFarlane said the business is concentrated in the City is because the system is open and works. “You could have put it anywhere, but it came to London, so I think it will be very hard to extract,” he said.

EU law complicates the matter further. Five years ago the European Central Bank demanded that euro transactions should be “exercised within the euro area”, arguing that the scale of the business is systemic and therefore should be under regulatory oversight of the central bank that issues the currency.

Prof Orphanides said it was a thinly disguised attempt to divert the trade to Frankfurt and Paris. Britain took the ECB to the European Court and won the case. It is widely-assumed that the UK would lose this protection after Brexit, but in fact the court ruled that the ECB lacks the competence to regulate clearing systems. This remains the law.

Brussels could try to impose the same rule but this would need a new EU regulation, passed by a majority of states. It is far from clear that the no-euro states such as Sweden, Denmark, or Poland would accept this.

For all the bluster following the Referendum, there are larger issues at stake in Britain's relationship with Europe than the scramble for bits of the City. While France and others could block any British request to join the EEA, there are many reasons why they might hesitate to do so.

An EEA-style deal would ensure that Britain continues to pay into the EU budget. Bavaria's ruling Social Christians have warned German Chancellor Angela Merkel that they will not support any increase in Germany's budget payments to make up the loss, demanding instead that the overall EU budget should be slashed.

This is one of many fissures - both inside states, and between EU states - that are already emerging within a week of the Brexit vote. Germany has a vastly greater stake in open trade than some of the EU's more closed economies, not least because of 820,000 car exports each year to Britain.

The German manufacturing machine is enmeshed with suppliers in the UK, which is why the powerful industry federation BDI says it would be "very, very, foolish" to impose trade barriers of any kind.

Ultimately, there is a deeper issue. The EU needs an amicable settlement with Britain to minimize economic and strategic damage. The elephant in the room is that the UK helps to anchor the military defence of the EU's eastern border with Russia, and its political role in NATO is crucial for keeping an ever more reluctant US Congress attached to the alliance.

If the EU adopted a seriously hostile position, it would become impossible to maintain democratic consent in Britain for NATO, and for the solidarity clause of Article V that commits British servicemen to risk their lives for Europe. Without the Anglo-Saxon defence umbrella, the Baltic states are sitting ducks. Poland is vulnerable.

Whether or not Brexit plays into the hands of Russia's Vladimir Putin depends entirely on how the key EU capitals respond. Wiser heads know this, even in Paris.