# THE BANK OF ENGLAND IN EUROPE: DOES EU MEMBERSHIP CONSTRAIN NON-EURO CENTRAL BANKS?

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## Speakers

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| **Jon Cunliffe** | **Deputy Governor, Bank of England** |
| **Matt Holmes** | **Managing Director Government and Regulatory Affairs, Deutsche Bank** |
| **Sheri Markose** | **Professor of Economics, University of Essex** |
| **Guntram Wolff** | **Director, Bruegel** |

The report *EU Membership and the Bank of England* aimed to identify what the UK's membership of the EU means for the BoE's ability to meet its policy objectives. The Bank of England has a dual mandate, to deliver monetary stability and financial stability. In terms of Bank of England's objectives, from the monetary policy perspective, there are no major constraints from EU membership. From the objective of financial stability, the impact is more complex. While financial stability is ultimately a national responsibility, participation in the Single Market means that regulations which apply to the UK are decided at the EU level.

As a member of the EU, the UK has been affected along three spectrums: overall openness, dynamism and stability of the economy.

### Openness

- **Trade openness** - UK's trade with the EU accounts for 44% of UK exports and 53% of imports. Gravity models indicate that UK-EU trade has risen faster than would be suggested by standard determinants of trade, suggesting factors beyond globalisation and geographic proximity.
- **Financial openness** – The UK benefitted from the single market for financial services and free movement of cross-border capital flows between EU member states. UK on average has been the top destination for FDI flows in the EU. Intra-EU cross-border bank lending grew faster than other forms of cross-border lending.
- **Labour migration** - Since 1973 the UK's population rose by 8.4 million, 20 % of which is due to immigration from within the EU. Net increase through EU migration has mainly occurred after 2004 EU enlargement.

**Dynamism**
There is a rich literature that documents the effect of openness on dynamism through innovation and specialisation. However, EU-specific literature is limited. There is a weak correlation between trade openness and business spending on R&D. Intra-EU production concentration has increased faster relative to NAFTA from 1996 to 2001. Product and labor market regulation have not made UK less dynamic. In terms of labor market regulation, UK's employment protection legislation is less stringent and closer to the level of US and Canada than to France and Germany.

**Stability**

- **Risks to the financial system** - Openness can go both ways, increased openness can lead to increased volatility as it becomes harder to manage risks. The average size of financial firms grew considerably prior to the crisis, particularly in the UK. EU policies may have reinforced this and the euro also played a role.

- **Exposure to shocks** - Financial interconnectedness helps risk-sharing and portfolio diversification, but can also propagate shocks. Prior to 2008 shocks from the EU counter-balanced UK business cycles. During the crisis, EU banking groups sharply withdrew funds from the UK, which contributed to tightening of credit conditions and weakness in lending. External shocks have amplified the downturn of UK growth since 2008.

**Micro- and Macroprudential Supervision**
In the case of banks with very large branches globally, to what extent can the Bank of England be confident that it has the right micro and macroprudential tools? For banks operating in the UK and continental Europe, there is concern about convergence or divergence of approaches between the SSM and the Bank of England. For instance, there is a supervisory divergence when it comes to subsidiaries vs. branches of foreign institutions operating in the UK. If there is more transparency, commonality and communication there are less risks in the future.

Much regulation comes from the EU, which has a strong impact on financial stability in the UK. However, the oversized financial sector in the UK also poses a risk to global financial stability. In terms of the regulatory framework, the banking system regulatory framework has not stress tested itself. Basel requirements do not give sufficient amount of time to build reserves against risks. Presently, Basel 3 and international financial reporting standards (IFRS 9) place conflicting demands on banks, such as in term of loan loss provisions and regulatory capital requirements. There is a need for "joined up" regulatory reforms.

The UK faces a struggle for good cross-border regulation globally - with the US, Japan and others. But with the EU, UK has cross-border laws that are more beneficial to the UK as a member of the EU. However, with the Single Market, UK cannot be on the level playing field at the same time preserving the regulatory autonomy and flexibility it desires. Only 40 percent of financial activities in the UK are related to the European Union. As such regulation is not an EU issue, but a national one requiring a national system of approaches. However, on systemic risks rather than idiosyncratic risks, UK depends on others.

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