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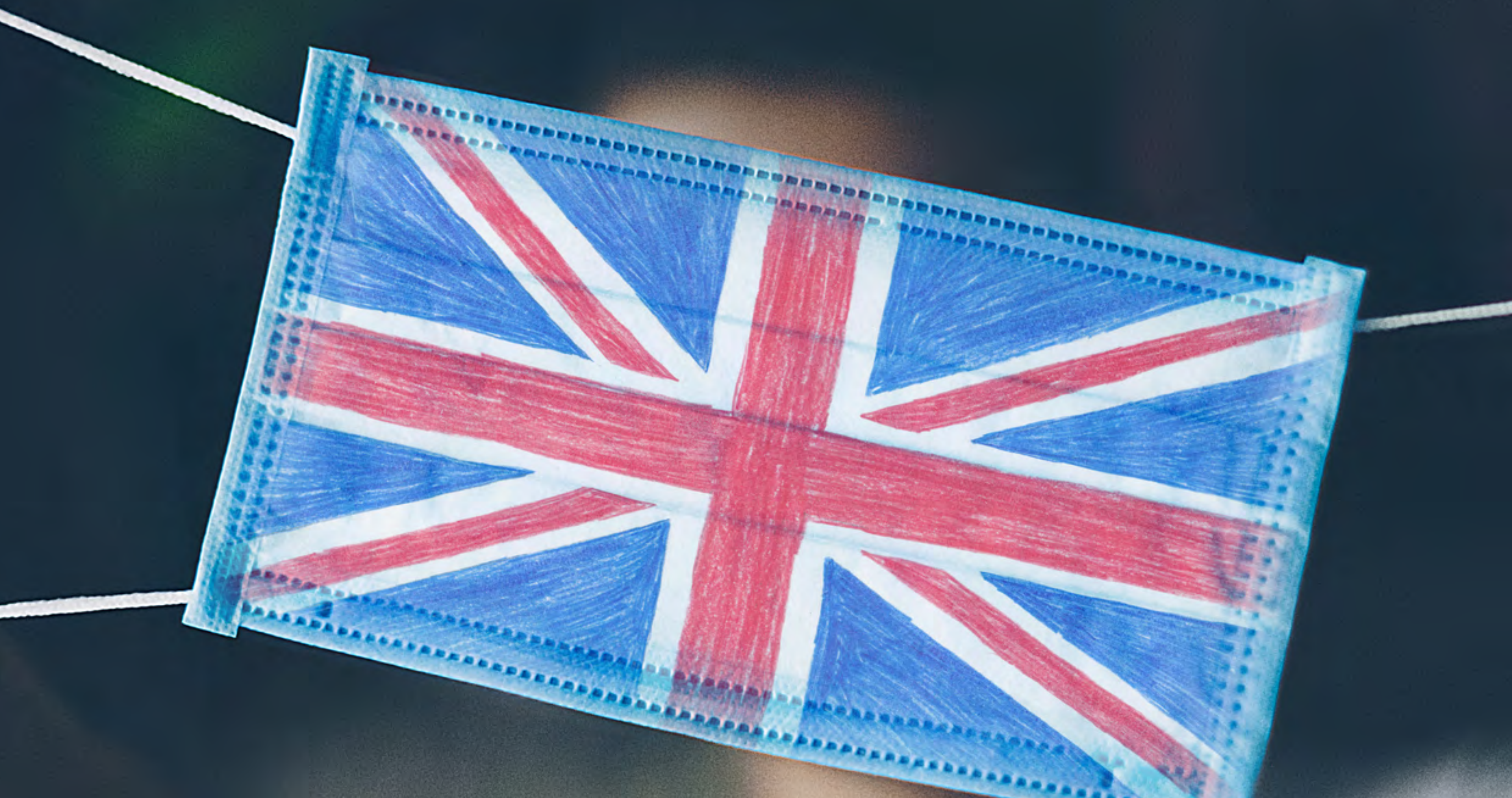

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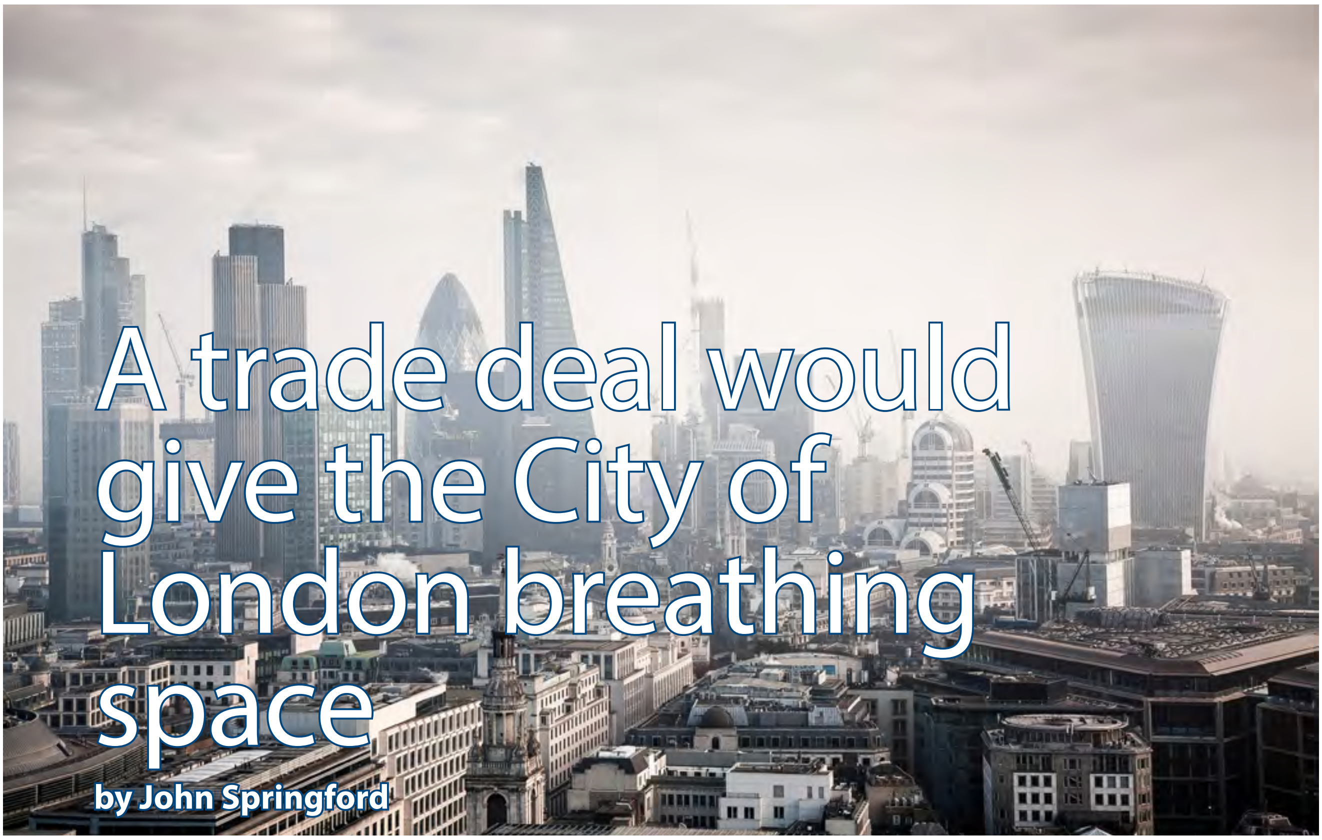

A trade deal would give the City of London breathing space

by John Springford

The EU's decisions on financial equivalence for the UK are formally separate from the trade deal under negotiation. But in reality, the two are linked.

The British government has marginalised big business during the EU trade negotiations – and none more so than finance. By prioritising sovereignty over close economic ties with Europe, the UK has accepted that trade in financial services will be more difficult once the transition period ends. This is despite the City of London's status as a global financial centre, responsible for a sizeable chunk of British exports and tax revenues. The City is not only a cluster of banks, markets and insurers, but also the accountancy, consulting and law firms that service them.

The trade agreement that the UK and EU are negotiating offers little in practice to the sector. But the City of London is still hoping for a deal: the EU is more likely to grant equivalence in some areas of financial services if a trade deal is struck. Equivalence is a unilateral decision, taken by the European Commission, that a third country's regulation and supervision is similar enough to the EU's. That decision would allow British firms to provide services across the EU. In the event of no deal, access on the basis of equivalence will be limited to areas where the EU is worried about its own financial stability.

The EU has granted the UK equivalence in derivatives clearing until mid-2022, despite the spat over the UK's Internal Market Bill. The European Central Bank (ECB) has always been concerned that ending EU banks' access to clearing houses in London might cause financial instability. After the 2008 financial crisis, regulators tightened regulation on derivatives (such as futures and options) and mandated that some derivatives be 'cleared', so that if one participant in a derivatives contract went bust, the contract would be carried out without harm to the other. If the EU failed to grant equivalence on short notice, there would be a scramble to move derivatives contracts to clearing houses within the EU, which do not yet have the capacity to cope. But equivalence will be temporary, and over time both the Commission and the ECB will press for more derivatives to be cleared within the EU's jurisdiction: neither wants to outsource regulation and supervision of a critical part of the EU's financial system to the UK.

The ECB is not convinced that equivalence decisions in other areas – the trading of shares, advice about mergers and acquisitions, and so forth – are needed in order to protect the

EU's financial system. As a result, the European Commission and the member-states have been more willing to use the equivalence process in these areas for leverage in the trade negotiations. If a trade deal is agreed, and Boris Johnson drops the provisions in the Internal Market Bill that violate the terms of the Withdrawal Agreement, it is more likely that equivalence will be granted by the EU in some of these areas.

But there is one important area in which the Commission said on July 9th that it will not grant equivalence: investment banks that provide investment services to clients in the EU, even to 'professional clients' in other financial institutions. In August, Commission Vice-President Valdis Dombrovskis said that new rules were still being implemented, so the Commission would not be able to grant equivalence to allow UK investment banks to continue to serve EU clients from January 2021. Investment banks headquartered in the UK and seeking to provide cross-border services will have to apply to the national authorities of each member-state they want to operate in.

If the EU does not grant equivalence decisions in other areas, many banks have already set up subsidiaries in the EU that will allow them to continue to provide services, and are ready to move more staff and capital to offices on the continent as needed. Many have done so already, operating on the basis that no deal will happen, in order to minimise risk.

Not all areas of finance are covered by the EU's equivalence regime in any case – especially those where banks and insurers are providing services to ordinary consumers, rather than other financiers. But that does not mean that equivalence decisions would not be helpful. The City may currently be a ghost town, with most people working from home, but once the pandemic is over there will still be benefits to being able to dip into a big pool of skilled financiers in London rather than having workers distributed across Europe. Banks can also use their capital more efficiently if they provide services from one institution, rather than several, each of which will have to be capitalised.

That is why a trade deal is worth having for the City: the EU will take the mostly political decision to allow equivalence if the UK signs up to a state aid regime that is similar to its own, provides the EU with long-term access to its fishing waters, and so forth. The trade deal itself may include provisions for an ongoing dialogue between the regulatory bodies on financial markets, similar to those included in the EU's trade deal with Japan. Those dialogues will be needed to preserve a stable equivalence regime between the EU and the UK.

But in the longer term, it is unclear which of two competing visions for the future of EU financial markets will win out – with important ramifications for the City. The first view sees the EU financial system as a pillar of 'strategic autonomy'. In 10-15 years, there would be a fully-fledged capital markets union. The EU system would be open to London, New York and Asia but would be more developed itself. An EU safe asset, such as the common EU bonds that European leaders recently agreed should finance the recovery fund, would underpin a stronger international role for the euro and the European financial system. The EU would face less exposure to US sanctions, because Europe would be less dependent on the US financial system.

The opposing view sees a more 'independent' European capital market as inevitably more closed: instead, the EU should maximise its involvement in the regulation of global markets. Free-trading national governments in the EU and the financial services lobbies stress that tighter equivalence rules and EU capital market rules that diverge from the global norm will raise the cost of finance for companies and consumers. And the capital markets union has made slow progress so far: centralised supervision of capital markets and a single set of rules for insolvency, stock exchanges, taxation and many other things will be needed to create a single market in this area. The Commission proposed new common supervisory measures on September 24th to try to restart the process.

Which is more likely? The trajectory has undoubtedly been towards the centralisation, albeit slow, of financial regulation at the EU level. The ECB has become the supervisor for the largest banks in the eurozone, and as a result it has sway over the banking regulations that the Commission proposes. Member-states are resisting losing the power to supervise and regulate capital markets, but centralising logic is powerful here, too – a consolidated market would allow the costs of recessions and benefits of upswings to be shared more equally across the continent. A deal would give the City breathing space, but Brexit gives the UK the power to go its own way, and it should not be surprised if the EU does the same over time.

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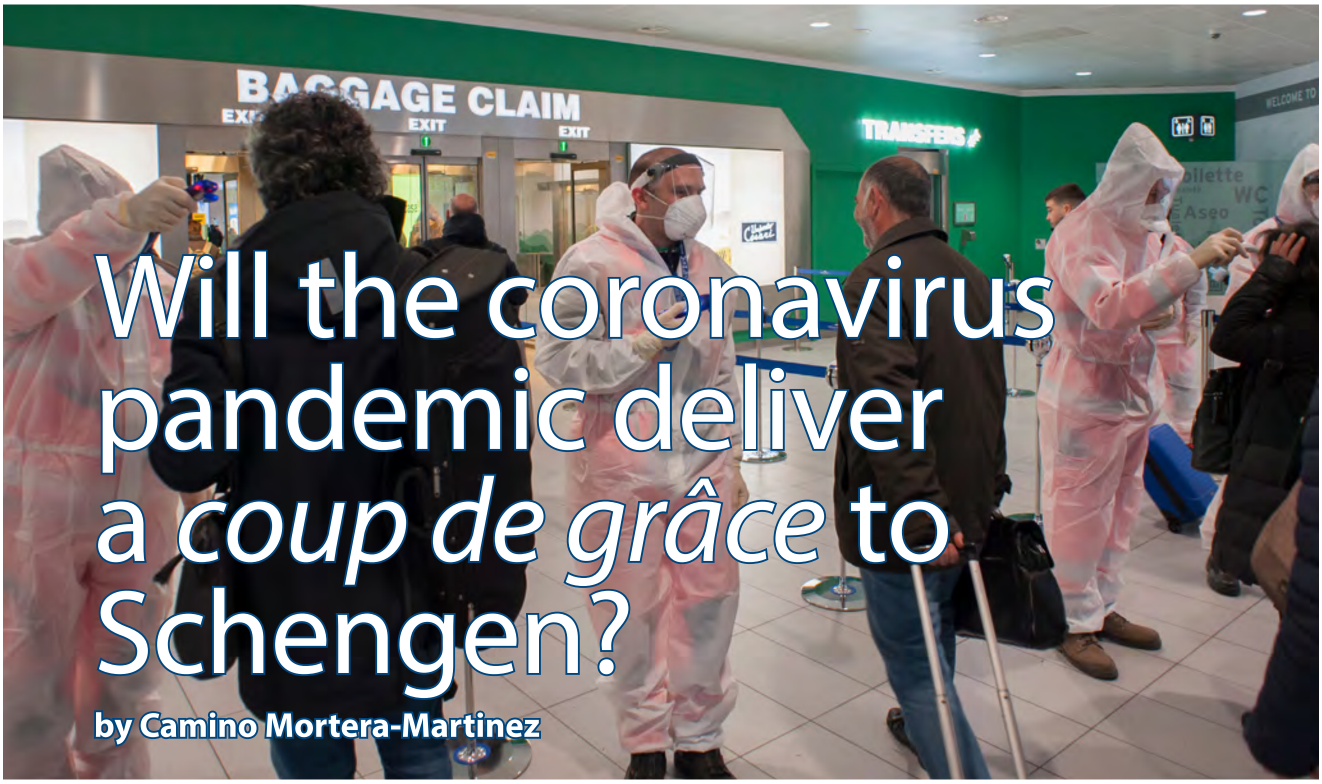

Will the coronavirus pandemic deliver a *coup de grâce* to Schengen?

by Camino Mortera-Martinez

The EU's Schengen area will survive the pandemic. But member-states need to co-ordinate border closures and set clear criteria for imposing quarantines, or they will imperil the single market.

For over six months, the world has been grappling with a pandemic that has killed almost a million people, infected many more and crippled the global economy. While most headlines rightly focus on the human and economic costs of COVID-19, the spread of the virus has created much collateral damage – including to Europe's passport-free Schengen area. Or so the story goes. Ever since the EU's members began closing their borders to contain transmission, some have feared Schengen's demise. And yet, as the 2015 security and migration crises showed, although the Schengen area may be flawed, it is more resilient than it may appear. This is because Schengen was devised with the idea that man-made problems or natural catastrophes will happen and that member countries may sometimes need to close their borders.

The pandemic has led to three very different, and unequally complex, problems for the EU. First, member-states have restored passport checks; second, the EU as a whole has issued a travel ban for non-EU citizens; and third, EU countries have imposed quarantines or refused entry to fellow European citizens. The first two problems relate to Europe's border-free area of Schengen and are comparatively less serious. The third touches upon the heart of the EU's internal market and may inflict longer-lasting damage on Europe.

At the peak of the pandemic, internal border controls were inevitable. Whereas there is mixed scientific evidence on the effect of protracted travel restrictions on curbing transmission, it would have been a tough political sell to demand that member-states keep their frontiers open while requiring their residents to stay at home. Schengen's governing law, the Schengen Borders Code (SBC), allows for such restrictions, although they have to be temporary. But member-states have been clumsy and at times inconsistent in their use of the rules.

There are two legal reasons to re-introduce border controls temporarily. In non-urgent cases, when there is a threat to a country's public policy or security, the SBC allows for the re-introduction of checks for up to 30 days, renewable for up to a maximum of six months. This is the clause member-states use when they put controls in place because they are, for example, hosting a major sporting event, like the World Cup. The only other legal justification for member-states to introduce border checks is when a serious threat to their public policy or internal security requires immediate action. In this case, controls may only last ten days, although they can be renewed for up to two months. A pandemic falls rather neatly within this category, despite the fact that the SBC does not list public health as a reason to close borders.

And yet countries like Denmark and Finland decided to invoke the non-urgent clause, presumably because it allowed them to set border checks for longer. France has simply extended checks already in place since the 2015 Paris terrorist attacks. Other countries did not bother notifying the Commission at all (a legal obligation under the SBC). At the time of writing, eight member-states still have border controls in place. All countries have exceeded the deadline for when they had to end border checks; many had no legal justification to begin with.

Because there is no central Schengen authority with direct enforcement competences, the Commission has very little power to ensure Schengen countries comply with the law. It can bring them to court, which it has understandably not done in the midst of the pandemic. But closing and opening borders seemingly at random creates uncertainty for citizens and business. Schengen countries do not always notify their neighbours about new border checks, and they sometimes evoke non-COVID-19 related risks to keep their borders shut. The EU needs to streamline internal border controls, if they are needed to contain second or third waves of COVID-19. For that, the Commission should make sure countries co-ordinate their border closures with one another, as per a recent Franco-German initiative, which focuses on facilitating regular contact between border authorities.

If the European Commission has been unable, or unwilling, to call member countries to order, it may be because it is finding it difficult to navigate coronavirus politics. Only four days after criticising Donald Trump for imposing a travel ban on Schengen countries, the Commission "invited" member-states to stop non-European citizens who do not permanently reside in the EU from entering the Schengen area. The Commission has no competences to shut access to the Schengen area. Nor has it ever asked member-states to close the bloc's external borders. The SBC allows member countries to deny entry to non-European citizens for public health reasons. But it does not provide for a blanket entry ban.

Paradoxically, the Commission urged Schengen countries to close the external border in the hope that this would keep Europe's internal borders open. Instead, the ban emboldened even more countries to shut theirs. The move ruffled feathers among Europe's partners, some of which had lower infection rates than the EU. Moreover, because the ban is voluntary, application has been patchy. None of this helps to make Schengen external borders stronger and more resilient – a long-time Commission ambition. Here, too, co-ordination is vital. The EU institutions cannot and should not police Schengen's external borders. But they can help Schengen's functioning by avoiding heat-of-the-moment decisions and making sure that they follow their own rules.

A more serious problem is that, with their travel restrictions, member-states have virtually stopped the free movement of people within the EU. Commission President Ursula von der Leyen correctly identified the risk that the pandemic is posing to the EU's internal market in her State of the Union address to the European Parliament on September 16th 2020. Instead of simply linking internal border controls with migration, as Juncker did in his own 2018 speech, von der Leyen said that a fully functioning Schengen area was necessary to "restore" the EU's single market. By shifting the focus from migration to the EU's biggest economic achievement, she hopes to win support for her much awaited 'New Migration Pact'.

The EU's citizens' directive allows countries to exceptionally limit the free movement of Europeans if the World Health Organisation declares a pandemic. But restrictions have been uneven and, at times, arbitrary. To put an end to this, the EU is asking member-states to use a traffic light system based on numbers and percentage of COVID-19 positive cases to apply, or lift, limits on the free movement of people. Under this system, member countries should send their testing data to the European Centre for Disease Prevention and Control, which would publish a weekly map indicating whether EU countries may impose quarantines upon arrival or deny entry. If member-states do not set clear criteria soon, the current restrictions may persist for longer than necessary, threatening the functioning of the EU's single market. Curbing the free movement of people also seemingly echoes the idea that foreigners bring problems home, fuelling nativism and populism.

The pandemic will not be Schengen's downfall. But it threatens to further erode member-states' trust in each other's governments, citizens, and their ability to deal with crises, be they health-, migration- or economy-related. The COVID-19 pandemic has laid bare the EU's lack of full control over Schengen's borders. If member-states continue taking unilateral, knee-jerk decisions every time there is a problem, they will in the end endanger the future of the European Union's single market.

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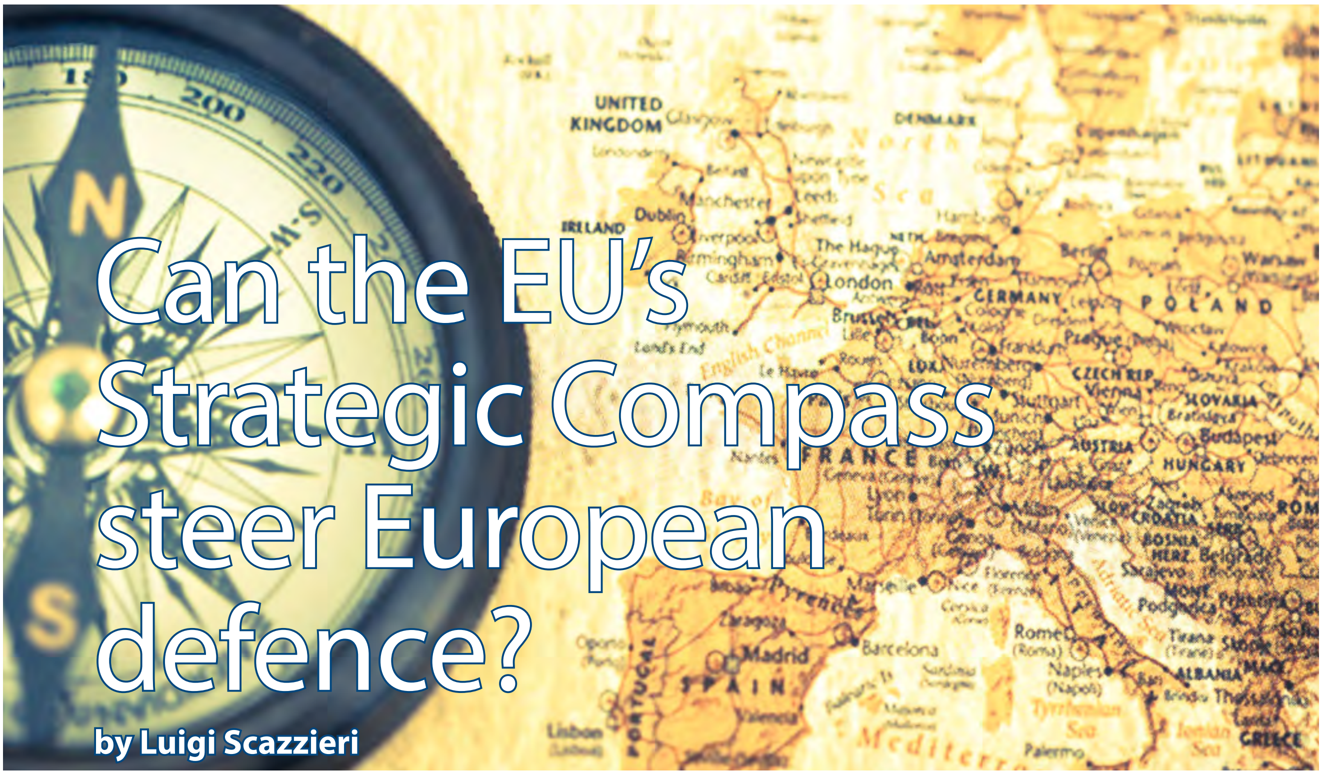
Can the EU's Strategic Compass steer European defence?



by Luigi Scazzieri

The EU's planned 'Strategic Compass' will define its security and defence ambitions. Though not a panacea, it could give European defence more coherence and should help foster a common strategic outlook among member-states.

Europe's security is threatened by conflict in its neighbourhood and big power competition on the global stage. In June 2020 EU defence ministers agreed to develop a 'Strategic Compass', a new strategy defining EU aims in security and defence policy. The Compass, which is supposed to be adopted by European leaders during the French Presidency in the first half of 2022, will build on a comprehensive threat analysis that the European External Action Service (EEAS) will complete by the end of this year. The Compass will not replace the EU's 2016 Global Strategy, which set out the overall priorities of the Union's foreign policy. Instead, it is supposed to be a 'mid-range' strategy, translating the EU's priorities into tangible goals and defining what capabilities the Union should develop. The Compass also aims to foster a common European 'strategic culture', pushing member-states towards a common understanding of the key threats to Europe and how to counter them together.

The Strategic Compass is designed to maintain momentum and inject coherence into European defence. In recent years, the EU has launched several initiatives to strengthen its Common Security and Defence Policy. The Union now has a €7 billion European Defence Fund (EDF) to finance defence research and procurement. The European Commission has a Directorate for Defence Industry and Space, to provide leadership for defence industrial co-operation, build a more open defence market and support 'military mobility'. Twenty-five member-states have launched Permanent Structured Co-operation (PESCO), a framework to facilitate joint procurement projects and improve readiness. Finally, the EU has a €5 billion 'European Peace Facility' to train and equip foreign security forces, and is spending €1.5 billion on improving military mobility, including by upgrading infrastructure.

Despite these substantial efforts, member-states still lack a common vision of what the EU should do in security and defence. In November 2016, they agreed on three priorities: preventing and managing crises in the neighbourhood; building up partners' capabilities; and protecting the EU and European citizens. But member-states remain divided about what each entails. Their different strategic outlooks (and their lack of capabilities) make it harder for the EU to manage crises in its neighbourhood. Another large disagreement is over whether the EU should have a role in territorial defence. Most member-states see that as NATO's task. But Article 42.7 of the Treaty on European Union also commits member-states to assist each other if they come under attack. France wants to use the Compass to flesh out the clause, so that it explains how member-states would respond to an attack. But the debate that France has launched about 'European strategic autonomy' has caused tensions with the US and divisions within the EU. Many member-states are wary of upsetting Washington or undermining NATO.

The lack of a coherent common vision and a shared strategic outlook have prevented the member-states from spelling out in detail what capabilities the EU should focus on. This has limited the effectiveness of PESCO and risks limiting that of the EDF. While negotiating the 2021-2027 EU budget, European leaders substantially cut funding for the European Peace Facility (from €10.5 billion to €5 billion), the defence fund (from €13 billion to €7 billion) and military mobility (from €6.5 billion to €1.5 billion). Some PESCO projects are ambitious and useful, for example the Twister programme for a surface-to-air missile. But most projects have not been launched specifically to address identified capability shortfalls, and many are progressing slowly. Efforts to develop common equipment also remain hindered by different arms export policies. Meanwhile, the recession caused by the COVID-19 pandemic is likely to squeeze defence budgets. This makes the success of EU defence co-operation initiatives even more important, as they could blunt the impact of defence cuts.

There is a risk that the Compass will do little to fix the existing issues in European defence. Defining a new strategy is clearly not the same as launching common projects to fill Europe's well-documented capability shortfalls. Moreover, it will be challenging for member-states to agree on what the main threats to Europe are and how to counter them. To reach consensus, member-states may be tempted to avoid hard questions, or draft an overly ambitious list of what they think the EU should do. There is also a risk that member-states will try to hide disagreements behind ambiguous concepts like 'strategic autonomy', without at the same time spelling out what they mean. This would only heighten US concerns that EU defence initiatives undermine NATO, and deter those member-states that care most about US security guarantees from investing in the success of EU defence efforts.

To avoid the risk of the Strategic Compass being an irrelevant exercise, the threat assessment that the EEAS is currently developing should prioritise between the different threats to the EU. On the basis of the threat assessment, the Strategic Compass should focus on fostering further convergence in strategic outlook between member-states and agreement on the priorities for capability development.

Member-states need to tackle some difficult questions. First, they should spell out what tasks they think the EU should focus on and what military capabilities it needs, based on those already identified by NATO's defence planning process. A sharper definition of goals would then ideally lead to more focus in PESCO projects on filling established capability gaps. Second, member-states should agree on whether the EU should have a role in territorial defence and high-intensity operations that seek to separate warring parties, or whether it should focus on lower-intensity crisis management and areas that NATO does not have great expertise in, such as the protection of civilian infrastructure from cyber attacks. Third, member-states should agree on how the EU's mutual assistance clause would operate, in case of an attack on a member-state that is not in NATO. Finally, member-states should clarify how the mutual assistance clause would interact with NATO's Article 5 mutual defence guarantee in the event that a state that is a member of both the EU and NATO is attacked, including through a cyber-attack.

The Strategic Compass cannot be a panacea for European security and defence. EU efforts to become a serious player in security have suffered from a lack of key military capabilities and of political will, and from the fact that NATO remains the bedrock of defence for most member-states. The EU has had multinational 'Battlegroups' on standby since 2007, but despite several opportunities to deploy them – such as the 2013 Mali crisis – has never done so.

The Strategic Compass in itself cannot push member-states to invest in filling long-known capability gaps, agree on issues where they sharply differ, or persuade them to invest in making the EU a more capable security and defence actor if they do not want it to be so. But the Strategic Compass can be useful if it succeeds in narrowing differences in threat perception and strategic outlook between member-states, and fosters agreement on a few priority areas for capability development, giving both EU and national defence projects greater coherence.

Luigi Scazzieri
Research fellow, CER @LScazzieri

CER in the press

Frankfurter Allgemeine Zeitung
23rd September
Independent experts like Charles Grant from the London-based **CER** are cautiously optimistic. He argues that Johnson is under "enormous pressure" to make a deal possible. … Mr Grant considers the remaining gaps in the trade talks to be bridgeable.

The New York Times
18th September
"The fire at Moria has shifted public attention to the dire conditions of Greece's refugee camps," said Camino Mortera-Martinez of the **CER**. ..."The EU's much-awaited proposal to fix its migration problems will do very little to prevent tragedies like Moria's in the future, unless the politics in the continent change."

Financial Times
8th September
Sam Lowe, a trade expert at the **CER** says a no-deal exit would also complicate other aspects of Britain's dealings with the EU, tarnishing relations for years to come. ...Mr Lowe argues that a no-deal outcome would probably also have negative knock-on effects. It might make it harder for Britain to secure side-deals in areas such as financial services and data, or to agree bilateral "easements" agreements with third countries to reduce bureaucracy at the border.

The Economist
4th September
As Sam Lowe of the **CER** notes, the economic difference between a barebones trade deal and no deal is not all that large. A deal would avoid tariffs in sensitive sectors like cars, but in either case disruption from customs checks, lorry queues and intrusive non-tariff barriers would be substantial.

Bloomberg
1st September
"If she wants to, Lagarde has the standing to put a lot of pressure on governments to find a woman for the job [of member of the ECB's Executive Board], which would force them to look at their hiring practices," said Christian Odendahl, chief economist at the **CER**.

The Guardian
30th August
As Sophia Besch of the **CER** argued recently, Europe must be able to defend its geopolitical interests. Call it "strategic autonomy". Or simply call it survival. In a world where once trusted friends join the ranks of the predators, soft power is not enough.

The Times
28th August
Charles Grant, director of the **CER** criticised Mr Wallace and said Ms Tikhanovskaya was not a pawn of western neoliberalism. He told *The Times*: "I suggest Mick Wallace goes to Belarus to talk to the people there. The overwhelming majority want the regime of Lukashenko to step aside and allow free elections. In contrast to Ukraine in 2014, this is not a 'geopolitical' popular movement."

The New York Times
13th August
"If you have a massive outbreak, people are going to respond by being cautious and it will take a while for confidence to return," said John Springford of the **CER**. "It makes sense that London is going to be among the hardest hit places."

Le Journal du Dimanche
26th July
"Theresa May was enthusiastic about the idea of finding an ambitious diplomatic and security agreement," said Ian Bond of the **CER**.

Recent events

21 September
CER/Kreab webinar on 'The EU's aims for its future relationship with the UK' with Clara Martínez Alberola

11 September
Webinar on the interaction between fiscal and monetary policy in the eurozone with Isabel Schnabel

9 September
Members' webinar on 'Tensions in the Eastern Mediterranean and the South China Sea' with Ian Bond and Luigi Scazzieri

4 September
Webinar on 'What next for Belarus?' with Katia Glod, Nigel Gould-Davies and Dirk Schuebel

30 July
Webinar on 'Is Xi Jinping's China Dream fated to be a nightmare for the West?' with David Rennie

Forthcoming publications

An offer the EU can't refuse: What is Europe doing to fight corruption?
Camino Mortera-Martinez

The UK-EU foreign policy relationship
Ian Bond

How economic stability can enhance European sovereignty
Christian Odendahl

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