

GLOBAL MARKETS

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Brexit: No Big Deal

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The United Kingdom's formal exit from the European Union on December 31, 2020 ended more than five years of Brexit drama that had dominated British political life and hampered the British economy since 2015. Now, after years of political turmoil, tempestuous arguments pro and con, and an 11-month transition period that allowed Prime Minister Boris Johnson to negotiate some terms with the E.U. instead of dropping out with a messy "no-deal Brexit," some of that economic anxiety persists.

But for all the continued handwringing over Brexit – whether it means a gain or loss in Britain's negotiating power, or whether Britain is swapping reductions in regulation and immigration for increased trade costs and barriers – one argument seems to have gone overlooked. The U.K. and E.U. legal systems were never a good fit, and this fundamental difference offers

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An Uneasy Partnership

Brexit consternation and uncertainty weighed heavily on the British economy over the past five years. GDP growth in the U.K. decelerated from 2.6% in 2014 to 1.4% by 2019. According to Balance of Payments data, almost \$900 billion in financial capital flowed out of the United Kingdom since 2014. Prior to David Cameron's reelection in 2015 – when he launched the Brexit furor with his pledge to hold a referendum on whether Britain should leave the European Union – the British pound traded at 1.55 to the dollar. It dropped to a low of 1.21 in mid-2019 before rebounding to 1.35 at present. The FTSE 100 stock index returned a meager 1.5% per year in dollar terms over the past five years, while the S&P 500 Index delivered 12.5%.

Nonetheless, Brexit uncertainty will likely fade in the coming years, as the underlying strengths of the British economy will once again reassert themselves.

As we noted in [our 2Q 2016 Global Markets letter](#), the British economy and financial system are fundamentally different from the remainder of the European Union.

“Differences between the British financial system and the financial systems of other E.U. countries are rooted in their very different approaches to the law. Of the 28 member countries in the European Union, only the U.K. and Ireland are Common Law countries. The remaining 26 countries share a Civil Law heritage. The Common Law approach is to generally allow any contractual relationship that is not expressly prohibited in law. Civil Law tends to take the opposite approach whereby contractual relationships are considered illegal unless authorized by code or statute. As a result, financial innovation is rare in countries governed by a Civil Law system whereas the greater contractual freedom in a Common Law system can be highly conducive to alternative financial institutions and products.”

Since the United States inherited its Common Law framework from Britain, Americans seldom appreciate just how rare and precious our legal system is in the world. Only nine developed economies have a Common Law system: the United States (except Civil Law Louisiana), the United Kingdom (except Civil Law Scotland), Canada (except Civil Law Quebec), Australia, New Zealand, Hong Kong, Singapore, Ireland, and Israel. A little less than 500 million people live in these countries, with the U.S. and Britain accounting for 80% of the total.

British Common Law Is More Flexible than European Civil Law

Due to its greater contractual freedom and flexibility, the Common Law framework is more conducive to financial innovation and development than the Civil Law system. Civil Law economies tend to rely on commercial banks, with a diminished role for alternative financial institutions and securities markets. Common Law countries like the United Kingdom and the United States support highly variegated financial ecosystems with a rich mix of traditional banks, alternative financial institutions, investment funds, and capital markets. This is why the overwhelming majority of financial activity will not leave London for continental Europe after Brexit.

A wider variety of financial institutions and markets facilitates a wider variety of business enterprises with the potential to raise significant capital and thereby achieve maximum efficient scale. Traditional

banks require collateral that can be readily resold if loans are not repaid, leaving them reluctant to make financial resources available for less tangible assets, such as technology or intellectual property. Therefore, technological innovation is significantly more robust in Britain, where alternatives to bank financing are plentiful, than in the rest of Europe.



For example, according to U.K. Tech Nation and Dealroom.co, the U.K. boasts 77 start-up “unicorns” (new technology companies with valuations exceeding \$1 billion) vs. 33 in Germany and 14 in France. The U.K. receives more venture capital investment than Germany and France combined, and 1/3 of European venture capital is invested in Britain.

Civil Law judges do not interpret case law, so all new financial or economic activities falling outside the scope of existing laws require authorizing legislation before they can proceed. By design, this approach to law limits innovation. As a result, Civil Law countries tend to enact legislation only after innovative financial activities or business models first gain traction in the Common Law world.

Geographically, Britain is in Europe, but philosophically, the British legal, financial, and economic systems better resemble those of the United States. Legal development in the European Union draws heavily upon the language, institutions, philosophy, and structure of the Civil Law. Although British firms must now comply with sometimes burdensome European Union customs regulations, the British economy should find itself increasingly unshackled from the less flexible and more bureaucratic mentality that pervades Civil Law Europe.

Both the United Kingdom and the European Union May Benefit from Brexit

Meanwhile, the European Union may also benefit from Britain’s absence. To accelerate economic growth, the European Union must recapitalize troubled banks, particularly in Italy. Even more importantly, the E.U. countries need to liberalize their financial systems to create greater space for capital markets and alternative financial institutions. The E.U. recognizes this problem and crafted agreements it calls the Banking and Capital Markets Union, which describe a framework for a more dynamic financial and economic model. Britain already has this model.

A Britain free to experiment and innovate should create similar models that the European Union can learn from and emulate. Plus, Britain’s departure – and the political and economic upheaval that surrounded it – ought to impress upon the E.U. the urgency of solving its fiscal, monetary, and governance issues, lest other member countries decide to bolt for the exits.

Ultimately, both the U.K. and the E.U. may thrive more as discrete, eager trading partners than as two incompatible legal systems yoked into an irreconcilable marriage. Both will be freer to do what their legal, financial, and economic systems are designed to do. The European Union can communicate with legal clarity to its member states (except, of course, Ireland), while the U.K.’s Common Law system will remain free to channel capital to a variety of growing businesses, in ways that have made London a financial hub for centuries.

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