In or out: a general framework

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When assessing the viability two currency areas (the United Kingdom and the euro area) coexisting within a broader jurisdiction, we tend to point to the United States as the counter-factual, or if you wish the role model. The United States is of course a federal nation-state and naturally has a large federal budget and a single currency. How nice would it have been if Europe was in that situation. A Spanish job seeker would have received his unemployment benefit from the EU budget, financed by proper EU tax revenues, thus helping to avoid the sovereign debt predicament. How nice would it have been if Spanish banks were backstopped by a federal budget, in turn backstopped by the European Central Bank. Again, the sovereign debt crisis would never have occurred, or in any case not turned systemic. Of course we would not be in the mess in which we are now. The Spanish economy, to stick to that example, would have recovered long ago, and the European economy would be growing at a pace comparable to that of the US.

If we accept this logic, the implication is that there is no place for the United Kingdom in the European Union, ultimately. After all, the euro area would need to develop into a federal state, or, in today's jargon, toward a political, fiscal and banking union. We have set major steps towards the latter union, so "all" we have to do next is establish the two other unions. This sounds clean and simple, except that it is not that simple, not least because there is no room for opt-outs in that framework. Let me be blunt. Either we adopt that federalist framework, and offer the UK the choice to either give up its opt out or leave the European Union, or we do not adopt that framework. But if we do not, we have to look around for other role models. The US surely cannot be that role model unless some day the State of New York decided to proclaim independence and introduce its own currency. What could that role model be?

Let me again be provocative. How many examples do we have of major economies that encompass two jurisdictions of which one is a prime global financial centre glued to a lumpy mainland economy, each with their own currency? I can think of only one, the People's Republic of China. Are there parallels with the European Union? China has a democratic deficit, but that is obviously not what I mean. More seriously, China's mainland is a slow adjuster, running a large (though now shrinking) current account surplus, and using Hong Kong as its global financial market hub. Is that not more or less describing the euro area's relationship with the UK, or more appropriately, London? What if we accept the idea that in a ever-more globalised world the one-state-one-currency model is simply out of date? Is it really wrong to assume that one geographical entity – Europe – should comprise multiple, partly overlapping, jurisdictions, not as an intermediate stage of development but rather as the steady state?

This is of course an old idea, one that the French have dubbed "l'Europe à géométrie variable". In fact, this is potentially consistent with the central premise of the theory of fiscal federalism, namely that jurisdictions should be shaped so as to internalise the externalities of their actions and policies of lower jurisdictions as much as possible. For instance, achieving optimal water management dictates that local jurisdictions sharing a main river, coast line or whatever entrust a higher-level jurisdiction with their water management. For centuries this has been the model in the Netherlands where municipalities created higher order jurisdictions tasked with water management, without which the country would now be, at best, a big swamp, but more likely be swallowed by the North Sea. By way of a footnote, fiscal federalism and the subsidiarity principle, or at least the mainstream interpretation thereof, are each other's opposite.

So in my view a successful coexistence of the United Kingdom and the euro area in the European Union requires a change in mind set. It is fine to have a Schengen area. But if we follow my logic, for it to function properly it needs to be empowered with a democratically accountable -- if not elected -- executive, and endowed with financial resources – if not taxing power – to carry out a common border protection. I understand this idea is actually gaining ground in the European Union, spurred by the deplorable situation in e.g. Lampadusa in Italy, which is a hopeful sign that perhaps the mind-set is changing. Such policy would probably also steal the thunder of some of the so-called populist movements in some member state. Another hopeful sign that the mind-set is changing is the fact that the UK has not signed up to the Fiscal Compact, and indeed I think it should not. The implication being that the Fiscal Compact should actually be seen as the first step towards fiscal union, in which the UK should not participate.

Banking Union is more difficult to tackle as it aims to achieve to objectives: a truly internal financial market – which is clearly relevant for the UK – and stability of the euro – in which the UK has an interest but which is strictly speaking not its responsibility. So perhaps we need two banking unions, one geared to internal market goals (i.e. a single rule book applying to the EU) and one geared to financial stability (i.e. the single resolution mechanism applying to the euro area). This only goes to illustrate that multiple jurisdictions is the name of the game for the future. Once we accepted that logic, the question as to whether the UK should be in or out of jurisdiction A or B, almost becomes a matter of fine tuning.

If that framework is accepted, it is actually relatively easy to answer the questions that are put in front of us. For instance, the answer to question 11 – do you consider that the MIP is an appropriate system for detecting and correcting underlying economic imbalances – is, if we limit ourselves to the issue of current account imbalances, is no for the United Kingdom because it can rely on exchange rate adjustment, and yes for euro zone members, because it cannot rely on such a mechanism. And so on, and so forth.