

Submission to the Balance of Competences Review – Economic and Monetary Policy

John Springford, Centre for European Reform

Britain's failed attempt to block Jean-Claude Juncker's European Commission presidency has emboldened those who want Britain to leave the EU on both sides of the Channel. Both British eurosceptics and Continental Anglosceptics believe some or all of the following: that the eurozone will integrate further; that the priorities of the eurozone will predominate over those of the euro 'outs'; and that David Cameron will win nothing but minor reforms in any negotiation, proving Britain's marginalisation.

In this view, the "remorseless logic" of eurozone integration will marginalise Britain to such an extent that it will be forced to leave the EU, since it will not join the euro. This argument has some merits – there is little reason to believe that the British have enough political capital to lead a push for major EU reform, for example. But the economic interests of the 'ins', 'pre-ins' and 'outs' overlap to a greater degree than they are opposed. If these interests are managed with care, there is little reason why Britain should leave the EU.

The UK, rightly, does not participate in most of the rules and institutions that make up eurozone's governance. It does not take part in eurogroup meetings, contribute to the bailout funds, or take part in the eurozone's fiscal rules or the banking union. It does participate in the 'European Semester', in which the European Commission identifies fiscal, external and private sector imbalances in EU member-states and recommends reforms to remedy them. But the EU cannot apply sanctions on the UK if it does not follow Commission advice. Britain's absence from the strictures of eurozone governance is fair: these policies are intended to prevent poor national macroeconomic policies in one member-state from causing trouble for the others. That is their intention: but the impact of the fiscal rules, given that they have required the eurozone to collectively impose austerity when demand is depressed, has been the opposite.

The eurozone's economic prospects would improve if it moved towards further fiscal, financial and political integration. The sustainability of debt in Spain, Italy and Portugal is doubtful – and in Greece, certain – given low growth, and low inflation in some countries and deflation in others. The debt will either have to be written off, monetised or mutualised, and tight monetary and fiscal policy will have to be relaxed in order to raise nominal economic growth. Second, that the history and theory of currency unions suggests that most do not survive in the long run without common instruments – either debt mutualisation or a budget, or both – to prevent recessions from spiralling into depression conditions, since they do not have independent monetary policy.

Far from damaging the UK's interests, more federalism would help it. The upshot of the eurozone crisis, to which policymakers must take a good deal of blame, has been a prolonged slump in the UK's largest export market. None of this is to say that the UK's weak recovery between 2009 and 2013 was all – or even largely – down to the eurozone crisis. But the slump has put paid to British hopes of an export-led recovery: as the eurozone moved into external surplus, the British current account inevitably moved further into deficit. Were the eurozone to be a more stable and faster-growing place, the benefits to Britain's economy would be obvious.

The problem is that there is no political appetite in the eurozone for further integration. Thus Britain is in a difficult position: the eurozone is likely to continue to drag on the UK's economy, and its problems are likely to remain unresolved until a crisis forces further integration or break-up. But

there are few areas where the eurozone member-states' interests are so aligned against the British that they render its position untenable in the meantime – or after.

The British have been worried about a eurozone 'caucus', particularly on single market regulation. But the Germans, Finnish and Dutch have little interest in, say, extending 'social Europe' – and align themselves more with the British on social and employment rules. Western Europeans in general are as concerned about immigration from Central and Eastern Europe as the British, even if the tone of their newspapers and mainstream politicians is less hostile.

On extending the single market and free trade agreements, it is simply not true to say that eurozone member-states constitute a protectionist bloc, and are opposed to market liberalisation. To understand why, consider the OECD's product market regulation indicators, which show how keen different EU member-states are to regulate their economies. Between 1998 and 2013, the eurozone and other EU member-states converged on the UK, as their levels of product market regulation were reduced more quickly than Britain's (see Chart 1). Their overall level of product market regulation is now only marginally above that of the UK (the index ranks countries' level of regulation between 0 and 6).

Chart 1. OECD index of product market regulation

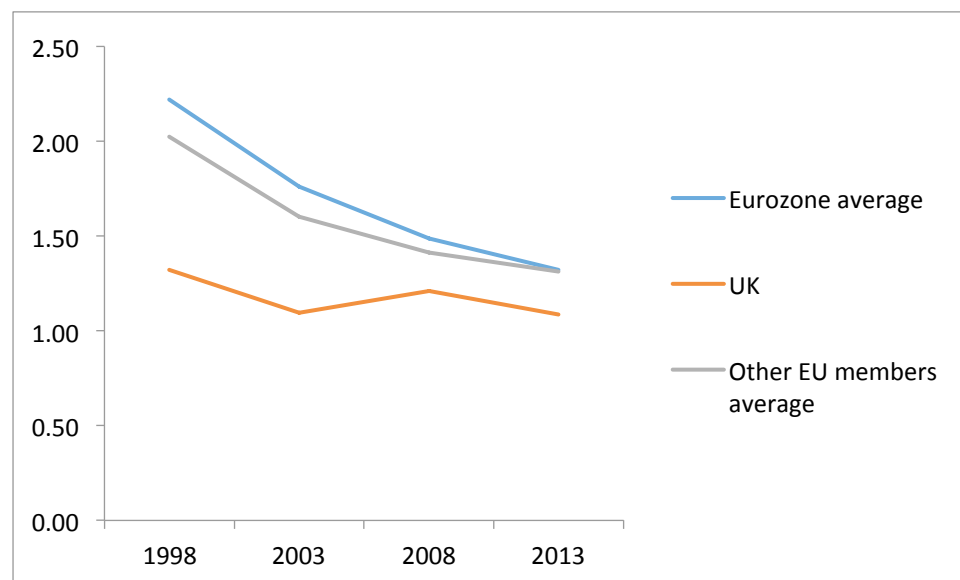
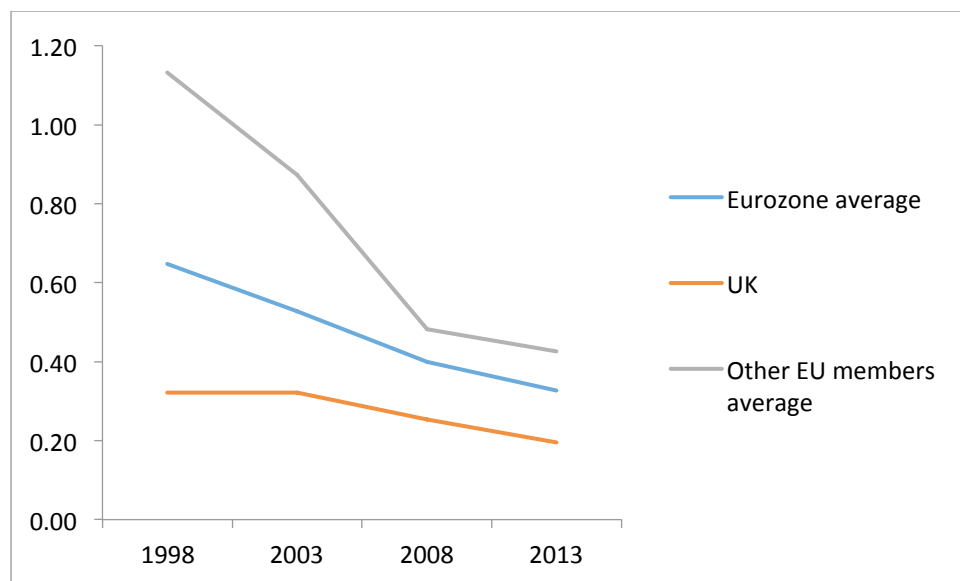


Chart 2 shows the OECD's measure of the willingness of countries to open their markets to foreign competition. It shows the same pattern of convergence as the overall index, and offers little evidence that the eurozone will club together to block free trade deals or the European Commission's initiatives to extend the single market.

Chart 2. OECD barriers to trade and investment index



If the eurozone ‘caucus’ is going to be a problem, it will be over financial regulation. The City of London’s position as the EU’s dominant wholesale financial centre – and one that is outside the eurozone – would seem to suggest a major clash of interest. Many Britons fear that the the rest of the eurozone will gang up on the City in an attempt to shift activity to Frankfurt and Paris. However, the situation is more complex than City of London banks, the British media and eurosceptic think tanks suggest.

The UK has already won a double majority voting system on the European Banking Authority – the institution that writes EU ‘prudential’ financial rules, which seek to prevent the financial system from blowing up. Under the system, both eurozone and non-eurozone members must find a majority in favour of a financial rule. Eventually, if other member-states join the single currency, this system will have to be revisited, as it would end up giving Britain disproportionate power over rules. But this is likely to be a long time coming: Poland, the Czech Republic, Sweden, Hungary, Croatia, Romania and Bulgaria do not look likely to join the single currency in this decade. Denmark has a euro opt-out, like the UK.

Moreover, British and eurozone member-states do not have serious differences over prudential regulation. The UK has gone further than most other EU member-states to force their banks to raise capital and liquidity, to reduce leverage, and to try to ringfence retail and investment banking. Before the crisis, the UK was rightly accused of running a light-touch regime. This charge no longer holds: now the problem lies in the difficulty of creating a eurozone banking union that is capable of preventing banking crises and limiting their effects when they do occur.

There are areas where the UK is losing its battles, but it is far from clear that a eurozone ‘caucus’ is to blame. The financial transactions tax is likely to be a smaller tax on a smaller number of securities and derivatives than the original proposal, because the member-states that have signed up to it – several eurozone members have not – cannot agree on how much activity it should catch in its net. It may end up covering just equities. If so, the financial transactions tax would be similar to the UK’s stamp duty on shares, which also has extraterritorial reach: an investor from another EU member-state that sells a share in a British company must pay UK stamp duty. And the European Court of Justice has yet to rule on the final proposal – the UK government has taken it to court over the issue – because it is not yet agreed. It may find that the extraterritorial scope of the tax means that it is illegal under the EU treaties (as the European Commission’s legal service has found).

But is not the ECB's location policy a sign of increasing regulatory protectionism on the part of the eurozone? The ECB's rationale for the policy is not without justification: it argues that it should supervise clearing houses, since they will need emergency central bank lending in euros – 'liquidity' – if they get into trouble. Clearing houses are increasingly important bearers of risk, because complex derivatives – financial contracts that were at the centre of the 2008 crash – are being standardised and investors forced to trade them on exchanges. Regulators hope that this will make the risks in the financial system more transparent. If a clearing house gets into trouble, derivatives markets will freeze, unless the central bank keeps it going with liquidity. And in trades denominated in euros, most participants are large eurozone-based banks: the ECB has a legitimate interest in the supervision of this activity. The British should not blame eurozone protectionism for the ECJ's ruling, if it concurs with the ECB.

There are a few other areas where it is possible to envisage conflict in upcoming years. The resolution of a eurozone headquartered bank with large operations in the City of London is one. The eurozone and the UK government may have opposing interests when it comes to resolution: eurozone authorities will seek control of the bank's assets, even if a part of its balance sheet is under the Bank of England's jurisdiction. There are unresolved questions about how banks that get into trouble in London will access ECB liquidity.

But the City of London's position as the EU's largest wholesale centre does not appear to be severely imperilled by the eurozone. And even where conflicts do arise, as a member of the EU, it can defend its single market rights at the ECJ. Rather, the potential for serious conflict lies more in the EU's institutions and priorities than its rules. The solution lies in diplomacy.

The British government will have to get used to the fact that the top jobs in the next European Commission will mostly go to eurozone member-states, as the UK is the only rich and large EU country that is not in the euro. There is some sympathy in northern Europe for the UK's position. But the British are squandering this sympathy, by pursuing a strategy of threats, vetoes, and red lines. The source of the trouble is the Conservative demand for a renegotiated settlement as the price of the UK's continued membership of the EU. This strategy was intended to appease English euroscepticism while securing policy changes at the EU level, but it has stoked anti-British sentiment to the degree that other member-states fear making common cause with the UK. And the strategy makes it harder to create the conditions for compromise between the interests of the eurozone, the UK government and the City of London's single market rights that is needed to make Britain's position – in the EU, but not in the eurozone – legitimate on both sides of the Channel.

The route to a new EU settlement will be slow and tortuous. The eurozone will probably have to integrate further to flourish, and, over time, some member-states who have committed to joining will do so. But there are few reasons why a political settlement between members of the single market and of the eurozone cannot be reached, if politicians will only try.