CHATHAM HOUSE

Chatham House, 10 St James's Square, London SW1Y 4LE
T: +44 (0)20 7957 5700 E: contact@chathamhouse.org
F: +44 (0)20 7957 5710 www.chathamhouse.org
Charity Registration Number: 208223

**Parliamentary Evidence**

# The Future of the European Union: UK Government Policy

Dr Robin Niblett

Director, Chatham House

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## Summary

The December 2011 European Council meeting was a watershed for the UK's relationship with the European Union (EU). It exposed the growing divergence between the UK's approach to its membership of the EU and that of the overwhelming majority of other member states. Britain's position outside the eurozone means that it will have minimal influence over near-term changes to the EU's institutional architecture, which are being organized around the need to stabilise the monetary union and may include building a fiscal union. The risk has grown, therefore, that the UK will be pushed to the margins of European integration and that this will undercut its influence and interests within the EU overall.

The UK has three options. It can take the radical step of withdrawing from full EU membership. It can sit on the sidelines of the EU while other member states focus their energies on saving the single currency. Or it can make the most of its EU membership. Either of the first two options would demonstrate a serious misreading of the UK's national interests at the start of the 21st century. These interests are best served through active UK participation in the EU.

Stepping back or sitting aside from the EU would also reveal a misreading of the process of European integration. Even a fiscally united eurozone will be divided between the more and less competitive, between those who favour a more federal or a more intergovernmental Europe, and between the smaller and the bigger states. Britain will continue to be an important player in this multi-tiered Europe.

Rather than holding the EU at arm's length at this critical juncture, the government should be more proactive than it has been in its approach towards the large realm of EU policy outside European Monetary Union (EMU). For example, it should lay the groundwork for a deepening of the Single Market in the services sector, drive the agenda on collective approaches to energy, trade and climate change, and build more coordinated European foreign policies towards the Middle East and the Asia-Pacific region.

## Evidence

*The Logic of EMU*

The December 2011 European Council was a watershed for the UK's relationship with the EU. It exposed the growing divergence between the UK's approach to its membership of the EU and that of the overwhelming majority of other EU member states. Since December, the divergence has widened rather than narrowed. Eurozone members and those EU member states that hope to join the single currency area (and even countries such as Sweden and Denmark which currently do not) are working together to create new structures of financial and political integration that they hope will put the euro on a more stable footing for the future.

There are some in the UK and beyond who expect the current crisis to be the beginning of the end of the single currency. Others expect it to retreat into a core group of North European countries clustered around (and sharing some of the same competitive advantages as) Germany. These expectations ignore the political thinking on continental Europe that launched the euro and the economic drivers that created a large rather than 'core' eurozone in the first place.

The decision in 1992 to create the euro was not driven by economic logic. Principally it reflected the determination of the French government of President François Mitterrand to contain the economic power of a unified Germany. The creation of the euro also reflected Chancellor Kohl's desire to bind a unified Germany irreversibly into an integrated Europe with France and Germany at its core. This fundamental Franco-German political pact at the heart of the eurozone remains intact.

With France and Germany locked into a single currency, there was economic logic (as well as political pressure) to launch the euro with a larger rather than smaller number of members. If Italy had remained outside the euro, German companies would have faced stiff competition in their domestic market and internationally from companies based in Italy's dynamic north pricing their goods in cheap lira. If Spain had remained outside the euro, German companies would have been tempted to shift more of their production to its relatively cheaper labour market. In either case, prospects for German domestic growth and job creation would have been affected. This economic dynamic remains in place today; as such, Germany and other northern states have a powerful economic incentive to keep the eurozone together.

Most eurozone members also see membership of the single currency as part of their defence against the growing might of China and other emerging economies, as well as a counterbalance to the economic power of the United States. Despite the current turmoil, being inside the euro offers EU members greater long-term stability in terms of interest rates, inflation and exchanges and some prospects for solidarity (in terms of the role of the European Central Bank and other mechanisms of intra-eurozone financial support). Carrying out painful structural reforms to their welfare systems is likely to be easier inside the eurozone than if each country had to manage its own currency. This is a principal reason why other EU members are still queuing to join the euro.

Certainly, there is a growing risk that Greece will leave the euro. The contagion effects of such an event could force out vulnerable countries such as Portugal or even Spain. But the pressures and incentives to avoid this outcome are enormous. Even if it happens, the impetus to sustain the euro in some form, covering as many EU members as possible, would be powerful. If it did have to be re-fashioned, it would likely be with the political dimensions of a fiscal union debated and approved from the outset.

*The UK and the single currency – divided we stand*

Given its geography and its history, the UK has never shared the same political commitment to European integration as other European countries. This means that not only the British public, but also the two major political parties have viewed the single currency with considerable scepticism. No UK government, either at the time of its launch or since, has been a strong and consistent advocate of membership, doubting the economic benefits and fearing the domestic political consequences.

The divide between British and continental European perspectives concerning the relative merits and risks of joining the single currency has not abated. Today, with the euro crisis in full flow and with British public opinion as eurosceptic as ever, there are no prospects of the UK joining the euro at any point in the near- to medium-term (indeed, remaining outside the eurozone is even written into the ‘Coalition Agreement’). There is also little prospect that the UK will join the fiscal compact any time soon, as other non-euro and ‘pre-in’ governments have chosen to do.

For their part, eurozone members have drawn the opposite lesson from the crisis. They now recognise the insufficiency of the political mechanisms in place to manage the single currency during periods of stress. They have committed, therefore, to deepen their fiscal coordination and have embedded national commitments to fiscal discipline in a treaty that requires a dilution of legislative sovereignty and a commensurate increase in the power of EU institutions.

The UK must recognize that, absent a sudden implosion of the entire single currency, building this fiscal union and resolving the euro crisis in a sustainable manner will be the overriding objective of most EU member states for the next few years.

The UK will be on the margins of this process, and its absence could affect its political relations with other EU member states. The attitudes of the Netherlands and of Poland are a case in point. Both countries have traditionally been close bilateral allies of the UK within the EU: the former as one of the main advocates of an open EU Single Market, like the UK; and the latter as a sovereignty-minded late-comer to EU integration with strong Atlanticist instincts, also like the UK. Today, however, the governments of both countries have thrown in their hand with the logic of deeper European integration. And their officials are deprecating in private about the UK's stance.

It is true that deeper political integration within the eurozone should not imply material changes to the overall EU *acquis*, whether in the management of the Single Market or negotiation of the budget, nor in more intergovernmental areas such as EU enlargement or foreign policy. And, while the UK may end up as the only EU member state outside the fiscal compact (or one of a very few), it has been in this sort of position before (as the only EU member state not to adopt the 'Social Chapter' initially) while remaining a full participant in other areas of EU competence.

On the other hand, close and regular cooperation between EU members on an issue as fundamental as fiscal policy will change the dynamics of EU integration and the UK's place in Europe in ways that are hard to predict. There is a risk that 'package deals' of demands and concessions among euro members over issues that begin in the fiscal realm will then spread into other aspects of EU policy-making. This was partly the concern of the UK government in the lead-up to the December 2011 summit; the fear was that new regulations governing EU financial services – a Single Market issue in which the UK has a full vote – might be driven by concerns over the stability of the euro rather than by the need to sustain market openness and stability.

## Options for the UK

Faced with a structural transformation of the EU in which it does not want to share, the UK has three options. It can take the radical step of withdrawing from full membership of what looks likely to be an even closer Union. It can sit on the sidelines while other EU member states focus their energies on saving the single currency. Or it can make the most of its EU membership. I argue in this evidence for the third option.

The first option, **reconsidering full EU membership,** presupposes that UK leverage within the EU will inevitably decline as the euro crisis deepens. By this logic, the UK might as well get out before it is pushed into a second tier of membership from which it is increasingly difficult to shape an EU that best fits UK interests. Is this likely to be the case?

On the contrary, there is every possibility that an integrating eurozone will contain the same tensions and inconsistencies that the EU as a whole has carried since its inception: between big and small states; between those that favour a more federal future and those that want to preserve as much national sovereignty as possible; between those that are already competitive and those that are struggling to become so; and between those who foresee the eurozone becoming a genuine transfer union and those, such as Germany, which currently remain committed more to the principle of 'collective responsibility rather than solidarity'.[1]

These cleavages within the eurozone mean that the UK will continue to find receptive partners to promote a range of its EU priorities, whether in the Single Market, on the budget, on energy policy, or on priorities for EU foreign and security policy. In contrast, stepping out of the EU but remaining inside the European Economic Area would turn the UK into a consumer rather than a co-designer of the Single Market and into an observer rather than a leader of its more intergovernmental policies.

The second option, **sitting on the side lines**, fails to recognise the enormous value that the UK gains from its membership of the EU and the importance of the UK's voice in shaping the future evolution of the Union in ways that reflect the best of British ideas as well as national interests.

The UK's membership of the EU already gives it (almost) barrier-free access to a single market of 500 million of the world's wealthiest consumers; estimates suggest that trade between EU countries is twice as high as it would be without the Single Market. It is a key reason that the UK continues to attract some of the largest inflows of foreign direct investment (FDI) and sends the lion's share of its own FDI into the EU. Government estimates suggest that 3.5 million jobs in the UK are linked to exports to the EU, and the income gains for UK households from the Single Market are in the region of £1,100–£3,300 per year.[2]

Even if the UK adjusts its patterns of trade to take better advantage of emerging markets, Europe is likely to remain by far its dominant market. At the end of 2011, eight of the UK's top ten trading partners were in the European Economic Area.[3] And, if the UK were to double its exports to China, these would still only match the volume the UK currently exports to the Republic of Ireland.[4]

In addition, at a broader political and geopolitical level, the UK's attachment to Europe is likely to increase rather than decline in the coming years. As a medium-sized power in a world of increasingly large players, and at a time when the United States is spending more of its time and energy in Asia, being part of a unified European market and of a coordinated diplomatic entity enhances rather than diminishes UK international influence. This applies as much to negotiations with third parties over UK trade interests, energy security and climate policy as it does over preventing nuclear proliferation or the spread of instability in the Middle East.

The third option, **making the most of its EU membership**, represents the best choice for the UK, in light of both the compelling economic case and the strategic realities inside and outside the EU.

Moreover, as a major player in a multi-tiered Europe, the UK government has every opportunity to build alliances with other EU members and within EU institutions on EU policies that do not form part of eurozone competence, but that continue to be of direct interest to the UK. These include:

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[1] Philip Whyte, 'Governance reforms have left the euro's flawed structure intact', Centre for European Reform, 18 April 2012 http://centreforeuropeanreform.blogspot.co.uk/2012/04/governance-reforms-have-left-euros.html

[2] These figures are taken from the Department for Business, Innovation and Skills. For more information, see Department for Business, Innovation and Skills, The UK and the Single Market, 2011, http://www.bis.gov.uk/assets/biscore/international-trade-investment-and-development/docs/u/11-719-uk-and-single-market, p. 3. According to BIS, in 2008, 49% of total inward FDI originated from EU member states.

[3] Office for National Statistics, 'Trade in goods – one month geographical analysis ', 9 February 2012, http://www.ons.gov.uk/ons/rel/uktrade/uk-trade/december-2011/stb-uk-trade-december-2011.html#tab-Trade-in-goods---one-month-geographical-analysis--seasonally-adjusted- .

[4] The Guardian, 'UK export and import in 2011: top products and trading partners', 10 January 2012, http://www.guardian.co.uk/news/datablog/2010/feb/24/uk-trade-exports-imports.

- Liberalising further the Single Market by opening up the EU market in services, a key element of a European ‘growth strategy’ that is supported both by northern EU governments such as the Netherlands and Denmark and southern governments in Italy, Spain and Portugal. A 2005 study examining the economic gains for the EU of integrating services into the Single Market, undertaken by the Dutch Planning Bureau, suggested this could yield growth benefits of 0.6–1.5% of GDP;[5]

- Energy policy, where the European Commission’s emphasis on building a more inter-connected and open energy market plays directly to UK strategic and economic interests;

- Re-designing the EU budget, where Germany shares many of the UK’s interests in re-balancing funds towards new drivers of economic growth;

- International climate negotiations, where UK and EU leadership and leverage were instrumental in the breakthroughs made at the Durban summit in November 2011;

- Trade policy, where the UK, EU Commission and a number of member states see the completion of new free trade agreements or economic partnership agreements as critical to the much-needed European growth strategy;

- Designing and conducting more coherent EU foreign and security policies in targeted areas where the common interests of all EU member states are clear, such as the sanctions regimes against Damascus and Tehran or joint operations to combat piracy off the Horn of Africa.

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[5] See European Commission, ‘Economic Benefits of the Services Directive’, 20 May 2009, http://ec.europa.eu/internal_market/services/docs/services-dir/explanatory/economic_benefits_en.pdf . The case for expanding the Single Market was made by Prime Minister David Cameron and other EU leaders in two letters to Herman Van Rompuy and José Manuel Barroso in February and March 2012, http://www.number10.gov.uk/news/joint-letter-to-president-van-rompuy-and-president-barroso/ ; http://www.number10.gov.uk/news/letter-to-european-council-on-european-growth/

## Conclusion

The UK's national interests are best served by active participation in the European Union. But, given eurozone members' rush to build a fiscal union, the government will need to be more proactive than it has been in the past in its approach towards EU policy. It cannot afford to hold the EU at arm's length.

In order to overcome the growing suspicions of their EU counterparts about UK objectives and motivations, the Prime Minister and his senior ministers will also need to engage consistently, not spasmodically, in EU policy debates.

And they will need to work as collaboratively as possible with EU institutions such as the European Commission, the increasingly powerful European Parliament and the European External Action Service, rather than treating them instinctively as obstacles to progress or threats to national sovereignty.

The euro crisis will change the EU. The UK's psychological detachment from the process of deepening European integration will be more apparent than before. But the contributions that it can offer and the benefits that it can obtain from active EU membership will continue to make the EU one of the cornerstones of Britain's place in the world.