Towards a Genuine Economic and Monetary Union: The Implications for the UK and Euro-Outs

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**Introduction**

The International Economics department at Chatham House carried out a project entitled ‘Towards a Genuine Economic and Monetary Union: the implications for the United Kingdom and Euro-Outs’ [October 2013 – June 2014] with the support of the European Commission Representation in the United Kingdom. As part of this project, it organized two research workshops in early 2014. Experts, officials and market practitioners from all over Europe took part in the workshops, which were held under the Chatham House rule to ensure frank and open debate.¹

The workshops looked at different aspects of the movement by the Euro area (EA) towards a deeper economic and monetary union (EMU) by creating common institutions and joint policies, and its implications for those EU countries not participating directly in EMU, especially the United Kingdom. The first workshop looked at the implications for the single market in goods, investment and non-financial services. The second workshop focused on capital movements, euro financial markets, and the role of London as a major international and European financial centre.

The project sought to explore some of the wider implications for the United Kingdom and other ‘euro-outs’ of these moves, and how they might respond in economic and political terms, as Europe moved from crisis to more normal conditions. It took place against the background of moves by the EA towards deeper integration (as set out in the European Commission’s blueprint and the so-called Four Presidents report in late 2012), the rising tide of euro-scepticism in many European countries in the run-up to the European elections in May 2014, the UK prime minister’s call for an ‘in-out’ referendum on the United Kingdom’s membership of the EU, the referendum on the Scottish independence to be held in September 2014, and the UK government’s ongoing review of the balance of competences between member states and European institutions.

**The single market in goods and non-financial services**

One of the lessons that emerged from the crisis in Europe is the crucial role of competitiveness. The failure of EU member states to achieve sufficient convergence of competitiveness contributed to the tensions that emerged in 2010–12. In addition to this, the inability of Europe as a whole to raise its competitiveness vis-à-vis the rest of the world was an important factor in the depth of the recession in the EU and the EA. As a result, deepening of the single market and national structural reforms have emerged again as a potential way to improve competitiveness.

The review of the balance of competences between the United Kingdom and the EU on the single market (2014) reached a positive conclusion on the impact of economic integration through the single market. Most studies suggest that GDP in the EU and the United Kingdom are appreciably greater than they would have been without the single market. Although single-market deepening has provided support at the EU level for the United Kingdom’s liberal policy framework in some areas, integration has also imposed some constraints on national policy-making. Nevertheless, the review concluded that the trade-off between costs and benefits (economic and political) has been of benefit overall to the United Kingdom.

The United Kingdom has been a strong supporter of the single market, and British business is very positive. At the core of the EU’s development, the single market has driven growth and prosperity in the

¹ The Chatham House rule states that ‘When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.’
member states, and should continue to do so. At the same time the political will to drive its development into more politically sensitive areas is under challenge. Significant enhancement of the single market may not be possible in the near future and could be significantly influenced (positively or negatively) by ongoing institutional developments in the EA.

**Options for the United Kingdom**

In a recent report (2013), the Confederation of British Industry (CBI) concluded that it is in the interests of British business to maintain strong economic ties within Europe as well as to continue exploiting its strengths in third markets. The CBI looked at other potential models for the United Kingdom, including:

- The Norwegian model, which is a step removed from EU membership;
- The Swiss model, which includes a series of bilateral relationships;
- The Turkish model, being part of a customs union;
- And the go-it-alone (or World Trade Organization) model, which entails leaving the EU and unilaterally negotiating new trade agreements.

It concluded that none of these would allow the same level of market access in Europe as the current situation permits, and would reduce the United Kingdom’s ability to influence decisions about the single market and to set the ‘rules of the game’.

The main difference between the status quo and a looser free trade agreement (FTA) between the United Kingdom and the EU is not about tariffs – the country would be likely to have the same tariff rates in product lines as the EU. But on rules of origin and regulatory standards there could be differences. Also, when it comes to renegotiating FTAs with third countries, the United Kingdom will be in a weaker position than if it were negotiating as part of the wider EU.

**Trade in professional services**

Trade in professional services has taken a different route. Liberalization here would also enhance competitiveness and lower prices to customers. The obstacles to trade in these services are primarily related to regulation and to the different legal systems across the Union. Germany is a key constituent in this debate, and is not overly interested in liberalising trade in services because its economy is more focused on manufacturing. But there is an opportunity to get Germany on board because there are important complementarities between manufacturing and services. There have also been some success stories, such as mutual recognition in legal qualifications. But important barriers still remain. For example, in legal partnerships the United Kingdom allows lawyers to be involved in management whereas in France this is illegal – these differences mean that national regulations are still a barrier to completion of the single market in services.

**Financial aspects of the single market**

The current agenda is dominated by moves towards banking union, which would play a significant role towards completing the single market in financial services. A full banking union would imply a set of common rules for financial services across its members. Perhaps even more importantly, it would imply a
sharing of fiscal resources and decision-making across the area covered by banking union, especially in terms of the resources needed to resolve big bank failures.

The two main elements of banking union would be supervision, with the establishment of a single supervisory mechanism (SSM), and resolution, through a single resolution mechanism (SRM). The two are very much connected, because the single supervisor would be heavily involved in decisions about whether a financial institution was viable, or whether it needed to be resolved. So it is inconceivable that countries outside the EA would be part of the SRM without being part of the SSM. The opposite is not necessarily true, however. It is possible that a country could become a member of the SSM, and agree to its large banks being supervised by the European Central Bank (ECB), without signing up to the SRM. If the ECB decided that one of its banks needed to be recapitalized or wound up, it would then be for the national government to decide on the appropriate action. Joining the SSM would involve a significant transfer of decision-making power to the ECB, and therefore would be controversial. But the SRM would go one step further – not only would decisions be transferred about whether financial institutions were sound or not, but also fiscal resources would be committed by central institutions.

Ultimately this would be a significant step towards a fiscal union. But to take that step would raise very large questions about political accountability. It is not clear that European democracies and European citizens are yet ready for that step. As far as the ‘outs’ are concerned, this would be an even bigger hurdle to clear. Given that they are already concerned about the pooling of monetary sovereignty within the single currency, sharing fiscal sovereignty would likely be even more difficult.

**The implications for the United Kingdom**

The implications of the move towards banking union will be most significant for the United Kingdom, among all the ‘outs’, given the role London plays in euro-denominated financial markets.

As the review of the balance of competences on financial services and the free movement of capital (2014) also points out, it is not clear at this stage what the ultimate impact of the banking union will be. However, it is likely to pose a number of challenges to the United Kingdom’s interest in maintaining a central role of influence in an internationally competitive financial market in the EU. This will be especially true over time, as it is likely that there will be a divergence of policy interests between participating and non-participating members. EU institutions should, therefore, consider how to ensure that the diverse nature of member states, which have different legal requirements in relation to the euro, are fully respected by EU processes, systems, policies and rules. In particular, UK policy-makers are worried about the loss of importance for London as a major financial centre. Despite the fundamental role played by London in European financial transactions, the United Kingdom is likely to continue to lose influence over the European process of reforms.

**The Financial Transactions Tax (FTT)**

The Financial Transactions Tax (FTT) is another area at the interface of fiscal and financial policy that is also likely to be a point of contention between the ‘ins’ and ‘outs’. Most members of the EA are committed to introducing an FTT, though precisely how that would be designed is still to be decided. And the precise design matters greatly. At one level the FTT can be seen as increasing financial stability, raising revenue and enhancing the single market in financial services. But because the FTT would introduce a tax wedge within the FTT zone, it would also distort competition between those countries inside and outside the FTT zone. There are fears that the rules for the FTT would be set in such a way as force business to move from the ‘outs’ to the ‘ins’.
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This illustrates a more general point about decision-making in a multi-speed Europe. Decisions about financial issues could be taken within the EA in the interests of its members. At the same time, these decisions could have ramifications for the single market across the entire EU. The ‘outs’, not being members of EMU, would find it more difficult to be involved in the political discussions leading up to EA decision-making. But the United Kingdom in particular is very skilled and competitive in financial services, so its involvement could potentially result in better decisions. The lack of involvement would also raise fears about whether those decisions were biased against the interests of the ‘outs’.

**Political implications**

The economic issues have to be seen as part of the wider political backdrop. There is a massive divide between elites and decision-makers versus citizens, and the EU is widely seen as suffering from a democratic deficit. There are worries about a rise in the scepticism towards the EU in many member states, including those that have traditionally been more pro-European, such as France and Italy. The European Parliament elections in May 2014 have been seen as a further indication of this trend. There are many ways to address the democratic deficit, including a more accountable federal structure. But it is not clear that there is political support for going down this route at present.

This is also a dynamic situation. As the EA moves towards greater integration, it is likely that the differences between the ‘ins’ and the ‘outs’ will increase, and interests diverge further. But the ‘outs’ have not shown the will to act as a cohesive political body, even though their interests are reasonably convergent. And the United Kingdom has not been prepared to take a lead in coordinating the ‘outs’. This is partly because of the state of the debate about Europe in the United Kingdom; but also there might be resistance from the other ‘outs’ since the United Kingdom would be seen as a dominant member of that grouping. On their side, European institutions have a role to play in improving their capacity to send a more positive message to the United Kingdom and the other ‘outs’.

Finally, the debates about Scottish independence and the role of member states within the EU raise wider issues for other regions in the EU that would like to be independent, such as Catalonia in Spain. These debates are likely to continue, whatever the result of the Scottish referendum, and the EU will have to address the issue of member states breaking up but their constituent parts still wanting to remain part of the union.
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References


