Three British Eurodilemmas

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Summary

- Three key pieces of the European agenda are going to create profound political problems for the UK over the next few years. How the UK resolves - or does not resolve - these 'Eurodilemmas' will have far reaching consequences for the UK's relationship with the Eurozone and its influence in shaping the European single market. For investors in the UK this matters.
- The first is the negotiation of the EU budget for the 2014-2020 period. Although the sums of money involved are not huge, discussion of an EU budget increase and a possible threat to the UK rebate will be a lightning rod for the debate about the EU. For the UK, domestic politics makes supporting a bigger EU budget very difficult, but there is a danger that taking a perceived extreme position will leave the UK further isolated.
- The second is the suggestion there should be a further European treaty to set out new arrangements for managing the Eurozone. The Commission and the Germans look set on a new treaty, though other member states, including France, are less enthusiastic.
- For the UK, a new treaty would intensify the political debate on the EU, while potentially putting in place arrangements that would place the country firmly on the margins of much of the substantive business of the EU. As it approaches the discussions about the treaty, the UK is likely to find the other member states, whatever their views, less patient and willing to accommodate its concerns.
- The third is the development of the Eurozone banking union which, although it is likely to be a protracted process, could ultimately weaken the UK's ability to shape financial services regulation in the EU and may ultimately change financial firms' logic for locating in the City of London rather than the Eurozone.

Over the months and years ahead, Britain faces three basic 'Eurodilemmas'. Running through all three is the recurrent problem for the UK of exercising influence over an EU which in trying to resolve the problems of the Eurozone, is moving far away from the British 'comfort zone' on European integration. For investors in the UK this has both short and long term consequences.

In the short term it weakens the UK's negotiating position on shaping the new arrangements for the Eurozone, including banking union and on issues of high importance for the UK's financial services sector more widely. In the long term, the prospect is of the UK finding itself firmly on the margins of a rebooted European Union built around the Eurozone.

A Britain that finds itself in this position is also likely to have less say in the rules and scope of the single market. For the last ten years the loose political and fiscal governance of the Eurozone has meant that the uneven overlap between the Eurozone and the European single market has not really mattered. This has allowed the UK to exercise considerable influence without accepting substantial political and fiscal integration. This is likely to recede. This Global Counsel Insight explains why.

Banking union

London has emerged over the last six months as a supporter of the concept of banking union in the EU. It recognises that it would both logically fit with the single market for financial services and be the mechanism for breaking the transmission link between bank failures and individual sovereign balance sheets. The problem for London is that it will also inevitably shift the centre of gravity in the EU market for financial services into the Eurozone, where the UK has no intention of going.

Although the EU's banking union proposals are still at a very rudimentary stage, it is already possible to see the basic problem for the UK. The most likely outcome of the current process is that the European Banking Authority (EBA) will remain the rulemaking body for banking in the single market. But the Eurozone bloc, through the ECB, will take common positions when the EBA makes policy decisions. With guidelines, binding technical standards and restrictions on activities made by majority voting and with no UK veto, there is a very obvious weakness in the UK's ability to counter proposals that run counter to its perception of London's interests.

The UK will push hard for safeguards in this respect, and the European Commission has proposed a complicated structure based on a combination of simple and qualified majority voting and a three-member appeals board. The membership of this board would have to contain non-Eurozone states and its decisions would only be overturned by simple majority containing three non-Eurozone states. This is intended both to protect the interests of non-Eurozone states and prevent Eurozone states using their caucus to block intervention in Eurozone institutions.

However there will be a number of clear political incentives for things to run against the UK. The first is that any kind of pan-Eurozone fiscal backstops for banks will create a strong push from the large financial contributors, particularly Germany, for a high level of regulatory harmonisation. They will also encourage an intrusive level of supervision. National regulatory discretion is likely to be very limited. Any perception that the UK is trying to undercut Eurozone standards will not encourage accommodation of its views.

Prudential supervision poses a different kind of headache for London. The new system will shift prudential supervision of credit institutions within the Eurozone to the ECB. This will probably happen in a number of waves, starting with bailed-out institutions and the largest Eurozone banks and eventually covering most or all credit institutions. Non-Eurozone states will be able to join this system on a voluntary basis.

Here the issue is the degree to which countries might pay a price in consumer and investor confidence, and potentially capital costs, for staying *out* of such a system. Would governments prefer to hand supervision over in return for potential access to ESM resolution funding in the event of a future crisis? Would institutions rather be operating in jurisdictions backed by the fiscal backstop of the entire Eurozone? Probably, yes. For banks holding large euro-denominated positions in London there may be advantages to being directly backed by the ECB. Indeed, the ECB is likely to keep agitating for large Euro-denominated trades and positions to be moved into Eurozone.

Unlike the UK, other European states not currently in the Eurozone are keen to find a *modus vivendi* inside the new system. Some, like Poland, take a particularly close interest because they are legally bound eventually to join the euro. Sweden, whose own banks operate widely in Eurozone markets, and the Czech Republic, whose banking system is dominated by Eurozone lenders, will both see logic to being in the new system, provided their non-Eurozone status does not completely deprive them of influence in the ECB's decision making structure. The more who join the new system, the weaker the UK's leverage for shaping the influence of the 'outs'. In time, the UK's position outside the prudential net of the ECB could act as a disincentive to establish in London.

The next treaty

The evolution of a banking union within the EU is only one part of the larger reconfiguring of the Eurozone that will cause problems for the UK. Berlin in particular is pushing for a new European treaty to be drafted in 2013 to codify new fiscal governance and political arrangements in the Eurozone. It would like to see the European Court of Justice given jurisdiction over the fiscal disciplines agreed in the 2012 Fiscal Compact. As with the German insistence on the new Fiscal Compact in December last year, this is an important political part of Berlin's tentative steps towards any collective underwriting of the European sovereign debt.

The idea of trying to ratify a new treaty is however deeply unpopular in France and most other EU states. Even German allies like Poland and the Netherlands are distinctly cool on the idea of pushing a new treaty through Parliaments, let alone public referenda as required in Ireland. Unless Germany makes a new treaty non-negotiable, the most likely outcome is a new treaty process pushed back into a new European Parliament and new European Commission in late 2014 or 2015. The interim two years would allow the European Commission and President of the European Council Herman Van Rompuy time to socialise ideas and give Member States time to try and shape domestic political attitudes. A roadmap for this process is scheduled to be agreed in December 2012.

Any new treaty process promises prolonged discomfort for the UK, even if it technically addresses only questions of Eurozone governance. More than any previous treaty negotiation since the 1970s, Britain is likely to be presented with a take-it-or-leave-it attitude from France and Germany. Not least because it will be assumed in advance that there is little prospect of the UK signing a treaty as anything other than an associate member.

Some European Commission officials believe that if the new treaty negotiations can be structured in such a way as to involve the repatriation of powers to member states alongside the federalising of new powers in Brussels, then the UK may find the exercise more comfortable. But history suggests this swap is not likely to be substantive.

As with banking union, the chief problem for the UK lies in the fundamental shift of the centre of gravity towards the Eurozone, and the Eurozone's ability to dictate the terms of trade for the wider single market. Even if Britain was to play an entirely constructive role – and the British Conservative party's rhetoric and instincts do not suggest that this is likely – the inherent focus on the reconstruction and future effectiveness of the Eurozone will weaken London's hand.

As Polish Foreign Minister Radek Sikorski warned in an interesting speech in the UK on September 22, even Poland, an ally of the UK on many policy issues and currently outside the Eurozone, nevertheless sees its future being with the integrators, not the outsiders. Being in the EU but outside the Eurozone threatens to be a lonely place for London.

The EU Budget

The third key problem for the UK is the EU budget. Decisions about the EU budget between now and 2020 will need to be made in the coming months. The European Commission has proposed an increase in EU appropriations of around 6.8% in 2013. It also wants an additional 5% over the 2007-2013 budget for the 2014-2020 period. Much of this extra spending would be absorbed by reimbursements for national projects that have been rolled over from previous years.

But the topline rise at a time of general fiscal austerity across Europe has provoked considerable irritation in national treasuries. For the UK it is particularly toxic. Britain has been a net contributor to the EU budget for every one of its 34 years of EU membership. Unlike other large net contributors like France it does not benefit substantially from collectively spending policies such as the European Common Agricultural Policy.

It would be a significant understatement to say that the British Coalition government has little appetite for selling an EU budget increase to the British public. The British political negotiating position on both budgets has been hardline and inflexible. Although the Commission's budget prompted similar angry reactions from Paris, Berlin and Scandinavia, there is good reason to suspect that both France and Germany will compromise early rather than stick with the UK to the bitter end.

Paris suspects it can sell a higher EU budget as a bigger package of investments in growth to balance the German model of fiscal austerity it has signed up to. For Berlin, ultimately there will be a wish to keep Warsaw on side, and the Poles are anxious about any shrinking of Poland's share of the European redistributive 'solidarity' spending that has provided their economy with a significant boost in recent years.In principle, although the 2013 budget will be agreed by majority vote, the UK could exercise a veto over the longer term 2014-2020 package. But the decision to do this would provoke a further crisis around Britain's European vocation, and poison any future treaty negotiations from the start.

This reinforces the point that the key implication of the budget debate across the EU will not be the end result, which is marginal in the broader picture of EU public expenditure, but the way it shapes the wider European debate. In net-contributor states like Germany and the Netherlands it is likely to strengthen a grim and growing resentment of the development of a transfer union in the EU. In the UK it will antagonise and mobilise Conservative Eurosceptics at exactly the time when the Coalition government would prefer to focus attention anywhere but Europe. Even the pro-European Labour party is likely to be nervous about publicly endorsing a bigger EU budget.

In this political context the pressure on the Conservative leadership to commit to some form of referendum on European membership will be very strong. Conservative leader David Cameron used a recent speech to imply that as the EU entered a period of 'renegotiation' a fresh mandate for membership would need to be sought from the British public. This contrasts with the opinion of other ministers that holding such a referendum would be divisive and even suicidal for the Conservative Party.

For Britain, the EU budget debate looks likely to initiate the most difficult period of its relations with the EU for decades. Officials in the European Commission often complain that Britain suffers from a serious lack of European solidarity: it does not see itself as part of the European 'family'. This is basically right. Put crudely, Britain's European policy for the last twenty years has been based on a policy of widening the EU to the East as a block to any possible further political deepening. This strategy is defunct, thanks to the Eurozone crisis.

Britain is faced with choosing its own place in a deepening Eurozone that, if it survives intact, will become the economic and political core of the European Union. This leaves the UK in an uncomfortable peripheral position with respect to the rulemaking and management of the European single market. Assuming the UK stays out of both a banking union and the new Eurozone, the UK's influence over the making of single market policy will weaken in a way that safeguards and voting weights can mitigate but not reverse. This is Britain's fundamental 'Eurodilemma', irrespective of which political party governs Britain.

Whether this will matter for the City of London and to investors in Britain will depend on two things. First, the extent to which this loss of influence produces a single market in which Britain is less able to attract international business. Second, the extent to which the attractions and protections of operating within the Eurozone banking union diminish the attraction and security of locating in the City of London. These are both questions business would do well to start considering now.

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