House of Commons Foreign Affairs Committee, The future of the European Union: UK Government policy
Written evidence to the, Ruth Lea, Economic Adviser, Arbuthnot Banking Group, 22 May 2012

Summary

- The December 2011 European Council and the subsequent signing of the "Fiscal Compact Treaty" by 25 EU Member States (excluding the UK and the Czech Republic) would at face value seem to have little impact on the UK's EU policy and place in the Union. After all the British Government remains firmly committed to EU membership, which is not, in my judgement, in the country's best interests.
- But perhaps the December Summit will be seen by future historians of the EU as a watershed event for the UK and the EU, when the UK's isolation was obvious, at last, for all to see. Moreover, despite the PM's veto, the European Council has simply pushed ahead with the Treaty, which will probably be incorporated into the EU Treaties sooner rather than later. One can only conclude that Britain's influence on EU events, as crisis engulfs the Eurozone, is minimal.
- Given the lack of UK influence in the EU, we are in the weakest possible position to drive forward institutional or policy developments in the EU. Whilst we remain a member, the best we can do is respond to decisions made by the Franco-German axis and EU institutions and attempt to obtain the best deal for us. This may seem like a counsel of despair, but it is a realistic one.
- In any case, any major near-term to medium-term developments in the EU will almost certainly concern the Eurozone as EU institutions and the EU17 Member States struggle with the existential threat to the currency. Britain, thankfully outside the euro, is inevitably at the periphery of events, a bystander.
- Moreover, any notion that the British Government could use the Eurozone crisis to negotiate any repatriation of powers, and develop a different form of membership, is a chimera. There is absolutely no evidence that our EU partners would accept such a move.
- It is not clear that the Treaty will have any direct impact on other aspects of the EU and its policies. But the indirect impacts of its implementation must not be underestimated. The Treaty is part of the on-going centralisation of EU policy-making. Under these circumstances, I would expect the EU's institutions to push ahead with the further centralisation of policy-making, some of which is intended, at least putatively, to "save the euro".
- Having vetoed the incorporation of the Fiscal Compact Treaty into the EU Treaties in December 2011, the UK Government should continue to reject any such move for the sake of consistency, at the very least. If the Government is prepared to agree to the incorporation they should at the least get guarantees that the EU-wide Financial Transactions Tax will remain subject to veto in order to support the City. They can, after all, do little to protect the City from the flood of EU Single Market financial regulations which are subject to QMV.

Submitter of evidence

Ruth Lea has worked in the Civil Service (the Treasury, the Civil Service College, the CSO and DTI (1970-88), with a short break lecturing in economics); the City (Mitsubishi Bank (1988-93), Lehman Brothers (1993-94), Arbuthnot Banking Group (since 2007)); ITN (1994-95) and the Institute of Directors (1995-2003). She was Director of the Centre for Policy Studies (2003-07) and Director of Global Vision (2007-10).

I would be happy to give oral evidence to the Committee.

Submission

<u>To what extent should the December 2011 European Council and its outcome be seen as a watershed in the UK's EU policy and place in the Union?</u>

1. A brief analysis of the background to the "Treaty on Stability, Coordination and Governance of the Economic and Monetary Union", otherwise known as the "Fiscal Compact Treaty",[1] is required in order to assess the significance of the December 2011 European Council meeting for Britain.

2. The Treaty is intended to strengthen the Eurozone's Stability and Growth Pact (SGP), whereby general government deficits should not exceed 3% of GDP and general government debt should not exceed (or is "sufficiently declining towards") 60% of GDP, by introducing a new range of medium-term objectives, including a "balanced budget rule" and an automatic mechanism to take corrective action. The former states that budgets must be balanced, with "a lower limit of a structural deficit of 0.5% of GDP", or in surplus. Concerning the corrective action, if the European Court of Justice judges that a member has failed to comply with the "balanced budget rule", it can impose a fine, a sum "that shall not exceed 0.1% of GDP". It should be noted that there is some flexibility in the "balanced budget rule" in that "exceptional circumstances" are allowed for. In addition, the target is expressed in terms of the "structural" (i.e. the cyclically-adjusted) balance, not the actual recorded balance, which can allow for large deficits if the economy in question is performing well below potential. Note also that, because the Treaty is exclusively about the Eurozone, it does not directly affect the UK.

3. Putting aside the feebleness of the SGP to impose fiscal discipline on the Eurozone's members in the first decade of the euro's existence, there are significant doubts about the Treaty's potential success, given the horrendous and deep-seated structural problems faced by the Eurozone in its current dysfunctional configuration. The Treaty is, significantly, only concerned with fiscal discipline in the Eurozone and should be seen in the general context of the EU's endeavours to tighten economic governance procedures.[2] It is not, as sometimes reported, concerned with the development of an EU fiscal union, broadly defined as comprising a common Ministry of Finance, common sovereign debt (the mutualisation of debt) and substantial financial transfers from the rich, highly competitive northern economies (principally Germany) to the less competitive peripheral economies. Such a fiscal union is arguably necessary to save the currency area in its current configuration. There are moreover few signs that the Eurozone is moving towards such a union. It should also be noted that the Treaty does nothing to address the fundamental structural fissure at the heart of the Eurozone crisis, namely the competiveness mismatch between the northern and the peripheral economies, which is tearing the currency union apart. It can be argued that the Treaty, by focussing on fiscal discipline, has simply side-stepped or chosen to ignore the causes of crisis engulfing the euro.

4. 25 out of the 27 Member States signed the Treaty in March 2012, with the UK and the Czech Republic the only two dissenting members. The Czech Republic may yet sign, leaving the UK completely isolated. December's Summit was, of course, noted for the British Prime Minister's veto of the EU's plans to incorporate the proposed Fiscal Compact Treaty into the current EU Treaties when his stipulations for relatively modest safeguards for the City of London were refused. His veto forced the separate Treaty but the EU clearly intends to push ahead and incorporate the Treaty into the EU Treaties "as soon as possible".[3] The likelihood is that this will happen sooner rather than later.

5. So to what extent should the December 2011 European Council and its outcome be seen as a watershed in the UK's EU policy and place in the Union, given this background? The short answer appears to be "very little" at face value. After all the UK's EU policy remains committed to membership of the EU, which is not, in my judgement, in the country's best interests.[4]

6. But developments since the PM's veto have merely served to underline our lack of influence in EU affairs, implying our place in the Union is firmly at the periphery. The Fiscal Compact Treaty has gone ahead essentially as planned by the European Council, even if it remains outside the main EU Treaties. Because the UK is (rightly) outside the Eurozone, which is understandably focussing on trying to hold the currency union together, the UK is inevitably increasingly peripheral. Our influence diminishes as crisis engulfs the Continent, even though the future of the Eurozone has major implications for the country. If the Eurozone pushes ahead towards full fiscal union the UK's influence in EU affairs will diminish even further. Perhaps the December Summit will be seen by future historians of the EU as a watershed event – an event when the UK's isolation was obvious, at last, for all to see.

<u>Between now and 2020, what institutional architecture and membership should the UK seek for the EU? Should the UK embrace a formalised two (or more)-tier EU and start to develop ideas for multiple forms of EU membership?</u>

7. Given my earlier comments on the lack of UK influence in the EU, I believe we are in the weakest possible position to drive forward developments in the EU. Whilst we remain a member, the best we can do is respond to decisions made by the Franco-German axis and the institutions of the EU and attempt to obtain the best deal for us. This may seem like a counsel of despair, but it is a realistic one.

8. More specifically, any debate on the future of the EU and its institutional architecture is inevitably dominated by the possible resolution of the existential Eurozone crisis. It is worth speculating as to how the UK should respond, given possible Eurozone resolution scenarios. Very broadly three such scenarios can be identified. The first scenario is that the EU17 members push ahead with full fiscal union and the Eurozone bloc survives broadly as currently configured. The EU is already a two-tier organisation comprising the EU17 (and arguably the pre-in aspirants) and the "outs" the UK, Denmark and possibly Sweden.[5] With fiscal union, or political union, a two-tier structure would be formalised and the UK's peripheral position would be reinforced. The second scenario is a possible major reconfiguration of the currency union with either the weaker countries returning to their own currencies or, more fundamentally, a split into a northern Eurozone and a southern Eurozone to reflect the competitiveness gap between these two blocs. The power would indubitably be with the northern Eurozone bloc. Britain should, of course, stay clear of both blocs, but with the Eurozone split Britain would look less isolated from mainstream affairs than with full fiscal union. The third scenario is a complete collapse of the bloc which would shake the EU to its very foundations and could possibly present the UK with an opportunity to remodel, or reform, the EU as a looser trading relationship. But I regard this scenario as highly unlikely with the chances that the UK could drive forward a major reform of the EU as vanishingly small. There is simply no stomach for such a "reformed" EU in the other EU Member States.

9. There are, of course, non-currency "multi-tier" aspects to the EU already (Schengen springs to mind) but these are of minor significance compared with the currency and will almost certainly remain so. On a slightly related issue, there is much speculation that the UK Government could negotiate the repatriation of certain powers thus creating a different class, or form, of EU membership. But there is absolutely no evidence that our EU partners would accept such a move and plenty of evidence to show they would block it totally. For example, German Minister of Finance Wolfgang Schäuble said last October that Britain should forget any attempts to use the Eurozone crisis to repatriate EU social and employment laws.[6] The repatriation of powers is a chimera.

<u>What is the relationship between the new 'fiscal compact' Treaty and the EU's *acquis*? What impact might the conclusion of the 'fiscal compact' Treaty have on other aspects of the EU</u>

and its policies, such as the EU budget, enlargement, or the Common Foreign and Security Policy?

10. I assume for all practical purposes that the Treaty is already part of the *acquis* and if/when it becomes part of the EU Treaties then it will formally become part of the *acquis*.

11. It is not clear that the Treaty will have any direct impact on other aspects of the EU and its policies. But the indirect impacts of its implementation must not be underestimated. The Treaty is part of the on-going centralisation of EU policy-making. The history of the EU tells us that its proponents only have forward gears and the EU's institutions cumulatively accrue competencies and influence. They do not divest power. Under these circumstances, I would expect the institutions to push ahead with further control over policies, possibly including budgetary issues or matters relating to the CFSP. Where there is a possible link between an EU policy (say budgetary control or promoting an EU-wide Financial Transactions Tax) and "saving the euro", I would expect "saving the euro" to be invoked frequently in support of increased EU activism. Concerning the implications for enlargement, I would speculate that successful countries on the EU's periphery, Turkey springs to mind, would have even less interest in joining the EU if it means an EU-grip on its economic policies.

Should the UK Government support the incorporation of the 'fiscal compact' Treaty into the EU Treaties? If it should, what demands and safeguards, if any, should it make its condition for doing so?

12. Having vetoed the incorporation of the Fiscal Compact Treaty into the EU Treaties in December 2011, the UK Government should reject any such move for the sake of consistency, if nothing else. But, as already commented, the Treaty states clearly that the European Council wishes to proceed with its incorporation "as soon as possible" and I expect the UK Government to agree to this.

13. The Government should revisit the Prime Minister's demands for some relatively modest safeguards for the City of London and insist they are enshrined in the Treaty. Specifically, any proposals for an EU-wide Financial Transactions Tax should strictly remain subject to veto. But there is little that the UK can do about the EU's heavy programme of financial regulations because they are part of the Single Market and subject to QMV where we have just 8½% of the vote in the Council of the European Union. As such the UK has little influence over the legislation relating to one of its major businesses, arguably one of its most successful businesses, some of which has been described as "harmful".[7] Membership of the Single Market is increasingly disadvantageous for this country. But this is a different issue.

References

1. European Council, "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union", signed on 2 March 2012. Subject to ratification by at least 12 Eurozone members, the Treaty enters into force on 1 January 2013. Available on www.european-council.europa.eu.
2. Council of the European Union, "Council confirms agreement on economic governance", press release, 4 October 2011. This press release for example outlines the "Six Pack", the six legislative proposals on economic governance in the EU (though more specifically in the EU17), agreed by the Council of the European Union (the Council) in October 2011. The proposals related to a reformed SGP, reducing macro-economic imbalances and promoting competition. The press release is available on www.consilium.europa.eu.
3. The precise words in the Treaty are "…bearing in mind that the objective of the Heads of State and Government of the euro area Member States and of the other Member States of the European Union is to incorporate the provisions of this Treaty as soon as possible into the Treaties on which the European Union is founded."

4. See Ruth Lea and Brian Binley MP, *Britain and the EU: a new relationship*, Global Vision, May 2012, for wide-ranging discussion of the options open to the UK.
5. Only Britain and Denmark have formal opt-outs whilst Sweden has decided to stay out of the euro for the time being. The other seven, however, are legally bound to join and wish to do so except, perhaps, the Czech Republic.
6. "David Cameron told by Berlin: drop demands for repatriation of powers", *Guardian*, 19 October.
7. *The Economist*, "Save the City", 7 January 2012.