THE FEDERAL TRUST
for education & research
enlightening the debate on good governance

January 2016

The Eurozone:
IN and OUT relations

Graham Bishop

This pamphlet is published by the Federal Trust whose aim is to enlighten public debate on issues arising from the interaction of national, European and global levels of government. It does this in the light of its statutes which state that it shall promote 'studies in the principles of international relations, international justice and supranational government.'

Up-to-date information about the Federal Trust can be found on the internet at: www.fedtrust.co.uk, or you can follow us on Twitter (@FedTrust) and Facebook (www.facebook.com/fedtrust).

This pamphlet is published as a contribution to public debate. It should not be assumed that it or similar pamphlets in the future necessarily represent the collective view of the Federal Trust.

ISBN 978-1-903403-99-0.

The Federal Trust is a Registered Charity No. 272241
84 Moorgate
London EC2M 6SQ
United Kingdom

Company Limited by Guarantee No.1269848

Design by Fred Fieber

The Eurozone: IN and OUT relations

Graham Bishop

About the author

Graham Bishop is a Consultant on European Integration – Political, Financial, Economic and Budgetary – and founder of financial services consultancy *Grahambishop.com*. He has been a Special Advisor to the House of Commons Treasury Select Committee and has given evidence to the House of Lords European Committee's inquiry on the euro area. He was a member of the European Commission's Expert Group on Redemption Funds and Eurobills.

Contents

Executive Summary and Conclusions

NOTE: This paper was finalised before the letter from Council President Tusk to Prime Minister Cameron on 2nd February 2016. The proposals are in line with the analysis in this paper but they may yet be subject to significant change by the Heads of Government – either at the Summit of 18/19th February 2016 or later. Moreover, the European Parliament – as co-legislator – will have to agree to some of the proposals.

- The 1992 Treaty of Maastricht set up the legal and political framework for all EU members to use the single currency – but two states (UK and Denmark) had an opt-out that was expected to be temporary. The Treaty specifies the goal of one currency in the EU with good reason – to provide a mechanism to encourage good economic governance. Political accountability in Europe is delivered by a two-chamber system: Council and Parliament. The size of national populations – over time - plays a key role in allocating voting power. Britain's population is set to overtake that of France in the next (perhaps five) years, so the UK would become the second-most influential power within the world's largest trading bloc of more than 500 million people.

- European `visions' are not received well in the UK and are usually ignored, **but** the chances of reaching a particular goal are much reduced if you do not have a vision of where you want to go! Unsurprisingly, the EU has struggled so far to create a robust and incisive response to an economic crisis that should never have happened if `the rules' had been obeyed. Once the darkest moments of the crisis had passed, EU leaders began to create a vision of a union that would not have to endure such problems again. Following the election of Commission President Juncker, this somewhat vague vision has been crystallised as the Five Presidents' Report (see p. 17) with a final deadline of 2025 – a decade ahead – to complete the economic and monetary union. There are many problems to be resolved – not least migration. However, the core problem for Britain is that if anything approaching the `Favourable Scenario' materialises as a natural result of the improving competitiveness that Prime Minister Cameron seeks, then the Eurozone is likely to expand substantially. It is quite conceivable that there will be only one OUT at the end of this decade: the UK.

- Britain is already `out' of many core policies of the EU – as is evident from the lengthy list (see p. 38). There is great goodwill towards the UK and a real willingness to find a `fair' solution. But if an agreement cannot be reached and fears of a de-stabilising Brexit materialise, then it is difficult to see the goodwill remaining and producing a harmonious exit deal on trade relations. This would have a particular impact on the City – the Favourable Scenario for the deepening integration of EU27 already makes the status quo of today – Brin EU/Brout Euro – look increasingly difficult to sustain by the end of a further decade of evolution.

- The British Government's `demands' are encapsulated in four `baskets': economic governance; competitiveness; sovereignty and immigration. These can be broken down into at least 14 specific items and 11 of those (so at least 80%) are easily met – or already have been. The politically neuralgic topic of immigration may be able to be shoehorned into existing Treaty `safeguards'. But the economic impact of reduced public spending on in-work benefits appears minor (£1.5 bn) when compared with potential Brexit losses of some of the City's more than £60 bn contribution to tax revenues. The tough proposal for a European Border and Coast Guard is unlikely to have been implemented by Referendum Day and any acrimonious failure even to agree it may be particularly unhelpful. The UK does not seek a veto over Eurozone actions and wants to ensure it is not liable for the cost of any Eurozone problems. The obverse must also be true: the Eurozone cannot be liable for any costs arising from another financial crisis in the City.

- If the EU turns out to be successful in achieving the vision laid out in the Five Presidents' Report (see p. 10) for implementation during the next decade, then EU27 may well have solved its problems by attracting all EU states into euro membership – except the UK. Prime Minster Cameron accepts that the UK cannot demand a veto, partly because its abolition was one of Prime Minister Thatcher's greatest achievements. At that stage, the UK's situation would only be marginally different from a de facto Brexit: `bound by EU rules but only marginal influence upon them' – as opposed to `bound but no influence at all' under formal Brexit.

Introduction

This paper seeks to consider the problems posed for the European Union as a whole by having most of its members using the single currency while others remain outside it – perhaps permanently. How can these problems be solved – or merely mitigated? Will the solutions – or mitigations – help or hinder UK Prime Minister Cameron's renegotiation of the UK's relationship with Europe?

The UK's problems with Europe date back to the concepts that created the original political impulses after 1945 to form a closer union that would prevent further conflicts. The insularity of the political debate on Brexit today is eerily reminiscent of the British political class's reaction to the Maastricht Treaty in 1992.

The UK misjudgement in 1992 was total. Following the timetable laid down in the Delors Report, a "three stage" process was launched in 1992. However, the December 1994 decision in Madrid by the Heads of Government to start the technical preparations was almost completely ignored (or even ridiculed) by the British establishment because the EU was at the time engulfed in an existential crisis – about exchange rate movements, including sterling. To general astonishment in Britain, the exchange rates of the currencies of 300 million people were `irrevocably locked' in January 1999 and the notes and coins were introduced flawlessly for this vast number of people in 2002.

A decade and a half later, 340 million people use this currency – more than five times the population of the UK – and there is widespread recognition that the fate of the UK's economy is `irrevocably locked' to the fate of the euro. In a decade, could it be 440 million using the euro as their currency?

Since 2012, there has been a series of "Presidents' Reports" laying out a fairly detailed plan for a major deepening – but now of "economic and monetary" union with a two stage process for achieving it – "by 2025 at the latest". The European Council of December 2015 authorised the preparatory work to continue and a group of independent experts is to be set up to plot out the exact details for Stage 2 that is planned to begin in 2017. If Prime Minister Cameron succeeds in his negotiations, how will the UK mesh with states in the complete `economic and monetary union' in 2025?

Again, the British establishment is ignoring the "Five Presidents" (see p.17) process because the EU is apparently engulfed in another existential crisis – this time about migration, having narrowly scraped through the Greek economic crisis.

What if the migration problem is sufficiently ameliorated and Schengen is no longer at risk? Then the EU has probably launched itself on a path to a genuine Economic Union, Financial Union, Fiscal Union and finally a Political Union to maintain the necessary democratic legitimacy of the new system. What if the Eurozone `succeeds' as a result of this process of improving competitiveness and all bar the UK adopt the euro? There is a clear risk either of actual Brexit soon, or de facto Brexit by "2025 at the latest".

Background

The introduction sets the scene for analysing the problems for the EU of having most of its members using the euro as their currency and some not using it. This section on the "background" is designed to give the basic information on the legal and power structure of the EU.

Summary: `The Treaty' specifies the goal of one currency in the EU with good reason – to provide a mechanism to encourage good economic governance. Political accountability in Europe is delivered by a two-chamber system: Council and Parliament. The size of national populations – over time – plays a key role in allocating voting power. Britain's population is set to overtake that of France in the next (perhaps five) years, so the UK would become the second-most influential power within the world's largest trading bloc of more than 500 million people.

Legal Relations between the Eurozone INs and OUTs

As a first step, it is worth reviewing the precise legal commitments towards euro membership undertaken by the Member States. The "Treaty on the Functioning of the European Union" (TFEU) specifies these. Only two states have embedded into the TFEU a right not to join – the UK and Denmark. However, as a practical matter, the conditions for applying for membership include the obligation to be a member of the Exchange Rate Mechanism (ERM) for two years. As this is not compulsory but merely an aspiration, states such as Sweden have avoided euro membership for many years. Some other states that have joined the EU since the 1992 Treaty of Maastricht have followed this example.

Treaty provisions

The first article of the TFEU sets the scene for the creation of the general concept of a `union' and Article 3 then specifies explicitly that an integral component of this union is an `economic and monetary union' with a currency – the euro. The concept of the economic and monetary union (EMU) is then fleshed out in more detail in Article 119, which lays out the economic activities necessary to achieve it.

The Treaty-writers in 1988 had extremely fresh in their minds the huge problems created by the aftermath of the First Oil Shock of 1974 for their then newly-constructed "Single Market". They had been seared by the lack of co-ordination of economic policies and the disparate exchange rate policies pursued by the Member States.

The resulting currency volatility nearly caused the Customs Union – the essence of Free Trade – to be fractured with customs barriers applied to offset `competitive' currency devaluations. Policymakers were desperate to put an end to this volatility, and the constraints of a single currency were the chosen mechanism to achieve it.

Looking back over the recent period since the Greek crisis erupted in 2010, it would be easily understandable if the present generation of policy-makers were nervous about any steps that might undermine the current drive towards even closer co-ordination of economic policies.

TFEU extracts

Article 1. By this Treaty, the HIGH CONTRACTING PARTIES establish among themselves a EUROPEAN UNION, hereinafter called 'the Union', on which the Member States confer competences to attain objectives they have in common… This Treaty marks a new stage in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as openly as possible and as closely as possible to the citizen.

Article 3. 4. The Union shall establish an economic and monetary union whose currency is the euro.

TFEU TITLE VIII: ECONOMIC AND MONETARY POLICY: Article 119

1. For the purposes set out in Article 3 of the Treaty on European Union, the activities of the Member States and the Union shall include…the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition.

2. Concurrently …these activities shall include a single currency, the euro, and the definition and conduct of a single monetary policy and exchange-rate policy...

The TFEU is very explicit that the monetary counterpart to economic co-ordination would include "a single currency, the euro". In the recent turbulence, the desire to maintain the unity of the euro was probably the driving force that sustained the massive contributions to the European Stability Mechanism (ESM) and the willingness to see the collective obligation to the European Central Bank (ECB) rise to a third of GDP.

A technical drafting change to the TFEU text to remove the `activity' of 'a single currency' might seem trivial, but it could be argued that it would strike at the core discipline of economic policy co-ordination. Such a step could remove the pressure for the OUTs to converge their economic policy with the INs, perhaps even reducing the pressure on the INs to stay IN when the going gets rough – thus inducing massive, precautionary financial flows. Deposits in Greek banks have nearly halved since their peak – falling by about 60% of current GDP.

Moreover, the whole thrust of Capital Markets Union (CMU) is to replace a significant amount of "sticky" bank deposits with readily marketable securities. That will facilitate capital flight on an unimaginable scale – IF savers become concerned about the safety of their retirement savings.

In any case, the UK negotiated a very substantial Protocol to the Treaty – running to 3 pages, 10 articles and numerous sub-paragraphs. By contrast, the Danish "exemption" was a few brief paragraphs – but has the same political effect: it is up to Denmark to decide when it wants to join. (Key extracts below)

The INs might be entitled to ask "what exactly would the UK gain from such a change to the current situation?" Do any other OUTs feel the need for such a change? The INs may have a shrewd feeling about what they could lose in terms of the drive to economic co-ordination.

PROTOCOL (No 15) RECOGNISING that the **United Kingdom** shall not be obliged or committed to adopt the euro without a separate decision to do so by its government and parliament,.. 1. Unless the United Kingdom notifies the Council that it intends to adopt the euro, it shall be under no obligation to do so.

PROTOCOL (No 16) ON CERTAIN PROVISIONS RELATING TO **DENMARK** TAKING INTO ACCOUNT that the Danish Constitution contains provisions which may imply a referendum in Denmark prior to Denmark renouncing its exemption… 1. In view of the notice given to the Council by the Danish Government on 3 November 1993, Denmark shall have an exemption.

Source: TFEU

Voting Power in the EU

Raw political power in the EU flows from the voting power in both the Council and Parliament – certainly for legislation under co-decision arrangements where both `Chambers' have to approve an identical text. This applies to legislation affecting the Single Market. The voting arrangements are laid down in the Treaty and any changes are bitterly fought – especially by those losing relative power.

The Five Presidents' Report (see p. 17) puts particular emphasis on improving democratic accountability, with a greater involvement of the European Parliament on behalf of the citizens of Europe. But the intention is to reinforce the role of the national Parliaments – a shared aim with the UK. The only question to be answered is: How? The legislative process of the EU is already cumbersome and most observers are wary of adding what would effectively be a third Chamber of national Parliaments as a further layer.

Effective democratic accountability at the national level should mean that a government can only take a position in Council votes if it has the support of its own Parliament on the matter discussed. So UK suggestions for greater involvement of national Parliaments should be welcome - providing it is a consultative process rather than an attempt to insert a new blocking mechanism. However, most EU observers are well aware that the House of Commons' scrutiny mechanism is ineffectual –although they fully recognise the excellent work done by the un-elected House of Lords.

In any case, any attempt to shift power to the national Parliaments will almost certainly require the agreement of the European Parliament. That may be very difficult to obtain just at the moment when the Five Presidents' Report is proposing that the European Parliament acquire additional influence as the direct representative of the peoples of Europe.

European Parliament

The UK has 73 seats out of 751 – 9.7% of the total. Italy also has 73 seats while France is at 74 and Germany 96. So, in principle, the UK is the third most influential state. However, many observers argue that the UK punches below its weight in the Parliament, an observation that probably reflects the position whereby both UKIP and Conservatives – with 44 MEPs (60% of the UK representation) –are outside the two political families that form a de facto coalition in the Parliament. As the UK's GDP is substantially larger than that of France and with a higher population, the UK should move into the second most numerous position in the next few years, although effective power will depend on the political balance of the UK's MEPs.

Qualified majority in Council

A new voting rule has applied in Council since November 2014 for a "double majority". A proposal now needs support from 55% of States (16 out of 28), representing at least 65% of the EU population. **The majority of the population is measured by the governments casting their vote in Council – necessarily with the support of their national Parliament.**

Under this new system, the UK has a 12.73% share of the vote – up by more than half from its share of 8.2% under the old system – and just third behind France. As the UK population rises, the UK share will also rise. According to the United Nations' population forecast, the UK population should exceed that of France by 2020 – making Great Britain the second most powerful member of the EU, especially when Parliament seats are adjusted.

In the near future, leaving the EU would mean walking away from the second most-powerful seat in the world's largest trading bloc.

The Eurozone and QMV

The 19 members of the Eurozone already exceed the minimum 16 states required to approve a proposal and the have 66% of the population – just above the 65% threshold.

Looking ahead to 2020/2025: Romania, Bulgaria, Croatia and Czech may be in ERM II and approaching Euro membership. By the end of that time frame, the Eurozone could move up to 23 states and 75% of the population – an overwhelming QMV vote. Polish membership would take the population coverage up to 82%.

As the Single Market should be nearer to completion than it is today, there would be relatively few debates about fundamental new competences. Instead, the ordinary legislative work may have more to do with regular reviews of existing legislation to tweak it for new developments. So the ECOFIN Council would have much less work. Commissioner Hill has stated that there will be 100 reviews of financial legislation in the next five years – underlining the shift to a reviewing process.

A powerful implication could follow: the economic governance issues that apply only to the Eurozone would be at the heart of political activity in the economic field. The operation of the European Semester annual cycle of euro area peer group review of economic policy – with the powerful expectation that states will respond – will make the Eurogroup the main focus of the political economy of Europe. **As euro**

non-members come to realise that the economic sea in which they swim is actually being determined by the Eurozone, there may well be a powerful gravitational pull to join the influencers.

"Balance of Competences" between the EU and its Member States

The Single Market required a pooling of sovereignty over many basic trade issues so that non-tariff barriers to cross-border trade were removed. Naturally, this required each state to permit goods/services from other EU states to be able to compete freely on its territory. Otherwise, the forces of protectionism would simply substitute domestic `trading standards' and alleged safety concerns for explicit tariffs on imports.

Even at this stage of a Single Market that is acknowledged by Prime Minster Cameron as incomplete, questions are being asked about whether too many powers – competences – have been transferred to Europe. The breadth of the Single Market touches on a vast array of regulations that reach into almost every facet of economic life. In the UK, this has prompted demands for a repatriation of powers from `Brussels'.

So the balance of powers between the EU and its members was analysed in immense detail by the UK Government before the General Election in May 2015 – the Balance of Competences Review. Though this was undertaken from a specifically British perspective, the exercise was followed with great interest elsewhere in the EU because an excessive shift of powers away from Britain would be mirrored in most other states. The UK government did not publish any conclusions but the private sector was more forthcoming in two major studies.

- CEPS: "More reform than renegotiation or repatriation"[1]

  The CEPS conclusions are clear: "From political speeches in the UK one can identify three different types of possible demand: reform of EU policies, renegotiation of the UK's specific terms of membership, and repatriation of competences from the EU back to the member states. As most of the reviews are now complete, three points are becoming increasingly clear:

  i) The reform agenda – past, present or future - concerns virtually every branch of EU policy, including several cases reviewed here that are central to stated UK economic interests.

  The argument that the EU is 'unreformable' is shown to be a myth.

---

[1]British Balance of Competence Reviews, Part III: More reform than renegotiation or repatriation, Centre for European Policy Studies (CEPS), 8 Deceber 2014, http://www.ceps.be/publications/british-balance-competence-reviews-part-iii-more-reform-renegotiation-or-repatriation.

ii) The highly sensitive cases of immigration from the EU and social policies may translate into requests for renegotiation of specific conditions for the UK, but further large-scale opt-outs, as in the case of the euro and justice and home affairs, are implausible.

iii) While demands for repatriation of EU competences are voiced in general terms in public debate in the UK, no specific proposals emerge from the evidence as regards competences at the level at which they are identified in the treaties, and there is no chance of achieving consensus for such ideas among member states." [Author's emphasis]

- European Movement Senior European Experts: "Britain & the EU: What the Balance of Competences Review Found"[2]

This group includes many former UK Ambassadors to the EU and former senior EU officials – the classic `insiders' on such topics. They pointed out that "In no case does the Review recommend the transfer of competence to the national level." They also pointed to the long list of `opt-outs' that the UK already has (see p. 38).

It is clear that even the existing depth of the Single Market does not pose problems for the UK and so, correspondingly, should not be a concern to more integrationist-minded states.

Part I: The forces working on the other 27 states

Summary: European `visions' are not received well in the UK and are usually ignored, but the chances of reaching a particular goal are much reduced if you do not have a vision of where you want to go! Unsurprisingly, the EU has struggled so far to create a robust and incisive response to an economic crisis that should never have happened if `the rules' had been obeyed. Once the darkest moments of the crisis had passed, EU leaders began to create a vision of a union that would not have to endure such problems again. Following the election of Commission President Juncker, this somewhat vague vision has been crystallised as the Five Presidents' Report with a final deadline of 2025 – a decade ahead – to complete the economic and monetary union. There are

[2] European Movement, SEE Briefing "Britain & the EU: What the Balance of Competences Review Found", https://view.publitas.com/british-influence/britain-the-eu-what-the-balance-of-competences-review-found/page/1

many problems to be resolved – not least migration. However, the core problem for Britain is that if anything approaching the `Favourable Scenario' materialises as a natural result of the improving competitiveness that Prime Minister Cameron seeks, then the Eurozone is likely to expand substantially. It is quite conceivable that there will be only one OUT at the end of this decade: the UK.

EU level vision:

The Five Presidents' Report/Completing EMU

After the most acute phase of the financial crisis, the leadership of the European Union produced several reports on their vision for a process of adjustment to the new world. But that world has also been changing swiftly. As examples, the Greek crisis went through a new phase last year; Russia suddenly annexed the Crimea and started a proxy war with the Ukraine; the Syrian conflict surprisingly suddenly precipitated a sudden influx of a million refugees. The list could go on.

The British political class seems to have a complete aversion to noticing the development of `visions' from Europe. But the foundation of the "European vision" was actually laid by Winston Churchill in 1946. It has crystallised in several step changes in the decades since and the latest phase of the vision took shape under then-Council President van Rompuy in mid-2012. The latest iteration is the Five Presidents' Report in June 2015.

This Report laid out a two-stage process to completing EMU – by 2025 at the latest. The breadth of the economic, financial and political plan is immediately apparent from the chapter headings listed below and the Roadmap is attached as Appendix I:

1. The Nature of a Deep, Genuine and Fair Economic and Monetary Union
2. Towards Economic Union - Convergence, Prosperity and Social Cohesion
3. Towards Financial Union - Integrated Finance for an Integrated Economy
4. Towards Fiscal Union - an Integrated Framework for Sound and Integrated Fiscal Policies
5. Democratic Accountability, Legitimacy and Institutional Strengthening

The Commission's subsequent "Communication on steps towards Completing Economic and Monetary Union" in October 2015 set out some concrete steps for achieving Stage 1, and then on to Stage 2. These include that "the European Parliament should organise itself to assume its role in matters pertaining especially to the euro area… However, as the euro area evolves towards a genuine EMU, some decisions will increasingly need to be made collectively while ensuring democratic accountability and legitimacy… A future euro area treasury could be the place for such collective decision-making."

It also proposed a fiscal stabilisation function for the euro area with guiding principles "It should not lead to permanent transfers between countries… should not undermine the incentives for sound fiscal policy-making … be tightly linked to compliance with the broad EU governance framework… should not be an instrument for crisis management and should help to prevent crises - making future interventions by the ESM less likely."

Stage 1 runs from July 2015 to June 2017 as a period of 'deepening by doing'.

Stage 2 (`completing EMU') should run from July 2017 to 2025 at the latest and include `concrete measures of a more far-reaching nature…for each euro area Member State to participate in a shock absorption mechanism for the euro area.'

Given the enormous importance of other items on the agenda for the European Council of 17/18 December 2015, the Council's Conclusions were surprisingly positive. Work is to proceed rapidly on aspects that will be most welcome to Prime Minister Cameron such as boosting competitiveness. ECOFIN is to report back by June on the priority items. On the profound reform of the European Union, the Heads of Government stated "The legal, economic and political aspects of the more long-term measures contained in the report need to be further explored. Further to additional work to be undertaken by the Commission and the Council, the European Council will come back to those measures at the latest by the end of 2017." In the next two years, many governments will refresh their mandate from their people so these topics will be discussed. In particular, this means the big issues may be tackled by a future Chancellor of Germany and a future President of France. [3]

The Single Market

Ever since his 2013 `Bloomberg' speech, the Prime Minister has emphasised the huge value of a successful Single Market for the UK. As he put in his letter to President Tusk: "The United Kingdom has always been a champion of making Europe more competitive." However, there is a BUT… "The integrity of the Single Market must be protected."

---

[3] For a more detailed analysis of the proposed changes to economic governance, see Graham Bishop's publication "Completing Economic and Monetary Union: the Role of Eurobills" http://www.grahambishop.com/ViewArticle.aspx?ID=29913&CAT_ID=542&Search=

This is code for ensuring that a progressively integrating (and probably expanding) euro area should not explicitly caucus against the UK's interests. But Mr. Cameron explicitly excluded in his letter seeking veto powers. In part, that may have been a simple recognition that it would be politically impossible. But it is possible that he would have felt the restraining hand of history. Probably the greatest European achievement of Prime Minister Thatcher was the 1985 Single European Act that abolished the veto in Single Market matters and introduced Qualified Majority Voting (see above).

For the rest of the EU, demanding an improved Single Market is like asking to walk through an open door. Commission President Juncker made this a centre-piece of his election campaign; pledged to the European Council and the European Parliament that he would achieve it and made it the top priority of his term of office.

On 28 October 2015, the "European Commission presented a roadmap to deliver on President Juncker's political commitment to unleash the full potential of the Single Market and make it the launch-pad for Europe to thrive in the global economy." The programme is entitled "A deeper and fairer Single Market: Commission boosts opportunities for citizens and business". The concept should appeal to the Prime Minister – just as it did to his predecessor three decades ago.

But why is it necessary to make this still a policy priority thirty years later? After all this time, surely all barriers have been swept away? Sadly, we have all recognised that those economic agents who benefit from barriers that have the effect of shutting out foreign competition have proven very adept at protecting their vested interests. A small example of the potential gains where significant economic barriers remain affecting the UK: The Commission estimates that a more ambitious implementation of the Services Directive would add 1.8 % of EU GDP.

In the Commission's words "The Single Market is one of Europe's greatest achievements, designed to allow goods, services, capital and people to move more freely. It offers opportunities for professionals and businesses and a greater choice and lower prices for consumers. It enables people to travel, live, work and study wherever they wish. But these opportunities do not always materialise, because single market rules are not known, not implemented or simply jeopardised by unjustified barriers."

This statement also highlights the role of free movement of people – epitomised by the Schengen Agreement. Widespread internal border controls would quickly stifle many key aspects of the Single Market and return Europe to a series of national compartments. That is why free movement of people – as opposed to free movement of benefit claimants – is an absolute red line for many other governments in these negotiations.

The scale of the Commission's ambitions is clear from the summary of its proposals – see Appendix II.

Political: Migrant/refugee situation

The New Year brought a new rash of border controls within the Schengen area, underlining the urgency of the need to control the external borders of the Schengen area. The need for action was reinforced by the Paris attacks in November 2015 and the subsequent meeting of Interior Ministers re-iterated that existing plans must be implemented fully and rapidly. On 15th December, the Commission announced a detailed proposal to set up a "European Border and Coast Guard". The subsequent European Council meeting agreed that the Commission proposal should be enacted by June 2016.

It is clear that national sovereignty remains a key issue for states such as Greece, which wishes to remove the key right of the Border Force to intervene without the permission of the host state – in extreme situations. Nonetheless, Frontex was able to deploy 300 personnel and 15 vessels on 29th December 2015 in response to the Greek "request" for assistance at the beginning of December, rather than face the country's immediate exclusion from Schengen.

In September 2015, the Commission adopted "an important set of measures to manage the EU's external borders and protect our Schengen area without internal borders. Today's proposals will help to manage migration more effectively, improve the internal security of the European Union, and safeguard the principle of free movement of persons. The Commission is proposing to establish a European Border and Coast Guard to ensure a strong and shared management of the external borders."

According to the proposal, the powers of the new European Border and Coast Guard will include:

- A major increase in staff. "A rapid reserve pool of border guards and technical equipment: The Agency will be able to draw on at least 1,500 experts that can be deployed in under 3 days… The new Agency's human resources will more than double that of Frontex, to reach 1,000 permanent staff, including field operatives, by 2020." (The UK Border Force alone has 8,000 employees.)

- A major constitutional innovation is being forced by the magnitude of this crisis. "The right to intervene: Member States can request joint operations and rapid border interventions, and deployment of the European Border and Coast Guard Teams to support these. Where deficiencies persist or where a Member State is under significant migratory pressure putting in peril the Schengen area and national action is not forthcoming or not enough, the Commission will be able to adopt an implementing decision determining that the situation at a particular section of the external borders requires urgent action at European level. This will allow the Agency to step in and deploy European Border and Coast Guard Teams to ensure that action is taken on the ground even when a Member State is unable or unwilling to take the necessary measures."

- Probably another major constitutional event will occur when a European Union force is empowered to operate outside the Union's territory on behalf of the Union. "A mandate to work in third countries: The Agency will have a new mandate to send liaison officers to and launch joint operations with neighbouring third countries, including operating on their territory."

The force of events has correspondingly required the emergence of major innovations in Union policy. On the one hand, €1 billion of Union money is to be made available to Turkey to stem the migrant flow from its side – with another €2 billion from member state sources. The carrot is further enhanced by the offer to re-start accession negotiations. On the other hand, the Union will equip itself with its own Border Guard that can – in the extreme – operate on a Member's territory without the Member's permission.

National Level

Political: Elections to end-2017

Each head of Government sitting round the EU negotiating table on 18/19 February 2016 will be thinking of three things: (i) their own future as Head of Government in their home country (ii) the future of Europe and (iii) the future of the UK. Sadly, it is likely to be in that order of priority. In days gone by, the future of Europe may have loomed larger for some statesmen… but not today (with the possible exception of Chancellor Merkel).

2015

Poland has recently elected a new right-wing government that is taking a far harder line on European matters. Indeed, the new approach to controlling the media is creating great concern around the rest of the EU. Even so, the new Polish Government has made little secret of its intense opposition to any UK actions that discriminate against its own citizens.

Spanish elections on 20th December failed to produce a clear result. Moreover, the Catalan regional election also failed to produce a viable regional government amidst a fracturing of support for Catalan independence. If a new regional election has to be called, that would probably be on 11th March. So Acting Prime Minister Rajoy would be weighing very carefully any decisions in Brussels on 18/19 February that could be read across to Catalan independence – which he opposes strongly. There may yet be a new General Election in Spain.

2016

18/19 February: European Council: EU negotiation will be the major item.

26th February –3rd April at the latest: Irish Parliamentary elections: according to Politico/Spillane "The more likely date will be 26th February as this will mean that the new government will be in place for the 100th Anniversary of 1916 and St Patrick's Day. It will more than likely be called on 29th January after the Labour and Fine Gael National Conferences." Brexit is hugely important to Ireland and any Government is likely to do whatever it can to reduce Brexit risk.

5th March: Slovakian Parliamentary elections - Robert Fico looks set to be re-elected as Prime Minister.

6th April: Netherlands Referendum - The referendum question will be: "Are you for or against the Approval Act of the Association Agreement between the European Union and Ukraine?" The decision to hold a referendum was made after more than 427,000 valid requests were received within six weeks, more than the required number of 300,000 requests. Clearly Prime Minister Rutte will be weighing up any potentially inflammatory impact from the Brexit discussion.

28th April: Austrian Presidency election: leading candidates in the opinion polls are a Green and an independent – former President of the Supreme Court.

June- September: Brexit Referendum?

October: Czech Senate elections — but it has little power.

TBD: Romanian Parliamentary elections – after a wave of scandals and party re-groupings, the situation is very fluid. However, the result may well influence any decision about formally targeting euro membership.

Autumn: Italy – Possible Constitutional referendum to approve the `Renzi' reforms of the Senate's powers. Success would underpin Renzi's political power and thus the highly significant labour market reforms that he has introduced. (Labour market reforms by the UK's Thatcher in the 1980s and Germany's Schröder in the 2000's laid the foundation of subsequent economic growth in both states.)

2017

By 15th March: Netherlands Parliamentary elections – Opinion polls currently suggest Geert Wilders' PVV party could double its seats and emerge as the largest bloc in Parliament. Any potential fallout from UK developments will be carefully considered by the Government as it moves towards this poll.

April-May: French Presidential elections – The key question dominating French politics in the run up to the December 2015 regional elections was the potential challenge from Marine Le Pen's National Front. In the event, the national Front topped the poll in the first round but failed to gain any regions in the run-off as turnout surged and massive tactical voting prevented their advance. A Eurosceptic vote for Britain to leave the EU could well fire up the right wing in France with their demands for a `Frexit' referendum, but the 6m National Front votes last December are unlikely to be enough to catch up with the 10.3m for Hollande or 9.7m for Sarkozy polled in the 2012 election.

June: French Parliamentary elections – As the Parliament election comes shortly after the Presidential election, it gives voters a second chance for tactical voting to balance the Presidential result. At the 2012 election, turnout at 55-57% was well down.

October: (latest) Czech Parliamentary elections - Despite public opposition, the current Coalition has already declared that if re-elected it will lay out a roadmap for euro adoption.

22nd October: latest (27th August earliest): German Parliamentary elections.

Could the Eurozone expand further?

Basic economic statistics

If they had the political inclination, several OUTs could join the euro – on the basis of their public finance. So the Sixth Round of the European Semester – to be finalised in June 2016 – may give a good opportunity to see what they would further need to achieve in terms of their overall economic structure to consider joining in the foreseeable future – say by the end of Stage 2 in 2025.

2016 forecast	**Euro**	**OUT**	**UK**	**PL**	**RO**	**CZ**	**SE**	**HU**	**BG**	**DK**	**CR**
Pop - m	***342***	*171*	*66*	*38*	*20*	*11*	*10*	*10*	*7*	*6*	*4*
GDP - € billion	***10693***	*4372*	*2111*	*790*	*326*	*267*	*363*	*201*	*97*	*206*	*72*
GDP Per head	***98***		*101*	*65*	*52*	*80*	*114*	*64*	*43*	*113*	*54*
Deficit-%GDP	***-1.8***		*-3.0*	*-2.8*	*-2.8*	*-1.3*	*-1.3*	*-2.1*	*-2.7*	*-2.5*	*-4.7*
Debt-% GDP	***93***		*88*	*52*	*41*	*41*	*44*	*74*	*33*	*39*	*92*
Growth, %	***2***		*2*	*3*	*4*	*2*	*3*	*2*	*1*	*2*	*1*
Unemp. - %	***11***		*5*	*7*	*7*	*5*	*8*	*7*	*9*	*6*	*16*
Current a/c - % GDP	***4***		*-4*	*-1*	*-2*	*-2*	*6*	*5*	*1*	*7*	*3*

Note: GDP per head: EU 15=100

Source: European Commission November 2015 Forecasts

Note: GDP per head: EU 15=100

Latest comments on `euro adoption' by OUTs

Background – The damage done by the Greek crisis to the image of euro membership as a hallmark of sound economic governance cannot be overestimated. Moreover, some of the OUTs are poorer than Greece and the idea that they would have to contribute to future bailouts is as repugnant as it was to the poorer states IN the euro area. So probably a necessary condition for a further wave of euro adoption is that Greece gets on to a solid path of recovery and thus the risk of further bailouts recedes substantially. The renewed tension between Greece and its creditors at the beginning of 2016 is not helpful and may serve to postpone recovery yet again.

Economic situation – The 2016 European Semester[4] started with the Annual Growth Survey[5] (AGS), underlining the Commission's three-pillar jobs and growth strategy: investment, structural reforms to modernise economies and ensure responsible fiscal policies. The Commission's plan is to revamp the Semester process in 2016 and adopt a tougher approach: "The Excessive Imbalances Procedure … will be used in case of severe macroeconomic imbalances that jeopardise the proper functioning of the economic and monetary union, like those that led to the crises. The Commission will also invite greater Council involvement in the specific monitoring of

[4] http://ec.europa.eu/europe2020/making-it-happen/index_en.htm
[5] http://ec.europa.eu/europe2020/making-it-happen/annual-growth-surveys/index_en.htm

countries with excessive imbalances for which the Excessive Imbalances Procedure is not activated." This is code for a greater collective oversight by the Eurogroup of every aspect of economic policy and not just public finances.

The AGS reported that several OUTs would be subjected to an In Depth Review (IDR) whose conclusion will be finally signed off by the European Council in June. These include Romania, Sweden, Hungary, Bulgaria, Croatia and - for reference - the UK. Given the medium term nature of these recommendations, it would be unlikely that any of these states would be in an economic situation that would make them candidates for euro membership soon. None of them – or the other OUTS except Denmark – have even begun the two-year trial period of ERM II membership.

Public opinion – the Commission sponsors an annual survey of public opinion in the OUTs and the latest (Eurobarometer 418) was published in May 2015.

- "A majority is in favour of joining the euro in four countries: Romania (68%), Hungary (60%), Bulgaria (55%) and Croatia (53%).
- A relative majority of respondents (42%) would like the euro to be introduced as late as possible. Only people in Romania favour early adoption of the currency."

Political comments

- Romania: for several years, the government has had a formal policy of aiming to adopt the euro. Though there has been slippage of the date, the current Convergence Plan continues to affirm 2019 as the target date to adopt the euro despite scepticism about the timetable from, amongst others, the Governor of the Central Bank. However, Romania has applied to participate in Banking Union.
- Hungary: Prime Minister Orbán stated in June 2015 that his government will no longer entertain the idea of replacing the forint with the euro in 2020, as was previously suggested.
- Bulgaria: In early 2015, Bulgaria planned to start talks on adopting the euro. In July, it established a Council to propose a specific date – though only once the Greek crisis is resolved. In the interim, it is considering an application for the ERM II in 2018.
- Croatia: The President of Croatia favours joining the euro by 2020 but her role is somewhat ceremonial and the November general election has not produced a conclusive result at the time of writing.

- Poland: The recent election of the Law and Justice Party to become the government of Poland for the next five year term suggests that adoption of the euro will be off the political agenda until there is a change of government.

- Denmark: The new minority government is dependent on support from an anti-EU party that nearly doubled its vote to become the second largest party. Following the December referendum rejection by 53% of voters on co-operation on justice and home affairs, any idea of a euro referendum is probably on the back burner.

- Sweden: The Eurobarometer poll reported 32 percent of Swedes in favour of adopting the euro (up by 9 percent from November 2014), but 66 percent opposed (7 percent lower than November 2014). With such strong public opposition, it seems unlikely that there will be a political push towards euro membership.

- Czech Republic: A May 2015 poll gave 69 percent against euro membership with only 24 percent supporting it. Unsurprisingly, the coalition government had announced the previous month that it had agreed neither to set a euro adoption target nor to enter ERM II before the next General Election – at the latest, in October 2017. But it agreed that if it is re-elected, it would set a deadline of 2020 to agree on a specific euro adoption roadmap.

Conclusions about possible adoption of the euro by current OUTs

By 2020, it seems quite unlikely that any additional states will adopt the euro as their currency.
By 2025 – the planned end-point of Stage 2 of the Five Presidents' plan for completing Economic and Monetary Union - it could be a very different story if the Greek crisis has been seen to have been resolved and the Eurozone is growing again reasonably - the entire focus of current economic policy of the Union. Failure would certainly create a new phase of the euro crisis.

- Romania, Bulgaria, Croatia and Czech Republic may be in ERM II and approaching Euro membership.
- Poland and Hungary will have had elections that could change their government and the current trajectory of economic policy could make euro membership feasible.
- Denmark could join at any time when public opinion moves in favour-given the long-standing success of its very tight ERM relationship

to the euro. Swedish economic policy should give the government of the day an easy option to join if public opinion swings.

For the UK: the ink may be just about dry on any Treaty changes that Prime Minister Cameron wins when membership of the Eurozone begins to change significantly. He is clear that Britain wants the Eurozone to succeed. But if it does, then it seems probable that – at most – there will only be five OUTs left by 2025. That very success could well tip up to four other states into membership – potentially leaving the UK standing alone.

At present, the only example of Britain obtaining special treatment for the OUTs is a highly technical example of European Banking Authority delegated acts. This hinges on there being "four or more" OUTs. British electors will have to think very carefully about the limiting case of Britain being the only OUT by 2025. The Prime Minister's letter to President Tusk was explicit that the UK does not seek a veto – which would be the case if there were only one OUT.

Two Scenarios for EU28 for the decade to 2025

Scenario analysis is a powerful analytical tool to consider possible outcomes in an uncertain world. Its strength lies in the requirement for rigorously following through the logical consequences of any particular sequence of actions so each step has to be logically consistent with the whole stream of events. The scenario-builder cannot pick and choose from inconsistent outcomes.

The European Union has now laid out a vision for achieving a good outcome to the problems that currently exist – the Five Presidents' Report. Complete success for that process would represent the most `Favourable Scenario'. The huge efforts being made by the EU to improve its competitiveness (strongly supported by the UK) and growing signs of some success, point to an outcome towards that end of the spectrum of possibilities. On the other side, many UK commentators point out various black possibilities that often seem inconsistent with each other.

The significance to the Brexit debate is clear: an EU/Eurozone that is recovering its self-confidence amidst economic expansion and improving levels of employment/ voter satisfaction will be far more able to tolerate `awkward' behaviour by a major member. That is why the UK Government stresses so strongly its desire to see a successful euro-zone – implicitly, an outcome that is much more towards the more favourable end of the spectrum. On the other hand, if that member's behaviour is blamed for a disastrous outcome, then attitudes to such states are likely to be very much harder.

The Favourable Scenario for the euro-INs

- The Five Presidents' Report is implemented fully by 2025.
- The Single Market reforms are completed in all their components including Digital, Energy, Services and Consumers – boosting competitiveness, and thus productivity.
- Trade agreements are concluded with the US and other major trading blocs.
- As a result of such wide-ranging reforms, growth in output per employee rises from under 1% annually back to 2% annually - the levels of the 1980s and 1990s. (This is still half the levels achieved in the UK in the 1980s as Mrs Thatcher's reforms bore fruit – triggering growth rates of 3-5%, surging tax revenues, rising employment etc.)
- With good productivity and falling unemployment, the euro-zone has the resources for a good decade before the aging/declining population becomes a problem.
- Eurozone economic management would be vindicated and public attitudes amongst many OUTs would be transformed as their neighbours grew rapidly and their collective economic management system – the European Semester – seemed to work.
- This outcome would provide a magnetic attraction to many OUTs and euro membership would rise substantially – perhaps to the point that the UK would be the only remaining OUT at the end of the decade.

The Black Scenario – especially for Britain

- Migration pressures force a major disruption to the Schengen agreement.
- The Single Market fractures due to the simple problem of moving people and goods across borders. So the drive to deepen it falls away, and covert barriers appear again.
- Low growth and continuing high unemployment trigger a further rise in nationalist/populist sentiment.
- Brexit sets an example and some other states secede – thereby leaving the euro.

- Trade barriers proliferate amidst competitive currency devaluations and huge flows of speculative capital.

- Controls on cross-border capital flows re-appear – completing the dismemberment of the Single Market.

- For Britain, more than 40% of exports to the rest of the EU could face new tariff and non-tariff barriers, as well as competitive devaluations. Moreover, those competitive devaluations by our EU competitors would also reduce our competitiveness in the non-EU markets representing the other 60% of our exports.

Part II: The British Problem

Summary: The British Government's `demands' are encapsulated in four `baskets': economic governance; competitiveness; sovereignty and immigration. These can be broken down into at least 14 specific items and 11 of those (so at least 80%) are easily met – or already have been. The politically neuralgic topic of immigration may be able to be shoehorned into existing Treaty `safeguards'. But the economic impact of reduced public spending on in-work benefits appears minor (£1.5 bn) when compared with potential Brexit losses of some of the City's £60 bn contribution to tax revenues. The tough proposal for a European Border and Coast Guard is unlikely to have been implemented by Referendum Day and any acrimonious failure even to agree it may be particularly unhelpful. The UK does not seek a veto over Eurozone actions and wants to ensure it is not liable for the cost of any Eurozone problems. The obverse must also be true: the Eurozone cannot be liable for any costs arising from another financial crisis in the City.

Cameron letter to Tusk

Discussions with Britain's EU partners had been limited due to the lack of detail about the UK's `demands'. On 10th November 2015, Prime Minister Cameron finally wrote to Council President Tusk (and delivered an explanatory speech) setting out the UK's reform agenda. However, he made the point that "the purpose of this letter is not to describe the precise means, or detailed legal proposals, for bringing the reforms we seek into effect."

The European Council responded on 17/18th December: "The European Council had a political exchange of views on the UK plans for an (in/out) referendum. Following today's substantive and constructive debate, the members of the European Council agreed to work closely together to find mutually satisfactory solutions in all the four areas at the European Council meeting on 18-19 February 2016."

In his letter to President Tusk, Prime Minister Cameron specified four areas for `reform' and key extracts are set out below. It is worth examining these demands in some detail as they are often discussed more in terms of slogans. Many of the items in this lengthy list will be agreed easily – opening the way to a political analysis that a large proportion of the demands have been met completely – 11 of the 14 readily-identifiable items. Such a success would easily be portrayed as a negotiating triumph.

1. Economic Governance

"There are today effectively two sorts of members of the European Union… Euro members and non-Euro members…. Other countries will in due course join the euro. But, for now, there are nine of us outside; and it matters to all of us that the Eurozone succeeds… Nor are we looking for a veto over what is done in the Eurozone. What we seek are legally binding principles that safeguard the operation of the Union for all 28 Member States – and a safeguard mechanism to ensure these principles are respected and enforced.

These principles should include recognition that *(author's comments in italics)*:

- The EU has more than one currency. *[Problematic – the concept of the euro as the currency of the Union is deeply embedded in the Treaty – as a major plank of economic policy. The strength of the UK opt-out is such that this should not be a concern to the UK (see below).]*

- There should be no discrimination and no disadvantage for any business on the basis of the currency of their country. *[Sounds obvious but the devil will be in the detail.]*

- The integrity of the Single Market must be protected. *[The "double majority" voting system for vital aspect of banking regulation may be a model (see below).]*

- Any changes the Eurozone decides to make, such as the creation of a banking union, must be voluntary for non-euro countries, never compulsory. *[Obvious]*

- Taxpayers in non-euro countries should never be financially liable for operations to support the Eurozone as a currency. *[Obvious]*

- ….financial stability and supervision is a key area of competence for national institutions like the Bank of England for non-Euro members. *[Sounds obvious but how to handle cross-border spill-overs into the Eurozone? Who pays? See below.]*

- And any issues that affect all Member States must be discussed and decided by all Member States. *[Obvious]*

2. Competitiveness

… The United Kingdom has always been a champion of making Europe more competitive.

So the United Kingdom welcomes the current European Commission's focus on supporting economic growth and scaling back unnecessary legislation. This has included some important measures that British businesses have called for, such as the further steps towards a single digital market, which could add 3 per cent to EU GDP; and a Capital Markets Union, which will help get finance to entrepreneurs and growing businesses. *[So the UK fully supports one of the major drivers of Commission President Juncker's entire policy. Moreover, two key agreements on data protection – a significant plank of the Digital Single Market – were struck on December 17th. The paradox for the UK is that the more successful the competitiveness drive, the more likely the euro area is to expand over the next decade – perhaps even leaving the UK as the only OUT.]*

The United Kingdom also welcomes the new trade strategy published last month, reflecting an agenda we have been advocating for years and including pursuing potentially massive trade deals with America, China, Japan and ASEAN. *[Again, supporting one of President Juncker's priorities for his term.]*

.. the burden from existing regulation is still too high. So the United Kingdom would like to see a target to cut the total burden on business. *[Another Juncker priority and an agreement between Commission, Council and Parliament was struck on December 15th – ticking an important Cameron `box'.]*

…The United Kingdom believes we should bring together all the different proposals, promises and agreements on the Single Market, on trade, and on cutting regulation into a clear long-term commitment to boost the competitiveness and productivity of the European Union…

3. Sovereignty

..Questions of sovereignty have been central to the debate about the European Union in Britain for many years. I have three proposals in this area.

First, I want to end Britain's obligation to work towards an "ever closer union" as set out in the Treaty. It is very important to make clear that this commitment will no longer apply to the United Kingdom. I want to do this in a formal, legally-binding and irreversible way. *[The commitment is actually to "ever-closer union of the peoples of Europe" not some `super-State'. To put the counter-factual, does the UK wish to divide the people of Europe instead?]*

Second, while the European Parliament plays an important role, I want to enhance the role of national parliaments, by proposing a new arrangement where groups of national parliaments, acting together, can stop unwanted legislative proposals. The precise threshold of national parliaments required will be a matter for the negotiation. *[If this amounts to a back-door change in the careful weighting of the majority voting system, it may trigger great opposition. In any case, the UK is about to become the second most influential member.]*

Third, I want to see the EU's commitments to subsidiarity fully implemented, with clear proposals to achieve that…

In addition, the UK will need confirmation that the EU institutions will fully respect the purpose behind the JHA Protocols in any future proposals dealing with Justice and Home Affairs matters, in particular to preserve the UK's ability to choose to participate. National Security is – and must remain – the sole responsibility of Member States, while recognising the benefits of working together on issues that affect the security of us all.

4. Immigration

The UK believes in an open economy… The issue is one of scale and speed… At the same time, our net migration is running at over 300,000 a year. That is not sustainable… we need to be able to exert greater control on arrivals from inside the EU too.

We need to ensure that when new countries are admitted to the EU in the future, free movement will not apply to those new members until their economies have converged … We also need to crack down on the abuse of free movement, an issue on which I have found wide support in my discussions with colleagues. This includes tougher and longer re-entry bans for fraudsters and people who collude in sham marriages. It means addressing the fact that it is easier for an EU citizen to bring a non-EU spouse to Britain than it is for a British citizen to do the same. It means stronger powers to deport criminals and stop them coming back, as well as preventing entry in the first place. And it means addressing ECJ judgments that have widened the scope of free movement in a way that has made it more difficult to tackle this kind of abuse.

But we need to go further to reduce the numbers coming here. As I have said previously, we can reduce the flow of people coming from within the EU by reducing the draw that our welfare system can exert across Europe. So we have proposed that people coming to Britain from the EU must live here and contribute for four years before they qualify for in-work benefits or social housing. And that we should end the practice of sending child benefit overseas. *[The actual proposals from the UK are economically insignificant to the UK (see below) but politically neuralgic for many EU states. The Treaty provides some safety nets for example in Article 45 (3) "subject to limitations justified on grounds of public policy, public security or public health". Creative use of these may yet offer an acceptable way forward.]*

I understand how difficult some of these issues are for other Member States…"

Next Steps

The precise form all these changes will take will be a matter for the renegotiation… if we are able to reach agreement, it must be on a basis that is legally-binding and irreversible… …and where necessary has force in the Treaties."

Possible Solutions and Mitigations

Migration: Will the timetable of action be swift enough to impact the UK referendum?

- The existing Frontex force is already `assisting' Greece to harden its borders forthwith.
- If Turkey delivers on its side of the bargain, then the flows into Greece could be sharply reduced in the next few months.
- But the 1 million migrants who arrived in 2015 will still be creating distressing, newsworthy events for quite some time to come. Moreover, the tiny percentage who have camped in Calais in an effort to reach the UK are unlikely to diminish noticeably by Referendum Day.
- The referendum campaign could well bracket the final stages of the legislative debate on the Commission's Border Force proposal. It would be very unhelpful to the "Remain In" campaign if the process disintegrated amidst acrimonious sovereignty debates – especially if led by a discredited Greece. That would suggest that the EU is incapable of handling the migration problem.
- On the other hand, it is likely that those arguing for a Brexit will raise the sovereignty flag and argue that Britain should not be part of this sharing. But they will then have to explain to a nervous British public what they would do if France ceased to tolerate the physical UK border being located at Calais (and for Eurostar passengers in Brussels and Paris). The

> fundamental contradiction of their policy would be fully exposed: wanting the EU to fail but unable to explain how the UK would then avoid being engulfed in the subsequent maelstrom.

The economic insignificance of the UK's migration demands

The Prime Minister is prepared to risk the UK risk leaving the European Union to reduce the payment of in-work benefits to EU migrants – saving £1.5 billion of expenditure or about 0.1% of GDP. Brexit could put at risk a significant portion of the City's tax revenue and foreign exchange earnings – each of which runs at more than £60 billion annually.

Stopping the entry of these migrants would remove a very significant safety valve for the UK economy – putting at risk our continued economic growth as we run out of labour. On either count, leaving the EU to reduce the effect of `in-work' benefits may be politically appealing but could be economically disastrous.

In his Chatham House speech accompanying the letter to Council President Tusk, Prime Minister Cameron pointed to the most politically explosive problem area – immigration. "We now know that, at any one time, around 40 percent of all recent European Economic Area migrants are supported by the UK benefits system…… with each family claiming on average around £6,000 a year of in work benefits alone… …and over 10,000 recently-arrived families claiming over £10,000 a year. We need to restore a sense of fairness, and reduce this pull factor subsidised by the taxpayer." The Commission spokesman later described the immigration aspects as the "most problematic" part of the negotiations.

> The stated proportion of claimants was about twice external estimates so the Department for Work and Pensions published its analysis. The DWP underlined the unreliability of its assessment given the sample size of only 5% and the out-of-date data. However, it reported "This represents between 195,000 and 235,000 (numerator) EEA Nationals in recently arrived households claiming benefits or tax credits at March 2013".

Applying the upper estimate to the Prime Minister's speech:

- Each (of 235,000) families claiming £6,000 per year: cost £1.4 billion
- Over 10,000 …claiming over £10,000 per year: cost £0.1 billion

The latest unemployment figures were announced by ONS at the same time:

- "For July to September 2015, 73.7% of people aged from 16 to 64 were in work, the highest employment rate since comparable records began in 1971.

- The unemployment rate for July to September 2015 was 5.3%, down from 6.0% for a year earlier and the lowest since 2008." In the three months to November, the rate fell again to 5.1%

This is excellent news for Britain BUT if the "235,000" had not been here, then the unemployment rate could well have been under 5% and perhaps exacerbating even further the skills shortages that are now reported as a bottle-neck for the UK's economy. This would not be surprising as the Office for Budget Responsibility estimated in July 2015 that the medium term "Non-Accelerating Inflation Rate of Unemployment (NAIRU)" is now 5.4%.

Balance of Competences Review

Those hostile to British membership of the European Union expected this review would identify a swathe of policies for repatriation – and some were overt in looking for items which would require a Treaty change that they knew would be unacceptable to the rest of the EU. That would provide the argument to campaign for OUT.

However, they were deeply disappointed with the Review and very little publicity was given to it – to the extent that the House of Lords was sharply critical of public money being wasted unless the results were properly drawn together.[6] Others were not so reticent and two substantial analyses have been published (see above). Both analyses were damning for the Prime Minister's chances of finding something substantial to bring back from his negotiations. As a result, the PM's letter to President Tusk did not include any request for repatriation of powers – beyond the issue of in-work benefits for EU migrants.

Protecting the UK's role in the Single Market: A double majority

In the EU generally, the term "double majority" refers to the process of a decision by QMV (see above) where there now has to be a majority of members states <u>and</u> a majority of the EU's population voting in favour of a proposal. However, when the term is used by UK commentators, they normally mean a special mechanism to protect the UK's place in specific aspects of the Single Market by requiring a majority of euro-INs and also a majority of euro-OUTs.

[6] House of Lords EU Select Committee, 25 March 2015: "Review of the Balance of Competences between the UK and EU" http://www.parliament.uk/business/committees/committees-a-z/lords-select/eu-select-committee-/news/balance-of-compentences-report-published/

Currently, there is only one example of such a protective mechanism and it is contained in the highly technical legislation for the operation of the European Banking Authority when it sets detailed measures to implement "level 1" – primary – legislation for the banking sector. Article 44 of the EBA Regulation require the Board of Supervisors to adopt `rules of procedure' on a series of immensely detailed possibilities.

Deep in these `rules' is Article 3.6 which lays out the voting rules to deal with two very particular circumstances where the majority might force a Member State to take action against its will (i) Article 17 Breach of Union law and (ii) Article 19 Settlement of disagreements between competent authorities in cross-border situations.

> 3.6. With regard to decisions in accordance with Articles 17 and 19 of the Regulation, the decision … shall be adopted by a simple majority of the voting members of the Board of Supervisors, which shall include a simple majority of … [euro] participating Member States and a simple majority of its members from competent authorities of non-participating Member States. From the date when four or fewer voting members are from … non-participating Member States, the decision proposed by the panel shall be adopted by a simple majority of the voting members of the Board of Supervisors, which shall include at least one vote from … non-participating Member States.

This legislation is to be reviewed by 1 January 2017 and every three years afterwards. It provides a model for a protective mechanism in the extreme case where a state believes its sovereignty is genuinely being impinged upon. However, the concept becomes ever-more difficult as the number of non-euro states falls. In the limiting case of only one non-euro state, then these rules appear to give that state a veto. Prime Minister Cameron was explicit in his letter to President Tusk that he did not seek a veto.

It should be well within the capability of the EU and UK negotiators to propose `horizontal' legislation that would import this into all single market legislation – to deal with the extreme situation of direct enforcement onto an unwilling state.

However, the converse of this approach is that Eurozone states cannot be forced to provide financial support for the stability of a euro-OUT at times of stress (see below).

`Brexit' versus `Brin EU/Brout Euro'

Summary: Britain is already `out' of many core policies of the EU – as is evident from the lengthy list (see below). There is great goodwill towards the UK and a real willingness to find a `fair' solution. But if an agreement cannot be reached and fears of a de-stabilising Brexit materialise, then it is difficult to see the goodwill remaining and producing a harmonious exit deal on trade relations. This would have a particular impact on the City - the Favourable Scenario for the deepening integration of EU27 already makes the status quo of today - Brin EU/Brout Euro – look increasingly difficult to sustain by the end of a further decade of evolution.

British opt-outs from core EU policies

Economic and Monetary Union (EMU) (For many of these policies, the UK is subject to analysis – but not to sanctions for breaching them.)

- Non-member of the euro
- Treaty on Stability, Co-ordination and Growth (TSCG)
- Euro Plus Pact
- Fiscal Compact
- Stability and Growth Pact (SGP)
- Excessive Deficit Procedure (EDP)
- Six Pack/Two Pack
- Banking union – no financial liability will fall upon non-members
- Financial Transaction Tax (FTT) – should it ever come into existence

Freedom, security and justice The UK has the right to opt-out of legislation relating to justice and home affairs as Protocol 36 of the Lisbon Treaty grants the UK has the right to opt-in/out of individual pieces of legislation. The UK was granted a block opt-out of all JHA legislation that came into force before the Lisbon treaty, 130 measures in total. Last year, the UK chose to opt back in to the 35 of those including the European Arrest Warrant and Europol.

Schengen agreement on free movement of people

Charter of Fundamental Human Rights

Goodwill towards the UK

Commission President Juncker – State of the Union message to European Parliament – September 2015 "I am totally convinced that we will have a fair deal with Britain… I believe that the EU is better with Britain in it and that Britain is better within the EU.'

Council President Tusk – letter to the European Council following receipt of Prime Minister Cameron's letter (author's comments in bold):

"1. On the relations between the euro ins and outs we could search for an agreement around a set of principles that will ensure the possibility for the euro area to develop further and be efficient while avoiding any kind of discrimination vis-à-vis Member States that are not yet, or, in some cases, will not be part of the euro. We are also looking into the possibility of a mechanism that will support these principles by allowing Member States that are not in the euro the opportunity to raise concerns, and have them heard, if they feel that these principles are not being followed, without this turning into a veto right." ***The key point is that Prime Minister Cameron did not ask for a veto because he knew it would be impossible. The real difficulty will come as the euro area expands and the non-euro members move ever closer to asking for veto rights.***

"2. On competitiveness, there is a very strong determination to promote this objective and to fully use the potential of the internal market in all its components. Everybody agrees on the need to further work on better regulation and on lessening the burdens on business while maintaining high standards. The contribution of trade to growth is also very important in this respect, in particular trade agreements with fast growing parts of the world." ***Two obvious wins for Cameron.***

"3. The third basket concerns sovereignty. There is wide agreement that the concept of "ever closer union among the peoples" allows for various paths of integration for different countries. Those that want to deepen integration can move ahead, while respecting the wish of those who do not want to deepen any further. There is also a largely shared view on the importance of the role of national parliaments within the Union as well as strong emphasis on the principle of subsidiarity." ***Former Council President Van Rompuy obtained agreement on the concept of "various paths of integration" at the European Council meeting in Ypres at the centenary of the outbreak of the First Wold War – but Cameron wants to scrap the objective, rather than just the paths. The "largely shared view" on the role of national Parliaments could turn out to conceal a wide gulf over any attempt to make an effective change to voting weights by substituting Parliaments for national governments.***

Moreover, the European Parliament can be expected to resist anything that trims its new found powers, and the rise in its influence that is likely to flow from the Five Presidents' Report.

"4. The fourth basket on social benefits and the free movement of persons is the most delicate and will require a substantive political debate at our December meeting…" ***This is the neuralgic political issue, yet its economic significance is surprisingly limited – see above – but an existing safeguard clause may yet be able to square the circle.***

"… all Member States and the institutions must show readiness for compromise for this process to succeed. Our goal is to find solutions that will meet the expectations of the British Prime Minister, while cementing the foundations on which the EU is based. Uncertainty about the future of the UK in the European Union is a destabilizing factor. That is why we must find a way to answer the British concerns as quickly as possible." ***EU27 recognises the risk of destabilising the whole EU. But if British intransigence did result in a destabilising Brexit, would EU27 really give the UK a favourable trade deal immediately afterwards?***

Economic Importance of the City

A key factor in the Brexit debate is the role of the UK as an OUT, but home to the financial heart of the EU as a whole. The financial services sector is colloquially called `the City' but is actually widely spread across the UK. The importance flows both ways and TheCity(UK) produces excellent statistics[7] (Key Facts about the UK as an International Financial Centre report 2015) to demonstrate this:

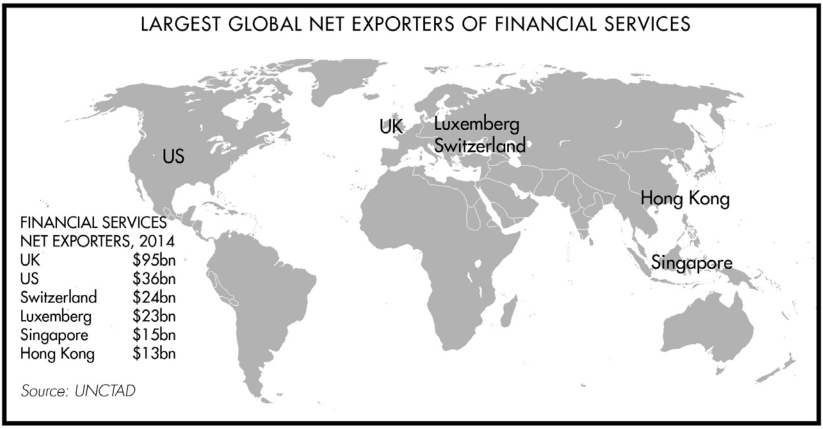
- The table above shows the UK as the outlier in terms of its massive deficit with the rest of the world. At a forecast 4% of GDP in 2016, the UK deficit is the biggest in the EU and is nearly twice the next largest apart from Cyprus. TheCity(UK) research shows that the UK financial services industry produced its highest ever trade surplus in 2014 - £62bn. With legal services, accountancy and management consultancy, the surplus reached £71 bn. After taking account of this massive surplus, the UK still recorded a current account deficit of £98 bn that year.

  The ONS remarked "The deficit in 2014 equated to 5.5% of GDP at current market prices. This was the largest annual deficit as a percentage of GDP at current market prices since annual records began in 1948". Without any of the City contribution, the deficit would have been nearly 10% of GDP – a scale of deficit without any parallel in the industrialised

[7] TheCity(UK): "Key Facts about the UK as an International Financial Centre report 2015", http://www.thecityuk.com/research/our-work/reports-list/key-facts-about-the-uk-as-an-international-financial-centre-report-2015/

world. The continued success of the "City" remains absolutely vital to the UK's economic future.

- On the other side of the coin, the City is the EU's dominant financial centre – certainly in terms of exporting financial services. In the event of Brexit, what would happen? It is impossible to answer that question decisively – but it would be unlikely to happen swiftly and cleanly. The idea of funding the EU economy via Capital Market Union would have to be put on hold for several years – with major, adverse consequence for the economy of the INs.



Implications for the City of London

The foreign exchange earnings and tax revenues generated by the UK's financial services sector are vital to the UK's economic future – see comments above. A similar analysis can be made for all export sectors. However the risks to the City are particularly clear-cut.

Brexit – `Equivalence' is vital

As the US Federal Reserve Board begins to raise interest rates, there may be a feeling that the financial crisis is over and thus, correspondingly, perhaps the tsunami of financial regulatory measures may be relaxed. That is not the case. The lessons learnt in the heat of the crisis are now hard-coded into the genetic structure of global financial regulations and cannot just be ignored if they happen to be inconvenient. This reality may be particularly unwelcome for British advocates of leaving the EU and converting British financial regulations into a system based on the general principles laid down by international bodies. The British Commissioner Lord Hill has spoken trenchantly on this issue in the recent past (see below).

Lehman Brothers failed in September 2008 and the entire financial world trembled at the edge of the abyss. Politicians reacted and the G20 (rather than G7/8) was suddenly elevated to become the central global player. In November 2008, the G20 leaders met in Washington and adopted Common Principles for Reform of Financial Markets including the commitment "…we will implement reforms that will strengthen financial markets and regulatory regimes so as to avoid future crises…. However, our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary…"

The European Union is a formal member of the G20 so the EU is the main mechanism for the final step of converting this still rather general political rhetoric into detailed legislation that binds financial institutions operating on the Union's territory. Then-Commissioner Barnier often began speeches by referring to the EU fulfilling its commitments to the G20. EU legislation can take the form of Directives, which then have to be transposed by national governments into their own domestic law. The Commission then checks that it has been transposed accurately and completely – following up with enforcement proceedings if needed. However, in the spirit of creating a `single rulebook', an increasing amount of detailed legislation is being put into force by Regulation, because they take direct effect throughout the EU.

Many of these legislative actions are now binding on financial institutions as the transposition periods have elapsed e.g. CRDIV/CRR, Solvency 2. Others – such as MiFID/MiFIR – may come into force with a delay. But it is these precise legal texts that will be enforced by national supervisors and courts – not some general international principles such as Basel 3, even if they are quite detailed.

Since the dawn of the Single Market era in 1992, the EU has struggled with the problem of the extra-territorial reach of other states' financial regulations – especially those of the United States. But the G20 meetings of 2008 and onwards recognised fully that a single commercial entity might be operating globally and must be properly overseen and regulated to avoid the risk of contagion. But such a firm might have subsidiaries and branches in many states, so the question is `whose rules'?

To avoid a nightmare of practicalities, the answer from the EU was and continues to be that it would accept the operations of financial institutions providing they were subject to rules that are "equivalent" to those of the EU. This concept gives effect to the G20 spirit of close co-ordination and consistent implementation. The EU cannot abandon this approach of seeking from its trading partners "equivalence" with its own financial regulations without abandoning its commitment to the whole G20 process.

On the issue of equivalence, the Commission website is very clear: "In certain cases the EU may recognise that a foreign legal, regulatory and/or supervisory regime is equivalent to the corresponding EU framework… Typically, equivalent provisions require verifying in an assessment that a third-country framework demonstrates equivalence with the EU regime when it comes to:

1. having legally binding requirements,

2. having effective supervision by authorities,

3. achieving the same results as the EU corresponding provisions and supervision (outcome-based analysis)."

The third, outcome-based analysis described above may be the one that is highly inconvenient for proponents of Brexit if they genuinely intend to move UK regulations away from rigorously following evolving EU rules. In a remarkably frank intervention, Commissioner Hill spoke at a recent "FT Future of Europe Breakfast". He was particularly firm and clear on some Brexit issues that are key for the future of the City of London. "Some say that if there is Brexit, there is no risk because the UK will get the same access (or even better). This is a complete and fundamental misunderstanding of how the rules work. They are misleading about the consequences for business models. People need to be honest… you cannot have your cake and eat it… I do not believe there is a respectable argument that you can leave and have the same access as now…"

These are powerful words for the Commissioner – a former Leader of the House of Lords – to use in the heart of the City at a time when the Brexit debate is strengthening and the future of the City of London is fast becoming a key element in the negotiations.

Financial stability and supervision

Prime Minister Cameron emphasised in his letter to President Tusk that matters of financial stability and supervision are "key areas of competence for national institutions like the Bank of England for non-euro members." Two pieces of EU legislation came into force on 1 January 2016: Solvency2 (revamping the regulation of the EU insurance sector) and the Single Resolution Mechanism (SRM) for banks. The latter completed the system for resolving large banks that were hitherto "Too Big to Fail". So financial stability as it applies to banks and insurers seems complete – though not yet tested.

A crucial item for financial stability is still outstanding in this area: the resolution of Central Counterparties (CCPs). These little-known entities now face a massive concentration of risk from the decisions by the G20 back in 2008. As their activities span many markets, firms, countries and currencies progress on a resolution framework is proving exceptionally difficult. The potential sums involved are immense and recent comments from the Bank of England make clear that the key to a successful resolution is the prompt supply of liquidity and new capital to ensure that their customers believe the CCP would then be safe to deal with. If the needed liquidity is denominated in euro, how can the Bank of England supply that? Though intensely technical, the question of who pays very large sums in a crisis may yet be difficult to resolve.

`Brin EU/Brout Euro'

The alternative to Brexit may appear to be maintaining the status quo of `inside the EU but outside the euro'. Clearly, this is a realistic policy option with the current balance of 19 euro INs and 9 euro OUTs as the euro area could only muster a Qualified Majority Vote if it is completely united on a particular issue. The example of disintegrating support for the Financial Transaction Tax suggests such unanimity will difficult to obtain. The EU is set in any event to evolve rapidly during the next decade – for the many reasons set out above. If something approaching the "Favourable Scenario" does indeed come to pass, then the current status quo may be difficult to sustain towards the end of a further decade of evolution. Two main possibilities present themselves:

- "Things go well' for the Eurozone, and that decade could end with all EU members except Britain using the euro as their currency. Recasting current data, the Eurozone would have a population of 448 million and a GDP of □12.4 trillion, versus the UK's 65 million population and □2.6 trillion GDP. Globally, the Eurozone GDP would match China's but remain behind the □16.6 trillion of the US. It will require extremely engaged and adept lobbying by the UK government and UK-based financial firms to maintain the current degree of influence on the EU's regulatory framework when the Eurozone is about five times the size of the UK.

- "Things go badly' for the Eurozone, and this creates for the whole European Union a set of interlocking crises from which the UK could not in any circumstances escape. The outlook for the UK would then be bleak indeed.

Appendix I: Five Presidents' Roadmap to 2025

STAGE 1 — 1 JULY 2015 - 30 JUNE 2017

IMMEDIATE STEPS

Economic Union

- **A new boost to convergence, jobs and growth**
- Creation of a euro area system of Competitiveness Authorities;
- Strengthened implementation of the Macroeconomic Imbalance Procedure;
- Greater focus on employment and social performance;
- Stronger coordination of economic policies within a revamped European Semester.

Financial Union

- **Complete the Banking Union**
- Setting up a bridge financing mechanism for the Single Resolution Fund (SRF);
- Implementing concrete steps towards the common backstop to the SRF;
- Agreeing on a common Deposit Insurance Scheme;
- Improving the effectiveness of the instrument for direct bank recapitalisation in the European Stability Mechanism (ESM).
- **Launch the Capital Markets Union**
- **Reinforce the European Systemic Risk Board**

Fiscal Union

- **A new advisory European Fiscal Board**
- The board would provide a public and independent assessment, at European level, of how budgets – and their execution – perform against the economic objectives and recommendations set out in the EU fiscal framework. Its advice should feed into the decisions taken by the Commission in the context of the European Semester.

Democratic accountability, legitimacy and institutional strengthening

- **Revamp the European Semester**
- Reorganise the Semester in two consecutive stages, with the first stage devoted to the euro area as a whole, before the discussion of country specific issues in the second stage.
- **Strengthen parliamentary control as part of the European Semester**
- Plenary debate at the European Parliament on the Annual Growth Survey both before and after it is issued by the Commission; followed by a plenary debate on the Country-Specific Recommendations;
- More systematic interactions between Commissioners and national Parliaments both on the Country-Specific Recommendations and on national budgets;
- More systematic consultation and involvement by governments of national Parliaments and social partners before the annual submission of National Reform and Stability Programmes.
- **Increase the level of cooperation between the European Parliament and national Parliaments**
- **Reinforce the steer of the Eurogroup**
- **Take steps towards a consolidated external representation of the euro area**
- **Integrate into the framework of EU law the Treaty on Stability, Coordination and Governance; the relevant parts of the Euro Plus Pact; and the Inter-governmental Agreement on the Single Resolution Fund**

■ 20

Annex 1

Roadmap Towards a Complete Economic and Monetary Union

STAGE 1 — 1 JULY 2015 - 30 JUNE 2017

IMMEDIATE STEPS

Economic Union

- **A new boost to convergence, jobs and growth**
- Creation of a euro area system of Competitiveness Authorities;
- Strengthened implementation of the Macroeconomic Imbalance Procedure;
- Greater focus on employment and social performance;
- Stronger coordination of economic policies within a revamped European Semester.

Financial Union

- **Complete the Banking Union**
- Setting up a bridge financing mechanism for the Single Resolution Fund (SRF);
- Implementing concrete steps towards the common backstop to the SRF;
- Agreeing on a common Deposit Insurance Scheme;
- Improving the effectiveness of the instrument for direct bank recapitalisation in the European Stability Mechanism (ESM).
- **Launch the Capital Markets Union**
- **Reinforce the European Systemic Risk Board**

Fiscal Union

Appendix II: Single Market

Consumers: The Commission will take action to ensure that consumers seeking to buy services or products in another Member State, be it online or in person, do not face diverging prices, sales conditions, or delivery options, unless this is justified by objective and verifiable reasons. The European Commission and European Consumer Centres frequently receive consumer complaints involving unjustified differences in treatment on grounds of nationality or residence.

SMEs and start-ups: Start-ups contribute a lot to the economy, but a number of entrepreneurs leave Europe because they can't bring their innovative ideas to the market. Efforts are under way in the context of the Investment Plan and the Capital Markets Union to ease access to finance for SMEs. In addition, the Commission intends to simplify VAT regulation, reduce the cost of company registration, put forward a proposal on business insolvency and make all information on regulatory requirements accessible in a single digital gateway. The Commission will also work on clear and SME-friendly intellectual property rules and take the final steps needed for the Unitary Patent to become an attractive and affordable way for European companies, including SMEs, to capitalise on their ideas.

Innovative services: The Commission will develop a European agenda for the collaborative economy. New business models bring benefits to citizens and companies alike and help optimising the use of existing resources. However, questions arise whether existing regulations are still fit for purpose or whether new rules are needed. At the same time, we need to make sure that public policy objectives such as consumer protection are respected and tax and labour law complied with.

Professionals: The Commission will improve the opportunities for businesses and professionals to be mobile across borders. It will improve the recognition of professional qualifications and facilitate the cross-border provision of business services, construction and other services that generate growth. Taken together, these actions will make it easier for companies and professionals to access new markets, allowing them to grow from small national actors into larger European players.

Supporting all this, the Commission will work hand in hand with Member States and market participants to create a real culture of compliance for Single Market rules. Particular attention will be paid to the services sector and to public procurement, which is essential to spend taxpayer money efficiently. The Commission will strengthen mutual recognition to open up more opportunities to companies that want to expand cross-border. It will also reinforce market surveillance in the area of goods to keep non-compliant products from the EU market.

The Prime Minister has said that relations between the members of the Eurozone and members of the European Union not in the Eurozone is a crucial topic of his "renegotiation" strategy. In this pamphlet Graham Bishop argues that this target is a shifting one. Whatever the present outcome of the Prime Minister's negotiations, the issue of the relationship between the United Kingdom and the Eurozone will need constant review and refinement over the coming years.

ISBN 978-1-903403-99-0

9 781903 403990 >

THE FEDERAL TRUST

for education & research

enlightening the debate on good governance