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Europe unites, Europe splits

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Summary

- The dust is settling on what may be an historic EU Summit in Brussels on 9 December, with a potentially far-reaching agreement on a step towards greater fiscal integration of 26 EU member states, from which the UK alone has chosen to be excluded.

- EU states have bought forward the creation of the EU's new ESM bailout mechanism and agreed to negotiate tough new deficit rules. These steps probably fall short of the kind of massive resources that might have calmed market nerves about preventing contagion from a Spanish or Italian liquidity crisis. That will matter less if the package of fiscal discipline measures is enough to unlock ECB support for more direct bond market interventions.

- Britain's 'veto' – which was nothing of the sort – and self-chosen isolation has been greeted both in Britain and in continental Europe as the beginning of the end for Britain in Europe. It almost certainly is not, although it suggests that relations between the UK and 'core' Europe are going to become increasingly distant and tense in the years ahead.

- In the immediate short term the UK may have done its European partners a favour. By refusing to participate it has ruled out change to the European Treaties, which would have required difficult referenda in a number of European states. Instead the other members of the EU will negotiate a new intergovernmental treaty.

The dust is settling on what may be an historic EU Summit in Brussels on 9 December, with a potentially far-reaching agreement on a step towards greater fiscal integration of 26 EU member states, from which the UK alone has chosen to be excluded. As the sovereign debt markets spend the weekend assessing the extent to which the package is likely to calm nerves about a sovereign liquidity crisis in Europe, this Global Counsel Insight note looks at some of the medium and long term political implications for the EU of what has been agreed, and not agreed.

The Eurozone states have agreed to bring forward the creation of the permanent European Stability Mechanism bailout fund by a year although officials no longer believe that this will reach the €1000bn target set in October, as investors – including China - have proved reluctant to step up. Its eventual size is likely to be closer to €500bn and will take a number of years to accumulate. The voting requirements for utilizing the ESM were also slightly relaxed to require only 85% support for interventions, and the automatic imposition of haircuts on private investors implicated in ESM actions was removed. Both of these would in principle make the ESM easier to activate.

Eurozone states will also consider strengthening IMF resources by around €200bn that can in principle be used for liquidity support for Eurozone states, although the German Bundesbank remains uncomfortable with the idea of direct

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Central Bank support to Eurozone states in this form.

Collectively these agreements probably fall short of the kind of massive resources that might have calmed market nerves about preventing contagion from a Spanish or Italian liquidity crisis. That will matter less if the package of fiscal discipline measures is enough to unlock ECB support for more direct bond market interventions. The ECB is unlikely to commit itself explicitly either way, but politically the Friday package represents a number of important steps forward in this respect, as Mario Draghi acknowledged

The signatories to the future intergovernmental treaty have agreed in principle to implement statutory requirements to maintain budgets in neutral or surplus. Structural deficits must be limited to 0.5% and automatic correction mechanisms established that are activated if these rules are breached. Structural reform and debt issuance plans will have to be submitted to the European Commission for approval. States that breach the existing 3% limits for annual deficits will be subject to "automatic consequences," although these are undefined and can be blocked by a qualified majority of Member States. Draft budgets will also be submitted to the Commission for scrutiny. This tightens the criteria of the existing Stability and Growth Pact and requires that it be locked into domestic law. It maintains a veneer of national autonomy, but submits governments both to strict discipline and intrusive scrutiny from their European peers and the European institutions. There is no question that it represents a further step towards closer economic integration in Europe.

They've signed up it, but can they sell it?

Although France secured some key concessions on the route to this package - limited automaticity in enforcing breaches of fiscal discipline measures, and no automatic write-downs for sovereign bondholders of states receiving support from the future European Stability Mechanism bailout system – there is no question that this deal looks like it was written in Berlin.

The emphasis on fiscal discipline was regarded as key to winning the backing, and potentially the further intervention, of the ECB. This in turn is the chief fixation of the sovereign debt markets. But it reinforces the extent to which this package asks Member States to sign up to an approach that will be widely regarded as imposing what are perceived as German prerogatives. Whether this can be sold to voters at the national level is a significant question.

For the weaker states of the periphery the experience of closer fiscal integration will feel, in the first instance, indistinguishable from painful austerity. Moreover, it will be austerity that is explicitly required and policed from Brussels. What this will mean for the politics of integration is far from clear, but it suggests a future in which 'Europe' comes to mean fiscal discipline and hardship, rather than anything empowering or enabling. It took a protracted and painful compromise to corral European voters and states into the 2007 revised Lisbon treaty, which involved no similar leap in reduced autonomy. So it would be wildly optimistic to assume that the journey to ratifying this package will be a smooth one.

In this respect, the UK may have done their partners a favour. The fact that UK intransigence means that this agreement will be pursued as a new intergovernmental treaty (rather than a revised European treaty) means that it will not be subject to unanimity. This in turn means it could in principle survive a couple of small states changing their minds about participation. Sweden, Denmark, the Czech Republic and Finland are just some of the states that may have trouble delivering popular and parliamentary support.

The treaty will inevitably become a focus for popular resentment of austerity in Spain, Greece, Italy and Portugal. Irish legal experts are still debating the need for a referendum on the new treaty in Ireland, which has a constitutional requirement for a public referendum on transfers of sovereignty to the EU. Dublin will be deeply

concerned that a rejection of the treaty would weaken its hand in negotiating the terms of its own bailout package.

Slamming on the fiscal brakes, searching for the growth accelerator

The more fundamental problem with the approach implied by this package is that it is at best incomplete. Both the ECB's fixation with moral hazard and the bond market's need for voluble displays of fiscal discipline cannot be sidestepped. But statutory debt brakes and strict limits on both nominal and structural deficits present the prospect of European states collectively slamming on the budget brakes in unison at a time when sources of external demand are weak and the European economy is effectively a closed system. The crucial complement to this fiscal discipline is a credible programme of measures to unlock new employment and business investment and to rebuild business and consumer confidence. At this point it is missing. This should worry us, and when they have thought it through, it will worry both the ratings agencies and the markets.

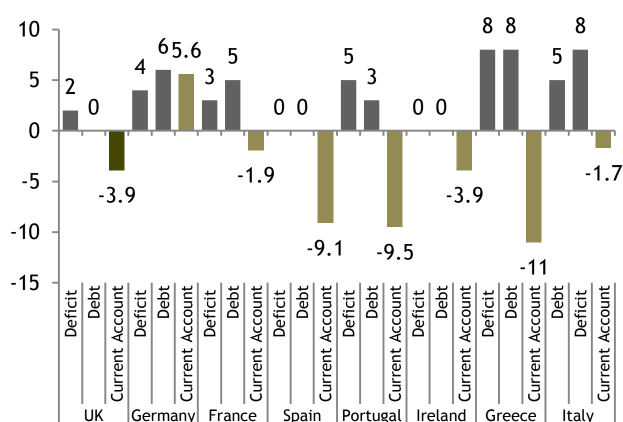

Chart 1: The European dashboard on the eve of the crisis - fiscal balance criteria alone for the previous decade gave few clues to the vulnerabilities ahead. General Government Deficits and Debt - years in breach of the Stability and Growth pact 2000-2007. Current account balance 2007 %GDP.

Source: European Commission 2007

Nor is it clear that the sole focus on fiscal deficits and debts is the right one if the long term aim is avoiding a repeat of the current crisis. Some of the Eurozone's best performers under the Maastricht Stability and Growth Pact criteria were Ireland and Spain. Germany was among the worst. A much better predictor of potential weakness among the Eurozone states was the scale of their asset bubble problems and their current account deficit, with its implicit threat of vulnerability to a sudden stop in external funding. The fact that such an assessment would obligate Germany – as a net capital exporter and key funder of the debt binge from which the periphery is now suffering – in major adjustment policies probably explains why it is not part of the new pact. But it should be.

Domestic politics tips the UK's European hand

Even as a sideshow to the bigger questions of saving the euro, the UK's decision to walk away from the final package is a significant development. Despite UK support for a closer Eurozone fiscal integration over the last six months, UK Prime Minister David Cameron was highly wary of getting drawn into a solution that implicated Britain in new structures or processes without the political cover of parallel concessions. Whatever the merits of the arguments, the timing was terrible. Politically and tactically, Britain was trying to strike concessions with a Franco-German fire truck on the way to a Eurozone house fire. The French in particular had no patience for it. So inevitable was the outcome that it is not really true to say that the UK vetoed EU treaty change: there was never any realistic prospect of it happening. What is striking, however, is that the UK left the Summit with no allies at all.

Cameron's chosen target was both symbolic and opportunistic: a series of guarantees that would enable the UK to derogate significantly from financial services rules, chiefly freedom to impose the kind of capital ratios proposed by the UK Independent Commission on Banking, which are higher than those in the CRD4 capital requirements regulation. The British also used the negotiations to try and force clarity on suggestions that derivatives transactions denominated in euros should in future be conducted only within the

Eurozone - a possibility that for obvious reasons has had the UK distinctly jumpy.

So in reality what the UK was looking for was less *carte blanche* for protecting the City and more policy space and assurances on a small number of key issues in the on-going debate on financial services regulation after the banking crisis. Ironically, the outcome probably leaves the City more exposed rather than better protected. The relocation of Financial Services regulation to the EU level, and the power of EU regulators to intervene directly with UK firms and regulators mean that this key shift in European financial regulation is largely a done deal. With such a large raft of financial services legislation passing through the European Commission over the next 12 to 18 months, a position that isolates the UK in Brussels is not an obvious way strengthen the UK's hand. City lobbying has always flirted with pressing the Eurosceptic button to encourage a firm UK defence of the industry's prerogatives at the EU level. In this case, it has got a lot more than it would probably wish for.

The key reason for this is political. Cameron had no appetite for a further serious fight with his Eurosceptic backbenchers on Europe. He was given a serious shock in November when more than eighty of them defied the Tory whip to support the idea of a referendum on EU membership. Although Cameron personally is a pragmatist who recognises the value of European engagement for UK interests, he feels profoundly politically vulnerable from the right. When he makes his statement to the House of Commons on Monday he will be channelling Margaret Thatcher's famous "No No No" speech to the House of Commons of October 1990.

In the short term, he will be strengthened with his party, although his junior Liberal Democrat coalition partner will find the decision to walk away from a European agreement difficult to support, as their leader, Nick Clegg indicated over the weekend. Cameron will also arguably be strengthened with the British electorate, which has no appetite for further European integration. The long term consequences are less clear.

Is Britain is on it way out of the EU?

Many British and continental commentators have assumed since Friday that this spells the end for Britain in Europe. This is certainly a plausible reading of events, although it comes with some big caveats. The first is that it would require the other 26 European states successfully to implement the package agreed on Friday and for the European economy to stabilize. As we discussed above, this is a big requirement. However, in those circumstances the UK's position outside the new treaty grouping must be likely to translate into diminished influence, compounding the profound resentment fallout from Friday's Summit will create in the short term.

Nevertheless, it is possible to overstate that argument. Life in Brussels will in many respects continue as normal. The fact that 'the 26' (if there are ultimately 26, which should not be counted on) are coordinating closely on budget deficit planning will not smooth out their diversity of views on foreign policy, energy policy or single market rules. It will not end the horse-trading of policy priorities across the full sweep of EU policy. Sweden and France will disagree tomorrow on what they disagreed on yesterday. This will to some degree constrain a tendency of the Eurozone group to caucus in a way that directly conflicts with UK influence. The new intergovernmental treaty will not replace or replicate the existing European treaties or the European Commission's roles in these areas. Certainly, UK officials are counting on this being the case and will pay close attention to the legal relationship and operational implications of the new treaty with existing ones.

More likely over time is that the UK's detached role simply becomes a subtle drain on status and influence. However, as implied above, the UK may not stay around to feel this. UK Eurosceptics will see self-imposed isolation from the rest of the EU on this as a ratchet in the political process of securing a referendum on UK membership of the EU. They know they have a wide swathe of British public opinion behind them. They will now want to fight the next election on a promise of a referendum. Should they secure it, they are likely

to win it. Although it probably narrows the odds, Friday's Summit does not guarantee a trajectory that ultimately sees the UK leave the EU – especially if the new arrangements are perceived to succeed it is plausible to imagine a scenario where the UK seeks a late-in-the-day return to the fold. But it has surely rendered the UK's complex and difficult political relationship with the EU even more so.

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