Could eurozone integration damage the single market?

by Charles Grant

Can Britain be at ease in a European Union that is increasingly focused on the euro and its troubles? Britain's eurosceptics think not. The eurozone's many problems require it to integrate more closely, and that will be bad for Britain, they say, since the euro countries will start to act as a bloc and manipulate EU institutions for their own benefit. Therefore Britain should quit this euro-centric club and negotiate a new and looser bilateral relationship with the EU.

David Cameron's government has begun technical talks with its partners on reforms to the EU, prior to an in-or-out referendum. His officials say that though arguments over EU migrants' access to benefits will generate more political heat, the relationship between the eurozone and the wider EU is the most important substantive problem. Both George Osborne, the chancellor, and many business leaders see this issue as a priority.

Their worry is that the 19 euro countries could caucus and impose their wishes on the 28-country single market. The euro countries can do so since new voting rules – introduced by the Lisbon treaty – came into force last year: their votes combined make a 'qualified majority' in the Council of Ministers. British ministers are particularly concerned about the City of London: other EU countries that know little about finance – or which seek to favour their own financial centres – could vote for rules that harm its competitiveness.

The recent furore over the European Financial Stability Mechanism (EFSM) has reinforced British worries. The eurozone wanted this fund, to which Britain has contributed, to make an urgent loan to Greece, to prevent it defaulting on payments due to the IMF and the ECB. Britain tried to stop the loan, reminding its partners of an earlier European Council decision that the EFSM should not be used for the eurozone bail-outs. But eurozone governments had a qualified majority in favour and pushed ahead. Since Britain could not block the loan, it decided to vote in favour, in return for guarantees against potential losses. To British officials, this is a clear example of eurozone putting the currency's needs ahead of legal niceties or the interests of the euro-outs.

Therefore one of David Cameron's key demands in the renegotiation is 'safeguards' for the single market. Unfortunately for Britain, however, few EU governments show much understanding for British concerns. Even a country such as Poland, which is many years away from joining the euro, is untroubled about the possibility of the eurozone acting in ways that harm the market. And in Berlin, the capital which matters most, few figures sympathise with the British position.

When the British ask for safeguards, German officials respond that eurozone countries do not caucus; how can they, when their disagreements on economic policy are so great? The British sometimes cite the ECB's declared policy of making clearing houses for euro securities locate within the eurozone as an example of the problem they face: EU institutions want to privilege the eurozone in ways that may damage the City. But this policy did not result from caucusing in the Council of Ministers, and when the British complained about it to the European Court of Justice, they won their case, last March.

When the EU drew up rules on banking supervision in 2012, it found a way of alleviating British concerns: in the European Banking Authority, decisions require a majority of both euro and non-euro countries. But the Germans insist that such 'double-majority' voting should not apply to financial regulation more broadly, because as more countries joined the euro, the system would evolve towards a British veto. And for one country to enjoy such a privileged position, they say, would be contrary to the fundamental principles of the EU.

Many Germans suspect that the safeguard Cameron really wants is a veto for the City on financial rules. In fact he will not ask for that. But German paranoia about British intentions is fuelled by memories of the debacle of the European Council of December 2011: Cameron said he would not sign the 'fiscal compact' that Germany wanted without an agreement to change certain voting rules affecting the City. The Germans blocked the changes, he did not sign and the fiscal compact became a non-EU treaty. German officials are still bitter about this episode.

Might the EFSF affair be a harbinger of eurozone caucusing in other areas? At one point it looked as though the euro countries might unite behind a 'financial transactions tax' (FTT), which if applied to financial centres in the EU but not elsewhere in the world, could damage the City. But many member-states opposed the tax, including euro members such as the Netherlands and Ireland. So in 2012 a smaller group of 11 euro countries announced plans to proceed with an FTT of their own, which still had the potential to harm the City. However, the 11 failed to agree on the FTT's design and it is now effectively dead.

The Commission's plans for a capital markets union (CMU) – led by Jonathan Hill, the British commissioner – will generate a series of new financial regulations. But most euro countries agree with the British that CMU is an excellent idea, so eurozone caucusing is unlikely to be a problem.

"Cameron needs a deal that protects the single market and the City from the risks of eurozone integration."

One other issue, however, could perhaps prove problematic. The Single Supervisory Mechanism, which supervises eurozone banks, worries about the 'doom loop' through which banks lend to governments that are in turn responsible for back-stopping them; the deterioration of a sovereign's credit risk may weaken that country's financial system. In the eurozone there is a case for tackling this problem through the imposition of limits on how much a bank can lend to its own government. In Britain and other member-states with their own central banks, where the case is weaker, there may be resistance to proposals for EU-wide rules.

In truth, there is unlikely to be much eurozone caucusing in the foreseeable future. The British government's point, however, is that the eurozone will integrate further, increasing the risk of caucusing. What safeguards could it ask for that might be acceptable to other governments? There could be a promise of a future treaty article stating that nothing done by the eurozone may damage the single market. Non-euro countries could gain the right to observe meetings of eurozone ministers. They could also be allowed to press an 'emergency brake': if one of them thought a eurozone decision would damage the market, the decision would be postponed for, say, a year, while the European Council reviewed it.

The British government has not convinced many of its partners that its concerns about the relationship between the euro and the single market are justified. The Treasury, in particular, needs to do a better job of getting its message across, if it is to win credible safeguards. But the other EU governments, too, need to make an effort to help the British on this issue. Cameron needs to be able to argue that the deal he has won will protect the single market and the City from the risks of eurozone integration. Otherwise British voters may conclude that the EU is driven by the interests of the eurozone, and the referendum may be lost.

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