

Congressional Testimony

The European Union's Future

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Testimony before the U.S. House of Representatives Subcommittee on Europe, Eurasia and Emerging Threats, July 14, 2015

Subcommittee Chairman Royce, ranking member Engel, members of the Subcommittee on Europe, Eurasia and Emerging Threats, it is a pleasure to testify before you today on the future of the European Union. In my written testimony, I will in line with the hearing invitation address three issues: The impact on European Union institutions from the Greek sovereign debt crisis; the impact on European institutions from the upcoming United Kingdom referendum on EU membership; and the impact on EU institutions of the growing electoral success of euro-skeptic parties.

The Impact on European Institutions of the Greek Sovereign Debt Crisis

The Greek sovereign debt crisis is first and foremost a crisis for the euro area, as it has since 2010 highlighted fundamental flaws in the original institutional design of the common currency laid down in the early 1993 Treaty of Maastricht. Appropriately since 2010, the euro area has as part of the European crisis response undergone a dramatic institutional deepening. A new fiscal rescue fund (e.g. a de facto Euro Area Monetary Fund) in the ESM has been created with enough financial firepower (€500bn) and freedom of action to directly rescue banks and lend sufficiently and conditionally to governments to stabilize their finances in any new emergency. The ECB has introduced a new “conditional lender of last resort” function through its OMT program, which guarantees any member state access to potential future emergency support (e.g. sovereign bond purchases) of the ECB in return for undertaking a conditional program of economic reforms. The euro area has introduced a new single banking supervisor and a single resolution mechanism will become operational by 2016. In short, the Greek sovereign debt crisis, as well as the crises in other euro area members since 2010, has led to a historic further institutional deepening of the common currency area.

Relative to the existing EU institutions, recent developments have cemented the existence of a multi-speed Europe, where the countries in the euro undertake dramatically more integration, while other member states remain on outside the common currency and only affected to a limited degree. The majority of recent crisis related euro area institutional deepening has taken place legally outside the existing EU Treaty framework through a number of inter-governmental Treaties, such as the ESM Treaty¹

¹ <http://www.esm.europa.eu/pdf/ESM%20Treaty%20consolidated%2003-02-2015.pdf>

or the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union². Recalling, however, that this multi-speed situation has been de facto present in the EU for decades and with respect to EMU since the inception of the euro in the early 1990s, there is no obvious reason to fear that existing EU institutions cannot cope with this situation also going forward. This view is underlined by the creation of the new banking union, which while a matter of life and death for the euro area, is also an urgently important reform for the rest of the EU. The banking union, which in the euro area has seen the transfer of banking supervisory functions to the ECB, also includes establishing much closer banking regulatory integration for the entire EU in the rules making European Banking Authority (EBA). As part of this setup, obvious fears existed among the non-euro members that their regulatory and rules making concerns would be trumped by the now dominant euro area single supervisor at the ECB. However, as a result the EU banking regulatory process has now been established with extensive “minority protections” built into the system to protect the voice of the non-euro area members. Regulatory decisions normally taken by a simple or qualified majority vote (on a one member one vote basis) now requires support by a simple majority of both participating and non-participating member states in the banking union to be adopted³. Dramatic institutional integration of the euro area banking sector has thus been achieved in the banking union without jeopardizing the national sovereignty of non-euro area members in the process.

Recent events over the weekend saw a dramatic escalation in the confrontation between the Greek government and the rest of the euro area. Ultimately, the tentative agreement struck very late Sunday saw a climb down by the Greek government on almost all policy areas⁴. This was a result of the disastrous Greek government decision to call a referendum on its bailout conditions on July 5th. The referendum produced a result – a resounding no! – interpreted elsewhere in the euro area as the desire by the Greek public to distance themselves from the euro. This political interpretation for the first time opened for the broader political acceptance in many euro area countries that Greek might have to leave the common currency. As a result, this weekend’s negotiations took place with a major taboo in euro area politics – the possible exit from euro area institutions of a member state – broken, and Alexis Tsipras for the first time faced this potential economic and political calamity for Greece. His subsequent agreement to the terms of the euro area is both understandable and commendable.

Yet, the decision by the euro area to make the possibility of exit from the common currency area an explicit – and obviously extremely effective – negotiating tool will have changed the nature of the euro currency itself. Given the willingness of the top euro area political leaders to use his threat, the irreversibility of the common currency in all member states is less certain today, and subject to a higher degree of political uncertainty. This will potentially complicate the conduct of monetary policy in the euro area going forward, and especially potentially raise the risks associated with ending the current asset purchase program of the ECB as scheduled in September 2016. It cannot be ruled out that financial

² http://europa.eu/rapid/press-release_DOC-12-2_en.pdf

³ For details, see http://europa.eu/rapid/press-release_MEMO-13-780_en.htm?locale=en

⁴ http://www.consilium.europa.eu/en/press/press-releases/2015/07/pdf/20150712-eurosummit-statement-greece/?utm_source=DSMS&utm_medium=email&utm_campaign=Euro+Summit+Statement+12%2f07%2f2015&utm_term=952.30436.1082.0.30436&utm_content=all+customers

markets may then once again add a certain degree of re-domination risk (e.g. the threat of euro liabilities not remaining denominated in euros) on so Greek and other euro area members' debts and other financial instruments. As such, at least some of the stabilizing effects of Mario Draghi's famous "whatever it takes speech"⁵ in July 2012 may have been put at risk this weekend.

This has significantly increased the political and financial onus on the euro area to agree to more and deeper institutional integration of the euro area in the short to medium term. Only further deepening of relations within the common currency area, including especially in fiscal affairs, can hope to restore the irreversibility of the common currency put at risk this weekend. The Five Presidents' Report⁶ recommendations have taken a new urgency for the euro area now.

Recent events in the Greek sovereign debt crisis can therefore be expected to lead to an accelerated integration of the euro area, though not have material direct implications for EU institutions.

The Impact on European Institutions of the Upcoming UK Referendum on EU Membership

The upcoming UK referendum on EU membership is highly unlikely to lead to material and lasting changes to EU institutions for the reason that the referendum is overwhelmingly likely to be fought with the UK government, prime minister and main British opposition parties all actively campaigning to stay in the EU. As a result, the referendum is overwhelmingly likely to be a public "yes" to continued UK EU membership. There are three main explanations for this conclusion:

David Cameron and the UK Government Will Campaign For a Yes; it is a natural part of a rational negotiation strategy to extract maximum concessions for David Cameron to threaten his political opponents in the rest of the EU with potentially campaigning against UK membership in the referendum. He is, however, highly likely in the end to campaign for a yes in the referendum for several reasons:

- 1) Avoid severing ties between the Conservative Party and the vast majority of British businesses; while most UK businesses will, to avoid alienating any potential current or future customers, prefer to refrain from taking a public stance in the referendum, if forced to do so by a potential looming no vote, they will do so in favor of staying inside the European Union. Were David Cameron to actively campaign for a no in the referendum, this would lead to a very damaging split between the Conservative Party and its traditional financial support base
- 2) A no vote would be economically very damaging to the UK; one of the main reasons for bringing forward the UK referendum as much as possible is to remove the uncertainty surrounding the outcome and thus alleviate the confidence risks to future investments in the UK economy. At the same time, it is clear that a no vote in the referendum would usher in a period of acute uncertainty surrounding the UK economy and location for especially foreign direct investment (FDI) into the UK serving as a production facility for the entire EU economy. For a country with the largest current account deficit in the G-7 at about 5 percent of GDP (roughly double the level

⁵ <http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>

⁶ http://ec.europa.eu/priorities/economic-monetary-union/docs/5-presidents-report_en.pdf

in the United States), a no vote would hence be a source of potential financial instability for the UK both in the short and long term. Judging from prior comments from large foreign investors in the UK, it seems clear that the UK would stand to lose not only a sizable part of its future inward FDI, but also see a number of its main current foreign investors leave in the case of a vote to leave the EU. This would, apart from the City of London, pose substantial challenges for a number of large UK cities, which today hosts sizable FDI facilities

A Favorable Economic Context; the UK economy is currently projected to grow at 2.4 in 2015 and 2.2 percent in 2016, the most likely year of the referendum⁷. Combined with low levels of projected unemployment, low inflation forecasts and what will still then be a generally accommodating monetary policy by the Bank of England, the UK referendum date is likely to be chosen by David Cameron amidst a broadly favorable economic situation in the United Kingdom. This will most likely avoid the risk that the UK population will vote against the recommendation of the UK government to punish it for poor economic circumstances around the time of the referendum.

EU Law Is Very Flexible When Political Will Is Present; probably the defining characteristic of European integration is the complexity of the EU's institutional design and decision making processes. However, this very complexity is merely a reflection of the intricate calibration of pooling of national sovereignty – quite uniquely in the world politically possible – among EU member states to precisely match the always conflicting forces of integration and national self-determination. As a result, the EU has over time developed a number of legal instruments to incorporate particular national sensitivities within the overarching EU legal Treaty architecture.

In principle, EU law is valid throughout the 28 member states. Yet, in a number of cases, individual member states have secured a so called “legal opt-out” from specific elements of the EU Treaty, exempting them from having to implement relevant policies at home. Currently, four EU members have such explicit legal opt-outs; Denmark (four), Ireland (two), Poland (one) and indeed already the United Kingdom with another four opt-outs. Currently the UK has official legal opt-outs in the Lisbon Treaty from of the euro, the Schengen Agreement, Justice and Home Affairs, and parts of the Charter of Fundamental Rights of the European Union.

Rather than secure a legal opt-out exempting a member state from a specific element of European law, EU law also has introduced the legal guarantee, or specification/clarification to assuage any fears in a given member state related to the interpretation of a given legal statute. This removes the opportunity for alternative subsequent interpretations to emerge in a specific area.

Lastly, reflecting the tremendously time consuming process and political difficulty of negotiating and ratifying a new EU Treaty, examples exist from Ireland of having specific opt-outs and legal guarantees added as a protocol to the existing EU Treaty (adding protocols does not require re-ratification in all member states of the entire Treaty), against the promise to introduce them into the actual Treaty only at the time of the next future broader Treaty change.

⁷ The political guarantee issued by Prime Minister Cameron merely states that the referendum has to be held by 2017, but it could come earlier.

In short, the EU legal framework is a highly flexible animal, when EU leaders require some flexibility and legal finessing to overcome a particular political problem. Given how Germany and many other EU members have expressed their clear political interest in seeing the UK remain a member of the EU, there can be no doubt that the full arsenal of EU legal flexibility around the Treaty will be made available to David Cameron. Everything except revisions of the existing EU Treaty that would require re-ratification will be on the table.

There will consequently be ample opportunities for David Cameron to secure politically symbolic and important, as well as legally binding, changes to the EU laws governing the economy of the United Kingdom as part of the now ongoing negotiations. Outright Treaty changes would be impossible, as would the undermining or opt-out of core EU principles. Yet, there is little reason to believe that the rest of the EU would not offer the UK government Danish or Irish style opt-outs of specific issue areas of a sufficient political, economic and legal scope to secure David Cameron's agreement and support for a referendum campaign yes.

What such areas would be will be revealed as part of the negotiations, but could include the UK opting out of things like the EU Working Time Directive⁸, EU rules for social benefits to the dependents of recent arrivals, securing a legal guarantee that the City of London will not be discriminated against as the euro area banking/capital markets union deepens, or perhaps even a symbolic UK opt-out of the "ever closer union" phrase at the beginning of the EU Treaty.

In the end, the upcoming UK referendum about membership of the EU is therefore not likely to materially affect the function or scope of existing EU institutions and will not set in motion a general renegotiation of the EU Treaty. Instead the referendum and the associated negotiations are likely to lead to the UK becoming exempt from some elements of existing EU law through legal opt-outs and/or legal clarifications and Treaty protocols.

The Impact on European Institutions of the Growing Electoral Success of Euro-skeptic Parties

In recent years, many EU countries have witnessed the growth of new parties, which when compared to the traditional mainstream center-right and center-left parties in Europe can be classified as broadly euro-skeptic in their political outlook. This includes parties like UKIP in the UK, True Finns in Finland, Five Star Movement in Italy, Freedom Party in Austria, Party for Freedom in the Netherlands, Danish People's Party in Denmark, Front Nationale in France, or AfD in Germany.

At the same time, however, it must be kept in mind that European parliamentary systems have historically often operated successfully with very large anti-establishment – and indeed to a degree anti-democratic – representation in national and the European parliament. Prior to 1989, this was seen with the often sizable communist parties in national legislatures and in the European parliament a host of nationalist anti-EU parties and movements. The height of mainstream party political dominance in

⁸ Ironically, the UK was exempt from the Working Time Directive from the introduction of the Maastricht Treaty in 1993 until Tony Blair's government opted back in 1998.

Europe during the 1990s and early 2000s is therefore to a degree a historical anomaly, while the recent growth of euro-skeptic parties represents almost a return to the historical political norm.

With the exception of Hungary and in January 2015 Greece, the new wave of euro-skeptic parties in Europe has generally not seen their popularity break out of the historical range of up to an around 25 percent representation in parliament⁹. These levels are in parliamentary systems, where the mainstream centrist parties general agree on the broad lines of European policy, not an immediate threat to the stability and continuity of day-to-day European policy making. Simply put, in European parliamentary systems it is largely irrelevant what a 25-30 percent parliamentary minority might favor, when the remaining 70-75 percent of parliaments wish to generally maintain the status quo.

There is no immediate reason – outside extraordinary economic crisis situations like currently in Greece or latently irredentist polities like Hungary nourishing populism – to believe that euro-skeptic parties are going to continue to grow beyond their historical political range and into effective governing majorities across Europe. This is due to the narrowness of the core shared political message of many of these parties, which apart from shared opposition to EU integration and more recently austerity demands, represent a mixture of both right- and leftwing populism. Many – though not all and for instance not Syriza – of the new euro-skeptic parties combine rightwing anti-immigration platforms with traditionally leftwing pro-welfare state policies. This can be described as a welfare chauvinistic political platform, advocating a strong and activist role for the state in protecting the social welfare of only the native population. This policy mix has generally and successfully targeted the lower-skilled segments of European electorates, yet has to date failed to extend much beyond these groups. Slightly simplified, this group of euro-skeptic parties will often be the largest blue-collar parties in Europe today, but will fail to become majoritarian parties due to the relatively small share of these voters in the total electorates.

At the same time, even if euro-skeptic parties are unlikely to be able to regularly wield governing power in Europe, their recent rise has already had and will continue to have important shaping influences on EU institutions through several channels. First of all, their stronger political voices very significantly raise the political hurdles for further revisions of the EU Treaty, and in particular the prospects for unavoidable referenda successfully approving such treaty reforms. This means that the EU for the foreseeable future will have to continue to function within the broad legal framework laid down in the 2009 Lisbon Treaty. As witnessed since the Greek crisis began, this does not present the EU and especially the euro area with insurmountable political obstacles for new integrationist measures in emergencies, though clearly adds greatly to their complexity and potentially slows down their negotiation. Going forward, the EU's ability to act decisively in the face of new emerging challenges will therefore be gradually more constrained by what will become an ever more outdated legal foundation in the Lisbon Treaty.

Secondly, the rise of euro-skeptic parties pose a particular challenge for the euro area, as it is the common currency which (as described above) faces the most acute need for further both political and economic integration. The political hurdles to achieve for instance even just an embryonic fiscal union

⁹ See also Nicolas Veron (2014) for data for this for the European Parliament at <http://blogs.piie.com/realtime/?p=4372>

complete with common political decision making over some budgetary issues, some potential meaningful euro area counter-cyclical fiscal policy tools and the prospects of issuance of joint debt securities (Eurobonds) will be very high. This is especially so for periods where the absence of acute economic crisis will cause European policymakers and electorates to hesitate in surrendering the required additional national sovereignty to such new necessary institutions. The euro area is therefore at risk from the rise of euro-skeptic parties of remaining an essentially unfinished and hence inherently more unstable institutional project even in the medium to long term. This will again in the future expose EU institutions to the same risk faced in recent years of Europe's entire political energy devoted to stabilizing the common currency, while neglecting the of other policy challenges facing the EU.

In sum, the recent (re)emergence of euro-skeptic parties across Europe will therefore not materially affect the overall direction of EU policies, but will greatly slowdown the adaptability of the EU's institutional design by making further EU Treaty revisions very difficult.