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BREXIT AND EMU: FROM EMU OUTSIDER TO INSTIGATOR

Michele Chang*

Abstract

Although the UK never adopted the euro as its currency, it did influence the development of Economic and Monetary Union (EMU) and its departure from the EU will have significant consequences for the euro area. First, Brexit will affect the EU economy, placing pressure on the EU budget. This could lead to reforms resulting in an embryonic EU budget. Second, it will alter existing alliances within the EU. The divide between the euro-ins and euro-outs will become larger, and Germany's leadership of the EU will be consolidated. Finally, it will shift the EU's political resources as it deals with the consequences of Brexit. Indeed, certain actors have already advocated for reforms of financial legislation in anticipation of Brexit.

Keywords: Brexit, EMU, European Union

1. Introduction

Since joining the European Community in 1973, the UK has participated as an “awkward partner.”¹ This status as a relative outsider was cemented by the Maastricht Treaty that included an opt-out from joining Economic and Monetary Union (EMU). The UK's departure from the EU would not have the same impact on EMU as the exit of a euro area country.² Nevertheless, Brexit could affect EMU in the following ways: changing economic conditions that create incentives for further integration; altering the alliances within the EU, both between the euro-ins and outs as well as within the euro area; and shifting political resources to deal with the consequences of Brexit. The focus of the paper will be on the effect that Brexit could have on EMU, not how the UK itself might be affected.

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¹ Stephen George, *An Awkward Partner: Britain in the European Community* (3rd edition, Oxford University Press 1998)

² Moreover, no legal mechanism exists for a euro area exit.

Section 2 briefly outlines the UK's participation in the main pillars of EMU (monetary, financial, fiscal, and economic integration). Section 3 analyzes the potential impact of Brexit on each of these pillars, recalling how integration in these pillars historically has occurred and how Brexit may change such dynamics. This includes Brexit's effect on potential reforms that were identified in the 2015 Five Presidents' report on "Completing Europe's Economic and Monetary Union"³ and the Commission's 2017 "White Paper on the Future of Europe,"⁴ as well as reforms suggested by prominent politicians and analysts. It is important to note that Brexit does not pose the only challenge to EMU in the near future; elections and domestic political developments in euro area countries would play a greater role, particularly those involving Euroscepticism.⁵ Section 4 considers whether Brexit will act as a force for euro area integration or disintegration.

2. EMU and the UK

The UK government officially joined the European Monetary System in 1979 but declined participation in the Exchange Rate Mechanism (ERM), a system of fixed exchange rates between the currencies of the European Community. The pound joined the ERM in October 1990, only to have it ejected from the system during the 1992-93 currency crisis; on "Black Wednesday" (13 September 1992), the pound and the Italian lira left the ERM and the UK's traditional Eurosceptic stance hardened. The UK (and Denmark) obtained an opt-out from the Maastricht Treaty's plans for monetary union. Besides the UK and Denmark, there are seven others EU member states (so-called pre-ins)⁶ that are expected to join the euro area once they achieve the Maastricht Treaty convergence criteria on inflation levels, interest rates, debt and deficits, and exchange rate stability. Nevertheless, both the opt-out countries and the pre-ins have various responsibilities and have participated in activities in the four pillars of EMU (monetary, financial, fiscal, and economic). Each of these pillars will be considered in turn, focusing on the UK's involvement.

2.1. Monetary Integration

The monetary pillar entails three main elements: the use of the euro as the national currency, the setting of monetary policy by the European Central Bank (ECB), and the participation in the euro

³ Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz, "Completing Europe's Economic and Monetary Union" Brussels, 22 June 2015 <https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf> accessed 15 March 2017

⁴ European Commission, "White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025" Brussels, 1 March 2017 <https://ec.europa.eu/commission/sites/beta-political/files/white_paper_on_the_future_of_europe_en.pdf> accessed 15 March 2017

⁵ See Marlene Wind's contribution in this volume, "Brexit and Euroscepticism"

⁶ Sweden, Bulgaria, Croatia, the Czech Republic, Hungary, Poland, and Romania

area bailout fund, the European Stability Mechanism (ESM). The UK has retained the pound sterling as its currency, and the Bank of England continues to set monetary policy. Nevertheless, the Bank of England participates in the European System of Central Banks (composed of the ECB and all EU national central banks) but is not part of the Eurosystem; the central bank governors of the latter and the six members of the Executive Board compose the Governing Council of the ECB, its main decision-making body. While euro-outs retain independence for setting monetary policy, they do participate in the committees⁷ and working groups that advise the General Council.

In summary, the opt-out largely fulfilled the objective of separating EMU from UK interests. British participation in the monetary pillar was limited to the inclusion of the Bank of England in the ESCB.

2.2. Financial Integration

Participation in EMU's financial pillar is more complicated, as financial integration is an integral part of the EU's single market. Indeed, the legislation governing areas such as capital requirements applied to all EU member states, and the UK was a key player in such negotiations.⁸ EU financial regulations were created through the Lamfalussy Process, in which national supervisors and regulators would meet to decide on common regulations and ensure their smooth implementation. After the global financial crisis, EU financial governance was reformed through the creation of the European System of Financial Supervision. This included a new institution for EU financial surveillance, the European Systemic Risk Board, as well as an upgrading of the Lamfalussy Process's so-called "level 3" committees of national supervisors to supervisory authorities: the European Banking Authority (EBA, in London), the European Securities and Markets Authorities (ESMA, in Paris), and the European Insurance and Occupational Pensions Authority (EIOPA, in Frankfurt).

Financial integration shifted from an issue concerning the single market to the euro area with the widespread belief in the doom loop between banks and their sovereigns.⁹ In order to break the

⁷ These committees are: the Accounting and Monetary Income Committee, the Banking Supervision Committee, the Banknote Committee, the Committee on Cost Methodology, the Eurosystem/ESCB Communications Committee, the Eurosystem IT Steering Committee, the International Relations Committee, the Legal Committee, the Market Operations Committee, the Monetary Policy Committee, the Payment and Settlement Systems Committee, the Statistics Committee, the Budget Committee, and the Human Resources Conference. European Central Bank. *The European Central Bank, the Eurosystem, the European System of Central Banks* (ECB 2008, p.19)

⁸ Lucia Quaglia, "The Politics of Financial Services Regulation and Supervision Reform in the European Union" (2007) *Journal of Common Market Studies* 46, 2, pp.269-290

⁹ Jean Pisani-Ferry, "The Euro Crisis and the New Impossible Trinity" [2012] *Bruegel Policy Contribution* 2012/01; David Schäfer, "A Banking Union of Ideas? The Impact of Ordoliberalism and the Vicious Circle on the EU Banking Union" (2016) *Journal of Common Market Studies* 54, 4, pp.961-980

“vicious circle”¹⁰ in which weak banks that could require public assistance thereby made it more likely for a sovereign to default, further weakening the banks that held a major portion of sovereign debt, which worsened the sovereign’s credibility. One way out of this doom loop was banking union, particularly an integrated banking supervisor. This led to the creation of the euro area’s Banking Union, which refers to the Single Supervisory Mechanism (SSM) housed at the ECB, the Single Resolution Mechanism (SRM), and the Single Rulebook. Euro-ins are automatically part of the SSM and the SRM, while euro-outs can join Banking Union under a system of “closer cooperation” between the SSM and national supervisory authorities. The Single Rulebook¹¹ is considered a pillar of Banking Union but pre-dates agreement on the establishment of single financial supervision that marked the beginning of Banking Union in 2012, as the term “Single Rulebook” was coined already in 2009.¹² The legislation associated with the Single Rulebook concerns all EU member states as an internal market issue.

The shift towards strengthening euro area governance of financial markets potentially threatened the role of the UK in European finance. The UK is the most important financial center for euro-denominated transactions, boasting a daily turnover in excess of €927 billion.¹³ Its four clearing houses benefitted from the consolidation of operators since the euro’s introduction.¹⁴ The ECB attempted to shift the settlement of euro-denominated transactions to the euro area in its 2011 policy framework.¹⁵ The UK countered that this went beyond the ECB’s competence and violated single market provisions on the free movement of capital, services and establishment by discriminating on the basis of location and sought an annulment. On 4 March 2015, the European Court of Justice (ECJ) supported the UK position,¹⁶ and the ECB arranged a swap line with the Bank of England in case of liquidity shortages.¹⁷

The UK defended the interests of euro-outs as financial integration continued apace. The British

¹⁰ Euro Area, “Euro Area Summit Statement” 29 June 2012

¹¹ Capital Requirements Directive (CRD IV, Directive 2013/36/EU), Capital Requirements Regulation (CRR, Regulation (EU) No 575/2013), Deposit Guarantee Schemes Directive (DGS, Directive 2014/49/EU) and the Bank Recovery and Resolution Directive (BRRD, Directive 2014/59/EU)

¹² “The Single Rulebook”, *European Banking Authority* < <http://www.eba.europa.eu/regulation-and-policy/single-rulebook> > accessed 15 March 2017

¹³ Uurintuya Batsaikhan, “Brexit and the UK’s Euro-denominated market: the role of clearing houses” (*Bruegel blog post*, 7 June 2016) < <http://bruegel.org/2016/06/brexit-and-the-uks-euro-denominated-market-the-role-of-clearing-houses/> > accessed 15 March 2017

¹⁴ Marcel Magnus, Aleinor Anne Claire Duville-Margerit and Benoit Mesnard, “Brexit: The United Kingdom and EU Financial Services” (2016) *Briefing for the European Parliament*

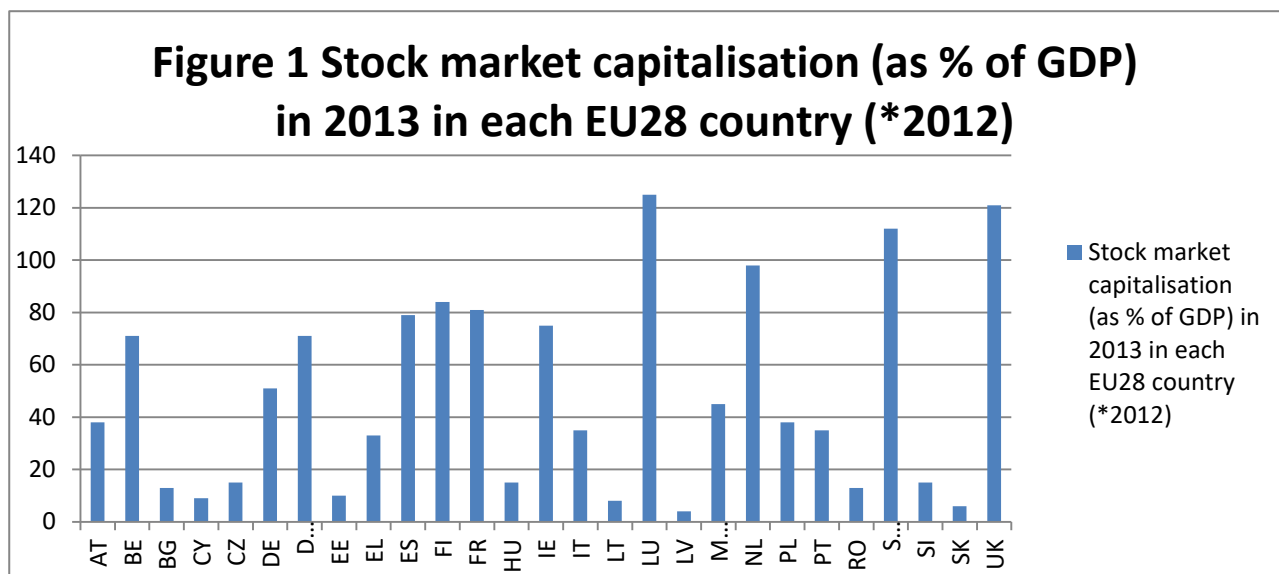
¹⁵ ECB, ‘Eurosystem Oversight Policy Framework’ (July 2011) <<https://www.ecb.europa.eu/pub/pdf/other/eurosystemoversightpolicyframework2011en.pdf> > accessed 27 February 2017

¹⁶ ECJ, Case T-496/11 United Kingdom of Great Britain and Northern Ireland v. European Central Bank, ECLI:EU:T:2015:133.

¹⁷ Jim Brunsten, “ECB Steps Up Warning on UK Clearing after Brexit” *Financial Times* (London, 22 January 2017)

government pressed for a double-majority voting system in the EBA, as its extant majority system would have effectively allowed the euro area to govern the technical standards that would have been applied to all EU banks.¹⁸ Article 3.6 of the 2014 revised voting procedure therefore requires that decisions be adopted after a simple majority of euro-ins and a simple majority of euro-outs.¹⁹ Chancellor of the Exchequer George Osborne considered EBA voting as a significant test case that had wider application for the role of the UK in a two-speed Europe.²⁰

Shortly after the inauguration of Banking Union came plans for the loftily-named Capital Markets Union (CMU). The EU-28 hosts 17 major national stock exchanges with a market capitalization of listed companies of €10.6 trillion at the end of 2015.²¹ When CMU was launched in 2015, stock market capitalization as a percentage of GDP varied substantially (see Figure 1), with the UK as the second-highest cap-to-GDP ratio. According to the Commission, the lack of venture capital markets of a similar depth to that in the US cost the EU economy €90 billion over the previous five years.²² A report from the House of Lords supported CMU as “a project for the whole EU, and not just the Eurozone, and the UK stands to benefit through its role as a financial markets hub.”²³



Source: European Commission, “Capital Markets in the EU”, 18 February 2015.

¹⁸ Alex Barker, “Britain Threatens to Block Banking Union” *Financial Times* (London, 8 November 2012)

¹⁹ European Banking Authority, “Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors” <[https://www.eba.europa.eu/documents/10180/15718/EBA+DC+001+\(Rules+of+Procedure+EBA-BoS+Rev3\)_final.pdf/b5bb9d8e-050e-4b0b-95ff-cf86e2547b2c](https://www.eba.europa.eu/documents/10180/15718/EBA+DC+001+(Rules+of+Procedure+EBA-BoS+Rev3)_final.pdf/b5bb9d8e-050e-4b0b-95ff-cf86e2547b2c)> accessed 20 April 2017

²⁰ Alex Barker, Peter Spiegel and George Parker, “UK Close to Clinching Bank Union Safeguards.” *Financial Times* (London, 12 December 2012)

²¹ Jan Schildback and Martin Waibel, “European Exchange Landscape: Too Fragmented” (*Deutsche Bank Research Talking Point*, 2 May 2016)

<[https://www.dbresearch.de/servlet/reweb2.ReWEB?document=PROD000000000401796&rwnode=DBR_INTERNET_EN-PROD\\$NAVIGATION&rwobj=ReDisplay.Start.class&rwsite=DBR_INTERNET_EN-PROD](https://www.dbresearch.de/servlet/reweb2.ReWEB?document=PROD000000000401796&rwnode=DBR_INTERNET_EN-PROD$NAVIGATION&rwobj=ReDisplay.Start.class&rwsite=DBR_INTERNET_EN-PROD)> accessed 1 March 2017

²² European Commission (2015). “Capital Markets Union: Factsheet” (Brussels, 30 September 2015)

²³ House of Lords European Union Committee, “Whatever It Takes”: “The Five Presidents’ Report on Completing Economic and Monetary Union”, *13th Report of Session 2015-15*, published 12 May 2016

Despite the similar monikers, plans for CMU differ substantially; while Banking Union aimed to stabilize financial markets through centralized supervision, CMU is about creating new financing opportunities. The financial fragmentation that accompanied the sovereign debt crisis led to vastly different funding conditions across borders and inhibited the return of economic growth, particularly to peripheral economies that had to pay higher interest rates than similar firms in core economies like Germany, Austria or the Netherlands. Promoting the development of European capital markets could open new avenues of funding for firms and encourage investment and growth.

When the Juncker Commission began in 2014, Jonathan Hill was appointed the Commissioner for the new Directorate General of Financial Services and Markets (DG FISMA). On the one hand, Hill's appointment was in line with the objective of reinvigorating capital markets, given the crucial role played by British capital markets. It also contained symbolic significance to have a British Commissioner at the helm to remind people of the important benefits that EU membership conferred on the City of London. On the other hand, plans to hold a referendum on the UK withdrawal from the EU also made it impossible for CMU to propose anything too ambitious: with the future of the UK's membership uncertain, Commissioner Hill could not embark on bold new commitments that would implicate the UK. When the 2015 Five Presidents' report had advocated a single capital markets supervisor for the EU,²⁴ for example, this prompted protests from the UK.²⁵

On 30 September 2015, a Commission action plan outlined measures to achieve a “well-functioning and integrated Capital Markets Union by 2019.”²⁶ Some of the associated proposals included boosting the moribund market for securitization, creating new prospectus rules to lower costs for companies trying to access capital markets (especially small companies), supporting long-term infrastructure investment through Solvency II,²⁷ and strengthening venture capital markets. The Five Presidents' proposal on supervision, however, had been dropped from the action plan.

In summary, the UK had fully participated in financial market integration until the sovereign debt crisis shifted it from an issue for the single market to the euro area, thanks to the doom loop between banks and sovereigns threatening the integrity of the euro area. Therefore, the UK remains

²⁴ Juncker et al, “Completing Europe's Economic and Monetary Union”, p.12 (n 3)

²⁵ Nicolas Veron, “Europe's Capital Markets Union and the New Single Market Challenge” (2015) *Bruegel blog post* 30 September <<http://bruegel.org/2015/09/europes-capital-markets-union-and-the-new-single-market-challenge/>> accessed 20 March 2017

²⁶ European Commission, “Action Plan on Building a Capital Markets Union” Communication to the European Parliament, the Council, the European Economic and Social Committee and the Committee of Regions, 30 September 2015 < <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015DC0468>> accessed 17 March 2017

²⁷ European Commission, “Capital Markets Union—Accelerating Reform” Communication to the European Parliament, the Council, the European Economic and Social Committee and the Committee of Regions, 14 September 2016 < http://ec.europa.eu/finance/capital-markets-union/docs/20160914-com-2016-601_en.pdf> accessed 19 March 2017

outside of banking union (specifically supervision and resolution) but participates in other areas of financial integration like the Single Rulebook and CMU.

2.3. Fiscal policy cooperation

Fiscal policy cooperation began with the Maastricht Treaty convergence criteria to enter EMU on deficits (3% of GDP) and debt (60% of GDP). Article 125 TFEU, the no-bailout clause, prevented fiscal transfers across Member States, and the fiscal criteria were supposed to render bailouts unnecessary. These convergence criteria were codified in the Stability and Growth Pact (SGP) rules on deficits and debt levels. The SGP established a preventive arm warning states that approached the deficit limits and a corrective arm triggering the Excessive Deficit Procedure (EDP), which eventually could impose fines on the euro area member state in violation of the SGP. Euro-outs could be found in violation of the SGP and be placed under the EDP, but they would not be fined. The UK most recently was under the EDP in 2015. All Member States are required to submit to regular reporting of their fiscal situation to the European Commission, with euro area countries submitting a “Stability Programme” and euro-outs a “Convergence Programme”. The independent Office for Budget Responsibility (established in 2010) prepared the UK’s forecasts for its Convergence Programme.

Although the SGP’s rules were relaxed in 2005, the euro crisis prompted the tightening of the SGP as part of the six-pack and the two-pack. The UK’s opt-out exempts it from the two-pack regulations that tighten fiscal surveillance, the six-pack’s new sanctions for noncompliance with fiscal rules, and the directive requiring Member States to set domestic numerical rules for achieving fiscal targets.²⁸ These fiscal reforms were reinforced (and in some cases duplicated) by measures in the 2012 Treaty on Stability, Coordination and Governance (TSCG). Having been urged on by Draghi’s call for a “fiscal compact”²⁹, the EU’s attempt to enact the necessary treaty changes was blocked by the UK. Member States therefore opted use an intergovernmental treaty to circumvent the unanimity required by treaty changes.³⁰ All EU countries except the UK and the Czech Republic signed the TSCG. While UK Chancellor of the Exchequer Osborne accepted the “remorseless

²⁸ UK government, “Review of the Balance of Competences between the United Kingdom and the European Union: Economic, and Monetary Policy” (London, December 2014)
<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/388847/2903003_BoC_EMP_acc.pdf>
accessed 6 April 2017

²⁹ Mario Draghi, “Hearing Before the Plenary of the European Parliament on the Occasion of the Adoption of the Resolution on the ECB’s 2010 Annual Report” (Strasbourg, 1 December 2011)
<<https://www.ecb.europa.eu/press/key/date/2011/html/sp111201.en.html>> accessed 15 March 2017. See also Jonathan Yiangou, Micheal O’Keeffe, and Gabriel Glöckler, “‘Tough Love’: How the ECB’s Monetary Financing Prohibition Pushes Deeper Euro Area Integration” (2013) *Journal of European Integration* 35, 3, pp.223-237

³⁰ Federico Fabbrini, *Economic Governance in Europe* (Oxford University Press, 2016)

logic”³¹ that a single currency imposed on further fiscal integration, the UK once again opted out. To support fiscal consolidation across the euro area, the Five Presidents’ report proposed the creation of a European Fiscal Board,³² which was set up in October 2016. The European Fiscal Board operates in strictly an advisory capacity, and its members come from both the Eurozone and euro-outs.

The sovereign debt crisis also prompted the creation of bailout funds. The UK’s participation in bailouts was not straightforward, despite its opt-out. The EU responded to the first Greek crisis in 2010 with a comprehensive package that included the European Financial Stability Facility (EFSF, €440bn), as well as the European Financial Stability Mechanism (EFSM, €60bn). The latter used the EU budget as collateral to borrow money on financial markets, thereby implicating the UK. At the December 2010 European Council summit, Prime Minister David Cameron agreed to the treaty change that would be needed to create the European Stability Mechanism (ESM), the permanent euro area bailout fund established in 2012. In return, the EFSM would no longer be used for euro area bailouts.³³ The UK (like other euro-outs) does not participate in the ESM. Cameron’s deal regarding a new settlement for the UK within the EU also excluded the use of funds provided by euro-outs for euro area crisis management³⁴. Nevertheless, the UK did participate in the Irish bailout through bilateral loans.

In summary, the UK’s participation in fiscal policy cooperation is limited to budgetary surveillance and the submission of a Convergence Programme to the European Commission. It has opted out of all fiscal policy cooperation agreements, including those outside of the framework of EU law. It voluntarily contributed to the Irish bailout and negotiated the separation of EU-backed funds for future euro area bailouts.

2.2 Economic Policy Cooperation

Economic policy cooperation is less institutionalized than the other pillars of EMU in that it is limited to coordination, with few powers delegated to the EU. The main instruments of economic policy cooperation are the Broad Economic Policy Guidelines (BEPG), Europe 2020, and the Macroeconomic Imbalances Procedure (MIP) that was established as part of the six-pack. The BEPG and Europe 2020 are procedures governed by soft law, in which the Commission makes

³¹ Chris Giles and George Parker, “Osborne Urges Eurozone to ‘Get a Grip’” *Financial Times* (London, 20 July 2011)

³² Juncker et al, “Completing Europe’s Economic and Monetary Union” p.14 (n 3)

³³ Matthew Holehouse, ‘EU Demands Britain Joins Greek Rescue Fund’ *The Telegraph* (London, 13 July 2015)

³⁴ Fabian Amtembrink, Anastasia Karatzia and Rene Repasi, “Renegotiation by the United Kingdom on its Constitutional Relationship with the European Union: Economic Governance” In-depth analysis prepared for the European Parliament’s Committee on Constitutional Affairs, September 2016

recommendations for the euro area along with country-specific recommendations (CSR). The European Semester was introduced in 2010 so that the reporting of economic policy coordination (National Reform Programmes) and fiscal policy coordination (the aforementioned Stability and Convergence Programmes) were coordinated under a common timeline that would enable Member States to take into account the CSRs in national budgetary proceedings. Multilateral surveillance applies to all EU Member States, with the exception of the adoption of sections of the BEPG relating to the euro area (Article 121 (1) TFEU).

The MIP aims to identify economic imbalances such as asset bubbles, financial crises or competitiveness imbalances before they become excessive. A scoreboard of 11 indicators was developed to screen for potential imbalances, which are published in the Alert Mechanism Report (AMR). Countries deemed at risk of imbalances are subject to an in-depth review (IDR) to confirm suspected imbalances, with follow-up measures included in the CSR. Should such imbalances be confirmed, the Member State enters the Excessive Imbalances Procedure (EIP), which can eventually lead to fines for euro area countries (in contrast to the soft law used for the BEPG and Europe 2020). The UK underwent an IDR every year from 2012-2016. None of these imbalances were ever found "excessive", and its 2016 IDR yielded "no imbalances."

In summary, the UK participates in EU economic policy coordination organized under the European Semester. Its status as a euro-out exempts it from the fines associated with the EIP, and the other aspects of economic policy coordination pose few constraints on national governments.

3. Brexit and EMU

Although the UK opted out of the single currency, the UK's presence in the EU still affected its development. It will continue to affect economic conditions in the near future; depending on how hard of a Brexit ensues (referring to the existence or nonexistence of transitional arrangements for access to EU markets), the loss of economic growth and output in both the UK and the EU could be substantial. Moreover, Brexit could alter alliances within the EU. First, the UK was an ally to other countries that voluntarily remained outside of the euro area. Brexit affects that balance considerably and removes the largest economy from that group. Second, the UK tended to pursue market-friendly policies that suited the interests of like-minded countries both in and out of the euro area.³⁵ Brexit could transform this dynamic. Finally, dealing with Brexit could shift political resources as countries deal with the ramifications of Brexit and the loss of British markets and

³⁵ See also Catherine Barnard's contribution in this volume, "Brexit and the EU Internal Market"

financial support.

This section considers the impact of Brexit on each of the aforementioned pillars and the likelihood of either further integration or disintegration, depending on: changing economic conditions that recast incentives for euro area integration; altering alliances within the euro area and between the euro-ins and euro-outs; and shifting political resources due to the consequences of Brexit. Both the impact of Brexit on the status quo as well as the possibility for future reforms will be analyzed. The latter will be drawn both from priorities stated by the euro area in the Five Presidents' report³⁶ and Commission White Paper,³⁷ as well as reforms suggested by prominent politicians and analysts. Numerous actors have noted the opportunity that Brexit poses for further European integration, with one of the main dissenters no longer in the game. Indeed, some have even considered further integration to be a necessity, both due to the need for a united Europe to successfully negotiate Brexit as well as for the long-run sustainability of EMU.³⁸

3.1. Monetary integration

What explains progress in monetary integration, and how would Brexit influence these factors? Some of the leading theories include: liberal intergovernmentalism, which emphasizes the role of large member states, especially Germany; neofunctionalism, which gives a critical role to supranational institutions; constructivism, which looks at shared ideas; and domestic politics and institutions.³⁹

A consensus emerged on the need to reinforce the “timber-framed”⁴⁰ governance structure of EMU after the euro crisis rocked its foundations, and much has been done to reinforce over the last decade. What remains for the monetary pillar? Two of the most contentious reforms, debt restructuring and the introduction of Eurobonds, would require a Treaty change⁴¹ and are unlikely to be pursued after Brexit negotiations have concluded; it lacks the support of large Member States like Germany, and no consensus exists on their utility. Other euro area reforms appear more viable. Institutional innovations suggested by the Five Presidents' report included a full-time Eurogroup presidency, a euro area finance ministry, and single representation of the euro area.⁴² Finally, monetary union could expand to include more euro-outs in the coming years.

³⁶ Juncker et al, “Completing Europe’s Economic and Monetary Union” (n 3)

³⁷ European Commission, “White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025” (n4)

³⁸ See also Federico Fabbrini’s contribution in this volume, “Brexit and EU Treaty Reform”

³⁹ Michele Chang, *Economic and Monetary Union* (Palgrave Macmillan, 2016)

⁴⁰ Wolfgang Schäuble, “Banking union must be built on firm foundations” *Financial Times* (London, 12 May 2013).

⁴¹ Federico Fabbrini, “Reforming Economic and Monetary Union: Legislation and Treaty Change” *Spotlight Europe* #2017/01

⁴² Juncker et al, “Completing Europe’s Economic and Monetary Union” (n 28)

Brexit would add additional challenges to achieving these ends. First, Brexit will lead to changing economic conditions through exchange rate fluctuations. The uncertainty generated by Brexit has led to a weaker pound. If a soft Brexit were to emerge, the exchange rate would likely stabilize. In the case of a hard Brexit, the exchange rate volatility that would ensue could affect the incentives for euro-outs to join. In the past, exchange rate volatility has served as an impetus for more cooperation in Europe; both the Snake and the European Monetary System were created in part as a response to the instability of the European currencies against the dollar.⁴³ Indeed, the 1992-93 ERM crisis convinced many European leaders that monetary union was the better option, given the difficulty in maintaining a fixed exchange rate in a world of mobile capital.⁴⁴ Could a similar calculation be made by the euro-outs to get closer to EMU? Or for the euro-ins to strengthen cooperation? Currently only Denmark is part of the ERM II, in which membership is required for 2 years without devaluation before adopting the euro. During the global financial crisis, there was some acknowledgement that the existence of the euro had prevented it from becoming a currency crisis as well, and Denmark briefly considered euro membership.⁴⁵ The euro-outs have declined to join EMU for political reasons as well as economic,⁴⁶ and the exchange rate volatility would have to be sustained and severe for them to abandon their political reservations and adopt the euro. The 2016 Eurobarometer poll showed 52% of respondents across the 7 pre-ins are against euro adoption, an increase from 49% in 2015.⁴⁷

Second, Brexit could alter alliances between remaining EU member states, both inside and outside of the euro area. For those remaining euro-outs, the division with the euro area could harden. The euro-ins already can outvote euro-outs under the qualified majority voting rules introduced by the Lisbon Treaty, and Brexit has intensified interest in multi-speed integration. In February 2017, the Benelux countries declared that in their vision of the future of Europe, “different paths of integration and enhanced cooperation could provide for effective responses to challenges that affect member states in different ways.”⁴⁸ Among the Commission White Paper scenarios,⁴⁹ a multi-speed Europe emerged quickly as the favored option of Germany, France, Italy and Spain. While French President Francois Hollande deemed the idea of a multi-speed Europe “necessary”, others viewed it

⁴³ Peter Ludlow, *The Making of the European Monetary System* (Butterworths Scientific 1982)

⁴⁴ Paul De Grauwe, “What Have We Learnt about Monetary Integration since the Maastricht Treaty?” (2006) *Journal of Common Market Studies* 44, 4, pp.711-730

⁴⁵ Marcus Walker, “Denmark Pushes for Vote to Adopt Euro” *Wall Street Journal* (New York, 5 November 2008).

⁴⁶ Michele Chang, *Economic and Monetary Union* (no 32)

⁴⁷ Flash Eurobarometer 440, Report: Introduction of the Euro in the Member States that have not yet Adopted the Common Currency. April. doi:10.2765/12914

⁴⁸ Charles Michel, “Benelux Vision on the Future of Europe” 3 February 2017 <<http://premier.fgov.be/en/benelux-vision-future-europe>> accessed 12 March 2017

⁴⁹ European Commission, “White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025” (n4)

as “dangerous”⁵⁰ in that it could exacerbate the existing divisions between EU member states over issues like the euro, Schengen, and migration and create a second-class EU citizenship. Bulgaria and Romania, for example, expressed concern that Brexit would lead to their marginalization;⁵¹ euro-outs were difficult to marginalize when the UK figured among their ranks, but Brexit would reduce euro-outs to a group of small- and medium-sized countries. If multi-speed Europe emerges as the preferred integration path, some euro-outs likely would reconsider euro area membership. Most have accepted the need for the euro area to intensify integration to be viable in the long-term, which would exacerbate the notions of a “core” and a “periphery” in the EU.

Institutionally, the Eurogroup would gain importance. Although the Economic and Financial Affairs Council (Ecofin) retains formal decision-making authority, the subset of finance ministers of the euro area known as the Eurogroup has become a key institution in EU governance. The Eurogroup began as an informal group in which members could discuss matters of common interest. The sovereign debt crisis solidified its power and influence; the European Stability Mechanism’s Board of Governors, its highest decision-making body, consists of the Eurogroup members. Critical decisions on EMU are made by the Eurogroup, not Ecofin,⁵² and a multispeed Europe would intensify this pattern. Remaining outside of the euro area therefore would entail costs in terms of engagement and influence in the EU, though some euro-outs might accept this price.

Even within the euro area, Brexit could provoke shifting alliances.⁵³ The euro crisis contributed to rising intergovernmentalism in EU governance⁵⁴ that left Germany as the euro area’s “reluctant hegemon”.⁵⁵ Brexit would solidify German leadership within the euro area and the EU, as “other EU member states have already directed their attention increasingly towards Berlin, with this in part a result of Britain’s growing isolation”⁵⁶.

3.2 Financial Integration

Brexit’s impact on the euro area will be more direct in that the UK participated in EU financial cooperation as part of the single market. The withdrawal of the UK will have major changes on the

⁵⁰ Alex Barker, Paul McClean and Stefan Wagstyl, “Will EU Core States Leave Partners Behind after Brexit?” *Financial Times* (London, 7 March 2017).

⁵¹ Almut Möller and Tim Oliver (eds) *The United Kingdom and the European Union: What would a “Brexit” mean for the EU and other States around the World?* DGAPanalyse Deutsche Gesellschaft fuer Auswaertige Politik e.V, 2014)

⁵² Article 136 (2) states that “only members of the Council representing Member States whose currency is the euro shall take part in the vote” for matters involving the proper functioning of EMU.

⁵³ See also Uwe Puetter’s contribution to this volume, “Brexit and EU Institutional Balance of Power”

⁵⁴ Christopher J. Bickerton, Dermot Hodson and Uwe Puetter, eds., *The New Intergovernmentalism: States and Supranational Actors in the Post-Maastricht Era* (Oxford University Press 2015)

⁵⁵ William Paterson, “The Reluctant Hegemon? Germany Moves Center Stage in the European Union” (2011) *Journal of Common Market Studies* 49, Annual Review, pp.57-75

⁵⁶ Tim Oliver, “European and International Views of Brexit” (2016) *Journal of European Public Policy* 23, 9, p.1323

EU's financial system. Its banking sector's asset size is between a third and a half of that of the euro area, its bank balance sheets are three times the euro area's GDP, and it is much more international. About 10% of all euro area and 15% of non-euro area bank branches or subsidiaries are in the UK, and five of those subsidiaries are supervised by the SSM.⁵⁷

The European Commission contends that work on CMU will continue and that the basic building blocks will still be in place by 2019. According to Commission Vice President for Financial Services Valdis Dombrovskis, "The prospect of Europe's largest financial centre leaving the single market makes our task more challenging, but all the more important."⁵⁸ Concrete plans beyond 2019, however, appear to be modest. In the Commission's White Paper,⁵⁹ CMU is only mentioned twice. Under the "Carrying on" scenario, the Commission envisions that "further steps are taken to strengthen financial supervision...and to develop capital markets to finance the real economy."⁶⁰ This seems to exclude expanding the supranational reach of European institutions across capital markets. Only more ambitious "doing more together" scenario advocates "fully integrated capital markets."⁶¹

Previous research on the political economy of European financial regulation indicates the importance of large Member State interests⁶² and the domestic politics behind them,⁶³ converging ideas,⁶⁴ and the institutional features of national banking sectors.⁶⁵ These will be affected by the aforementioned factors that Brexit will alter and thus impact the development of financial sector integration in the future. For example, Brexit will reconfigure the extant alliances present in European financial integration. France, Italy, Spain's "market-shaping" coalition seeking "financial stability and consumer protection, as well as the protection of national industry" conflicted with the UK, the Netherlands and Nordic countries' "market-making" coalition prizing "competition and

⁵⁷ Ignazio Angeloni, "Banking union and the United Kingdom in the single market." Speech to the Barclays Annual Bank Capital Conference, London, 9 March 2016

⁵⁸ Fiona Maxwell, "EU's capital markets disunion" *Politico* (Brussels, 22 February 2017)

⁵⁹ European Commission, "White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025"(n4)

⁶⁰ European Commission, "White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025" p.16 (n4)

⁶¹ *Ibid*, p.24

⁶² Shawn Donnelly, "Power Politics and the Undersupply of Financial Stability in Europe" (2014) *Review of International Political Economy* 21, 4, pp. 985-1005

⁶³ Alexandra Hennessey, "Redesigning Financial Supervision in the European Union (2009-2013)" (2013) *Journal of European Public Policy* 21, 2, pp. 151-168; Scott James, "The Domestic Politics of Financial Regulation: Informal Ratification Games and the EU Capital Requirement Negotiations" (2016) *New Political Economy* 21, 2, pp. 187-203

⁶⁴ Schaefer, "A Banking Union of Ideas? The Impact of Ordoliberalism and the Vicious Circle on the EU Banking Union" (n 5)

⁶⁵ David Howarth and Lucia Quaglia, *The Political Economy of European Banking Union* (Oxford University Press 2016)

market efficiency.”⁶⁶ Brexit deprives the latter of its largest and most influential member and largest beneficiary of Capital Markets Union, as the UK, Luxembourg, Sweden, Ireland and the Netherlands were the strongest advocates of CMU; Germany, France, Italy and Austria viewed CMU more cautiously, and the Central and Eastern European states were unlikely to benefit substantially based on the presence (or lack) of a large, non-bank-based financial sector.⁶⁷ Questions have been raised if this will affect EU support for the completion of CMU,⁶⁸ but Commissioner Dombrovskis insisted that Brexit makes CMU “more urgent.”⁶⁹

Brexit provides the opportunity to reconsider CMU’s next steps. Brexit will lead to a “regulatory splintering” once EU capital markets cease to be subject to the UK’s Prudential Regulation Authority.⁷⁰ Moreover, Brexit has revived the question of euro-denominated transactions being cleared in London. The aforementioned ECJ ruling⁷¹ and ECB swap agreement will no longer apply after the UK exits.⁷² In May 2017 the Commission already announced the EU’s intention to move clearing activities to the EU as part of its plans for the reform of the European Market Infrastructure Regulation (EMIR): “CCPs that play a key systemic role for EU financial markets are subject to the safeguards provided by the EU legal framework, including, where necessary, enhanced supervision at EU level and/or location requirements.”⁷³

How can the UK’s relationship with the EU be preserved, at least in financial services? This will be a major topic for Brexit negotiations. British firms would lose passporting rights, referring the ability of firms to provide financial services across the EU. To retain them, UK banks would need subsidiaries in the EU, as the only non-EU countries given passporting rights are in the European Economic Area. Banks moving from the UK to the EU would have to comply with EU regulations and the SSM framework.⁷⁴ For those without EU subsidiaries, another option is equivalence, in which both sides agree that rules and legislation are similar. Equivalence arrangements, however, suffer from their “piecemeal” approach, as the rights are narrowly defined in specific articles and

⁶⁶ Lucia Quaglia, *Governing Financial Services in the European Union: Banking, Securities and Post-Trading* (Routledge 2010): p.8

⁶⁷ Quaglia, Howarth, and Liebe, “The Political Economy of European Capital Markets Union” (n 51)

⁶⁸ Philipp Ständer, “What Will Happen with the Capital Markets Union After Brexit?” (2016) *Jacques Delors Institute Policy Paper* no.191

⁶⁹ Jim Brunsten, “Brexit Makes EU Capital Markets Union More Urgent, Says Commissioner” *Financial Times* (London, 14 September 2016)

⁷⁰ Reza Moghadam, “How a Post-Brexit Redesign Can Save the Capital Markets Union” *Financial Times* (London, 13 February 2016)

⁷¹ ECJ, Case T-496/11 United Kingdom of Great Britain and Northern Ireland v. European Central Bank (n 18)

⁷² Batsaikhan, “Brexit and the UK’s Euro-denominated market: the role of clearing houses” (n 8)

⁷³ Commission, “Commission Proposes Simpler and More Efficient Derivatives Rules”, Press release, 4 May 2017, <http://europa.eu/rapid/press-release_IP-17-1150_en.htm> accessed 7 May 2017

⁷⁴ ECB, “Relocating to the euro area”

<<https://www.bankingsupervision.europa.eu/banking/relocating/html/index.en.html>> accessed 7 May 2017

can be quickly withdrawn.⁷⁵ Bank of England Governor Mark Carney has called for a system of “mutual recognition and cooperation” of UK and EU financial rules.⁷⁶

A window of opportunity could arise allowing for a reassessment of the roles of the ESAs more generally⁷⁷ and for furthering CMU to include supervision. For example, the ESAs will already be affected through the relocation of the EBA from London to the Continent. The EBA’s double majority voting system likely will be reconsidered due to Brexit. In addition, Schoenmaker and Veron have proposed the expansion of ESMA’s powers, noting that “It is in the interest of the United Kingdom to have a well-regulated, well-supervised EU-27 financial system as its neighbour.”⁷⁸

Finally, there is the possibility that Brexit and its aftermath will discourage further integration, including CMU. This is not only possible, some would argue that it is preferable given the “broadly varying financial practices and structures” in the EU, and priority should be given to euro area integration.⁷⁹ Moreover, “the absence of strong spillovers and availability of domestic options to unilaterally contain financial stability”⁸⁰ had prevented shifting financial regulation to the EU in the past and could continue to do so after Brexit. With its strongest advocate leaving the EU, the remaining proponents are relatively small and would have difficulty winning over more ambivalent Member States.

3.3 Fiscal Integration

The flurry of euro area fiscal reforms since 2010 have exacerbated the complexity of the rules concerning fiscal policy cooperation. To that end, the Commission advocated the “streamlining and reinforcement of the European Semester.”⁸¹ In the longer-term, the Five Presidents’ report suggested that the euro area could acquire a fiscal stabilisation function, as “all mature Monetary

⁷⁵ Aliénor Anne Claire Duvillet-Margerit, Marcel Magnus, Benoit Mesnard and Aspasia Xirou, “Third Country Equivalence in EU Banking Legislation” European Parliament Briefing, 7 March 2017, p.1, <[http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/587369/IPOL_BRI\(2016\)587369_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/587369/IPOL_BRI(2016)587369_EN.pdf)> accessed 21 April 2017

⁷⁶ Mark Carney, “The High Road to a Responsible, Open Financial System” Speech to Thomson Reuters, Canary Wharf, 7 April 2017

⁷⁷ Ständer, “What Will Happen with the Capital Markets Union After Brexit?” (n 60)

⁷⁸ Dirk Schoenmaker and Nicolas Veron (2017). “Brexit should drive integration of EU capital markets” Bruegel blog post. 24 February 2017 < <http://bruegel.org/2017/02/brexit-should-drive-integration-of-eu-capital-markets/>> accessed 27 February 2017

⁷⁹ Anton Brender, Florence Pisani and Daniel Gros, “Building a Capital Markets Union...Or Designing a Financial System for the Euro Area?” (2015) *CEPS Commentaries* 2 June 2015

⁸⁰ Lucia Quaglia and Aneta Spendzharova, “The Conundrum of Solving ‘Too Big to Fail’ in the European Union: Supranationalization at Different Speeds” (2017) *Journal of Common Market Studies* DOI 10.1111/jcms.12531

⁸¹ Jean-Claude Juncker, “A Deeper and Fairer Economic and Monetary Union: Two Years On”. Speech on the State of the Union to the European Parliament, 14 September 2016, p.7 < https://ec.europa.eu/commission/sites/beta-political/files/2-years-on-emu_en_0.pdf> accessed 7 April 2017

Unions have put in place a common macroeconomic stabilisation function to better deal with shocks.”⁸² Brexit could facilitate the creation of a euro area fiscal capacity. Post-Brexit, the EU will be poorer; this would be a consequence of declining trade and investment with the UK as well as the loss of Britain’s contributions to the EU budget. Brexit would lead to a “permanent funding gap” for the EU budget that could amount to €10 billion per year.⁸³ Conflict between net contributors to the EU budget and net beneficiaries would ensue, as the former (including Denmark, Germany, the Netherlands, and Sweden) would be under pressure to increase their national contributions. Moreover, EU programmes would face the threat of major cuts. Brexit therefore presents a “window of opportunity” for reform of the multiannual financial framework and even the creation of a separate euro area budget.⁸⁴ The latter is a longstanding idea that was raised in the 1970 Werner Report,⁸⁵ the European Community’s original blueprint for EMU, but was not included in the 1989 Delors Report⁸⁶ that set the conditions for EMU under the Maastricht Treaty. The idea of a euro area budget enjoys renewed interest, which would logically be accompanied by a euro area finance ministry.

Nevertheless, disagreement remains over building a euro area fiscal capacity. Germany, in particular, has opted to pursue stronger fiscal rules to strengthen euro area fiscal governance, with no indications of a shift in attitude towards reforms that could lead to fiscal transfers or risk sharing across the euro area.⁸⁷ Instead, the German government has supported intergovernmental measures rather than risk-sharing ones. For example, German Finance Minister Wolfgang Schäuble advocated upgrading the ESM to a European Monetary Fund that would take over the monitoring of euro area budgets from the Commission,⁸⁸ which is quite different from a euro area finance ministry that could engage in countercyclical spending. German reluctance to approve reforms that would have cross-border budgetary implications also have prevented the creation of euro area deposit insurance, something that is essential for the completion of banking union and, according to Guntram Wolff, is a “prerequisite for a euro-area fiscal capacity.”⁸⁹ While Brexit presents the

⁸² Juncker et al., “Completing Europe’s Economic and Monetary Union” (n 3)

⁸³ Jörg Haas and Eulalia Rubio, “Brexit and the EU Budget: Threat or Opportunity?” (2016) *Jacques Delors Institute Policy Paper* no.183

⁸⁴ See also Federico Fabbrini’s contribution in this volume, “Brexit and EU Treaty Reform”

⁸⁵ Pierre Werner (chair), “Report to the Council and the Commission on the Realisation by Stages of Economic and Monetary Union in the European Community” Luxembourg, 8 October 1970

⁸⁶ Reference was made instead to “binding rules for budgetary policies” with no euro area budget for cyclical adjustment, see Jacques Delors (chair), “Report on Economic and Monetary Union in the European Community” (1989) p.16

⁸⁷ Matthias Matthijs, “Powerful Rules Governing the Euro: The Perverse Logic of German Ideas” (2016) *Journal of European Public Policy* 23, 3, pp.375-391

⁸⁸ Albrecht Meier, “Berlin continues quest for ‘European Monetary Fund’” *Der Tagesspiegel* (Berlin, 8 March 2017)

⁸⁹ Guntram Wolff, “What Are the Prerequisites for a Euro-Area Fiscal Capacity?” *Bruegel Policy Contribution* 9 September 2016

greater possibility for such reforms, substantial political obstacles remain; Germany's reform proposals continue to involve stronger rules rather than shared risk.

3.4. Economic policy coordination

The Five Presidents' report suggested a euro area system of Competitiveness Authorities in which Member States assigned independent entities to assess issues like the evolution of wages vis-à-vis other euro area countries and major trading partners. These national bodies would meet annually to coordinate actions. In addition, the report proposed strengthening the Macroeconomic Imbalances Procedure in a way that would encourage structural reforms by making more use of the corrective arm.

Structural reforms may be necessary, as Brexit will likely lead to worsening economic conditions for both the UK and the EU: "There is a consensus, even including the proponents of 'leave', that there would be a short-term negative shock to the EU economy from Brexit." Eight euro area countries figure among the UK's top import and export destinations and will be affected strongly by Brexit. Nevertheless, it is not clear that EU economic policy coordination would be able to improve the situation. Indeed, one study found "strong and robust evidence that neither [the SGP] nor the Lisbon Strategy have had a significant beneficial impact on...economic performance."

Moreover, the soft law nature of economic policy cooperation has always made compliance with recommendations uneven at best, as consequences for noncompliance were limited. A recent study indicated that in 2016 the situation had worsened, with the proportion of country specific recommendations that were followed dropping from 7% in 2014 to 2% in 2016; the excessive imbalances procedure seems to have made little difference. While many agree on the need for reform, the nature of the reforms have been contested. In contrast to shifting views of the relationship between the single currency and financial supervision discussed above, other areas have been prone to "ideational stickiness and inertia, and despite some policy experimentation, overarching policy frameworks and their rationales have not been overhauled." Brexit is unlikely to change these dynamics.

4. Conclusion

Monnet's prediction that Europe will be forged in crisis has been recalled frequently over the last decade, and Brexit presents a major challenge for European integration. Nevertheless, the UK's non-participation in EMU means that Brexit will have more of an indirect effect, particularly on monetary and financial integration. The divide between the euro-ins and euro-outs will become

larger, which could give the needed impetus to a euro zone enlargement. In terms of further integration within the monetary pillar, however, Brexit would strengthen the already-dominant position of Germany. In the financial pillar, the exit of the U.K. will affect further integration decisively by changing the EU financial landscape and altering alliances between the remaining member states. While the pursuit of CMU would continue under its currently narrow remit, further supranationalism in supervision and regulation is questionable due to opposition to risk sharing by Germany and others. The loss of the EU's foremost advocate (and beneficiary) of financial market liberalization offers a window of opportunity to reconsider existing structures but likely would lead to only incremental changes, absent another crisis or the emergence of German leadership in this direction. Its impact on fiscal integration is less certain, with the budgetary pressures on the post-Brexit multiannual financial framework presenting new challenges that require reforms that could lead eventually to a euro area budget. Nevertheless, German opposition to risk sharing could again stymie reforms in this direction. Finally, Brexit's impact on economic policy will likely reinforce existing tendencies.

Will Brexit promote integration or disintegration in EMU? The euro crisis already prompted substantial reforms in euro area governance and the recognition that further integration is needed. Brexit's impact on economic conditions, existing alliances and political resources ensure that the euro area integration will continue, at least in some areas. It may even expand in euro area membership. In this way, the EU's biggest euro-out would have (inadvertently) instigated further euro area cooperation.