PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 41 (891), 30 June 2016 © PISM

Editors: Sławomir Dębski (PISM Director) • Katarzyna Staniewska (Managing Editor)
Jarosław Ćwiek-Karpowicz • Karolina Borońska-Hryniewiecka • Anna Maria Dyner • Patryk Kugiel
Zuzanna Nowak • Sebastian Płóciennik • Patrycja Sasnal • Marcin Terlikowski

A “Non-euro” Zone after a Possible Brexit

Sebastian Płóciennik

The UK’s exit from the European Union will change the relationship between eurozone countries and those without a common currency—primarily to the detriment of the latter. They will be faced with a choice between fast-track adoption of the euro or political and economic marginalisation. The obvious political and economic risks associated with both options can be limited by stabilising the relationship between the eurozone and EU Member States without the common currency. In this context, it is worth considering strengthening the European Exchange Rate Mechanism.

So far, the eurozone and non-euro countries have had a stable and relatively non-conflicting relationship. The monetary union underwent a slow enlargement when some smaller, open economies of Central Europe were accepted, bringing the number of eurozone members to 19 without exerting stronger pressure on other EU countries to adopt the euro swiftly. There have been few objections to incorporate the latter into discussions about reforms and further development of economic integration. On the other hand, none of the countries outside the eurozone attempted to block the EU’s corrective actions regarding the monetary union or its creation of new institutions of economic governance.

This stable coexistence of two integration platforms resulted to some extent from the relative weakness of the eurozone, which was hit particularly hard by the recent crisis and the relative strength of the non-euro countries. Their economies have fared well in recent years, and their governments have prevented more serious institutional detachments from the EMU-peloton. Soon, however, this condition may change, not only because of the ongoing consolidation of the eurozone, but, above all, due to the highly probable exit of the United Kingdom from the European Union.

"Non-euro" Depends on the United Kingdom. The current position of the “non-euro” zone is determined by three factors, the first of which is economic potential. The combined GDP of the UK—which is a clear leader among other “non-euro” countries—and Denmark, Sweden, Poland, Czech Republic, Hungary, Romania, Bulgaria and Croatia, is equivalent to about 40% of GDP across the eurozone (€4.2 billion and €10.4 billion). Population size further emphasises the importance of “non-euro” countries. They have 170 million people, only two times less than in the EMU. Another argument, and perhaps the most significant from the economic point of view, is the importance of the financial sector. The City of London, powerful banks such as HSBC, Barclays and RBS, and the thousands of global financial institutions located there, make up the most important and active international financial centre in Europe.

The second factor determining the position of the “non-euro” countries was its quite firm institutional foundations. This is anchored in the UK and Denmark’s guaranteed opt-out, with the Maastricht Treaty permitting them to remain outside the EMU. Other countries were required to adopt the euro once they met the convergence criteria, but there is no specific date when this would take place. As a result, they can plan many years ahead while outside the eurozone and invest in political alliances with EU countries with a similar status.

The third factor was the political influence in financial matters, mainly based on Britain’s resources. Significantly, the European Banking Authority (EBA), created in 2011 in order to conduct stress tests for banks in the whole EU, is based in London. The position of the United Kingdom also strengthened the appointment of Jonathan Hill as EU Commissioner charged with monitoring financial stability, financial services and capital markets union. The United Kingdom could also come out unscathed from disputes with the institutions of monetary union. In the spring of 2015 it won a lengthy dispute with the ECB, which wanted large transactions denominated in euro to be carried out exclusively by clearing houses located in EMU-countries.

The political influence of the United Kingdom, of which other “non-euro” countries are evident beneficiaries, seemed to be cemented by the agreement in February 2016 pertaining to the UK’s special status in the European Union. Thanks to the British

efforts, “non-euro” countries can refer to the assurance that the EU is an area of "more than one currency", a statement that blocks discrimination against countries on the basis of their national means of payment. In addition, the deal excludes the UK from the cost of any "rescue packages" for the eurozone countries, while giving the British government the right to request discussions at the European Council on the impact of decisions taken by the eurozone on the other EU countries. Last but not least, Prime Minister David Cameron was able to weaken significantly the “ever-closer-union” principle, a source of concern of many non-euro countries reluctant to politically integrate.

The Brexit Effect. If the UK leaves the European Union, this will not only invalidate the generous agreement achieved by the British government in February 2016. It would also virtually eliminate the importance of all three factors discussed above in determining the relationship between the eurozone and the “non-euro” countries. Indeed, the importance of some began to erode within a few days of the referendum result being announced. This is how the resignation of Commissioner Hill, the great advocate of a "multi-currency system" in the European Union, should be interpreted. Further developments restricting British influence in the EU will not be long in coming. In the new reality it will hardly be possible prevent European Banking Supervision moving to eurozone countries. Behind the scenes there will be many efforts to weaken the City, by enticing its flagship financial institutions to move to Paris, Luxembourg or Frankfurt. The latter city just offered 1.2 million m^2 of office space to interested businesses.

In addition, Brexit dramatically shrinks the “non-euro” platform. All remaining countries will provide only the equivalent of 16% of the eurozone GDP and less than one third of its population. Without London’s consolidating role, the institutional differences will become much more visible. The stable status of the opt-out will remain only through Denmark, which, however, unlike the UK, has chosen an almost rigid link between its currency (the krone) and the euro through the ERM2 (Exchange Rate Mechanism) within a margin +/- 2.25% (instead of the regular margin of +/- 15%). Among Sweden and the countries of Central and Southern Europe, some do not want to accept the single currency, despite commitments to do so, some are hesitating, and others want to but do not meet the criteria.

The Pressure of the Eurozone. The weakening of the “non-euro” platform coincides with a slightly improving economic situation in the eurozone. Figures from 2015 tend to be optimistic, showing that, in most eurozone countries, there appeared to be economic growth, even with the recurring problem of Greek insolvency, which was met by a quick decision on financial assistance. In the opinion of many economists, the eurozone has built in recent years a relatively stable system of crisis management, and is now better equipped to cope with tension that it was during the shock of 2008 to 2009.

The stabilisation of the eurozone does not mean that disputes between its members, on the direction of economic policy, or more broadly, the direction of integration, will disappear. In recent years, the austerity approach of restrictive fiscal policies espoused by Germany dominated. An alternative approach is proposed by France, which opts for stimulation of growth through increasing public spending and loosening the financial corset. In this respect, France can count on the support of the large southern countries, Italy and Spain. In addition, the French stress the fact that the correction of economic policy in the eurozone must be backed by the establishment of a political union, for which they can count on the support of the German Social Democrats, as evidenced by the recently published joint manifesto of the foreign ministers Frank-Walter Steinmeier and Jean-Marc Ayrault. Their ideas for a swift deepening of political relations have met rather reserved reactions from Chancellor Angela Merkel, but even she may in time give way to radical deepening concepts.

If this economic and political vision gains the upper hand in the EMU, the consequences for the EU Member States outside the eurozone could be serious. They may face a political core, inward oriented, less willing to listen to the concerns of outsiders. It should come as no surprise if they are pressured by claims that their ability to devalue their own currencies in the single EU market is "unfair" competition for those who do not have such an option. During crises, eurozone countries are in fact forced to conduct “internal devaluations” involving structural reforms and the reduction of labour costs, which are politically much riskier than devaluation. The continued existence of the single market therefore requires (as claimed by proponents of “French” option) that all have uniform operating conditions, and, as such, a single currency.

Refresh the ERM. It is therefore likely that countries outside the eurozone will face an awkward choice between fast-track adoption of the euro or risking political and economic marginalisation in the EU. This dilemma applies especially to Central and Eastern European countries whose accession treaties oblige them to join the EMU. The problem lies in the fact that their societies and political elites are very sceptical about such a move, and this applies particularly to Poland. Increasing pressure for deeper integration and the adoption of the euro may thus open the door to a rise in Euroscepticism and anti-EU movements.

Finding a way out of the impasse will be very difficult, but not impossible. The European Union needs an institution that will allow the coexistence of the core eurozone and a "first external circle" consisting of the EU Member States without the euro. This would alleviate concerns from France and other countries about devaluation competition in the common market. In this context, it could be helpful, for example, to revitalise the European Exchange Rate Mechanism (ERM2), the aim of which is to keep the exchange rate against the euro in the range of +/- 15%. Since the creation of the eurozone it has been downgraded to function as an EMU accession criterion. At the new, post-Brexit integration stage, the role of ERM could be upgraded by combining membership with more political say in financial matters. In this way, on the one hand, exchange rates will stabilise and integration deepen, not weaken, while, on the other hand, countries without the euro will reduce the risk of decoupling from the core of integration.

This, let’s call it ERM3, is obviously not an ideal solution. It may, for example, open up discussions about the status of the European Economic Area countries that have access to the common market but in no way coordinate their exchange rate policy and monetary policy with the EU. It could also create a "moral hazard" for weaker eurozone countries raising the threat that one may play the "exit" card, for, in the event of trouble, they would fall not into institutional limbo but into the ERM3’s safety net. Neither can speculative attacks on the adopted exchange parity be ruled out, as well as economic problems with those non-euro countries that have been profiting from floating exchange rates. These obvious risks require a thorough analysis of every detail of the new exchange rate mechanism. However, the proposed solution could reduce the political and institutional tensions between the eurozone and the “non-euro” members of the EU in the event that the UK leaves.