

Can Brexit Lead to Further Integration? The Case of Economic and Monetary Union

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Executive Summary

- > Although the United Kingdom obtained an opt-out from Economic and Monetary Union (EMU), its departure from the European Union (EU) will have important effects on EMU's development.
- > These effects will be felt through three primary channels:
 - First, Brexit will create more pressure on the euro-outs to adopt the euro;
 - Second, it will alter existing alliances within the EU that by extension will affect the trajectory of euro area integration;
 - Finally, EU legislative reforms post-Brexit open up windows of opportunity to make the euro area more robust.

The UK's departure from the European Union (EU) will profoundly affect European integration. Although many have lamented the blow that this presents to the EU, Brexit also presents a window of opportunity for it to consider its reform options after the UK's exit, including policies related to Economic and Monetary Union (EMU). Although the UK famously declined participation in EMU and retained the pound as its currency, this policy brief argues that Brexit will affect the future trajectory of EMU in several ways. First, it will place pressure on euro-outs to adopt the euro as their currency. Second, it will alter existing alliances within the EU, including between the euro-ins and euro-outs. Third, Brexit will prompt changes in EU

legislation to account for the departure of the UK, thus opening the door to reforms to strengthen European financial market integration and possibly even fiscal cooperation.

The UK and EMU-related policies: What are the stakes?

The UK served as an important advocate for the interests of the euro-outs as the euro area pressed ahead with further integration during the sovereign debt crisis. For example, the decision to move to banking union shifted financial integration from a single market issue (concerning the EU-28) to one in which the euro area deepened integration through centralized banking supervision. The UK government pursued a double-majority voting system in the European Banking Authority (EBA) to prevent the euro-outs from being overwhelmed by euro area decisions in banking. Article 3.6 of the 2014 revised voting procedure requires a double majority in that decisions are adopted after a simple majority of euro-ins and a simple majority of euro-outs.

Such agreements protecting euro-outs could be jeopardized by Brexit. When the largest euro-out leaves the EU, the remaining countries are relatively small economies. Sweden and Poland are the largest euro-outs in terms of Gross Domestic Product (GDP), ranking 7th and 8th respectively out of the EU-28. Post-Brexit, the euro-outs would comprise less than 20% of the EU-27's GDP. 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' (Michel 2017). Among the Commission White Paper scenarios (European Commission 2017a), a multi-speed Europe emerged quickly as the favoured option of Germany, France, Italy and Spain. While then French President Hollande deemed the idea of a multi-speed Europe 'necessary', others called it 'dangerous' (Barker et al. 2017) 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 (Möller & Oliver 2014). 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.

Moreover, Brexit will reconfigure the current alliances in European financial integration, which could have an impact on capital markets union (CMU). 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 market efficiency' (Quaglia 2010: 8). Brexit deprives the latter of its largest and most influential member and the largest beneficiary of CMU, as the UK, Luxembourg, Sweden, Ireland and the Netherlands were its strongest advocates; Germany, France, Italy and Austria viewed CMU more cautiously, while 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 (Quaglia et al. 2016). Questions have even been raised if Brexit will affect EU support for the completion of CMU (Ständer 2016).

Additionally, one cannot expect EU legislation to remain static. One area that has already attracted much attention is the ability for UK clearing houses to continue to handle euro-denominated transactions. The UK's clearing houses have a daily turnover of over €927 billion. The European Central Bank (ECB) already tried to shift the settlement of euro-denominated transactions to the euro area in its 2011 policy framework. The UK brought the case to the European Court of Justice (ECJ) on the grounds that it contravened single market provisions on the free movement of

capital, services and establishment by discriminating on the basis of location. The ECJ ruled in favour of the UK, and the ECB arranged a swap line with the Bank of England to deal with potential liquidity shortages. Post-Brexit, this ECJ ruling and ECB swap agreement will no longer apply as the UK will not be part of the single market. A May 2017 press release declared 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) (European Commission 2017b).

Policy Implications of Brexit for EMU

The aforementioned shifting of alliances and concomitant changes to EU legislation post-Brexit provide a window of opportunity for the EU to improve its legislation and governance. This would not only help the EU deal with Brexit, but would also strengthen the still-vulnerable EMU architecture .

First, Brexit demands a reassessment of the legislation and supervision of financial markets. For example, CMU could be furthered through the expansion of the European Securities and Markets Authority (ESMA) to include supervision, as foreseen by the Commission's 2017 reflection paper on the future of EMU (European Commission 2017c). Although Brexit necessitates some shifts (like the move of the European Banking Authority out of London) and makes others likely (such as the rules governing euro clearing), this should not be done in a way that provokes unnecessary market disruption. Markets have had a relatively benign reaction to Brexit thus far, but this could change quickly if Brexit turns hard and sudden. The euro area is still dependent on London financial markets, and it would be in the interest of both sides to find an interim agreement to smooth the transition.

Second, the EU should try to make the adoption of the euro more attractive to the euro-outs. Brexit will trigger additional legislative changes in the EU that could have a negative impact on the euro-outs once their largest member leaves the club, which could cause them to reconsider membership. There are precedents for the EU easing participation in monetary integration (e.g. the creation of the Cohesion Fund that co-financed infrastructure projects in Greece, Ireland, Spain and Portugal to assist their fulfilment of EMU's convergence criteria), and such support could help overcome the political and economic obstacles to EMU membership in some countries.

Third, Brexit will prompt the reform of the multiannual financial framework. While building a euro area fiscal capacity seems like a distant possibility given German opposition, the time is ripe to consider reforms that would put the EU in a better position to deal with the economic issues that accompany Brexit. For example, in the US risk-sharing by private actors plays a larger role in stabilization than centralized fiscal policy. This example could also be followed in the EU. Nevertheless, a stronger fiscal underpinning is needed in the EU to move forward with banking union through joint deposit guarantees. This would also encourage greater private risk-sharing and make EMU more robust.

Conclusion

Despite the fact that the UK does not use the euro, Brexit will have important implications for EMU's future. The UK's significant financial sector and the loss of its budgetary contributions will lead to numerous EU reforms in the wake of its exit. The EU should take advantage of this. Encouraging the adoption of the euro by current euro-outs is a step in the right direction. While financial sector reforms are inevitable, the EU should be mindful of the benefits that London's financial markets have provided in the past and not make Brexit unnecessarily disruptive. Finally, the EU should use post-Brexit reforms as an opportunity to strengthen the euro area and make it more robust against future crises.

Further Reading

An extended version of this argument can be found in this upcoming publication: Chang, M. (2017) 'Brexit and the EU Economic and Monetary Union', in F. Fabbrini (ed) *The Law & Politics of Brexit*, Oxford: Oxford University Press.

Barker, A., et al. (2017) 'Will EU Core States Leave Partners Behind after Brexit?', *Financial Times*, 7 March.

European Commission (2017a) *White Paper on the Future of Europe: Reflections and Scenarios for the EU27 by 2025*, Brussels, 1 March.

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European Commission (2017c) *Reflection Paper on the Deepening of Economic and Monetary Union*, Brussels, 31 May.

Haas, J. & E. Rubio (2016) *Brexit and the EU Budget: Threat or Opportunity?* Policy Paper no.183, Paris: Jacques Delors Institute.

Michel, C. (2016) 'Benelux Vision on the Future of Europe', 3 February 2017, <http://premier.fgov.be/en/benelux-vision-future-europe>, accessed 12 March 2017.

Möller, A. & T. Oliver (eds) (2014) *The United Kingdom and the European Union: What would a "Brexit" mean for the EU and other States around the World?* DGAPanalyse, Berlin: Deutsche Gesellschaft für Auswärtige Politik e.V.

Quaglia, L. (2010) *Governing Financial Services in the European Union*; New York: Routledge.

Quaglia, L., et al. (2016) 'The Political Economy of European Capital Markets Union', *Journal of Common Market Studies* 54(S1): 185-203.

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