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CENTRE FOR EUROPEAN REFORM

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by Charles Grant

Britain's departure from the EU grows ever more likely. David Cameron, the prime minister, wants Britain to stay in. But he seems set on a path that could lead to an exit. British withdrawal requires two conditions to be satisfied. First, the government of the day must call a referendum on whether to leave the EU. Second, a majority of voters must want to quit. The first condition seems likely to be met, and the second is, for now, fulfilled.

Cameron will probably go into the 2015 general election with a commitment to renegotiate the terms of British membership and then hold a referendum on the outcome. The British people would vote on whether to stay in the EU with the 'better deal' that he had negotiated, or leave.

The problem with this strategy is that it assumes a significantly better deal is available. Many senior Conservatives believe that the other EU countries will offer treaty opt-outs because they wish to keep Britain in the club and because they will need a British signature on the new EU treaty that is likely to emerge around 2016. The Conservatives will certainly try to pull out of EU labour market rules. They will draw on the government's review of EU competences, currently underway, for ideas on other areas to withdraw from. (The government is already activating a treaty article that allows it to opt out of many laws on police and judicial co-operation.)

However, though the other EU governments want Britain in the Union they will not grant it treaty opt-outs. They worry that if Britain escaped labour market rules, which they view as intrinsic to the single market, it would gain an unfair competitive advantage. And if Britain could opt out of EU policies it disliked, others would demand the same privilege: the French might exempt their car industry from state aid rules, or the Poles spurn directives that force their coal-centred economy to cut carbon emissions. And if Britain blocked a new EU treaty the others would go ahead with another sort of treaty minus the UK, just like they did last December.

Cameron could probably come home with a piece of paper promising a 'better deal for Britain' – perhaps an agreement on reforming the working time directive, and safeguards for the City of London and the single market. But Tory eurosceptics would see that the 'better deal' had failed to repatriate powers. They would campaign for withdrawal in the referendum and split their own party.

Meanwhile the Scots, who are somewhat more EU-friendly than the English, are due to vote on independence in a referendum in 2014. Britain's eurosceptic drift will help the nationalists, whose best argument is that if the Scots stay shackled to the United Kingdom they will be dragged out of the EU. They will argue that if the Scots left Britain they could apply for EU membership and get in at about the same time that the rest of the UK left it.

So why is Cameron pursuing such a risky strategy? He has difficulty controlling his party: on October 31st, 53 Conservative MPs voted with the Labour Party (which saw a chance of embarrassing Cameron) to defeat his EU budget strategy in the House of Commons. Tory right-wingers dislike Cameron for being 'moderate', and not only on the EU. They fear that the United Kingdom Independence Party (UKIP) will steal enough votes to deprive the Conservatives of a majority in the next general election. Cameron seems to believe that only a referendum pledge can see off the UKIP threat, pacify hard-line eurosceptics and strengthen his grip on his party.

Though risky, Cameron's strategy is not doomed to failure. Even if the better deal for Britain turns out to be of little substance, a 'Yes to the EU' campaign fronted by the leaders of the main parties could defeat the quitters.

The Labour Party is less eurosceptic than the Conservatives. Paradoxically, however, a Labour government could find it harder to keep Britain in the EU than a Tory one. In a speech on November 18th, Labour Leader Ed Miliband said that with the EU in a state of flux, it was the wrong time to talk of referendums on membership. Such talk, he pointed out, could deter foreign investment in Britain.

But in the run up to the general election, if the Conservatives are committed to a referendum, Miliband may find it hard to resist making a similar pledge. Otherwise he would face taunts of elitism and of being scared of the people.

Suppose that Miliband wins the next election, having promised a referendum. He would certainly call for 'reform' of the EU but could not credibly seek to repatriate powers since Labour likes most of the things the EU does, especially labour market rules. So a Labour government would hold an in-out referendum, midway through a parliament when it would be likely to be unpopular, when no better deal had been negotiated, and when the Conservatives in opposition – with a new, more eurosceptic leader – would probably campaign for withdrawal. The quitters could well win such a referendum.

A British referendum is probably three or four years away, but the trend of public opinion is increasingly anti-EU. In recent years most opinion polls have shown a majority for leaving the Union. The euro's travails are one reason. For three years the eurozone has lurched from crisis to crisis, with its leaders arguing over piecemeal reforms that do not seem to have resolved its fundamental problems. All this has been appalling PR for the EU.

"Cameron seems to believe that only a referendum pledge can see off the UKIP threat, pacify hard-line eurosceptics and strengthen his grip on his party."

And what those leaders are doing – centralising economic policy-making and talking of 'political union' – makes the EU less congenial to the British. The more the EU moves beyond the relatively limited economic club that the British joined, the more suspicious they become of it. Recent developments such as the fiscal compact and the putative banking union will not apply to the UK. But there is nevertheless a risk that the countries in these clubs will caucus and try to impose their wishes on outsiders such as Britain.

The EU's reputation has also been hit by the growing hostility of Britons to immigration – although its rules on free movement do not affect Britain's ability to exclude non-EU citizens. People blame Brussels for the presence of so many immigrants in the country. This has prompted Cameron to muse openly about changing those rules.

Politicians should not ignore public opinion. But they are partly responsible for the surge of eurosceptic sentiment. For two decades Britain's EU debate has been one-sided: eurosceptic politicians and commentators have set the agenda, while few politicians (or business leaders) have argued the merits of the EU. Pro-EU politicians have seen the short-term advantages of saying little about an unpopular subject. So they have lost the argument by default. Unless politicians, business leaders and trade unionists find the courage to make the case for membership, it is only a matter of time until Britain leaves the EU.

Charles Grant
Director, CER

Germany's opposition and the euro crisis

by Katinka Barysch

Although Germany's next general election is not scheduled until October 2013, the campaign started in earnest on September 28th 2012. On that day, the opposition Social Democrats (SPD) chose Peer Steinbrück as their candidate for the chancellorship, dismissing the other two members of the party's leadership trio. Steinbrück promises not only more social justice at home but also quicker and more sustainable solutions to the euro crisis: less pain for Greece and Spain, a bigger rescue fund, a genuine banking union and deeper political integration. Could a Steinbrück-led government, together with France's Socialist President François Hollande, offer a pro-growth alternative to Merkel's austerity-focused euro strategy?

The SPD likes to portray itself as the more pro-European of the mainstream parties. It could hardly call for more European solidarity and at the same time vote against eurozone bail-outs. Since 2010, therefore, the SPD has voted alongside Merkel's Christian Democrats (CDU) in almost all important decisions on the euro. In recent votes, for example on the fiscal compact, Merkel could not muster a clear majority among her own – increasingly eurosceptic – MPs. She had to rely on the support of the SPD and the Greens instead.

This leaves the SPD in a bind since voters do not believe that it offers a distinct alternative to Merkel's euro strategy. Nor does the SPD dare to divert too much from Merkel's chosen course, of which two-thirds of voters whole-heartedly approve. When SPD politicians criticise Merkel's euro policies, they focus on the process – foot-dragging, U-turns, backroom dealings and lack of honesty – not the substance. They call for more solidarity and growth but insist that they, too, would demand tough decisions on austerity and reforms from the countries concerned. They effectively promise to do almost the same as Merkel, only somehow better.

Steinbrück knows that on the subject of the euro, Merkel is unassailable in Germany. He will therefore build his election campaign around other topics, notably banking and social justice. However, his calls for alleviating poverty sound feeble since Merkel's government has come out in favour of minimum wages and extra money for childcare and poor pensioners.

Tougher regulation of financial markets should be a sure vote-winner in a country where most

Photograph © Deutscher Bundestag/ phototek/ Thomas Trutschel people believe the banks have got off lightly after causing the financial crisis. Equally important, the subject endears Steinbrück to his party base, which is still deeply suspicious of his conservative and pro-business leanings.

In September, just before his nomination as candidate, Steinbrück presented a 30-page plan on financial sector reform. He proposes a financial transaction tax, a legal separation of investment and retail banking along the lines suggested by the UK's Vickers commission, a euro-wide banking resolution fund, and tougher rules on bonuses, hedge funds and rating agencies.

The trouble is that many Germans do not believe him. When he was finance minister and then president of the state of North Rhine Westphalia, he was responsible for overseeing the region's 'Landesbank' (WestLB), which used its public guarantee to borrow cheaply and invest badly. It later buckled under a mountain of toxic assets. As finance minister in Angela Merkel's grand coalition (2005-09), Steinbrück long insisted that German banks were fundamentally sound – only to implement two bank bail-outs at considerable expense to the German taxpayer in 2008. Steinbrück's credentials as a left-winger were further undermined in October this year, when newspapers revealed that he has collected well over €1.5 million in speaker's fees and book royalties since departing the finance ministry in 2009 – and failed to tell parliament about it.

Steinbrück's public approval ratings have plummeted since the revelation and some in his party already ask whether he will last until the 2013 election. But 11 months is a long time in politics. And the outcome of the 2013 election will, as always, depend on the complicated arithmetic of German coalition politics. Merkel's CDU, alongside its Bavarian sister party (the CSU), is clearly leading in the polls. But Merkel's current coalition partner, the Free Democrats (FDP), might not get the 5 per cent of the vote necessary to return to the Bundestag. Nor can the SDP and their preferred coalition partner, the Greens, expect a majority of the votes. Steinbrück has ruled out coalition talks with either the hard-left Linke or the chaotic Pirate party. Most Germans therefore think that a grand coalition of CDU/CSU and SPD is the most likely outcome of the 2013 election.

But Steinbrück has already said no to this option, promising not to join another grand coalition under any circumstances. After the 2005-09 CDU/SPD tie-up, voters punished the SPD for diluting its political principles. The party gained a miserable 23 per cent of the vote in the 2009 election. Moreover, if SPD voters deem the election a foregone conclusion, they will not turn out. Steinbrück must offer a real alternative to Merkel to mobilise his electorate and his party. Many observers predict that he will perform another U-turn in 2013, accepting the job of vice-chancellor and finance minister in a third Merkel government. But one former SPD minister and long-time friend of Steinbrück insists that he is serious about his all-or-nothing strategy. That would probably leave the pragmatic former Foreign Minister Frank-Walter Steinmeier to lead the SPD into a new grand coalition.

The euro policies of such a coalition are unlikely to be fundamentally different from Merkel's current course. First, Merkel has already shifted on many issues, into a direction that the SPD feels comfortable with. With Greece in its fifth year of recession and unemployment in Spain at 25 per cent, the public mood in Germany has become more compassionate. What is more, with her erstwhile ally Nicolas Sarkozy gone, Merkel can no longer dominate eurozone gatherings. She now faces a southern club of Spain, Italy and France. Merkel now frequently and publicly concedes that South European countries will not be able to reduce their debt through austerity alone. More must be done to return them to growth, she says, echoing the SPD's line.

Second, the SPD will also have to compromise if it is to re-join the government. The SPD's initial support for eurobonds has already crumbled – although SPD leaders still speak favourably of the idea of a 'debt redemption fund' that would pool much of the eurozone's existing excess debt. Steinbrück and his SPD colleagues know that Merkel is not the only, or even the most important, obstacle to debt mutualisation. The mighty constitutional court has declared eurobonds illegal, the vast majority of Germans simply do not want them, and even within the SPD there is no majority for them.

In government, the SPD would probably push for a banking license for the European Stability Mechanism (to increase its fire power), but seek to curtail ECB bond-buying, which it considers non-transparent and undemocratic. It would be more open to an EU banking union than the CDU, including a joint resolution fund (paid for by the banks, not taxpayers). But whatever the next election outcome, Germany will not offer a quick fix for the euro.

Katinka Barysch
Deputy director, CER

Eurozone: Trouble in the core?

by Simon Tilford

Many people lazily assume that the eurozone is now split into a strong, prosperous core and a weak, depressed periphery. Southern Europe and Ireland – the periphery – face exceptional economic weakness as they tighten fiscal policy and undergo a painful period of internal devaluation in a drive to reduce their costs relative to the core. By contrast, Germany, Austria, the Netherlands and Finland – the core – are assumed to be structurally robust economies, with sound public finances, competitive export industries, and good economic prospects. The reality is different and more worrying.

There is no doubting the existence of an arc of depression. Greece, Ireland and Portugal have already suffered huge collapses in economic activity. In the case of Greece and Portugal there is more to come, whereas Ireland faces stagnation. Italy is rapidly sliding into the depression camp: the Italian economy is now 7 per cent short of its pre-crisis peak and will contract sharply in 2013. The picture is similarly grim in Spain.

What about the eurozone's prosperous core? Germany's economy is growing, albeit slowly (it expanded by 0.9 per cent over the last year), and is around 2 per cent bigger than in the first quarter of 2008. This compares well with the periphery, and with the UK (whose economy is still 3 per cent short of its pre-crisis size). But it can hardly be described as dazzling; even the best performing economy in the eurozone is lagging the supposedly crisis-hit US.

Despite very low real interest rates, a relatively expansionary fiscal policy and low unemployment, domestic demand in Germany is barely growing. Investment has fallen for three straight quarters and is still down 8 per cent relative to its pre-crisis peak. The much prophesied surge in consumption has not materialised; private consumption has risen by just 0.6 per cent over the last year. Foreign demand is again the key source of stimulus – export growth easily outstripped that of imports during the 12 months to September 2012.

What about the rest of the core? Austria is performing pretty much in line with Germany. But Finland and the Netherlands are doing far worse. Finland's economy stagnated over the last year, whereas the Dutch one contracted by over 1.4 per cent. Strikingly, the Dutch economy is still 3 per cent short of its pre-crisis peak. The Finnish gap is

4.3 per cent, and hence not much narrower than Spain's at 5.6 per cent.

Germany and the Netherlands are running huge and growing trade surpluses – they are kept afloat by foreign demand (and the rise in indebtedness this implies in the countries running the offsetting trade deficits). Germany's surplus is now almost back to the level of early 2008 and the Dutch one is at an all-time high. Without the stimulus imparted by these trade surpluses they would be in economic crisis and no doubt running much bigger budget deficits. The two small core economies – Austria and Finland – have broadly balanced trade.

The problem for all the core countries is that their exports are now coming under strong pressure as the eurozone slides deeper into recession, and growth in the global economy falters. At the same time, fiscal policies – which had until recently been relatively expansionary, at least in Germany and Austria – are being tightened. The result will be a weakening of labour markets and further pressure on household spending.

What about France, a country that straddles the core and periphery? The French economy has barely grown over the last year, but it has almost recouped the activity lost in the downturn. France's superior performance to Finland or the Netherlands largely reflects stronger household consumption. The country is not considered part of the core because of concerns over its export competitiveness (it has a sizeable trade deficit). France has its weaknesses, but the country is hardly the 'sick man of Europe' (as *The Economist* recently implied).

Structural reforms will not lead to phoenix-like economic recoveries in the periphery. To suppose that they will is another example of the faith-based thinking that led many to argue that fiscal contraction in a recession would be expansionary. Reforms should boost productivity growth in the long-term, if combined with a recovery in business investment. But they are no panacea: after all, Finland, the Netherlands and Ireland are liberal and flexible economies, and are doing very poorly. Europe needs the eurozone core to generate strong domestic demand, and for inflation in the core to rise relative to the periphery. A stagnant core spells serious trouble for the eurozone; the periphery will remain stuck in a depression, with all the attendant political conflict.

In the face of stagnation at home, will core governments do more to boost demand? There is little sign of that in Finland or the Netherlands, both of which are tightening fiscal policy further and steadfastly opposing unorthodox steps to loosen monetary policy, such as quantitative easing. What about Germany? The German government will probably reverse the planned tightening of fiscal policy as Germany's economy weakens. But it is not about to undergo a damascene conversion to the cause of expansionary macroeconomic policies.

Simon Tilford
Chief economist, CER

CER in the press

The Economist
17th November 2012
Charles Grant of the CER believes that he [Mr Hollande] is trying to strengthen his position relative to Germany in three ways. One is to forge stronger links with Mediterranean countries, especially Italy and Spain, to form a block that could help to counter Mrs Merkel.

The Guardian
7th November 2012
The CER's John Springford has calculated the UK contribution would be £7.4bn a year if the EU budget were frozen, while the German or Commission plans would result in an additional £400m-550m a year "at most".

The New York Times
7th November 2012
"The reason why we've seen the economy implode much more rapidly than thought is that they grossly underestimated the impact that fiscal austerity of this magnitude would have on the Greek economy," said Simon Tilford of the CER.

The Wall Street Journal
2nd November 2012
Hugo Brady of the CER is worried the government's anti-EU stance may unleash a torrent in Brussels and in Westminster just as the bloc is reinventing itself. Mr Cameron's defeat in Wednesday's vote may be the first sign that euro-scepticism has slipped out of the government's control.

The Guardian
20th September 2012
Schäuble's mantra has consistently been that what's good for Europe is good for Germany... "He's an old-fashioned, very serious European federalist," said Katinka Barysch of the CER.

Channel 4 News
31st October 2012
Philip Whyte of the CER said that despite a complicated structure, reducing the UK's contribution would not result in a more efficient EU budget: "They are right that the structure is crazy. There is a huge appetite for reform, but cutting the budget will not help."

International Herald Tribune
30th October 2012
"The politics of the EU budget are always nasty, but they may be nastier this time partly because of Mr Cameron trying to be Mrs Thatcher," said Stephen Tindale of the CER.

Recent events

Ditchley economics conference

9-10 November
CER economics conference on 'Europe's future in an age of austerity', Ditchley Park
Participants included: Peter Bofinger, Marco Buti, Richard Lambert, Thomas Mayer, David Miliband, Stephen Nickell, Lord Skidelsky, Bart Van Ark and Charles Wyplosz

30 October
CER-Kreab Gavin Anderson breakfast on 'Britain and the EU: Future direction', Brussels
Speaker: Sir Jon Cunliffe

Sir Jon Cunliffe

Connie Hedegaard

18 October
CER-Kreab Gavin Anderson breakfast on 'Strengthening Europe's economy through climate policies', Brussels
Speaker: Commissioner Connie Hedegaard

12-14 October
CER-EDAM conference 'The 8th Bodrum roundtable', Turkey
Speakers included: Egemen Bağış, Carl Bildt, Thomas Carothers, Kemal Derviş, David Miliband and Nickolay Mladenov

David Miliband and Carl Bildt

Recent publications

Economic recovery requires a better deal for labour
Simon Tilford

US foreign policy after the presidential election: What should Europeans expect?
Clara Marina O'Donnell

Cameron's European 'own goal': Leaving EU police and justice co-operation
Hugo Brady

Connecting Europe's energy systems
Stephen Tindale

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