Britain and the Eurozone: What Next?

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JOHN REDWOOD, DEC 14 2011

There has been much sound and fury but little progress in Euroland in the days following David Cameron's veto at the meeting of the EU heads of government in Brussels on 11 December. Far from them saving the Euro, they agreed to differ on some things, and agreed to delay on others. We were told the UK was isolated, yet most of the nine non Euro members have reservations and none have finally signed up to the package.

At the end of the long meeting of heads of government in the EU in Brussels last week, the Heads of State or government of Euroland issued a statement. They agreed a "new fiscal compact and strengthened economic policy coordination", and "the development of our stabilisation tools to face short term challenges."

The Statement was not also made by the nine non-Euro members of the EU. We were told verbally they were in support but they did not put their names to it. At the end of the statement it says these other countries "indicated the possibility to take part in this process after consulting their Parliaments where appropriate". That is very weak language, and implies the nine did not sign up to the whole agenda of the 17, and decided to play it long to gauge Parliamentary and public reaction at home.

It is not quite the UK isolated story we read about. It appears that several countries outside the Euro have reservations about agreeing to major controls on their budgets by the rest of the EU.

The aim of the agreement for the 17 Eurozone countries is to create a stronger central economic government for the whole area. They wish to build on the Stability and Growth Pact, the European Semester (budget approval and control), the new macro-economic imbalances procedure, and the Euro Plus pact. They want these rules to be more legally binding on the 17 than the old rules proved to be.

At the heart of the new elements in the proposal is the fiscal rule. Each state is to run a balanced budget. They are not allowed to run a structural deficit of more than 0.5%. Were this rule to be applied to the UK today, it would mean additional spending cuts and tax rises to the tune of £60 billion a year to eliminate most of the structural deficit.

There would also need to be additional cuts or tax rises for countries with an overall debt higher than 60% of GDP. Any country failing to produce a budget which conformed with these rules would be required to produce an alternative, and could face sanctions. Again, if this applied to the UK it would mean additional cuts or tax rises to start to reduce the debt.

The statement had less to say on stabilisation. They say they will rapidly deploy the leveraging of the European Financial Stability Facility. They do not explain how they will borrow the money for it. They wish to speed up the use of the new ESM to July 2012, still a long seven months away. They say they will pay more financial resources into their funds, without specifying how much by whom and when.

So where do we go from here? The Euroland area countries have decided to adopt these new proposals in March, or at an earlier date. They still want them to be incorporated into Treaties of the whole EU, but clearly this is not possible all the time the UK and other members refuse or want to discuss and delay. The markets will judge the package by how much money it puts on the table to deal with the large balance of payments imbalances, and the state borrowing demands in the weaker countries. Little progress was made on this.

When it comes to completing a fiscal union, there was modest progress by the 17 Eurozone nations, but much more work to be done on what legal framework can be used, how these rules can be enforced, and how you get from the high debts and deficits today to where they say they want to be.

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