ANALYSIS

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Taneli Lahti – Vesa Vihriälä

EUROPE UNDER PRESSURE

– Europe's and Finland's options after Brexit

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SUMMARY

Britain's withdrawal from the EU will weaken the Union, change the power relations of the member states and probably also the balance of the Union's policies. After deepening and enlargement, the EU may become more divergent.

In the EU, Britain has been a leader among countries in in favour of market oriented policies, free trade, light regulation and strong subsidiarity. With Britain's departure, these ideas are likely become less influential and the EU's policies less market oriented.

At the same time, the relative power of large member states will grow. In particular, countries like France, Spain and Italy are likely to gain in influence. For Finland, Germany will remain a key partner among the large member states, but it will have to look for new flexible alliances among like-minded countries to replace the UK as a partner in promoting market oriented views in EU policy making.

For a small and peripheral country like Finland, the EU's unity and the efficient functioning of the single market are of great importance. While the remaining of Britain in the single market would obviously be a preferred option, Finland should not support arrangements that would increase the risk the EU becoming more fragmented and disintegrated.

Taneli Lahti is the Director of EU and Trade Policy at the Confederation of Finnish Industries.
Vesa Vihriälä is the Managing Director of the Finnish Business and Policy Forum EVA and the Research Institute of Finnish Economy ETLA.

Brexit will mean a change of course in the evolution of the European Union. For the first time a member is leaving the Union, after decades of enlargement and deepening integration.

The outcome of Britain's referendum did not come without warning. Throughout its membership in the EU many in Britain have been critical towards the Union and in particular the idea of ever closer integration. Also in other member states concerns about further integration of the EU have increased in recent years, although sometimes for opposite reasons. The idea of an ever closer Union can no longer be taken for granted in the same way as it was a decade ago.

Brexit means change not only in the composition of the EU, but also in the orientation of its policies. Britain has been known in the EU as a strong proponent of market oriented policies and free trade.

Britain has been traditionally critical of new regulatory initiatives and of endowing EU institutions with new powers. Correspondingly, the UK has negotiated itself several exceptions and opt-outs from policy initiatives leading to deepening integration. Likewise, Briatin has systematically opposed increasing the EU's budget and ensured itself a rebate from its budgetary contributions.

With the departure of the UK the perhaps strongest proponent of these type of policies is leaving the Union, and balance of EU policies can therefore be expected to change.

Some expect that Britain's departure will make it possible for the remaining member states to take further steps toward closer integration. There are however critical attitudes towards further pooling of sovereignty in other parts of Europe as well. Future direction the EU is therefore not obvious.

But what do these changes mean for Finland? What kind of choices will Finland face? And how should Finland position itself in the Brexit negotiations and in the ensuing debate about the future direction of the Union?

EU is shrinking, international influence waning

Britain's withdrawal makes the EU smaller by definition. The shrinking of the EU will have two effects: the combined size of European countries participating in close integration decreases and EU's influence in the interaction with other major economic regions will be reduced.

The scale of integration will be reduced after Brexit as the EU's four freedoms, i.e. the free movement of goods, services, capital and people, apply to a smaller population. From a global perspective, the EU's economic integration has been exceptionally deep.

According to economic theory and extensive empirical research, a decrease in integration results in the weakening of the economy's productive capacity and well-being of the citizens of both Britain and the EU. The extent to which this occurs, however, is more difficult to determine and in some respects disputed.

At the same time the EU's political global influence is likely to decline. The EU's negotiating power will be weaker in negotiations on trade in goods and services, regulation of financial markets, technological standards, climate policy and other matters. The EU's ability to promote European values and interests in global contexts risks to be weakened.

Britain of key importance in finance, higher education and defence

By European standards Britain is a large country (see adjacent table). In terms of population, it ranks immediately after France in third place with approximately 13% of the EU's population. However, the economic and political importance of Britain is greater than this.

Britain share of the EU's GDP is about 18%. Britain is especially significant in the production of services.

Britain's share of the EU's total financial sector's value added is 24% and the share of assets 21%. These figures nevertheless underestimate the importance of the country's financial services. The City of London is one of the world's largest centers of financial services.[1]

British universities are ranked high among the world's universities. The often cited Times Higher Education comparison ranks six British universities among the world's top 30 universities but only two universities from other EU countries.[2] With its 125 Nobel prize winners, Britain ranks second after the United States in most Nobel laureates per country.

Britain's defence spending of around EUR 50 billion annually is the highest of the EU countries and ranks the fifth highest in the world. Britain along with France is one of the few EU countries that can participate in significant military interventions outside their own territory. It is also one of the two EU countries with nuclear weapons.

From the viewpoint of the EU's global influence, Britain plays a significant role based on its history as a great power and due to its comparative strengths. Britain is a permanent member of the UN's Security Council and it has permanent representatives on the executive boards of the International Monetary Fund and World Bank. Britain is a member of the G7 and G20 groups formed by the leading industrialized countries. It also has permanent representatives in the Bank for International Settlements and the Financial Stability Board, which play significant roles in global regulation of the financial markets.

How relations between Britain and the EU evolve will, in principle, have a significant impact on the future of the Union. If it was possible for Britain to combine access to the single market with substantially greater national decision-making powers, for example, regarding migration and a smaller share of EU funding, other countries might be tempted to seek a similar arrangement.

However, since the functioning of the single market depends fundamentally on pooling of regulatory powers and resources of its participants, a combination of participation in the single market, regulatory autonomy and no contribution to the financing of its policies and institutions is conceptually flawed. The benefits of the single market and common policies cannot be separated from the attached responsibilities and constraints.

The form of future relations between the EU and Britain and the process leading to an eventual agreement are still open. Both of these can be expected to be of significant importance for the EU's future. (For more details, see the adjacent article *Various Brexit-scenarios possible*.)

Economic impact will probably be smaller than expected

The impact of Brexit on the economies of Britain and other EU countries was assessed before the referendum in numerous analyses. Except for a couple of exceptions, all the analyses estimated that Brexit will weaken Britain's economic growth significantly and have a negative impact on the economic development of other EU countries.

In the short term, these outcomes are based on an increase in uncertainty, a weakening of the value of the British pound, higher interest rates and a reduction in trade of both goods and services between Britain and other EU countries.

In the longer term, Britain's economic growth would be dampened by the weaker development of productivity and labour input. Britain would receive less direct investment and it would not be able to take advantage of foreign labour to the same extent as in the recent past.

On the other hand, Britain can be expected to adapt to the new conditions. The weakening of the pound may temporarily strengthen British exports' cost competitiveness, and it may aim to develop a more growth-friendly regulatory environment compared to the rest of EU.

Table Size of UK and EU economies in 2015

	UK	EU	UK, % of EU
Population, million	65	510	13
GDP, billion €	2.6	14.7	18
GDP (PPP), % of global GDP	2.4	16.9	
Industrial production, billion €	0.3	2.5	12
Financial sector			
– assets, billion €	7.2	33.8	21
– personnel, 1000	398	2 864	14
– value added, million €	180	765	24
– % of GDP	7.0	5.2	

Sources: Eurostat, ECB, IMF.

The effects of Brexit are larger for Britain than the remaining EU countries, although fewer estimates of the impact on the GDP of the EU countries have been made. A key factor affecting the outcome of these assessments is the assumption about how much the trade between Britain and the EU will decrease.

In its analysis the OECD estimates that Britain's GDP will be 3% lower than the baseline scenario in 2020 and more than 5% lower than in 2030 as a result of Brexit. The estimate is based on a presumption that trade would be determined on the basis of WTO rules at the end of 2018 and subsequently on the basis of a free trade agreement to come into force later.

The IMF estimates the loss of production in 2020 will be slightly higher, around 5% in the WTO scenario. The projections by other organizations regarding Britain's GDP losses in the WTO and free trade scenarios vary mostly between 2–8%. If Britain were to remain a member of the European Economic Area like Norway, Britain's loss would be clearly lower, 1–4% of GDP.[6] In several forecasts Britain will fall into recession in 2017.

In the remaining EU countries, the GDP loss is estimated to be lower than in Britain. According to the OECD the GDP of the EU countries will be 0.9 per cent lower in 2020. The IMF's estimate for 2019 is -0.5%.

Of the EU countries, the hardest hit will be the Irish economy, the GDP of which may contract by nearly 2 % according to the IMF. The IMF expects Finland's GDP will incur a loss of about 0.3% in 2019. The Research Institute of the Finnish Economy, Etla, has estimated that Finland's loss in the beginning of the WTO scenario will be 0.25 per cent of GDP, but that this effect is temporary and will disappear of the longer term.[7] This is mostly due to Finland's trade with the UK being lower than the EU average.

The first observations regarding the economic reactions to the Brexit vote suggest smaller direct or

Various Brexit-scenarios possible

Relations between the EU and Britain can develop after Brexit in several ways. The main alternatives are, on the one hand, an EEA type of arrangement and, on the other hand, a free trade agreement or a scheme based on WTO rules. There is also talk of a soft and hard Brexit as well as a compromise somewhere between these two models. While there is no clear definition of what a soft or a hard Brexit would mean, an arrangement where trade will be based on the WTO rules or a free trade agreement covering only goods trade definitely could be called hard Brexit.

The chances for an EEA type of Brexit seem small for political reasons. The result of the referendum in Britain has been interpreted as reflecting the desire to limit immigration, for regulatory autonomy and independence from decisions made jointly in the EU. These objectives would not be fulfilled in the EEA-EFTA models. In addition, in these models Britain would have to contribute to the EU budget and it would lose its influence on EU legislation, which it would nevertheless be obliged to follow.

It can be difficult to find political support for compromise options such as the partnership model proposed by the think tank Bruegel. This is partly due to the fact that any compromises on migration and the powers of the EU Court of Justice do not correspond with Britain's key objectives.

At the other end of the spectrum a key constraint of the negotiations on a compromise is the conceptual indivisibility of four freedoms and the balance of benefits and obligations. If it was possible for a country to pick and choose the most advantageous elements of EU membership without the obligations of it, many other member states would be tempted to seek a similar arrangement. This could ultimately put the existence of the single market into question and thereby lead to a spiral of disintegration.[3]

Broadly speaking, the implementation of Brexit options are as follows[4]:

EEA arrangement based on Norwegian model

Britain would have full access to the single market and all of the four freedoms would be realized in full, including labour mobility. The EU court would mandate the validity of EU legislation in Britain, but it would not participate in EU decision making. Britain would contribute to expenditure from the EU budget, although less than that as a member.

If it copies the Norwegian model precisely, the UK would also not be part of the common agricultural policy nor the customs union. Being outside the customs union means that Britain could set its commercial policies towards third countries independently. On the other hand, it means a customs border and the administrative burden associated with the determination of the value added of goods produced elsewhere.

immediate effects than were generally anticipated before the referendum. Britain's economic growth has shown no signs of a significant slowdown. A recession in 2017 does not anymore seem likely.

Most noticeable consequence has been weakening of pound

This is partly due to the change in macroeconomic policy: The Bank of England and the UK government reacted to the emerging economic uncertainty with accommodative monetary policies and by loosening fiscal policy.

The most noticeable consequence has been a significant depreciation of the pound. At the end of October, the pound had weakened by about 15% compared to the level prevailing before the Brexit vote (Figure 1). This is an indication of the deterioration of investor confidence in the British economy.

Significant economic effects have not been observed in other EU countries. Several indicators show, however, an increase in the uncertainty about economic development (Figure 2).

The smaller-than-anticipated economic impact may have an impact on the Brexit negotiations. The short term economic cost of may be lower than expected. Since the economic interests of other countries are relatively smaller, political factors are likely to dominate in how the relationship between Britain and the EU evolves.

Power of large countries grows and small ones decreases

Britain's withdrawal from the EU can influence economic policy in several ways. First, the relative weights of the remaining EU countries will change as a big member state leaves. Second, Britain has been one of main proponents of market oriented policies, so support for these policy preferences will be reduced.

EFTA agreement like Switzerland

This model is very close in practice to the EEA option. It would not be based on a single agreement like the EEA, but on a series of bilateral agreements between the EU and UK. Britain's access to the single market would be limited to some extent; in particular, services could not be offered cross-border, at least not fully. For example, Swiss banks cannot offer their services to EU countries directly from Switzerland.

Similarly, the power of the EU Court of Justice to interpret the legitimacy of EU legislation in Britain would be limited. In terms of labour mobility, Britain would, in principle, have decision-making power, but in practice the EU could set labour mobility as a condition for access to the single market. Britain would not participate in EU decision making, but it would contribute financially to policies financed from the EU budget.

Partnership agreement

The compromise solution, in which Britain would be part of the single market, although it could to some extent regulate labour mobility. This kind of "Continental Partnership" model has been proposed by a group of experts by the think tank Bruegel.[5]

Britain could participate in the EU's decision making processes via a special consultation procedure, albeit without voting rights. Offsetting these advantages, it would have to pay part of the EU budget and approve the EU Court of Justice's power of interpretation on the legitimacy of EU law.

Customs Union like with Turkey

Goods could move between the territories duty-free and without any border-crossing formalities, but the free mobility of services, capital and people would require separate agreements. For example, financial services could not, in principle, be provided cross-border.

Britain would not participate in the budget nor the EU's decision-making processes. The EU would impose a customs union trade policy towards third countries and in the customs union Britain would have to follow the regulations set by the EU.

Free trade agreement like with Canada

Trade in goods would be subject to a free trade agreement between the EU and Britain and in addition freedom to provide services could be agreed in a limited fashion. Britain would have its own trade policy in relation to third countries.

Britain would not participate in the EU decision-making process and would not make any contributions to the EU budget.

Trade relations under the WTO Agreement

Tariffs on trade in goods by Britain and the EU would be determined in accordance with the WTO agreement. In practice, the duties would be higher than in separate free trade agreements.

Britain would not enjoy any special advantages in the EU market nor would it participate in the EU decision-making process or contribute anything to the EU budget.

A qualified majority is defined in the Lisbon Treaty with respect to the number of countries and population size. A qualified majority in the Council requires the support of 55% of the number of member states and 65% of the population of the member states. After Britain departs, the coalitions required for a qualified majority in the Council will change. Furthermore, Britain's withdrawal will obviously affect also the political balances in the Parliament. The relative impact will be smallest on the Commission, where the size of the country of origin of a Commissioner is not supposed to affect his or her influence on the decisions of the college.

Mathematically Finland's position will not change

Brexit will lead to an increase in the weight of large countries and a reduction in the weight of the smallest countries. When one of the big members leaves, the importance of the remaining large countries will increase for reaching a qualified majority of the population. Also, small member states will have one potential large partner less to build an alliance with.

The development of the EU can be expected in the future to be determined increasingly on the basis of the objectives of a few big countries. The magnitude of the change is illustrated in the game theoretical analysis of Kóczy (2016), which indicates the likelihood of different countries being pivotal in ensuring a qualified majority.[8]

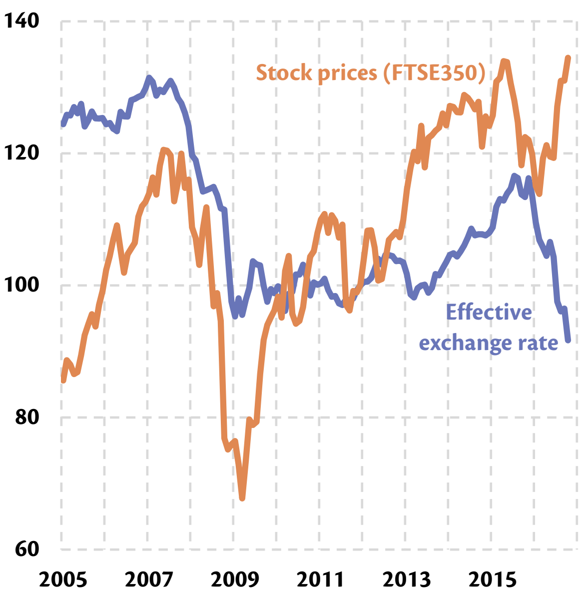
According to the analysis, the power of Germany, France, Italy and Spain will grow by about 15% while in Poland it will grow by about 7%. The power of Malta, Luxembourg, Cyprus and Estonia will in contrast decrease by 5–8%. The analysis suggests that Finland's position will remain unchanged (Figure 3).

The real influence of countries is, of course, not based merely on the mathematical probability of them bringing the decisive vote to a decision. Influence is also affected by the similarity of objectives: if several countries, especially large member states, have similar objectives in certain policy areas, their potential for reaching their objectives are naturally better.

Staal (2016) evaluated the effects of Britain's departure on the influence in the EU countries by examining how often countries have voted the same way as Britain in the Council. Based on this analysis, the biggest losers of influence would be Ireland, Luxembourg, the Netherlands and Sweden, but also Denmark, Slovenia and Spain.

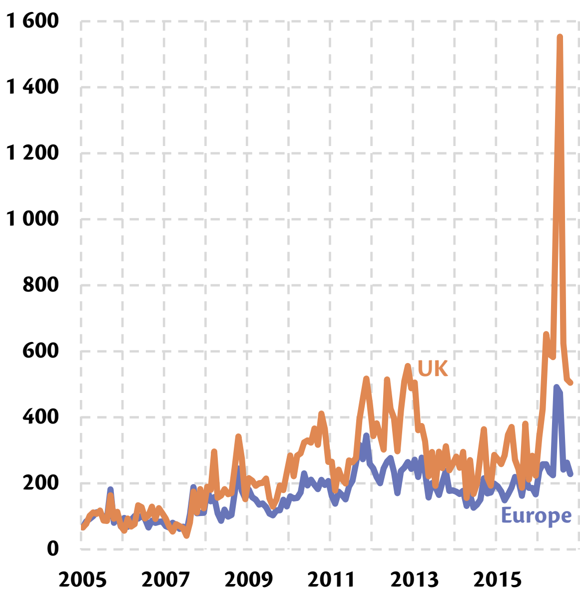
However, since the decisions of the Council are usually reached through consensus, i.e. without voting, voting behaviour is not a very good measure of the uniformity of views. A better picture is obtained if we look at the kind of economic policies driven by Britain.

Figure 1 UK stock prices and effective exchange rate (2010=100)



Sources: BIS, Bloomberg.

Figure 2 Economic policy uncertainty index in Europe and UK (2005=100)



Source: www.policyuncertainty.com/europe.

Cancelation of Brexit is unlikely

In theory, it should be possible to cancel Brexit, for example, by a parliamentary decision, or a new referendum. Some options were discussed immediately after the referendum by the supporters of UK's EU membership, and some have been recently brought up by former leading politicians. However, at the moment the likelihood of any of them materialising soon seems small.

A Supreme Court's decision that the British withdrawal from the EU must be approved by Parliament would not change the situation decisively. Many members of Parliament who opposed withdrawal from the EU have said they will respect the outcome of the referendum.

The British government has announced that it will launch the process of leaving the EU formally in the first quarter of 2017. The two-year negotiations starting then can only be stopped by a unanimous decision of all 28 EU countries.

A situation in which such a consensus of all EU member states would be formed is difficult to imagine at the moment. Once has therefore to assume that Britain will not be a member of the EU by the end of 2019.

Of course, it is possible and even probable that various transitional agreements will be agreed in the negotiations. Thus, the formal separation is unlikely to lead to an immediate cessation of the validity of all British EU rights and obligations in 2019.

Northern market oriented approach weakening

Particularly in the Council, Britain has consistently been a proponent of market oriented policies irrespective of the political orientation of its government. With the help of its efficient civil service and strong tradition of diplomacy, the UK has had an important impact on European policies, which smaller like-minded counties as well as more cautious and compromise seeking counties have often supported.

Britain has consistently emphasized the promotion of free trade and challenged initiatives for more regulation. In addition, it has at several occasions sought exceptions from EU policy initiatives and rules from applying to Britain. On the other hand, Britain has been in favour of closer integration of the euro area. (For more details, see the adjacent article *British Orientation: Free trade, financial stability and special status.*)

Brexit will inevitably lead to a weakening of support for market oriented economic policies in the Council. Northern European countries that have tended to align their views with the UK will be left with no obvious successor for the departing leader of their group. It can be anticipated that their views will be less reflected in the emerging political balance of the EU.

These EU member states have often emphasized the benefits of market mechanisms, supported free trade and sought to avoid unnecessary regulation. They believe in strict compliance with rules adopted, fiscal discipline and they strive to limit the EU budget to a minimum.

Another group of countries, mainly from Southern Europe, tends to rather stress the importance of regulation over market forces and solidarity between countries, in other words, a larger common budget and income transfers to economically less well-off countries. These countries tend to promote more flexibility in the application of fiscal rules, while emphasizing importance of case-by-case discretion.

Although the Council is not voting often, the number of votes naturally affects the bargaining power of the various parties. Britain's withdrawal makes it more difficult to form a 35% blocking minority with respect to the population size.

For example, the combined share of Britain, Germany, the Netherlands, Sweden, Denmark and Finland of the total population of the EU is about 36%. In the current composition of the EU, these countries would thus be able to form a blocking minority. Without UK, the share of the population of these countries is reduced to 27%. Even if this group is broadened to include other market-oriented countries like Estonia, Latvia, Ireland and Slovenia, the coalition would reach only 33% of the population.

The power relationships are changing not only in the council but also in the European Parliament. When the British MEPs leave the Parliament, there will be less voices generally favouring market-oriented policies.[9]

Hix, Hagemann and Frantescu (2016) raise the issue of product and labour market regulation as a key whole, anticipating that regulation will be increased rather than simplified.

Germany's influence on economic policy will weaken

Use of nuclear energy and non-conventional energy sources, such as the shale gas, will no longer have the same kind of support enjoyed until now. On the other hand, the drive for harmonization of taxation and taxes on financial transactions might increase after Brexit.

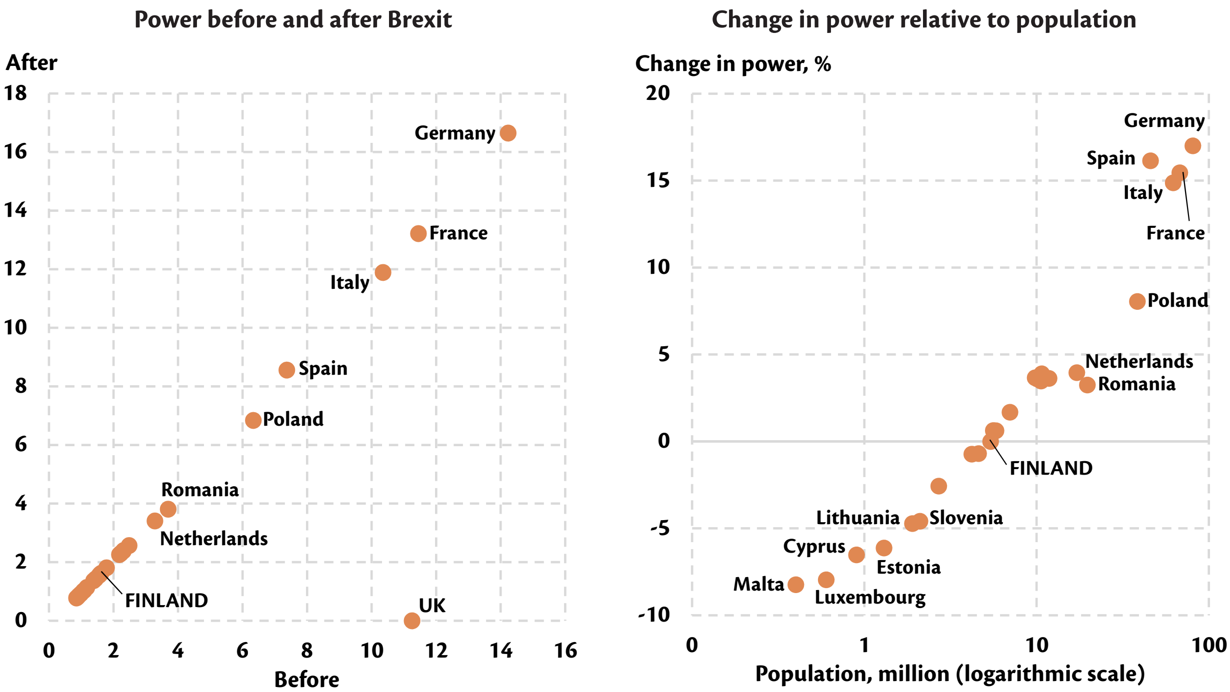
Hix, Hagemann and Frantescu also mention the weakening of intellectual property rights and the likely rise in the EU budget contributions as a consequence of Brexit. It should be remembered, however, that the budget requires unanimous support in the Council. In addition, the level of taxation is ultimately a matter for national decision making.

Although Germany appears to increase influence most from a game theory perspective, its position relative to France, Italy and Spain is likely to weaken in economic policy issues. This is due to the fact that the British positions have often been closer to the German positions than those of France, Italy or Spain. The situation is of course influenced by how strong the governments of various countries are internally.

Results of the Brexit referendum have been interpreted at least partly as voters' criticism of globalization and its negative effects on income distribution. Departure was supported in areas where the residents are typically, for example, less educated and elderly, so it is more difficult for them to adapt to international competition and technological developments. These areas are also characterized by a rapid increase in the number of immigrants, even though immigrants do not account for a large share of the population, as well as above-average income inequality and poverty rates.[10]

Based on these observations, several politicians, among them Britain's new Prime Minister, Theresa May, have reached the conclusion that there is a need for stronger measures to offset the "excesses" of the market economy. This means measures relating not only to taxation but also assorted types of business regulation and the strengthening of workers' rights. It is obvious that critical attitudes toward immigration, which was a key issue for Brexit supporters, have a significant impact on British policies.

Figure 3 Mathematical power of EU countries in Council before and after Brexit



Source: Kóczy (2016).

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British policy will not, of course, have a direct impact on EU policies in future. However, it is plausible that, at least in countries where the EU-critical forces are strong, people may come to similar conclusions as those made in Britain. If that happens, these kinds of political reactions will also be reflected in decision making at the EU level.

Direction of integration far from clear

The effects of Brexit on the future of EU's political and institutional development can be potentially far-reaching. It brings to fore questions about ideal distribution of powers and competences between various levels of governance, EU, national, regional and local. In terms of desirable developments, there are two somewhat opposite points of view: either the Union continues to integrate or decision making powers will be returned to the national level.

Those who embrace the idea of closer cooperation within the EU see that Brexit opens up an opportunity and even increases the need for closer integration. The possibility arises from the fact that the group of countries opposed to centralised policy making will be substantially weakened as one of its strongest members is leaving the EU.

The need for closer integration is backed by the view that Brexit itself is a negative shock to the EU's unity and undermines the EU's collective strength in relation to the outside world. With wider mutual solidarity and more efficient decision making these problems could be overcome or at least they could be constrained.[11]

Nationalistic views are not identical

On the other hand, many interpret the results of the Brexit vote as an extreme reaction by citizens to decision-making having been transferred to the EU level too much already. This interpretation is put forward by EU-critical political forces across Europe.

Some of the strongest proponents of this view has been the leader of the ruling Law and Justice party in Poland Jaroslav Kaczynski and Hungarian Prime Minister Viktor Orban, who demand the return of powers delegated to the EU back to the member states in the name of a "cultural counter-revolution".[12] In addition, at least in France and the Netherlands, EU-critical parties have campaigned on promises to organize referenda on EU membership.

The views of the political powers demanding a re-nationalization of jurisdiction are not mutually very coherent or internally consistent. For example, in Poland and Hungary views are highly critical of a common EU immigration policy, which would require these countries to take on refugees coming from outside the EU in accordance with the principle of shared burdens.

Yet, in these countries freedom of movement between countries is considered important. Similarly, they are in favour of EU cohesion policy, which supports these countries significantly. In the Netherlands EU-critical forces are in turn critical of income transfers to poorer EU countries.

The calls to restrict the EU's power are based on the idea that the policy of the Union does not enjoy legitimacy in the eyes of the citizens. It lacks legitimacy because citizens do not feel they can influence EU decisions affecting them as well as through national governments and parliaments.[13]

Germany's need for compromises will grow

Cooperation between Germany and France has been a driving force in European integration since the very beginning. While the economic policy orientations and philosophies of these countries have differed, they have been able to compromise at major turning points.[14]

Since the outbreak of the euro crisis, Germany emerged as the EU's leading member state. This was largely due to the relative strength of the German economy. Although Germany had to partially forsake its important principle of avoiding joint financial responsibility of member states' public finances to shield the euro area from extreme market pressures, it largely determined the focus of institutional development in recent years.

It can be assumed that Germany's position will continue to be of decisive importance in the EU's institutional development. However, Germany's influence is likely to weaken with the departure of UK, its important partner in issues regarding economic policies, its increasingly fragmented domestic political landscape and the concerns of other EU member states due to what is considered its dominant position among European countries.

A period of divergent integration is foreseen

The EU has often taken steps towards closer integration as a response to crisis situations. The euro crisis forced the adoption of stability mechanisms implying a new type of mutual support in the euro area, initially a temporary EFSF and later a permanent mechanism, the ESM. Economic policy coordination was intensified through the so-called six-pack and two-pack legislative packages and the fiscal compact. A Banking Union with common banking supervision was introduced. The ECB demonstrated its ability to resolve acute liquidity problems, finding sufficient room for manoeuvre within its legal mandate to create instruments like the Outright Monetary Transactions for bond purchases.

Financial difficulties within the EU and the euro zone could lead to a push for further integration also in future. Given the vulnerabilities associated with high levels of public and private debt in many countries and large amounts of non-performing loans in many banks, one cannot exclude the possibility of significant pressures on individual banks and sovereigns. However, such pressures are unlikely lead to a crisis, which only could be averted by qualitatively new steps toward further mutualisation of risk in the short term. The euro area has been strengthened enough to withstand even serious crises without them becoming existential.

One factor is that the aforementioned crisis management tools allow handling major liquidity problems in a smooth manner without any ad hoc institutional arrangements. The second is that the

British Orientation: Free trade, financial stability and special status

In trade policy, Britain has consistently promoted the negotiation of free trade agreements with as many partner countries as possible. It has also seen free trade agreements as a way to strengthen the partner countries' commitment to democracy and human rights.

Britain has wanted the trade agreements to be as comprehensive as possible and to eliminate both duties as well as the other obstacles of trade arising from technical matters and regulatory differences. It has been one of the strongest proponents to the negotiations with the United States and Canada, and has also encouraged the Union to proceed rapidly in other ongoing negotiations.

Britain has expressed reservations about the use of anti-dumping measures and sought to ensure that their use has been moderate, avoiding any trade-distorting effects. It has stressed the importance of competitive discretion with the utilization of these instruments.

Financial market regulation on the EU level has been increased and strengthened considerably in recent years. Along with the formation of the banking union, banking supervision and crisis resolution in the euro area were transferred to EU level.

Britain remained outside the banking union, but supported the formation of it in the euro area. At the same time, it sought to ensure that the regulation of banks remained as simple and light as possible. It was therefore in its interests to ensure that the single market functions smoothly, and that the regulation of the banking union and the non-participating actors would not become differentiated in a way that would be detrimental to the functioning of the single market.

This is how Britain balanced the legislative work and prevented heavier financial market regulation in the creation of the euro area. Instead, it has regarded it necessary to have a strong crisis resolution mechanism and to ensure adequate financing related to it.

In this case, its view has been in line with that of the IMF. Britain's motive is ensuring its own financial stability, because a crisis in the euro area's financial markets would inevitably be reflected in the British market and the economy in a broader sense.

Britain has traditionally emphasized light and easily enforced legislation and supervision in the **regulation of the single market**. Promotion of the EU's global competitiveness has generally been a starting point for the regulation.

In agricultural policy Britain has traditionally pushed for the reform of the common agricultural policy and the reduction of funds allocated to it from the EU. In terms of the labour market, Britain has recognized the importance of keeping regulation of the labour market as a task for the member states. For example, it has opposed the regulation of working time at the EU level, and stressed subsidiarity in all matters of work and social policy coordination and regulation.

Britain is one of the net contributors to the EU budget, and as such has worked to **cut tasks financed by the EU budget and to limit the budget**, especially in recent years. It has achieved its objective quite well banking sector as a whole is significantly better capitalised. Finally, it is worth noting that a euro member exiting the monetary union is no longer a taboo, as Greece's exit almost occurred in the summer of 2015, at a point when such a possibility was not even supposed to exist. It is also important that the acute threat of a departure did not lead to serious disturbances outside Greece. Despite the potentially large adverse effects, this safety valve or threat – however it may be interpreted – will reduce the likelihood of a major crisis leading to further steps toward integration.

No acute need for large new steps towards deeper integration

And, in absence of an acute crisis, it is difficult to see a pressing need for institutional changes requiring a broad political consensus. In particular this concerns developments that would require amendment of the EU treaties, such as giving binding fiscal authority over member states' public finances to the EU or to the level of the euro area.

Instead, pragmatic and more modest integration steps are very likely within the next few years. Some are already ongoing. Probably the most important of these is the completion of the Banking Union's missing or incomplete parts.

This includes the creation of a common deposit insurance, as proposed by the Commission, as well as ensuring a sufficient fiscal backstop for the crisis resolution mechanism.[15]

Further practical integration is taking place also in the area of completing the single market. The Commission has put forward several initiatives, for example for the creation of a Capital Market

as the financial framework for 2014–2020 is in relative terms slightly lower than the previous financial term. When the financial framework was negotiated, the other member states and institutions tended to try to accommodate with the British proposals, as the Brexit threat was already in the air.

Britain is nevertheless still a large recipient of EU funding. Its universities and research institutes are some of the most efficient utilizers of EU research funding, its agriculture and rural areas benefit significantly from EU funding, and it benefits greatly e.g. from financing from the European Regional Development Fund and European Social Fund. For the years 2014–2020, Britain has been allocated 11.8 billion euros of EU funding under the EU cohesion policy.

Britain has consistently advocated a **tighter economic and monetary union**, even though it negotiated an opt-out clause for itself regarding the adoption of the single currency. In 2010–2014 in particular, Britain considered the strengthening of fiscal policy rules and coordination of economic policies indispensable and strived to contribute to it.

At the same time, however, Britain stressed on several occasions that, for example, the sanctions associated with improving the implementation of the Stability and Growth Pact could not come into question in its own case. On the one hand, Britain supported the tightening of fiscal rules, but simultaneously ensured that the related tightening of sanctions could not under any circumstances apply to itself. According to amendments of the Stability and Growth Pact, the public economy deficit and debt limits are indicative and not binding for Britain.

On the one hand, Britain was among the countries that supported aid programmes for countries in crisis, and called for formation of the European Stability Mechanism with strong capital. On the other hand, it wanted to make sure that it would not in any case need to participate in the support programmes obliged by the EU, even indirectly via EU budget guarantees.

Similarly, the British Minister of Finance George Osborne urged the euro countries to tighten integration with reference to the remorseless logic of the monetary union, at the same being one of Ecofin's loudest exclusivity critics of the euro group. Britain was especially troubled by the practice of the euro group meeting one day before the Ecofin Council and discussing to a large extent the same issues, in confidence, as the Council itself.

Britain has acted as a **truthsayer** in the Council. It has been customary for Britain to be one of the first speakers in the various meetings of the Council and on a majority of the issues. The positions are usually sharp and clear, coordinated and skilfully articulated. It has been easy for others of the same opinion to follow in Britain's wake and to relate their own position to the British one.

When Britain leaves the Council, it is not clear who will fulfil its role as a main proponent of market-liberal European politics. There is probably no single member state that could take over the task alone. Therefore, the balance of European policies will rely much on the ability of like-minded countries acting together, forming flexible and well-coordinated alliances on issues most important to them. The Nordic countries that have tended to agree on many policy issues with the UK, particularly Finland, Sweden and Denmark, will need to work even more closely than before together and with other proponents of market-oriented policies in various corners of the EU.

Union, an Energy Union and for a Digital Single Market. These can be expected to move forward at their own speed, relying on the normal community method, in which the Commission proposes and the Council and Parliament decide.

Some new items may well also emerge on the agenda. The Commission and several member states can be expected to promote the creation of fiscal stabilisation mechanisms, even though many member states are likely to also strongly oppose their creation.

Degree of integration might differ from one policy area to another

For those who would want to proceed on establishing a new joint fiscal stabilisation mechanism, the way forward could be enhanced cooperation between the willing member states. Those who would not want to participate, could be excluded. Voluntary participation in different forms has been applied to several policy areas and initiatives already, such as the Banking Union, the ESM, the Fiscal Compact, and indeed the Schengen agreement. It is also being tried in the field taxation, with a group of member states pursuing the joint introduction of a Financial Transaction Tax, FTT. The same logic could be applied to other new initiatives where a participation of all member states could not be realistically expected.

If this was the case, the result would be a process of differentiated integration (variable geometry or Europe à la carte), where the degree of integration varies between countries, from one policy area to another.

This differentiation could possibly take place also within the euro area, and not only between the euro area and other EU countries. Such integration processes would possibly have to be based on intergovernmental agreements, with EU institutions nevertheless having an important role in their implementation.

Finland's goals unchanged, priority given to EU unity

The type of Brexit arrangement that least interferes with the functioning of the single market is in the immediate economic interests of Finland and the other remaining EU countries. The worst option would be to arrive at a situation where there is no agreement at all between the EU and UK, and having to rely on WTO rules only.

An EEA or EFTA type arrangement would be least disturbing to the single market. But, as such an arrangement seems unlikely to be acceptable to the UK, the next best option for regulating economic and other relations between the EU and UK could take the form of a partnership agreement where access to single market would be combined with some restrictions on the applicability of EU law on Britain on the one hand and loss of British influence on EU legislation on the other hand.

However, a compromise option has an associated risk of a chain reaction, which has already been mentioned: if the benefits of the single market can be enjoyed without the obligations of membership, special arrangements or in extreme cases withdrawal from the EU may also begin to be an option worth considering by other countries. If more member states would start distancing themselves from the common project, this would have as a result a weakening of the single market. The political and economic consequences of such a development would have to be assumed to be deeply negative to all.

The negotiation of the new arrangement is likely to be at least as difficult and complex as any of the recent negotiations the EU has conducted with any third country. The UK should be expected to aim at fullest possible access to the single market, while limiting the resulting obligations to a minimum. The EU-27 should and is likely to demand the UK's agreement to rules and regulatory framework of the single market, including all four freedoms, agreement to the jurisdiction of the ECJ and contributions the EU budget as the price for the full access. The resulting agreement is likely to be compromise between these ambitions. Considering the starting positions, the complexity of the exercise and the fact that there is no precedent to draw from, the talks will probably need some years to conclude.

A balanced partnership arrangement should be one that will not act as a catalyst to further divisions inside the EU. Finland should only support a compromise option, in itself sensible, if it is fairly certain that it will not lead to the proliferation of specific arrangements. If and when such a threat is likely to exist, the EU's unity and cohesion should be a priority to Finland. In addition, direct economic ties between Finland and the UK are less important than those of most other among EU countries. In terms of Finland's economic interests, the indirect effects of Brexit on the EU's finances and output outweigh the effects of Brexit on the economic relations between Finland and Britain.[16]

Efficiency of single market is increasingly important

In the course of the negotiations, it is of course necessary for Finland to take care of its own particular interests as well. From Finland's perspective, it is particularly important to ensure that security cooperation between the British and the EU remains strong.

It is also in Finland's interest that the education and research opportunities offered by Britain are retained as much as possible for EU citizens.

But, Brexit does not necessitate a fundamental change in Finland's traditional EU policies or objectives. If anything, it underlines the importance of policy orientations in support of Finnish long-term interests: the promotion of an efficient single market, strengthening research, development, and innovation activity, emphasizing national responsibility in fiscal policy, respecting the joint rules e.g. on fiscal policy, a pragmatic approach to jurisdiction issues with emphasis on the community method, highlighting the security dimension of the EU, etc.

The efficient functioning of the single market is all the more important when scale and specialization benefits are sought and competition is supported within the shrinking EU area. This applies especially to trade in services, public procurement and financial markets.

As the City of London will be outside the EU, it is essential to develop the EU's financial markets to be both more efficient and more stable. Promotion of the banking union and capital market union thus gain additional arguments.

Shifting the focus of EU resources to promoting innovation, research, development and education activity will increase in importance.

Finland must be prepared to make compromises

Finland's tradition of pragmatism still offers a good starting point when it comes to formulating its positions concerning institutional development of the EU. It is natural for Finland to emphasize the principle of subsidiarity, where decision making should take place as close as possible to those citizens affected by the decisions in the first place. This principle is also applicable to the conflicts arising from pressures towards deeper integration on the hand and the pressures toward repatriation of some competences.

As long as there is no strong evidence that the shift of fiscal power and responsibility to the euro area level is necessary for the stability and good functioning of the economic and monetary union, the current division of fiscal power is easy to defend.[17]

On the other hand, it should not be overwhelmingly hard for Finland to accept and support common decision making and responsibility when the actions of one member state are not enough to solve problems in the euro area or the overall EU, or when uncoordinated policies lead to clearly inferior outcomes.

The need for supranational measures is obvious in ensuring financial stability. This supports not only completing the banking union, but also the development of crisis management procedures of both banks and sovereigns through common legislation.[18]

The strengthening of common policy is well founded, for example, in issues related to immigration from outside the EU and the EU's role in security policy.

But, Finland could find itself in a difficult dilemma in case some countries were to pursue more shared decisions and responsibilities as a group, and thereby giving up the principle of moving forward only together as EU27 or at least as the euro area.

Intergovernmentalism is not a good approach for small countries

On the one hand, such a differentiation would allow Finland to opt out of cooperation that it finds unsavoury. For example, if some of the euro countries would want to create an automatic fiscal stabilisation mechanism, Finland might want to remain outside. On the other hand, such arrangements would strengthen intergovernmental cooperation at the expense of the so-called community method and could undermine the EU's cohesion and decision-making ability.

For a small country the intergovernmental approach is not, in principle, a good approach, and the weakening of EU unity could be detrimental also from a security policy standpoint. Finland needs to assess very carefully whether staying out of various projects is sensible.

When Brexit reduces the influence of the countries which emphasise market oriented policies, implementation of Finnish policy priorities becomes more difficult. This highlights the importance of Germany as the key country with similar orientations. Furhermore in relation to the euro area, Finland's objectives have been often similar to those of Germany, so close cooperation with Germany will continue to be important in future.

However, Finland also needs to foster understanding of its goals among other countries, and not only those with which it traditionally tends to share similar views and objectives.

In terms of Finland's EU policy the new balance of power signifies a more difficult operating environment. In particular, in case Germany and France arrive at an agreement on an issue, it will be even more difficult than before to steer policies in another direction. The importance and relative weight of the French-German-partnership is even heavier than before.

Germany is deeply and historically committed to further European integration, and is ready to enter into compromises for that purpose. There have been several cases also in the recent past of Germany putting considerations of longer term European integration ahead of more short term or domestic policy considerations. This has been key for the building up of the ESM and the Banking Union, for example. This can be expected to continue also in the future. Once France and Germany find agreement on a particular issue, developments tend to accelerate quickly. Such developments may put Finland into a difficult position if not well prepared.

The paper is a shortened and updated translation of an EVA analysis in Finnish "Unionin horjahdus – Euroopan ja Suomen valinnat Brexitin jälkeen", which was published on 25 November 2016.

Endnotes

[1] According to Global Financial Centres Index, London ranks as one of the world's most important financial hubs together with New York City. In Europe it is in a league of its own in this comparison: Luxembourg is ranked 12th, and Frankfurt is ranked 19th. Global Financial Centres Index; https://en.wikipedia.org/wiki/Global_Financial_Centres_Index.

[2] The Times Higher Education University Rankings; https://www.timeshighereducation.com/world-university-ran-kings/2016/world-ranking#!/page/0/length/25/sort_by/rank_label/sort_order/asc/cols/rank_only

[3] The critical attitude of other EU countries towards a soft Brexit is described, for example, in Grant (2016). In Wyplosz (2016) economists representing different countries assess the interests of their countries and the countries' most likely political positions in the Brexit negotiations. The main message of these assessments is that in most countries of the EU cohesion will take precedence over the preservation of close economic relations if these matters come into conflict. On the other hand, the discussion on the positions of different countries is, of course, somewhat misleading due to the fact that in all countries there are political forces with different attitudes towards EU integration. At the moment, there is no government in any EU country that is in favour of withdrawing from the Union like Britain. However, the governments in a few countries, in particular Poland and Hungary, are very critical of the EU's supranational role. In addition, France and the Netherlands, the EU-critical parties are in a very strong position despite being in the opposition, and it cannot be ruled out that they will significantly increase their influence in the elections to be held in 2017.

[4] See e.g. OECD (2016) and Sapir (2016).

[5] Pisani-Ferry et al. (2016).

[6] See e.g. Miles' article in Baldwin (2016).

[7] See Lehmus and Suni (2016).

[8] See Kóczy (2016) and the working papers cited therein.

[9] See Tiilikainen (2016).

[10] See. e.g. Baldwin (2016) and appendix 1 in Darvas and Wolff (2016).

[11] A group of experts assembled by the Notre Europe think tank and the Bertelsmann Foundation presents a programme for closer co-operation in the EU in three stages in response to the Brexit vote, see Enderlain et al. (2016).

[12] Financial Times September 7, 2016.

[13] Leino and Saarenheimo (2016) examine in an interesting way the separation of powers in economic policy making between the EU and national level and bring up problems with the legitimacy of EU decision making.

[14] Brunnermeier, James and Landau (2016) comprehensively evaluate Germany's and France's assorted economic philosophies and how difficult it has been to reconcile these views.

[15] Finalizing the banking union is not an easy process. Germany wants to set restrictions on banks' investments in government bonds or their risk weighting as a precondition for a joint deposit guarantee. For example, if the situation of Italian banks deteriorates due to rising interest rates, their ability to withstand the restrictions on government bonds may be limited. That is why they find it hard to agree to amend the rules related to government bonds.

[16] For example, the Britain's share of all Finnish goods exports is only 5%, which corresponds to 2% of GDP. The latter ratio of only eight EU countries is smaller than that of Finland, and of these only Italy and Austria are old EU countries. Vihriälä's article in Wyplosz (2016) examines in some detail the economic relations between Finland and Britain.

[17] The argument in favour of reallocating fiscal policy powers to the level of the euro area is based primarily on the assumption that this would be better to smooth out the differences in the cyclical fluctuations of member states. Such smoothing would no doubt be useful for short-term growth, but it also involves the well-known moral hazard problem, i.e. those benefitting from the fiscal transfers might not take care of their economies in the best possible way. Various calculations indicate that an effective fiscal transfer scheme would require a substantial increase of the common budget, at least doubling it. Since it is obvious that no political support exists for this in the foreseeable future, attention has turned on fiscal risk-sharing mechanisms outside the EU budget proper that work according to different predetermined rules. However, also this involves moral hazard. Experience regarding compliance with the fiscal rules suggests that there is not much certainty that countries receiving significant amounts of support from the fiscal transfer scheme would seek to implement economic reforms to strengthen their economies and pay back the aid. Neither does a comparison with the United States support the hypothesis that a scheme to smooth cyclical fluctuations between the states is a necessary condition for the functioning of a monetary union, see e.g. Vihriälä (2015).

[18] A current issue regarding financial stability is how the Bank Recovery and Resolution Directive applies and in particular how the so-called bail-in is carried out in distressed banks. These involve short-term stability risks, but without the realization of bail-in the banks' risk-taking incentives remain high. In the coming years it will be necessary to take a position regarding fiscal backstops for the common deposit guarantee scheme and resolution fund as well as limits on banks' sovereign bond risk. At the same time arises the question of the sovereign debt restructuring mechanism. The stance taken by Finland, which emphasizes the responsibility of creditors with regard to sovereigns and banks, can be considered good from the standpoint of long-term financial stability. However, practical implementation is difficult and faces a lot of political resistance from countries with high debt levels.

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