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European Union Committee

11th Report of Session 2013–14

Euro area crisis: an update

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SUMMARY

There are welcome signs that the euro area crisis has eased. The eurozone has exited recession, and there are positive indications of progress in countries such as Ireland, Portugal and Spain. More than anything else, the ECB President Mario Draghi's July 2012 commitment to "do whatever it takes" to save the euro has caused the existential crisis threatening the single currency to subside.

While the crisis may have abated, it would be unwise to conclude that the storm has entirely passed. Fundamental weaknesses remain which make the euro area vulnerable to future shocks. There are immense economic imbalances between core and periphery countries. Unemployment, and in particular youth unemployment, is at destructively high levels. The programme of structural reforms is incomplete in a number of Member States. Growth across the euro area is anaemic, and there are growing fears of a damaging deflationary spiral. Continued political tensions due to the effect of 'austerity' on the lives of EU citizens are apparent. Such weaknesses will continue to test the economic and political stability of the euro area for as long as they persist.

In light of this, EU leaders need to promote growth-friendly policies, and press on with structural reform and the completion of the Single Market. Creditor Member States, notably Germany, have their own obligations to stimulate growth and demand. The ECB must ensure that its comprehensive assessment of the banking system (concluding in October 2014) is robust, yet does not undermine the euro area's fragile recovery. However these steps are not enough. We do not underestimate the political challenges of deeper euro area integration, but such integration is vital if the single currency is to prosper.

This in turn raises significant challenges for the UK. The euro area crisis has seriously altered the institutional and decision-making structure of the EU. Euro area authorities, notably the ECB and the Eurogroup, have grown in influence, while the Commission's role has diminished. Moves towards euro area integration leave the UK in an increasingly isolated position. In order to ensure the UK's interests are effectively promoted, the Government and the Bank of England should maintain and develop constructive relationships with the increasingly powerful euro area institutions. All parties should also redouble their efforts to convince euro area colleagues of the benefits of the City of London as the leading global financial centre for the EU as a whole.

The economic fortunes of the UK and the euro area are intrinsically linked. If all can be convinced of the mutual benefits of prosperity both for the euro area and the Single Market, then the UK and the City of London have much to contribute and much to gain.

Euro area crisis: an update

CHAPTER 1: INTRODUCTION

1. This is an update report on recent developments in relation to the euro area crisis. **We make this report to the House for debate.**

2. This Committee has already examined the severe effects of the financial crisis on the euro area a number of times. Our reports since the outbreak of the financial crisis in 2008 have included:

- EU Legislative Initiatives in Response to the Financial Turmoil (December 2008);[1]
- The future of EU financial regulation and supervision (June 2009);[2]
- The future of economic governance in the EU (March 2011);[3]
- The euro area crisis (February 2012).[4]

3. Following the publication of the latter report, we decided to conduct twice-yearly updates on the euro area crisis. These updates were conducted in July 2012, January–February 2013 and July 2013. On each occasion we heard evidence from a range of experts, and wrote to the UK Government setting out our views. These submissions, and the exchange of correspondence that followed, are contained in Appendix 3.

4. This report brings our scrutiny of the crisis up-to-date. It is based upon evidence heard during February and March 2014 from:

- Senator Mario Monti, former Prime Minister of Italy;
- Erkki Liikanen, Governor of the Bank of Finland and former Chairman of the High-level Expert Group on European Bank Structural Reform;
- Roger Bootle, Managing Director, Capital Economics;
- Gerard Lyons, Chief Economic Adviser to the Mayor of London;
- Simon Tilford, Deputy Director, Centre for European Reform;
- Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England;
- Matthew Fell, Director, Competitive Markets, CBI.[5]

We are grateful to all of them for their assistance.

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1 House of Lords European Union Committee (1st Report, Session 2008–09, HL Paper 3).

2 House of Lords European Union Committee (14th Report, Session 2008–09, HL Paper 106).

3 House of Lords European Union Committee (12th Report, Session 2010–12, HL Paper 124).

4 House of Lords European Union Committee (25th Report, Session 2010–12, HL Paper 260).

5 Mr Fell gave evidence in the context of the Sub-Committee on Economic and Financial Affairs' examination of shadow banking.

CHAPTER 2: IS THE CRISIS OVER?

5. This update inquiry took place against the backdrop of cautious optimism about the prospects for the euro area economy. One of our witnesses defined a crisis as "when events are in clear danger of spiralling out of control and when no one is in control of the situation."[6] In light of this, we asked our witnesses when the crisis could be judged to be over.

6. Mario Monti thought that 2014 would be the year when the euro area would show that "the dramatic circumstances that were originated by the Greek crisis and all the consequent events are indeed behind us." The next task would be "the much simpler, yet still very demanding, one of ensuring proper economic policies within this eurozone." It was therefore "too early to disarm the weaponry for confronting a crisis."[7] Gerard Lyons felt that it was premature to judge the crisis to be over.[8] Matthew Fell thought that the situation had improved considerably and that the "acute stage" of the crisis had come to an end. The euro area was now in a response phase. The crisis would only be resolved gradually, and this would be a painful process for countries on the periphery.[9]

7. Sir Jon Cunliffe said that the crisis had comprised two distinct phases. The first was the difficulty that many euro area Member States had found themselves in before the financial crisis. Rather than taking advantage of the low interest rates engendered by the single currency to invest in productive capacity and structural reform, they allowed housing and consumer booms to be created. Although there had been some improvement in economic performance, that element of the crisis was still playing itself out in the context of high unemployment and high levels of debt. The second element of the crisis was "the redenomination risk: that some countries might leave the single currency and redenominate into a national currency."[10] This was an existential crisis. Yet the ECB President Mario Draghi's July 2012 commitment to "do whatever it takes" to save the euro had seen that threat recede. Although it was not possible completely to put the genie back in the bottle, he thought that "we are well past the point of that existential fear around break-up".[11]

Assessing the economic outlook

Positive signs…

8. How do such assessments stand up against the current economic outlook for the euro area? In a speech launching the Greek Presidency of the Council on

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6 Matthew Fell, Evidence to the Sub-Committee on Economic and Financial Affairs on shadow banking, 11 March 2014, Q 27.

7 Q 1.

8 Q 27.

9 Evidence to the Sub-Committee on Economic and Financial Affairs, 11 March 2014, *Op. Cit.*, Q 27.

10 In this context, the redenomination risk refers to the threat that the single currency might collapse and countries re-adopt individual national currencies.

11 QQ 50–2.

8 January 2014,[12] the President of the European Commission, José Manuel Barroso, cited the following indicators of progress:

- In 2013, Ireland became the first euro area member to emerge successfully from its adjustment programme, and was able to issue long-term debt at lower yield levels than many other EU Member States that had not requested financial assistance;
- On 1 January 2014, Latvia—a country that itself had undertaken a demanding financial adjustment programme and now had the highest growth rate in the EU—became the 18th member of the euro area;
- Spain was expected to exit its bank support programme—a programme that had been "very successfully implemented" and was already bearing fruit;
- Economic growth had returned to Portugal, its external deficit figures had improved, interest rate spreads had been reduced and unemployment had fallen for nine consecutive months;
- There were "encouraging" signs following the implementation of the Cypriot support programme in 2013;
- Greece was expected to emerge from recession and reach a primary budget surplus in 2014, restoring confidence and attracting the attention of international investors.

9. Our witnesses also noted positive signs. Mario Monti said that much of the remedial work regarding the banking sector and fiscal discipline had now been undertaken.[13] Erkki Liikanen pointed to the reduction in sovereign bond spreads; consolidation in the real economy; and the fact that, taking Greece, Italy, Ireland, Spain and Portugal together, the current account was in surplus.[14] Gerard Lyons agreed that the eurozone was past the worst, and that the situation was improving in Ireland, Latvia, Portugal and Spain.[15] Simon Tilford told us that the euro area's exit from recession and signs of a return to growth in the periphery were reasons for guarded optimism.[16]

…But a long way to go

10. Nevertheless, all of our witnesses agreed with Simon Tilford when he said that the euro area was not out of the woods yet.[17] They highlighted a number of interlinked unresolved issues.

11. **High unemployment / youth unemployment.** Mario Monti and Erkki Liikanen agreed that the high rate of unemployment, and in particular youth unemployment, was the biggest problem affecting Europe today.[18] Roger Bootle said that it was a major concern that there was little sign of

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12 Statement by President Barroso following the College visit to Athens for the start of the Greek Presidency, Athens, 8 January 2014. Available at http://europa.eu/rapid/press-release_SPEECH-14-4_en.htm.

13 Q 1.

14 Q 13.

15 Q 27.

16 Q 29

17 *Ibid.*

18 QQ 7, 18.

improvement.[19] Erkki Liikanen noted that it varied from country to country. Where there was strong protection of permanent employees and there were high numbers of short-term employees without any protection, youth unemployment tended to be high. He cited reforms to the labour market in Germany, where youth unemployment had been cut dramatically. This had been successful because labour market authorities were effective in drawing young people into the labour market, businesses and the labour market authorities worked closely together (for instance on apprenticeship schemes), and because there was a preference amongst German citizens for work.[20] We consider this issue in detail in our new report on *Youth unemployment in the EU*.[21]

12. **Continued economic imbalances.** Gerard Lyons pointed out that economic fundamentals were still considerably divergent across the euro area. He added that monetary policy had become a shock absorber, and the ECB needed to remain accommodating until it was confident that the economy was resilient to further shocks. Overall, the core of the euro area was in much better shape than the periphery and the structural adjustments had very much been put on the periphery. In this sense, the euro area was "a microcosm of the imbalanced global economy."[22]

13. **Anaemic economic growth.** Simon Tilford noted that economic activity was still well below pre-crisis levels, both in individual Member States and across the euro area as a whole:

> "We are at the very early stages of recovery. Typically, after a loss of activity of that magnitude, the recovery would be pretty robust. It is not. The recovery is very weak and vulnerable. It is very export dependent—domestic demand in the eurozone remains very weak".[23]

14. Gerard Lyons said that the fragility of European economies left them very vulnerable to any future shocks, whether domestic, European or external. While confidence by itself could not pull an economy up, its absence could hold it back. The real problem in the euro area was a lack of demand.[24] Mario Monti called for more focus on policies promoting growth, both at Member State and EU level. He advocated a deepening in the Single Market for goods, services, capital and people, and "the introduction of more doses of competition in the markets for products and services." Growth needed to be stimulated through a more visionary EU investment policy, through more action by the European Investment Bank, and by linking energy, transport, information and communication technology systems. Tackling corruption was key. It was also important that enforcement of deficit rules did not provide disincentives to genuine public investment.[25]

15. **Restricted bank lending.** Sir Jon Cunliffe noted that, though there had been some improvement in cross-border bank lending over the past six

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19 Q 26.

20 QQ 18, 22.

21 House of Lords European Union Committee, *Youth unemployment in the EU: a scarred generation?* (12th Report, Session 2013–14, HL Paper 164).

22 QQ 27, 37.

23 Q 29.

24 QQ 27–8.

25 QQ 1–2, 7.

months, it remained at a very low level and might not ever be restored to pre-crisis levels "because banks learnt a lesson about risk and the mispricing of risk, and they will be more careful in the future."[26] Erkki Liikanen agreed that credit flows were still constrained.[27] We note that restricted lending has created particular difficulties for SMEs since the start of the financial crisis. Such problems must be tackled if sustainable economic growth is to be delivered.

16. **Incomplete structural reforms.** Sir Jon Cunliffe noted that periphery countries had already made quite strong adjustments, but stressed that "structural reform has to continue and to be carried through."[28] Mario Monti agreed that greater flexibility and openness in labour markets was needed to create growth.[29] Simon Tilford said that structural reforms were important in boosting productivity, but there was a risk that they were viewed as a panacea. The lack of demand in the economy required very different macroeconomic policies.[30] Roger Bootle warned that, while structural reforms were necessary, "do not expect to get much of a pay-off in the short term. … the thing about the euro crisis is you cannot have long time horizons".[31]

17. **The risk of deflation.** These problems have caused a fall in euro area inflation rates, heightening fears of a deflationary spiral. Mario Monti was not too concerned by the risk of deflation, because he was confident that policymakers would implement expansionary fiscal policies if it proved a threat.[32] Erkki Liikanen said that there were various causes of subdued inflation: fragile economic activity, low demand, restricted credit flows, and falling energy and food prices. Yet he stressed that "we do not have signs of deflation in the euro area", and that the ECB would be ready to act if the outlook worsened.[33]

18. Others were less sanguine. Roger Bootle thought that deflation was a particular risk in the context of "phenomenally high" debt-to-GDP ratios. Pointing to the example of Japan, he said that, "if deflation gets really ingrained so that people come to expect deflation, it is devilishly difficult to shift."[34] Simon Tilford noted that there was not a single member of the euro area whose inflation rate was over the 2% target. If eurozone growth struggled to exceed 1% per annum and inflation remained very low, then it was hard to see how the debt burdens of a number of Member States could be made sustainable.[35] He found it "quite curious that, even now, with inflation in every Member State at under 2% and money growth at 1%, we are still seeing discussions over whether the eurozone should adopt more aggressive strategies to counter deflationary pressure rather than actual

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26 Q 54.

27 QQ 13, 15.

28 Q 52.

29 Q 7.

30 Q 45.

31 *Ibid.*

32 Q 2.

33 QQ 15-6.

34 QQ 26, 30.

35 Q 29.

action."[36] There have also been recent reports that a growing deflationary threat in China could have damaging knock-on effects on the euro area in particular.[37]

19. Simon Tilford added that such deflationary pressure was being exacerbated by **the strength of the euro on the exchange rates**. Although Germany was competitive at the exchange rate, others such as Spain, Italy and France were not, damaging their chances of engineering export-led growth.[38]

20. **The need for deeper integration.** A number of our witnesses stressed the need for the euro area to press ahead with deeper integration to resolve these weaknesses. Simon Tilford argued that "the eurozone countries continue to deny the implications of what they have done … that they will have to become considerably more integrated politically than they are ready to acknowledge."[39] Sir Jon Cunliffe stressed the need for effective adjustment mechanisms if a future crisis was to be averted. Although the political obstacles were considerable, such solutions as a central euro area budget, debt mutualisation, unemployment insurance schemes and direct recapitalisation of the banking system through the European Stability Mechanism (ESM) all needed to be considered.[40] On the other hand, Roger Bootle argued that "all these dangers have come about as a result of fusing together … economies that are very different." Thus the most effective way to restore growth would be to break up the single currency, possibly replacing it with northern and southern currency zones. Although he believed that this would make economic sense, he conceded that it was not politically likely.[41]

21. **Political tensions.** Our February 2014 report on *'Genuine Economic and Monetary Union' and the implications for the UK* found that there was a clear conflict between some of the steps that were economically necessary to secure the eurozone and those that were politically realistic.[42] President Barroso acknowledged such pressures in his January 2014 speech, when he said that the citizens of countries like Greece continued to face "extremely difficult situations … social difficulties, hardship, very important sacrifices—and we know that those positive effects that we are already seeing are not immediately felt by the man and woman on the street."[43] Roger Bootle argued that the continued weaknesses in the euro area would be exacerbated by continued political tension. He cited instability in Italy,[44] as well as the forthcoming European Parliament elections, which he predicted would produce a boost to eurosceptic parties in a number of European States.[45]

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36 Q 32.

37 Evans-Pritchard, A. (2014), 'Paralysed ECB leaves Europe at the mercy of deflation shock from China', *Daily Telegraph*, 12 March.

38 Q 32.

39 Q 44.

40 QQ 52, 63. For a full discussion of these issues, see House of Lords European Union Committee, *'Genuine Economic and Monetary Union' and the implications for the UK* (8th Report, Session 2013–14, HL Paper 134).

41 QQ 37, 49.

42 House of Lords European Union Committee, *'Genuine Economic and Monetary Union' and the implications for the UK*, *Op. Cit.*

43 Statement by President Barroso, *Op. Cit.*

44 See paragraphs 25–7.

45 Q 26.

National case studies

22. In assessing the prospects for the euro area, we took as case studies the situation in the three largest euro area economies.

i) France

23. In January 2014, the French President, François Hollande, announced his intention to move forward with a programme of structural reforms to reduce labour costs and cut public spending and taxation.[46] Erkki Liikanen welcomed this commitment to improve the competitiveness of French businesses as a step in the right direction. However, he warned that "there is no structural reform without pain. … The jury is still out."[47] Gerard Lyons agreed that there remained a long way to go. He noted that unemployment was at a 16-year high in France, whereas in Germany it was at a 20-year low. Although it was possible for France to turn things around, he said that the challenges there should not be underestimated.[48]

24. Simon Tilford acknowledged that France had its share of structural problems, particularly in the labour market. Yet in many ways he believed it compared well with Italy, Spain and even the UK. France was the only country other than Germany to have regained pre-crisis levels of activity, and its debt position was more sustainable than many other countries. It also attracted considerable foreign investment, and had good skills and infrastructure. Therefore it could not be thought of as the sick man of Europe.[49]

ii) Italy

25. Similar structural reform proposals were put forward in Italy, but the situation there was complicated by renewed political turmoil. In February 2014, the Mayor of Florence, Matteo Renzi, replaced his Democratic Party colleague Enrico Letta as Prime Minister. He promised a sweeping series of reforms during his first 100 days in office, including to the labour market, public administration and the tax system.[50]

26. Our witnesses had mixed views as to the outlook for Italy. Mario Monti told us that uppermost in his thoughts during his own time as Prime Minister had been the knowledge that, if Italy had collapsed, the whole of the eurozone might have been "at very, very serious risk." However he was positive about the future, noting that Italy was alone in southern Europe in having gone without a support programme. Pointing to successful pension reforms already undertaken, he expressed the hope that "this perception of Italy as a financially unstable country could gradually give room to a more realistic and deeper assessment."[51] Erkki Liikanen noted that Italy had had low growth for a long time, but had nevertheless been able to create a primary surplus and

46 Carnegy, H. (2014), 'Interest in 'painful' private life wipes smile off Hollande's face', *Financial Times*, 14 January.

47 Q 20.

48 Q 45.

49 *Ibid.*

50 Dinmore, G. and Segreti, G. (2014), 'Matteo Renzi sets out plans for first 100 days', *Financial Times*, 17 February.

51 Q 8.

roll over its high fiscal debt. As a result, its public finances were structurally healthier than might have been imagined, and it was doing well in sovereign bond markets.[52]

27. Others were more pessimistic. Roger Bootle described the Italian situation as "desperate and the debt-to-GDP ratio there has risen very substantially. All along I have thought that Italy is a much more serious vulnerability than Greece, because Greece is comparatively small and can somehow be fixed or fiddled, whereas Italy is not—it is big—and the political scene there remains very difficult."[53] He said that Italy needed "a radical reform programme lasting a number of years combined with a demand stimulus from central Europe led by Germany". However he did not think this was likely to occur.[54] Simon Tilford also thought that Italy was in very serious trouble, and that structural reforms, however aggressive, were unlikely to lead to a miraculous recovery. He thought that Italy needed a different macroeconomic approach altogether.[55]

iii) Germany

28. The economic outlook for Germany, as the largest creditor state in the euro area, is somewhat different. Yet Simon Tilford argued that it was nevertheless part of the problem. He asserted that an effective euro area recovery could only be driven by German domestic demand. However, it was running a very large external surplus with a "huge glut of savings"[56]:

> "Quite a few German policymakers now argue that most of their surpluses with the rest of the world are not with the eurozone and, hence, it is no longer a problem. The problem with that argument is that the surplus still pushes up the real value of the euro and still prices other euro countries' firms out of non-European markets and third markets and it still increases deflationary pressures."[57]

29. Simon Tilford added that one of the worst aspects of the crisis was the way in which German critics of the country's export dependence had been sidelined.[58] In Roger Bootle's view, the German approach to macroeconomic issues was flawed. They did not understand that it was impossible for everyone to operate a trade surplus at the same time. That attitude was "almost the biggest obstacle in the whole eurozone."[59]

30. Others were more sympathetic to the German position. Gerard Lyons considered that, overall, the German economy was well-placed to take advantage of global developments. He said that, while there were arguments that more of the heavy lifting should be done by surplus countries, Germany quite reasonably asked "Why should the good become like the bad?" He found it difficult to criticise Germany in light of its own painful structural

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52 Q 20.
53 Q 26.
54 Q 45.
55 *Ibid.*
56 QQ 29, 32, 35.
57 Q 49.
58 Q 47.
59 Q 46.

adjustments over the past ten years.[60] Erkki Liikanen believed that Germany had sought "to find a compromise between their national aspirations and European interest."[61]

31. Sir Jon Cunliffe said that "the nature of crises where countries need external help is that the people providing the external help have a lot of authority and influence in the system." As the largest creditor country, Germany had a very important role to play and needed to do more to ensure that effective adjustment mechanisms were in place. He conceded that there were times when a quicker, cleaner response would have been helpful, and that "the economic prescription in some countries was too tilted towards austerity initially because that was necessary for some of the creditor countries." Nevertheless, this had to be viewed in the context of Germany's need to secure parliamentary and public support for its position. In his view, if Berlin had not stood behind the euro, the single currency would not have survived.[62]

Conclusions

32. **EU leaders have been encouraged by evidence that the euro area is in recovery. There are indeed welcome signs that the euro area crisis has eased. In particular, the existential crisis that placed the very survival of the single currency in jeopardy has subsided. Nevertheless, fundamental weaknesses in the euro area remain, including:**

- **Destructively high levels of unemployment and youth unemployment;**
- **Immense economic imbalances between core and periphery Member States;**
- **Anaemic growth, with economic activity well below pre-crisis levels;**
- **Inhibited bank lending;**
- **Incomplete structural reforms across a number of Member States, notably France and Italy;**
- **Subdued inflation, raising fears of a damaging deflationary spiral;**
- **The strength of the euro on the exchange rates, making it difficult for weaker economies to engineer export-led growth;**
- **Continued political tensions at the effect of "austerity" on the lives of EU citizens.**

These weaknesses will continue to test the economic and political stability of the euro area for as long as they persist.

33. **While the crisis may have abated, it would be unwise to conclude that the storm has entirely passed. The economic fragility of many Member States means that the euro area remains vulnerable to future shocks. EU leaders need to act against unemployment by promoting**

60 QQ 37, 47.

61 Q 19.

62 Q 61.

growth-friendly policies, and press on with structural reform and the completion of the Single Market. Creditor Member States, led by Germany, have their own obligations to stimulate growth and demand across the euro area.

34. **Such steps on their own are not enough. There is no guarantee that the new arrangements for euro area integration, in their present incomplete state, could withstand a further crisis. We do not underestimate the political challenges of deeper integration. Yet Economic and Monetary Union must be accompanied by closer fiscal and political union if the single currency is to prosper.**

CHAPTER 3: THE ROLE OF THE EU INSTITUTIONS

35. We asked our witnesses for their views on the role of the ECB and the other EU institutions during the course of the crisis.

The role of the ECB

36. Our witnesses praised the performance of the ECB. Simon Tilford argued that the ECB had kept the show on the road and that Mario Draghi had done "enormously well". Given the political sensitivities between Member States over some of the issues involved, he did not think anyone could have done a better job.[63] Mario Monti noted how impressive it was for such a new institution to establish such credibility so quickly. In particular, its ability to ensure continued low interest rates was "a very remarkable achievement". In his view, the ECB had repeatedly proved able to adapt to circumstances and, in effect, to "invent operational tools that they see fit within the limits of their mandate."[64]

37. Sir Jon Cunliffe said that the crisis had tested all central banks, but political sensitivities meant that it was more difficult for the ECB. In particular under Mario Draghi the ECB had done a very good job of minimising the redenomination risk. In terms of its monetary policy, he thought that the ECB had done as much as possible given the divergent views of its members:

> "They have kept interest rates very low; they have undertaken some bond purchases; Draghi has instituted forward guidance to try to guide them through the system to where they are going. … it has made huge amounts of liquidity available, often to severe criticism in some of its constituent Member States."[65]

38. Not that the ECB was perfect. Sir Jon Cunliffe's one caveat was that, prior to Mario Draghi's "do whatever it takes" speech, the ECB could have done more to prevent the "redenomination genie getting out of the bottle".[66] Simon Tilford felt that initially there had been much complacency about demand in the euro area, with a mantra that "this was all a supply-side problem and that fiscal austerity of this magnitude against a backdrop of very weak demand would not be contractionary and would pose no deflationary threat."[67] While he too thought that Mario Draghi had done "a brilliant job", Roger Bootle suggested that the ECB had been overly complacent about the seriousness of the problem. It had also been slow to recognise the danger of deflation.[68]

39. In assessing the ECB our witnesses focussed on two current concerns: its comprehensive assessment of the euro area banking system, and the

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63 QQ 33, 35.

64 QQ 3–4.

65 Q 55.

66 *Ibid.*

67 Q 35.

68 Q 33.

ramifications of the German Constitutional Court's ruling on the legality of the ECB's programme of Outright Monetary Transactions (OMTs).[69]

The comprehensive assessment of the banking system

40. Ahead of taking on its new role as supervisor of euro area banks, the ECB is conducting a comprehensive assessment of the banking system (including stress tests undertaken in conjunction with the European Banking Authority (EBA)). The assessment began in November 2013. The process will be completed, and banks' individual results published, in October 2014.

41. In our *'Genuine Economic and Monetary Union'* report, we warned that uncertainty over financial backstop arrangements in the event of a capital shortfall being revealed could result in the ECB tempering its assessment in order to avoid creating financial instability in the short run. However this would run the risk ultimately of undermining its credibility as a supervisor.[70] As a member of the ECB Governing Council, Erkki Liikanen stressed that "we must guarantee that any bank or division that will be taken over by the ECB is sound and properly capitalised." The three elements of the comprehensive assessment—the risk assessment, the asset quality review and the stress tests—were designed to ensure that this was the case.[71] Mario Monti said that "they have to be tough enough so as to be credible, but one hopes that their toughness does not reveal a landscape that is so full of holes as to make it impossible to have sufficient financial means."[72]

42. Sir Jon Cunliffe observed that the ECB had a huge incentive to undertake the comprehensive assessment properly because of the risk to its reputation—a key element of a central bank's armoury. Although he acknowledged that the history of stress testing in the EU was not a happy one, he was confident that the process would be more effective than when responsibility had lain with national supervisors.[73]

The German Constitutional Court ruling on OMTs

43. On 7 February 2014 the German Constitutional Court found that the ECB's programme of Outright Monetary Transactions (OMTs)[74] was "incompatible with primary law", because it "does not appear to be covered by the mandate of the European Central Bank". However, it added that, if the OMTs decision were interpreted restrictively, it could be lawful. It therefore referred the questions to the Court of Justice of the European Union (CJEU) for a definitive interpretation of the relevant EU law,

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69 For a full discussion of these issues, see House of Lords European Union Committee, *'Genuine Economic and Monetary Union' and the implications for the UK*, *Op. Cit.*

70 *Ibid.*

71 Q 15.

72 Q 6.

73 Q 56.

74 The programme through which the ECB would purchase unlimited amounts of national debt on the secondary markets, provided that the country in question had agreed to a reform programme.

following which the German Constitutional Court would consider the implications.[75]

44. Erkki Liikanen stressed the ECB's view that the programme was "totally compatible with the treaty and with our mandate." Every Member State was responsible for its own public finances and needed to have a primary surplus and undertake its own structural reforms. Bridge funding could be undertaken by the EU or IMF but would be heavily conditional. In addition, the ECB could only undertake the purchase of sovereign debt if the national programme was fully on track. He also stressed that the risk to the ECB was limited by focussing on one to three-year bonds.[76]

45. On the other hand, Roger Bootle warned that "if the ECB were to want to embrace outright, proper quantitative easing, there would be an almighty row with the Bundesbank and other parts of the German establishment."[77] Although Matthew Fell acknowledged that the ECB's OMTs intervention had brought the acute stage of the crisis under control, it nevertheless rested on shaky legal grounds.[78] Simon Tilford agreed that it was a "big ruling", because it would constrain the German Government irrespective of how the CJEU responded. He was surprised that the markets were so relaxed, because it put up a potentially significant obstacle.[79] Sir Jon Cunliffe noted that the legal process would take one or two years, and was unsure how the issue would play out over that period.[80]

Conclusions

46. **The ECB has emerged with well-deserved credit for its handling of the euro area crisis. Its actions have kept interest rates low and provided much-needed liquidity to the financial system. Mario Draghi's July 2012 pledge to "do whatever it takes" to save the euro did more than anything else to defuse the redenomination risk that was threatening the very existence of the single currency.**

47. **Nevertheless, the ECB faces significant challenges. It is about to take on the vital role of supervisor of the euro area's largest banks. In preparation for assuming these powers, it is undertaking a comprehensive assessment of the banking system, including stress tests carried out in conjunction with the EBA. It is still unclear what deficiencies the assessment will uncover, and the extent to which these will be revealed. The ECB is caught between ensuring that the process is robust and the risk of undermining the euro area's fragile recovery. As it prepares to complete its comprehensive assessment in October 2014, the ECB must not allow any uncertainty over financial backstop arrangements to cloud its judgment or prevent full**

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75 German Federal Constitutional Court (2014), 'Principal Proceedings ESM/ECB: Pronouncement of the Judgment and Referral for a Preliminary Ruling to the Court of Justice of the European Union', Press release no.9/2014, 7 February, available at http://www.bverfg.de/en/press/bvg14-009en.html. For the full decision see http://www.bverfg.de/en/decisions/rs20140114_2bvr272813en.html.

76 Q 16.

77 QQ 33–4.

78 Evidence to the Sub-Committee on Economic and Financial Affairs, 11 March 2014, *Op. Cit.*, Q 27.

79 Q 34.

80 Q 62.

transparency. The way in which the ECB handles the comprehensive assessment will be a test of its credibility.

48. **The German Constitutional Court's recent ruling on Outright Monetary Transactions means that uncertainty about the legitimacy of that tool will continue for the next year or more. That case also illustrates the battle the ECB has on its hands in steering a monetary policy course that all its members can sign up to. This must not stop it from taking decisive action whenever required, and in particular to counter the deflationary threat should the current pattern of subdued inflation persist. We will continue to scrutinise the growing role of the ECB in the coming months.**

The Commission

49. Our witnesses were less positive about the performance of the European Commission. Mario Monti said that to begin with it had not been sufficiently aware of the need for reform of financial regulation and supervision.[81] On the other hand, Erkki Liikanen welcomed the Commission's work in ensuring better governance, and noted how it had borne up well under a heavy workload of financial market regulation.[82]

50. Simon Tilford thought that the Commission had started well by arguing for symmetrical adjustment—offsetting internal devaluations and weak demand in the south with counter-measures in the north. Unfortunately, the Council, led by creditor Member States, forced it to change tack. As a result, "Germany quickly became the benchmark for all other countries to emulate rather than part of the problem." In his view, the Commission had become the advocate of creditor countries, with negative implications for the handling of the crisis.[83] Roger Bootle thought that the Commission had shirked its duty to encourage creditor Member States to accept their responsibilities: "What happens is that the German view wins out, which means that the solution to this is to carry on clobbering the periphery, so you end up with a lack of demand in the system, which leads you on to deflation and so on and so forth."[84]

51. Sir Jon Cunliffe said that the Commission found it difficult to play a role in crisis management for the euro as a whole because it did not have the tools or the instruments to do so.[85] However, he did not think it was a question of the Commission losing power to the Council as an EU institution: "The Commission lost power and was not able to have the influence that national Governments and national parliaments in the eurozone were able to have because this was about hundreds of billions of euros, and that sort of thing is controlled by national parliaments in the EU."[86]

81 Q 5.

82 Q 16.

83 Q 35.

84 *Ibid.*

85 Q 57.

86 Q 60.

The European Parliament

52. Likewise, Sir Jon Cunliffe said that the European Parliament had played a limited role in the euro area crisis because "many of the key crisis management decisions were about money", which was controlled by national parliaments.[87] Simon Tilford thought that it had done a good job in terms of regulation of the financial sector, but that its role had been limited in relation to "the big macro issues".[88] Mario Monti said that it had surprised many in terms of ensuring effective enforcement of eurozone governance rules.[89] Erkki Liikanen gave rapporteurs on European Parliament committees credit for the way they had approached the issue, noting that the Parliament had not caused undue delays when compromises and solutions on important legislation were needed.[90]

The Eurogroup

53. Sir Jon Cunliffe noted that much of the crisis response had been handled by the Eurogroup (the informal body that brings together the finance ministers of countries whose currency is the euro), "and rightly so, because they were paying the cost of the crisis; it was theirs to manage. The euro did not put in place any political machinery for integration. … So when the crisis hit there was no machinery on the political side for reaching a consensus about what needed to be done." Given the Eurogroup's informal nature, he observed that "one of the challenges for the euro members going forward is how they provide for a necessary level of political integration without creating a federal state".[91] This has important implications for the UK, which we examine in Chapter 4.

The troika

54. The ECB/Commission/IMF 'troika' is not an EU institution, and it includes one global body in the IMF. Yet it has played a key role in relation to the crisis in negotiating financial assistance for stricken euro area Member States.

55. Sir Jon Cunliffe said that the early troika programmes were quite patchy, with mistakes made and difficult internal dynamics. The IMF was sitting on the same side of the table as the central bank, rather than on the other side as would normally be the case. The Commission was negotiating as a representative of the other members of the single currency as well as the EU as a whole. Much of the support was coming from euro area members, who had to go through their own governance procedures. Thus "it may have looked a bit clunky compared to how you would normally see one of these adjustment programmes happen, but the complexity of the challenge was very different." Overall, he thought that the Spanish and Irish programmes had been successful, and the Greek and Cypriot programmes less so, with Portugal somewhere in between. Sir Jon Cunliffe added that the IMF's role had been required because Germany did not think that the Commission had the necessary expertise in crisis management and adjustment programmes,

87 QQ 57, 60.

88 Q 36.

89 Q 5.

90 Q 16.

91 Q 57.

and it wanted an independent check on its role. Although the IMF's involvement had raised tensions, he thought it had made the support programmes more robust.[92]

56. Erkki Liikanen noted that there were different views about the troika in the countries affected. Some said that it was ignorant of what was happening, while others welcomed the clarity that it brought. He also stressed the benefits of the IMF's neutrality and expertise, and thought the IMF and the Commission had worked well together.[93] Simon Tilford thought it curious that the IMF had got involved in the situation given that the euro area did not have an external financing problem and was "enormously wealthy". He believed that this had damaged the IMF's reputation, and had done Europe a disservice by giving intellectual backing to a strategy that was unlikely to work.[94]

57. We note the conclusions of the recent report of the European Parliament Economic and Monetary Affairs (ECON) Committee that, while the troika helped struggling EU countries out of the crisis and prevented the situation from getting worse, flaws in the troika's structure and working methods hindered national ownership of economic reforms, and compromised transparency and accountability.[95]

Conclusion

58. **The euro area crisis has seriously altered the institutional and decision-making structure of the EU. Some authorities have grown stronger, notably the ECB and the Eurogroup, or, in the case of the troika, have had to be created. By contrast, the Commission's power and influence in determining the crisis response has diminished. While the European Parliament has played an important role in financial regulation, its part in crisis management has been limited. The full ramifications of these developments have still to be determined, but it is noticeable (and perhaps inevitable) that it is euro area authorities, as opposed to those representing the EU 28, that have grown in power and influence. In responding to these developments, two principles need to be kept in focus. First, as we explored in our recent report into the role of national parliaments in the EU, institutions must be fully accountable to citizens for their actions.[96] Second, the impact of these changes both on the EU as a whole, and on non-euro area members such as the UK, must be constantly borne in mind.**

92 QQ 57–8.

93 Q 17.

94 Q 35.

95 European Parliament (2014), 'Troika helped to avoid the worst, but flawed structure harmed recovery', press release, 13 March. Available at http://www.europarl.europa.eu/news/et/news-room/content/20140307IPR38407/html/Troika-helped-to-avoid-the-worst-but-flawed-structure-harmed-recovery.

96 House of Lords European Union Committee, *The Role of National Parliaments in the European Union* (9th Report, Session 2013–14, HL Paper 151).

CHAPTER 4: THE EURO AREA CRISIS AND THE UK

59. We considered with our witnesses the implications of these developments for the UK, and in particular on the nature of the relationships between key UK players (including the Bank of England and the City of London as well as the Government) and the euro area and the EU as a whole.

The Bank of England and the ECB

60. In light of the ECB's growing significance, we asked our witnesses to reflect on its evolving relationship with the Bank of England. Erkki Liikanen cited the European Systemic Risk Board (which is chaired by the ECB President and vice-chaired by the Governor of the Bank of England) as an example of how the EU had been able to draw on the expertise of the Bank of England. Noting discussions in other forums, Governor Liikanen said that key figures met often and professional and personal relationships were good and open.[97] Gerard Lyons and Simon Tilford agreed that the Bank of England had a very good relationship with the ECB. However, Mr Tilford was not convinced by the Bank of England narrative that this was a relationship of equals.[98]

61. Sir Jon Cunliffe noted that the good relationship between the Bank of England and the ECB had historically been concerned with monetary policy. Given their respective new supervisory functions, they now needed to work together on financial stability and macroprudential policy and build a relationship that had not existed before. As a supervisor of 18-plus countries with vastly different banking sectors, the ECB would favour a rules-based approach. Given the complex financial sector that it was responsible for, the Bank of England would favour a more judgment-based approach. Such supervisory approaches needed to be made to fit, and an effective working relationship would take time to build. He also acknowledged that it would have resource implications for the Bank of England.[99]

The City of London and the euro area

62. We asked our witnesses whether the City of London was acknowledged as an EU asset as well as a UK asset. Mario Monti said that the importance of the City for the EU was recognised more than the UK believed.[100] Simon Tilford was confident that central bankers, business leaders and regulators across the EU fully understood the importance of the City of London. If the UK withdrew from the EU, he thought that the City would suffer in the long term because the resentment engendered within the euro area would make it vulnerable to regulatory attacks.[101]

63. Gerard Lyons was positive about the prospects for London. He stressed that the wholesale market for Europe's financial sector remained in London, but it was also very well positioned at the global level. He said that while the City

97 Q 24.

98 QQ 42–3.

99 Q 65.

100 Q 11.

101 Q 39.

did not disagree with individual EU proposals, it tended to oppose the mass of regulations.[102]

64. Matthew Fell acknowledged that the EU was the single biggest market for the UK, so the UK should be looking to exert an influence on it. At the same time, the UK should seek to diversify its trading activity and move away from an overreliance on the EU markets.[103]

65. Roger Bootle noted that European politicians tended to view the financial sector with distaste, with the danger for the UK that "this great national asset is squeezed to death and clobbered." He detected a feeling within the euro area that "London has unfairly stolen a march and it is destabilising, and in some sense humiliating, that the majority of euro business is done in London". However, London was not competing with Paris or Frankfurt but rather with global centres such as New York and Singapore, and most of its future business would come from providing financial services to the rest of the world.[104]

66. Sir Jon Cunliffe cautioned against viewing negative sentiment about the financial sector as directed specifically at the City of London. He said that there were some who regarded the City as a threat to EU financial stability or wished to see its financial activity relocate, but the view that the financial centre for the euro should be in the euro area was not the position of national governments or the Commission. He believed that many in the EU recognised that London was in fact competing with other global centres "and that this huge financial centre brings benefits to the eurozone and the EU because of liquidity, innovation and international reach."[105]

The UK and the EU

67. In light of this, several of our witnesses stressed the importance of the UK to the EU. Erkki Liikanen argued that "because the UK has such a strong financial centre with the City … when we reform our regulation of the financial markets, it is very important to get proper competent input and expertise from the UK authorities."[106] In Simon Tilford's view, as the regulatory leader in financial services, what the UK argued for tended to go.[107]

68. However, Roger Bootle said that, in the context of deeper euro area integration, "the danger for Britain would be that all the power and the influence would reside in the eurozone core of the EU." Unless there were cast-iron legal guarantees and a willingness among euro area leaders to conceive of the EU consisting of "ins" and "outs", "the danger has to be that Britain would be marginalised and all sorts of things would be decided in the eurozone core and in effect imposed on Britain." In those circumstances, it might be preferable to withdraw from the EU completely.[108]

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102 Q 38.

103 Evidence to the Sub-Committee on Economic and Financial Affairs, 11 March 2014, *Op. Cit.*, Q 28.

104 QQ 40–2.

105 Q 69.

106 Q 24.

107 Q 39.

108 Q 40.

69. Gerard Lyons noted the propensity in the UK to look at the euro area primarily from an economic point of view, whereas on the continent it was viewed primarily from a political perspective. He acknowledged the importance of safeguards secured by the Government to protect non-euro area Member States, but stressed that the Government needed to ensure that they were retained in the future.[109]

70. Sir Jon Cunliffe said that, while it would be more convenient if the euro area did not need closer integration, the single currency was a fact and its break-up would be detrimental to the UK. In his view, the UK needed to help to facilitate progress towards euro area integration, while recognising the "real political difficulties for those countries and we should not assume them away because in economic theory they should act in a certain way." At the same time, the UK needed to ensure that such integration did not damage or jeopardise the community of 28 and the Single Market, "and that we do not suddenly discover that the EU has collapsed into the eurozone to all intents and purposes." He did not think it was practical for the UK to be involved in Eurogroup meetings, because "you really have to have the people in the room who are bearing the cost." The better approach was to have contacts with the Eurogroup, ensure its meetings took place in the context of other EU meetings, and being ready to offer technical advice without lecturing or providing unwanted counsel.[110]

Conclusions

71. **The economic fortunes of the UK and the euro area are intrinsically linked. Although the UK economy has suffered from the decline in business activity arising from the euro area crisis, it stands to benefit from a prosperous euro area. The UK must therefore do all it can to support its EU partners on the path towards closer integration. Nevertheless, such moves towards integration leave the UK in an increasingly isolated position. In order to ensure that the UK's interests are effectively promoted, the Government and the Bank of England should therefore maintain and develop constructive relationships with the increasingly powerful euro area authorities, notably the Eurogroup and the ECB.**

72. **In the context of the election of a new European Parliament and the appointment of a new Commission during 2014, all parties should redouble their efforts to convince euro area colleagues of the benefits of the City of London as the leading global financial centre for the EU as a whole. If all can be convinced of the mutual benefits of prosperity both for the euro area and the Single Market, then the UK and the City of London have much to contribute and much to gain.**

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[109] QQ 38, 42.

[110] QQ 59, 68.

CHAPTER 5: SUMMARY OF CONCLUSIONS

Is the crisis over?

73. EU leaders have been encouraged by evidence that the euro area is in recovery. There are indeed welcome signs that the euro area crisis has eased. In particular, the existential crisis that placed the very survival of the single currency in jeopardy has subsided. Nevertheless, fundamental weaknesses in the euro area remain, including:

- Destructively high levels of unemployment and youth unemployment;
- Immense economic imbalances between core and periphery Member States;
- Anaemic growth, with economic activity well below pre-crisis levels;
- Inhibited bank lending;
- Incomplete structural reforms across a number of Member States, notably France and Italy;
- Subdued inflation, raising fears of a damaging deflationary spiral;
- The strength of the euro on the exchange rates, making it difficult for weaker economies to engineer export-led growth;
- Continued political tensions at the effect of "austerity" on the lives of EU citizens.

These weaknesses will continue to test the economic and political stability of the euro area for as long as they persist. (paragraph 32)

74. While the crisis may have abated, it would be unwise to conclude that the storm has entirely passed. The economic fragility of many Member States means that the euro area remains vulnerable to future shocks. EU leaders need to act against unemployment by promoting growth-friendly policies, and press on with structural reform and the completion of the Single Market. Creditor Member States, led by Germany, have their own obligations to stimulate growth and demand across the euro area. (paragraph 33)

75. Such steps on their own are not enough. There is no guarantee that the new arrangements for euro area integration, in their present incomplete state, could withstand a further crisis. We do not underestimate the political challenges of deeper integration. Yet Economic and Monetary Union must be accompanied by closer fiscal and political union if the single currency is to prosper. (paragraph 34)

The role of the EU institutions

76. The ECB has emerged with well-deserved credit for its handling of the euro area crisis. Its actions have kept interest rates low and provided much-needed liquidity to the financial system. Mario Draghi's July 2012 pledge to "do whatever it takes" to save the euro did more than anything else to defuse the redenomination risk that was threatening the very existence of the single currency. (paragraph 46)

77. Nevertheless, the ECB faces significant challenges. It is about to take on the vital role of supervisor of the euro area's largest banks. In preparation for assuming these powers, it is undertaking a comprehensive assessment of the banking system, including stress tests carried out in conjunction with the EBA. It is still unclear what deficiencies the assessment will uncover, and the extent to which these will be revealed. The ECB is caught between ensuring that the process is robust and the risk of undermining the euro area's fragile recovery. As it prepares to complete its comprehensive assessment in October 2014, the ECB must not allow any uncertainty over financial backstop arrangements to cloud its judgment or prevent full transparency. The way in which the ECB handles the comprehensive assessment will be a test of its credibility. (paragraph 47)

78. The German Constitutional Court's recent ruling on Outright Monetary Transactions means that uncertainty about the legitimacy of that tool will continue for the next year or more. That case also illustrates the battle the ECB has on its hands in steering a monetary policy course that all its members can sign up to. This must not stop it from taking decisive action whenever required, and in particular to counter the deflationary threat should the current pattern of subdued inflation persist. We will continue to scrutinise the growing role of the ECB in the coming months. (paragraph 48)

79. The euro area crisis has seriously altered the institutional and decision-making structure of the EU. Some authorities have grown stronger, notably the ECB and the Eurogroup, or, in the case of the troika, have had to be created. By contrast, the Commission's power and influence in determining the crisis response has diminished. While the European Parliament has played an important role in financial regulation, its part in crisis management has been limited. The full ramifications of these developments have still to be determined, but it is noticeable (and perhaps inevitable) that it is euro area authorities, as opposed to those representing the EU 28, that have grown in power and influence. In responding to these developments, two principles need to be kept in focus. First, as we explored in our recent report into the role of national parliaments in the EU, institutions must be fully accountable to citizens for their actions.[111] Second, the impact of these changes both on the EU as a whole, and on non-euro area members such as the UK, must be constantly borne in mind. (paragraph 58)

The euro area crisis and the UK

80. The economic fortunes of the UK and the euro area are intrinsically linked. Although the UK economy has suffered from the decline in business activity arising from the euro area crisis, it stands to benefit from a prosperous euro area. The UK must therefore do all it can to support its EU partners on the path towards closer integration. Nevertheless, such moves towards integration leave the UK in an increasingly isolated position. In order to ensure that the UK's interests are effectively promoted, the Government and the Bank of England should therefore maintain and develop constructive relationships with the increasingly powerful euro area authorities, notably the Eurogroup and the ECB. (paragraph 71)

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[111] House of Lords European Union Committee, *The Role of National Parliaments in the European Union*, *Op. Cit.*

81. In the context of the election of a new European Parliament and the appointment of a new Commission during 2014, all parties should redouble their efforts to convince euro area colleagues of the benefits of the City of London as the leading global financial centre for the EU as a whole. If all can be convinced of the mutual benefits of prosperity both for the euro area and the Single Market, then the UK and the City of London have much to contribute and much to gain. (paragraph 72)

APPENDIX 1: EU SUB-COMMITTEE ON ECONOMIC AND FINANCIAL AFFAIRS

The members of the Sub-Committee who conducted this inquiry were:

Viscount Brookeborough
Earl of Caithness
Lord Carter of Coles
Lord Davies of Stamford
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Harrison (Chairman)
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Lord Vallance of Tummel

Declaration of Interests

Viscount Brookeborough
None relevant

Earl of Caithness
None relevant

Lord Carter of Coles
None relevant

Lord Davies of Stamford
None relevant

Lord Dear
None relevant

Lord Flight
Director, Flight & Barr Limited
Director, Flight and Partners Limited
Director, Investec Asset Management Limited (international investment manager)
Director, Gulf Overseas Investment Fund Limited
Chairman, CIM Investment Management Limited
Director, Investec Asset Management Holdings Pty Ltd
Chairman, Downing Structured Opportunities VCT1 plc
Director, Metro Bank plc
Director, Marechale Capital
Chairman, Aurora Investment Trust plc
Director, Edge Performance VCT plc
Chairman, EIS Association
Consultant, Arden Partners plc
Consultant, TISA (previously PIMA)
Consultant, Kinetic Partners
Member, Advisory Board, Guinness Renewable Energy EIS Fund

Lord Hamilton of Epsom
Director, Jupiter Dividend and Growth Trust PLC
IREF Global Holdings (Bermuda) Ltd
IREF Australian Holdings (Bermuda) Ltd

AREF Holdings (Bermuda) Ltd

Lord Harrison (Chairman)

None relevant

Lord Kerr of Kinlochard

Deputy Chairman, Scottish Power plc
Director, Rio Tinto
Director, Scottish American Investment Co Ltd
Member, International Advisory Board, Edinburgh Partners
Chairman, Centre for European Reform
Vice President, European Policy Centre

Baroness Maddock

None relevant

Lord Marlesford

Independent National Director, Times Newspapers Holdings Ltd
Non-executive Director, Gavekal Research (Hong Kong)
Advisor to Sit Investment Associates Minneapolis (USA)

Lord Vallance of Tummel

Member, Supervisory Board, Siemens AG
Member, International Advisory Board, Allianz SE
Chairman, Amsphere Ltd

The following Members of the European Union Committee attended the meeting at which the report was approved: Lord Boswell of Aynho (Chairman), Lord Bowness, Baroness Corston, Lord Dear, Baroness Eccles of Moulton, Lord Foulkes of Cumnock, Lord Hannay of Chiswick, Lord Harrison, Lord Maclennan of Rogart, Lord Marlesford, Baroness O'Cathain, Baroness Parminter, Baroness Quin, Baroness Scott of Needham Market, Lord Tugendhat, Lord Wilson of Tillyorn.

A full list of registered interests of Members of the House of Lords can be found at http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at http://www.parliament.uk/hleua and available for inspection at the Parliamentary Archives (020 7219 5314).

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. In addition to the witnesses listed below, Matthew Fell, Director, Competitive Markets, CBI, gave evidence in the context of the Sub-Committee on Economic and Financial Affairs' examination of shadow banking.

Oral evidence in chronological order

QQ 1–11	Senator Mario Monti, former Prime Minister of Italy
QQ 12–25	Erkki Liikanen, Governor of the Bank of Finland
QQ 26–49	Roger Bootle, Managing Director, Capital Economics
	Gerard Lyons, Chief Economic Adviser to the Mayor of London
	Simon Tilford, Deputy Director, Centre for European Reform
QQ 50–71	Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England

Alphabetical list of all witnesses

Roger Bootle (QQ 26–49)

Sir Jon Cunliffe (QQ 50–71)

Governor Erkki Liikanen (QQ 12–25)

Gerard Lyons (QQ 26–49)

Senator Mario Monti (QQ 1–11)

Simon Tilford (QQ 26–49)

APPENDIX 3: CORRESPONDENCE BETWEEN THE EUROPEAN UNION COMMITTEE AND THE UK GOVERNMENT ON THE EURO AREA CRISIS (JULY 2012–AUGUST 2013)

July–October 2012

Letter from the Chairman of the House of Lords European Union Committee, Lord Boswell, to Mark Hoban MP, Financial Secretary, HM Treasury, 24 July 2012

Thank you for your evidence before the House of Lords European Union Sub-Committee on Economic and Financial Affairs at its meeting on 17 July 2012, on developments in the euro area crisis since the publication of the Committee report in February. You will be aware that the Sub-Committee also heard oral evidence from: Gideon Rachman, Chief Foreign Affairs Columnist, Financial Times, Mats Persson, Director, Open Europe, Professor Patrick Minford, Professor of Applied Economics, Cardiff Business School, on 3 July; and from Dr Richard Corbett, Member of the Cabinet of Herman Van Rompuy, President of the European Council, on 10 July.

The future of the euro area

Since you appeared before us, the situation in the euro area has developed rapidly. The possibility of Greek default is again being discussed, and Spanish borrowing costs have risen dramatically. In your appearance before us, we were struck by your view that there is a strong political will within the euro area to see it continue and to remain intact, as well as your view that, at every stage of the crisis, euro area leaders have shown that they are prepared to take the necessary steps to ensure its survival. You pointed out that, by contrast, the debate on the euro in the UK is seen in economic terms. Do you agree with Professor Minford that the enormous commitment that Member States have vested in the euro means that it is now almost impossible to go back? Do you agree that the euro area is therefore likely to survive, even if it is in a modified form? If so, what impact would this have on the euro as an international currency?

Mr Persson argued that it is now very difficult for Greece to get out of its current position, and that "within the next year there will need to be a fundamental decision about whether Greece can remain inside the euro." Do you agree with him? How do you anticipate events unfolding in the autumn as negotiations on Greece's fiscal position continue? For how long can euro area leaders, led by Germany, be expected to remain committed to providing such significant financial support to Greece? What will the implications be for vulnerable nations such as Cyprus, which has just assumed the Presidency of the Council of the EU, and what support is the UK providing to Cyprus? Is it possible for the euro currency to continue, even if the euro area itself does not survive in its present form?

Mr Rachman told us that he would prefer a Greek exit to take place in "as controlled a fashion as possible, as opposed to a chaotic breakdown where Greece leaves the euro and then you suddenly have border guards trying to stop people taking euros out of the country". What planning and preparatory steps do you believe need to be undertaken if an orderly exit is to occur without serious ramifications in terms of contagion both to other euro area Member States, and to the EU as a whole? What planning does the European Commission, in particular, need to undertake, and are you aware of the Commission undertaking such work? In your evidence to us you told us that "a wide range of contingency planning is undertaken by government." What further information can you give us on the nature of the work that is being undertaken? Are you confident that UK authorities have optimal plans in place to protect UK markets, entities and citizens from the turbulence consequent on a Greek exit?

You told us that there was still uncertainty about the size of the ESM, and Dr Corbett told us that there was a question of whether the funds available were sufficient in size to create an effective firewall. Mr Rachman pointed to the danger of a crisis in Italian funding requirements, because Italy has almost €2 trillion worth of debt due to be rolled over in the next few years. In his view, if Italy cannot borrow from the markets, "then you have a real meltdown". Is it possible to construct a firewall large enough to secure Spain and Italy's position, given that, as Mr Persson told us, their leaving the euro would fragment the single market, whose survival and deepening is a pivotal objective of UK Government policy? At the time of writing, both Spanish and Italian bond markets were coming under intense pressure. How large does such a firewall need to be in order to be effective?

The implications of fiscal and banking union for the UK

In our February 2012 report, we stressed that it was vital that, while the euro area states take the steps they consider necessary to strengthen the euro, including on fiscal integration, matters relating to the single market remain the preserve of all 27 EU Member States. We urged the UK Government, together with other Member States, to devise a means of securing the fiscal integration desired by euro area Member States while at the same time protecting the integrity of the single market, including its provisions for financial regulation. The 28/29 June EU summit called for the development of a "specific and time-bound road map for the achievement of a genuine Economic and Monetary Union". The report by the President of the European Council, Herman Van Rompuy, *Towards a Genuine Economic and Monetary Union*, set out "four essential building blocks" for the future EMU: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and strengthened democratic legitimacy and accountability. A key element of this package is so-called "banking union", including a proposal for a new banking supervisory framework, which you told us would be published in early September, with the hope of legislation being agreed by the end of the year.

The Government have made clear that, whilst they support the development of closer fiscal integration and banking union, the UK will not take part in the fundamental elements of a banking union, including a common deposit guarantee scheme or placing the UK under the jurisdiction of a single European financial supervisor. In his letter to us of 5 July, your ministerial colleague, Lord Sassoon, asserted that the UK's "non-participation in any banking union should not and need not adversely affect London's position as the leading financial centre in Europe. A euro area banking union will not change the fundamental Treaty freedoms that underpin the single market." He also pointed out that the June European Council committed to "preserve the unity and integrity of the single market" in any proposals that are brought forward.

Whilst you have explained why the Government have come to this conclusion, others see considerable risk to the UK's ability to maintain its influence on the EU and other Member States. Gideon Rachman warned that the Government had not appreciated what is entailed in urging deeper integration on the euro area whilst at the same time saying "we want to stand aside", and questioned how long a political union of 17 would be prepared to tolerate their major financial centre not being inside that core. He also feared the impact of a growing anti-UK narrative in the EU. Mr Persson warned of the risk of potential discrimination against UK firms, and the likelihood of the euro area 17 writing regulatory rules for all 27 Member States. Professor Minford agreed that the integration process would place enormous pressure on the single market, and that "the logic leads to [the UK's] exit from the EU". Dr Corbett told us that there is a growing fear that the UK might not participate as fully in the EU as many other Member States would wish us to, and that a UK exit from the EU is an accident waiting to happen.

We will be examining the proposals for reform of the EU banking sector in the autumn, and we acknowledge that the proposals are at an embryonic stage. At this stage, we reiterate our concern, expressed in our February report, that shifting discussions outside the main EU channels to forums where the United Kingdom has no voice risks marginalising the UK over time. Our concern would be accentuated should other non-euro area Member States decide to participate in banking union. What steps are the Government taking to ensure that the UK is not marginalised? How can the Government ensure that the UK's influence is not diminished by its unwillingness to be a part of the "genuine Economic and Monetary Union" that euro area Member States are being encouraged to agree to? In your letter of 19 July you provided statistics on UK banks' exposure to sovereign and private debt within the euro area up to December 2011. We would be grateful for more up-to-date and detailed data on the extent of this exposure.

The role of the ECB

In our February report, we concluded that additional ECB intervention was likely to prove essential if progress was to be made in resolving the crisis. One proposed element of the prospective banking reform package is an enhanced role for the ECB in the new European supervisory mechanism, and in acting as an agent to the EFSF/ESM in the purchase of sovereign bonds of countries whose borrowing rates are high. Professor Minford argued that the survival of the euro will ultimately depend upon the ECB as an "enormously powerful institution". Mr Persson stressed that the ECB was the only European institution with deep enough pockets to move the markets, but that many potential tools are not within its mandate. He warned that German support for the euro could begin to evaporate if such steps as ECB purchase of government bonds were contemplated, because they do not see the ECB as a lender of last resort for the euro. In your evidence you told us that the ECB were willing to take on new roles, but that the scope and reach of these powers still need to be determined. Does the ECB have sufficient financial resources and tools available to act as an effective backstop to the euro area? Does its mandate need to be amended in order to undertake such a role, would this require treaty change, and if so, is this a realistic proposition?

Banking supervision and the direct recapitalisation of banks

The euro area summit statement envisaged that, once the new banking supervisory mechanism is established, the ESM will be able to recapitalise euro area banks directly. You have stated that such a move would reduce some of the pressure that sovereigns face. Yet Germany has made clear that direct recapitalisation cannot take place until the supervisory mechanism is in place. Mr Rachman stressed the resistance of public opinion to such reforms, and we note his observation that some of the conclusions of the 28–29 June summit are already beginning to unravel. How realistic is it to expect those Member States under greatest financial strain to agree to the establishment of a banking supervisory mechanism without the direct recapitalisation of banks being first put in place? Equally, how realistic is it to expect Germany and other creditor nations to agree to direct recapitalisation without a supervisory mechanism having first been established, or without debtor nations having first introduced much-needed structural reforms? How in your view can this impasse be resolved? Is it possible to devise a sequencing of these proposals that would satisfy all Member States? Is it realistic to expect that Member States will ultimately agree to the establishment of a "fiscal union"?

Eurobonds

Our February report concluded that the question of whether eurobonds are a necessary step towards solving the euro area crisis needed to be addressed. Yet we have been told that Chancellor Merkel has made clear her belief that eurobonds will not be introduced in her lifetime, opinion polls state that up to 80% of Germans oppose their introduction, and the German Constitutional Court has stated that debt pooling involving joint and several liabilities is not allowed. Mr Persson warned that the introduction of eurobonds would be suicide for Europe because it would take away pressure for structural reform and create an incentive for spending. Yet he also argued that the euro cannot survive in its current form unless there is a permanent mechanism that subsidises peripheral Member States. Dr Corbett told us that there was no agreed definition of a eurobond, and that President Van Rompuy would be seeking to explore what is acceptable in the medium term and subject to what conditions. Do you believe that it is now necessary for a system of mutualisation of sovereign debt (whether in the form of eurobonds or not) to be introduced if the euro area is to survive? If so, how should such a system work? Is it realistic (or even reasonable) to expect Germany and other creditor nations to be persuaded that it is in their best interests to introduce such a mechanism?

The Compact for Growth and Jobs

Our February report also stated that ultimately the resumption of sustainable economic growth will hold the key to resolving the crisis. The 28–29 June EU summit announced details of a €110 billion "Compact for Growth and Jobs". Dr Corbett described this as "an important decision", and you called it "a good package". Yet Mr Rachman, Professor Minford and Mr Persson all agreed that the amounts involved were trivial. It appears to us that only a small part of the €110 billion package is genuinely new money. Do you agree? Are we any nearer identifying an effective means by which sustainable economic growth within the EU can be restored in the prevailing economic climate?

Financial markets and the democratic process

In our February report, we observed that national governments and EU institutions have sometimes struggled to keep up with the pace of events during the crisis, and stressed the need for effective leadership both from the EU institutions and Member States. Dr Corbett agreed that whereas markets can move at a click of a mouse, democratic processes take somewhat longer. In his view, it was therefore almost unavoidable that the response to the crisis would proceed on a "step by step" basis. Professor Minford stressed the importance of public opinion, which could destabilise the situation either because German voters "are not willing to throw good money after bad" or because debtor nations "get austerity fatigue". We have been told on the one hand that voters across the euro area remain committed to the euro, but on the other that there has been a "massive change in tone and rhetoric" in the media coverage of the EU in Germany, for instance. In your evidence you accepted that Member States need to satisfy markets and external participants, but you also stressed that they need to ensure that their decisions have legitimacy in the eyes of their electorates. You added that "we are seeing, through economic governance measures, a move of power away from national Parliaments towards the centre of the eurozone in a way that we in the UK would not be happy about if it was happening to us." What more do you believe needs to be done in providing the inspiring leadership necessary to make effective decisions in solving the crisis? Is it realistic to expect that public support within euro area Member States for the single currency can be maintained? Given the speed with which the media and financial markets operate, as exemplified by the current turbulence in the financial markets, is it even realistic to expect the political process to keep up with the pace of events? If not, how can the crisis be resolved?

We recognise that this is a fast-changing situation in which Governments may have to make decisions at short notice. We hope that you will feel able to share as much of your thinking with us as practicable as matters develop.

Letter from Rt Hon Greg Clark MP, Financial Secretary, HM Treasury, to the Chairman, 3 October 2012

Thank you for your letter of 24 July, following my predecessor's evidence session at the House of Lords European Union Sub-Committee on Economic and Financial Affairs on 17 July 2012, seeking an update on the euro area crisis. You ask a series of important questions, which are addressed in groups below.

You ask about the future of the Euro Area

It is in Britain's interest to see a stable euro area. Economic uncertainty emanating from the euro area continues to have a chilling effect on the global economy, including the UK.

We have been clear that the euro area needs to take urgent short term action to deal with the instability that it confronts, to recapitalise banks, deal with high interest rates, and put beyond doubt their commitment to defend their currency. The euro area has taken some important steps in that direction to demonstrate its commitment.

For instance, the ECB's announcement of the 6 September of how it intends to stand behind the euro (which is covered in further detail below) is very welcome. Furthermore, we welcome the European Council's intention to consider proposals to achieve a genuine Economic and Monetary Union that would allow the euro area to stand fully behind a strong and stable single currency. However, as the euro area takes those important steps towards closer integration, it is vital that we preserve the unity and integrity of the EU Single Market in financial services, which I cover in further detail later.

We believe a number of further steps are necessary. First, the euro area and its institutions need to do more to support demand and share the burden of adjustment. Second, the euro area governments need to provide a credible fiscal backstop behind the euro area banking sector. Third, the euro area needs to go further to provide a credible road-map towards broader fiscal and economic integration. Fourth, to support these steps, the euro area needs much closer oversight of each country's fiscal and financial policy. And finally, we all need to comprehensively address Europe's growth challenge, tackling Europe's overall low productivity, lack of economic dynamism and limited flexibility. In the longer term, the euro area, like any single currency, needs closer economic and fiscal integration to secure its future.

Resolving the uncertainty surrounding Greece is a critical element to resolving the ongoing crisis in the euro area. Greece has made some important and significant commitments to its euro area partners that need to be respected as part of continued euro membership. We welcome the commitment of the euro area to work in partnership with the Greek government to ensure they remain on the path to reform and sustainability within the euro area, and we believe that it is in the UK's interests for Greece to remain in the euro area while respecting its commitments. I would note, in that context, the statement by the Eurogroup of 21 February 2012, which reiterated the euro area's commitment "to provide adequate support to Greece during the life of the programme and beyond until it has regained market access, provided that Greece fully complies with the requirements and objectives of the adjustment programme."

We support Cyprus' efforts to tackle their financial difficulties. Cyprus is a Commonwealth member as well as an EU Member State and it is in all our interests that the Cypriot economy is successful and its banking system stable. As you may be aware, Cyprus has officially requested financial assistance from euro area member states through the EFSF/ESM and also from the IMF. There have been two technical missions visiting Cyprus over the summer, and negotiations for an assistance package will begin in the near future. As an IMF member, the UK will be involved in any discussions at the IMF Board regarding Cyprus' request for assistance.

In connection with speculation about a country exiting the euro area, you ask about contingency work in the Treasury. HM Government has a wide range of contingency plans to cover all kinds of potential risks to the UK economy. It is not appropriate for the Government to give any further detail about the nature of its contingency plans, nor can we comment on any equivalent work undertaken by the Commission.

In addition to this, the Financial Services Authority has been working with UK-regulated businesses to ensure that they have appropriate contingency plans in place against any such risks to their businesses.

With regards the construction of a firewall, on 30th March the euro area agreed to increase the ceiling on the combined lending capacity of the EFSF and ESM from €500 billion to €700 billion. As the Chancellor has said, €700 billion is not as big as some wanted, and the IMF itself had asked for. We have always said that how the euro area increases the size of the firewall, to help ring-fence other countries, is up to them. Irrespective of the particular option chosen, it is paramount that the euro area stands convincingly behind the euro. However, as I have previously stated, the Government has been clear that in order to provide a truly comprehensive solution to the crisis a number of other steps are necessary.

You ask about the role of the ECB

We welcome the commitment of the European Central Bank (ECB) to do what they can to ensure the proper functioning of the euro area monetary union. The new Outright Monetary Transactions (OMTs) programme announced on 6

September will enable the ECB to address distortions in government bond markets and ensure the appropriate transmission of its monetary policy decisions to the euro area economy.

More broadly, the ECB has introduced a range of 'non-standard' measures in response to the global financial crisis and the euro area sovereign debt crisis. The ECB itself has made clear that these non-standard measures cannot be considered an alternative to Member States undertaking necessary economic reforms and moving towards greater fiscal sustainability. This is one of the reasons why the ECB has decided that a necessary condition for OMTs is strict and effective conditionality attached to an appropriate European Financial Stability Facility (EFSF) or European Stability Mechanism (ESM) programme.

You ask about the implications of fiscal and banking union for the UK

Closer fiscal integration in the euro area will not result in any marginalisation of the UK. Multiple forms of EU membership already exist and we support a multi-speed, flexible EU where Member States with a range of different interests and needs can work together. This can take place in either informal groupings, such as the like-minded groups, or more formal groups, for example the Schengen area countries. Of course, on issues that concern all 27 Member States, the EU must continue to function at the level of all 27, and the institutions must always work for the benefit all 27 Member States, ensuring they guarantee the integrity of the Treaties.

The UK is not becoming isolated and nor are we losing any influence within the EU, remaining an active, engaged and vigorous participant in debates and negotiations as a full member. This year alone it has encouraged innovation, freed business from over-regulation, and led, with 11 like-minded partner States, the European debate on the structural reforms needed to deliver growth, including the opening of service and energy markets. The UK also engineered a deal to end its liability to the euro area crisis through the EU budget. We have also made tough but intelligent use of EU sanctions, which were a key pillar of the international community's approach to handling Iran, Syria and Burma.

In refraining from entering into closer fiscal integration within the euro area the UK is not indicating any desire to withdraw from the EU. Membership is fundamentally in our national interest, being vital to how we create jobs, expand trade and protect our interests around the world.

The committee is right to note the important questions that greater integration raises in relation to democratic legitimacy and accountability. This issue is important to Member States and will be addressed by the 4 Presidents in their October and December reports.

The UK endorsed the June European Council conclusions on banking union based on the ECB being granted powers of supervision over euro area banks. It is important that the euro area takes steps to address the economic weaknesses in the monetary union, and these proposals are of great significance to this. The measures discussed logically flow from monetary union and are designed to ensure the success of the single currency. As the UK does not use the euro, it will not be joining the banking union, something that has been definitively stated by this government.

We have been consistently clear about the importance of the distinction between the single currency and the single market. As the Chancellor has noted, although banking union is an issue separate from the single market, so long as it is being designed for the euro area as a whole, the level of integration in the euro area could have profound implications for the operation of the single market. The UK remains committed to maintaining the integrity and operation of the single market and will work to ensure that this is upheld as the legislation on the banking union is developed.

The UK financial services industry will remain an unparalleled global financial centre outside the banking union. It will continue to offer strong and well-respected regulation and supervision, as well as culture, diversity and access to top quality services and skilled workforce that is unmatched in other financial centres. Clustering effects mean that there are national, regional and global services and clients within close proximity. All of these advantages will remain in place with a banking union across the euro area.

You ask about banking supervision and the direct recapitalisation of banks

On 29 June 2012, euro area Heads of State or Government, agreed that the ESM may have the potential ability to recapitalise banks directly once a single supervisor for euro areas banks is in place, with the relevant sovereign subject to appropriate conditionality, including compliance with state aid rules. Euro area finance ministers agreed that the technical discussions on the future ESM direct bank recapitalisation will start in the autumn.

It is too early to make an assessment on this issue, as the details of the proposal are not yet available. The ESM Treaty is an intergovernmental agreement between euro area Member States only. The UK will neither participate in, nor contribute to the mechanism.

You ask about Eurobonds

Amongst other actions, the euro area needs to strengthen fiscal integration and effect more pooling of resources, whether through common Eurobonds or some other mechanism. The Government has been consistent with our euro area partners in stating that we think Eurobonds deserve further consideration as a means to providing greater collective support and responsibility in the euro area. We note that a number of models for Eurobonds have been proposed by various institutions and individuals to date. For example, in its Green Paper, Feasibility of introducing Stability Bonds, November 2011, the European Commission set out three possible models for Eurobonds.

We recognise that there are a number of different models for Eurobonds and, in practice, there are a number of issues that would need to be worked through: the guarantee structure and legal issues (including implications for the EU treaty), the size of Eurobond issuance relative to national bond issuance, the period for which Eurobonds would be issued as well as more technical design and operational issues.

There is almost certainly a need for Eurobonds to be accompanied by greater fiscal integration among euro area Member States, so that those Member States with stronger public finances can be confident this will be in their long-term interests too. Ultimately, this will be a matter for the euro area to decide—and all euro area Member States, including creditor countries, would need to be comfortable with any such arrangements.

You ask about the Compact for Growth and Jobs

A return to sustainable growth is the only way for Europe to pay down its debts and exit the current crisis. Member States must continue to take tough decisions to prioritise reforms that best enhance growth and ensure flexible, well-functioning labour markets. In parallel, it is essential that the European Commission uses EU-level policy levers to fully support growth. This is subject to additional spending pressures not being placed on the EU Budget.

The UK has led the Growth Agenda in Europe and will continue to do so. Much of the broad and ambitious agenda set out in the "Compact for Growth and Jobs" is based on a joint letter sent by the UK and 11 other Member States, including Italy and Spain in February. Agreement on the Unitary Patent Package at June European Council demonstrates that Europe-wide action can be taken to boost growth. The Unitary Patent will allow the holder to protect their intellectual property rights across 25 participating Member States, leading to considerably reduced costs for SMEs and a boost to innovation. We will also continue to push for further deepening of the Single Market and for the completion of trade deals with other markets, such as India, Canada and Singapore.

On the amounts involved in the "Compact for Growth and Jobs", I disagree with the suggestion that they are trivial. The €10 billion increase in the paid in capital of the European Investment Bank (EIB) agreed in principle at the June European Council, is an entirely new measure. This alone will allow the Bank to perform up to €60 billion of extra lending, which it is envisaged will in turn procure up to €120 billion of additional investments from other parties, contributing significantly to the European economy.

June European Council also saw Heads of Government call for the immediate launch of the Project Bonds pilot scheme, which has since been agreed by the relevant European Institutions. The Commission estimate that this scheme should bring additional investments of up to €4.5 billion for pilot projects in key transport, energy and broadband infrastructure areas. The Government believes project bonds represent a potential solution to the challenge of maintaining high levels of investment in public infrastructure at times of severe fiscal constraint and the absence of private sector risk takers.

The structural funds in the EU Budget are a tool for all Member States to make use of. The "Compact for Growth and Jobs" identified €55 billion within current Member State allocations that has not yet been spent, funds readily available for investment in fast acting growth measures that are most suitable at the national level. Although this money is not 'new', the Compact increases its flexibility by encouraging reprogramming to high priority areas and the increased use of financial instruments, which could help leverage private sector finance. The Government supports these attempts to increase the value for money and effectiveness of structural funds.

You ask about financial markets and the democratic process

The Governments believes clear and effective decision making is important in a crisis. However, this is a crisis of the euro area and as such; further consideration of euro area leadership is required. The question of public support is also important. We have seen public demonstrations in many euro area countries, though these have not necessarily been against the euro itself where public support has tended to remain more robust. Ensuring continued support for the single currency is obviously a matter for Members of the single currency themselves.

While actors in financial markets can move almost instantly, political processes, for obvious reasons, often take longer. But we should not forget that significant measures have been taken throughout the crisis by euro area Member States and by all 27 members of the European Union. We have been clear about what more we think needs to be done to bring the crisis to a close.

February–March 2013

Letter from the Chairman to Rt Hon Greg Clark MP, Financial Secretary, HM Treasury, 13 February 2013

Thank you for your evidence before the House of Lords European Union Sub-Committee on Economic and Financial Affairs at its meeting on 5 February 2013, on developments in the euro area crisis. You will be aware that the Sub-Committee also heard oral evidence on 15 January from: Roger Bootle, Managing Director, Capital Economics, Martin Wolf, Chief Economics Commentator, Financial Times, Graham Bishop, Independent Consultant on European Affairs; and on 22 January from Professor Charles Goodhart, London School of Economics, Professor Paul de Grauwe, Head of European Institute, London School of Economics, John Peet, Europe Editor at the Economist. In addition, the Committee held a seminar on 31 January which focused on the impacts of austerity in the EU. This involved the following panellists: Stephen Alambritis, Leader of Merton Council, Holger Schmieding, Chief Economist, Berenberg Bank, and Dr Waltraud Shelkle, Senior Lecturer, London School of Economics. There were also contributions from attendees including the Portuguese and Greek Ambassadors to the UK, other EU Member State Embassy representatives, academics, the European Commission, HM Treasury and thinktanks. A note of this seminar is attached for your information.

Introduction

Since we last examined the euro area crisis in July 2012, the landscape has changed considerably. In recent weeks we have seen a number of prominent figures such as the Commission President, José Manuel Barroso, the IMF Managing Director, Christine Lagarde and the ECB President, Mario Draghi, suggest that the euro area is over the worst of the crisis. Professor Goodhart agreed, attributing this to Mario Draghi's pledge on 6 September 2012 to do "whatever it takes" to stop the euro breaking apart. But whilst this commitment to buy short-dated bonds of troubled countries in unlimited amounts (known as Outright Monetary Transactions) has led to relative calm in the financial sector, Professor Goodhart argued that the economic conditions of many of these peripheral countries has continued to worsen. According to Mr Wolf, the crisis had turned from being "critical to chronic". You agreed that it was too early to say if a corner had been turned and pointed out that a contraction in growth was forecast.

Notwithstanding the caution shown by such experts, we fear that a degree of complacency amongst EU policymakers may have set in. This complacency has expressed itself in back-tracking on a number of important agreements designed to tackle the crisis. These include further steps towards a genuine Economic and Monetary Union, as well as plans for the European Stability Mechanism to directly recapitalise banks and thus decisively break the link between sovereigns and their banks. Do you perceive any such complacency amongst European leaders? If so, what can be done to ensure that the commitment remains to taking the urgent steps needed to tackle the crisis?

The ECB and Outright Monetary Transactions

The ECB's commitment in September 2012 to engage in Outright Monetary Transactions in respect of troubled euro area economies was described by Mr Peet as "probably the single most important development last year". You too pointed out that bond spreads had reduced since last summer. However, Dr Schmieding expressed frustration with the delay in providing a backstop for struggling sovereigns, something he had been urging the ECB to do since July 2011. He did acknowledge that this announcement, though delayed, had worked wonders. If, however, the commitment had been made earlier, much of the damage inflicted upon the euro area economy could have been mitigated.

Professor de Grauwe was concerned that the ECB pledge had created a false sense of security since, whilst the financial markets had stabilised following this commitment, the macroeconomic situation had not improved and was actually more fragile than a year ago. We fear that the ECB's commitment may mask the underlying macroeconomic and structural weaknesses endemic in many euro area Member States.

We are also concerned that this initiative could unravel. The ECB was clear that any country benefiting from the bond-buying programme would need to agree to carry out certain reforms and the programme would be suspended if any country failed to stick to these agreed reforms. Professor de Grauwe was critical of this design, stating that "the correct set-up is for the ECB in times of crisis to provide the liquidity and then another mechanism, not ruled by the ECB, to try to contain the moral hazard issues". In his view the ECB should not be acting as "both fireman and policeman" because the fireman role would prevail in the end. In his view, the threat to suspend OMT was therefore not credible. Professor Goodhart agreed that a full suspension of a bond-buying programme was unlikely but felt that it might be possible for the ECB to apply partial pressure if they felt a country was not sticking to its agreed reforms. What are the risks in the ECB taking on this dual role? What is likely to happen if a country engaged in a bond-buying programme resiles on its agreed reforms?

European Stability Mechanism

Developments in relation to the European Stability Mechanism (ESM) have been one of the clearest signals of complacency amongst policymakers in relation to the euro area crisis. Last September the Finance Ministers of Finland, Germany and the Netherlands issued a joint statement indicating that "the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities". To compound this, the *Financial Times* reported on 14 January that the European Commission had discreetly proposed to have Member States make good the losses of private banks before they are recapitalised by the ESM. Professor Goodhart argued that these two developments were a clear move away from breaking the link between sovereign states and their banks. Mr Peet told us that "when market sentiment improves countries like the Netherlands, the Germans and others tend to take back what they have conceded". You agreed about the necessity of breaking the link between sovereigns and their banks. Does this mean you disagree with the statement made by the Finance Ministers of Finland, Germany and the Netherlands as well as the Commission's revised proposal? What steps do you believe now need to be taken if the link between sovereign states and banks is decisively to be broken?

The European Stability Mechanism and European Financial Stability Facility were downgraded by Moody's Investors Services in December, which cited a high correlation in credit risk present among the entities' largest financial supporters. Mr Bootle stated that this was not significant: whilst politicians took rating agencies seriously, markets did not. Professor de Grauwe added that, since rating agencies had made so many mistakes in the past, they had lost credibility. Professor Goodhart pointed out that rating agencies do have an impact on generalised public opinion if not on informed opinion. In your evidence you pointed out that agencies did not have access to any privileged information in making their sovereign credit rating assessment. The Chancellor of the Exchequer has previously placed great store by the UK's AAA rating. Given that the UK has been placed on negative outlook, how important is the UK's AAA rating from the Government's perspective? Is Mr Bootle right to state that they have more political resonance than economic importance? This Committee conducted an inquiry into Credit Rating Agencies in July 2011 and we were told[112] that some large institutional investors like mutual funds, pension funds and insurance companies could have specific investment funds which were restricted to bonds whose rating was no lower than a certain threshold (for example only 'investment grade' bonds). This indicates quite significant impact on the markets of a downgrade. However, has this assertion been borne out by subsequent developments?

Structural Reforms

Encouraging troubled countries to pursue structural reforms has been an important element of the response to the euro area crisis. Mr Peet told us that the logic behind a single currency where you lose monetary and devaluation instruments was that countries needed to work harder in terms of structural reforms in order to retain competitiveness. Yet for many years the incentive to do this has been weak because the markets were rewarding these countries with very low interest rates. Mr Bishop applauded this renewed emphasis on structural reforms, indicating that many of these counties were undergoing a Thatcher-style revolution, which they would not have done unless it were imposed on them. Professor Goodhart agreed that there would likely be long run pay-offs but pointed to the short-term problems, in particular the reduction in incomes and output in the sectors involved. Mr Wolf cited unemployment rates of more than 25% in the case of Greece and Spain, 15% in Ireland and 17% in Portugal. In your evidence you too stressed the importance of structural reforms. Do you accept that they are creating significant short-term pain for the citizens of the Member States involved? What measures do you think Member States should be taking to combat these negative impacts?

Mr Peet was convinced that improvements in competitiveness in some of these countries were beginning to be seen. He highlighted the sharp reduction in unit labour costs, sharp rise in net exports and impressive reductions in current account deficits in many Member States. The Portuguese Ambassador told us that 2012 had brought its first trade surplus since 1943. Professor Goodhart agreed that the relative competitiveness of southern countries was beginning to improve, although he was uncertain how much of this was down to structural reform. Mr Bootle also sounded a note of caution, arguing that measures such as a reduction in unit labour costs could be achieved without real competitiveness gains. He highlighted, for example, that there had been no reduction in export prices in these peripheral countries. He also added that regaining competitiveness through internal deflation

[112] By Dr Marco Annunziata, in his previous capacity as Chief Economist at Unicredit Group

could in fact worsen debt ratios. Do you agree that we are seeing improvements in competitiveness in these economies or, like some of our witnesses, are you sceptical of the accuracy of the measures used?

Professor de Grauwe was particularly critical of the across-the-board deflationary policies being enacted in the euro area. He stressed that the strategy of undertaking structural reforms to improve competitiveness had its maximum impact if just one country was pursuing them. If all euro area countries pursued this approach simultaneously then there was little potential for growth in the system. He suggested that northern European countries needed to stimulate their economies and allow wages and prices to rise, although he thought that this was politically unrealistic. Mr Peet was similarly concerned by the system-wide deflationary approach. He pointed out that Germany had run a current account surplus of 6% of GDP last year, making the adjustment process for other countries much harder. Alan Ahearne, Research Fellow, Bruegel, agreed with this, stating that the only way for the euro area to avoid a decade of high unemployment would be through a German fiscal stimulus. Given the symbiotic relationship between the UK economy and the euro area economy, are you concerned by the across-the-board deflationary policies being pursued in the euro area? Do you think Germany and others should be doing more to counteract this?

Austerity

Along with structural reforms, fiscal consolidation has been a key element of the response to the euro area crisis. The debate over whether this is the right focus has risen in prominence over the last few months as increasingly pessimistic economic data have emerged from the region. For example, Spain's national statistics office recently revealed that, in the fourth quarter of last year, unemployment rose above 26% for the first time in the country's history. This has disproportionately affected young people, with the data indicating that 60% of under-25s were unemployed. In relation to Greece, Mr Alambritis highlighted the troubling fact that 4000 doctors had left the country from 2010–2012. In his view they were faced with two options: unemployment or migration.

In terms of the arguments in favour of financial retrenchment, Mr Bishop pointed out that "somebody has to buy the bonds" and if you allowed a fiscal expansion in some of these heavily indebted countries, that would be put at risk. Mr Schmieding pointed out that the euro area had been forced by the ECB and the bond markets to frontload austerity. In his view, 2012 would mark the peak of austerity and from this point onwards conditions would ease.

Mr Peet did not reject the need for austerity but felt there had been an overemphasis on it. This, he believed, stemmed from the fact that the crisis began in Greece, "creating the impression that this was all about fiscal irresponsibility". Whilst many of the witnesses we spoke to were in agreement that some austerity was necessary, they stressed that this was only part of the solution and did not warrant the disproportionate response shown by policymakers. We are concerned by the overemphasis on fiscal consolidation in response to this crisis. Do you think this emphasis will pay off in the long run? What is the evidence that it is having a beneficial effect? In our view there appears to be a growing body of evidence that suggests there will be years of stagnant growth in the euro area as a result. This could have extremely damaging consequences. What are your views of the prospects for growth for the euro area? What are the long-term prospects for the euro area and the EU as a whole, and for the EU single market, in the global economic context?

Dr Shelkle asserted that the distinguishing feature of this crisis was a significant debt overhang in a number of different sectors. Although deleveraging was necessary, it needed to be properly sequenced, with the private sector deleveraging first, thus justifying a temporarily high government deficit. The private sector's subsequent revival would lead to an increase in tax revenue which would then allow the public sector to deleverage. Yet austerity has meant that the private sector could not offload its debt onto the public sector. Do you accept the arguments behind sequential deleveraging? Do you think this justifies an easing of fiscal consolidation?

Ireland is often cited as a success story in relation to fiscal consolidation. You indeed felt there was a sense of progress in Ireland and that the economy was recovering. Mr Bishop pointed out that Ireland was achieving re-entry into the financial markets ahead of schedule. However, Mr Bootle attributed this to the special characteristics of Ireland, such as its size and openness to external trade, rather than any proof that fiscal consolidation worked. Professor Goodhart agreed that we should be cautious in drawing definitive conclusions regarding fiscal consolidation from Ireland's experience. He pointed out that "the Irish are also perhaps the European world leaders in the flexibility of migration", which Professor de Grauwe saw as an important economic 'safety valve' for the economy. Does the progress shown in Ireland demonstrate that austerity and structural reforms can work, or is it simply a special case?

Political and social pressures

Our witnesses were particularly concerned about the political and social unrest that could result from the programmes of austerity and structural reforms. Mr Bootle's fear was that, whilst citizens might be capable of putting up with adverse circumstances for a few years, "if this goes on and on with no sign of any improvement then in the end something is going to crack". Professor de Grauwe agreed. The Portuguese Ambassador saw no sign of a public backlash against the EU. For the Portuguese people, responsibility lay primarily at the national level. The Greek Ambassador agreed with this, stating that despite the fact that there was 25% unemployment in Greece, more than 60% of Greek citizens wanted to stay in the euro. Professor Goodhart highlighted the risk of political extremism, citing the increase in popularity of the Golden Dawn party in Greece. Do the social and political repercussions of the crisis concern you? How much risk do you perceive of a breakdown in social cohesion and a rise in political extremism?

Country-specific issues

As well as discussing the experience of Ireland, our evidence sessions touched on the experiences of some other key euro area Member States. Greece has for so long been at the eye of the storm, and for a time Greek exit from the euro area seemed likely. Mr Peet believed that a key moment came last year when Germany and others in the euro area reached the conclusion that it would be too dangerous and unpredictable to allow a country to exit the euro area. Despite this positive step forward, Ruth Lea, Economic Adviser, Arbuthnot Banking Group, pointed out that Greek debt levels were still dangerously high with very poor growth prospects, suggesting that Greece has little chance of hitting the target set by the IMF of 124% of GDP in 2020 unless there were further debt write-offs. Mr Bootle and Mr Wolf were also convinced that some sort of restructuring of Greek debt would take place. Mr Wolf argued that, if this coincided with "a situation in which Greece had no hope of growth", an exit from the euro area was still possible.

Professor Goodhart suggested that an exit could be triggered through political miscalculation. He anticipated an "exaggerated game of chicken in which we get a politician elected not with a mandate to leave the euro but with a mandate to change and ease the terms on which they are going to be supported". How do you see events unfolding in Greece over the next few months? Has the threat of Greek exit now passed, or should EU leaders still be wary of the possibility? Is there still a threat of contagion, or could it be argued, given the problems experienced in other Member States such as Italy and Spain, that contagion has already occurred?

Concerns over the state of the French economy were expressed on a number of occasions. Mr Peet feared that France was not carrying out the much-needed structural reforms and was losing competitiveness against other euro area economies. He believed there was a risk of France falling behind countries like Italy and Spain in terms of structural reform. Indeed Mrs Lea pointed out that France's unit labour costs were 15% higher than in 2005, whilst Ireland had managed to bring its unit labour costs back to 2005 levels. Professor Goodhart added that the French economy was beginning to look like a southern EU economy. Dr Shelkle was more positive about the French economy, pointing out that it had a first class civil service as well as a more diverse industrial and export base than the UK. What is your assessment of the outlook for France? What would be the consequences for the EU should France find itself in serious economic and financial difficulties?

Genuine Economic and Monetary Union

Since the June 2012 European Council, the heads of the main European institutions have put forward several proposals for so-called 'Genuine Economic and Monetary Union'. These proposals set out four essential building blocks for the future of EMU: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework, and strengthened democratic legitimacy and accountability. There was resounding agreement amongst our witnesses regarding the importance of such reforms. There were, however, concerns in relation to the interpretation of these reforms in different Member States. Mr Wolf pointed out that there was a fundamental difference in the understanding of the meaning of economic and monetary union amongst Member States. In his view, the Germans and the Dutch interpreted more integration as "a hell of a lot more discipline that stops people misbehaving" whilst the Portuguese and the Greeks were expecting much greater support when things went wrong. For him, it was important not to "underestimate the severe political problems that are involved in actually reaching the deal". Professor Goodhart was similarly concerned about the difficulty in reaching a deal, believing the French would be unwilling to move towards a system where German ideas would dominate. What would you identify as the necessary elements of "Genuine Economic and Monetary Union" if it is to prove effective? How likely do you think it is that these differences in opinions can be overcome and agreement will be reached on greater integration?

Fiscal Union

One of the four building blocks of a Genuine Economic and Monetary Union is greater fiscal integration. This particular element was expanded on in a major document published by the Commission at the end of November last year entitled "A blueprint for a deep and genuine Economic and Monetary Union: Launching a European debate". This set out a timetable for euro area integration, including plans for a separate euro area budget and joint issuance of debt. Few of the more ambitious proposals made it into the December 2012 European Council conclusions. Mrs Lea described the December European Council as a "damp squib" where "complacency and national interests seemed to take precedence over the serious consideration of the Blueprint's recommendations". How would you respond to this? Were you disappointed with the progress made at the December European Council?

Mr Bootle was convinced that fiscal union was a key feature of a fully functioning monetary union. He disagreed with the common perception of fiscal union as a system of temporary assistance for asymmetric shocks. He argued that what was really required was a "continual flow of money from the more prosperous parts to the less prosperous parts". Mr Wolf argued that Germany was only willing to do the absolute minimum necessary in terms of fiscal union, indicating that the type of continuous fiscal transfers envisaged by Mr Bootle were politically unrealistic. Mr Bishop, however, offered a slightly different perspective, arguing that the fact that southern countries were restoring competitiveness through structural reforms would negate the need for fiscal transfers. How would you respond to this? Do you believe it is possible to achieve a viable economic and monetary union without a system of fiscal transfers? What is the likelihood of agreement being reached on a system of political union, necessary to complement a genuine economic and monetary union, given the divergent views of Member States? Can EU solidarity realistically transfer into a system of political union?

Banking Union

As you know, this Committee published its report on *European Banking Union: Key issues and challenges* in December 2012. In that report we expressed regret that the three-pronged approach to banking union originally envisaged, including a Single Supervisory Mechanism, a common resolution mechanism and a common deposit insurance scheme, was undermined so quickly under political pressure, led by Germany. At the time of writing, only the Single Supervisory Mechanism proposals have been brought forward. A number of our witnesses lamented the lack of progress on banking union. Professor Goodhart stated that the banking union was supposed to break the link between sovereign states and banks, but recent developments (or lack thereof) meant this would not be the case. Mr Peet feared that "banks will be European in life but national in death". You stated that it was necessary to sequence the banking union agreements and that proposals for a Single Resolution Mechanism were due to be brought forward this summer. But in your evidence to us on the Banking Union inquiry, you stated that "it is important to be able to have the ability to have a mutualised system of deposit insurance". Is the proposal for a common Deposit Insurance Mechanism now dead? What are the implications of this?

You have told us that, in negotiations over the SSM, the UK Government were successful in securing safeguards, particularly the so-called "non-discrimination clause" and in relation to voting mechanisms in the European Banking Authority (EBA). As such, the principle of double majority voting will apply in relation to key decisions taken by the Board of Supervisors of the EBA. We do, however, note that there will be a review of the voting arrangements if and when there are four or fewer non-participating Member States. You told us that two other Member States had so far publicly committed to not participating in banking union. In his recent speech on the UK's future in the EU, the Prime Minister cited the banking union deal as an example of the sorts of safeguards that the UK was seeking. How confident are you that the deal on banking union will safeguard the position of the UK and its financial sector in the longer term?

Implications for the UK

The implications for the UK of banking union, and the wider steps towards genuine and economic monetary union, are immense. Mr Wolf stated that "we are in a historic moment for the future of our country's relationship to the continent whatever happens". He argued that if the euro area breaks up, this would have terrible consequences. If they succeed in stabilising the euro area, the region will be transformed as a result of greater integration. He felt it difficult to see the UK continuing to get the same sort of special arrangements that were secured as part of the negotiations over the SSM. In the context of the Prime Minister's speech, and with the prospect of an attempted renegotiation and referendum on the UK's future in the EU before 2018, how confident are you that the UK will be able to secure the safeguards it desires as the euro area moves towards closer integration? What would you identify as the Government's priorities in any renegotiation, in particular in relation to the financial sector?

Conclusion

In conclusion, the biggest enemy in the current climate is complacency, whether it be that of European leaders that the euro area has definitively turned a corner, or whether it be that of observers in the UK that the implications of these developments for the UK can be safely ignored. Positive signs of progress there may have been, but there remains a long way to go before the euro area crisis can be judged to have come to an end. The EU is at a crossroads, and with the prospects of significant steps towards fiscal and economic integration ahead, the implications for the UK are immense. Given the potential consequences for the UK, and in light of the Prime Minister's speech, it is more imperative than ever that the Government remain at the centre of vital discussions about the future direction not only of the euro area, but of the EU as a whole.

Letter from Rt Hon Greg Clark MP, Financial Secretary, HM Treasury, to the Chairman, 15 March 2013

Thank you for the opportunity to appear before the House of Lords European Union Committee on 5 February 2013 and discuss developments in the euro area, as well as your follow-up letter of 13 February 2013. I am writing in response to the questions you raised, although almost all of the questions were actually covered when I appeared before your Committee. Where this is the case, I have set out my oral answers below for the benefit of the Committee.

EU policymakers' commitment

You asked whether I perceived a degree of complacency amongst European leaders and policy makers and what needed to be done to ensure that the commitment remains to take the steps needed to tackle the crisis.

As I noted when I appeared before your Committee, a significant amount of progress has been made in a number of policy areas. The institutional framework for monetary union has already been strengthened; more recently, the ECB's announcement of its Outright Monetary Transaction (OMT) mechanism, and its clear commitment to stand behind the euro, made an important contribution to improved market confidence. There has also been some progress on Banking Union though we look forward to more.

I agree that the key issue for euro area leaders and policy makers is to maintain momentum, building on what has been achieved to date, and to stand ready to do more were the situation to deteriorate again.

The ECB and Outright Monetary Transactions (OMT)

You asked about the risks of the ECB's role under its Outright Monetary Transactions (OMTs) programme and what may happen if a country engaged in an OMT bond-buying programme resiles on its agreed reforms.

You will be aware that the EU Treaty provides for the independence of the ECB from EU institutions and national governments, a principle which I will respect by not commenting on the relative merits of different policy options. However, as I said when I appeared before your Committee, I strongly welcome the ECB's commitment to do what they can to ensure the proper functioning of the euro area monetary union, and the reassurance that this appears to have given to markets—though, of course, it has not, to date, been necessary to test the programme's implementation.

I note that the ECB has made clear that its non-standard measures, including OMTs, cannot be considered an alternative to Member States undertaking necessary economic reforms and moving towards greater fiscal sustainability; OMTs themselves will only be considered to the extent they are warranted from a monetary policy perspective. This is one of the reasons why the ECB has decided that a necessary condition for OMTs is strict and effective conditionality attached to an appropriate European Financial Stability Facility (EFSF) or European Stability Mechanism (ESM) programme.

European Stability Mechanism (ESM)/Bank recapitalisation

You asked whether I disagreed with the statement made by Finance Ministers of Finland, Germany and the Netherlands as well as the Commission's revised proposal to have Member States make good the losses of private banks before they are recapitalised by the ESM. You also asked what steps I believed now needed to be taken if the link between sovereign states and banks was decisively to be broken.

As I said when I appeared before your Committee: I think the common ambition here has to be to break the link between banks and sovereigns and that is the purpose of a single supervisory mechanism and the further reforms that are being made. We have embarked on that. We have not completed it but our shared ambition has to be to make sure that you can have confidence that there will not be contagion between the two.

UK credit ratings and wider implications

You asked how important the UK's AAA rating was from the Government's perspective. The credit rating is one important benchmark for any country, but the credibility of a government's economic strategy is tested continuously by financial markets. On 22 February 2013 Moody's downgraded the UK rating one notch to Aa1 with a stable outlook. The market reaction to the downgrade was measured. UK gilt yields fell the first day of market trading after Moody's announcement. These near-historic low government bond yields continue to reflect the credibility earned by the Government's credible economy strategy.

Structural Reforms

You asked whether I accepted that structural reforms undertaken in Greece, Spain, Portugal and Ireland are creating significant short-term pain for their citizens and what measures I thought Member States should take to combat these impacts.

As I said when I appeared before the Committee: I do not think it is right for a Minister of the Crown in this country to make an assessment of the domestic policies of another.

Competitiveness

You asked whether I agreed that we are seeing improvements in competitiveness in those euro area countries most affected by the crisis or whether I was sceptical of the accuracy of the measures used.

As I said when I appeared before the Committee: There is a challenge for the European Union to be competitive internationally and that involves looking at the components of competitiveness, of which labour markets are an important one. (…) One of the other things that we know is absolutely important to Europe's competitive position is the value added that individual workers can have. That takes you into training and skills—as to whether, in any particular country and across Europe, we are investing in particular in training, but also in research and development so that the value that we add to our activities competes with the rest of the world.

One of the most important aspects of policy in this country, and I am speaking in my capacity as Minister for Cities—that is to say the principal cities outside London—is that we know that the connectivity, the infrastructure that connects important conurbations in this country and on the Continent is a very important contributor to their success in terms of attracting investment, in terms of keeping costs down, in terms of making it an efficient place for labour to be located. So infrastructure is an important aspect of it.

High deficit, low competitiveness countries in the periphery must continue to tackle their problems. The European Commission's latest Alert Mechanism Report of 28 November 2012, part of the EU-level Macro Imbalances Procedure which assess competitiveness imbalances across the EU, points to the challenges in correcting external and internal imbalances that will need to be addressed over a number of years but also notes that progress has been made in reducing current account deficits in recent years.

Deflationary policies in the euro area

You asked whether I was concerned by the deflationary policies being pursued across the euro area and if I thought Germany and others should be doing more to counteract this.

As I said when I appeared before the Committee: I do not think it is right for a Minister of the Crown in this country to make an assessment of the domestic policies of another.

Fiscal consolidation

You are concerned about the emphasis on fiscal consolidation in the crisis and asked if I thought this will pay off in the long run. You also asked for the evidence that fiscal consolidation was having a beneficial effect, my views on the arguments behind sequential deleveraging and whether I thought they justify an easing of fiscal consolidation.

As I said when I appeared before the Committee: Our view is exemplified in the policy that the Government is pursuing. I think it is a necessary position, in terms of conditions of stability and conflicts of business investment, that underlying problems are resolved in this country and in some other countries. It is evident in terms of the excessive deficit reduction procedures that have been introduced in other countries that bringing down what were unsustainably high levels of public sector deficits was something that needed to be done.

I think there is a general recognition that these things went out of control. There were contributory factors from the financial crisis but that was not, by any means, the sole cause of them and it is necessary to restore that degree of confidence. Most countries in the EU are embarked on journeys to do that but there are other things that need to be done as well, just as in this country we are trying to prioritise infrastructure investment within the envelope of the spending cuts that we have.

Periphery Member States have undertaken a significant fiscal consolidation and are starting to improve their current account balances as noted by the European Commission's latest Alert Mechanism Report of 28 November 2012, part of the EU-level Macro Imbalances Procedure, which assess competitiveness imbalances across the EU.

Growth prospects

You asked for my views on the prospects for growth for the euro area and the long-term prospects for the euro area, the EU and the single market in the global economic context.

As I said when I appeared before the Committee: I think it is too soon to make a definitive assessment of whether the worst is over in terms of the eurozone economy. What I do think there is a recognition of (…) is that as well as the fiscal consolidation that most Member States have been engaging in, there are supply side reforms and there are questions of investment in infrastructure: for example, questions of completing the single market. Moving beyond that, the Prime Minister has talked about a free trade agreement with the United States of America. There are other reforms that at EU level, as well as in Member States, should be contemplated, which whatever the overall economic situation can only be good in terms of laying the foundations for future growth and prosperity.

Ireland

You asked whether the progress shown in Ireland demonstrates that austerity and structural reforms can work, or if Ireland is a special case.

As I said when I appeared before the Committee: The Troika, the IMF, the Commission and the ECB have made an assessment and it continues to be that the programmes are on track and that the Irish economy is beginning to recover.

Political and social pressures

You asked about my concerns regarding the social and political repercussions of the crisis.

European prosperity at the levels many Europeans have come to expect, faces challenges. There are no easy solutions or shortcuts; an argument the Prime

Minister and Chancellor have consistently made to European leaders. Sustainable European growth and recovery can only come from Member States reforming and boosting their productivity and competitiveness. For national governments this will require vision, leadership, resilience and a prolonged commitment to reform.

Greece

You asked for my views on the events unfolding in Greece over the next few months and whether the threat of a Greek exit has now passed or if EU leaders should still be wary of the possibility.

As I said when I appeared before the Committee: it is too early to comment on whether the crises that have been faced in different countries have been resolved permanently. There is always the possibility of new exogenous shocks to the system that need to be absorbed. But what one does see in Greece is that it has been possible to make the next stage of disbursements, that Parliament has continued to endorse the reforms that have been introduced there, and it is widely accepted and understood that the period of transition has been very exacting.

Threat of contagion

You also inquired about the threat of contagion and if this is already occurring given the developments in Member States such as Italy and Spain.

Throughout the crisis, we have been clear that the euro area partners needed to develop a credible ring-fence to protect other vulnerable euro area Member States from contagion, and, properly recapitalise Europe's banks. As outlined above, some important steps forward have been made to reduce the risk of contagion, but a number of additional steps around banking union are also necessary.

France

You asked about my assessment of the outlook for France and what the consequences for the EU would be should France find itself in serious economic and financial difficulties.

As I said when I appeared before the Committee: I do not think it is right for a Minister of the Crown in this country to make an assessment of the domestic policies of another.

Genuine Economic and Monetary Union

You asked what I would identify as the necessary elements of 'Genuine Economic and Monetary Union' if it is to prove effective and how likely it was that the differences in opinions on EMU can be overcome to reach an agreement on greater integration. You also asked what the likelihood of an agreement on a system of political union being reached was and whether I thought EU solidarity can realistically transfer into a system of political union. You also asked whether I believed it is possible to achieve a viable economic and monetary union without a system of fiscal transfers.

As I said when I appeared before the Committee: The questions are clearly related and it is hard to say. In this country, one of the reasons why we declined to join the euro was that there was a worry that it might lead to fiscal consequences, but there is a view that it need not necessarily lead to that, nor to a permanent need for transfer payments. The doctrine of convergence was the driving reason—perhaps article of faith—that underpinned the idea that the eurozone could, in the long term, find its place and be a place of stability. (…) We are not going to be part of the eurozone, but members of the eurozone take the view that this does not require full fiscal union. That is for them to work out during the years ahead.

December European Council

You asked if I was disappointed with the progress made at the December European Council.

The Council marked significant progress in protecting the UK's interests as the euro area moves towards closer integration. As I discussed in my letter of 26 January 2013, the Prime Minister secured in the Council Conclusions, robust language on protecting the single market in its entirety but also more significantly, language agreeing specific safeguards to protect the single market in financial services and protect the interests of the UK's financial sector. I discussed these in detail in my letter of 12 January 2013.

Banking Union

You asked whether proposals for a common deposit mechanism were no longer part of the Banking Union negotiations and what the implications of this would be.

The agreed Council proposal for the Single Supervisory Mechanism does not include any reference to the common deposit insurance mechanism. I understand that the Commission intends to publish proposals on the Single Resolution Mechanism in 2013. Until they do that we do not know what form of funding or mutualisation arrangements are envisaged, or whether the proposals will include a common deposit insurance mechanism.

Separately, the proposal to update the Deposit Guarantee Schemes Directive (DGSD) remains on the legislative agenda. However, moving this forward will depend on the Presidency's capacity to resolve the deep differences between the European Parliament and the Council on this dossier. The current Presidency (Ireland) has a full agenda, including CRD IV, Banking Union and Recovery and Resolution Directive. It is not clear that they will prioritise the DGSD.

You also asked how confident I was that a deal on banking union will safeguard the UK's position and its financial sector in the longer term.

As I said when I appeared before the Committee: discussions that took place before Christmas on banking union illustrated that it is possible, without rancour and without any flight to the lowest common denominator, to identify and agree a settlement that allows those countries that want to join together, at least their banking system into the initial places of banking union, while having very clear and, I would say, unambiguous protections for the single market and Britain's place in that. In particular, the text in Article 1 of the ECB Regulations making it absolutely clear that discrimination on grounds of currency cannot take place was agreed unanimously, as I say, without any great deal of trauma. I think it shows that where there are different conceptions of how countries want to engage in the future, this is not an inevitable recipe for deep contention and division. It is possible through good relations and a rigorous approach to policy to find outcomes that are mutually satisfactory.

Implications for the UK

You asked how confident I was that the UK will be able to secure the safeguards it desires as the euro area moves towards closer integration.

As I stated in my letter of 26 January 2013, the agreement at the December European Council of the Regulations on the Single Supervisory Mechanism and changes to the European Banking Authority provides a good example of how the Government can secure important changes to safeguard its interests.

As the Prime Minister made clear in his December Post-Council Statement:

> "A single currency needs a single system for supervising banks, so Britain supported the first steps agreed towards a banking union, but in return we and others demanded proper safeguards for countries that stay outside the new arrangements. The European Council therefore agreed a new voting system that means that the euro area cannot impose rules on the countries outside the euro area, such as Britain, without our agreement. There is also an explicit clause that says that no action by the European Central Bank should directly or indirectly discriminate against those countries outside a banking union. That is vital for our financial services industry, which must continue to be able to provide financial products in any currency".

This agreement proved it is possible to find solutions that safeguard the interests of all as the euro area moves towards closer integration.

You also asked about the Government's priorities in any renegotiations, in particular relation to the financial sector.

The Government does not have assigned priorities for any renegotiation. The next Conservative Manifesto in 2015 will ask for a mandate from the British people for a Conservative Government to negotiate a new settlement with our European partners in the next Parliament.

Finally, I would also like to take this opportunity to update you briefly on the Proposal for new regulation governing financial assistance for Member States whose currency is not the euro. The timetable for discussing the Proposal has still not been agreed and there is no indication that the dossier is to be taken forward in the near future; it is not currently on the Irish Presidency's Council work programme. I will of course write with an assessment of the Proposal and the Government's position as and when the issue is to be taken forward; in the meantime, I would note that there is, as yet, no further clarity on the read across to the Banking Union Proposals that would influence the Proposal, about which I have written previously.

July–August 2013

Letter from the Chairman to Rt Hon Greg Clark MP, Financial Secretary, HM Treasury, 1 August 2013

Thank you for your evidence before the House of Lords European Union Sub-Committee on Economic and Financial Affairs at its meeting on 23 July 2013, on developments in the euro area crisis. This letter forms the latest of our regular six-monthly updates in relation to the euro area crisis. You will be aware that the Sub-Committee also heard oral evidence on 2 July from: Ruth Lea, Economic Adviser, Arbuthnot Banking Group, Professor Stephen Haseler, Director, Global Policy Institute, and Vicky Pryce, former Joint Head of the Government Economic Service. In addition, the Sub-Committee held a private briefing with Reza Moghadam, Head of European Department, International Monetary Fund.

Introduction

A great deal has happened since we last explored the euro area crisis in February 2013. There was the poorly handled bailout of the Cypriot banking sector in March, a flare-up of the crisis in Portugal and Greece and more back-tracking by EU leaders from the important reforms necessary to mend the flaws in the euro area. In our previous letter to you on this subject we wrote that relative calm had been restored following ECB President, Mario Draghi's commitment to do "whatever it takes" to stop the euro breaking apart. However we also warned against any false assumptions that the worst of the crisis was over. **As we set out below, we are pleased to note indications of incipient improvements: though debt levels have increased, so has consumer confidence, and the squeeze on real incomes appears to be easing. But it is still far too soon to be complacent.**

The key theme that emerged from our most recent discussions was the concept of "muddling through": in other words, EU leaders were only motivated to act when a flare-up of the crisis occurred, and even then, they were only willing to do the bare minimum to tackle the most immediate problem. **We are concerned that sufficient progress has yet to be made in truly reforming the euro area to ensure that crises do not continue to plague the EU.**

You felt it unfair to accuse EU leaders of just muddling through, since the difficulty in reaching agreement was simply a reflection of the complexity of the negotiations. You pointed out in your evidence to us that progress had been made, with agreement on the Single Supervisory Mechanism (SSM) and the Bank Recovery and Resolution Directive (BRRD), as well as the recently published proposal for a Single Resolution Mechanism. Whilst some progress has been made, implementation of these agreements will take much longer. The SSM will not be operational until mid-2014 at the earliest and the BRRD will not come into effect until 2018. Given the significant disagreement already evident on the SRM, progress on this dossier seems unlikely any time soon.

Ms Pryce pointed out the irony that we need "another good crisis" for any progress to be made. It should not have to come to this. Whilst we accept the difficulty of a group of sovereign states reaching agreement on such complex issues, it is imperative that the euro area moves towards a position of stability (let alone growth) as soon as possible.

Austerity and structural reforms

An issue that our previous update focused on was the poor performance of the euro area economies. Whilst there had been proclamations that the crisis was over, we argued that in some respects it was only just beginning. Austerity as a response to the crisis had been overemphasised and we highlighted the short term pain that structural reforms were inflicting on these economies. The real challenge now, we stressed, was how to restore much-needed growth and competitiveness to the euro area, and by extension, the EU as a whole.

The Commission has since eased its stance on austerity. In May 2013, the Commission announced that France, Spain, Poland, Portugal, the Netherlands and Slovenia would all have more time to complete their austerity plans. The June European Council conclusions confirmed this change of emphasis by stating that "for some Member States, the pace of fiscal consolidation has been adjusted to respond to economic conditions". **We welcome this shift.** On 22 July 2013, Eurostat reported that euro area government debt had increased from 90.6% of GDP in the fourth quarter of 2012 to 92.2% of GDP in the first quarter of 2013[113], demonstrating that the emphasis on austerity had been self-defeating.

This flexibility was welcome but Ms Lea felt that it was merely a "prolongation of austerity rather than an abandonment of it". There was a unanimous view in the evidence we heard that a short term stimulus was required. You highlighted the Commission's work with the European Investment Bank (EIB) to increase support for small businesses as an example of where growth enhancing measures were being undertaken. Ms Lea was unimpressed with the Commission's "feeble" effort to restore growth. She described the Commission-EIB initiative as a "very good idea" but it had come "pretty late in the day". In her view "there is a terrible reluctance to grab hold of this thing and really make some serious difference to it".

We have however seen some brighter economic data emerge from the region recently. On 25 July we learnt that euro area PMI data[114] was at its highest levels in 18 months. Many have taken this as an indication that the euro area may return to growth this year. In addition, the reduction of the pressure on bond yields since the ECB's commitment to "do whatever it takes" last year should not be underestimated. This may in turn enhance the economic performance of the countries in question. **What further measures would you suggest the EU could take in order to promote growth?**

In exchange for easing the terms of fiscal consolidation, there was a renewed drive for these economies to undertake structural reforms. In our previous correspondence we indicated that, whilst structural reforms would likely benefit these economies in the long run, they would create significant short term pain. **We have seen progress in terms of structural reforms: there is a clear indication, for example, that real wages have fallen to more sustainable levels and competitiveness has improved in many of these countries. However, we remain concerned about the impact of structural reforms, not only on short-term economic growth, but also on the political stability of the Member States affected. In countries like Cyprus, Greece and Portugal there are warning signs still that citizens' tolerance of austerity is being sorely tested. The political ramifications of this are as alarming as they are uncertain.**

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113 Eurostat, *Euro area government debt up to 92.2% of GDP*, news release 114/2013.

114 Markit's composite Purchasing Managers Index (PMI) is a key benchmark indicator for measuring business and economic conditions and is based on data from thousands of companies across the region.

Direct bank recapitalisation

The meeting of the Eurogroup on 20–21 June reached agreement on the main elements of direct bank recapitalisation. At this meeting, the strict terms under which the European Stability Mechanism (ESM) could provide funds directly to euro area banks were agreed. Banks must have "an appropriate level" of bail-in applied, the country requesting assistance must not be able to perform the recapitalisation itself without "very adverse effects" on its fiscal sustainability, and the institution being bailed out must be systemically important. Furthermore, the bail-out must be viewed as indispensable to the stability of the euro area as a whole. If these criteria are met, a maximum of €60 billion can be used for direct recapitalisation.

Despite this agreement, there are still a number of hurdles to overcome before direct recapitalisation can be used. The instrument will not be finalised until national parliamentary scrutiny procedures have been finalised and the Single Supervisory Mechanism (SSM) is in force. Securing national approval could be a major stumbling block since, for example, Article 2 of the German implementation law of the ESM treaty explicitly excludes direct bank recapitalisation. In addition, the SSM was seen as a prerequisite to direct recapitalisation, but it is not anticipated to come into force until mid-2014 at the earliest.

The figure of €60 billion was described as a "drop in the ocean" by Ms Lea. In her view it was "a pretty small number considering the size of the European banking system". Ms Pryce indicated that the delay in reaching agreement on this had already been extremely costly. If Spanish banks, for instance, had been directly recapitalised much earlier, it would have eased the situation and prevented a great deal of pain. **What is your view of the delay? Given the delay, and given the small amounts involved, how meaningful is this agreement in practice?**

In your evidence to us you emphasised that the €60 billion should not be viewed in isolation, since the resources available to a country during a crisis would be much greater than this figure implied. For instance, an appropriate level of bail-in has to be arranged before direct recapitalisation can take place and sovereign states can also borrow directly from the ESM. **We accept this but worry that relying on sovereign states to borrow from the ESM would increase their debt burden (i.e. the exact problem that direct bank recapitalisation was trying to avoid). Does this concern you? Can you provide further clarity on your view that the Eurogroup, if needed, can bring substantially greater resources to bear than just the □60 billion available from the ESM itself?**

Greece

The crisis in Greece has recently reignited. In June 2013, the Democratic Left party pulled out of the coalition government forcing the Greek Prime Minister, Antonis Samaras, to reshuffle his cabinet in order to avoid a snap election. At the same time, there was concern that the IMF might have to suspend its disbursements to Athens after a shortfall of €3–4 billion opened up in Greece's bailout programme. This shortfall was eventually met but only after last-minute negotiations with the troika.

Meanwhile, the Greek economy remains in a dire condition. The economy is in its sixth year of recession, unemployment is near 27% and nearly two out of three under-25s are out of work. According to economists, current forecasts of GDP growth of 0.6% in 2014 are realistic, but this is far from the 3% annual growth rate the country needs to achieve from 2015 to 2021 to makes its debt affordable.

Ms Pryce highlighted the problem of unemployment and the "continued disquiet of the population about things being imposed on them undemocratically by the Germans and others". She stated that there was an impasse: "There is no way that Greece can actually get itself out of the problems it is finding itself in now". She indicated that "the pressures that are coming from an economy that is really collapsing are too great for any politician to deal with, and with such a wafer-thin majority, we are going to get into trouble". Ms Pryce called for a high degree of infrastructure spending by the EU. She accepted that structural reforms, in terms of reform of the public sector and pensions, were necessary but a proper industrial strategy was also key. Ms Lea was sceptical about the possibility of an industrial strategy being enacted. She instead foresaw major defaults, a third bailout and prolonged social pain.

The situation in Greece is arguably unsustainable and a change in approach is necessary. Further significant debt restructuring now seems inevitable. Do you have a view on what could be done to restore sustainable debt levels as well as decent growth and employment levels to this economy? We have noted your reticence in commenting on the domestic policies of other Member States, most recently in the context of Latvia's accession to the euro. Yet as Greece's own accession to the euro demonstrated, the consequences of such "domestic policies" can be dramatic indeed for all Member States. Given that a number of these policies are essentially imposed by the troika, and the fact that what happens to the Greek economy has systemic implications for the rest of the EU and the UK, we hope that you will be willing to engage in this discussion.

Cypriot bailout

One of the most alarming events since we last explored this issue was the inept handling of the Cypriot bailout. In March 2013, the troika agreed a €10 billion bailout with Cyprus. As part of the deal, a one-off bank deposit levy of 6.7% for deposits up to €100,000 and 9.9% for higher deposits was announced on all domestic bank accounts. This deal was subsequently rejected by the Cypriot parliament. The final agreement involved protection of deposits below €100,000 but forced losses on deposits over €100,000 in Bank of Cyprus and Laiki Bank. The deal also demanded the closing of Laiki Bank and a fundamental restructuring of Bank of Cyprus.

The negative reaction to the original deal and the ensuing uncertainty that it has created has been worrying. Capital restrictions imposed to prevent a run on Cypriot banks have been eased, but remain in place. Ms Pryce described this incident as the "worst bit of muddling through", and said that the idea that insured deposits should foot the bill was "crazy". You told us that everyone had learnt their lessons from this incident and the deal on the Bank Recovery and Resolution Directive would reflect the fact that deposits below €100,000 should be protected. Ms Pryce argued that, despite the protection now afforded to deposits below this threshold, there remained a problem of confidence in the Cypriot banking sector. A number of businesses, for example, have deposits above this threshold and so any kind of depositor bail-in has a huge impact on confidence. How would you respond to these concerns? How can the confidence that was shaken by these initial serious errors be restored?

Role of the ECB

The role of the ECB during the euro area crisis has been crucial, both as part of the troika and in terms of its commitment to buy unlimited amounts of bonds in the secondary market of a troubled country (known as Outright Monetary Transactions (OMT)). There was unanimous agreement that the ECB's announcement last year had been instrumental in taking the heat out of the existential crisis that had engulfed the euro area. A recent *Financial Times* article[115] highlighted the success of OMT in keeping a lid on markets in the context of the recent political and economic problems in Portugal. Unlike in the past, the issues in Portugal did not translate into increased borrowing costs elsewhere in the euro area.

Ms Pryce was complimentary about Mario Draghi's role at the helm of the ECB in comparison with his predecessor, Jean-Claude Trichet, "in the sense that he lowered interest rates at a time when there was a recession … whereas Trichet raised them at the time of a recession". Though everyone celebrated the ECB commitment to OMT, Ms Pryce pointed out that "there has not been any serious purchase of bonds" implying that this relative calm may not last if no action is taken. The same *FT* article highlighted this and indicated that OMT may have to be tested soon. It also pointed out that few details had emerged on how the mechanism would operate; Mario Draghi shifted his stance from saying the ECB would publish OMT's legal documentation "soon", to saying it would only publish it once a country had applied. Going beyond OMT, Professor Haseler put forward the interesting suggestion that there might be a role for the ECB to undertake some form of quantitative easing as other central banks, such as the Federal Reserve, were considering tapering off this type of support. **Does it concern you that the ECB has not been clear exactly how OMT would operate if it were to be used? Do you believe there could be scope for the ECB to undertake Quantitative Easing? Would you advise this in the right circumstances?**

Role of the IMF

The IMF recently published a report evaluating the success of the first bailout programme for Greece, where it admitted that mistakes were made. In this it said it had been too optimistic in its growth assumptions and that a debt restructuring should have been considered earlier. This report was particularly critical of the European Commission, claiming it lacked experience of managing financial crises and fiscal adjustment programmes.

Ms Pryce was clear that the IMF "did not distinguish themselves in the way they handled the Greeks". She did, however, highlight the inexperience the IMF had with dealing with developed economies, and the scale of the bailouts that such countries required. Whilst the IMF made a lot of mistakes, Ms Pryce applauded them for coming out and saying "perhaps we did not get it quite right".

On a more general point, Ms Lea was unclear "why the IMF got involved in the first place", since the euro area was a rich part of the world and not the usual target for IMF programmes. Professor Haseler agreed but added that it gave the European institutions some political cover. **How would you assess the IMF's performance during the euro area crisis? Is it both necessary and desirable for the IMF to continue in its role as part of the troika? If so, how can its interaction with the other troika members be enhanced?**

[115] Steen, M. and Atkins R. (2013), 'Draghi's 'Dirty Harry' act keeps euro crisis at bay', *Financial Times*, 22 July.

The implications for the UK

It is clearly important for the UK that the problems of the euro area are resolved. Reports that the existential crisis has receded along with the risk of euro area break-up are therefore welcome. The euro area is pursuing deeper integration in order to resolve its flaws and prevent another crisis, an issue that we are spending considerable time exploring as part of our current inquiry into *Genuine Economic and Monetary Union*. Given the vital importance of the German position, we will be visiting Berlin and Frankfurt, as well as Brussels, in the autumn to explore these issues. **Leaving aside the question of how necessary and realistic these proposals are, they pose considerable implications for the UK.**

Professor Haseler suggested that the UK should participate in this integration process. He highlighted that, whilst the euro area countries are talking about greater integration in the euro area, the UK is talking "the exact opposite language". In his view, the UK's participation in the single market but not the single currency was "ultimately unsustainable". Ms Pryce disagreed with this. She argued that the UK was more integrationist than many realised. Indeed, the UK was often more open to integration in a number of areas than those in the euro area. For example, it was partly through the UK's encouragement that integration in the retail banking, energy and services sectors had taken place. It was her view that the UK could continue to be part of the single market without being a member of the euro.

The UK has managed to maintain its position within the single market but outside the single currency for many years. Part of the reason for this co-existence has been the fact that, as many people often claim, the single currency has not been a 'genuine' one. As the single currency area becomes more integrated, it will be a huge challenge for the UK. Key euro area institutions, such as the Eurogroup, are becoming increasingly influential. There is a desire to build on this and create similar separate institutions elsewhere. **In your evidence to us you touched on your relationship with the Eurogroup. Can you expand on how you interact with this group? To what extent are you able to influence its discussions? How will you ensure your voice continues to be heard as the euro area Member States contemplate deeper integration? How would you respond to suggestions that other non-members of the euro area seem to manage a more effective and constructive relationship with the euro area?**

You emphasised the safeguards the UK Government secured in recent negotiations as evidence that it was possible for the single market to be preserved as deeper integration in the euro area progressed. **How long can the protections for the single market and for non-participating Member States, secured for instance in the context of the Single Supervisory Mechanism, persist? Can you provide details of the types of safeguards you will be seeking during the negotiations on the Single Resolution Mechanism? Has thought gone in to developing a 'blueprint' for such agreements? If so, could you provide details of this?**

It is important that the UK Government seriously consider how this country can continue to work effectively within an evolving European Union. The UK's unusual position as a member of the single market but not of the single currency is coming under strain. It remains to be seen whether it can be maintained.

Letter from Rt Hon Greg Clark MP, Financial Secretary, HM Treasury, to the Chairman, 29 August 2013

Thank you for your letter of 1 August 2013 on recent developments in the euro area. I was honoured as ever to have been asked to give evidence before the Sub-Committee on Economic and Financial Affairs.

I was however surprised to receive soon afterwards a lengthy letter, extensively trailed in the press, going over much of the same ground. In particular, I disagree strongly with the comments made by Lord Harrison to the press, the UK risks becoming marginalised while we remain outside the single currency and distant from any EU banking union, as well as the suggestion in your letter that the UK's position as a member of the single market but not the single currency is under strain. There is no evidence for that. This Government has no intention of joining the euro, nor of joining the banking union. We will retain responsibility for our own currency and monetary policy and will ensure that the Bank of England and not the European Central Bank retains responsibility for the supervision of UK banks. It is entirely feasible to do that while remaining an integral part of the single market.

Your letter asked a number of further questions.

First, you ask what further measures the EU could take in order to promote growth. In his Bloomberg speech, the PM stated that "there is a crisis of European competitiveness, as the rest of the world soars ahead". All EU Member States need to tackle unsustainable levels of debt, reform labour markets, and support business creation and innovation. At the EU level, the priorities are to complete implementation of the Single Market, push forward with new free trade agreements, and avoid new burdensome regulation.

Second, you ask about ESM direct recapitalisation. As I made clear in the evidence to the Sub-Committee on 22 July, the resources available through the ESM have to be seen in the context of the wider framework now agreed for bank resolution.

Third, you ask about Greece. The Government remains very closely involved in the discussions on how Greece can restore sustainable debt levels.

Fourth, you asked about the impact of depositor bail-in in Cyprus. As I set out in my evidence to the Sub-Committee, the Government made clear in all discussions the importance of protecting insured depositors.

Fifth, you asked about the ECB. The Government welcomes the ECB's commitment to ensuring the proper functioning of the euro area monetary union, including the Outright Monetary Transactions mechanism, and are confident the ECB has the necessary capabilities. Specific monetary policy decisions are a matter for the ECB.

Sixth, you ask about the role of the IMF in the Troika. The Government supports the continuing involvement of the IMF, both directly supporting countries in economic distress, and in providing credibility, technical expertise and rigorous scrutiny to programmes.

Seventh, you ask about the UK's relationship with the Eurogroup. As set out in my letter of 5 August to Lord Harrison, the UK works closely with all Member States. There is no basis for the suggestion that other non-members of the euro area are more effective in their interactions.

Eighth, you asked about the Single Supervisory Mechanism and Single Resolution Mechanism (SRM). The Government is currently considering the Commission proposal that has recently been published, on which we have already provided you an EM. In the negotiation we will seek to support the establishment of a practical and functional SRM whilst ensuring that appropriate safeguards for the Single Market are maintained.