HM Treasury

Review of the
Balance of Competences

Economic and Monetary Policy

call for evidence

March 2014

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You can download this publication from www.gov.uk

ISBN 978-1-909790-75-9
PU1634

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Executive summary

Subject	This is a call for evidence regarding the EU's competences in the field of the economic and monetary policy. This paper provides background information on the EU's competences in this area, covering the legal basis and development of these competences over recent decades.
Scope of this paper	The focus of this call for evidence is on economic, fiscal and monetary policy as laid out in primary legislation in Part Three, Title VIII, Articles 120-144 of the TFEU. Protocols 4, 12, 13, 14 and 15 of the TFEU and various regulations and directives relating to the Stability and Growth Pact and other relevant policies will also be addressed. Given the UK's opt-out from the euro, this review will not look in detail at the EU's monetary policy provisions.
Who should read this	Anyone with knowledge of or views on the EU's competences in this area. We are keen to get evidence from a wide range of stakeholders. These stakeholders include – but are not limited to – think tanks, academia, representative bodies, Parliament, other governments, and the EU and other international institutions.
Duration	The call for evidence will run from 27 March 2014 to 4 July 2014.
How to respond	If you have knowledge or experience of the application of EU competences in the field of economic and monetary policy, please respond by emailing balanceofcompetences@hmtreasury.gsi.gov.uk by 4 July 2014. Your evidence should be objective, factual information about the impact or effect of the competence in your area of expertise. We will expect to publish your response and the name of your organisation (unless you ask us not to) but not your individual name (unless you wish it included), in line with standard procedures. (Please note that even if you ask us to keep your contribution confidential we might have to release it in response to a request under the Freedom of Information Act.) Please base your response on answers to the questions on page 33.
Enquiries	By email: balanceofcompetences@hmtreasury.gsi.gov.uk By post: Balance of Competences Review – EUIP, HM Treasury, 1 Horse Guards Road Westminster London SW1A 2HQ. Please also direct related enquiries to this address, clearly marking that your question relates to the report on economic and monetary policy.
Next steps	We invite submitted evidence and expressions of interest from stakeholders, including for more information on events that we will be organising where stakeholders will be able to give their views. An FCO launch event will be held on 3 April 2014, and further events will be held during the call for evidence period. Please send expressions of interest via email to: balanceofcompetences@hmtreasury.gsi.gov.uk.

1 Introduction

The Balance of Competences Review

1.1 The Foreign Secretary launched the Balance of Competences Review in Parliament on 12 July 2012, taking forward the Coalition commitment to examine the balance of competences between the UK and the European Union. The review will provide an analysis of what the UK's membership of the EU means for the UK national interest. It aims to deepen public and Parliamentary understanding of the nature of our EU membership and provide a constructive and serious contribution to the national and wider European debate about modernising, reforming and improving the EU in the face of collective challenges. It will not be tasked with producing specific recommendations or looking at alternative models for Britain's overall relationship with the EU.

1.2 The review is broken down into a series of reports on specific areas of EU competence, spread over four semesters between autumn 2012 and autumn 2014. The review is led by Government but will also involve non-governmental experts, organisations and other individuals who wish to feed in their views. Foreign governments, including our EU partners and the EU institutions, are also being invited to contribute. The process will be comprehensive, evidence-based and analytical. The progress of the review will be transparent, including in respect of the contributions submitted to it.

1.3 HM Treasury is leading the part of the Balance of Competences review covering economic and monetary policy. This will assess and explain the impact on the UK of the economic and monetary policy provisions of the EU, exploring how these have evolved and developed over time, and how the EU exercises its competences in this area. The report will not look at the detailed operation of the EU's competences regarding monetary policy as the UK is not a member of the euro and has a permanent opt-out from joining.

The call for evidence

1.4 This call for evidence document sets out the background to the review on economic and monetary policy and provides a useful context for those giving evidence. It sets out the historical development of economic and monetary policy, and the systems, processes and obligations on Member States, as laid out in the relevant Treaty legal bases and regulations that underpin it.

1.5 This document asks for your input, with a series of questions to encourage evidence from you that will be used to produce a final report. This is your opportunity to express your views. We request input from anyone with relevant knowledge, expertise or experience; and we welcome contributions from individuals, companies and civil society organisations from within the UK and outside of it. In responding, it would be helpful if you could indicate whether you are responding as, for example, an individual, a business, a civil society organisation or a research institution.

1.6 Please base your response on answers to the questions set out on page 33. You do not have to answer all of the questions – please feel free to answer as many or as few as you like. Your evidence should consist of objective, factual information about the impact or effect of the EU's approach to economic and monetary policy on the UK national interest. Where possible, please give specific examples. The call for evidence will run from 27 March 2014 to 4 July 2014. Please send your evidence and related enquiries to balanceofcompetences@hmtreasury.gsi.gov.uk.

Box 1.A: What is a competence?

For the purposes of this review, we are using a broad definition of competence. Put simply, competence in this context is about everything deriving from EU law that affects what happens in the UK. That means examining all the areas where the Treaties give the EU competence to act, including the provisions in the Treaties giving the EU institutions the power to legislate, to adopt non-legislative acts, or to take any other sort of action. But it also means examining areas where the Treaties apply directly to the Member States without needing any further action by the EU institutions.

The EU's competences are set out in the EU Treaties, which provide the basis for any actions the EU institutions take. The EU can only act within the limits of the competences conferred on it by the Treaties, and where the Treaties do not confer competences on the EU they remain with the Member States.

There are different types of competence: exclusive, shared and supporting. Only the EU can act in areas where it has exclusive competence, such as the customs union and common commercial policy. In areas of shared competence, such as the single market, environment and transport, either the EU or the Member States may act, but the Member States may be prevented from acting once the EU has done so. In areas of supporting competence, such as culture, tourism and education, both the EU and the Member States may act, but action by the EU does not prevent the Member States from taking action of their own.

The EU must act in accordance with fundamental rights as set out in the Charter of Fundamental Rights (such as freedom of expression and non-discrimination) and with the principles of subsidiarity and proportionality. Under the principle of subsidiarity, where the EU does not have exclusive competence, it can only act if it is better placed than the Member States to do so because of the scale or effects of the proposed action. Under the principle of proportionality, the content and form of EU action must not exceed what is necessary to achieve the objectives of the EU Treaties.

Scope of this report

1.7 The areas of EU policy that will be considered as part of this report are those relating to Economic and Monetary policy, as set out mainly in Title VIII of Part Three of the Treaty on the Functioning of the European Union (Articles 119 to 144 and various Protocols) and the detailed Regulations and Directives which underpin the Treaty Articles. A detailed summary of the primary and secondary legal provisions in scope of the review is provided as an annex.

1.8 The focus of the report will be those aspects of EU competence which apply to the UK, including economic and fiscal policy. It will not consider in detail those aspects of economic and monetary union which do not apply to the UK, including the single currency. Where relevant evidence is received on the indirect impacts on the UK of economic and monetary union, this may be taken into account in the final report.

1.9 Some aspects related to these competences are still under ongoing negotiation. This review will not recommend any specific course of action for those negotiations.

Box 1.B: Links to other reports

The economic and monetary policy report overlaps with a number of other Balance of Competences Reviews from previous semesters. Where other reports have received evidence relevant to EMP, we will take this into account in the final report. The following list sets out some of the key areas that fall out of scope of this report and in scope of others:

Semester 1 (published 22 July 2013):

Single Market: The Balance of Competences Review opened with an overarching report on the Single Market, led by the Department for Business, Innovation and Skills. The Economic and Monetary policy report will not focus on the Single Market in detail, however there is an overlap regarding the impact of euro area integration on the Single Market.

Taxation: The taxation report was led by HM Treasury. There is an overlap with this report on the impact of further euro area integration, particularly whether further integration should include a more joined up EU tax policy. The analysis of the taxation report concluded that policy and decisions on taxation should remain a national competence.

Semester 2 (published 13 February 2014):

We do not expect there to be any substantial overlaps with the Semester 2 reports.

Semester 3 (due to be published in summer 2014):

Single Market – Financial Services and the Free Movement of Capital (FSFMOC): Led by HM Treasury. There is a substantial overlap with this report regarding the impact of further financial integration in the euro area, particularly the banking union, on UK interests. The banking union has largely been included in the FSFMOC report. Therefore, the Economic and Monetary Policy report will not consider in detail the impact of banking union on the UK.

Social and Employment: Led by Department for Business, Innovation and Skills. There are some overlaps with this report and economic and monetary policy in the areas of the social dimension of EMU and the European Semester. The social and employment report will cover the aspects of the European Semester which directly relate to social and employment policy.

EU Budget: led by HM Treasury. This report covers the application and effect of the EU budget and there may be overlaps here with economic and monetary policy regarding the future possibility of a budget for the euro area. This is raised as an issue in the EU Budget report but will be covered in the report on economic and monetary policy if any evidence is received on this.

Semester 4 (due to be published alongside this report, by the end of 2014):

Education and Youth: Led by Department for Education. There are overlaps with this report on issues related to the European Semester. The education and youth report will cover aspects of the European Semester which directly relate to education.

Consular, Voting and Statistics: A cross-cutting report led by Cabinet Office, Foreign and Commonwealth Office, and the UK Statistics Authority. This report may have some overlaps in the areas of fiscal and economic statistics and macroeconomic imbalances procedure regulations.

More information on these reports can be found here: https://www.gov.uk/review-of-the-balance-of-competences.

2 Historical development

A brief history of the EU Treaties

2.1 The Treaty on the European Economic Community (EEC), or the 'Treaty of Rome', was signed on 25 March 1957 and entered into force on 1 January 1958. The EEC Treaty had a number of economic objectives, including establishing a European common market. Since 1957 a series of treaties has extended the objectives of what is now the European Union beyond the economic sphere.

2.2 The amending treaties are:

- The Single European Act (which came into force on 1 July 1987). This provided for the completion of the Single Market as we know it today;
- The Treaty on European Union; 'the Maastricht Treaty' (came into force 1 November 1993). This covered matters such as justice and home affairs, foreign and security policy, and economic and monetary union;
- The Treaty of Amsterdam (came into force 1 May 1999);
- The Treaty of Nice (came into force 1 February 2003); and
- The Treaty of Lisbon (came into force 1 December 2009), which made a number of changes to the institutional structure of the EU.

2.3 Following these changes, there are now two main treaties that together set out the competences of the European Union:

- The Treaty on European Union (TEU); and
- The Treaty on the Functioning of the European Union (TFEU).

2.4 Article 5(2) of the TEU specifies that the Union has the competence to act 'only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein' (the principle of conferral). The TEU and the TFEU set out the legal basis for Union action in relation to various policy areas such as the Single Market, economic and monetary policy and energy policy.

2.5 In some policy areas, such as customs union, the Union has 'exclusive competence' to act, which means that only the Union may legislate and adopt legally binding acts in those areas unless the Member States are expressly empowered by the Union to act (Article 2[1] TFEU). In other areas, such as the Single Market and consumer protection, the Union and the Member States share competence, in which case the Member States may exercise their competence to the extent that the Union has not exercised, or has decided to cease to exercise, its competence (Article 2[2] TFEU). The Union also has 'coordinating and supporting competence' in certain areas, such as the protection and improvement of human health, to carry out actions to support, coordinate or supplement the actions of the Member States without superseding their competence in those areas (Articles 2[5], 5 and 6 TFEU).

EU legislative process

2.6 EU legal acts such as regulations and directives are generally adopted by what, after the Lisbon Treaty, is known as the 'ordinary legislative procedure' (formerly known as the 'co-decision procedure'). In most cases, only the European Commission can propose a new legal act. But it cannot become law unless it is jointly adopted by the Council (composed of ministers from each Member State) and the European Parliament. Under this procedure, the Council acts on the basis of qualified majority voting, where only a specified majority of votes is required and the share of votes of each Member State reflects its population size.

2.7 The Treaties also set out a small number of cases where EU legal acts are adopted under different procedures (referred to as 'special legislative procedures'). For example, acts in some areas, such as foreign and defence policy, can only be adopted if the Council acts unanimously, so the act will not be adopted if a minister from any one Member State vetoes it.

Historical development of economic and monetary policy

2.8 Economic objectives have been at the heart of the EU's historical development, from the creation of the European Coal and Steel Community in 1951(the forerunner of the EEC); to the introduction of the euro in 1999. The Treaty of Rome contained the first references to coordination of economic and monetary policy. Member States were to regard their macroeconomic policies as a 'matter of common concern', while the Treaty placed a number of constraints on the way members should run their balance of payments.[1]

2.9 It is arguable that these articles were primarily motivated by the desire to ensure that balance of payments crises did not threaten the Community's trade policy. However, they did provide a basis for the deeper economic and monetary cooperation that eventually followed.

2.10 During the decade after the Treaty of Rome, few concrete moves were made towards deeper economic and monetary coordination. That began to change, however, following a series of events which gradually undermined the prevailing international monetary framework – namely, the 'Bretton Woods' system, with the US dollar and gold at its centre. In terms of how this played out in Europe, France devalued the franc (after a period of inflation) in August 1969; shortly afterwards, Germany upwardly revalued the deutschmark – following major capital flight from the US dollar into the deutschmark.

2.11 It was against this background of rolling disintegration of Bretton Woods that the Hague Summit of 1969 called for the 'creation of an economic and monetary union (EMU)' and the 'harmonisation of economic policies'. Some immediate actions followed, such as the creation of automatic and unconditional short-term credits amongst Member State central banks, in order to bolster exchange rate parities. But more fundamentally, the Hague Summit led to the establishment of the Werner Committee; in order to map out the Community's path to its declared intention of EMU. Werner reported in 1970, recommending:

- full currency convertibility with exchange rate parities irrevocably fixed;
- centralised monetary policy with a single external monetary policy;
- major aspects of fiscal policy to be coordinated at Community level;
- completion of EMU by 1980, with early steps focused on reducing the margin of exchange rate fluctuation, alongside greater harmonisation of national economic policies; and

[1] A nation's balance of payments refers to all of its international monetary transactions.

- mechanisms for monetary support at short term and for financial aid at medium term.[2]

2.12 It was clear from the outset that monetary integration was to be taken in-step with wider economic integration – including through the provision of the necessary monetary as well as financial mechanisms – in order that greater economic harmonisation should bolster the durability of the monetary arrangements. In addition, on the monetary side, exchange rate fluctuations would be reduced gradually, and within an overall zone of fluctuation against the US dollar. Initially, this objective was pursued via a set up which came to be known as 'the snake in the tunnel'.

2.13 However, the 'snake' ran into multiple problems during the 1970s, as Member States failed adequately to coordinate policies in the face of major external stresses (e.g. the US ending the Bretton Woods system in 1971 by breaking the dollar's convertibility to gold; and the 1973 oil crisis). By 1977 only five of the Community's ten members had managed to stay inside the system, and it became clear that the goal of the Werner Report – a full EMU by 1980 – was badly off-track.

2.14 Instead attention then focused (starting at the Copenhagen and Bremen Summits of 1978) on developing a less ambitious approach – exchange rate management through the European Monetary System (EMS).[3] The EMS involved a deliberate degree of flexibility – both in terms of the relatively wide bands that were permitted, and through the fact that collectively-agreed devaluation and revaluations were permissible within the system. Such valuation changes happened on a number of important occasions, including the major French devaluation of 1983. Initially, a number of countries opted out of the Exchange Rate Mechanism (ERM) part of the EMS.[4] But by 1991 the only Member States to have remained outside were Greece and Portugal.

2.15 Meanwhile, the 1989 Delors Report on EMU had, like Werner nineteen years earlier, set out a plan of actions to make a full EMU a reality. This was a major influence on the Maastricht Treaty, signed in 1992. This was the Treaty that laid out the architecture for the euro, and the process for its creation. Amongst other important measures it:

- established that governments should avoid excessive deficits, a protocol to the Treaty then specified the values of deficits and debts that countries should not exceed;
- established a prohibition on the Union assuming the liabilities of Member States, or of Member States assuming the liabilities of other Member States;
- abolished remaining capital controls;
- created a three stage process that Member States and the Union would have to go through to create (or join) the euro:
    1. membership of the ERM;
    2. followed by a period of centralising and building the monetary institutions (including creating the European Central Bank) alongside testing the Member States against entry criteria; and
    3. followed by the introduction of the single currency itself.

[2] *Report to the Council and the Commission on the realization by stages of economic and monetary union in the Community*, Luxembourg, 8 October 1970 – The Werner Committee.

[3] This involved the creation of the European Currency Unit (ECU) – a weighted basket of Member States' currencies. The ECU was used both as the yardstick for assessing whether countries' currencies were fluctuating within agreed bands around a central rate; and it was used as the denominator, and means of settlement, for central bank interventions in support of the agreed exchange rate parities. Over time, it also began to be used, unofficially, as a basis for private transactions.

[4] This included the UK. But it should be noted that the UK did participate in some of the non-ERM aspects of EMS, including depositing a significant proportion of UK reserves in the European Monetary Cooperation Fund in return for ECUs.

2.16 However, very soon after the Maastricht Treaty was signed, the ERM entered a crisis phase. In June 1992 Denmark voted against the Maastricht Treaty in a referendum and German opinion polls suggested a majority of its population may not be in favour of joining. Meanwhile, inconsistencies in the set of policies many Member States were running at this time to try to keep their currencies in line with the deutschmark while also tackling high unemployment encouraged speculative attacks against a number of currencies in the ERM. Sterling and the Italian lira exited the ERM in September 1992. Spain and Portugal devalued in November, and the Irish punt followed in January 1993. Both Spain and Ireland reimposed temporary exchange controls during this time. Then, in August 1993, the whole system was decisively loosened, with all but the deutschmark and the Dutch guilder widening their bands to +/– 15 per cent against the European Currency Unit (compared to the original +/– 2.25 per cent for most countries).

2.17 However, this experience did not stop the participating countries, from 1994 onwards, pushing on with the 'second stage' of EMU (primarily focused on institution-building, and on meeting the macroeconomic convergence criteria) as envisaged at Maastricht. Eleven countries joined the euro formally at the start of 1999. Greece joined two years later, one year before euro notes and coins entered circulation. Since then, Slovenia, Cyprus, Malta, Slovakia, Estonia and, most recently, Latvia have also joined.

2.18 Along with the rules on excessive deficits set out on the face of the Maastricht Treaty, the euro was underpinned by detailed rules on fiscal policy. These were enshrined in EU regulations known as the 'Stability and Growth Pact', alongside a degree of closer economic coordination, with surveillance of Member States' policies by the Council on the basis of Commission assessments. Additionally, a broader strategy for EU level growth and reform was agreed in the Lisbon Strategy in 2010, which set out a range of reform targets monitored largely through peer review and the open method of coordination.[5]

The euro area crisis

2.19 As the historical review showed, the history of European monetary issues has been characterised by periodic crises along a path of increasing integration. The most recent period of 'euro crisis' can be seen in this light.

2.20 The 1970 Werner Report was clear that an effective EMU should involve significant coordination of fiscal and wider economic policies, in order for the monetary union to work successfully. Looking back at the period from 1999 to 2007, it is clear that wider economic policies were insufficiently coordinated to prevent the build-up of serious macroeconomic imbalances within the currency area. These imbalances were seriously exposed by the onset of the global financial crisis in 2007-08. Capital flows (which in the years leading up to the crisis, had flowed in aggregate from countries running large current account surpluses, such as Germany and the Netherlands, to those running large current account deficits such as Greece, Ireland, Spain, Cyprus and Portugal) stopped suddenly. Countries in the euro area running large current account deficits saw their domestic private sectors shift very sharply from net borrowing to net lending. In these circumstances, the only way to avoid a depression with a huge and immediate increase in unemployment was to run very large fiscal deficits. But, as growth failed to return, markets gradually became uneasy at the substantial build-up of public sector debt that this implied. In late 2009, when Greece announced that it had falsely understated its public borrowing numbers, market confidence in the sovereign debt of countries in the euro area

[5] The Lisbon Strategy was agreed by the European Council in March 2000 as an economic development plan for the EU from 2000-2010 and was the forerunner of the Europe 2020 strategy. It aimed to deal with issues such as low levels of productivity and economic growth across the EU through close cooperation between the EU and Member States, but the main targets (i.e. 70 per cent employment rate, and 3 per cent of GDP spent on R&D) were not reached.

running large current account deficits started to evaporate rapidly, culminating in the most serious phase of repercussions in the 2010 to 2012 period.

2.21 This period saw five euro area Member States take financial assistance packages; two countries conduct sovereign debt restructurings; bank failures; deep recessions in a number of Member States; and very high levels of unemployment, especially for young people.

Recovery and reform

2.22 In response to the economic and financial crisis in the euro area, over recent years EU leaders and Finance Ministers have taken various steps to strengthen and improve the system of economic governance underpinning the EU's, and in particular, the euro area's economic coordination.

2.23 In response to the onset of the crisis, in March 2010, the European Council set up a taskforce on Economic Governance to devise proposals for better budgetary discipline and an improved crisis resolution framework. The taskforce was chaired by European Council President Herman Van Rompuy and composed of Finance Ministers from the then twenty-seven Member States. The final report made a number of recommendations for strengthening economic governance in the EU.[6]

2.24 Many of the taskforce's recommendations were taken forward through a major package of economic governance legislation commonly known as the 'six pack', published by the Commission in September 2010 and which entered into force in December 2011. These measured strengthened fiscal surveillance in the EU and, for the euro area, enhanced the enforcement provisions of the SGP. They placed more emphasis on debt levels and preventative action, while requiring new minimum standards for national budgetary frameworks. In addition, they set up a new process, underpinned by sanctions, for detecting and correcting the sort of imbalances that were at the root of the crisis – the Macroeconomic Imbalances Procedure (MIP). The 2011 reforms also brought the surveillance of both budgetary and economic policies together under the European Semester, to ensure the consistency of the policy advice given.

2.25 Despite these reforms, as the crisis deepened towards the end of 2011, the Commission published two further proposals (the 'two pack') on economic governance that would apply only to the euro area Member States and which entered into force on 30 May 2013. These Regulations introduce additional surveillance and monitoring for the euro area countries and put in place rules to govern the provision of financial assistance to euro area countries.

2.26 At the same time, in the face of the ongoing crisis, a number of countries decided to go further towards fiscal discipline by signing the intergovernmental Treaty on Stability, Coordination and Governance (TSCG).[7] Provisions include the requirement for a balanced budget rule and an increase in the role of independent fiscal bodies.

2.27 An intergovernmental treaty was also established between euro area countries in July 2011 to create the European Stability Mechanism (ESM). This is a permanent facility for providing financial assistance to euro area Member States, which replaced the European Financial Stabilisation Mechanism (EFSM). (More detail on these financial assistance mechanisms can be found on page 28.)

[6] The full report can be found here: http://www.european-council.europa.eu/the-president/taskforce.aspx

[7] The TSCG or 'Fiscal Compact', signed by 25 EU Member States (all but United Kingdom and Czech Republic at the time), entered into force on 1 January 2013 and is binding for all euro area Member States that have ratified it, while other contracting parties will be bound only once they adopt the euro or earlier if they signal it.

2.28 At the time of publication, discussions continue at EU level on what further reforms to economic and monetary policy may be necessary to ensure the ongoing stability of the euro. The President of the European Council was tasked by the European Council in May 2012 with creating a Genuine EMU. As explained on pages 29 and 30, significant progress has been made on the banking aspect and discussions are ongoing on what this may entail on the economic, fiscal and political front. At the same time, European countries continue to grapple with how to ensure long term sustainable growth and what role the EU level should play in supporting this.

3 The current system

3.1 The Principles of the TFEU state that the Union has competence to provide arrangements for Member States to coordinate their economic policies.[1] Furthermore, Member States are to consider their economic policies as 'a matter of common concern.'[2] The Union therefore has responsibility for coordinating economic policies across Member States with the aim of maintaining 'stable prices, sound public finances and monetary conditions and a sustainable balance of payments'[3] across the Union.

3.2 The main Treaty articles that underpin economic and monetary policy for the EU are those in Part Three, Title VIII, Economic and Monetary Policy of TFEU. They are underpinned by a number of EU regulations and directives which set out more detailed provisions and which includes those agreed since the onset of the crisis (More details on the legal framework can be found in Annex A).

3.3 This chapter will consider the following elements involved in the operation of the current system:

1. governance and policy making;
2. monetary policy;
3. fiscal policy;
4. economic policy; and
5. mechanisms for financial assistance.

3.4 However, it is important to note at the outset that the UK has a unique position with regards to its obligations relating to economic and monetary policy as a result of its opt-out from Economic and Monetary union and the single currency secured at Maastricht. This means that a number of provisions and processes in this competence area do not apply to the UK. These are set out in Box 3.A.

[1] Article 2(3)
[2] Article 121(1)
[3] Article 119(3)

Box 3.A: The UK Opt-Out

Protocol 15 to the Treaties is clear that 'the United Kingdom shall not be obliged or committed to adopt the euro without a separate decision to do so by its government and parliament'. Furthermore, Protocol 15 paragraph 3 states 'the United Kingdom shall retain its powers in the field of monetary policy according to national law'.

As a result of this, the majority of monetary provisions and a number of economic and fiscal provisions in the Treaties do not apply to the UK (a detailed list of provisions is set out in Annex A).

In particular it is worth noting that the UK's obligation in relation to the excessive deficit procedure is different to other Member States. Whereas Article 126 TFEU states that 'Member States shall avoid excessive deficits', this does not apply to the UK. Instead Protocol 15 paragraph 5 states that the UK shall 'endeavour to avoid an excessive government deficit'. Importantly, the UK is not subject to sanctions under the SGP as the coercive provisions do not apply to the UK.

As a result of the opt-out, there are a number of areas of secondary legislation which do not apply to the UK.

For example, instruments of the Six-Pack and Two-Pack which were adopted under Article 136 TFEU do not apply to the UK at all. Nor do Articles 5 to 7 of Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, which places an obligation on Member States to have in place numerical rules for meeting the SGP targets. Recital 17 of the Directive explains that that the SGP reference values in Protocol 12 to the Treaties 'are not directly binding on the UK'[4] and 'the obligation to have in place numerical fiscal rules that effectively promote compliance with the specific reference values for the excessive deficit, and the related obligation for the multiannual objectives in medium-term budgetary frameworks to be consistent with such rules, should therefore not apply to the United Kingdom'.[5]

Additionally, the UK is not a party to the TSCG or the ESM Treaty.

Further details on legal provisions referred to in this box can be found in Annex A.

[4] However, conditionality not directly related to the EDP does apply to the UK – as in the new horizontal regulation 1303/2013. Recital 25 explains that by virtue of Protocol No 15, provisions on suspension of all or part of payments and commitments under the Regulation do not apply to the United Kingdom.

[5] Recital 17: 'By virtue of Protocol 15, the reference values mentioned in Protocol 12 on the excessive deficit procedure are not directly binding on the United Kingdom. The obligation to have in place numerical values for the excessive deficit, and the related obligation for the multiannual objectives in medium-term budgetary frameworks to be consistent with such rules, should therefore not apply to the United Kingdom'.

Governance and the policy making process

3.5 The Council that is given authority on economic and monetary policy is the Economic and Financial Affairs Council (ECOFIN). This is attended by the Economics and Finance Ministers of the 28 Member States, plus representatives from the Commission, European Central Bank, European Investment Bank, chairs of its preparatory Committees and invited guests. It meets formally nine times a year and informally twice a year.

3.6 On legislative matters it decides mainly by qualified majority, in consultation or co-decision with the European Parliament.

3.7 The main preparatory committee for ECOFIN is the Economic and Financial Committee (EFC), attended by representatives from the Member States, the Commission and the ECB. The EFC also has a deputy committee that prepare its meetings, which is composed of senior finance ministry officials; the EFC-Alternates.

Eurogroup

3.8 Finance Ministers of euro area Member States meet informally in Eurogroup meetings the day before ECOFIN to discuss issues relating to the specific responsibilities they share with regard to the single currency. The Eurogroup is not a configuration of the Council, and cannot take legislative decisions, but is recognised in Protocol 14 of the TFEU. The aim of the Eurogroup is to 'ensure ever closer coordination of the economic policies [of the euro area] and promote financial stability'.[6] The Eurogroup also has a preparatory body known as the Eurogroup Working Group (EWG).

3.9 During the crisis, the Eurogroup assumed a more prominent role, for example in discussion of crisis resolution, including issues related to macroeconomic adjustment programmes for euro area Member States. Reflecting the perceived need to strengthen the Eurogroup, while taking account of its informal role, in October 2011 the euro area Heads of State agreed ten measures for improving governance of the euro area to 'improve the effectiveness of decision making' while 'fully respecting the integrity of the EU as a whole'. This included the hosting of regular euro summit meetings of euro area leaders and a stronger preparatory structure. It was agreed that in line with current practice between ECOFIN and Eurogroup, non-euro area Member States would be kept fully informed of the preparation and conclusions from the summits.

3.10 While most commentators recognise the need for a stronger Eurogroup structure to enhance crisis decision making, some have highlighted the potential impact of these developments on the Council's decision making on economic and financial issues. While it is true that the Eurogroup has played a more prominent role during the crisis than previously, it remains a non-legislative body that can only discuss matters related to the single currency.

ECON Committee

3.11 The European Parliament also has an Economic and Monetary Affairs Committee (ECON) which is responsible for Parliamentary work on economic and monetary policies of the EU, taxation and competition policies, free movement of capital and the regulation of financial services. ECON is therefore 'at the centre of the Parliament's work on the current economic and financial crisis'.[7]

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[6] Taken from the October 2011 euro summit statement, which can be found here: http://ec.europa.eu/commission_2010-2014/president/news/speeches-statements/2011/10/20111027_speeches_1_en.htm

[7] Taken from http://www.europarl.europa.eu/committees/en/econ/home.html

Monetary policy

Special position of the United Kingdom

3.12 Article 3 of TFEU states that the Union shall have exclusive competence for monetary policy for the Member States whose currency is the euro. However, when provisions on economic and monetary union were introduced in the Maastricht Treaty, the United Kingdom gave notice that it did not intend to participate in full economic and monetary union or the introduction of the euro. Furthermore, the current UK Government, in its Coalition Programme for Government, stated that Great Britain will not join or prepare to join the euro in this Parliament.

3.13 The United Kingdom therefore retains its powers in the field of monetary policy according to national law. As a result, a number of Treaty provisions (notably large parts of Title VIII TFEU as well as provisions of the ECB Statute) do not apply to the UK.[8] Protocol 15 TFEU specifically sets out where provisions do not apply to the UK (as shown in Annex B).[9]

Convergence process

3.14 As noted in Chapter 2, the Maastricht Treaty set out the three steps Member States need to take to join the euro. These include complying with a series of convergence criteria which are set out in Article 140 of the TFEU (these can be found in Annex A).

3.15 After discussion with the European Parliament and European Council, and after a proposal from the Commission, the Council decides whether Member States with a derogation fulfil the necessary conditions to join the euro. With unanimity from the other euro area Member States, the necessary measures can then be taken for the Member State to introduce the euro as their currency.

3.16 Article 119(2) TFEU states that the activities of Member States 'shall include the single currency, the euro'. Therefore all Member States are expected to join the euro, unless they have negotiated a specific opt-out. The UK and Denmark are the only two Member States to have obtained a formal opt-out from joining the euro.

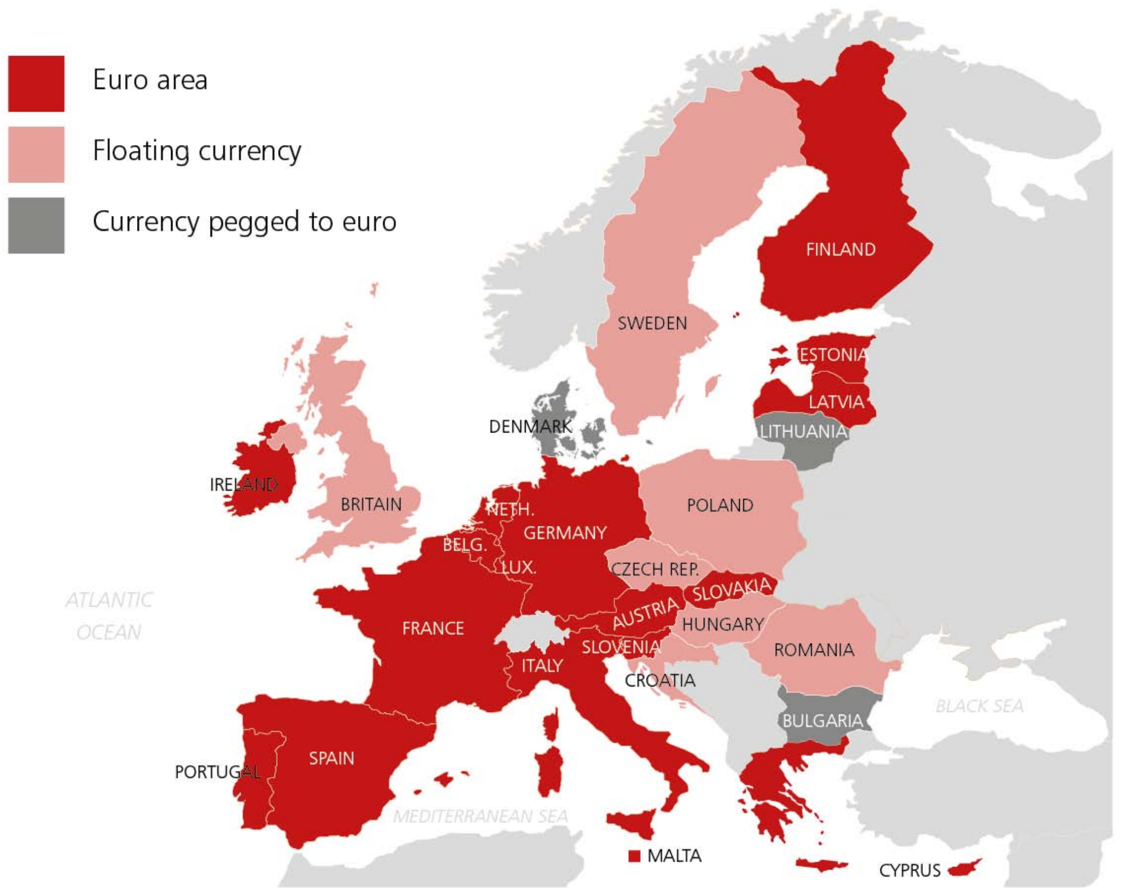
3.17 Member States with a derogation are those that the Council 'has not decided that they fulfil the necessary conditions for the adoption of the euro'. Technically neither the UK nor Denmark have derogations since they did not agree to join the euro from the outset. However, for many purposes the TFEU assimilates both the UK and Denmark to 'Member States with a derogation', hence the provisions of the TFEU which do not apply to Member States with a derogation are also disapplied in relation to the UK.

3.18 The following diagram indicates which countries of the European Union are inside the single currency euro area and which are outside of it.

[8] Protocol 4 to the Treaties on the Statute of the European Central Banks and of the European Central Bank.

[9] Now Protocol 15 to the Treaties on Certain Provisions relating to the United Kingdom of Great Britain and Northern Ireland.

Chart 3.A: European Union countries' currency status



Source: http://www.economist.com/blogs/graphicdetail/2014/01/european-economy-guide1 Jan 2014

The ECB and the euro

3.19 The European Central Bank (ECB) and the national central banks of all Member States together form the European System of Central Banks (ESCB), and the ECB and the euro area national central banks together form the Eurosystem. The principal tasks of the ESCB are: to define and implement the monetary policy of the Union; to conduct foreign exchange operations; to hold and manage the official foreign reserves of the Member States; and to promote the smooth operation of payment systems.

3.20 For euro area countries, monetary policy is centrally and independently managed by the ECB, whereas the UK's monetary policy is independently set by the Monetary Policy Committee of the Bank of England. Given that the single currency does not apply to the UK, this report will not analyse the operations of this system in detail. However, where relevant evidence is received on the indirect impacts on the UK of economic and monetary union, this may be taken into account in the final report.

3.21 More detail on the powers and tasks of the ECB and ESCB can be found in Annex A. The majority of these provisions do not apply to the UK due to the opt-out.

Economic and fiscal policy

The European Semester

3.22 The European Semester is the operational framework for the annual EU-level cycle for coordinating the reporting on, and assessment of, the structural reform and fiscal and economic policies of Member States across the European Union. The process was introduced in 2010 as a result of the economic crisis, in order to ensure better policy coordination across Member States.

3.23 The overarching objective of the European Semester is for the EU to support Member States' reforms to enable sustainable growth and jobs. This involves a wide variety of surveillance, reporting and peer review of policies in Member States.

3.24 The majority of this surveillance largely occurs in the first six months of the year, through the following three strands:

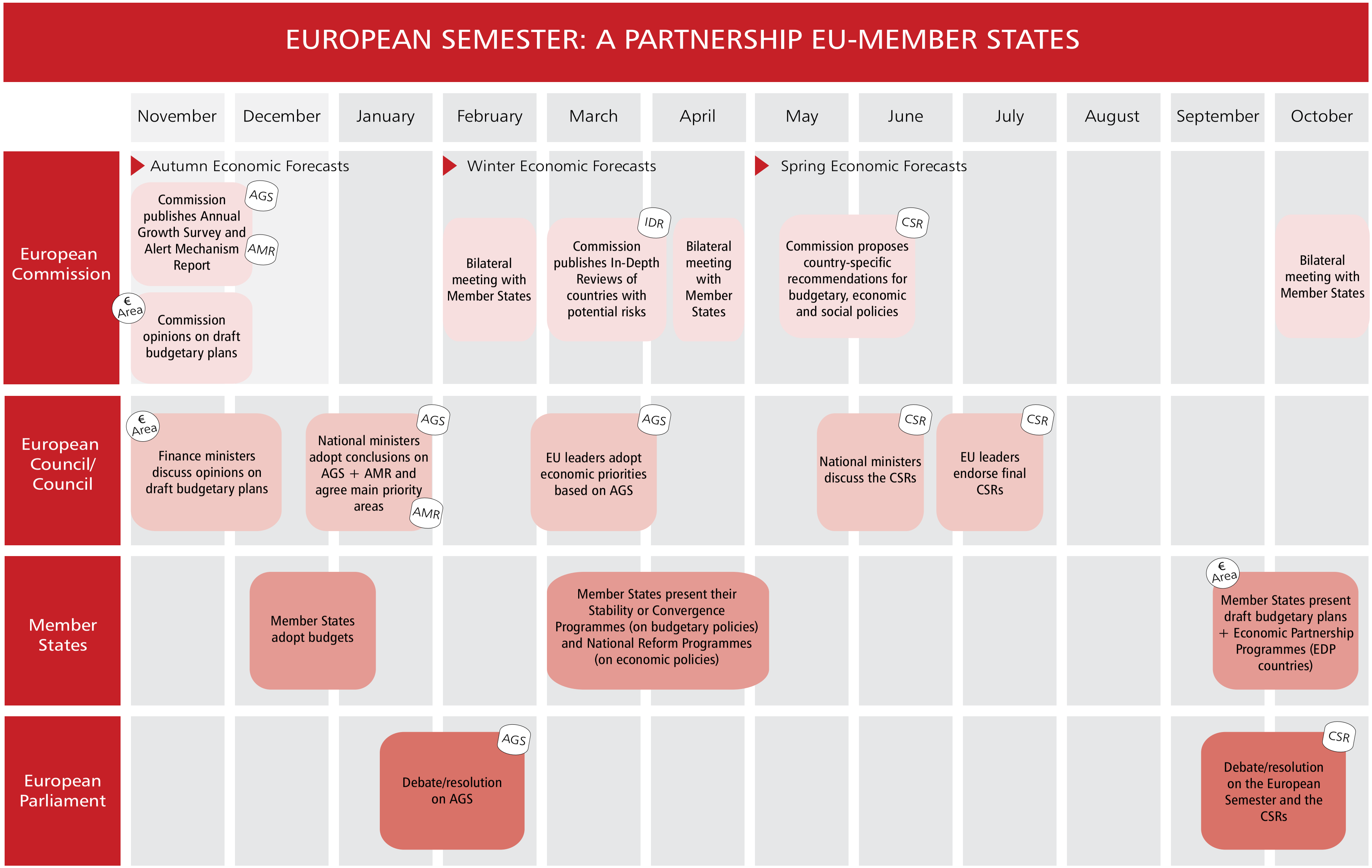
1. the Stability and Growth Pact;
2. the Europe 2020 Strategy; and
3. the Macroeconomic Imbalances Procedure.

3.25 These are focused on different elements of enabling sustainable economic growth and improving the fiscal situation in individual Member States and across the EU more broadly. Each of the three strands has its own area of focus, set of reporting requirements, coordinating instruments, compliance mechanisms and specific legal base. All three strands feed into the Country Specific Recommendations issued by the Commission on an annual basis (as described in Box 3.B). The UK is not subject to sanctions under the Semester process.

3.26 Since its first cycle in 2010, the use of the Semester process has evolved. For instance, the Commission has begun to extend the Semester into areas which are less economically focused, such as the inclusion of auxiliary social indicators in the Alert Mechanism Report 2014 and introduction of a justice scoreboard. In the view of some, it has strayed into areas that are outside its competence. This raises important questions about the purpose and scope of the Semester that will need to be considered by EU Member States in the coming months and years.

3.27 The following diagram shows the process and timeline of the European Semester.

Chart 3.B: European Semester



Glossary: AGS: Annual Growth Survey - AMR: Alert Mechanism Report - CSR: Country-Specific Recommendations - EDP: Excessive Deficit Procedure - IRD: In-Depth Review

Source: European Commission: http://ec.europa.eu/economy_finance/economic_governance/the_european_semester/index_en.htm

Box 3.B: Key components of the European Semester

The Annual Growth Survey

The annual European Semester timetable starts with the publication of the Commission's Annual Growth Survey (AGS) at the end of the previous year. This sets out the high level priorities for jobs and growth for the year ahead. These priorities have remained broadly the same in recent years and include: pursuing growth-friendly fiscal consolidation; restoring lending; promoting growth and competitiveness; tackling unemployment; and modernising public administration. The AGS is discussed in various Council formations (committees at both Official and Ministerial level). These discussions inform European Council conclusions on the AGS by Heads of State/Government at the March European Council meeting. In previous years, the European Council has shown broad agreement with the growth priorities outlined by the Commission.

The National Reform Programme

The key reporting requirement for national governments under Europe 2020 is the submission of the National Reform Programme (NRP) by each Member State in April. This outlines the structural reforms already being undertaken by Member States to implement the Country Specific Recommendations (CSRs) received in the previous year, in addition to other work they are undertaking to encourage sustainable growth and jobs. The NRP contributes to the Commission's analysis in preparation of the following year's CSRs.

Stability and Convergence Programmes

The preventive arm of the stability and growth pact requires Member States to outline their medium-term budgetary plans in the form of Stability programmes (for euro area member states), and Convergence programmes (for those outside of the euro area), which are presented to the European Commission and assessed annually in the context of multilateral fiscal surveillance under the European Semester. The deadline for submission of stability and convergence programmes is 30 April. The Commission assesses the programmes and, on the basis of a recommendation by the Commission, the Council forms an opinion which is reflected in the CSRs given at the end of May.

Country Specific Recommendations

Country Specific Recommendations (CSRs) to Member States take account of surveillance under Europe 2020, the SGP and the MIP. They are based on the Europe 2020 integrated guidelines, a Treaty-based instrument setting out broad orientations for Member States' economic and employment policies. The Integrated Guidelines were agreed by the European Council in 2010.

The Commission makes CSRs for all Member States apart from those subject to an economic assistance programme. This normally happens at the end of May each year. The CSRs are non-binding recommendations on policies to improve the position of public finances and to boost growth and jobs. In 2013 the UK's CSRs covered a wide range of different policy areas, including: fiscal and economic policy, housing, unemployment/skills, access to finance, and infrastructure. Following negotiations on the exact text of the CSRs at both working and Ministerial level, the CSRs are then endorsed by the June European Council meeting. Member States are expected to make use of the CSRs as they plan their reforms for the year ahead.

The Stability and Growth Pact

3.28 The Stability and Growth Pact (SGP) provides the framework for the coordination of national fiscal policies across the European Union. It aims to ensure that Member States pursue sound government finances. The SGP serves as the basis of EU fiscal surveillance and consists of numerical rules to ensure sound budgetary planning; procedural rules which are followed when the numerical thresholds are breached; and institutional arrangements to coordinate budgetary policies. It has been significantly strengthened in recent years as set out on page 13.

3.29 The SGP is underpinned by two reference values for public deficit (3 per cent of GDP) and debt (60 per cent of GDP) which Member States must respect. It consists of two main legal instruments; the preventive arm and the corrective arm.

3.30 The preventive arm requires Member States to be on track to achieve their Medium term objectives (MTOs), whilst the corrective arm consists of the Excessive Deficit Procedure (EDP), under which Member States receive recommendations and regular assessment when they breach the deficit or debt targets (these are further explained in Annex A). Charts 3.C and 3.D illustrate the preventive and corrective arm processes.

3.31 The MTO is a structural reference value for individual Member States' medium-term budgetary positions, specific to each country. All Member States must reach their MTOs or be on an appropriate adjustment path towards it, with an annual improvement of their structural balance of 0.5 per cent of GDP as a benchmark. MTOs are aimed at ensuring a healthy underlying budgetary position and are updated every three years (or more frequently if a Member State has undergone a structural reform that has significantly impacted its public finances).

3.32 Although the UK is subject to the SGP, it has a unique position with regards to its excessive deficit. Whereas other Member States 'shall avoid excessive government deficits',[10] the UK must undertake only to 'endeavour to avoid'[11] an excessive deficit.

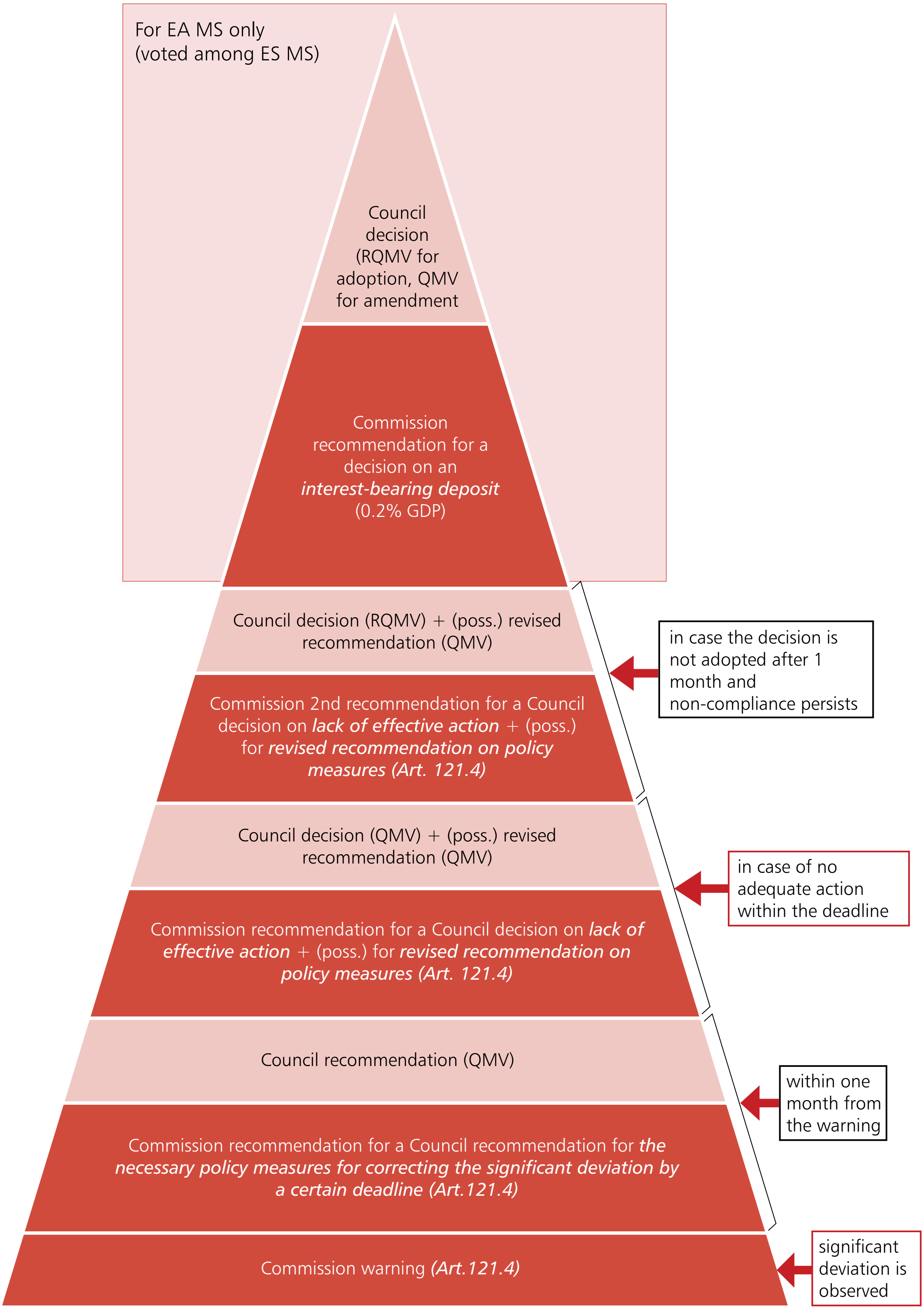
3.33 Non-compliance with either the preventive or corrective arms of the pact can lead to the imposition of sanctions for euro area countries. In the case of the corrective arm, this can involve annual fines for euro area Member States and, for all countries except the UK, possible suspension of financing from several EU funds until the excessive deficit is corrected.

3.34 In the context of the crisis and the need to get debt and deficits on a sustainable footing, the appropriate approach to fiscal policy coordination in the EU, including the application of the SGP by the Commission and Council, has been a repeated subject of discussion. In particular there has been, and remains, a significant debate amongst external commentators and policy makers about whether the EU's fiscal framework supports "growth" or results in "austerity" policies. This debate is likely to continue given the significant amount of fiscal consolidation still required.

[10] Article 126 TFEU

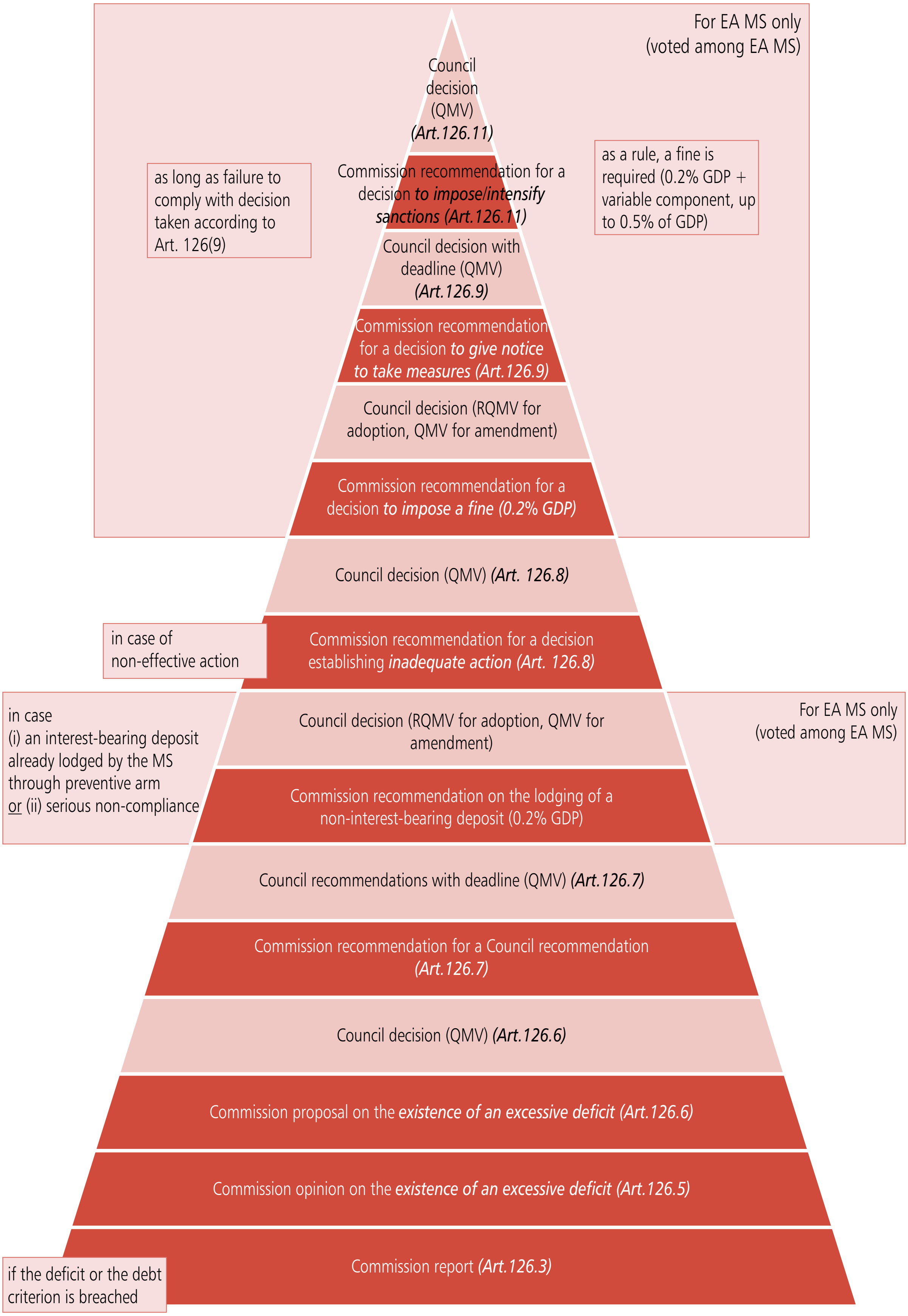
[11] Protocol 15, Article 139 TFEU

Chart 3.C: Preventive Arm



Source: European Commission: http://ec.europa.eu/economy_finance/economic_governance/images/preventive_arm.jpg

Chart 3.D: Corrective Arm



Source: European Commission: http://ec.europa.eu/economy_finance/economic_governance/images/corrective_arm.jpg

Europe 2020

3.35 In 2010, the European Commission proposed a ten year strategy aimed at a vision of 'smart, sustainable, inclusive growth rooted in greater coordination of national and European policy'. The focus of Europe 2020 is on the microeconomic structure of the economy and promoting the need for structural reform. In the framing document for Europe 2020 these were expressed as three mutually reinforcing priorities:

- smart growth: developing an economy based on knowledge and innovation;
- sustainable growth: promoting a more resource efficient, greener and more competitive economy; and
- inclusive growth: fostering a high-employment economy delivering social and territorial cohesion.

3.36 As part of the Europe 2020 agenda, the European Commission also proposed ambitious targets which were expected to be converted into individual national targets to be reached by 2020:

- 75 per cent of the population aged 20-64 should be employed;
- 3 per cent of the EU's GDP should be invested in R&D;
- the "20/20/20" climate/energy targets should be met (including an increase to 30 per cent of emissions reduction if the conditions are right);
- the share of early school leavers should be under 10 per cent and at least 40 per cent of the younger generation should have a tertiary degree; and
- 20 million fewer people should be at risk of poverty.

3.37 In line with the Public Services Transparency Framework launched in 2010, the UK Government has moved away from top-down target setting as a performance management tool. Although the UK had already previously committed to climate and energy targets, the Government did not set any new targets under the Europe 2020 Strategy.

The Macroeconomic Imbalances Procedure

3.38 The Macroeconomic Imbalances Procedure (MIP) is the EU-level framework for identifying and correcting macroeconomic imbalances, which came into force as part of the 'six pack' in December 2011 and runs alongside the SGP. The MIP reinforces economic governance in the EU and the euro area in order to provide an early warning system to prevent and correct harmful macroeconomic imbalances across the EU, which were a key cause of the current sovereign debt crisis. The MIP also aims to increase competitiveness.

3.39 In common with the SGP, the MIP comprises a preventive and a corrective arm. The preventive arm forms the basis for the annual MIP cycle, which starts when the Alert Mechanism Report (AMR) is published. The centrepiece of the AMR is a scoreboard, which each Member State is measured on. This comprises eleven macroeconomic and competitiveness indicators that monitor the potential development of problematic external and internal imbalances (such as current account balance, unemployment, and public and private sector debt, amongst others).

3.40 Each macroeconomic indicator has a threshold value above (or below) which the indicator will "flash", suggesting a potential imbalance. For example, any country with public sector debt higher than 60 per cent of GDP will flash on that indicator. Any imbalance may then be deemed problematic following further analysis. Following the publication of the AMR and discussion with the Council and the Eurogroup, the Commission may conduct in depth reviews on Member States as they seek to identify whether indicators that flash are representative of problematic imbalances.

3.41 The corrective arm of the MIP places Member States with problematic imbalances (subject to a Council decision using Qualified Majority Voting [QMV]) in an 'Excessive Imbalances Position'. Member States are then obliged to submit corrective action plans targeted at addressing these imbalances. For euro area countries, submission of an insufficient plan or a failure to comply with their plan leads to escalating sanctions. Any sanctions imposed are subject to a Council decision through Reverse QMV (hence the sanctions would automatically be imposed unless a qualified majority of Member States were to vote against them).

3.42 The power to impose sanctions under the MIP applies only to euro area Member States. The UK is therefore not subject to sanctions under the MIP, but its non-compliance could be made public.

Financial Assistance Mechanisms

3.43 The EU has established a set of financial assistance mechanisms, which have developed over time. These are aimed at providing support for Member States and 'third countries' (non-Member States with whom the EU holds close political, economic and geographic ties) that are experiencing financial difficulties. These mechanisms are only used in exceptional circumstances and are subject to strict conditionality and monitoring. In general, each disbursement of assistance is dependent upon successful completion of a review evaluating the implementation of programme conditionality. The Government supports the ongoing use of these facilities where the needs are exceptional and temporary.

3.44 The EU Budget acts as a guarantee for the use of Macro Financial Assistance (MFA), the EU Balance of Payments facility (EUBoP) and the European Financial Stabilisation Mechanism (EFSM) and each Member State therefore holds a contingent liability for their use. There is therefore no direct impact on the EU Budget unless the recipient of the loan defaults on repayments. More recently, these facilities have always been activated in co-operation with the IMF. Of the mechanisms for which the UK holds a contingent liability, only MFA and EUBoP remain able to engage in new programmes.

EU Balance of Payments facility

3.45 The EU Balance of Payments (EUBoP) facility is a financial assistance mechanism available to Member States whose currency is not the euro that are experiencing balance of payments difficulties. It has most recently been used to support Romania, Latvia and Hungary. This facility has a maximum lending capacity of €50 billion.

Macro Financial Assistance

3.46 The Macro Financial Assistance (MFA) facility is used to grant financial assistance to third countries in order to help them address acute balance of payments difficulties. MFA complements financing provided by the International Monetary Fund (IMF) in the context of an adjustment and reform programme.

European Financial Stabilisation Mechanism

3.47 The European Financial Stabilisation Mechanism (EFSM) was established in May 2010 to provide financial assistance to EU Member States facing financial difficulty. The mechanism was used as part of the international adjustment programmes for Ireland and Portugal. It was later agreed, in January 2012, that there would be no new commitments from this facility once the ESM was established (see paragraph A19 in Annex A for further detail). The EFSM has now fully disbursed its assistance programme to Ireland and will complete its disbursements to Portugal in the first half of 2014. The capacity of the facility is €60 billion.

European Stability Mechanism

3.48 The European Stability Mechanism (ESM) is an international financial institution set up in October 2012 by euro area Member States to replace the temporary European Financial Stability Facility (EFSF) and create a permanent mechanism providing financial assistance to its members.[12] The UK does not participate in this mechanism and therefore holds no liabilities for its activities. The maximum lending capacity of the ESM is €500 billion, subject to a €700 billion ceiling on the combined lending capacity of the ESM and the EFSF. The ESM has previously been activated to provide support to Spain and Cyprus.

[12] The EFSF was established by euro area Member States in 2010 to preserve the financial stability of Europe's monetary union by providing financial assistance to euro area Member States and is only used alongside assistance from the IMF.

Future development of EU economic coordination

3.49 As set out in previous sections, over recent years unprecedented changes have been made to strengthen the institutions governing the single currency, largely in response to the euro area crisis. However, it is clear that there remains work to be done to strengthen the euro area to ensure enduring economic recovery, including structural reforms and fiscal consolidation, as well as further institutional progress. Further steps towards deeper integration within the euro area are therefore likely over the coming years.

3.50 A process led by the President of the European Council, Herman Van Rompuy, is already underway to create a 'genuine economic and monetary union' (GEMU) and the Commission has published a report on a deep and genuine EMU. This work focuses on the four pillars of financial, fiscal, and economic integration, as well as democratic accountability and legitimacy. A variety of proposals for possible reforms has been put forward, including:

- further legislation in the spheres of banking union, economic policy coordination and support for structural reforms;
- further steps to strengthen the collective coordination of budgetary policy;
- coordination extended into areas such as tax policy and labour markets;
- enhancing the euro's fiscal capacity in order to provide sufficient resources to support important structural reforms;
- a debt redemption fund and 'eurobonds'; the common issuance of Government debt by euro area Member States;
- an autonomous euro area budget;
- a treaty for the euro area; and
- a euro area finance minister.

3.51 With the exception of the work on banking union, there are no concrete proposals in many of these areas but they demonstrate the potential level of ambition from some EU actors for closer integration. The Commission report states that a number of these changes would require treaty change.

Box 3.C: UK Government's position on euro area integration

A stable euro area is in the interests of all Member States, and the UK supports closer economic and fiscal integration for the euro area to strengthen the single currency. At the same time, the UK Government has been clear that it will not be part of closer integration and will protect the interests of those outside the single currency, especially in relation to the Single Market. As reforms are made, it is necessary to ensure that the EU continues to operate fairly for all its members, whether in the euro area or outside of it.

Genuine Economic and Monetary Union

3.52 To date, the key proposal aimed at ensuring further European integration has been banking union, which has been included in the third semester FSFMOC report (due to be published in Summer 2014). The aim of the banking union is to sever the link between banks and sovereigns, which is an issue with significant pan-European importance, given the shared single currency. The UK will not participate. However, a single supervisory mechanism (SSM) has already been established, and a single resolution mechanism (SRM) is currently being negotiated. Alongside the

SRM, Member States agreed to establish a single resolution fund (SRF) through an intergovernmental agreement (IGA) outside of the EU Treaties. The UK will not be a contracting party to the agreement but will have enforceable rights relating to certain aspects of it.

3.53 Meanwhile, other work has focused on the four areas agreed to be taken forward by EU leaders at their December 2012 summit:

- ex ante coordination of major economic reforms;
- the social dimension of EMU;
- structural reform contracts; and
- solidarity mechanisms to enhance efforts of member states under contracts.

3.54 Recent discussions have focused on contracts and solidarity mechanisms. The aim of these would be to extend controls over economic policy to drive structural reform in euro area Member States. They could provide a grant element to support reform in crisis-hit countries, as well as targeting a broad range of growth and job-enhancing policies and measures. The contracts would reflect the economic policy priorities identified in the European Council's shared analysis of the economic situation in the Member States and the euro area, and take into account the CSRs. It was agreed at December European Council that the European Council and the European Commission will carry out further work on the detailed design of these proposals, with a view to leaders reaching a decision on the issues in October 2014.

Challenges

3.55 It is clear that there is still some way to go before agreement on many of these matters is reached, given the current state of the political debate. However, they are already raising potentially significant issues for those countries who are outside of the single currency, including the UK.

3.56 For example, over recent years, a number of intergovernmental agreements have been agreed outside of the Treaties in order to take forward measure for closer integration. There is some debate around the use of IGAs and whether they are the correct devices to implement such reforms for participating Member States. Additionally, the UK Government has recently taken a number of cases to the Court of Justice of the European Union (CJEU) over discriminatory treatment regarding the financial transaction tax, the bonus cap, short selling and the ECB matter on clearing houses.

3.57 The UK Government has been clear that safeguards are needed to protect the rights and interests of non-euro area countries. The UK secured strong safeguards in this regard in the SSM and is continuing to negotiate to ensure there is equal treatment in the on-going SRM negotiations. However, this is an issue which will remain a priority for the UK in future negotiations.

3.58 Additionally, new EU Qualified Majority voting rules will take effect from 1 November 2014.[13] This means that should they vote together, euro area countries will have an in-built majority in votes, which presents a potential challenge for non-euro area countries and for decision making in the single market. The UK has, however, negotiated the new 'double majority' voting system which will apply in the European Banking Authority. This means that a majority of both euro area and non-euro area countries will be required for legislation to pass.[14]

3.59 Given the level of economic integration which some envisage, there have been suggestions that this may necessitate further political integration in the EU. For example, there has been

[13] This is set out in Article 16 of TFEU, which states that 'a qualified majority shall be defined as at least 55 per cent of the members of the Council, comprising at least 15 of them and representing Member States comprising at last 65 per cent of the population of the Union'.

[14] For further discussion on banking union and the implications for the UK's national interest, see the FSFMOC semester 3 report.

ongoing debate about the democratic oversight of measures put in place since the euro area crisis began. The Government is clear that national parliaments need to play a more significant role in the EU's decision-making since it is national parliaments that are the main source of democratic legitimacy and accountability in the EU.

3.60 In addition to these issues, it is likely that the EU will need to continue to focus its attention on some major economic challenges for the foreseeable future. Although the euro area's return to growth after a long recession is welcome and the risk of systemic crisis now appears less likely, the need for reform across the EU as a whole to entrench economic recovery and achieve sustainable growth is arguably more urgent than ever before. The consequence of years of low productivity, lack of economic dynamism and rigid labour markets is that the EU continues to face a significant growth challenge.

4 Questions

4.1 We welcome views in response to the following questions. For all questions, please try to give specific examples and provide evidence to support your view.

Governance and policy making process:

1 Does the economic governance system provide the appropriate balance of competence between the European Commission and the Council?

2 What is the appropriate role of the European Parliament in economic governance?

3 What do you consider to be the most appropriate role for National Parliaments in the economic governance system?

4 Does the current governance structure strike the right balance between institutions of the euro area (EWG, Eurogroup) and those of the European Union (EFC, ECOFIN)?

Monetary, fiscal and economic policy:

5 Given the UK opt-out from the single currency, is the current level of UK participation in the EU's economic, monetary and fiscal policy coordination appropriate?

6 What evidence is there of the indirect impact on the UK of economic and monetary union and the relevant EU competences exercised over euro area Member States?

7 What are the advantages and disadvantages of coordination of economic policy as a matter of 'common concern' between Member States?

8 Have recent developments to the economic governance system as a response to the euro area crisis taken account of the interests of all Member States (whether euro area, non-euro area or those with an opt-out)?

9 What are the advantages and disadvantages of the current framework for coordinating economic policy through the European Semester?

10 How effective is the European Semester framework at encouraging growth-enhancing economic reform?

11 Do you consider that the Macroeconomic Imbalances Procedure is an appropriate system for detecting and correcting underlying economic imbalances?

12 Does the current operation of the Stability and Growth Pact have the right obligations for all Member States (whether euro area, non-euro area or those with an opt-out)?

13 What are the key challenges in terms of implications for the UK of likely future developments in these areas?

EU financial assistance mechanisms:

14 Do you consider that the EU's role in the use of Financial Assistance Mechanisms is appropriate and can the balance of competence in this area be improved?

General:

15 Do you have any other points to raise that are not covered above?

A The legal framework

A.1 The first references to the establishment of a monetary union were made in the Treaty of Rome (1957), in the following articles:

- Article 103 stated that Member States should regard their macroeconomic policies as a 'matter of common concern'; and
- Articles 104 to 109 placed a number of constraints on the way members should run their balance of payments: pursuing equilibrium in external accounts; coordinating economic policies; removing exchange controls connected with the common market; providing a role for Commission recommendations when countries experience balance of payments difficulties; and allowing for the introduction of protection measures in the case of crises (subject to Council revocation).

A.2 Economic convergence and the establishment of an economic and monetary union are set out as objectives of the Union in the Preamble to the Treaty on European Union (TEU) and in Article 3 TEU. These objectives are summarised in a little more detail in Article 119 of the Treaty on the Functioning of the European Union (TFEU) which introduces Title VIII, Economic and Monetary Policy. The main provisions (comprising Articles 120-144 TFEU) cover economic policy, monetary policy and the euro.

A.3 Article 119 TFEU is a recast of old Articles 3 and 4 of the former Treaty establishing the European Community (TEC). Old Article 3 TEC provided for 'a system ensuring that competition in the internal market is not distorted'. New Article 119(1) TFEU (echoed by Article 120 TFEU) provides for 'the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy *with free competition*'. Protocol 27 on the Internal Market and Competition asserts that internal market 'includes a system ensuring that competition is not distorted'.

Economic policy: Articles 120 and 121

A.4 Article 120 requires Member States to conduct their economic policies with a view to contributing to the achievement of the objectives of the Union, as defined in Article 3 TEU, and in the context of the broad guidelines referred to in Article 121. This provision applies to the UK.

A.5 Article 121 requires Member States to coordinate their economic policies within the Council. Article 121 further provides a power for the Council to adopt Broad Economic Policy Guidelines for the Member States (BEPGs) and to monitor economic developments and consistency of economic policies by means of multilateral surveillance. Where it is established that the economic policies of a Member State are not consistent with the BEPGs or that they risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned and the Council may address the necessary recommendations to the Member State concerned. Article 121(6) contains a general power for the European Parliament and the Council to adopt detailed rules for the multilateral surveillance procedure.

A.6 Article 121 applies to the UK. However, BEPGs which concern the euro area generally do not apply to the UK.

A.7 Article 121 also provides the legal basis for the MIP.

Legal basis of the SGP: Articles 121, 126

A.8 Articles 121 and 126 of the TFEU provide the legal basis for the Stability and Growth Pact. Article 121 is the legal basis for the preventive arm of the SGP. This legislative power cannot be used on its own to adopt coercive measures. Article 126 forms the basis for the corrective arm and the EDP and Protocol 12 defines the reference values of 3 per cent of GDP for public deficit and 60 per cent of GDP for public debt.

The Preventive Arm

A.9 The first regulation of the SGP (Regulation (EC) No. 1466/97 and subsequently amended), 'the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies', provides for the preventive arm of the pact and entered into force on 1 July 1998. It seeks to ensure that fiscal policy is conducted in a sustainable manner over the medium-term cycle, with a view to preventing countries breaching the debt and deficit values. The preventive arm requires Member States' fiscal positions to be 'close to balance or in surplus position'.

A.10 The preventive arm is centred around the country-specific medium-term budgetary objective (MTO), which Member States must aim to achieve.[1] The addition of an expenditure benchmark as part of the 'six pack' reforms strengthened the preventive arm in 2011. This is designed to ensure that annual government expenditure is kept at a sustainable rate and allows the Council and Commission to assess whether 'sufficient progress' towards the medium-term budgetary objective is being made.[2]

A.11 Article 6 of the regulation states that in the event of significant deviation from the adjustment path towards the MTO, the Commission shall address a warning to the Member State concerned, in accordance with Article 121(4); a process which can ultimately lead to the issuance of sanctions for euro area Member States (as set out in Chart 3.C).

The Corrective Arm

A.12 The second regulation of the SGP (Regulation 1467/97 and subsequently amended) sets out the framework for the corrective arm of the pact; 'speeding up and clarifying the implementation of the excessive deficit procedure'. It entered into force on 1 January 1999 and allows countries to take action to correct their excessive deficit. The excessive deficit procedure is triggered when a country is in breach of one or both of the rules that the deficit must not exceed 3 per cent of GDP and public debt must not exceed 60 per cent of GDP (or at least diminish sufficiently towards the 60 per cent) as defined in Protocol 12 of the TFEU.

A.13 The 'six pack' introduced a new debt requirement to the corrective arm in 2011. This requires the general government debt of Member States to be less than 60 per cent of GDP or to be 'sufficiently diminishing and approaching 60 per cent of GDP at a satisfactory pace'.[3]

A.14 The Commission annually assesses the progress that Member States have made in meeting the EDP target and can find that 'effective action' has or has not been taken to reach the target by its deadline. Non-compliance with the corrective arm can lead to the imposition of sanctions for euro area countries. These can involve annual fines for euro area Member States and, for all

[1] See paragraph 3.31 on page 23 for further detail on the MTO.

[2] Article 5 of Regulation (EC) No. 1466/97 sets out the conditions for assessing the measures taken by Member States in order to attain 'sufficient progress' towards the MTO.

[3] As stated on page 51, Vade Mecum on the Stability and Growth Pact. This in turn is translated into a debt reduction benchmark which is set out in the Code of Conduct to the SGP.

countries, possible suspension of Cohesion Fund financing until the excessive deficit is corrected (as illustrated in Chart 3.D).

A.15 The UK is subject to the SGP. However, in accordance with Protocol 15 and Article 139 TFEU, the UK undertakes only to "endeavour to avoid" an excessive deficit and the sanctions provisions do not apply.

A.16 The SGP was reformed in 2011 and 2013 by the 'six pack' and 'two pack' legislative packages, which are set out below:

Box A.1: The 'Six Pack'

The 'six pack' is made up of the following five regulations and directive:

- Regulation No. 1173/2011 on the effective enforcement of budgetary surveillance in the euro area.
- Regulation No. 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area.
- Regulation No. 1175/2011 amending Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.
- Regulation No. 1176/2011 on the prevention and correction of macroeconomic imbalances.
- Regulation No. 1177/2011 amending Regulation (EC) No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.
- The first two of these regulations apply only to euro area Member States; the remainder apply to all Member States.
- Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States. This applies to all Member States and sets out minimum requirements on accounting and statistical requirements, national fiscal rules, forecasting procedures and the transparency and scope of budgetary frameworks.
- Parts of this directive do not apply to the UK in view of Protocol 15.

Box A.2: The 'Two Pack'

The 'two pack' consists of the following regulations:

- Regulation (EU) No. 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability.
- Regulation (EU) No. 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.
- Neither regulation applies to the UK.

Article 122

A.17 Article 122 provides for emergency measures in circumstances where a Member State may face 'severe difficulties' that arise as a result of the 'supply of certain products' (Article 122[1]), 'natural disasters' or other 'exceptional circumstances beyond its control' (Article 122[2]).

A.18 Article 122(2) was the legal basis for the adoption of Regulation 407/2010 of 11 May 2010 establishing the European Financial Stabilisation Mechanism, set up in response to instability in the euro area.

A.19 The European Council conclusions from 17 December 2010 stated that once the new, permanent European Stability Mechanism was in place, Article 122(2) would 'no longer be needed' for the purpose of safeguarding the financial stability of the euro, 'and should not be used for such purposes'.

Articles 123 – 125

A.20 Article 123 prohibits Union and Member State institutions from the use of overdraft or credit facilities with the ECB or the national central banks of Member States. It also prohibits the direct purchase of Union and Member State debt instruments by the ECB and national central banks.

A.21 Article 124 prevents Union or Member State authorities from establishing measures not based on prudential considerations that would enable them to gain privileged access to financial institutions.

A.22 Article 125 states that the Union and Member States shall not be liable for or take on the responsibility for the financial commitments made by other Member States and their authorities. This clause does not however prohibit loans from being made between the Union and Member States or between Member States themselves.

A.23 The application of these articles has been considered by the European Court[4] and by the German Federal Constitutional Court.[5]

Monetary policy: Articles 127 – 133

A.24 Chapter 2, Articles 127 – 133, define the powers and tasks of the European Central Bank (ECB) and the national central banks, which together form the European System of Central Banks (ESCB). The ECB and the euro area national central banks together form the Eurosystem. The powers and tasks of the ESCB are further spelled out in Protocol 4 to the Treaties on the Statute of the European Central Banks and of the European Central Bank.

A.25 The majority of these provisions do not apply to the UK by virtue of Protocol 15. The principal exceptions to this are Article 129, which concerns the governance of the ESCB by the decision-making bodies of the ECB, and article 127(6), which is a power for the Council to confer specific tasks on the ECB concerning prudential supervision of credit institutions but not insurance undertakings. This power is exercisable by unanimity and requires the UK's agreement.

Articles 134-135

A.26 Article 134 provides for the setting up of the Economic and Financial Committee (EFC). This provision applies to the UK which is a member of this Committee. Article 134(1) establishes the EFC 'in order to promote coordination of the policies of the Member States to the full extent needed for the functioning of the internal market'. Article 134(2) outlines the main tasks of the

[4] Case C-370/12 Pringle v. Ireland – 27 November 2012 –Court of Justice of the European Union.

[5] Cases No. 2 BvR 1390/12 – 21 September 2012; 2 BvR 2728/13 – 14 February 2014 and 2 BvR 1390/12 – 18 March 2014 – German Constitutional Court.

EFC, which are to report to the Council and the Commission on ‘the economic and financial situation of the Member States and of the Union...in particular on financial relations with third countries and international institutions’; to deliver opinions and help prepare the work of the Council; and to report to the Commission and to the Council, at least once a year, on ‘the situation regarding the movement of capital and the freedom of payments’, covering ‘all measures relating to capital movements and payments’.

A.27 Article 135 provides a special power for the Council to call on the Commission to make recommendations or proposals as appropriate on economic and monetary matters. This provision applies to the UK.

Articles 136 – 138: Provisions specific to Euro Area Member States

A.28 Articles 136 to 138 contain provisions specific to Euro Area Member States.

A.29 Article 136 confers powers to adopt measures specific to those Member States whose currency is the euro: (a) to strengthen the coordination and surveillance of their budgetary discipline; (b) to set out economic policy guidelines for them.

A.30 This power was used in conjunction with Article 121(6) TFEU to adopt the two instruments in the ‘six pack’ involving sanctions for euro area Member States. It is also the basis with Article 121(6) for the ‘two pack’ measures.

A.31 Article 136 provides a basis to ensure the proper functioning of the economic and monetary union. Secondary legislation for monitoring, assessing and resolving issues surrounding budgetary plans and imbalances amongst euro area Member States was adopted under this Article.

A.32 These articles provide for action by the EU, but where decisions are taken by the Council, only euro area Member States may vote. Article 136 does not apply to the UK since its scope is limited to Member States whose currency is the euro.

A.33 The power to impose sanctions under the MIP derives from Article 136. Failure to take sufficient corrective action under the MIP could therefore lead to sanctions for euro area Member States but those outside of the euro area are not subject to sanctions.

A.34 Article 136 was amended in 2013 following ratification by all Member States. The amendment created Article 136(3), which provided a permanent legal basis for the European Stability Mechanism (ESM). The UK is not a participant in the ESM Treaty and therefore does not have any financial exposure in relation to the operation of the mechanism, either directly or through the EU budget.

Articles 139 – 144: Transitional Provisions

A.35 Articles 139 to 144 contain transitional provisions for Member States in respect of which the Council “has not decided that they fulfil the necessary conditions for the adoption of the euro”. In particular, Article 139 makes it explicit that the coercive means of remedying excessive deficits (Article 126[9] and [11] TFEU) do not apply to Member States with a derogation and similarly acts of the ECB and measures concerning the euro do not apply. Article 139(4) makes it clear that voting rights of Member States with a derogation are suspended for the purposes of the same powers. So far as concerns the UK these disapplications and suspensions are reiterated in Protocol 15.

A.36 Article 140 spells out the procedure for ending a derogation, stating the following criteria which must be fulfilled by Member States:

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with article 126(6);
- the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System for at least two years without devaluing against the euro; and
- the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels.

A.37 It also provides the procedure for Denmark or the UK to join the euro if they wished to do so. Only Member States whose currency is already the euro may vote on the ending of a derogation. Additional details for the ending of the UK's opt-out are set out in Protocol 15.

A.38 Article 141 maintains in being a General Council of the ECB, in addition to the Governing Council and Executive Board provided for by Article 129, for the purposes of providing a forum with Member States with a derogation. Protocol 15 provides for the retention of this General Council whether or not there are any Member States with a derogation, so long as the UK opt-out remains. The UK's only financial contribution is to the administrative budget of the ECB.

A.39 Article 142 requires Member States with a derogation to treat their exchange-rate policy as a matter of common interest. This provision applies to the UK by virtue of Protocol 15.

Article 143: Balance of Payments facility

A.40 Article 143 (formerly Article 119 TEC) provides a mechanism for granting mutual financial assistance to a Member State, whose currency is not the euro, experiencing or seriously threatened with balance of payments difficulties. The EU Balance of Payments facility provides the basis for such mutual assistance.

Protocols

A.41 The following protocols are referenced previously in the text:

A.42 Protocol 4 on the Statute of the European System of Central Banks and of the European Central Bank.

A.43 Protocol 12 on the Excessive Deficit Procedure. Article 1 provides the reference values referred to in Article 126(2) of the TFEU of:

- 3 per cent for the ratio of the planned or actual government deficit to gross domestic product at market prices; and
- 60 per cent for the ratio of government debt to gross domestic product at market prices.

A.44 Protocol 13 on the convergence criteria that are set out in Article 140.

A.45 Protocol 14 provides for the Eurogroup to consist of Ministers of the Member States whose currency is the euro to meet informally. The Commission participates and the ECB has a standing invitation to participate in meetings. The president of the Euro group is elected by majority of the Ministers of euro area Member States.

A.46 Protocol 15 provides the provisions specific to the UK.

B UK obligations under the Treaty

B.1 The following articles in the field of economic and monetary policy apply to the UK:

- Article 119(1), (3): Coordination of economic policy;
- Article 120: *'Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Union...';*
- Article 121: *'Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council...'* But BEPGS that concern the euro area generally do not apply to the UK;
- Articles 122 – 125: Emergency measures;
- Article 126: Excessive deficit procedure (the UK must endeavour to avoid an excessive government deficit);
- Article 127(6): The power for the Council to confer specific tasks on ECB concerning prudential supervision of credit institutions but not insurance undertakings;
- Article 129: The governance of the ECSB by the decision-making bodies of the ECB;
- Article 134: Economic and Financial Committee;
- Article 135: The power for Council to call on the Commission to make recommendations or proposals as appropriate on economic and monetary matters;
- Article 139: Transitional provisions for Member States with a derogation;
- Article 140: The procedure for ending a derogation;
- Article 141: Cooperation with the ECB by Member States with a derogation;
- Article 142: Member States must treat exchange rate policy as a matter of common interest; and
- Article 143, 144: Powers to address balance of payments difficulties (applies only to Member States with a derogation).

B.2 The following articles do not apply to the UK:

- Article 119(2): Referring to EU monetary policy and the single currency;
- Article 121(2): The broad economic policy guidelines that concern euro area countries;
- Article 126(1), (9), (11): The avoidance of excessive deficits and the coercive means to enforce this;
- Article 127(1) to (5): The European System of Central Banks and the European Central banks.
- Article 128: The issuance of euro banknotes and euro coins;
- Article 130: The ESCB or ECB taking instruction from other institutions or organisations;

- Article 131: The statutes for national central banks, ESCB and ECB;
- Article 132: Decision-making powers of the ECB;
- Article 133: The laying down of measures necessary for use of the euro;
- Articles 136 and 137: Apply to euro area Member States only and hence do not include to the UK. This includes the first two six-pack regulations (No. 1173/2011 and No 1174/2011) and the two-pack regulations (No. 473/2013 and No. 472/2013), which are based on Art. 136;
- Protocol 15 also refers to Articles 138, 140(3), 219, 282(2) (except the first and last sentences), 282(5) and 283 which do not apply to the UK; and
- Corresponding provisions of the ECB statute are also disapplied.

C List of current euro 'ins' and 'outs'

Table C.1: List of Member States that are currently in or out of the euro single currency

Ins		Outs	
1	Austria	1	Bulgaria
2	Belgium	2	Croatia
3	Cyprus	3	Czech Republic
4	Estonia	4	Denmark (Opt-out)
5	Finland	5	Hungary
6	France	6	Lithuania
7	Germany	7	Poland
8	Greece	8	Romania
9	Ireland	9	Sweden
10	Italy	10	The UK (Opt-out)
11	Latvia		
12	Luxembourg		
13	Malta		
14	The Netherlands		
15	Portugal		
16	Slovakia		
17	Slovenia		
18	Spain		

D List of abbreviations

AGS	Annual Growth Survey
AMR	Alert Mechanism Report
BEPG	Broad Economic Policy Guidelines
CJEU	Court of Justice of the EU
CSR	Country Specific Recommendations
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive Deficit Procedure
EEC	European Economic Community
EFC	Economic and Financial Committee
EFC-A	EFC-Alternates
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EMP	Economic and Monetary Policy
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
EUBoP	EU Balance of Payments
EWG	Eurogroup Working group
FSFMOC	Financial Services and Free Movement of Capital (Semester 3 report)
GDP	Gross Domestic Product
GEMU	Genuine Economic and Monetary Union
IMF	International Monetary Fund
MFA	Macro Financial Assistance
MIP	Macroeconomic Imbalances Procedure
MTO	Medium Term Objective
NRP	National Reform Programme

QMV	Qualified Majority Voting
RQMV	Reverse Qualified Majority Voting
SGP	Stability and Growth Pact
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TEU	Treaty on the European Union
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance

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ISBN 978-1-909790-75-9