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European Union Committee

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**The future of
economic
governance in the
EU**

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The European Union Committee

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References in footnotes to the Report are as follows:

Q refers to a question in oral evidence
EGE refers to written evidence as listed in Appendix 2

SUMMARY

The banking crisis in 2008 triggered a crisis of confidence in the financial health of Member States of the euro area. Concerns over the level of Greece's public deficit and debt in late 2009 soon widened to include other euro area countries including Ireland, Portugal and Spain. By late 2010 Greece and Ireland had accepted financial assistance from emergency liquidity funds established by the EU and euro area Member States.

The effect of the banking crisis on countries across the EU demonstrated the interconnection between the banking sector and public finances. It showed the degree to which economies in the EU, and particularly the euro area, are interdependent. In addition, however, the crisis revealed shortcomings in the architecture of the Economic and Monetary Union. An asymmetry between a centralised monetary policy and decentralised fiscal and supply-side policies, combined with a build-up of competitiveness imbalances between Member States, have left the future stability of the euro area in doubt. These problems were exacerbated by a failure of the markets, and Member States themselves, to understand the construction of the euro area. This saw the markets treating the euro area as a single entity without considering, and thus acting on, the financial health of individual Member States (for example, there was very little difference between the cost of Greek and German sovereign debt).

In response the European Commission, supported by the European Council, have put forward a series of legislative proposals that would monitor and coordinate more closely economic policies between Member States. The Commission's proposals focus on two elements: fiscal discipline (through amendments to the Stability and Growth Pact and a new Directive to reinforce domestic fiscal frameworks) and macroeconomic stability (through new mechanisms to monitor and correct macroeconomic imbalances). Most of these proposals apply to all Member States in the EU. Sanctions to enforce these measures can only be imposed against euro area Member States since the need for closer economic cooperation is greater in the euro area.

Although not the full fiscal union in the euro area that some of our witnesses suggested was necessary, the design of these measures is a step in the right direction. Closer economic cooperation can help foster greater economic stability for all Member States in the EU, but particularly for those in the euro area. The proposals relating to fiscal discipline and cooperation should make it easier for Member States in the euro area to arrive at a collective fiscal stance that stands as an equal to a centralised monetary policy. Likewise, the proposals for greater macroeconomic surveillance and coordination should help detect and address excessive imbalances which have the potential to destabilise the euro area. We do, however, stress that the proposals should not result in countries with a current account balance in surplus being asked to make adjustments which will harm their global competitiveness.

We have concerns, however, about the likelihood of these proposals being successfully implemented. Previous attempts to enforce fiscal discipline in the euro area through the Stability and Growth Pact proved ineffective when it became clear that sanctions would not be imposed for breaches of the Pact. Now that they have a better understanding of the construction of the euro area the markets will

play the key role in restraining lax fiscal behaviour by Member States. However, if these new proposals for fiscal discipline and macroeconomic stability are to have any chance of success it is essential that the political authorities of the EU must take them seriously and ensure that they are adhered to. Where necessary they must be reinforced through sanctions that are credible and appropriate. The political resolve of Member States will determine whether these measures to increase the long-term stability of the EU, and the euro area in particular, are successful. We remain sceptical that this will be the case.

Supplementing the Commission's proposals will be a permanent crisis resolution mechanism, created and funded by euro area Member States. We support the establishment of the European Stability Mechanism. In particular, we welcome the inclusion of collective action clauses which will establish a formal mechanism to restructure sovereign debt. This is essential to ensure that the markets act to discipline Member States with irresponsible fiscal policies.

Although the European Stability Mechanism will be compulsory only for Members of the euro area, we believe that there may be times, as with Ireland, when it will be in the UK's interests to participate in financial assistance to Member States in difficulties. We therefore welcome proposals to allow Member States outside the euro area to contribute on an *ad hoc* basis when they wish to do so.

The problems in the euro area have, so far, been contained and no Member State has yet defaulted on its sovereign debt. However, the threat remains and the period until the new crisis resolution mechanism is introduced in 2013 is likely to be fraught despite reassurances from EU leaders. In particular, the willingness of taxpayers in countries subject to the most acute pressures to continue to shoulder the burden of adjustment cannot be taken for granted. If economic growth does not ease this burden they may be tempted to demand that bond-holders share the pain of adjustment, a prospect that could result in fresh financial turmoil. A focus on growth, in addition to fiscal discipline, is therefore essential.

The proposals covered in this report are well on their way to being adopted. However, we note that a number of issues remain unresolved, including: whether or not the time has come for euro bonds to be issued by the euro area as a whole rather than by individual members; the linkages between the new European Systemic Risk Board and the Commission's proposals on macroeconomic surveillance; and the possibility of developing further the proposed permanent crisis resolution mechanism into a European Monetary Fund.

The future of economic governance in the EU

CHAPTER 1: INTRODUCTION

Economic and monetary union

1. The foundations of the euro area were laid in 1988 when the European Council¹ asked Jacques Delors, then President of the European Commission, to set up a committee to study economic and monetary union (EMU), to result in Member States of the EU sharing a single currency. The committee's report concluded that if a single currency were introduced it would require: a greater coordination of economic policies; rules on the size of national budget deficits; and, the creation of a new, independent, European Central Bank (ECB), which would be responsible for the EMU's monetary policy.²
2. The European Council decided to move forward on the basis of the Delors report. The Treaty on European Union, signed on 7 February 1992 at Maastricht, set out the process and timetable for the introduction of economic and monetary union by the end of the century. This was to take place in three stages, which were designed to achieve economic convergence amongst Member States (in terms of inflation, stability of exchange rates and in budgetary positions, as opposed to the standards of living). This would, in turn, bring their economic cycles broadly in line. By the third stage Member States could progress to full economic and monetary union, so long as they achieved specified "convergence" criteria (these were requirements for a certain level of price stability, sustainable government finances, and stable exchange and interest rates). All Member States in the EU (with the exception of the UK and Denmark both of which secured formal opt-outs) and those who have joined since pledged to adopt the euro once they meet these criteria.
3. The third stage started on 1 January 1999. The 11 Member States which had achieved the convergence criteria launched the euro (although initially just for non-physical transactions such as electronic transfers) under a single monetary policy run by the ECB. After a three-year transition period, euro notes and coins were introduced on 1 January 2002.
4. The opt-out from the third stage of EMU secured by the United Kingdom stated that, even if it met the convergence criteria, it did not have to join the euro. Nor did Denmark, following a 'no' vote in a referendum.
5. Within the EU there are now 17 Member States who are members of the euro area, with a single currency and monetary policy. The expectation remains that other Member States without an opt-out will join the euro when they meet the convergence criteria.

¹ A council of all the heads of state or government of the European Union.

² Monetary policy is the regulation of the money supply and interest rates by a central bank, such as the ECB.

Background of the crisis

Deepening problems and piecemeal responses

6. The euro area initially appeared to have avoided the worst of the financial crisis that flared after the collapse of Lehman Brothers in September 2008, and early signs of economic recovery in the second half of 2009 gave grounds for optimism that the European economy was on the mend. But after the revelation in autumn 2009 that Greek public finances were in a much worse state than had hitherto been admitted, the capacity of the Greek government to finance its borrowing deteriorated. In early 2010, a sovereign default in the euro area looked a possibility and, after some hesitation, a rescue package worth €110 billion was put together at the beginning of May 2010, allowing Greece to avoid borrowing on the open market for three years if it so chose.
7. The package was made up of funding from euro area governments and from the IMF (and hence, indirectly, from non-euro area countries, of which the UK is the largest in the EU). This was routinely described as a ‘bail-out’. In fact, this description was inaccurate, as Professor Charles Goodhart, Professor of Economics at the London School of Economics, made clear: “at the end of the day the money is supposed to be paid back with interest. It has not been a bailout; it has been financing”.³
8. In the days after the Greek rescue, there were fears of contagion⁴ spreading to other vulnerable Member States. Ireland, Portugal and Spain were seen as most at risk, and the high level of Italian and Belgian debt were also causes for concern. In an increasingly febrile atmosphere there was speculation that UK public finances might also attract market attention.
9. To provide a bulwark against market speculation, the EU’s leaders agreed in May 2010 to create two temporary funds to provide liquidity to affected economies, the European Financial Stabilisation Mechanism (EFSM) and the larger European Financial Stability Facility (EFSF). These mechanisms will remain in place until 2013. At the time this report was published only one country, Ireland, had received assistance from these funds. The EFSM and EFSF are described in more detail later in this report (chapter 5).

The evolving policy responses

10. The crisis of confidence in the euro area exposed a variety of shortcomings in EU economic governance⁵ which we analyse in detail in chapter 2. As the magnitude of the challenges confronting the EU, and the euro area in particular, became clear in the wake of Greece’s problems, Member States began to consider what kind of governance reforms and capabilities were required, not only to ease the current crisis but to avoid another one.
11. Following the events in Greece in 2009, the Commission worked on legislative proposals to strengthen economic governance, culminating in a package of six proposals for new measures unveiled at the end of September

³ Q 102. See also, for example, QQ 184 (Dr Gros), 354 (Professor Louis)

⁴ Contagion is a scenario where the financial troubles of one economy spread to other economies.

⁵ There is some confusion about the meaning of the term ‘economic governance’ and the related, but distinct, term ‘economic government’. The latter has long been espoused especially by French contributors to the debate on economic and monetary union and would imply the creation of EU (or euro area) institutions for economic policy as a counterpart to the centralised monetary policies of the European Central Bank. Economic governance is a looser term that captures the different arrangements for running the EMU, and for coordinating economic policies within the wider EU.

2010. Four of these are intended to improve fiscal⁶ discipline amongst Member States (see chapter 3), while the other two introduce measures to oversee and correct macroeconomic imbalances⁷ (see chapter 4).

12. In parallel, at its March 2010 meeting, the European Council asked its new President, Herman van Rompuy, to chair a taskforce (made up predominantly of finance ministers of Member States) and put forward proposals for a better approach to budgetary discipline ('the van Rompuy taskforce'). The taskforce presented its final report in October 2010 and its proposals were endorsed by the European Council at its meeting on 28 and 29 October. With one exception⁸ there are only minor differences between the Commission's proposals and the van Rompuy taskforce's recommendations.
13. In addition, the van Rompuy taskforce looked at creating an improved crisis resolution framework. Following its report, Member States agreed at the European Council meeting in October 2010 to establish a permanent crisis resolution mechanism called the European Stability Mechanism (ESM), to replace the *ad hoc* EFSM and EFSF. We consider the proposed mechanism itself in more detail in chapter 5.

The EU 27 vs the euro area

14. In this report we consider and make recommendations on the proposals outlined above. Some of these will apply to all EU Member States, while others will only affect Member States of the euro area. The proposals which only apply to euro area Member States are those dealing with financial sanctions; all Member States are required to follow the same rules and submit to the same surveillance of their economic policies, but only euro area Member States can be punished for not doing so. In contrast, the proposals for a permanent crisis resolution mechanism indicate that it will be funded by, and apply solely to, euro area countries.
15. Mr José Leandro, Adviser on Monetary and Economic Affairs of the Cabinet of the President of the European Council, explained why the proposals for increased economic coordination applied to the whole EU, as opposed to just the euro area; "our economies are intertwined and interlinked ... decisions in one country may affect others". Irresponsible economic policies in one Member State may therefore have a damaging effect on other countries in the EU. Mr Leandro argued that this "spillover effect" needs to be "better taken into account through reinforced coordination".⁹ For those countries sharing a single currency this interdependence is even more pronounced, and hence sanctions are available to compel countries to behave in ways that do not injure their neighbours.

⁶ Fiscal policy relates to government taxation and spending decisions.

⁷ Such imbalances can be of different sorts, although their common characteristic is to affect the overall trajectory of an economy in terms of aggregate output (GDP), employment, competitiveness or the inflation rate.

⁸ The van Rompuy taskforce report includes the statement that financial sanctions "will be first applied to euro area Member States only. As soon as possible, and at the latest in the context of the next multi-annual financial framework, the enforcement measures will be extended to all Member States". A footnote excludes the UK because of the details of its opt-out from EMU. The Commission proposals, by contrast, do not foresee any extension of financial sanctions to non-members of the euro area. See paragraphs 111–114 for further discussion of this issue.

⁹ Q 227

16. Other witnesses gave additional reasons why cooperation should take place among all EU Member States. Dr Uri Dadush, Director of Carnegie’s International Economics Program, argued that economic coordination from countries with independent monetary and exchange rate policy could help those countries inside the euro area, increasing “the probability that shocks emanating in the Eurozone do not spillover onto other EU members”.¹⁰ Mr Benoît de la Chapelle Bizot, Finance Ministry Adviser of the Permanent Representation of France to the EU, meanwhile, argued that economic coordination was required to ensure the effective working of the single market.¹¹
17. Mr Declan Costello, Acting Director for Structural Reforms and Competitiveness in the Directorate General for Economic and Financial Affairs at the European Commission, informed us that the impetus for ensuring that many of the proposals about economic coordination applied to all EU countries and not exclusively to the euro area did not come from the Commission, but in fact was called for by those Member States of the EU hoping to join the euro one day. He explained that “they do not want a gulf to emerge between the surveillance elements and for there to be a wider gap between what we do for euro area countries and non-euro area countries”,¹² since this would then make it harder to enter the euro area at a later date. The Minister echoed this statement: “My personal observation is that there are those Member States outside the Eurozone that are committed to joining it as part of their accession treaty ... they have a particular interest in how the rules of the club develop”.¹³

The UK’s interest in economic governance

18. The UK has an opt-out from Euro membership—it does not therefore need to move towards economic convergence in the same way as most other Member States who are prospectively joining the Euro. We heard, however, several reasons why the UK should be interested in what has frequently been described as the “euro crisis”, when we are not, and are unlikely to be in the near future, members of the euro.
19. Our witnesses were unanimous in stating that the health of the euro area directly impacted upon the UK. Dr Thomas Mayer, Chief Economist at Deutsche Bank, told us that the current liquidity crisis “is first and foremost a Eurozone problem ... but the external, spillover effects of the Eurozone problem turn it into an EU and a global problem”.¹⁴ For example, the UK’s financial sector has substantial investments in euro area countries—a crisis in these Member States could therefore pose a significant threat to financial institutions in the UK.¹⁵ Dr Waltraud Schelkle, Senior Lecturer of Political Economy at the London School of Economics, therefore urged to the UK to recognise that it had “an enlightened self-interest” in ensuring the existence of a stable euro.¹⁶ The UK, through its involvement in the single market, is heavily interconnected with other European economies. In 2009, nearly sixty

¹⁰ EGE 18

¹¹ Q 294

¹² Q 374

¹³ Q 510

¹⁴ Q 138. See also Q 141 (Dr Annunziata)

¹⁵ See paragraphs 26–29 in chapter 2.

¹⁶ Q 122

percent of the UK's trade was with the EU. UK businesses will feel the strain if euro area economies stagnate or shrink.¹⁷ Mr Fabian Zuleeg, Chief Economist at the European Policy Centre, put it succinctly: "interdependence does not stop with different currencies".¹⁸

20. In addition to these arguments for self-interest, we would emphasise another: solidarity. Professor Jean-Victor Louis, Honorary Professor at the Brussels Free University, reminded us that "the European Union is founded and grounded on solidarity"¹⁹ and we believe that the UK should consider, and support where possible, the interests of other Member States in the Union.
21. The Government have stated that they "want to see, and have a strong interest in ... a much stronger and resilient Eurozone".²⁰ They conclude that the UK can play a role in supporting the euro area while at the same time protecting its own interests. At the same time, the Minister states that "there is a fine dividing line between providing support, ideas and advice, and getting stuck in to the detail of the rules when we are not part of the club".²¹ Ms Katinka Barysch, Deputy Director of the Centre for European Reform, expressed this view in stronger terms when she told us, "[the UK] cannot expect to play a leading role in the debates about Eurozone governance, in as much as it is not prepared to be bound by whatever rules come out of that debate".²²
22. **The UK has a strong interest in seeing the euro area stable and prosperous. It is therefore directly affected by developments in the euro area. The Government have a vested interest in ensuring that proposals to increase stability in the euro area through increased economic coordination are effective.** We will therefore consider and make recommendations on both those proposals that will apply to the UK and those that will not. In the latter case, we make these recommendations to inform the debate currently taking place whilst recognising that we are only observers not participants.

The inquiry

23. In this report, we consider the various proposals put forward by the Commission and the van Rompuy taskforce. As they are substantially the same in most areas (see paragraph 12 above) we have based our remarks on the Commission proposals. The exception is Chapter 5 on a permanent crisis resolution mechanism; the Commission has not brought forward proposals in this area so we have based our comments on the texts agreed by the European Council at its December 2010 meeting.
24. The membership of Sub-Committee A which undertook this inquiry is set out in Appendix 1. We are grateful to those who submitted written and oral evidence, who are listed in Appendix 2; all the evidence is printed with this report. The evidence taken as part of this inquiry was taken from October to December 2010. There is a glossary in Appendix 4. We also thank the Sub-Committee's specialist adviser Professor Iain Begg, Professorial Research Fellow at the European Institute, at the London School of Economics. **We make this report for debate.**

¹⁷ Office for National Statistics, *United Kingdom Balance of Payments*, 2010 Edition

¹⁸ Q 336

¹⁹ Q 353

²⁰ Q 505

²¹ Q 513

²² Q 460

CHAPTER 2: UNSTEADY FOUNDATIONS

The roots of the crisis

25. The initial cause of the crisis in the euro area may have been the global banking crisis in 2008, but the severity with which it impacted upon the euro area exposed shortcomings in the existing architecture of the Economic and Monetary Union (EMU). We consider first the role the financial sector played in creating the crisis before looking at the structural problems of the EMU.

The trigger – the financial sector

26. Mr Mark Cliffe, Chief Economist at ING Group, drew our attention to the clear connection between Member States' current fiscal difficulties and the problems of the financial sector in the banking crisis.²³ The root cause was that “the financial crisis has forced European governments to step in to support their banking systems”.²⁴ Ireland's current debt crisis, for example, is a direct result of its government's decision to offer a blanket guarantee to depositors. Many other countries also bailed out or supported their banks, escalating the level of public debt across Europe dramatically. In some cases this led to concerns that countries would not be able to service their debt, which in turn would then result in losses for banks holding the debt. Dr Marco Annunziata, Chief Economist at Unicredit Group, expanded on how this threatens the EU as a whole:

“Part of the concern that we have about the current situation in Ireland, Greece, and Portugal, is that the sovereign debt issued by these countries is being held in significant amounts by banks in other member countries—in the Eurozone ... but also outside the Eurozone, as in the UK. This implies that shocks and instability in one member country can no longer be isolated and contained to that country; they spill over”.²⁵

27. Dr Daniel Gros, Director of Centre for European Policy Studies, argued that this was a key issue and noted that “many people ... did not put enough emphasis on strengthening the banking system”.²⁶ He would “trade the entire van Rompuy package on economic governance against a couple of things on the banking side”.²⁷
28. Mr Costello noted that the Commission was working to create “a competitive banking system, one which avoids a recurrence of where, in countries such as Ireland, their share of the banking system goes beyond their capacity to support it”.²⁸ Supporting this goal was its work on a financial package of supervisory regulations and bodies to control the behaviour of the banking sector. Financial supervision lies outside the remit of this inquiry.²⁹ We note, however, that improvement and reform of financial supervision will be a vital part of measures to support the euro area in the long-term, for

²³ Q 62

²⁴ Q 53

²⁵ Q 127

²⁶ Q 170

²⁷ Q 171

²⁸ Q 385

²⁹ We have covered some of this material in a previous report however. See European Union Committee, 14th Report (2008–09): *The future of EU financial regulation and supervision* (HL Paper 106)

example the need to remedy the under-capitalisation of certain European banks. The connection between financial supervision and the wider economic governance framework covered in this report will take place through the European Systemic Risk Board (ESRB). We consider the ESRB in more detail in chapter 4.³⁰

29. **The interconnection of the sovereign debt and banking sectors was one of the principal elements that contributed to the current crisis. Recent events have demonstrated the debilitating effect on public finances of transferring private debt to the public sector. Mechanisms must be put in place to control the behaviour of banks and to ensure that the public sector does not end up carrying the cost of failing banks. These must be effective. We also note the risk of a vicious circle whereby a sovereign debt crisis puts pressure on banks, including UK banks.**

A fragile halfway house

30. While the banking crisis may have triggered the current crisis in the euro area, our witnesses pointed to a series of structural failings in the construction of the EMU which explain the severity with which euro area countries were affected. The first is an asymmetry at the heart of the EMU; that while monetary policy is centralised, fiscal and supply-side³¹ policies are left to the discretion of Member States. This can mean that the collective decisions of euro area countries do not necessarily add up to a coherent whole. Professor Goodhart told us that “the Eurozone is a difficult and fragile halfway house because it combines monetary centralism while leaving fiscal and indeed wider political issues to the individual nation states”.³² Since political and fiscal centralisation had not followed monetary union, “the current crisis that we see is a natural, indeed almost inevitable, result”.³³
31. In unitary states (a nation governed as a single unit where all sovereignty lies with the central government, for example Britain), as in federations (where the central government shares sovereignty with sub-national units, for example the USA), the central government typically has a large budget and fiscal policy acts in tandem with monetary policy to maintain macroeconomic stability. Typically, the central budget takes the strain in a downturn and budget deficits increase because tax revenues fall and public expenditure rises. A central government budget can also redress regional imbalances within a country: if a region encounters difficulties, it will raise less from national tax instruments and generally expect an increased share of national public spending. In the EU, however, the quasi-federal budget is very small as a proportion of GDP (1%, compared with the some 20% or more found in many federations), must always balance (it cannot therefore go into deficit) and is expressed in predominantly multi-annual spending programmes with little flexibility. Consequently it is unable to play a significant role either in automatic stabilisation or in redressing macroeconomic imbalances.
32. Other witnesses described further problems flowing from the very limited form of fiscal union in the euro area. Dr Mayer argued that a central bank alone could not ensure stability in a financial crisis—it needed help from

³⁰ See paragraphs 171–177

³¹ Policies affecting, *inter alia*, the labour market, social protection, research and development, and skills.

³² Q 82

³³ Q 83. See also, Q 486 (Professor Buiter), EGE 6 (Professor Gortsos)

fiscal authorities. A collective fiscal response to crisis can only be achieved by coordinated action by all the members of the euro area. Such coordination is very difficult to achieve, especially when rapid action is required.³⁴ Professor Willem Buiter, Chief Economist at Citigroup, suggested that by giving up monetary autonomy Member States had lost the ability to provide a lender of last resort able to supply liquidity to its financial sector. Traditionally, this function was assigned to national central banks at the discretion of the national government, but the power of Member States to demand such lending has gone because the European Central Bank is far more independent of political authorities than any national central bank could hope to be. He suggested that this meant that “no national government, with the possible exception of Germany ... will ever be able to compel the ECB very easily into providing the liquidity that it needs to prevent a potential default”.³⁵

33. In short, there is an asymmetry in the EMU between a powerful and centralised monetary policy and a fragmented and inadequately coordinated fiscal policy.

A problem of competitiveness

34. Other witnesses pointed to a different problem: a growing disparity in competitiveness between different states within the euro area. Dr Dadush, for example, told us that “The fundamental cause of the Eurozone crisis ... is the build-up over a decade of large macroeconomic imbalances and the loss of competitiveness of stricken countries”.³⁶ As Mr Leandro explained, “competitiveness imbalance means, for example, big divergences in current account balances” where Member States were “importing more than they were exporting and were losing competitiveness”.³⁷
35. There are two main reasons for these macroeconomic imbalances. Firstly, a single currency has meant a single base interest rate across the euro area. This in turn permits private credit to be available in relatively inflation-prone economies like Greece at the same nominal interest rate as much stronger economies such as Germany where inflation rates are lower. This leads to credit bubbles and unsustainable levels of private borrowing. Dr Dadush explained: “the competitiveness loss was made worse ... by a common monetary policy that was too loose for fast-growing and/or higher inflation countries in the European periphery and too tight for Germany and other countries in the European core”.³⁸
36. Secondly, when Member States became relatively less competitive “euro membership prevented these countries from devaluing their currencies to regain competitiveness”.³⁹ The European Trade Union Confederation (ETUC) described the other side of the equation, telling us that when Germany started a process of competitive disinflation (i.e. deliberately holding wage increases below the rate of inflation), “whereas in the past, the

³⁴ Q 130

³⁵ Q 485

³⁶ EGE 18

³⁷ Q 244

³⁸ EGE 18

³⁹ EGE 7 (Open Europe). See also, EGE 13 (Sir Martin Jacomb)

gains ... were simply neutralised by an appreciation of the national currency ... this was no longer the case under monetary union”.⁴⁰

37. Dr Buitter felt that there was nothing inherently worrying about some countries remaining uncompetitive in the sense of having lower productivity than their peers. The result would be “they will simply be poorer”.⁴¹ For others such as Open Europe, these “chronic gaps in competitiveness” are the “most critical shortcoming of the euro area”,⁴² while Dr Annunziata stated that in addition to stricter fiscal rules “it is equally important to foster convergence in competitiveness”.⁴³ Professor Jean Pisani-Ferry, Director of Bruegel (a European think tank), explained bluntly: “a number of countries in the euro area have lost competitiveness in a major way ... These countries will have to regain competitiveness. That is an imperative for everyone. If they do not, they will be permanently in a situation of high unemployment and struggling with growth. That is a dangerous situation for everyone”.⁴⁴ It would mean a sizeable number of countries depressing demand in the euro area as a whole.

Market failure

38. These structural problems were exacerbated by a failure by the markets, and Member States themselves, to understand the construction of the euro area. The markets treated all Member States within the euro as if they posed the same risk, which given Germany’s economic strength meant that the spread on sovereign bonds was extremely limited. The result, as Professor Goodhart noted, was that until late 2009 “the general belief was that there was really no sovereign risk in Eurozone countries”.⁴⁵ The markets assumed that the construction of the euro area would lead to responsible fiscal behaviour (through the Stability and Growth Pact) and a bail-out for any Member States which did encounter financial difficulties.⁴⁶ As Professor Buitter explained, “the markets got it radically wrong in the run-up to the financial crisis ... they underpriced credit risks generally and they undoubtedly will get it wrong again”.⁴⁷ Inflation-prone economies were able to access market funding far too cheaply, and without a spread in sovereign bond rates the market did not play its usual role in restraining irresponsible government behaviour. We consider the role of the market as a means of disciplining governments in chapter 3.⁴⁸

Looking to the Future

Fiscal Union?

39. The two structural problems we identify above (paragraphs 30–37) remain sources of destabilising pressures in the euro area. This led some witnesses to

⁴⁰ EGE 2

⁴¹ Q 500. See also Q 106 (Dr Schelkle)

⁴² EGE 7

⁴³ EGE 9

⁴⁴ Q 284. See also, Q 244 (Mr Leandro)

⁴⁵ Q 86

⁴⁶ To date, of course, the euro area has indeed provided financing for any Member State in financial difficulties.

⁴⁷ Q 495

⁴⁸ See paragraphs 79–82

ask “whether monetary union among sovereign states requires some sort of fiscal union”.⁴⁹ The term “fiscal union” is a generic term, and there have been a range of suggestions as to what such a union might entail. The suggestions range from a limited fiscal union where a euro area institution coordinated individual nations’ fiscal policies, to a full fiscal union, which Dr Annunziata described as “a central authority in Brussels [that] would to a large extent run fiscal policy for the whole of the euro area, in a system similar to that of the US”.⁵⁰ This would involve cross-border transfers of taxpayers money to pay for public services, but would also create a system of stabilisation that would mitigate regional imbalances.

40. Many witnesses felt that this would be beneficial; Dr Annunziata called “full fiscal integration” the “simplest solution”,⁵¹ while Mr Cliffe talked of the “fiscal transfers and burden sharing that would make it [the euro area] sustainable in the long run”.⁵² Professor Goodhart said that “it would be a lot easier for all, in terms of the operation of the system, if the centralised monetary system was coordinated with a much more centralised fiscal policy”.⁵³ The ETUC went even further, stating that “you need a European fiscal policy, or as you call it a closer fiscal union, to get the single currency to survive”.⁵⁴ Mr Mats Persson of Open Europe agreed and stated that to overcome the difference in competitiveness “you really need a full-blown fiscal union with continuous transfers”.⁵⁵
41. Although it seems that, from an economic point of view, full fiscal union might be desirable, our witnesses were strongly of the view that this would be politically impossible to achieve at present, or at any time in the near future.⁵⁶
42. An intermediate form of fiscal union might be to enhance the scope for collective borrowing by the euro area, so as to make it easier for fiscally vulnerable euro area countries to finance their deficits at an acceptable cost. This would imply accepting joint liability for a certain level of sovereign borrowing. Recent proposals for jointly issued eurobonds move in this direction. In practice, this is what the EFSF offers as a short-term expedient, but proposals to issue eurobonds that could be used to finance sovereign debt of all Member States have met considerable resistance. We consider these proposals further in chapter 5, but conclude that they are likely to represent a greater degree of fiscal integration than Member States are willing to accept at present.⁵⁷

A feasible alternative

43. It seems clear that a full fiscal union is unfeasible, and a more limited version unlikely. The direction taken by the Commission and the governments of the EU since the crisis has therefore been to propose new mechanisms, and to strengthen existing ones, to coordinate economic policies more closely to lessen the difficulties created by the absence of a fiscal union and a build-up of

⁴⁹ Q 452

⁵⁰ Q 127

⁵¹ Q 127

⁵² Q 64

⁵³ Q 98

⁵⁴ EGE 2

⁵⁵ Q 430

⁵⁶ For example, QQ 489 (Professor Buiter), 98 (Professor Goodhart), 294 (Mr de la Chapelle Bizot)

⁵⁷ See paragraphs 211–217.

competitiveness imbalances between Member States. Mr Mark Hoban MP, Financial Secretary at HM Treasury, illustrated this when he stated: “it is clear from this crisis that there needs to be much greater coordination between states in the Eurozone than there has been in the past”.⁵⁸

44. We heard scepticism from some witnesses that mere coordination, as opposed to union, would be sufficient. Mr Persson, for example, told us that “fiscal coordination ... might help a little bit, but it can only take you so far”⁵⁹, while Professor Christos Gortsos, Panteion University of Athens, felt that “in a long-term perspective ... the only viable solution” is a “single fiscal policy ... which could efficiently support the monetary unification”.⁶⁰ Others, however, were supportive. Ms Barysch felt that “a monetary union can work if the constituent nations agree on very close economic policy coordination and the enforcement of very strict rules”.⁶¹ Dr Annunziata agreed⁶² and endorsed the direction taken by the Commission and by the van Rompuy taskforce.⁶³
45. Overall, we felt that witnesses were uncertain as to whether closer fiscal coordination by Member States would be sufficient to overcome destabilising pressures within the EMU. Mr Hoban perhaps summed up the balance of the views when he stated that the Commission’s proposal created “the right framework”, but that “it depends how Member States react to this”.⁶⁴ We discuss the Commission’s proposals for greater economic cooperation in relation to fiscal policy and competitiveness imbalances in detail in chapters 3 and 4.
46. **There are flaws in the concept and design of the euro area, caused by an asymmetry between a centralised monetary policy and decentralised fiscal and supply-side policies, and by a build-up of competitiveness imbalances between Member States. The simplest solution, a greater centralisation of fiscal policy leading to a full fiscal union, is politically unfeasible at the present time. A more limited form of fiscal union consisting of collective borrowing by the euro area is perhaps more plausible. Given that there has been no general agreement on this issue among Member States, however, it is unlikely to be more than an incomplete alternative in the near future. The package put forward by the Commission and the governments of EU Member States (through the Van Rompuy task force) opts for a greater coordination of fiscal and economic policies among euro area countries to overcome these flaws. If these proposals work well, they should make it easier for Member States of the EU, and particularly the euro area, to arrive at a collective fiscal stance that is compatible with a single monetary policy.**

A break-up?

47. While the success or otherwise of these proposals will determine whether the euro area is able to survive in the longer term, some commentators have questioned whether it will be able to survive intact the immediate challenges of the financial crisis. Mr Cliffe informed us that while “the political will to

⁵⁸ Q 520

⁵⁹ Q 430

⁶⁰ EGE 6

⁶¹ Q 452

⁶² Q 128

⁶³ EGE 9

⁶⁴ Q 523

sustain monetary union is still very strong”,⁶⁵ “the markets now put a significantly higher probability on at least some exits from monetary union over the next few years”.⁶⁶

48. We heard two scenarios where a Member State in financial difficulties might leave. On the one hand a state could feel it would be to its economic advantage to leave, regaining the ability to set its own interest and exchange rates. Alternatively, it might be asked to impose “potentially politically intolerable fiscal austerity measures” to remain in the euro.⁶⁷
49. Witnesses suggested that a voluntary exit by a country in difficulties was highly unlikely since countries were better off in the euro than out.⁶⁸ They noted, however, that the fiscally strong countries in the euro area might leave, splitting the euro area in two. Professor Buiter put this view: “The only real risk for the euro area falling apart is not the fiscally weak and uncompetitive countries leaving; they’d be mad. It is the fiscally strong and competitive countries leaving”.⁶⁹ Mr Cliffe and Mr Persson told us that it had been suggested that the Germans, perhaps along with some other core euro area members, might wish to leave at some point.⁷⁰ This view, however, was dismissed by Ms Barysch: “when the initial debate [in Germany] has calmed down a bit, you will find a nation that remains very much committed to the European project because it doesn’t see an alternative”.⁷¹
50. Sir Martin Jacomb, Chairman of the Canary Wharf Group, argued that the euro area would survive simply because “the political imperatives to keep it going are too great”.⁷² Professor Buiter concluded that he was “optimistic about the survival of the enterprise [the euro]”, albeit “not about the elegance with which that survival will be achieved”.⁷³
51. It is important to recognise that withdrawal from the euro area would not be an easy exercise. It should not be confused with leaving the exchange rate mechanism (as the UK and others did in the early 1990s), because of both practical difficulties involved in recreating a national currency and legal constraints. Professor Louis stressed to us that “the monetary union has been conceived as irreversible”: there is no formal, legal process for a country to either leave the euro, or to be expelled from the euro.⁷⁴ According to Phoebus Athanassiou, Legal Counsel of the European Central Bank, “a Member State’s exit from EMU, without a parallel withdrawal from the EU, would be legally inconceivable”.⁷⁵
52. The Minister refused to speculate on whether the euro area would survive in its current form, simply noting that “there is no mechanism for countries to leave the euro”, and adding that “it would be quite a big step for that to happen”.⁷⁶

⁶⁵ Q 64

⁶⁶ Q 51

⁶⁷ Q 51 (Mr Cliffe)

⁶⁸ QQ 55 (Mr Cliffe), 132 (Dr Mayer), 134 (Dr Annunziata)

⁶⁹ Q 494

⁷⁰ QQ 51, 411

⁷¹ Q 462

⁷² Q 146. See also Q 63 (Mr Cliffe)

⁷³ Q 502

⁷⁴ Q 350

⁷⁵ Athanassiou P, *Withdrawal and expulsion from the EU and EMU: some reflections* (2009), ECB Legal Working Papers Series No. 10

⁷⁶ Q 506

53. Professor Goodhart stated that “the costs, political as well as economic, to a country voluntarily leaving the euro are huge”.⁷⁷ Mr Cliffe told us that any benefits for a country leaving the euro “would come along with considerable costs” and “there would be severe transitional costs for any members leaving the monetary union”.⁷⁸ In a paper for the ING Group, *EMU Break-up: Quantifying the Unthinkable* he concludes that “the numbers are debatable, but the impact would undoubtedly be traumatic”. The trauma would be most severe for those countries leaving the Euro, but other countries in the euro area and the wider EU would also suffer, and the report finishes with a warning that “this is perhaps something that policy-makers may care to reflect upon when they blithely talk of exit from EMU as being a policy option”.⁷⁹ It is perhaps worth noting that those countries currently in difficulties make up only a small proportion of the euro area’s combined gross domestic product (see Appendix 6).
54. **We believe that the political imperatives holding the euro area together are strong, and we do not think it is likely that any country, whether fiscally weak or strong, will try to leave voluntarily. We do, however, recognise that it is now conceivable that a country could be forced to leave the euro, or that the euro area could separate into two parts.**
55. **Any break-up of the euro area would not only be economically and politically costly for those Member States leaving the euro, but would have a damaging impact on all members of the euro area and the wider EU, not least the UK.**

Governance within the euro area

56. The role of the Eurogroup (a body composed of finance ministers of the Member States of the euro area), has grown significantly since its formation in 1998. It came into existence as an informal body, although it has since acquired formal recognition in the Lisbon treaty.⁸⁰ Its primary role has been to agree common positions in relation to ECOFIN⁸¹ decisions that pertain solely to the euro area. However, it also offers a forum in which euro area finance ministers could review economic conditions and debate policy choices.
57. There have been suggestions that the Eurogroup might be given a more official role among the EU institutions. We wondered whether this might create a risk of marginalisation for those Member States who are not in the euro. The Eurogroup, since it contains a majority of Member States of the EU, can effectively decide issues pertaining to the whole EU before they can be discussed at ECOFIN. This perception was strengthened by President Sarkozy’s calls for a unified economic government of the Eurogroup,⁸² and by recent agreement on a “Pact for the Euro” (see paragraphs 190–193).
58. Professor Louis reminded us that Mr Blair had opposed the idea of strengthening the formal role of the Eurogroup as it would have been “a farce” to have a decision-making body without the presence of the UK. The members of the Eurogroup at the time, meanwhile, saw this move as

⁷⁷ Q 99. See also QQ 404 (Professor Copeland), 409 (Mr Persson)

⁷⁸ Q 51.

⁷⁹ ING, *EMU Break-up: Quantifying the Unthinkable* (2010), p 16

⁸⁰ Q 336 (Mr Zuleeg)

⁸¹ The Economic and Financial Affairs Council. It is composed of the finance ministers of Member States.

⁸² See, for example, “Czechs reject Sarkozy’s Eurogroup presidency plans”, *EurActiv.com* (24 October 2008)

potentially “too divisive”.⁸³ Mr Zuleeg thought however that, since the Eurogroup was now in the Treaties, “it has an official role ... it has responsibility for coordinating Eurozone members”.⁸⁴

59. Ms Barysch also told us that the Eurogroup already exercised a leadership role. She noted, though, that Germany was reluctant to “institutionalise” the Eurogroup since it was dominated by southern European countries, in contrast to the EU 27 where their presence was balanced by the more “liberal and fiscally responsible” northern and eastern European countries.⁸⁵ The Government were clear that “ECOFIN Council should retain its primary role as the forum for discussion of EU macroeconomic and fiscal policies”. They would not, therefore, “support the creation of new euro area institutions” that could undermine its role.⁸⁶
60. **We did not receive compelling evidence to suggest that the Eurogroup needed a more formal role and position. Such a move could have implications for the UK and for the position of ECOFIN as the ultimate decision-making body on financial and economic matters. Recent decisions by the Eurogroup to adopt a “Pact for the Euro” have brought these implications into sharp relief.**

Speaking with a single voice

61. While the euro area is a single monetary union, a multiplicity of voices have spoken on its behalf during the current crisis.⁸⁷ On occasion, different participants have given conflicting comments or made remarks on behalf of one euro area country without ensuring that they had the support of other Member States. This has had unfortunate results at times. As an example, Mr Leandro, speaking to us about private sector involvement in sovereign bonds⁸⁸ admitted that “there have been a lot of misunderstandings about this ... Some say this is one of the reasons we are seeing the turmoil in the markets”.⁸⁹ Professor Buiters emphasised this point: “there is a huge communication deficit between the markets and European political leaders, especially but not only in Germany” and argued that politicians “do not communicate well with markets”.⁹⁰
62. Mr de la Chapelle Bizot put the need succinctly: “It will be really important to show the rest of the world unity at the level of the European Union. If the markets ... could consider that there is no unity, no impetus, no consensus to go forward and tackle the financial difficulty inside the European Union or the Eurozone, we will, together, face real difficulties”.⁹¹
63. **There is a clear need for the euro area to speak with one voice in crisis situations. It is essential that it improves the speed and clarity with which it communicates with the markets.**

⁸³ Q 348

⁸⁴ Q 336

⁸⁵ Q 459

⁸⁶ EGE 14

⁸⁷ Q 456

⁸⁸ See paragraphs 199–200 in Chapter 5 for further explanation of this issue.

⁸⁹ Q 261

⁹⁰ Q 495

⁹¹ Q 304

CHAPTER 3: FISCAL DISCIPLINE

64. Since 1997, the Stability and Growth Pact (see Box 1 below) has been the instrument through which the EU seeks to ensure fiscal discipline by Member States. The Commission's package of economic governance includes three Regulations that aim to broaden the SGP's surveillance of fiscal policy (see Box 2 on page 26), and strengthen the sanctions regime (see Box 3 on page 29). In addition, the Commission has proposed that Member States should incorporate certain rules into their domestic fiscal structures to reflect principles agreed at a European level (see Box 4 on page 37).

Fiscal surveillance: the Stability and Growth Pact

65. The SGP requires Member States to comply with two fundamental rules: keeping public accounts close to balance or in surplus and avoiding a current deficit in excess of 3% of GDP, with some latitude in periods of recession. Although a debt criterion of keeping public debt below 60% of GDP has been applied as one of the Maastricht criteria for acceding to the euro, it was not included in the SGP as an explicit target. Sanctions are available under the Pact to enforce the rules (for euro area countries only).

BOX 1

The Stability and Growth Pact

The Stability and Growth Pact (SGP) was established in 1997 as a rule-based framework for the coordination of national fiscal policies in the economic and monetary union (EMU), established to ensure responsible fiscal behaviour among Member States. The rule at the centre of the Pact is that Member States should aim for a budgetary position close to balance or in surplus over the medium term; in normal times, they are also required to ensure that budget deficits do not exceed 3% of GDP. The Pact consists of a preventive and a corrective arm.

The SGP applies to all EU Member States, aside from the provisions for financial sanctions (see below) which apply only to those nations in the euro area. This is because, with the exception of the UK and Denmark which have an opt-out from membership of the euro (see paragraph 2), all Member States are expected to join the euro as soon as they fulfil the convergence criteria. They should therefore be implementing economic policies that will bring them into closer economic convergence with the euro area.

The preventive arm

Under the provisions of the preventive arm, Member States must submit annual stability or convergence programmes, showing how they intend to achieve or maintain sound fiscal positions in the medium term. The Commission undertakes an assessment of these programmes, while the Council expresses an Opinion on them. The preventive arm includes two policy instruments.

- The Council, if asked to do so by the Commission, can address an **early warning** to a Member State to prevent the development of an excessive deficit.
- The Commission can directly address **policy recommendations** to a Member State about the broad implications of its fiscal policies.

The corrective arm

The corrective part of the Pact contains the **excessive deficit procedure** (EDP). The EDP is triggered if a Member State's deficit goes above a 3% of GDP threshold set out in the Treaty. If the Council decides that the deficit is excessive,

it issues recommendations to the Member State concerned to correct the excessive deficit, and gives a time frame for doing so. Non-compliance with the recommendations triggers further steps in the procedures which, for euro area Member States only, would eventually involve the possibility of financial sanctions. These could culminate in fines of up to 0.5% of GDP.

66. Its operation, however, has come under critical scrutiny across Europe. This is partly because of problems in enforcement, and these problems are considered in more detail below. In addition, however, it is clear that the design of the pact was flawed. This can be most clearly seen in the context of countries such as Ireland which before the financial crisis were in apparently sound fiscal situations.
67. The main criticism about the surveillance of the existing SGP has been that it focused almost exclusively on the deficit criterion of the SGP, allowing some Member States to run debt levels well above 60% without being penalised.⁹²

The Commission's proposals

68. Against this background, the Commission's proposals aim to reinforce the SGP's surveillance. The suggested changes are explained in detail in the box.

BOX 2

Proposed changes to surveillance under the Stability and Growth Pact

Regulation amending the legislative underpinning of the preventive part of the Stability and Growth Pact (amendment of Council Regulation 1466/97)⁹³

This proposal would implement a new principle of 'prudent fiscal policy-making', with the aim of ensuring that extra revenues in positive economic circumstances are not simply spent but are allocated towards debt reduction.

If a Member State is judged not to be running prudent fiscal policies it could lead to the Council making a formal recommendation to change its policies. For euro area Member States, this recommendation could be enforced by a financial sanction (see Box 3 for details).

Regulation amending the legislative underpinning of the corrective part of the Stability and Growth Pact (amendment of Council Regulation 1467/97)⁹⁴

The amendments to this regulation would speed up the stages of the excessive deficit procedure (EDP). In addition to the 3% deficit criterion, the EDP would be triggered if a country's public debt exceeded 60% of GDP. Member States will be benchmarked as to whether they can sufficiently reduce their debt. Those whose debt exceeds 60% of their GDP should take steps to reduce it at a satisfactory pace, defined as a reduction of 1/20th of the difference with the 60% threshold over the last three years.

The proposal also sets out in detail the process by which sanctions would be applied to euro area countries if they failed to follow recommendations issued to them under the EDP.

Both these Regulations will apply to the UK, although the sanctions specified under Regulation 1467/97 are only applicable to euro area Member States.

⁹² EGE 14 (HM Treasury)

⁹³ COM (2010) 526

⁹⁴ COM (2010) 522

The preventive arm of the SGP

69. We heard relatively little evidence on the proposed reform of the preventive arm of the SGP, which aims to ensure that Member States run prudent fiscal policies over the medium-term by limiting annual expenditure growth to “medium-term rate of growth of GDP”. Dr Marek Dabrowski, Centre for Social and Economic Research, while agreeing that the rules “go in the right direction”, noted that determining this growth rate in the current unstable economic environment “appears almost impossible and will become a subject of political bargaining”.⁹⁵ Professor Louis told us that the revised preventive arm of the SGP was a “substantial complement” to what was possible under the original framework.⁹⁶ More importantly, the proposals would allow sanctions to be imposed on Member States at an early stage under the preventive arm, rather than just under the corrective arm; we consider this aspect in more detail later in this chapter.

The corrective arm of the SGP

70. The reform of the corrective arm of the SGP introduces an explicit debt threshold into the pact, thereby ensuring that it would be used as a trigger in the excessive deficit procedure. Our witnesses were generally in favour of this proposal⁹⁷ although some also identified potential problems associated with it. Professor Jagjit Chadha, University of Kent felt that there were “significant information hurdles to overcome in assessing the public debt position of any country”,⁹⁸ and said that an increase in debt might not simply be the result of poor government policies. The Government, while “strongly” supporting the introduction of a debt threshold, also suggested that debt was a complex issue, and that Member States needed to maintain some discretion on how they manage it. The Government had concerns about the Commission’s proposals to benchmark how quickly countries are reducing their debt, arguing that the main consideration should be whether a country’s debt “is on a downward trajectory”, rather than the pace at which it is happening.⁹⁹ Dr Dabrowski also raised concerns about setting a numerical target for debt reduction.¹⁰⁰
71. Mr Leandro acknowledged that these issues were discussed by the Task Force and stated that these factors would be taken into account and an “intelligent assessment” made of whether the country is on the right or wrong path.¹⁰¹
72. **We welcome the Commission’s proposals to introduce an explicit public debt criterion, alongside the deficit criterion, into the excessive deficit procedure under the SGP. We consider it important that the most heavily indebted countries move rapidly to reduce their level of public debt. We do not, therefore, share the Government’s concerns about a numerical benchmark for reducing debt under the EDP. We believe that having such a benchmark will be an effective way of**

⁹⁵ EGE 10

⁹⁶ Q 357

⁹⁷ EGE 9 (Dr Annunziata), EGE 14 (HM Treasury), EGE 18 (Dr Dadush)

⁹⁸ EGE 5

⁹⁹ EGE 14

¹⁰⁰ EGE 10

¹⁰¹ Q 251

exerting pressure on heavily indebted countries to ensure that the higher a country's level of debt the faster it is reduced.

Statistics

73. The effective monitoring of Member State's fiscal policies, and the triggering of the excessive deficit procedure, clearly relies on the accurate reporting of deficit and debt statistics. Eurostat, the overseeing EU institution, does not have the power to dictate how national statistics are produced.¹⁰² After repeated problems with Greek government statistics, in particular after Greece revised its government deficit and debt data substantially between the 2 and 21 October 2009 at the start of the euro area financial crisis,¹⁰³ the Commission proposed legislation to enhance the powers of Eurostat. This was passed in summer 2010.¹⁰⁴
74. The IEA made a strong case for reliable, objective and timely economic statistics, concluding that "for the euro to survive, the institutional framework controlling the quality of economic information must be improved". It suggested that the poor quality of some Member States' statistics was well known by Eurostat even before the Greek crisis. However, published concerns about the quality of Greek data "had no discernible impact on the bond ratings until 2009".¹⁰⁵ We have considered this issue in our scrutiny work.¹⁰⁶
75. The van Rompuy taskforce report contains recommendations to improve the quality of statistics that go beyond the recent legislation. Mr Leandro explained that the taskforce felt that the Commission's proposal to reinforce the powers of Eurostat was insufficient, and that "steps needed to be taken to reinforce the reliability, competence and independence of national statistics systems".¹⁰⁷
76. Asked about the detail of the Taskforce's proposal, Mr Conrad Smewing, Head of the Fiscal Policy Team at HM Treasury, informed us that discussions in the taskforce had concentrated on higher level reforms to the SGP and professional standards of statisticians.¹⁰⁸ Mr Laurence Copeland of the Institute of Economic Affairs, commented that "governments are just as prone to gaming rules as banks, multinational corporations or, indeed, individuals. If there are rules, we have to make them as game-proof and robust as possible".¹⁰⁹
77. **Accurate and comparable statistics are essential if there is to be effective economic coordination between Member States. The Commission's proposal to enhance the powers of Eurostat, adopted in 2010, was a good start. The van Rompuy taskforce report suggested a need for measures to improve the quality of national statistical data and to strengthen further the Eurostat's powers. We agree, and recommend that the Commission should bring forward legislative**

¹⁰² EGE 8

¹⁰³ Report on Greek Government Deficit and Debt Statistics, European Commission, COM (2010) 1 final

¹⁰⁴ Q 387. Council Regulation (EU) No 679/2010

¹⁰⁵ EGE 8

¹⁰⁶ *Correspondence with Ministers December 2009–April 2010*

<http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/cwmsuba7april.pdf>

¹⁰⁷ Q 223

¹⁰⁸ Q 3

¹⁰⁹ Q 442

proposals to do so to ensure that measures to improve economic governance are not undermined by unreliable statistics.

Sanctions under the SGP

78. The Government have been clear that “sanctions as defined under the Treaty apply only to the euro area”.¹¹⁰ As a result, this proposal will not apply to the UK, and the UK will not have a vote in Council on decisions to apply sanctions. We recognise, however, that the success of these proposals will have direct implications for the health of the euro area as a whole. As we concluded in Chapter 1,¹¹¹ the continued health of the euro area is of direct interest to the UK, and we make our recommendations, therefore, to inform the debate currently being held at a European level on this proposal.

BOX 3

Enhancing sanctions under the Stability and Growth Pact

Regulation on the effective enforcement of budgetary surveillance in the euro area¹¹²

The Regulation would amend the existing sanctions procedure, detailed above, to introduce a new set of graduated financial sanctions for euro area member-states. In particular:

- Under the preventive arm of the SGP, an interest-bearing deposit of up to 0.2% of GDP could be imposed for significant deviations from the principle of ‘prudent fiscal policy making’;
- Under the corrective arm, a non-interest bearing deposit of up to 0.2% of GDP would be imposed if a Member State was placed in the EDP. This would be converted into a fine in the event of non-compliance with the recommendation to correct the excessive deficit.

The regulation proposes the use of reverse majority voting when imposing these sanctions. This would mean that the Commission’s proposal for a sanction will be considered adopted unless the Council overturns it by qualified majority.¹¹³

This Regulation will not apply to the UK.

Are sanctions needed?

79. Some witnesses felt that the role sanctions would play in promoting sensible fiscal policies would be overshadowed by the disciplining effects of the markets.¹¹⁴ Mr Hans Martens, Chief Executive at the European Policy Centre, for example, commented, “it is clear that whatever sanctions come out of this system, they are nothing compared with the sanctions that the market imposes”, explaining that when the markets see irresponsible fiscal behaviour, “the interest rate on government debt, and perhaps on private debt, goes up so substantially” that it becomes “the worst sanction” a

¹¹⁰ EGE 14

¹¹¹ See paragraph 22

¹¹² COM (2010) 524

¹¹³ Only the Member States of the euro area, other than the state on which sanctions would be imposed, may vote. A Qualified Majority must comprise at least 55% of the voting states, representing at least 65% of the total population of the voting states (see Article 8 of the draft Regulation and Article 238 (3)(a) TFEU).

¹¹⁴ QQ 453 (Ms Barysch), 202 (Dr Gros)

Government could face.¹¹⁵ The Minister agreed: “Markets can often exert more effective and speedier discipline than political processes”.¹¹⁶

80. Yet the markets have not been effective at restraining irresponsible fiscal policies up until now. We described in Chapter 2 the markets’ failure to assess correctly the risks posed by different Member States in the euro area.¹¹⁷ While the markets may have “learnt their lesson”, as Mr Cliffe informed us¹¹⁸, and will not make the same mistake again, it is clear that Member States are not willing to rely upon the markets alone to enforce fiscal discipline. The Treasury stated clearly that Member States themselves must be willing to enforce the SGP: “for the Stability and Growth Pact to be effective and credible, the EU must be clear that it is willing to take action against Member States who do not comply with its terms”.¹¹⁹
81. **After the events of the last year, the markets can no longer assume that all sovereign debt issued by euro area Member States bears the same risk. They will therefore play the key role in restraining fiscal irresponsibility by Member States by charging higher interest rates for countries deemed to have lax fiscal policies. The markets have not, however, always proven effective at enforcing responsible fiscal behaviour and further mechanisms to reinforce compliance must also be available.**
82. **The rules of the SGP must be enforced by Member States acting together through the Council. Repeated breaches by Member States in the past are proof that compliance is not otherwise guaranteed.**

Making sanctions credible

83. While in theory there have always been sanctions available for enforcing the Stability and Growth Pact, Mr de la Chapelle Bizot suggested that “in reality there were no sanctions for breaching the Stability and Growth Pact”.¹²⁰ The Commission’s proposals, therefore, are an attempt to rectify this situation, by making the sanctions plausible. As Mr Zuleeg suggested, the Commission is “trying to give the stability and growth pact teeth”.¹²¹
84. We heard two reasons why the previous sanctions process had been ineffective: the initial sanctions were too severe to use for anything less than the most severe infringements, and the room for political manoeuvre meant that sanctions were never levied when proposed to the Council.

More graduated sanctions

85. Mr Leandro explained one reason why the previous sanctions regime for excessive deficits under the SGP had been ineffective: sanctions had started “with a nuclear bomb”, which he explained, “could never be used”.¹²² By starting off with small sanctions, at an earlier stage in the process, it is hoped

¹¹⁵ Q 339

¹¹⁶ Q 528

¹¹⁷ See paragraph 38

¹¹⁸ Q 79

¹¹⁹ EGE 14

¹²⁰ Q 296. See also Q 500 (Professor Buitter), EGE 9 (Dr Annunziata), EGE 14 (HM Treasury), EGE 24 (Dr Hodson)

¹²¹ Q 343

¹²² Q 269

that the sanctions will be easier to apply, and more politically acceptable. Mr Leandro explained what the van Rompuy taskforce had proposed:

“We would start sanctioning the country in the preventive phase of the Stability and Growth Pact before we even get to the corrective phase, with an interest-bearing deposit if the country seriously deviates from what has been agreed. Then, if it continues misbehaving and falls into the corrective phase of the pact, this interest-bearing deposit will be transformed into a non-interest-bearing deposit. Then, if it continues misbehaving, a fine will be imposed. Then the fine can be increased, as stated in the treaty, so it’s a more progressive system and starts earlier”.¹²³

86. Several witnesses suggested fines were not a credible threat against countries already in fiscal difficulties. As Professor Buiter explained, “the penalties are still not credible, because they are fines ... if a country is fiscally challenged, you are not going to be able to extract money out of it”.¹²⁴
87. The Minister felt differently, and drew our attention to provisions that allow sanctions to be reduced or cancelled “on the grounds of exceptional economic circumstances”.¹²⁵ The ability to impose sanctions earlier in the preventive and corrective arms of the SGP, starting with less punitive interest bearing deposits, gives the Council a more credible sanction to use against countries which may be experiencing financial difficulties.
88. **We welcome the introduction of a more graduated system of sanctions against non-compliance with the SGP. The availability of sanctions earlier in the process will help ensure that irresponsible behaviour by Member States is discouraged so that the corrective arm can be avoided.**

Less political discretion

89. France and Germany breached the SGP in 2002–2003, leading to a conflict between the Commission (which wanted to initiate sanctions) and the Council (which demurred). Subsequently, France and Germany simply “changed the rules”,¹²⁶ as Mr Leandro phrased it. Many witnesses saw this as an example of the prime failing of the current sanction regime: too much political discretion in determining when penalties should be imposed. Dr Annunziata summarised the issue: “for the sanctions to be credible, the room for political discretion should be minimised—this is the sad but realistic lesson from the original SGP”.¹²⁷
90. Several witnesses argued for sanctions to be made fully automatic, to be triggered when certain criteria are reached. Dr Annunziata, for example, told us that only automatic rules would work: “unless enforceability of rules is ensured, changes to the rules themselves risk being irrelevant”. He concluded that suggestions for reverse majority voting are “insufficient”.¹²⁸ Ms Vicky Ford, Member of the European Parliament, reminded us that “the ECB would like sanctions to be as automatic as possible”. She continued,

¹²³ Q 269

¹²⁴ Q 501. See also Q 340 (Mr Martens), EGE 6 (Professor Gortsos)

¹²⁵ EGE 8

¹²⁶ Q 234

¹²⁷ EGE 16. See also Q 453 (Ms Barysch), EGE 16 (Dr Annunziata), EGE 10 (Dr Dabrowski)

¹²⁸ EGE 9. See also Q 458 (Ms Barysch), EGE 21 (European Movement UK)

however, that “colleagues around the Parliament would like them to be as automatic as practical, which is slightly different”.¹²⁹

91. Mr Leandro described the course taken by the van Rompuy taskforce and the Commission to deal with this issue:

“It was decided to apply reverse majority decision-making, which means that a Commission recommendation for a sanction is automatically approved unless opposed by a qualified majority of Member States”. This would ensure that “the decision-making process is also more automatic and provides for less political interference”.¹³⁰

92. A number of witnesses suggested that the use of reverse majority voting would make it more likely that sanctions would actually be applied. Mr Zuleeg suggested that “this new majority voting rule ... could work well”, adding that it might make it easier for sanctions to actually apply to large Member States “even if they are unwilling to accept them”.¹³¹ Professor Buiter was more modest in his praise: “they have gone a very small way towards having more credible sanctions by making a switch to opting in rather than opting out”.¹³²

93. The Government agreed that reverse majority voting “would make it more difficult for Member States to avoid sanctions”.¹³³ However, they argued that there had to be “the proper institutional balance”¹³⁴ between the Commission proposing sanctions, and the Council’s ability to overrule their decision if necessary. They gave two reasons for this. First, the Minister argued strongly that “there should be some judgement used to determine whether it is appropriate to levy sanctions”,¹³⁵ as opposed to a fully automatic process. Secondly, Mr Curwen said: “it is very important for political legitimacy that the governments of the Member States meeting in the Council ultimately take that decision”.¹³⁶

94. It was the Minister’s view that the van Rompuy taskforce “gets the balance right” between “having an automatic process and having a blocking or reverse majority to overturn a decision to levy sanctions”.¹³⁷

95. **We believe that fully automatic sanctions are a step too far. The introduction of semi-automatic reverse majority voting, however, is a positive step. By reducing the scope for political interference this new voting system will make it more likely that sanctions will be applied, making them a more effective deterrent to non-compliance.**

Political will

96. While the introduction of reverse majority voting will make it harder for Member States to avoid sanctions, the blocking ability of the Council means that political expediency could still affect the way sanctions are applied. The

¹²⁹ Q 476. The ECB has argued for a “quasi-automatic application of sanctions”—see European Central Bank, *Reinforcing economic governance in the euro area* (June 2010)

¹³⁰ Q 269

¹³¹ Q 343

¹³² Q 500

¹³³ EGE 15

¹³⁴ EGE 15

¹³⁵ Q 528

¹³⁶ Q 20

¹³⁷ Q 537

Minister made the point succinctly: “the effectiveness of any sanctions system will be determined by the degree of political will within the Council to apply the system fairly”.¹³⁸ It remains to be seen whether Member States will continue to maintain their political will to enforce the rules more rigorously once the crisis is past.

97. Several of our witnesses thought it was implausible that sanctions could ever be successfully applied or obeyed. They argued that the sovereignty of Member States would make any attempt to impose sanctions immensely difficult, particularly against larger, more powerful Member States such as France and Germany. Professor Goodhart, for example, told us that “to impose sanction on large sovereign countries, in the present state of the world political system, just can’t be done”.¹³⁹
98. Mr de la Chapelle Bizot recognised the problem, and argued that the system could work but “only if there is a real endorsement by the different governments of the whole system”.¹⁴⁰ Another witness reminded us that much depended on the larger countries being willing to accept the new system: “Germany is by far the most economically and politically powerful country in these questions, so it has to be willing to accept that the rules that are now being drawn up will apply to it”.¹⁴¹
99. Dr Dermot Hodson, Lecturer in Political Economy at Birkbeck College London, raised another potential consequence of the new system, suggesting that implementing reverse majority voting might lead to a situation “in which Brussels might be blamed” for proposing sanctions, because it is “essentially getting the Commission to take ownership”.¹⁴² Mr Martin Larch, from the Directorate General for Economic and Financial Affairs in the European Commission, responded to the concern: “Brussels will take the blame anyway. That may be the case, but it is certainly not the case that the Commission take ownership of the sanctions”.¹⁴³ Mr Hoban remarked wryly that “it is tempting to blame Brussels for everything”, but added that the van Rompuy report asserted the need for the Council to be involved in the sanctions process, which should ensure they took responsibility for the process as well as the Commission.¹⁴⁴
100. **With its ability to block sanctions under the reverse majority voting procedure, final responsibility for the decision to impose sanctions will continue to rest with the Council—as is only appropriate. Only time will tell whether the collective will of Member States is strong enough to ensure that the sanctions process is applied even when the current crisis is over. We endorse the Minister’s remark: “the cost of the crisis in the Eurozone is a reminder to us that we must make these processes work much more effectively”.¹⁴⁵ We hope that this continues to be true beyond the immediate crisis.**

¹³⁸ EGE 23

¹³⁹ Q 90. See also QQ 453 (Ms Barysch), 128 (Dr Annunziata), EGE 7 (Open Europe)

¹⁴⁰ Q 297

¹⁴¹ Q 343 (European Policy Centre)

¹⁴² Q 126. See also Q 297 (Mr de la Chapelle Bizot)

¹⁴³ Q 393

¹⁴⁴ Q 530

¹⁴⁵ Q 534

101. **We stress the need for the Council to ensure that, despite its ability to block sanctions, they become an effective means to ensure Member States' compliance with the SGP once the current crisis is over. We remain sceptical this will be the case.**

Types of sanctions

Withdrawal of voting rights

102. The van Rompuy taskforce examined the question of whether Member States repeatedly breaking the rules should have their voting rights in Council suspended. Mr Leandro told us that “this was rejected by the taskforce. It was not considered politically feasible”,¹⁴⁶ a view which he said the Commission shared.¹⁴⁷ However, the van Rompuy taskforce report did not rule out the possibility, instead noting in a final sentence that it was an “open issue” that the European Council might consider in future.¹⁴⁸
103. Mr de la Chapelle Bizot was clear that the matter was not closed. “According to the German view, non-financial sanctions could be more dissuasive. It is a question of removing voting rights for outliers. France has decided to support Germany in that view and it is one of the questions that should be raised at a European Council level”.¹⁴⁹ Professor Buiter, among others, told us that this would be a useful power for the Council to have: “they should have opted for things like suspending the right to vote on the euro council for wilfully non-compliant Member States”.¹⁵⁰
104. The Minister refused to express a view on the proposal, simply noting that there would be “significant barriers” to implementing such an idea.¹⁵¹ Mr Curwen from the Treasury went slightly further, suggesting that “I think we would be concerned by any measure which undermined democratic legitimacy in the EU”.¹⁵² Other witnesses expressed similar concerns.¹⁵³
105. Professor Louis indicated another difficulty, telling us that there would need to be “a revision of the treaty” to suspend Member States' voting rights for breaking fiscal rules.¹⁵⁴ Mr de la Chapelle Bizot, conceded that a treaty change would be required, but added, “[that] is why some Member States thought about a kind of political agreement, with each Member State recognising the fact that if it is under the excessive deficit procedure, it will decide not to vote in some cases, without any constraint ... [although] it would only be a political commitment without any legal force”.¹⁵⁵
106. We are unconvinced that a political agreement of this nature is practicable. The removal of voting rights would be an extreme measure, presumably only to be used when a country has repeatedly breached the SGP and refused to take corrective action. Under these circumstances, we do not think it would

¹⁴⁶ Q 252

¹⁴⁷ Q 253

¹⁴⁸ Report of the van Rompuy taskforce to the European Council, *Strengthening economic governance in the EU* (2010)

¹⁴⁹ Q 296

¹⁵⁰ Q 500. See also EGE 6 (Professor Gortsos), EGE 3 (Dr Schelkle), EGE 16 (Dr Annunziata)

¹⁵¹ Q 525

¹⁵² Q 31

¹⁵³ EGE 18 (Dr Dadush), EGE 21 (European Movement UK)

¹⁵⁴ Q 355

¹⁵⁵ Q 300

be sensible to rely on such a state keeping to a political agreement that has no validity in law.

107. **We do not believe that the withdrawal of voting rights in Council is an appropriate sanction. Not only would it require a significant treaty change, it would raise significant questions about legitimacy and sovereignty if Member States were unable to have any say in decisions taken in Council. Nor do we think that a voluntary ‘political agreement’ is a plausible solution as an alternative.**

Incentives

108. Professor Pisani-Ferry suggested that there should be some form of incentive for better economic governance in Member States—in his words “better institutions could go hand in hand with more flexibility in the implementation of the common rules”.¹⁵⁶ Mr de la Chapelle Bizot argued that “we are sure that we have to create incentives”, referring to examples such as better access to European Investment Bank financing.¹⁵⁷ Dr Schelkle also expressed her support for the idea.¹⁵⁸
109. Others however, were less enthusiastic: Mr Martens said dismissively that he could not see the EU giving out incentives like a “Christmas present”,¹⁵⁹ while Mr Hoban informed us he was “old fashioned” and thought that “virtue has its own rewards”. He questioned: “should people be incentivised simply to obey the rules?”.¹⁶⁰ Mr Leandro echoed this viewpoint, arguing that “the real incentive for countries to abide by the rules is the fact that, going forward, the markets will be applying a much more differentiated approach”.¹⁶¹
110. **We believe that the overriding incentive for Member States is that of maintaining a stable and prosperous euro area. We do not feel that other incentives should be necessary.**

Sanctions outside the euro area

111. At present, sanctions under the SGP can only be imposed on euro area countries.¹⁶² The Commission’s proposals do not propose any change to this status quo. The van Rompuy taskforce report, however, proposes extending “enforcement mechanisms” to all Member States “by making a range of EU expenditures conditional upon compliance with the SGP”. It suggests that this should be done as soon as possible and “at the latest in the context of the next multiannual financial framework”. A footnote in the report excludes the UK because of its opt-out from EMU.¹⁶³
112. This appears to us to be a significant step. The Treaty only envisages the imposition of financial sanctions on Member States whose currency is the euro, reflecting the greater need for a strict observance of fiscal rules in the

¹⁵⁶ Q 277

¹⁵⁷ Q 299

¹⁵⁸ Q 121

¹⁵⁹ Q 338

¹⁶⁰ Q 531

¹⁶¹ Q 254

¹⁶² Article 126 (II) TFEU gives the Council power to impose sanctions. By virtue of Article 139 and Protocol 15 this provision only applies to Member States whose currency is the euro.

¹⁶³ van Rompuy taskforce, *Strengthening economic governance in the EU*, op. cit.

euro area. This situation has not changed. The problems currently being experienced by euro area Member States are the result of structural failings in the EMU. To suggest widening the scope of a coercive enforcement mechanism to Member States outside the euro area seems unjustified and inconsistent with the principle underlying the Treaty.

113. The Government, considering this issue in the context of structural funds, have stated that they “have a principled objection to proposals for contractually binding ‘conditionality’ to be applied to funding”. They argue that there should be no “punitive link” between entitlement to cohesion funds and the effectiveness of macroeconomic and fiscal policies.¹⁶⁴ We consider the idea of making EU funds conditional upon compliance with the SGP further in our report on the EU financial framework from 2014.¹⁶⁵
114. **We do not support the recommendation in the van Rompuy taskforce report to extend sanctions to Member States outside the euro area (excluding the UK) by making EU expenditure conditional upon compliance with the SGP. Sanctions are imposed on euro area countries on the basis of express Treaty provisions. It is inappropriate to do so through other means for Member States outside the euro area.**

Supplementing the SGP: implementing sound fiscal rules at a national level

National fiscal frameworks

115. During the inquiry a key question that emerged about fiscal surveillance was whether fiscal discipline had to be imposed by stronger rules and tighter surveillance at an EU level, or should come from reinforcing domestic fiscal structures at a national level. The van Rompuy taskforce report focuses on central oversight, while encouraging the development of domestic fiscal rules and improved institutions.¹⁶⁶ The Commission, meanwhile, have proposed a new Directive on national fiscal frameworks. This Directive would see the objectives of the SGP reflected in national budgetary rules and establish minimum standards for different aspects of the budgetary process (see Box 4 below).
116. Mr Larch explained the rationale behind this Directive: “EU rules are necessary to co-ordinate fiscal policymaking in the EU and in the euro area, but they are not sufficient to make fiscal policy coordination work”. He concluded that “there would need to be national fiscal frameworks that are conducive to the kind of fiscal policymaking that is consistent with the provisions of the Treaty”.¹⁶⁷
117. The Commission propose that Member States implement national fiscal rules along the line taken by Germany, which in 2009 introduced a constitutional provision to mandate balanced regional and federal budgets. Ms Barysch explained: “Germany would like to see similar legislation in all Eurozone Member States”. She noted that “they also know that not all

¹⁶⁴ Government Explanatory Memorandum 16336/10, *Conclusions of the fifth report on economic, social and territorial cohesion: the future of cohesion policy* (November 2010)

¹⁶⁵ The report from the European Union Select Committee, *EU Financial Framework from 2014*, will be published in March 2011.

¹⁶⁶ Q 276

¹⁶⁷ Q 371

European countries are as rule-abiding as they are, so they want to have some sort of external oversight for that". Germany envisaged this external oversight coming from the markets which would impose discipline through higher borrowing costs.¹⁶⁸

BOX 4

Directive on budgetary frameworks of Member States

This proposed Directive sets out minimum requirements to be followed by Member States to strengthen and align their budgetary frameworks with the new European economic governance rules, by:

- ensuring consistent accounting systems;
- aligning national fiscal rules close to the balance goal, the 3% deficit limit currently set out in the SGP and the proposed addition of a debt threshold of 60% of GDP;
- switching to multi-annual budgetary planning; and
- ensuring that the system of public finances is covered by the framework (for example, ensuring that public expenditure through regional authorities is accounted for in the same way).

118. We heard evidence that the fiscal discipline in the EMU had a better chance to be respected in a decentralised system. Professor Pisani-Ferry felt that it was difficult to exercise fiscal discipline from Brussels, which could not create a model of fiscal discipline which reflected the differences between Member States' domestic institutional arrangements. He concluded that "you need to decentralise and find definitions of fiscal discipline on which there is ownership at national level", while emphasising that such an approach "was not inconsistent with the overall aim of EU fiscal discipline", but simply a different model.¹⁶⁹ Dr Annunziata took a similar view, and argued that, in the absence of a greater degree of political union, a decentralised system for fiscal discipline was needed where fiscal rules were enshrined in national legislation, so as "to tie the hands of national governments in a way which is recognized as desirable by the elected national legislature".¹⁷⁰

Accounting for regional expenditure

119. This proposal would make countries which delegate substantial levels of expenditure to regional or sub-national bodies ensure that all levels of government operate under the same accounting rules and are subject to the same fiscal rules as the central government. Given that in some countries excessive expenditure by sub-national authorities has had negative effects on public finances at a national level, we welcome this step.

Minimum standards and beyond

120. The Directive would require Member States to place minimum standards on their domestic fiscal frameworks but, as Mr Larch confirmed, the proposed directive "does not require the implementation of these requirements by law. There can be any kind of provision".¹⁷¹ The van Rompuy taskforce report

¹⁶⁸ Q 470

¹⁶⁹ Q 276

¹⁷⁰ EGE 9

¹⁷¹ Q 370

echoes the Commission's proposals. Mr Leandro explained that "some countries are more sensitive than others about transposing common requirements into national legislation", which was why the report did not specify how the minimum standards should be incorporated.¹⁷²

121. Dr Hodson saw this as a key proposal that might have a real impact:
 "If you ask, 'How could we get compliance without exerting peer pressure or sanctions?' it is by making sure that the objectives set at the EU level are compatible with the framework conditions for making fiscal policy. Those Member States that have better defined fiscal rules tend to have a better track record of compliance. I think that was perhaps the most significant part of the Commission's proposals".¹⁷³
122. He expressed regret that the proposal did not require Member States to incorporate the rules in national law, lamenting that it "takes a big step back from what could be a real change to how fiscal policy is made".¹⁷⁴
123. The Government have not been enthusiastic about the proposal, stating that "the construction and operation of Member States' national fiscal frameworks should be a matter for national governments to decide".¹⁷⁵ The Minister, whilst conceding that it was important to ensure that the right fiscal frameworks were in place in Member States and that a "high-level political agreement" on their outline might be appropriate,¹⁷⁶ emphasised that it was "dangerous to be too specific". He argued that a prescriptive legal framework would make no allowance for differences between Member States, and that "it almost takes away responsibility from Member States ... Real change takes place when Governments take ownership of their fiscal position".¹⁷⁷
124. Mr Persson also opposed the use of legislation, arguing that it would be "very difficult to tell a national Parliament that from now on, one of our key policies—our budget policy—will be subject to [EU] rules rather than to votes in Parliament".¹⁷⁸
125. We heard two variants on the proposal. Ms Ford informed us that among some Members of the European Parliament there was a desire for a two-tier system, where euro area nations would have to go further than the proposed Directive and incorporate the fiscal rules suggested in the Directive into national legislation. She explained that "there is quite a lot of concern that they need to have enforceable, clear, transparent budgetary processes across the Eurozone", and suggested that an amendment on these lines might be made by the European Parliament.¹⁷⁹
126. Dr Annunziata, meanwhile, contended that it was possible to have a set of rules "that are in principle generally accepted and where the thrust of the rule is the same across countries", but where the "details of implementation could vary from country to country".¹⁸⁰ He proposed that limits could be

¹⁷² Q 241

¹⁷³ Q 126

¹⁷⁴ Q 126

¹⁷⁵ Government Explanatory Memorandum 14497/10, *Proposal for a Council Directive on Requirements for Budgetary Frameworks of the Member States* (October 2010)

¹⁷⁶ Q 539

¹⁷⁷ Q 538

¹⁷⁸ Q 431

¹⁷⁹ Q 481

¹⁸⁰ Q 129

imposed on deficits and public debt, as is currently the case with the SGP, but that each country would have the flexibility to choose what correction mechanism they would use. The details of these mechanisms could vary from country to country “as long as they are set in stone in the legislation giving reasonable assurances that they will guarantee an automatic correction of fiscal policy if certain limits are breached”.¹⁸¹

127. **The Commission’s proposal to complement the top-down oversight of fiscal policy through the incorporation of EU-wide rules in domestic budgetary frameworks is a welcome development. We believe it will complement other proposals to enforce responsible fiscal behaviour through promoting a national ownership of EU rules.**
128. **We welcome the proposal to ensure that, where countries delegate substantial levels of expenditure to sub-national authorities, these bodies are subject to the same fiscal rules as central government.**
129. **We support the thrust of the draft Directive which states that ‘provision’ for fiscal rules should be introduced at a national level. We note, however, that the Directive may be more effective if Member States implement these rules through national legislation as far as possible, rather than relying on administrative provisions.**

¹⁸¹ Q 129

CHAPTER 4: MACROECONOMIC SURVEILLANCE AND ENFORCEMENT

130. To supplement the existing system of fiscal surveillance under the SGP, the Commission has proposed the creation of an excessive imbalance procedure (see Box 5 below). This would greatly extend the Commission's surveillance of economic policies under the Broad Economic Policy Guidelines. Sanctions could be imposed, on euro area countries only, when countries fail to take action to correct macroeconomic imbalances.
131. In this chapter we look first at the Commission's new proposals on macroeconomic surveillance, before considering the accompanying sanctions regime. We then analyse the idea of a "European Semester" that aims to coordinate better the EU's different strands of surveillance of economic policies, before turning to the European Systemic Risk Board which will act as the interface between the EU's macroeconomic surveillance and its surveillance of the financial sector. Finally, we consider the importance of ensuring growth in Member States as a complement to measures designed to ensure fiscal prudence and macroeconomic stability.

The Commission's proposal for macroeconomic surveillance

132. In light of the shortcomings of the Stability and Growth Pact, there has been a recognition that a surveillance framework is needed which goes beyond fiscal issues to cover wider macroeconomic factors. As with the SGP, this framework would cover all Member States in the EU. As Mr Larch explained,
- "Before the crisis there was this prevailing paradigm in macroeconomic analysis that, if you keep your fiscal house in order and if you keep inflation low and stable, you ensure overall macroeconomic stability; you do not have to worry about anything else. The crisis taught us that this paradigm no longer holds. It taught us that there are some other imbalances ... that are a threat to overall macroeconomic stability."¹⁸²
133. Macroeconomic imbalances¹⁸³ might be caused by very different phenomena, including: divergences in different areas such as current account positions or competitiveness trends across countries; excessive domestic demand growth (which can contribute to asset price inflation and credit bubbles); or an overreliance on exports. The surveillance framework proposed by the Commission (see Box 5 below) aims to detect imbalances at an early stage, in time to allow the formulation of corrective policies that will prevent a significant imbalance from occurring.¹⁸⁴

¹⁸² Q 378

¹⁸³ In general terms, a macroeconomic imbalance exists where the trajectory of an economy is unsustainable and risks causing problems of volatility or instability, including financial instability. Such imbalances often manifest themselves in deficits or surpluses on the current account of the balance of payments.

¹⁸⁴ Q 384

BOX 5**Regulation on the prevention and correction of macroeconomic imbalances**

This proposal for a Regulation¹⁸⁵ would introduce a new element to the EU's economic surveillance framework: the 'excessive imbalance procedure' (EIP). This procedure will comprise a regular assessment of the risks of imbalances in a Member State based on a 'scoreboard' composed of economic indicators, but with provision for judgement to be exercised.

According to the provisions of this proposal:

- once an alert has been triggered for a Member State, the Commission will launch a country-specific, in-depth review in order to identify the underlying problems and submit recommendations to the Council on how to deal with the imbalances;
- for member-states with severe imbalances, including imbalances that put at risk the functioning of the EMU, the Council may open the EIP and place the Member State in an 'excessive imbalances position';
- a member-state under EIP would have to present a 'corrective action plan' to the Council, which will set deadlines for corrective action;
- A complementary regulation provides for sanctions to be imposed on euro area Member States who repeatedly fail to take corrective action (see Box 8).

This Regulation will apply to the UK.

134. Dr Dabrowski contended, however, that "the conceptual background of this legislation is very controversial, if not completely wrong". He argued that by trying to control current account imbalances, "the Commission intends to control a macroeconomic variable which is beyond direct policy influence in a world of free capital movement, especially within a single currency area".¹⁸⁶ Other witnesses were also sceptical, such as Dr Gros, who thought that the proposals for an excessive imbalance procedure were "a nice try", but added, "I'm not against it, but I'm very doubtful that it would work. If you get exactly the same thing, then it will work, but the next bubble will be different".¹⁸⁷ Dr Hodson was just as sceptical: "on the excessive imbalance procedure, my sense is that it is not going to amount to very much more than what we already see at present". He added that there was already surveillance of macroeconomic imbalances through the broad economic policy guidelines (see Box 6 below)—this would simply "see a wider range of indicators used".¹⁸⁸
135. In response to this scepticism, Mr Costello stated that the proposal amounted to "something significantly more" than the current system of surveillance. He acknowledged that it was true, "in a legal sense", that the Commission already had the authority to intervene when Member States implemented economic policy that was damaging to the EU, but he maintained that, in practice, this surveillance was limited and not really focused on imbalances. He stated that "what is proposed now is to embed

¹⁸⁵ COM (2010) 527

¹⁸⁶ EGE 10

¹⁸⁷ Q 189

¹⁸⁸ Q 123

the surveillance—not just to rely on a general treaty article but to put in place a formalised, structured surveillance framework based on secondary legislation”.¹⁸⁹

136. The Government has previously stated that “heightened surveillance of macroeconomic imbalances and competitiveness is crucial if the EU is to generate stronger and more stable growth in the future”¹⁹⁰ and the Minister was positive about the proposals put forward on macroeconomic surveillance. He told us that the proposals were “very helpful” and noted that “the cost of tackling [imbalances] is far less when they start to emerge than when they have triggered a crisis”.¹⁹¹

BOX 6

Article 121 and the basis for macroeconomic surveillance

Following the Lisbon Treaty, the rules on economic policies are detailed in Articles 120–26 TFEU. Article 121 prescribes a system of multilateral surveillance of economic policies conducted by Member States. It states that “Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council”. To this end, the Council shall “formulate a draft for the broad guidelines of the economic policies of the Member States and of the Union”.

From a legal standpoint, therefore, the EU already has in place a legal base from which to carry out macroeconomic surveillance. In theory, macroeconomic imbalances of the sort that have afflicted Ireland, Portugal, Spain and the UK should have been detected by the surveillance envisaged under the Broad Economic Policy Guidelines, with recommendations then issued to the countries in question about redressing the problems. Recommendations have certainly been issued, but in practice Member States took little notice of them. Professor Pisani-Ferry concluded: “The Broad Economic Policy Guidelines that were supposed to be the backbone of coordination have been consistently ignored by national policymakers.”¹⁹²

Private debt

137. As described above, events have shown that fiscal surveillance alone is not sufficient to detect incipient problems of macroeconomic imbalance. The construction of the SGP made it unable to catch the build-up of unsustainable private debt and the associated asset bubbles. Dr Annunziata made it clear that “from the point of view of the systemic stability of a country it is the sum of public and private debt that matters. This is the way in which markets tend to look at it”. He concluded that monitoring private debt was “a sensible step towards enlarging the stability pact to a broader set of variables”.¹⁹³ Professor Buiters also supported the surveillance of levels of private debt, noting that “what is private but systemically important or politically well connected becomes public when insolvency threatens”.¹⁹⁴ Ireland can be seen as a prime example: before the crisis it had highly

¹⁸⁹ Q 376

¹⁹⁰ Government Explanatory Memorandum EM 14515/10, *Proposal for a Regulation on the Prevention and Correction of Macroeconomic Imbalances* (October 2010)

¹⁹¹ Q 533

¹⁹² Professor Pisani-Ferry, *Euro area governance: what went wrong. How to repair it* (May 2010)

¹⁹³ Q 142

¹⁹⁴ Q 500

favourable fiscal indicators, but a highly indebted financial sector became a public sector problem when the government issued a blanket guarantee to depositors.

138. Mr Leandro agreed with these views,¹⁹⁵ as did the Minister who said that “the level of private credit is highlighted often ... clearly the macroeconomic surveillance should look at that as one of the factors that will create an imbalance”.¹⁹⁶ Mr Curwen informed us that since “there was no Treaty basis for having private debt considered, per se, in the SGP”, it was therefore “best looked at in the context of the multilateral surveillance process”.¹⁹⁷

Determining imbalances: a difficult discussion

139. Our witnesses pointed to some difficulties in widening surveillance to capture macroeconomic imbalances. First, the definition of imbalances is problematic and no clear explanation was offered in the Commission’s proposal.¹⁹⁸
140. The macroeconomic imbalances that have become so visible in recent years are of different sorts, and it is difficult to judge which are symptoms and which are the result of wider economic problems. Consequently, determining the appropriate statistical indicators to detect and identify the sources of imbalances is a challenging intellectual exercise.¹⁹⁹ Mr Cliffe asserted that macroeconomic surveillance would require a “whole host of variables” that would need to be monitored closely.²⁰⁰ Professor Pisani-Ferry explained that an analysis of imbalances would inevitably require “a discussion on what is behind them”. This, he considered, would be difficult since “it requires an assessment that is necessarily disputable and open to discussion, instead of the relatively mechanical approach that we have for fiscal or budgetary deficits”.²⁰¹ Thus, an excessive public deficit is easily pinpointed, but what constitutes unsustainable wage increases, excessive asset price inflation or unsafe credit growth is much harder to judge. Unless Member States were willing to have discussions about imbalances, the policy failures that brought them about, and possible solutions, this proposal would be an “empty exercise”.²⁰² Dr Dabrowski’s interpretation was slightly different: he argued that most elements of the proposal were subject to discretion, “and, therefore, for political bargaining”. He concluded that “one can hardly believe that such a vaguely defined and highly discretionary framework may work effectively”.²⁰³
141. Mr Curwen accepted that the implementation of the proposal was “not going to be straightforward”. The Commission would produce a list of the indicators to be monitored, differentiated between the euro area and non-euro area Member States to reflect the specific nature of the EMU, and this “scoreboard” would be agreed by the Council.²⁰⁴

¹⁹⁵ Q 228

¹⁹⁶ Q 532

¹⁹⁷ Q 29

¹⁹⁸ EGE 10 (Dr Dabrowski), EGE 7 (Open Europe)

¹⁹⁹ Q 439

²⁰⁰ Q 69

²⁰¹ Q 281

²⁰² Q 281

²⁰³ EGE 10

²⁰⁴ Q 40

BOX 7**The German surplus**

Although not the only country in the euro area to be running a surplus (indeed, that of the Netherlands has consistently been higher as a proportion of GDP in recent years) our evidence frequently led to discussions over Germany's competitiveness.

In the years preceding the crisis, Germany pursued a policy of wage moderation and extensive labour market reform that led to a progressive improvement in its labour costs relative to other EU countries. In combination with its traditional strength in industrial exports, this policy helped to boost German export growth while constraining internal demand. To the extent that German export success reflects a commitment to improved competitiveness on the global, and European, stage it has manifestly been in the interests of the whole EU.

Others, however, view Germany's net export performance as being at least partly derived from the equivalent of a 'beggar-thy-neighbour' strategy of holding down domestic demand. They argued that the burden of reducing macroeconomic imbalances within the euro area should fall not only on countries in deficit, but on surplus countries as well. The German authorities, it was suggested, could reduce its surplus by boosting internal demand and should be receptive, rather than resistant, to lending or transferring funds to the deficit countries from which Germany's surplus derives.

Correcting imbalances

142. How best to deal with imbalances will depend on the nature of the imbalance. A runaway property bubble, as occurred in Spain and Ireland (and, to a lesser extent, the UK), reflects mistakes in domestic policies in these countries and could have been mitigated by a combination of regulatory and fiscal action. The Spanish construction boom, in particular, was a direct cause of the country's worsening current account deficit, reflecting excessive domestic demand, but mirrored in the surpluses of Germany and the Netherlands. In Spain, as in certain other countries, wage increases not backed by productivity increases led to a gradual deterioration in relative unit labour costs. Discussion over correction of imbalances brought up a key point of controversy: whether those countries currently running a surplus on the current account of their balance of payments should also be called upon to take action to help reduce macroeconomic imbalances. In most cases Germany was used as a key example (see Box 7 above).
143. Mr de la Chapelle Bizot made the point that there were "different ways of achieving surpluses", and that it was important to look at whether they were sustainable, or if they were the result of policies that were detrimental to other Member States within the EU.²⁰⁵ A country which deliberately restrains domestic demand to bolster its net exports or (as China is currently accused of doing) holds down its exchange rate to gain a competitive advantage, may be accused of acting in an unfair manner (a "vicious" surplus). By contrast, a country which invests in skills, research and productivity growth can reasonably claim that it is achieving success by virtuous means (a "virtuous" surplus). Our witnesses were divided on this issue, illustrating the sheer difficulty of ascertaining what is a "virtuous" or a "vicious" surplus.

144. This distinction is critical when it comes to prescriptions for how to redress imbalances and how the burden of adjustment should be shared. The question of current account balances also has an intra-EU (euro area) and global dimension. The EU as a whole (unlike the US or indeed China) has been quite close to balance vis-à-vis the rest of the world, but there have been growing divergences in current account positions inside the EU. Much of Northern Europe is in surplus, while Southern Europe is in deficit. This intra-European divergence may be helpful if it reflects an investment of surpluses into improved productivity and growth in deficit countries. In recent years, however, these surpluses financed excessive government deficits (in Greece, for example), and excessive private debt (such as in Ireland) that proved unsustainable.
145. Dr Annunziata argued that “surveillance should be symmetrical in the sense that large current account surplus should be as undesirable as large deficits”.²⁰⁶ Professor Goodhart criticised the Commission’s proposal for “trying to constrain the position of the deficit countries, which the market is doing in any case, rather than looking at a more symmetric adjustment mechanism in which the surplus countries have to play a role as well”.²⁰⁷ He explained that while Germany was in surplus, “the counterpart to that surplus has been the Germans transferring capital to other deficit countries” because “the German banks are ... buying very large quantities of the debt of the peripheral countries”. The result was that “unless things change quite rapidly, the surplus countries are going to find their capital investments in these countries are going to suffer a very large hit indeed”.²⁰⁸ Professor Pisani-Ferry took a slightly softer line, suggesting it was necessary “to foster a discussion that takes into account the interdependence” between surplus and deficit countries.²⁰⁹
146. Lord Monks, General Secretary of the ETUC, simply stated that “the economics of it are that not everybody can repair their deficits if the surplus countries continue to run strong surpluses”.²¹⁰ Mr Ronald Janssen, Economic Adviser at the ETUC, explained further: “it is not sufficient to cut the external deficits of the periphery countries. They need to turn it into an export external surplus. By logic, that means that Germany should in theory become a deficit country for a while”.²¹¹
147. Dr Gros thought that these arguments were “irrelevant”. He contended that over the time markets would redress the balance: “the market works, slowly ... if you give countries enough time to make the adjustment, it works”.²¹² Ms Ford summed up the views of several witnesses when she asked, “How do you tell a country to be less competitive versus its neighbours, especially when it is competing in a global market?”²¹³
148. The Commission’s view was that, while correcting surplus would be a part of the debate, clearly the urgency and rigour would fall much more immediately

²⁰⁶ EGE 9

²⁰⁷ Q 82. See also Q 74 (Mr Cliffe)

²⁰⁸ Q 88. See also QQ 109 (Dr Schelkle), 78 (Mr Cliffe)

²⁰⁹ Q 284. See also Q 110 (Dr Schelkle)

²¹⁰ Q 308

²¹¹ Q 309

²¹² Q 201

²¹³ Q 484. See, for example, EGE 7 (Open Europe), Q 439 (Mr Persson)

and severely on countries in deficit.²¹⁴ Mr Leandro confirmed this was also the view of the van Rompuy taskforce:

“According to the taskforce report reforms are needed in all countries, both in those that have accumulated large deficits because of competitiveness deficiencies and also in those that have accumulated large surpluses. It is more urgent in the current context to take corrective action in the countries with deficits than in those with surpluses. However, there is also a need in the countries with surpluses ... for a better-balanced growth model, less reliant on exports and more reliant on domestic demand”.²¹⁵

149. The Minister expressed a slightly different view, noting that “we are very good at identifying what should happen to deficit countries but, equally, those countries with surpluses need to think through which policies they should implement”.²¹⁶ We questioned how the Commission could ask Germany to reduce its overall competitiveness, and the Minister clarified their approach: “we would not say, ‘Can you make yourself less competitive?’ ... However, if there were particular restrictions in place that skewed the balance of the economy, that might be recommended”.²¹⁷
150. Mr de la Chapelle Bizot felt this would be an acceptable approach, and that macroeconomic surveillance could aim to identify and avoid “non-cooperative policies”.²¹⁸ He also remarked that this would be helpful at a wider EU level, since it would allow Member States to consider a currency devaluation by one country was “in the interests of the whole European Union or not”.²¹⁹
151. We feel that, in principle, an adjustment of imbalances which address both deficits and surpluses would be more effective than putting the emphasis of reform purely on those countries in deficit and experiencing a loss of competitiveness. In particular, there is a risk that excessive retrenchment by deficit countries (competitive deflation) will lead to a downward spiral in demand that is contrary to the collective interest of the EU and will damage the surplus countries as well. We recognise that it is unreasonable to ask successful Member States to reduce their competitiveness in a global environment. It is, however, in the interests of all Member States in the euro area that the proceeds of those countries in surplus are not deployed in ways which disadvantage their neighbours, and that those countries in deficit are supported in making the structural adjustments necessary to improve productivity and levels of employment.
152. We believe that the approach set out by the Minister, of identifying and correcting particular policies that contribute to macroeconomic imbalances is the correct one. There must be a distinction, however, between the manner in which countries in deficit are engaged with compared with those in surplus. It would not be appropriate to issue corrective recommendations to countries with current account surpluses.
- 153. The euro area crisis has made clear the need to extend surveillance to monitor and correct macroeconomic imbalances that threaten the**

²¹⁴ Q 382

²¹⁵ Q 245

²¹⁶ Q 540

²¹⁷ Q 550

²¹⁸ Q 302

²¹⁹ Q 302

stability of the euro area. Fiscal discipline alone is not sufficient to ensure the stability of the monetary union. We welcome therefore the Commission's proposals to monitor excessive imbalances.

154. It is essential that the level of private debt should be monitored as part of any comprehensive surveillance mechanism and we welcome the Commission's proposals to ensure that this is included under new proposals to detect excessive imbalances.
155. We recognise the intrinsic difficulty of defining, measuring and analysing macroeconomic imbalances, and distinguishing between excessive and benign imbalances. Therefore the success or otherwise of the planned macroeconomic surveillance will depend on the capacity of the early warning system to detect excessive imbalances at a sufficiently early stage, and Member States having the political will to engage in honest discussion of the results. This calls for judgement in distinguishing between macroeconomic developments which can be blamed on national policy choices (such as property bubbles), improvements in competitiveness that arise from sound structural policies, and current account divergences that reflect inconsistencies between domestic demand among Member States.
156. We recognise that there are two sides to current account imbalances, but we do not believe that countries in surplus should be subject to the same procedures as those in deficit. Where excessive current account deficits arise as a result of national policy choices, it is proper that they should be the subject of corrective recommendations under these proposals. It is not appropriate or realistic, however, to issue corrective recommendations to a country with a current account surplus. Nevertheless, surpluses are not always benign and it is important that surplus countries also face pressure from their peers to contribute to the reduction of imbalances in ways which do not damage their global competitiveness.
157. The causes of the current crisis are now well known; the causes of any future crisis, however, are likely to be different. The Commission and Member States must ensure that the criteria and types of imbalance covered by this surveillance are regularly reviewed to maintain their relevance as EU and global economies develop.

Enforcing competitiveness?

158. In contrast to the sanctions available for enforcing fiscal discipline under the SGP, the sanctions proposed under the excessive imbalance procedure for macroeconomic surveillance are new. Our witnesses suggested that, while the market could quickly punish governments for irresponsible fiscal behaviour, it would not play the same role in the macroeconomic sphere. The market will help rebalance macroeconomic imbalances in the long-term, but it will not act quickly. Mr Leandro explained why the van Rompuy taskforce had recommended sanctions to enforce the EIP: to "make sure that what has been recommended has a chance to be implemented ... both Commission and taskforce members recognised that ultimately, in the case of this imbalance [mechanism], you need sanctions and an enforcement mechanism".²²⁰ The Commission agreed,²²¹ as did some of our other witnesses.²²²

²²⁰ Q 250

²²¹ Q 374

BOX 8**Enforcing the excessive imbalance procedure****Regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area**²²³

This Regulation creates a series of sanctions to enforce the Commission's proposals for an excessive imbalance procedure (see Box 5 on page 41).

The sanctions process

If a euro area member-state repeatedly fails to act on Council EIP recommendations to address excessive imbalances, it will have to pay, according to the provisions of this Regulation, a yearly fine equal to 0.1% of its GDP. The fine can only be stopped by a qualified majority vote (according to the reverse voting mechanism), with only euro area member-states having the right to vote.

This Regulation will not apply to the UK.

159. Others however, even those who argued that a symmetrical adjustment should take place, were concerned about the use of sanctions to enforce the EIP. Dr Schelkle argued that “you cannot punish a government” just because their private sector is “not as competitive as those of the Dutch, the Finnish or the Germans”.²²⁴ She argued that governments would not necessarily be able to control imbalances, and that it would be unreasonable to “punish sovereign Member States for imbalances that governments cannot be held responsible for”.²²⁵
160. Earlier in this chapter we recognised the intrinsic difficulties of defining and measuring imbalances. Mr Persson put this in the context of sanctions and argued that the criteria for an excessive imbalance would be “subject to judgement” and “endless negotiation between the Council and the Commission”. It was therefore “not as easy as with fiscal rules” where there are clear targets.²²⁶ Professor Copeland agreed.²²⁷
161. If recommendations are to be addressed to both surplus and deficit countries, as suggested by the Commission,²²⁸ this would potentially mean sanctions under the EIP could be levied against not only those countries in deficit, but also competitive countries which refused to comply with the Commission's recommendations. Several witnesses suggested that the thought of punishing surplus countries such as Germany for refusing to comply with recommendations that would lower their relative competitiveness was ridiculous.²²⁹
162. The SGP gives concrete, measurable criteria for judging responsible fiscal performance. It is therefore reasonable that sanctions are available to force the compliance of Member States who break these criteria. Recommendations under the EIP, however, will be based on more subjective decisions, and we would be concerned if sanctions were used to enforce these decisions if reasoned argument has failed. We do not feel that sanctions can

²²² Q 500 (Professor Buitter), Q 301 (Mr de la Chapelle Bizot)

²²³ COM (2010) 525

²²⁴ Q 108

²²⁵ EGE 17

²²⁶ Q 440

²²⁷ Q 441

²²⁸ QQ 381, 382

²²⁹ Q 283 (Professor Pisani-Ferry). See also QQ 75 (Mr Cliffe), 97 (Professor Goodhart)

realistically be levied against a sovereign nation because it refuses to act to reduce its own competitiveness, even if such a decision might be against the interests of the euro area as a whole.

163. **Because of the intrinsic difficulty in determining what constitutes an excessive imbalance, we have strong reservations about resorting to sanctions within the excessive imbalance procedure, especially for outcomes that are much less directly under the control of governments.**

Economic and fiscal policy coordination: the European Semester

164. The idea of establishing a ‘European Semester’ as an additional instrument for enhanced surveillance was approved at the ECOFIN Council on 7 September 2010. The Semester intends to align better three strands of EU economic policy: macroeconomic surveillance, fiscal consolidation and structural reforms. In other words, it will bring closer together the procedures underpinning the Europe 2020 Strategy, the Stability and Growth Pact and, assuming that it is adopted, the excessive imbalance procedure.
165. Until now, the Commission has conducted fiscal surveillance and issued recommendations under the SGP to a different annual timetable from that used when conducting surveillance and issuing recommendations under the Europe 2020 Strategy for growth and jobs. Mr Costello explained some of the difficulties this caused: “We took care to ensure that those recommendations were not inconsistent, but that is not to say that they were as aligned as they should have been”. He explained that the European Semester would allow the Commission to issue both sets of recommendations in one go. Secondly, it will allow the Commission to issue its recommendations on fiscal policy before Member States’ budgets are adopted, rather than after the fact as had previously been the case.²³⁰
166. The UK will be subject to the European Semester.²³¹ Mr Costello noted that, since the UK’s fiscal and calendar years are different from other Member States, “it is probably a nicer fit for the UK budget calendar than any other”, although he noted wryly that “that was not the original validation for this”.²³²
167. When first proposed, there were concerns that the European Semester would mean that the Commission was being given oversight over the UK budget before it was approved by Parliament. Several witnesses disagreed with this interpretation, with Mr Zuleeg pointing out that “oversight implies some form of control. That is ... not really on the table”. He added that the function of the Semester was “simply to have a discussion about what impact a budget in one country has on other countries before it actually happens”.²³³
168. Witnesses, overall, had positive comments about the European Semester.²³⁴ In Mr de la Chapelle Bizot’s view, “it will feed the debate and will provide Members of Parliament with another point of view, which could be different from the Government’s. I think it will help the national Parliament to vote

²³⁰ Q 391

²³¹ See also European Union Committee, 5th Report (2010–11): *The EU Strategy for economic growth and the UK National Reform Programme* (HL Paper 81).

²³² Q 392

²³³ Q 336

²³⁴ QQ 46 (Mr Smewing), 336 (Mr Zuleeg), EGE 22 (European Policy Centre)

with more information”.²³⁵ The Government support the European Semester, noting that it will put EU level surveillance of fiscal and macroeconomic policies on “a common timetable”.²³⁶

169. **We believe that Member States will benefit greatly from the introduction of a European Semester which will lead to more coherence in the way the Commission offers advice on how Member States could coordinate economic policies across the EU.**
170. **Rather than downgrading the role of national parliaments we believe that a European perspective can only strengthen national parliaments’ scrutiny of their national executives by providing more information.**

European Systemic Risk Board

171. The proposals on macroeconomic surveillance include a role for the European Systemic Risk Board (ESRB), a body created under the new European system of financial supervision, and established from January 2011. The ESRB is in charge of macro-prudential supervision, with the power to issue systemic risk warnings. Its primary objective is to identify and prevent risks to financial stability, and it provides an important means by which the monetary authorities, led by the European Central Bank, contribute to the overall surveillance of Member State economies.
172. There is an inter-linkage between macroeconomic surveillance and the ESRB. The Commission made it clear to us that “whenever the Commission steps up surveillance on a Member State and believes, on the basis of its analysis, that there are imbalances, when formulating recommendations to the Member State it will take into account the deliberations of the European Systemic Risk Board”.²³⁷ Mr Leandro further clarified its role, explaining that the idea was for the new macroeconomic surveillance framework to consider the opinions and inputs of the ESRB when assessing macro-imbalances, so that fiscal, financial and structural dimensions could be integrated.

BOX 9

Financial supervision

The new financial supervision architecture consists of the European Systemic Risk Board for macro-prudential supervision (ESRB) and the European Supervisory Authorities (ESAs) for micro-prudential supervision. The ESAs oversee the supervision of banks, insurers and securities markets.

The ESRB will oversee macroeconomic and financial market trends, and identify and deter the build-up of excessive risk at an early stage. The ESRB “has been conceived as a ‘reputational’ body with a high-level composition that should influence the actions of policymakers and supervisors by means of its moral authority,” according to the Commission proposal.²³⁸

The board will be made up of governors of the 27 national central banks, the president and vice-president of the ECB, a member of the European Commission and the chairs of the three ESAs. The ESRB has no binding legal powers.

²³⁵ Q 303

²³⁶ EGE 14

²³⁷ Q 382

²³⁸ COM (2009) 499, para 6.2

173. Some witnesses emphasised the significance of the ESRB in the macroeconomic surveillance architecture. Dr Annunziata defined the ESRB as “extremely precious” and noted that its role would be complementary to the monitoring taking place under the SGP.²³⁹ It will bridge the gap between supervision and regulation of the financial sector and the budgetary policies of Member States. Given that the ECB has also been a major contributor to the response to the economic crisis, initially by providing liquidity to banks and subsequently by buying up sovereign debt, its place in the governance architecture is important.
174. Despite the ESRB’s potential importance, we were unclear as to how it would operate in practice. We posed this question to our witnesses. Professor Pisani-Ferry responded that there was not much information to clarify what the ESRB was going to do, or how. He stated, though, that there was a great deal of crossover between financial stability (overseen by the ESRB), macroeconomic imbalances (monitored through the EIP) and fiscal surveillance (through the SGP). He warned that the discussion treated the three different fields as if they were “three silos”, whereas “they had much in common”. He observed, “How the policy framework is going to clarify better the distinction of what exactly the role is of this three-part procedure is a major issue for the clarity of the policy framework”.²⁴⁰
175. Professor Copeland suggested there were a number of potential concerns. In particular, he questioned whether the ESRB would “have the power, and the political independence, to make objective assessments of risks associated with banks’ sovereign lending, questions which are obviously very sensitive in political terms since they involve passing judgment on the sustainability of fiscal policy at national level”.²⁴¹
176. **The European Systemic Risk Board (ESRB) is a key new body in the European financial supervisory framework, and will serve as the interface between macro-economic surveillance and macro-prudential supervision. We recommend that more consideration should be given to the way the ESRB interacts with the Commission and ECOFIN in the excessive imbalance procedure and the SGP. We encourage the Government to ensure that the analyses of the ESRB are considered, and acted upon, when the Commission and Council consider the results of the proposed macroeconomic surveillance framework.**
177. **The European Central Bank has played a central role in managing the crisis and will continue to be a cornerstone of EU economic governance. The ESRB is the route through which the central banks, and the ECB in particular, should be able to contribute actively to discussions on the fiscal and macroeconomic positions of Member States.**

Long term correction of competitiveness imbalances: economic growth

178. Economic growth is central to any programme to reduce imbalances and restore competitiveness in the EU. As Mr Cliffe argued, “the integrity of

²³⁹ Q145

²⁴⁰ Q 282

²⁴¹ EGE 20

monetary union isn't just about fiscal discipline and fiscal responsibility; it's also about economic growth".²⁴²

179. Professor Goodhart drew attention to a situation where "the interest rates that peripheral countries, which are seen as under threat, are having to face are high, and their prospective growth is terribly low, and that simply is not sustainable". He concluded that "what is missing from all the work in Europe is any study or exercise about how the heck these countries are going to get growth, particularly through the net export side".²⁴³ Mr Zuleeg's greatest concern was that there was little debate about the growth part of economic governance. All the emphasis on enforcement and sanctions was of little significance if not accompanied by measures leading to growth as, ultimately, "debt has to be eroded through GDP growth".²⁴⁴
180. We considered the significance of Europe 2020, the EU strategy for jobs and growth, as a driver for growth across the EU. Mr Costello felt that Europe 2020 "should be the growth component of the entire recovery strategy that countries need".²⁴⁵ While other mechanisms would address fiscal stability and imbalances, the Europe 2020 strategy should drive growth as "part and parcel" of the discussions on economic governance.²⁴⁶ Mr Martens argued that Europe 2020 should be an integral part of discussion about economic governance, because structural reforms were essential for ensuring future growth.²⁴⁷
181. Other witnesses were more sceptical. Professor Goodhart said that while Europe 2020 would help, he did not believe that the strategy would have any "immediate effect", which would be needed in the short run to offset austerity programmes.²⁴⁸ Dr Dadush argued that Europe 2020's credibility was weak. He explained that "Structural reforms ... can only be achieved by determined action at the national level, fully legitimized by the national political process. EU guidelines can help provide a framework, but that is where they stop".²⁴⁹
182. The Minister had a similar view, noting that while Europe 2020 could help encourage future growth, it required "real focus and commitment from Member States to deliver some of the priorities in there".²⁵⁰ He also remarked on the importance of the single market project to enhance EU growth: "the more work we have done to widen and deepen the single market, the better the chances of economic growth". This will "help Member States tackle their deficits. It will help improve stability".²⁵¹
183. Professor Mario Monti, President of Bocconi University and a former European Commissioner, echoed these views in an article in December 2010. He argued that an uneven development of the single market lay behind divergences in competitiveness and the inadequate economic performance of the EU, especially in the euro area. He suggested that "the proposed

²⁴² Q 63

²⁴³ Q 94

²⁴⁴ Q 333

²⁴⁵ Q 398

²⁴⁶ Q 398

²⁴⁷ Q 334

²⁴⁸ Q 96

²⁴⁹ EGE 18

²⁵⁰ QQ 554–5

²⁵¹ Q 519

framework goes a long way towards providing economic governance but neglects economic union”.²⁵²

184. We agree that promoting growth should be a vital component of any measures to help the EU out of the current crisis. The Europe 2020 strategy has an important role to play in this regard, although its success will depend on the willingness of Member States to take national action to meet its priorities. Further developing the single market should also be a priority to help drive growth.²⁵³
185. **Loss of competitiveness and an absence of growth are a damaging combination for the Member States struggling to deal with the aftermath of the crisis. Reviving growth and reducing the deficit are complementary rather than competing objectives. Countries with large fiscal and current account imbalances need policies that support growth and restore competitiveness to ensure long-term sovereign debt sustainability.**
186. **We believe that the emphasis should be on both dimensions of the Stability and Growth Pact: ensuring stability while enhancing growth so that recovery from the crises of the past three years can be achieved along with competitiveness.**
187. **The enhanced EU economic governance regime must connect with overarching policies such as Europe 2020 to ensure the single market is able to stimulate growth and competitiveness across the EU. The EU and the UK Government should be driving forward the single market agenda, along the lines set out by Professor Mario Monti in his report *A new strategy for the single market*,²⁵⁴ with a view to making it an integral part of the reformed economic governance architecture. Without a return to sufficiently robust economic growth, the prospects for dealing with the legacy of the crisis will be much more slender.**

The Pact for the Euro

188. The Pact for Competitiveness was a proposal circulated by France and Germany to Member States before the European Council on 4 February 2011. It suggested a series of measures to reduce the competitive divide among euro area countries through much closer coordination of structural reforms—well beyond those currently envisaged under Europe 2020. The Pact for Competitiveness included:
- the abolition of salary indexation systems;
 - the mutual recognition of educational diplomas and vocational qualifications;
 - the creation of a common assessment of corporate income taxes;
 - overhaul of national pension systems;
 - the insertion of a “debt alert mechanism” into national constitutions of all Member States; and
 - the establishment of national crisis management regimes for banks.

²⁵² Monti M, “Europe must buck short-term tendencies”, *Financial Times* (13 December 2010)

²⁵³ A report from the European Union Select Committee on the single market will examine some of these issues in more detail. It will be published in early April 2011.

²⁵⁴ Monti M, *A new strategy for the single market* (May 2010)

189. Due to concerted opposition from a number of Member States, the proposal was never formally tabled for consideration by the European Council.²⁵⁵ Instead, Herman van Rompuy was asked to explore the matter further and report back at the European Council meeting in March 2011.
190. Mr van Rompuy put his proposals to a meeting of the heads of state or government of the euro area at a meeting on 11 March 2011. The “Pact for the Euro” was endorsed by this group, which indicated that they would adopt the Pact at the European Council meeting on 24 and 25 March 2011. The group’s statement invited non-euro area Member States to participate in the Pact on a voluntary basis.²⁵⁶
191. The Pact for the Euro requires Member States to pursue measures to achieve the following objectives:
- foster competitiveness;
 - foster employment;
 - contribute further to the sustainability of public finances; and
 - reinforce financial stability.
192. The Pact for the Euro does not go as far as was proposed by France and Germany in the Pact for Competitiveness, but it does commit euro area Member States to coordinating more closely a number of areas which fall under national competences, and goes beyond currently agreed strategies such as Europe 2020. It is therefore a significant step for the euro area Member States to take.
193. **The Pact for the Euro was proposed after we had completed taking evidence so we were unable to discuss it with witnesses. We do, however, have concerns about its implications for those countries outside the euro area, particularly those Member States which choose not to participate voluntarily. The development of a ‘two-speed’ Europe would create a significant distinction within the single market between those states inside the euro area or participating voluntarily in the Pact and those who choose not to.**

²⁵⁵ Hollinger P and Spiegel P, “Cracks over Franco-German Eurozone plan”, *Financial Times* (4 February 2011)

²⁵⁶ *Conclusions of the heads of state or government of the euro area of 11 March 2011*:
http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/119810.pdf

CHAPTER 5: A CRISIS MANAGEMENT FRAMEWORK FOR THE EU

194. The crisis in the euro area brought to light a significant omission in the economic governance arrangements of the EMU: the absence of a crisis management framework. This deficiency has been exacerbated by the ‘no bail-out’ clause²⁵⁷ of the TFEU. As the crisis unfolded, uncertainties as to whether the EU was going to support countries experiencing financial difficulties led markets to speculate about the resilience of the system, while at the same time increasing the pressures on it.
195. Professor Pisani-Ferry explained that the founders of the euro had assumed that only a regime to prevent a crisis was needed. They felt that putting in place some sort of crisis resolution mechanism “would have created a moral hazard and therefore would have done more harm than good”.²⁵⁸ The euro area now finds itself dealing with the immediate crisis without a mechanism for crisis management, while simultaneously trying to put in place a framework for crisis management in the future.²⁵⁹
196. This chapter reflects this perspective and distinguishes between the measures put in place by the EU to mitigate the ongoing crisis, and those to put in place a more permanent system for the future.

The current crisis: towards 2013

197. To provide a bulwark against the market speculation, the EU’s leaders agreed in May 2010 to create two temporary funds to provide liquidity to affected economies. The European Financial Stabilisation Mechanism (EFSM) provided €60 billion underwritten by all 27 EU Member States; the larger European Financial Stability Facility (EFSF), funded and available only to the euro area, had funding of up to €440 billion. The EFSM²⁶⁰ was under-written by the EU budget and was established under Article 122.2 of the Treaty on the Functioning of the European Union (TFEU), which provides for temporary assistance to a Member State when it is in “difficulties or is seriously threatened by natural disasters or exceptional circumstances beyond its control”. The EFSF, in contrast, was created as a new entity, called a Special Purpose Vehicle, with a limited life span of three years. In addition, the IMF agreed to make available a credit line of up to €250 billion, making a total of €750 billion.
198. These decisions succeeded in easing tensions somewhat, but there were continuing pressures on vulnerable Member States. By late autumn 2010, Ireland had become the focus of attention and was eventually obliged to accept a rescue package. The overall package was of a similar order of magnitude to that offered to Greece, and included funds from the EFSM and EFSF, and again an IMF contribution. There were some key differences, however. First, some €35 billion of the Irish facility was to be available for

²⁵⁷ Article 125 prohibits the Union from being liable for the financial commitments of governments. It means that there should be no scope for a Member State to borrow directly from any EU body, including the ECB which is also specifically precluded from directly purchasing government securities (Article 123). In this way the monetisation of debt (printing money) is ruled out, a provision designed to prevent inflationary pressures.

²⁵⁸ Q 272

²⁵⁹ Q 396

²⁶⁰ Established by Council Regulation 407/2010

direct support of Irish banks and, secondly, part of the funding was in the form of direct bilateral loans from the UK (€3.44 billion), and Sweden and Denmark (€0.9 billion combined).

Private sector involvement

199. During discussions on the establishment of a permanent crisis mechanism (due to come into existence from 2013) to replace these two temporary mechanisms, public declarations by politicians that the private sector would have to bear some of the costs of the crisis spread unease among bondholders, leading to an increase in the interest rates of sovereign bonds of peripheral countries. We discussed the shortcomings of the euro area's communications with the markets in Chapter 2.²⁶¹
200. Mr Leandro was clear that this was a misunderstanding. He said that a statement made by the finance ministers of France, Germany, Italy, Spain and the UK during the G20 meeting in Seoul stated unequivocally that “private sector involvement does not apply to outstanding debt ... it will apply only under the new mechanism after 2013”.²⁶²
201. This assertion was commented on by several witnesses. Professor Buiters's view was that this was “a commitment they could not make”.²⁶³ He argued that “the only debt that's likely to be restructured in the near future—there will be sovereign debt restructuring—is the old debt”.²⁶⁴ Dr Annunziata also argued that it was “sidestepping the problem” to say that only debt issued after 2013 would be subject to haircuts,²⁶⁵ adding that “the problem we are facing today is that a number of European countries are saddled with substantial amounts of public debt”.²⁶⁶
202. While we recognise that some observers believe that there will inevitably be haircuts for bond-holders on currently issued sovereign debt, we heard evidence that this would lead to further market unease and contagion.²⁶⁷ Under these circumstances, we support the Government's position that, to uphold market confidence, there must be no haircuts for bond-holders in the short-term. This may be difficult to achieve, and every effort should be made to ensure that those countries currently financing large public debts with help from their EU partners, including through the EFSM and EFSF, are able to continue to do so until a new permanent mechanism can be brought in from 2013.²⁶⁸ The Irish election campaign has shown that there will be pressures to ease the burden on the two countries that have received rescue packages. Difficult compromises may have to be reached between citizens in these countries and bond-holders in others. The recent decision to reduce the interest rate charged to Greece reflects the recognition that Member States in trouble can only do so much. We welcome the recent decision by euro area Member States to increase the size of the lending capacity of the EFSF.

²⁶¹ See paragraphs 61–63

²⁶² Q 261

²⁶³ Q 495

²⁶⁴ Q 496

²⁶⁵ A haircut occurs when a lender has to accept a reduction in the redemption value of a bond because of the inability of the borrower to pay it in full; for example, if only 90 cents is repaid per euro, the haircut would be ten cents (10%).

²⁶⁶ Q 134

²⁶⁷ QQ 101 (Professor Goodhart), 135 (Dr Annunziata), 178 (Dr Gros)

²⁶⁸ See paragraphs 227–234 for more information on the new permanent mechanism.

Member States should make clear that the EFSM and EFSF could be increased again, if necessary, to ensure that any countries in difficulties will have access to sufficient liquidity support.

203. **The finance ministers of France, Germany, Italy, Spain and the UK have stated that there will be no losses for the private sector on sovereign debt issued before a new permanent crisis mechanism comes into force in 2013. While we recognise that this commitment may be necessary to maintain market confidence in the euro area in the short-term, we are doubtful that it will prove sustainable. It implies a significant burden upon citizens in the debtor countries; a burden that they may find difficult to maintain in the period to 2013 and beyond.**
204. **We welcome the recent decision by euro area Member States to increase the size of the EFSF. We recommend that Member States make clear that they will have no hesitation in further increasing the size of the EFSF, if that is necessary, to preserve the solvency of euro area Member States. In addition, we recommend that Member States carefully consider the interest rate on loans given by these two mechanisms to ensure that they do not prove overly onerous on those countries receiving assistance.**

Role of the European Central Bank

205. A key principle of the EMU is the independence²⁶⁹ of the ECB. By separating national fiscal policy and the ECB, the founders of the monetary union believed that monetary policy was safe from being used by policy-makers as a lender of last resort in times of strain on public finances. In the absence of political independence, the central bank can be forced to print money to finance government budget deficits.
206. While we did not consider the issue in much detail, it became clear during our inquiry that the ECB played a key role in the euro area's response to the sovereign debt crisis through the purchase of Greek government debt²⁷⁰ and that of other stricken euro area countries (the "Securities Market Programme"). The ECB's intervention was intended to prevent another banking crisis in the EU "where many banks had unknown but potentially significant exposures to fiscally challenged sovereigns."²⁷¹ According to Dr Schelkle, the ECB's bond purchase programme showed "that the separation of fiscal and monetary policy cannot always be maintained."²⁷² Whilst the ECB's programme helped stabilise the markets, it led to strong criticism from different quarters, especially from the out-going President of the Bundesbank Axel Weber²⁷³ and German economists.²⁷⁴ Dr Mayer and Dr Gros suggested that "a major casualty of the emergency decisions was the

²⁶⁹ The independence of the ECB and the national central banks of the Eurosystem has a constitutional status, as it has been set down in both the Treaty on the Functioning of the European Union (Article 282.3) and the Statute of the European System of Central Banks rather than in secondary legislation.

²⁷⁰ ECB Press Release, *ECB decides on measures to address severe tensions in financial markets* (10 May 2010)

²⁷¹ Buiters W and Rahbari E, "Greece and the fiscal crisis in the Eurozone", *Centre for Economic Policy Research Policy Insight No. 51* (2010)

²⁷² EGE 3

²⁷³ Bloomberg, Thesing G and Buergin R, *Weber Says ECB Should Phase Out Bond Purchases Now* (13 October 2010)

²⁷⁴ Bloomberg, Gros D and Mayer T, *ECB May Kiss Credibility Goodbye*, (May 11 2010)

ECB. With its move to prop up the failing bonds of governments in financial distress, it has allowed itself to be transformed into an agent of fiscal policy ... in the long run this is likely to undermine confidence in the ECB and the euro.” The ECB programme was described as almost equivalent to quantitative easing by Professor Buiter²⁷⁵ (see Box 10 below).

BOX 10

The ECB and quantitative easing

Article 123 of TFEU forbids the ECB from giving credit to, or purchasing sovereign debt from, sovereigns. However, the Article does not forbid it from purchasing sovereign debt on the secondary markets. Under its newly-created “Securities Markets Programme” it can purchase any private and public securities in secondary markets. The ECB argued that this did not amount to quantitative easing (a policy where central banks create money to buy government debt and other assets to boost the money supply) and that it was acting on the basis of its mandate to preserve financial stability rather than deliberately supporting the liquidity of sovereigns in the euro area. Other observers have suggested that the ECB’s “distinction between quantitative easing and asset purchases under the Securities Markets Programme is semantic, not substantive”.²⁷⁶

207. Witnesses elaborated on the risks of the ECB’s policies. Professor Louis suggested that although the Securities Market Programme was legal, it was a policy “that has necessarily to be temporary” because of its effect on the ECB’s balance sheet.²⁷⁷ According to Professor Buiter the ECB have “at least €67 billion of wonky sovereign debt on their books outright under the SMP [Securities Markets Programme], and they hold a lot more sovereign debt from the peripheral countries as collateral against bank loans, where the banks themselves are, in all likelihood, insolvent in a number of cases”.²⁷⁸
208. Dr Mayer envisaged two alternatives if these debts went bad: the ECB would have to be recapitalised, or the bad debt would have to be paid off through creating money. In the first case, Germany, as the largest shareholder, “would have to foot the largest bill”. The second alternative would eventually cause inflation.²⁷⁹
209. Barry Eichengreen, Professor of Economics and Political Science at the University of California, Berkeley, said in his article *Drawing a line under Europe’s crisis* that “the ECB, recent events remind us, is a lender and market-maker of last resort and not just the steward of a monetary union ... its legitimacy and credibility are at stake”.²⁸⁰
210. **The ECB’s purchase of sovereign bonds has longer-term consequences for its reputation and balance sheet. These should be carefully monitored and assessed. The ECB should consider how to reduce its own exposure to heavily indebted banks and sovereigns by shifting the funding burden to the new European Stability Mechanism (see paragraphs 227–232).**

²⁷⁵ Q 488

²⁷⁶ Buiter and Rahbari, “Greece and the fiscal crisis in the Eurozone”, op. cit.

²⁷⁷ Q 367

²⁷⁸ Q 492. See also Q 53 (Mr Cliffe)

²⁷⁹ Mayer T “What more do European governments need to do to save the Eurozone in the medium run?”, *VoxEU.org* (17 June 2010)

²⁸⁰ Eichengreen B, “Drawing a line under Europe’s crisis”, *Remarks at the Ninth annual Munich Economic Summit* (17 June 2010)

Eurobonds: the way forward?

211. The concept of a eurobond has been discussed for a while in some circles in the EU, especially in the European Parliament,²⁸¹ but it was never considered seriously until the crisis. The original proposal for a eurobond dates back to Jacques Delors in the 1980s, and was recently revamped by Mario Monti in his report on the Single Market to President Barroso.²⁸² The debate was given new life after Jean-Claude Juncker, the Luxembourg Prime Minister and President of the Eurogroup, and Giulio Tremonti, the Italian Finance Minister, authored an article in the *Financial Times* putting forward their idea of how a eurobond might function.²⁸³
212. They proposed that new sovereign debt from euro area Member States could be issued in the form of eurobonds through a new European Debt Agency. Up to 40% of the GDP of euro area sovereign debt could ultimately be jointly and severally guaranteed this way.²⁸⁴ They argued that this expression of commitment to the euro would increase the liquidity available to euro area members and end speculative attacks against Member States. The German Chancellor, Angela Merkel, however dismissed this idea on the basis that it would impinge on fiscal sovereignty and would possibly require a change in the Treaty to achieve.
213. Our witnesses were generally²⁸⁵ sceptical about this Eurobond proposal, suggesting that it would encourage moral hazard (Member States would have no incentive to follow fiscally responsible policies since the eurobonds would insulate them from the opinion of the markets) and would require an increased level of fiscal integration. Dr Annunziata explained that “a common Eurozone bond would need to be backed by a common pool of resources, presumably a pooling of tax revenues from the individual governments. This in itself would represent some pooling of sovereignty that government would need to be ready to accept”.²⁸⁶ He suggested that the scheme would require the pooled revenues to be set aside in a separate fund, otherwise all Member States could find their borrowing costs rise if the markets felt some individual Member States posed a high risk. The European Policy Centre agreed and suggested that the challenge would be to make certain that the cost of borrowing for the stronger countries (e.g. Germany) did not rise disproportionately and that there remained a “strong incentive for reform in the highly indebted countries”.²⁸⁷
214. Professor Buitter felt that the proposal by Juncker and Tremonti was unfeasible: “it’s uncapped ... and would remove any discipline of national sovereigns to keep their fiscal-financial houses in order”. He did suggest, however, that it was already possible to issue “jointly and severally guaranteed bonds—eurobonds if you want—under the existing Treaty, provided it is for a project”. Since the Treaty does not define what a project is, it might therefore be possible to have “a capped amount of jointly and severally debt issued”.²⁸⁸

²⁸¹ Q 483

²⁸² Monti, *A new strategy for the Single Market*, op. cit.

²⁸³ Juncker C and Tremonti G, “E-bonds would end the crisis”, *Financial Times* (5 December 2010)

²⁸⁴ Q 497

²⁸⁵ Although not unanimously—see for example EGE 3 (Dr Schelkle)

²⁸⁶ EGE 16

²⁸⁷ EGE 22

²⁸⁸ Q 496

215. Professor Pisani-Ferry explained another proposed version of a eurobond, designed to mitigate the problem of moral hazard.²⁸⁹ Common bonds could only be issued up to a certain threshold of GDP. This debt would be senior to the remaining public debt above the threshold, which would remain the sole responsibility of the individual Member States. This would ensure that the risk premiums on the national debt would remain variable, and serve as an incentive for states to maintain responsible a fiscal position.
216. The Minister told us that “no one has yet come forward with a formal proposal around eurobonds”,²⁹⁰ and added that he believed any issue of a joint eurobond would require a Treaty change to achieve.²⁹¹
217. **Discussions over the feasibility or otherwise of different proposals for eurobonds will continue. Although their proponents suggest that they would help stabilise weaker members of the euro area, there is little consensus on how they might work at the present time. They may well represent a greater degree of fiscal integration than Member States are willing to accept given the current disparities between economies in the euro area.**

Towards a permanent crisis resolution mechanism

218. A number of witnesses told us there was a need for a permanent fund to provide liquidity assistance,²⁹² although Open Europe argued forcefully against the idea. It gave two main reasons: that it would encourage moral hazard; and that a permanent fund would make taxpayers in one country liable for the mistakes of another.²⁹³

BOX 11

Liquidity and solvency

The linkage between solvency and liquidity became a recurrent theme during the course of our inquiry. The determination of whether a country is illiquid (a temporary inability to service debt) or insolvent (a long-term inability to service debt) is important to determine the effectiveness of a rescue mechanism. The fine line between illiquidity and insolvency for sovereign states is a question of judgement.

In practical terms, rescue funds such as the EFSM and EFSF facilities may help in case of illiquidity (since they will tide a fundamentally solvent government over a temporary period of difficulty), but will only postpone the problem for countries which are fundamentally insolvent. It has been argued, therefore, that to avoid a severe shock to a system when an insolvent government finally announces it cannot pay back its debts, there should be a debt restructuring mechanism put in place to deal with countries which are fundamentally insolvent.

219. Other witnesses argued for a debt restructuring mechanism which would provide for an orderly restructuring of an insolvent country’s public debt (also described as a managed default). At Germany’s insistence²⁹⁴ the issue

²⁸⁹ Delpa J and von Weizsäcker J, “The blue bond proposal”, *Bruegel Policy Brief 2010/03* (2010)

²⁹⁰ Q 570

²⁹¹ Q 572

²⁹² QQ 65-66 (Mr Cliffe), 100 (Professor Goodhart), 172 (Dr Gros), 290 (Professor Pisani-Ferry), 489 (Professor Buiter), EGE 3 (Dr Schelkle)

²⁹³ EGE 7

²⁹⁴ See Czuczka T, “Merkel’s coalition steps up calls for orderly insolvencies in euro zone”, *Bloomberg* (4 May 2010)

was prominent in debates on a permanent crisis mechanism during 2010. Ms Barysch explained why: “they [the Germans] decided that if the discipline can’t come from Brussels, it has to come from the markets”. The Germans therefore “wanted ... a restructuring clause ... so that we can ask the markets to discipline countries if we can’t do it ourselves”.²⁹⁵

220. Open Europe felt that an orderly default procedure “would come with several benefits”. They argued that it would transfer risk from taxpayers to creditors; reduce moral hazard; and ensure that the markets priced risk correctly by sending a clear message that no euro area country was “too big to fail”.²⁹⁶ Dr Dabrowski took a similar view, noting that “clearly defined rules and procedures of sovereign default ... could help minimise market panics in case of fiscal difficulties in individual countries and would force financial markets to better price ... risks in advance”.²⁹⁷ The Institute for Economic Affairs stated that if market forces were to control governments’ behaviour effectively, “reforms ought to be aimed at making a sovereign default look as inevitable an outcome of fiscal irresponsibility as it would in the absence of a monetary union”,²⁹⁸ while Professor Buitter stated such a mechanism was necessary “to deal with those sovereigns that are fiscally unsustainable and insolvent and who, in the absence of fiscal union, need to be restructured”.²⁹⁹
221. The Minister raised a note of caution, saying that if sovereign debt were issued with collective action clauses,³⁰⁰ it was likely to raise the cost of borrowing, particularly if investors were uncertain about the underlying economic health of the Member States concerned. For some Member States, there is a clear risk that the premium would soar and could push them towards a default on existing debt.
222. In addition to these points, we would suggest that a debt restructuring mechanism would offer a way forward to countries finding their debt burden an insurmountable obstacle to future growth.

A dual mechanism

223. A number of witnesses supported the establishment of a mechanism providing both liquidity assistance and debt restructuring.³⁰¹ Dr Mayer summarised what he thought its basic functions should be: “to give, in times of emergency and financial distress, emergency financial assistance coupled to adjustment programmes. The second function would be to make a default of a sovereign possible without this causing a systemic shock”.³⁰²
224. Dr Mayer, with Dr Gros, has previously proposed a ‘European Monetary Fund’ which he described as ‘a European IMF-plus’. This mechanism would offer financing, under strict conditionality in the same way as the IMF, but in addition would have “the ability to restructure the debt of an

²⁹⁵ Q 453

²⁹⁶ EGE 7

²⁹⁷ EGE 10

²⁹⁸ EGE 8

²⁹⁹ Q 489

³⁰⁰ Collective action clauses are provisions that allow a qualified majority of bondholders to change the terms of payment. They can facilitate creditor-debtor negotiations in cases where sovereign debt restructuring is necessary.

³⁰¹ See, for example, QQ 290 (Professor Pisani-Ferry), 489 (Professor Buitter)

³⁰² Q 131

insolvent country”.³⁰³ Dr Gros described the advantage of having such an institution: “you need an independent institution ... to take the difficult decisions on whether a sovereign is liquid or insolvent ... The Commission itself is not the proper place, because as a college it is becoming more and more political ... just making ECOFIN partially independent is not enough”.³⁰⁴ Dr Gros and Dr Mayer envisaged financing such an institution through contributions from euro area Member States, in proportion to the risk each country presents. Countries breaching the SGP would therefore pay higher contributions.

225. Dr Schelkle was supportive of the notion of an independent body: “we need a kind of equivalent of a European Monetary Fund”.³⁰⁵ Dr Annunziata, although he agreed that a permanent fund would be helpful in reducing the risk of systemic instability, questioned why the IMF was not suitable: “it would seem most wasteful to duplicate the features and expertise of the IMF by setting up a European Monetary Fund”.³⁰⁶ If this did happen though, he felt strongly that the expertise of the IMF should be involved: “The IMF, in terms of the design of the adjustment policies, needs to go hand in hand with any external financing and debt restructuring mechanism”.³⁰⁷
226. The Government have been reluctant to comment on the possible structure of a permanent crisis resolution mechanism. The Minister made clear that the Government “accept the need for a permanent mechanism”, but was not willing to comment in substantial detail since it had been decided that the UK “should be outside it” (see below, paragraphs 235–243).³⁰⁸

The current proposal

227. After EU Member States were forced to provide financial assistance to Greece, and to set up temporary liquidity facilities in the shape of the EFSM and EFSF, the idea of a permanent crisis resolution mechanism (PCRM) started to take shape.
228. The Commission legislative package on economic governance does not include a proposal for a permanent crisis resolution mechanism. Mr Costello explained that, since the EFSM and EFSF would be operational and providing financial support until 2013, the Commission initially decided to concentrate on the “ambitious package” to reform EU economic governance.³⁰⁹
229. The issue was, however, considered by the van Rompuy taskforce report and the European Council decided in October 2010 to “bring forward that debate”.³¹⁰ In December 2010 the EU Heads of State reached an agreement on a permanent resolution mechanism—the European Stability Mechanism (ESM). This will replace the EFSF and the EFSM when they expire in 2013. The new ESM will be founded on an inter-governmental basis, and will only be funded by, and available to, members of the euro area. There will be

³⁰³ Q 140

³⁰⁴ Q 172

³⁰⁵ Q 113

³⁰⁶ EGE 9

³⁰⁷ Q 141

³⁰⁸ Q 509

³⁰⁹ Q 261

³¹⁰ Q 261

provisions made so that other Member States within the EU can contribute to financial assistance packages on an *ad hoc*, bilateral basis.

230. The mechanism will be activated “if indispensable to safeguard the stability of the euro area as a whole”. The ESM will provide financial assistance to euro area Member States under strict conditionality, meaning that loans will only be provided if the Member States agree to take certain actions to improve their financial situation. These conditions would be decided on a case by case basis. In addition, from 2013 onwards all euro area government bonds will be issued with collective action clauses that will allow a qualified majority of bondholders to agree on legally binding changes to the terms of payment in the event that the debtor is unable to pay. There are, however, key issues that are still to be defined, such as the size of the mechanism, the terms under which the private sector would be involved, and the governance arrangements.
231. The European Council have proposed an amendment to the Treaties³¹¹ to establish the ESM. We consider in more detail the practical and legal steps that will be taken to achieve this in our report *Amending Article 136 of the Treaty of the Functioning of the European Union*.³¹²
232. On balance, the evidence we received was strongly in favour of the establishment of permanent crisis mechanism incorporating both a financial assistance fund and a mechanism for an orderly sovereign default. **We welcome, therefore, the Council’s proposals for a European Stability Mechanism. The existence of a formal way of restructuring sovereign debt will encourage the market to price better the risks posed by individual Member States within the euro area, and encourage more responsible fiscal behaviour by Member States which will no longer be insulated from market forces by their membership of the euro. Conditionality is a vital element and we support its application. The ECB should be consulted on the terms and conditions of loans under the ESM.**
233. Despite differing views on whether outstanding sovereign debt would have to be subject to haircuts, our witnesses were strongly of the opinion that the private sector had to share the burden under a permanent crisis mechanism. Dr Mayer told us that taxpayers would not accept that “lenders, who in the past have benefited from elevated returns by lending money to the country, would be entirely spared”.³¹³ Dr Annunziata agreed and felt that “some form of private sector participation in the pain of haircuts is necessary and healthy.”³¹⁴
234. **We welcome the principle, enshrined in the ESM agreement, that the private sector should share the burden of any restructuring of sovereign debt under the new ESM mechanism. It is only right that as they share in the rewards, they should share the risks.**

Should the UK participate?

235. As noted above, the ESM will be created and financed by the euro area. Non-euro area countries would be able to decide to participate voluntarily in

³¹¹ The EU is founded on two core Treaties: the Treaty on European Union and the Treaty on the Functioning of the European Union.

³¹² European Union Committee, 10th Report (2010–11): *Amending Article 136 of the Treaty on the Functioning of the European Union* (HL Paper 110).

³¹³ Q 133

³¹⁴ Q 134. See also, for example, Q 155 (Sir Martin Jacomb)

- financial assistance packages if they wish. The UK could thus choose to participate on an *ad hoc* basis.
236. The UK's involvement in the crisis resolution measures adopted by the EU up to 2011 is significant, though limited by non-membership of the euro. The UK participated in the EFSM (since it was secured by the EU budget), and through its contributions to the IMF was part of the rescue packages to Ireland and Greece. It also contributed separately to the Ireland rescue package through a bilateral loan. It did not, however, participate in the EFSF and the Government have made clear that the UK will not be participating in the ESM.³¹⁵ Both these vehicles are limited to the euro area.
237. We sought views on whether the UK should try to participate voluntarily in a permanent crisis mechanism. Mr Cliffe felt that it was “a political question”: should the UK and other non-members “play their part in the interests of the broader stability of the European Union”.³¹⁶
238. Witnesses drew our attention to the UK's interests in euro area countries such as Spain and Portugal. Dr Dadush pointed out that “a credit event in Spain and Italy would have devastating implications for the UK,” and wondered “why the UK would be a participant in the IMF, to rescue, say, Thailand, but should stand back if Spain is in trouble”.³¹⁷ The European Movement UK made the same argument, adding if the UK was outside any permanent mechanism it could not call upon it if needed.³¹⁸ The European Policy Centre commented if the UK did not pull its “economic weight” and help weaker Member States in economic difficulties, “future problems in the UK have to be faced alone”.³¹⁹ The other argument we heard was that if it did not take part “the UK's influence on the design and of the mechanism and on associated policy issues” would be “very limited”.³²⁰
239. Dr Annunziata thought that although there were strategic issues about the best way for the UK to influence the process, “this is a Eurozone problem ... there is no automatic argument as to why they should be extended to EU members that do not belong to the Eurozone”.³²¹ Professor Chadha was blunt: “there is no need for the UK, as a non-member of the Eurozone, to be involved in any Eurozone crisis fund”.³²² The Institute for Economic Affairs disputed the premise that the UK had to be a part of the mechanism to influence the debate: “Britain's influence, in or out of the Eurozone, is a direct function of our economic strength or weakness”.³²³
240. We asked the Minister why the UK was not taking part. He replied, “it is there to underpin the stability of the Eurozone, it is purely a matter for the Eurozone”.³²⁴ He clarified the UK's role and influence: “we should be outside it. We can give advice or comments—if that is welcome—on how it should be designed, but it is a matter for the Eurozone to lead on”.³²⁵

³¹⁵ Q 508

³¹⁶ Q 67

³¹⁷ EGE 18

³¹⁸ EGE 22

³¹⁹ EGE 22

³²⁰ EGE 22

³²¹ Q 141

³²² EGE 5

³²³ EGE 8

³²⁴ Q 558

³²⁵ Q 558

241. This view was echoed by the Minister for Europe to whom we spoke after the December European Council took place. He stressed that “the [ESM] is a mechanism of the Eurozone, by the Eurozone, for the Eurozone”.³²⁶ When pressed on whether the UK should have shown more solidarity towards the euro area, in light of UK banks’ exposure to EU debt, he responded that the UK had already shown its solidarity by agreeing to a treaty change, providing bilateral support to Ireland and contributing to other Member States receiving assistance through the IMF.³²⁷
242. **The ESM will be compulsory only for members of the euro area. However, we recognise that it might be in the UK’s interests to contribute to rescue packages for Member States in difficulties, as happened with Ireland. In this light, we welcome the recent European Council proposals which will allow Member States outside the euro area to contribute on a bilateral basis when they consider it is in their national interests.**
243. **We recognise the expertise of the IMF in this area. The IMF has been involved in the rescue packages provided to Greece and Ireland; we recommend that it should be involved in any future rescue package provided by the European Stability Mechanism.**

³²⁶ Q 9

³²⁷ Q 1

CHAPTER 6: FINAL CONCLUSIONS AND SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Final conclusions

244. The Commission's proposals for enhanced economic coordination, supported by the conclusions of the van Rompuy taskforce, are the only ones currently on the table. While the measures for enhanced coordination apply to all Member States, it is in the euro area that these measures are most necessary.
245. In design, we believe that they are a step in the right direction, and will complement the constructive work that has been done to strengthen regulation and oversight of the financial sector. The proposals relating to fiscal discipline and cooperation should make it easier for Member States in the euro area to arrive at a collective fiscal stance that is coherent with a centralised monetary policy. Similarly, the proposals for more intensive macroeconomic surveillance should help detect and address excessive imbalances which have the potential to destabilise the euro area. We do, however, stress that the excessive imbalance procedure should not result in countries with a current account balance in surplus being asked to make adjustments which will harm their global competitiveness.
246. Above all, it is the implementation of these measures that most concerns us. Previous attempts to enforce fiscal discipline on Member States were largely ineffective. If these new proposals for economic governance are to have any chance of success it is essential that the political authorities of the EU take them seriously and abide by the rules. Governments will, in future, be encouraged to do so by markets which are less likely to make the same mistakes again in treating the sovereign debt of all euro area Member States as risk-free. The markets are not foolproof however and will need to be supplemented by effective enforcement mechanisms. The political resolve of Member States, particularly France and Germany, will determine whether these measures to increase the long-term stability of the EU, and the euro area in particular, are successful.

Summary of conclusions and recommendations

Introduction

247. The UK has a strong interest in seeing the euro area stable and prosperous. It is therefore directly affected by developments in the euro area. The Government have a vested interest in ensuring that proposals to increase stability in the euro area through increased economic coordination are effective (para 22).

Unsteady Foundations

248. The interconnection of the sovereign debt and banking sectors was one of the principal elements that contributed to the current crisis. Recent events have demonstrated the debilitating effect on public finances of transferring private debt to the public sector. Mechanisms must be put in place to control the behaviour of banks and to ensure that the public sector does not end up carrying the cost of failing banks. These must be effective. We also note the risk of a vicious circle whereby a sovereign debt crisis puts pressure on banks, including UK banks (para 29).

249. There are flaws in the concept and design of the euro area, caused by an asymmetry between a centralised monetary policy and decentralised fiscal and supply-side policies, and by a build-up of competitiveness imbalances between Member States. The simplest solution, a greater centralisation of fiscal policy leading to a full fiscal union, is politically unfeasible at the present time. A more limited form of fiscal union consisting of collective borrowing by the euro area is perhaps more plausible. Given that there has been no general agreement on this issue among Member States, however, it is unlikely to be more than an incomplete alternative in the near future. The package put forward by the Commission and the governments of EU Member States (through the Van Rompuy task force) opts for a greater coordination of fiscal and economic policies among euro area countries to overcome these flaws. If these proposals work well, they should make it easier for Member States of the EU, and particularly the euro area, to arrive at a collective fiscal stance that is compatible with a single monetary policy (para 46).
250. We believe that the political imperatives holding the euro area together are strong, and we do not think it is likely that any country, whether fiscally weak or strong, will try to leave voluntarily. We do, however, recognise that it is now conceivable that a country could be forced to leave the euro, or that the euro area could separate into two parts (para 54).
251. Any break-up of the euro area would not only be economically and politically costly for those Member States leaving the euro, but would have a damaging impact on all members of the euro area and the wider EU, not least the UK (para 55).
252. We did not receive compelling evidence to suggest that the Eurogroup needed a more formal role and position. Such a move could have implications for the UK and for the position of ECOFIN as the ultimate decision-making body on financial and economic matters. Recent decisions by the Eurogroup to adopt a “Pact for the Euro” have brought these implications into sharp relief (para 60).
253. There is a clear need for the euro area to speak with one voice in crisis situations. It is essential that it improves the speed and clarity with which it communicates with the markets (para 63).

Fiscal discipline

254. We welcome the Commission’s proposals to introduce an explicit public debt criterion, alongside the deficit criterion, into the excessive deficit procedure under the SGP. We consider it important that the most heavily indebted countries move rapidly to reduce their level of public debt. We do not, therefore, share the Government’s concerns about a numerical benchmark for reducing debt under the EDP. We believe that having such a benchmark will be an effective way of exerting pressure on heavily indebted countries to ensure that the higher a country’s level of debt the faster it is reduced (para 72).
255. Accurate and comparable statistics are essential if there is to be effective economic coordination between Member States. The Commission’s proposal to enhance the powers of Eurostat, adopted in 2010, was a good start. The van Rompuy taskforce report suggested a need for measures to improve the quality of national statistical data and to strengthen further the Eurostat’s powers. We agree, and recommend that the Commission should bring

- forward legislative proposals to do so to ensure that measures to improve economic governance are not undermined by unreliable statistics (para 77).
256. After the events of the last year, the markets can no longer assume that all sovereign debt issued by euro area Member States bears the same risk. They will therefore play the key role in restraining fiscal irresponsibility by Member State by charging higher interests rates for countries deemed to have lax fiscal policies. The markets have not, however, always proven effective at enforcing responsible fiscal behaviour and further mechanisms to reinforce compliance must also be available (para 81).
 257. The rules of the SGP must be enforced by Member States acting together through the Council. Repeated breaches by Member States in the past are proof that compliance is not otherwise guaranteed (para 82).
 258. We welcome the introduction of a more graduated system of sanctions against non-compliance with the SGP. The availability of sanctions earlier in the process will help ensure that irresponsible behaviour by Member States is discouraged so that the corrective arm can be avoided (para 88).
 259. We believe that fully automatic sanctions are a step too far. The introduction of semi-automatic reverse majority voting, however, is a positive step. By reducing the scope for political interference this new voting system will make it more likely that sanctions will be applied, making them a more effective deterrent to non-compliance (para 95).
 260. With its ability to block sanctions under the reverse majority voting procedure, final responsibility for the decision to impose sanctions will continue to rest with the Council—as is only appropriate. Only time will tell whether the collective will of Member States is strong enough to ensure that the sanctions process is applied even when the current crisis is over. We endorse the Minister’s remark: “the cost of the crisis in the Eurozone is a reminder to us that we must make these processes work much more effectively”. We hope that this continues to be true beyond the immediate crisis (para 100).
 261. We stress the need for the Council to ensure that, despite its ability to block sanctions, they become an effective means to ensure Member States’ compliance with the SGP once the current crisis is over. We remain sceptical this will be the case (para 101).
 262. We do not believe that the withdrawal of voting rights in Council is an appropriate sanction. Not only would it require a significant treaty change, it would raise significant questions about legitimacy and sovereignty if Member States were unable to have any say in decisions taken in Council. Nor do we think that a voluntary ‘political agreement’ is a plausible solution as an alternative (para 107).
 263. We believe that the overriding incentive for Member States is that of maintaining a stable and prosperous euro area. We do not feel that other incentives should be necessary (para 110).
 264. We do not support the recommendation in the van Rompuy taskforce report to extend sanctions to Member States outside the euro area (excluding the UK) by making EU expenditure conditional upon compliance with the SGP. Sanctions are imposed on euro area countries on the basis of express Treaty provisions. It is inappropriate to do so through other means for Member States outside the euro area (para 114).
 265. The Commission’s proposal to complement the top-down oversight of fiscal policy through the incorporation of EU-wide rules in domestic budgetary

frameworks is a welcome development. We believe it will complement other proposals to enforce responsible fiscal behaviour through promoting a national ownership of EU rules (para 127).

266. We welcome the proposal to ensure that, where countries delegate substantial levels of expenditure to sub-national authorities, these bodies are subject to the same fiscal rules as central government (para 128).
267. We support the thrust of the draft Directive which states that ‘provision’ for fiscal rules should be introduced at a national level. We note, however, that the Directive may be more effective if Member States implement these rules through national legislation as far as possible, rather than relying on administrative provisions (para 129).

Macroeconomic surveillance and enforcement

268. The euro area crisis has made clear the need to extend surveillance to monitor and correct macroeconomic imbalances that threaten the stability of the euro area. Fiscal discipline alone is not sufficient to ensure the stability of the monetary union. We welcome therefore the Commission’s proposals to monitor excessive imbalances (para 153).
269. It is essential that the level of private debt should be monitored as part of any comprehensive surveillance mechanism and we welcome the Commission’s proposals to ensure that this is included under new proposals to detect excessive imbalances (para 154).
270. We recognise the intrinsic difficulty of defining, measuring and analysing macroeconomic imbalances, and distinguishing between excessive and benign imbalances. Therefore the success or otherwise of the planned macroeconomic surveillance will depend on the capacity of the early warning system to detect excessive imbalances at a sufficiently early stage, and Member States having the political will to engage in honest discussion of the results. This calls for judgement in distinguishing between macroeconomic developments which can be blamed on national policy choices (such as property bubbles), improvements in competitiveness that arise from sound structural policies, and current account divergences that reflect inconsistencies between domestic demand among Member States (para 155).
271. We recognise that there are two sides to current account imbalances, but we do not believe that countries in surplus should be subject to the same procedures as those in deficit. Where excessive current account deficits arise as a result of national policy choices, it is proper that they should be the subject of corrective recommendations under these proposals. It is not appropriate or realistic, however, to issue corrective recommendations to a country with a current account surplus. Nevertheless, surpluses are not always benign and it is important that surplus countries also face pressure from their peers to contribute to the reduction of imbalances in ways which do not damage their global competitiveness (para 156).
272. The causes of the current crisis are now well known; the causes of any future crises, however, are likely to be different. The Commission and Member States must ensure that the criteria and types of imbalance covered by this surveillance are regularly reviewed to maintain their relevance as EU and global economies develop (para 157).
273. Because of the intrinsic difficulty in determining what constitutes an excessive imbalance, we have strong reservations about resorting to sanctions

- within the excessive imbalance procedure, especially for outcomes that are much less directly under the control of governments (para 163).
274. We believe that Member States will benefit greatly from the introduction of a European Semester which will lead to more coherence in the way the Commission offers advice on how Member States could coordinate economic policies across the EU (para 169).
275. Rather than downgrading the role of national parliaments we believe that a European perspective can only strengthen national parliaments' scrutiny of their national executives by providing more information (para 170).
276. The European Systemic Risk Board (ESRB) is a key new body in the European financial supervisory framework, and will serve as the interface between macro-economic surveillance and macro-prudential supervision. We recommend that more consideration should be given to the way the ESRB interacts with the Commission and ECOFIN in the excessive imbalance procedure and the SGP. We encourage the Government to ensure that the analyses of the ESRB are considered, and acted upon, when the Commission and Council consider the results of the proposed macroeconomic surveillance framework (para 176).
277. The European Central Bank has played a central role in managing the crisis and will continue to be a cornerstone of EU economic governance. The ESRB is the route through which the central banks, and the ECB in particular, should be able to contribute actively to discussions on the fiscal and macroeconomic positions of Member States (para 177).
278. Loss of competitiveness and an absence of growth are a damaging combination for the Member States struggling to deal with the aftermath of the crisis. Reviving growth and reducing the deficit are complementary rather than competing objectives. Countries with large fiscal and current account imbalances need policies that support growth and restore competitiveness to ensure long-term sovereign debt sustainability (para 185).
279. We believe that the emphasis should be on both dimensions of the Stability and Growth Pact: ensuring stability while enhancing growth so that recovery from the crises of the past three years can be achieved along with competitiveness (para 186).
280. The enhanced EU economic governance regime must connect with overarching policies such as Europe 2020 to ensure the single market is able to stimulate growth and competitiveness across the EU. The EU and the UK Government should be driving forward the single market agenda, along the lines set out by Professor Mario Monti in his report *A new strategy for the single market*, with a view to making it an integral part of the reformed economic governance architecture. Without a return to sufficiently robust economic growth, the prospects for dealing with the legacy of the crisis will be much more slender (para 187).
281. The Pact for the Euro was proposed after we had completed taking evidence so we were unable to discuss it with witnesses. We do, however, have concerns about its implications for those countries outside the euro area, particularly those Member States which choose not to participate voluntarily. The development of a 'two-speed' Europe would create a significant distinction within the single market between those states inside the euro area or participating voluntarily in the Pact and those who choose not to (para 193).

A crisis management framework for the euro area

282. The finance ministers of France, Germany, Italy, Spain and the UK have stated that there will be no losses for the private sector on sovereign debt issued before a new permanent crisis mechanism comes into force in 2013. While we recognise that this commitment may be necessary to maintain market confidence in the euro area in the short-term, we are doubtful that it will prove sustainable. It implies a significant burden upon citizens in the debtor countries; a burden that they may find difficult to maintain in the period to 2013 and beyond (para 203).
283. We welcome the recent decision by euro area Member States to increase the size of the EFSF. We recommend that Member States make clear that they will have no hesitation in further increasing the size of the EFSF, if that is necessary, to preserve the solvency of euro area Member States. In addition, we recommend that Member States carefully consider the interest rate on loans given by these two mechanisms to ensure that they do not prove overly onerous on those countries receiving assistance (para 204).
284. The ECB's purchase of sovereign bonds has longer-term consequences for its reputation and balance sheet. These should be carefully monitored and assessed. The ECB should consider how to reduce its own exposure to heavily indebted banks and sovereigns by shifting the funding burden to the new European Stability Mechanism (para 210).
285. Discussions over the feasibility or otherwise of different proposals for eurobonds will continue. Although their proponents suggest that they would help stabilise weaker members of the euro area, there is little consensus on how they might work at the present time. They may well represent a greater degree of fiscal integration than Member States are willing to accept given the current disparities between economies in the euro area (para 217).
286. We welcome the Council's proposals for a European Stability Mechanism. The existence of a formal way of restructuring sovereign debt will encourage the market to price better the risks posed by individual Member States within the euro area, and encourage more responsible fiscal behaviour by Member States which will no longer be insulated from market forces by their membership of the euro. Conditionality is a vital element and we support its application. The ECB should be consulted on the terms and conditions of loans under the ESM (para 232).
287. We welcome the principle, enshrined in the ESM agreement, that the private sector should share the burden of any restructuring of sovereign debt under the new ESM mechanism. It is only right that as they share in the rewards, they should share the risks (para 234).
288. The ESM will be compulsory only for members of the euro area. However, we recognise that it might be in the UK's interests to contribute to rescue packages for Member States in difficulties, as happened with Ireland. In this light, we welcome the recent European Council proposals which will allow Member States outside the euro area to contribute on a bilateral basis when they consider it is in their national interests (para 242).
289. We recognise the expertise of the IMF in this area. The IMF has been involved in the rescue packages provided to Greece and Ireland; we recommend that it should be involved in any future rescue package provided by the European Stability Mechanism (para 243).

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

EU Sub-Committee on Economic and Financial Affairs and International Trade

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

Lord Browne of Madingley*
 Lord Hamilton of Epsom
 Lord Harrison (Chairman)
 Lord Haskins
 Baroness Hooper
 Lord Jordan
 Baroness Maddock
 Lord Marlesford
 Lord Moser
 Lord Trefgarne
 Lord Vallance of Tummel
 Lord Woolmer of Leeds

* Member until 10 February 2011

Declaration of Interests

Lord Browne of Madingley
None relevant

Lord Harrison (Chairman)
None relevant

Lord Hamilton of Epsom
Director, Jupiter Dividend and Growth Trust PLC
Director, New Star Global Property Management (Bermuda) Ltd
Director, Australian Property Management (Bermuda) Ltd

Lord Haskins
None relevant

Baroness Hooper
None relevant

Lord Jordan
None relevant

Baroness Maddock
None relevant

Lord Marlesford
Independent National Director, Times Newspapers Holdings Ltd
Director, Gavekal Research (Hong Kong)
Adviser to Sit Investment Associates (USA)

Lord Moser
None relevant

Lord Trefgarne
None relevant

Lord Vallance of Tummel
Member, International Advisory Board, Allianz SE (insurance)
Member, Supervisory Board, Siemens AG (Engineering)

Lord Woolmer of Leeds

None relevant

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

APPENDIX 2: LIST OF WITNESSES

Oral evidence

26 October 2010

Mr Peter Curwen, Director of Europe, and Mr Conrad Smewing, Head of Fiscal Policy, HM Treasury

Written evidence, EGE 14

Supplementary evidence, EGE 15

2 November 2010

Mr Mark Cliffe, Chief Economist, ING Group

9 November 2010

Professor Charles Goodhart, London School of Economics; and Dr Waltraud Schelkle, London School of Economics, and Dr Dermot Hodson, Birkbeck College, University of London

Written evidence from Professor Charles Goodhart, London School of Economics, and Dr Dimitrios Tsomocos, Oxford University, EGE 1

Supplementary written evidence from Professor Charles Goodhart, EGE 12

Written evidence from Dr Waltraud Schelkle, EGE 3

Supplementary written evidence from Dr Waltraud Schelkle, EGE 17

Supplementary written evidence from Dr Dermot Hodson, EGE 11

16 November 2010

Dr Thomas Mayer, Chief Economist, Deutsche Bank Group, and Dr Marco Annunziata, Chief Economist, Unicredit Group; and Sir Martin Jacomb, Chairman, Canary Wharf Group

Written evidence from Dr Marco Annunziata, EGE 9

Supplementary written evidence from Dr Marco Annunziata, EGE 16

Written evidence from Sir Martin Jacomb, EGE 13

Supplementary written evidence from Sir Martin Jacomb, EGE 19

23–24 November 2010, Brussels

Dr Daniel Gros, Director, Centre for European Policy Studies; Mr José Leandro, Adviser on Monetary and Economic Affairs, Cabinet of the President of the European Council; Professor Jean Pisani-Ferry, Bruegel; Mr Benoît de la Chapelle Bizot, Finance Ministry Adviser, Permanent Representation of France to the European Union; Lord Monks, General Secretary, and Mr Ronald Janssen, Economic Adviser, European Trade Union Confederation; Mr Hans Martens, Chief Executive, and Mr Fabian Zuleeg, Chief Economist, European Policy Centre; Professor Jean-Victor Louis, Brussels Free University; and Mr Declan Costello, Acting Director for Structural Reforms and Competitiveness, Mr Martin Larch and Mr Jonas Fischer, European Commission

Written evidence from the European Trade Union Confederation, EGE 2

Supplementary written evidence from the European Policy Centre, EGE 22

30 November 2010

Mr Mats Persson, Director, Open Europe; and Professor Laurence Copeland, Institute of Economic Affairs

Written evidence from Open Europe, EGE 7

Written evidence from the Institute of Economic Affairs, EGE 8

Supplementary written evidence from the Institute of Economic Affairs, EGE 20
7 December 2010

Ms Katinka Barysch, Deputy Director, Centre for European Reform; and Ms Vicky Ford MEP

9 December 2010

Professor Willem H. Buiter, Chief Economist, Citigroup

14 December 2010

Mr Mark Hoban MP, Financial Secretary, and Mr Michael Ellam, Managing Director, International, HM Treasury

Supplementary written evidence, EGE 23

Written evidence

Evidence marked * is associated with oral evidence and is printed. Other evidence is published online at www.parliament.uk/hleua and available for inspection at the Parliamentary Archives (020 7219 5314)

Order of receipt

- * Professor Charles Goodhart, London School of Economics, and Dr Dimitrios Tsomocos, Oxford University, EGE 1
- * European Trade Union Confederation, EGE 2
- * Dr Waltraud Schelkle, London School of Economics, EGE 3
- City of London Corporation, EGE 4
- Professor Jagjit Chadha, University of Kent, EGE 5
- Professor Christos Gortsos, Panteion University of Athens, EGE 6
- * Open Europe, EGE 7
- * Institute of Economic Affairs, EGE 8
- * Dr Marco Annunziata, EGE 9
- Dr Marek Dabrowski, Centre for Social and Economic Research, EGE 10
- * Dr Dermot Hodson, Birkbeck College, University of London, EGE 11
- * Professor Charles Goodhart, London School of Economics, EGE 12
- * Sir Martin Jacomb, Chairman, Canary Wharf Group, EGE 13
- * HM Treasury, EGE 14
- * HM Treasury, EGE 15
- * Dr Marco Annunziata, Chief Economist, Unicredit Group, EGE 16
- * Dr Waltraud Schelkle, London School of Economics, EGE 17
- Dr Uri Dadush, Director, Carnegie's International Finance Program, EGE 18
- * Sir Martin Jacomb, Chairman, Canary Wharf Group, EGE 19
- * Institute of Economic Affairs, EGE 20
- European Movement, EGE 21
- * European Policy Centre, EGE 22
- * Mark Hoban MP, Financial Secretary, HM Treasury, EGE 23

Alphabetical

- * Dr Marco Annunziata, Chief Economist, Unicredit Group, EGE 9 and EGE 16
- Professor Jagjit Chadha, University of Kent, EGE 5

- City of London Corporation, EGE 4
- Dr Marek Dabrowski, Centre for Social and Economic Research, EGE 10
- Dr Uri Dadush, Director, Carnegie's International Finance Program, EGE 18
- European Movement, EGE 21
- * European Policy Centre, EGE 22
- * European Trade Union Confederation, EGE 2
- Professor Charles Goodhart, London School of Economics, and
Dr Dimitrios Tsomocos, Oxford University, EGE 1 and EGE 12
- Professor Christos Gortsos, Panteion University of Athens, EGE 6
- * HM Treasury, EGE 14 and EGE 15
- * Mark Hoban MP, Financial Secretary, HM Treasury, EGE 23
- * Dr Dermot Hodson, Birkbeck College, University of London, EGE 11
- * Institute of Economic Affairs, EGE 8 and EGE 20
- * Sir Martin Jacomb, Chairman, Canary Wharf Group, EGE 13 and EGE 19
- * Open Europe, EGE 7
- * Dr Waltraud Schelkle, London School of Economics, EGE 3 and EGE 17

APPENDIX 3: CALL FOR EVIDENCE

The House of Lords EU Economic and Financial Affairs and International Trade Sub-Committee, chaired by Lord Harrison, is conducting an inquiry into the future of economic governance in Europe. We invite you to contribute evidence to this inquiry.

The Commission has outlined proposals for reinforcing economic stability, based on greater economic coordination in the European Union, while Herman Van Rompuy, President of the Council, is chairing a task force on economic governance which is considering crisis resolution arrangements, budgetary discipline and divergences in competitiveness between Member States. It is expected that legislative proposals and non-legislated agreements will be brought forward on these issues throughout 2011.

The Committee recognises that the stability and economic health of the Eurozone is vital to the UK's economy. It will therefore explore economic governance as it applies to the Eurozone, as well as to the EU as a whole.

The aim of our inquiry is to inform the debate on the future of economic governance in Europe, and to provide an opinion in advance of any proposals that may be put forward in 2011.

Particular questions raised to which we invite you to respond are as follows (there is no need for individual submissions to deal with all of the issues):

Lessons from the Eurozone crisis

What flaws has the recent fiscal crisis in Europe exposed in the existing system of economic governance? In particular, what lessons have been learned about:

- surveillance;
- statistics and their use in monitoring Member States;
- the interpretation and application of the Stability and Growth Pact;
- crisis management systems; and
- macro-economic and competitiveness imbalances amongst Member States?

Economic co-ordination and governance

What should be the objectives of economic coordination in the EU? Specifically, to what extent is greater economic coordination necessary or desirable for economic stability in the EU and the Eurozone?

Should greater coordination be sought across the full EU, or simply within the Eurozone? What might be the implications for the UK of separate economic governance measures within the Eurozone? What are the implications for the UK of the potential development of Eurozone-only institutions, such as the "Eurogroup Council"?

To what degree should economic governance be guided by political discretion as opposed to rules? Could enhanced EU-level political oversight of macroeconomic policy possibly lead to some form of 'economic government'? What is in the UK's national interest in relation to the reform of economic governance? How might a reform of economic governance in Europe affect the role of national parliaments and governments?

The Commission's proposals and Van Rompuy's task force have been concentrating on four areas in particular:

The Stability and Growth Pact

- What sort of reforms might be necessary to the Stability and Growth Pact?
- Should the level of public debt be of higher importance when considering how to achieve fiscal discipline?
- Should the level of private debt be monitored?
- Should there be a procedure for combating excessive debt and other facets of fiscal sustainability, such as unfunded obligations associated with an ageing population?
- What sort of sanctions should be available under the Stability and Growth Pact, and when should they be applied? Should the withdrawal of voting rights in Council or withholding EU structural funds be available as sanctions?

Surveillance of macroeconomic imbalances and competitiveness

- Is there a need for stronger macro-economic surveillance?
- Should there be changes to multilateral budget surveillance?
- What role should the broad economic policy guidelines play in the surveillance of macroeconomic imbalances and competitiveness?
- Should the power to issue policy warnings and recommendations to Member States whose policies are not consistent with the broad economic policy guidelines be used more extensively?

Coordination of fiscal and structural policies

- Should EU institutions have any say over national budgets? What role should the European Central Bank play?
- What should be the link between the Stability and Growth Pact and the Europe 2020 strategy? What might be the advantages of a European Semester?
- What measures might be used to reduce competitiveness imbalances between Member States, and what role might Europe 2020 play?

Crisis resolution mechanism

- Should there be a permanent crisis resolution mechanism? How should it be funded, and would it require Treaty change or the creation of new institutions such as a European Monetary Fund?
- What role should the International Monetary Fund or European Central Bank have?
- How might a permanent crisis resolution mechanism be set up to avoid the issue of moral hazard?
- Should the UK have participated in the European Financial Stability Facility (the special purpose vehicle funded by Eurozone members with contributions from Poland and Sweden)? What might be the repercussions if the UK does not participate in a permanent crisis resolution mechanism in the future?

We also would welcome your views on any other aspect of the Commission's proposals and the issues being confronted by the Van Rompuy task force. Written submissions need not address all questions

Interested parties are invited to submit a concise statement of written evidence to this inquiry by Friday 24 September 2010.

APPENDIX 4: MINUTES OF PROCEEDINGS

15 March 2011

Present:

Lord Hamilton of Epsom
 Lord Harrison (Chairman)
 Lord Haskins
 Lord Jordan
 Baroness Maddock
 Lord Moser
 Lord Trefgarne
 Lord Vallance of Tummel
 Lord Woolmer of Leeds

The Committee considered the draft report.

Paragraphs 1 to 246 were agreed to, with amendments.

It was moved by Lord Hamilton of Epsom to insert after paragraph 246:

As we look to the future, we feel that serious consideration should be given to enlarging the role of the European Central Bank in the economic management of the Eurozone.

The ECB already has responsibility for monitoring the banking sector in the Eurozone and we feel that in time their remit should be extended to the surveillance of national economies, asset bubbles, growth in private debt and any other economic developments that might destabilise the Euro.

Rather than being the lender of last resort, playing a role when serious debt and funding problems have arisen, the ECB should provide early warning and seek to address difficulties before they become crises. The ECB would be expected to produce regular reports on the economic health of all Eurozone nations. Inevitably these reports would influence financial markets and give the ECB great influence over the economic policies of nations within the Eurozone.

If the ECB assumed this role, we recognise that this would raise issues of accountability that should be considered further.

The Committee divided:

Contents

Lord Hamilton of Epsom
 Lord Moser
 Lord Trefgarne

Not-contents

Lord Harrison
 Lord Haskins
 Lord Jordan
 Baroness Maddock
 Lord Vallance of Tummel
 Lord Woolmer of Leeds

The amendment was disagreed to accordingly.

Paragraphs 247 to 289 were agreed to.

APPENDIX 5: GLOSSARY

AGS	Annual Growth Survey
Contagion	A scenario where the financial troubles of one economy spread to other economies
ECB	European Central Bank
ECOFIN	The Economic and Financial Affairs Council. It is composed of the finance ministers of all EU Member States
Economic governance	A loose term that captures the different arrangements for running the economic and monetary union, and for coordinating economic policies within the wider EU
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EGE	Refers to written evidence
EIP	Excessive imbalance procedure
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
ETUC	European Trade Union Confederation
EU	European Union
Eurogroup	A body composed of the finance ministers of the Member States of the euro area
Europe 2020	A strategy for jobs and growth agreed by the Member States of the EU
European Council	A council of all the heads of state or government of the European Union
Eurostat	The statistical office of the European Union
Fiscal policy	Policies relating to government taxation and spending decisions
Haircut	A haircut occurs when a lender has to accept a reduction in the redemption value of a bond because of the inability of the borrower to pay it in full; for example, if only 90 cents is repaid per euro, the haircut would be ten cents (10%)
GDP	Gross Domestic Product
IMF	International Monetary Fund
Macroeconomic imbalances	A macroeconomic imbalance exists where the trajectory of the economy is unsustainable and risks causing problems of volatility or instability, including financial instability. Such imbalances often manifest themselves in deficits or surpluses on the current account of the balance of payments
Monetary policy	Policies regulating the money supply and interest rates by a central bank
NCB	National Central Bank
PCRM	Permanent crisis resolution mechanism
SGP	Stability and Growth Pact
TFEU	Treaty on the Functioning of the European Union

APPENDIX 6: GDP OF EURO AREA MEMBER STATES**TABLE 1****Gross domestic product at market prices (billions of PPS)³²⁸**

Country³²⁹	GDP at Market Prices (PPP) 2009	% of Euro-area GDP (2009)
Germany	2242	26.6
France	1638	19.4
Italy	1471	17.4
Spain	1116	13.2
Netherlands	508	6
Belgium	295	3.5
Greece	249	3
Austria	245	2.9
Portugal	200	2.4
Finland	142	1.7
Ireland	133	1.6
Slovakia	93	1.1
Slovenia	42	0.5
Luxembourg	32	0.4
Cyprus	19	0.2
Malta	8	0.09

Source: Eurostat tec00001 (December 2010)

³²⁸ The Purchasing Power Standard (PPS) is the name given by Eurostat to an artificial currency unit that reflects the average price level of the EU. The figures for GDP are rounded to the nearest billion.

³²⁹ Estonia joined the euro area on 1 January 2011 and is therefore not represented in this table. Its GDP in 2009 was approximately 15 billion PPS, which would have made it the second smallest economy in the euro area after Malta.