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European Union Committee

8th Report of Session 2013–14

‘Genuine Economic and Monetary Union’ and the implications for the UK

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The staff of the Sub-Committee during the course of this inquiry were Stuart Stoner (Clerk), Rose Crabtree (Policy Analyst) and Sarah Yusuf (Committee Assistant).

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SUMMARY

'Genuine Economic and Monetary Union' is the EU institutions' vision for a strong and sustainable single currency, but its elements are highly contentious. Banking Union is vital to tackling the effects of the financial crisis. Yet what has been agreed is insufficient to break the vicious circle linking banking and sovereign debt. There is a strong case for some fiscal transfers and debt mutualisation, but proposals for an integrated budgetary and economic policy face widespread political opposition. Although the full vision remains a distant prospect, the eurozone is on the road towards greater integration. The implications for the UK are immense. A strong and prosperous eurozone is in the interests of all EU members, as is a strong and engaged UK (and a strong City of London). Achieving all three outcomes simultaneously will require close care and attention, together with goodwill on all sides.

The flaws in the single currency that 'Genuine Economic and Monetary Union' seeks to correct are now widely acknowledged. Yet there is a conflict between the steps that are economically necessary to correct these weaknesses and those that are politically realistic. Key EU players, including the Commission, the European Central Bank (ECB) and Germany, have different priorities. While the commitment to maintaining the single currency is as strong as ever, there is a continuing failure to agree on the measures that are needed. The 'Genuine Economic and Monetary Union' proposals encapsulate this tension.

Banking Union is the most urgent of the four 'Genuine Economic and Monetary Union' pillars. It is vital to securing the long-term stability of the eurozone. But only a partial Banking Union is in prospect. The Single Resolution Mechanism proposals being finalised are suboptimal. The process to resolve failing banks is too complex and the funding resources available are inadequate, leaving individual Member States largely responsible. There is no prospect of agreement on a common deposit insurance scheme. Confidence in the banking system will only fully be restored when the vicious circle linking bank and sovereign debt is broken.

The proposals for an integrated budgetary and economic policy framework are politically unrealistic at the present time. However, a system of substantial fiscal transfers is a characteristic of most currency unions. Equally, some degree of debt mutualisation may be inevitable if the single currency is to prosper. In the meantime, the imposition of so-called austerity policies could aggravate the problems facing weaker economies.

A system of top-down control also risks removing the power from citizens to determine at the ballot box how taxes are raised and public money is spent. Ensuring democratic legitimacy for the evolving system of economic governance is crucial. We will consider in detail this important issue in our forthcoming report on the role of national parliaments in the EU.

Notwithstanding these flaws, eurozone Members are politically committed to deeper integration. The UK has made clear that it will not participate. But many warn that the UK's influence is diminishing as a result. The Government would be wise not to close the door on the possibility of participation in some elements of Banking Union in the future, and must stress the City of London's strategic importance for the EU as a whole. The Government and we as parliamentarians each have a duty more effectively to promote the UK and the EU's mutual concerns. A strong and prosperous eurozone is in the interests of all EU members, as is a strong and engaged UK (and a strong City of London). Achieving all three outcomes simultaneously will require close care and attention, together with goodwill on all sides.

‘Genuine Economic and Monetary Union’ and the implications for the UK

CHAPTER 1: ‘GENUINE ECONOMIC AND MONETARY UNION’—STICKING PLASTER OR MIRACLE CURE?

1. The proposals for European ‘Genuine Economic and Monetary Union’ first emerged as a key plank of the EU institutions’ attempts to respond to the series of crises to hit the eurozone in the wake of the 2008 financial crisis.[1] In particular, the links between sovereign states and their seriously indebted banking sectors—the so-called ‘doom loop’—combined with the threat of cross-border contagion, threatened to overwhelm the eurozone.

2. When it was revealed by the IMF in the summer of 2012 that there was a near €40 billion hole in the balance sheets of Spanish banks, EU leaders recognised that urgent action needed to be taken. The President of the European Council, Herman Van Rompuy, prepared a report for discussion at the June 2012 European Council. The report, entitled *Towards a Genuine Economic and Monetary Union*, envisaged a “stable and prosperous EMU based on four essential building blocks”:

   (1) An integrated financial framework to ensure financial stability in particular in the euro area and minimise the cost of bank failures to European citizens. Such a framework would elevate responsibility for supervision to the European level, and would provide for common mechanisms to resolve failing banks and guarantee customer deposits;

   (2) An integrated budgetary framework to ensure sound fiscal policy-making at the national and European levels, encompassing coordination, joint decision-making, greater enforcement and commensurate steps towards common debt issuance. It was envisaged that this framework could also include different forms of fiscal solidarity;

   (3) An integrated economic policy framework which has sufficient mechanisms to ensure that national and European policies are in place that promote sustainable growth, employment and competitiveness, and are compatible with the smooth functioning of EMU;

   (4) Ensuring the necessary democratic legitimacy and accountability of decision-making within the EMU, based on the joint exercise of sovereignty for common policies and solidarity.[2]

3. The Council invited the Four Presidents to develop by the end of 2012 “a specific and time-bound road map for the achievement of a genuine

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1 It should be noted that many elements of ‘Genuine Economic and Monetary Union’ were not new proposals, and had in fact been set out in the 1989 Delors Report on Economic and Monetary Union in the European Community.

2 Van Rompuy, H., President of the European Council (26 June 2012), ‘Towards a Genuine Economic and Monetary Union’.

Economic and Monetary Union."[3] A final report was produced in December 2012, in preparation for that month's European Council.[4] The Commission published its own, complementary document, *A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate*, in November 2012.[5] Both papers set out the measures that needed to be taken in the short, medium and long term. The main elements of 'Genuine Economic and Monetary Union', and the proposed timeframe for its implementation, are set out in Boxes 1 and 2 below.

BOX 1

Main elements of 'Genuine Economic and Monetary Union'

Notwithstanding some differences of detail between the Four Presidents' Report and the Commission Blueprint, the principal elements of 'Genuine Economic and Monetary Union' are as follows:

(1) Banking Union, comprising:

- (a) Centralised bank supervision, led by the ECB (since agreed);
- (b) A Single Resolution Mechanism incorporating an effective common backstop, but limiting the exposure of taxpayers;
- (c) An operational framework to enable the European Stability Mechanism to be used for direct bank recapitalisation;
- (d) Common deposit insurance.

(2) Fiscal union:

- (a) Mechanisms for better discipline in, and coordination of, fiscal policy, building on the measures already agreed in the last three years;
- (b) A new fiscal capacity for the eurozone: initially to provide targeted but temporary support for countries undertaking structural reforms; subsequently becoming an instrument to help in dealing with country-specific economic shocks through a centrally-managed insurance system;
- (c) The possible establishment of forms of debt mutualisation, including the eventual introduction of a Eurobond available to all participating Member States, which would be jointly and severally guaranteed.

(3) Closer integration of economic policies intended to promote sustainable growth, competitiveness and employment and improving the resilience of the economy to shocks. This would include:

- (a) Further efforts to complete the Single Market, including by stimulating labour mobility across borders and possibly greater tax harmonisation;

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3 European Council Conclusions (29 June 2012). The report was prepared by President Van Rompuy in close collaboration with the Presidents of the European Commission, the Eurogroup and the European Central Bank, colloquially known as the 'Four Presidents'.

4 Van Rompuy, H., President of the European Council (5 December 2012), 'Towards a Genuine Economic and Monetary Union'.

5 European Commission (30 November 2012), 'A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate', COM (2012) 777 FINAL.

(b) A reinforced framework for ex-ante coordination of major policy reforms, notably those affecting the supply-side of the economy;

(c) Contractual relationships between Member States and the Commission on economic strategies, with accountability to both the European Parliament and national parliaments.

(4) Enhancement of democratic oversight of pooled economic policies.

BOX 2

Proposed timescale for 'Genuine Economic and Monetary Union' (as proposed in late 2012)[6]

Two distinct timetables were put forward, with the final version of the Four Presidents' Report suggesting three phases, two of which would be completed by the end of 2014, and the Commission suggesting short, medium and longer term developments of EMU.

Under **the Four Presidents' proposals**, an initial phase was to be completed by the end of 2013, and was expected to ensure fiscal sustainability and break the damaging links between banks and sovereign debt. A second phase, foreseen for 2013 and 2014, was supposed to complete the integrated financial framework and to put in place mechanisms for stronger policy coordination. In a third phase, beyond 2014, the plan was to improve the resilience of EMU by creating a "shock-absorption function at the central level".

The **Commission timetable**, which included much of the first two phases of the Four Presidents' proposals in its first stage, was as follows:

In the short term (within six to 18 months), completion of the Banking Union and—once an agreement on the Multiannual Financial Framework has been reached (which it was in June 2013, following the assent of the European Parliament)—create a "convergence and competitiveness instrument" within the EU budget to support the timely implementation of structural reforms. This support could be based on commitments set out in "contractual arrangements" concluded between Member States and the EU institutions.

In the medium term (18 months to five years), a further strengthening of the collective conduct of budgetary and economic policy—including tax and employment policy—could go hand-in-hand with a dedicated fiscal capacity for the euro area, relying on own resources and providing sufficient support for important structural reforms in large economies under stress. Short-term Eurobills or a Debt Redemption Fund, subject to strict conditionality, could also be considered.

In the longer term (beyond five years), based on the adequate pooling of sovereignty, responsibility and solidarity at the European level, it should be possible to establish an autonomous euro area budget providing for a fiscal capacity for the EMU. A deeply integrated economic and fiscal governance framework could allow for the common issuance of public debt. This could be the final stage in EMU.

6 *Ibid.*

Diagnosing the problem

4. The concept of 'Genuine Economic and Monetary Union' is based on the premise that the existing Economic and Monetary Union was somehow incomplete or deficient. The flaws in EMU's architecture, predicted by some at the outset of the single currency project, are now widely acknowledged, including by the EU institutions. The Commission has drawn attention to the following deficiencies:[7]

- The accumulation in some eurozone Member States of large private and public debts, losses in competitiveness, and macroeconomic imbalances, which rendered them vulnerable when the financial crisis struck. This led to significant contagion effects across the eurozone once the sovereign debt crisis developed.
- EMU's unique status amongst monetary unions in combining a centralised monetary policy with decentralised responsibility for most economic policies and with no centralised fiscal policy function or fiscal capacity (i.e. a federal budget). This meant that the rules governing the coordination of budgetary policies, as set out in the Stability and Growth Pact (SGP), were of vital importance.[8] Yet the SGP was insufficiently observed by the Member States and lacked robust mechanisms to ensure sustainable public finances.
- The coordination of national economic policies relied on soft instruments —peer pressure and recommendations—and had a limited impact on the actions of individual Member States. The approach was too weak to counter growing gaps in competitiveness and growth between Member States. Little consideration was given to the euro area-wide spillover effects of national measures.
- The global easing of inflationary pressure in the late 1990s led to a rapid and sustained expansion in the money supply. This resulted in a global excess of liquidity and ultimately a severe mispricing of risk of both private and public assets. The reliance by banks on national bonds for their open market operations resulted in strong yield convergence, considerably limiting market discipline despite differences in national budgetary performance. Euro area economies in a cyclical expansion and with relatively high inflation rates tended to enjoy low or even negative real interest rates. This led to significant credit expansion in some countries, fuelling significant housing bubbles.
- The inception of EMU saw a sharp acceleration in the pace of financial integration. While this created opportunities, it also accelerated the transmission of shocks across national borders. Yet the responsibility for prudential supervision and crisis management remained predominantly at the national level.
- The lack of an integrated EU-level framework and a mechanism to mutualise the response to risks coming from the banking sector resulted in powerful and damaging negative loops (often referred to as a 'vicious circle') between the banking system and sovereign states. This fuelled the debt crisis further. As a result, some Member States were excluded from

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7 *Ibid.*

8 The Stability and Growth Pact was agreed in 1997 and entered into force in 1998 and 1999.

market financing and there has been a risk of contagion affecting the euro area as a whole. The absence of an effective mechanism to provide liquidity to Member States in distress, and thus to manage contagion risk and to safeguard euro area financial stability, emerged as a clear inadequacy in the crisis management arrangements.

5. Our own analysis, as set out in our March 2011 report on *The Future of Economic Governance in the EU*, was that:

> "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)."[9]

6. In light of subsequent experience, other problems have been revealed, including a lack of crisis management capability or means of dealing with sovereign debt and bank resolution, and a range of legitimacy and political accountability challenges. In particular, the toxic link between banks and sovereign states was accompanied by retrenchment of financial activity within national boundaries, not least because many banks did not want to be exposed to risks posed by weak sovereign states as well as to credit risk. This created the pernicious 'doom loop' from which several of the most affected Member States struggle to escape. The Commission and EU Member States have long acknowledged the problem, but as yet have failed to reach agreement on the decisions necessary to break the link: in December 2013 they were roundly criticised by European Central Bank (ECB) President Mario Draghi for failing to do so.[10]

The sticking plaster approach

7. The Commission has been at pains to point out that significant steps have already been taken to seek to address the consequences of the crisis, some of which apply to all 28 members of the EU, some only to the eurozone and some to eurozone members plus others who choose to 'opt-in'. These are set out in Box 3 below.

BOX 3

Measures already taken to address the crisis

(1) Economic policy surveillance:

(a) The Six-pack, concluded in November 2011, comprising five regulations and a directive, which are designed to provide for tighter discipline on public finances. Provisions include the recasting of the Stability and Growth Pact and an obligation to

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9 House of Lords European Union Committee, *The future of economic governance in the EU* (12th Report, Session 2010–12, HL Paper 124).

10 Mario Draghi, President of the European Central Bank, speaking to the European Parliament (16 December 2013).

introduce stronger fiscal rules in national policy frameworks, together with a new mechanism to curb macroeconomic imbalances;

(b) The Two-pack, concluded in May 2013, consisting of two regulations applying only to the euro area, ensuring closer oversight of the public finances of euro area members. The first round of scrutiny of national budgets was conducted in autumn 2013;

(c) The European Semester and the euro-plus pact, the latter with 23 signatories, intended to promote better economic policy;

(d) The Fiscal Compact, designed to reinforce the governance of fiscal and economic policies, incorporated in the Treaty on Stability, Coordination and Governance (TSCG), signed by 25 Member States (subsequently also by Croatia).

(2) Financial regulation and supervision (broadly based on the recommendations of 2009 report of the high level group chaired by Jacques de Larosière):[11]

(a) CRD IV, the package which transposes—via a Regulation and a Directive—the new global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework;

(b) European Supervisory Authorities covering, respectively, the banking, insurance and securities sectors. These so-called ‘level 3’ agencies were given greater powers as a result of the reforms launched in 2009;

(c) European Systemic Risk Board (ESRB), charged with assuring ‘macroprudential supervision’—the interplay between macroeconomic developments, especially budgetary policies, and financial stability.

(3) Crisis resolution funding mechanisms, all of which were set up to provide resources for bailing out countries in difficulty:

(a) The creation of the European Financial Stability Facility (EFSF) (limited to eurozone and temporary), agreed in May 2010, with a nominal capacity of €440 billion and backed by the governments of the eurozone;

(b) European Financial Stabilisation Mechanism (EFSM) (EU-wide and temporary), also agreed in May 2010, with a capacity of €60 billion and backed by the EU budget;

(c) European Stability Mechanism (ESM) (eurozone and permanent), signed in February 2012 and based on a limited amendment to Article 136 TFEU, and a separate treaty, with a capacity of €500 million and backed by participating Member States. It was inaugurated in October 2012. The ESM obtains

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11 de Larosière, J. (Chairman) (2009), ‘The High-Level Group on Financial Supervision in the EU: Report’, 25 February.

its funds by issuing bonds and is obliged by the Treaty provision to impose strict conditionality on any loans it makes to Member States.

(4) Expanding the role of the ECB:

(a) Securities Market Programme through which the ECB purchased the debt of Member States on the secondary markets, but not directly from national treasuries;

(b) Access to Long-Term Refinancing Operations (LTROs) opened to banks which used them to ensure liquidity. The facility enables banks facing funding problems to borrow directly from the ECB in what is, in effect, lending in the last resort by the ECB;

(c) The offer of Outright Monetary Transactions (OMTs) through which the ECB would purchase unlimited amounts of national debt on the secondary markets, provided that the country in question had agreed to a reform programme;

(d) ECB President Mario Draghi's July 2012 commitment to "do whatever it takes" to save the euro;

(e) Participation, alongside the IMF and the Commission, in 'Troika' missions which oversee the adjustment programmes of the countries which have received a bailout (Greece, Ireland, Portugal and Cyprus);

(f) New supervisory function within the Single Supervisory Mechanism.

8. Taken as a whole, this represents a considerable achievement. Nevertheless, it was a paradox that the reforms were gradually bringing about a new architecture of economic governance, but often appeared piecemeal. Indeed, the whole process of governance reform has been a mix of crisis management and longer-term recasting of the system. The 'Genuine Economic and Monetary Union' package is itself a reflection of this. Whereas the proposals for an integrated financial framework, or Banking Union, are acknowledged as a pressing priority to ensure the stability of the banking sector, many of the proposals for fiscal union and economic integration can be seen as longer-term, or even idealistic, objectives. Whether such long-term steps are either politically realistic or strictly necessary to guarantee the stability of the eurozone has been the subject of considerable debate.

9. A contributory factor to the apparent ad hoc approach is the way in which the impetus for reform has ebbed and flowed in line with the intensity of the crisis at any given time. As the pressure from financial markets eased (aided in particular by Mario Draghi's welcome commitment to "do whatever it takes" to save the euro[12]), the air escaped from the ambitious 'Genuine Economic and Monetary Union' balloon. There was and remains a tangible sense of lost momentum, despite the renewed urgency to establish a Banking

12 Mario Draghi, President of the European Central Bank (26 July 2012), Speech at the Global Investment Conference, London.

Union following the Cyprus crisis, which came to a head in March 2013 after many months of uncertainty.[13]

10. This loss of momentum is also a reflection of the ambition of the 'Genuine Economic and Monetary Union' project. Given the political sensitivities involved, many Member States were reluctant to move as far and as fast as the EU institutions recommended, with the result that less has been agreed than the Commission and the Four Presidents had originally envisaged. As Box 4 below outlines, the 'Genuine Economic and Monetary Union' agenda has been continually buffeted by events.

BOX 4

Key events since June 2012[14]

June 2012:

- Spain requests financial support for the recapitalisation of its banks after the IMF publishes estimates of an aggregate capital shortfall of €37 billion on the most pessimistic assumptions;
- Renewed pressure on Spanish and Italian sovereign bond spreads;
- Elections in Greece result in the formation of a new coalition government;
- European Council calls for roadmap towards 'Genuine Economic and Monetary Union' and agrees a Compact for Growth and Jobs.

July–August 2012:

- ECB President Mario Draghi's commitment to "do whatever it takes" to save the euro calms markets.

September 2012:

- ECB announcement of OMTs reinforces commitment to the euro and results in a significant easing of sovereign bond spreads;
- German Constitutional Court decision allows ratification of the ESM Treaty and the Treaty on Stability, Coordination and Governance (TSCG).

October–November 2012:

- ESM Treaty (which formally spells out how the new mechanism will operate and establishes the financial vehicle for disbursing funds) is ratified and the ESM is able to start operating;
- Cyprus requests a bailout in light of the worsening problems in its banking sector, but no agreement is reached on how to proceed and a decision is deferred;

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[13] It had become clear that Cyprus had an over-extended banking sector which required shoring-up of the banking system as a whole, and restructuring of its two biggest banks. The sheer scale of the problems overwhelmed the ability of the Cypriot government to cope, requiring a combination of loans from the IMF and EU sources, and losses for large depositors in the banks. The initial proposal to subject all Cypriot bank deposit-holders to a one-off tax on their deposits was quickly abandoned under mounting political pressure.

[14] For a full timeline of events since the outbreak of the financial crisis, see http://www.bruegel.org/fileadmin/bruegel_files/Blog_pictures/Eurocrisis_timeline/121130_Eurocrisis_Timeline.pdf. See also http://www.theguardian.com/business/interactive/2012/oct/17/eurozone-crisis-interactive-timeline-three-years and http://www.ecb.europa.eu/ecb/html/crisis.en.html.

- Publication of the Commission's *Blueprint for a Deep and Genuine Economic and Monetary Union*.

December 2012:

- Publication of the Four Presidents' final report on *Genuine Economic and Monetary Union*;
- Italian Prime Minister Mario Monti announces his resignation, triggering fresh elections. There is limited market reaction;
- European Council agrees roadmap towards 'Genuine Economic and Monetary Union'.

January–February 2013:

- Indecisive Italian election results lead to deadlock in forming a new government;
- Cypriot problems deepen: A presidential election results in a change in government.

March 2013:

- Commission consultation documents on Convergence and Competitiveness Instrument and on closer coordination of economic policies are published;
- Cyprus bailout agreed after banks suspend access to accounts and capital controls are imposed to prevent an outflow of money.

April–May 2013:

- Italian coalition government led by Enrico Letta takes office;
- 'Two-pack' regulations to reinforce budgetary discipline are formally enacted.

June–August 2013:

- Negative reactions in some Member States to country-specific recommendations in the European Semester;
- Euro area returns to weak economic growth.

September 2013:

- German elections result in return of CDU as largest party: Angela Merkel remains as Chancellor pending outcome of coalition negotiations.

October–November 2013

- First Commission scrutiny of national budgets under the Two-pack regulations;
- Single Supervisory Mechanism formally approved;
- ECB asset quality review launched.

December 2013:

- German CDU/CSU/SPD[15] coalition government led by Angela Merkel takes office;
- Council agreement on Single Resolution Mechanism.

January 2014:

- Latvia becomes eighteenth member of eurozone;
- European Banking Authority publishes the main features of the stress tests on banks to be conducted later in 2014.

February 2014:

- In a split decision, the German Constitutional Court finds that the OMTs programme may be incompatible with primary law (i.e. the EU Treaties), but refers the case to the Court of Justice of the European Union for a definitive interpretation of the relevant EU law.

11. The focus of concern has also shifted. The period since June 2012 has been characterised by:

- A calming of the financial markets since Mario Draghi's commitment to "do whatever it takes" to save the euro;
- Anaemic, stagnant or negative growth in several eurozone Member States. The eurozone as a whole endured a double-dip recession, only returning—just—to growth in the second quarter of 2013;
- Continuing high unemployment (in particular youth unemployment) in countries such as Spain, reaching a peak across the eurozone of 12.2% in September 2013 and still rising in countries such as Italy;
- Increased disparities between eurozone members: today, French unemployment is more than double that of Germany, having been the same as recently as the middle of 2008;
- Falling inflation rates, prompting anxiety about the risks of a prolonged period of disinflation, or even deflation, leading to a Japan-style "lost decade" of growth.

12. As a result, the terms of debate have shifted from tackling deficits to growth and job creation. There is a widely held view that the focus on deficits is constraining growth by enforcing a eurozone-wide contraction in demand. The Commission appeared to acknowledge this when it referred in the Annual Growth Survey for 2013 to "growth-friendly fiscal consolidation".[16] Some softening of its position was apparent in the marginal extension for some Member States in the deadlines for dealing with excessive deficits.[17] There are also growing calls for Germany, as the largest Member State (and

15 Christlich Demokratische Union Deutschlands (the Christian Democratic Party of Germany); Christlich-Soziale Union in Bayern (Christian Social Union in Bavaria); Sozialdemokratische Partei Deutschlands (Social Democratic Party of Germany).

16 European Commission (28 November 2012), 'Annual Growth Survey', COM (2012) 750 FINAL.

17 Delivered in the country-specific recommendations issued in June 2013 as part of the European Semester.

given its substantial budget surplus), to seek to stimulate eurozone demand. Critics of German policy argue that its insistence on a so-called 'austerity agenda' threatens to thwart any hope of economic recovery and places the democratic process itself in jeopardy as extremist parties seek to transform political disenchantment into electoral support. The German response is to argue that its surplus is falling, and that measures to boost German demand would in any case be unlikely to help other eurozone countries.

13. Much argument has focussed on the treatment of legacy debts. Member States under the most economic pressure have stressed that such losses need, to a greater or lesser degree, to be mutualised so as to place the eurozone on a stable footing. Germany in particular has called on Member States suffering from excessive deficits to put their own affairs in order first by undertaking structural reforms to improve their competitiveness.

14. Such debates touch directly on several elements of the 'Genuine Economic and Monetary Union' proposals. Much of what is proposed is either highly contentious, politically unrealistic, or both. Some of the proposals put forward by the Commission are, in addition, not necessary to achieve the goal of a stable Economic and Monetary Union but derive instead from an integrating agenda. For these reasons, several of the 'Genuine Economic and Monetary Union' proposals appear to have been postponed indefinitely or quietly dropped, while others are likely to proceed only on a less ambitious scale than originally proposed. As this report sets out, the original vision for Banking Union has only been partially fulfilled, while the prospects of agreement on the most contentious elements of the other pillars, such as a eurozone budget and debt mutualisation, are—as things stand—remote.

15. **The asymmetry between a centralised monetary policy and decentralised fiscal and structural policies remains a fundamental flaw in EMU. This shortcoming was pointed out by many at the outset of the single currency project, but there was little political will to do anything about it. Instead, national central banks and regulators stood by while widespread mispricing of risk led to excessive borrowing in certain countries, most notoriously Greece. The mispricing of public debt may have been due in part to a false assumption by investors that there would be some degree of solidarity or ultimate common responsibility for governmental borrowing within the eurozone. The effect of this borrowing was to finance an expanding current account deficit in many countries which itself reflected a steady decline in their relative competitiveness. The outbreak of the financial crisis led to a crisis of confidence in the public debt of Greece, Portugal and to a lesser degree Italy, and in the real estate market and its principal lenders in Spain and Ireland. Because the obvious need of Spain and Ireland (and later of Cyprus) to recapitalise their banks was clearly beyond the capacity of these governments alone, a crisis of confidence in these countries' public debt was rapidly engendered. The resulting vicious circle linking banks and sovereign states is a defining symptom of the eurozone crisis.**

16. **The Commission has now acknowledged the flaws in Economic and Monetary Union. Yet there remains a clear conflict between the steps that are economically necessary to secure the eurozone and those that are politically realistic. Key EU players, notably the Commission, the**

ECB, and Germany, have different priorities. Thus while the political commitment to maintaining the single currency is as strong as ever, there is a continuing failure to agree the steps necessary to address its flaws. The end result is what was described to us as "the euro continuing as an injured patient with a massive sticking plaster in the form of bailouts."[18] Whether the 'Genuine Economic and Monetary Union' proposals form a realistic basis for overcoming such conflicts is a matter of considerable doubt.

A case for treaty change?

17. A further fundamental obstacle to addressing these flaws is the need for treaty change. In its Blueprint the Commission stated that, while some of the elements of 'Genuine Economic and Monetary Union' could be adopted within the limits of the current Treaties and thus could progress in the short to medium term, others would require modifications of the current Treaties and new competences for the Union, and could therefore only be completed in the long term.[19]

18. Specifically, the Commission acknowledged that the following proposals would require treaty change:[20]

- More intensive EU control of national budgetary policy, for example by setting up a European right to require a revision of national budgets in line with European commitments;
- Greater coordination on tax policy in the euro area;
- Moves towards a proper fiscal capacity, in particular if it provided for the EU level to borrow and thus to act in a demand stabilising manner;
- The establishment of a Debt Redemption Fund;
- Ensuring that there was appropriate democratic legitimacy and accountability of decision-making.

Further details of those elements of 'Genuine Economic and Monetary Union' which are likely to require treaty change are set out in Table 1 below.

TABLE 1

The timescale and legal form of the 'Genuine Economic and Monetary Union' proposals

Measure	Anticipated timing	Legal form
Banking Union, comprising:	Short term for initial stages, longer term to be completed	Secondary legislation and limited treaty change
i) Centralised bank supervision, led by the ECB	Agreement finalised in October 2013	Secondary legislation

18 Syed Kamall MEP, Q 217.

19 'Blueprint for a Deep and Genuine Economic and Monetary Union' (November 2012), *Op. Cit.*

20 *Ibid.*

Measure	Anticipated timing	Legal form
ii) A Single Resolution Mechanism incorporating an effective common backstop, but limiting the exposure of taxpayers	Council agreement reached in December 2013 on a limited mechanism. Trilogue negotiations continuing	Secondary legislation
iii) An operational framework to enable the European Stability Mechanism to be used for direct bank recapitalisation	Agreed in principle, details to be elaborated	Limited treaty change to Article 136; separate intergovernmental ESM treaty
iv) Common deposit insurance	In abeyance	Uncertain
Fiscal union	Mix of short, medium and long term	Initially, secondary legislation and intergovernmental treaty
Mechanisms for better discipline in, and coordination of, fiscal policy, building on the measures already agreed in the last three years	Already enacted through a succession of measures in 2011, 2012 and 2013. Implementation being tested	Secondary legislation and Treaty on Stability, Coordination and Governance (TSCG)
A new fiscal capacity for the eurozone: initially to provide targeted but temporary support for countries undertaking structural reforms; subsequently becoming an instrument to help in dealing with country-specific economic shocks through a centrally-managed insurance system	Proposals tabled in March 2013 for Convergence and Competitiveness Instruments (CCI) and discussed at December 2013 European Council; pushed back to October 2014	Initially, TSCG; more extensive permanent mechanism likely to require new treaty base
The possible establishment of forms of debt mutualisation, including the eventual introduction of a Eurobond available to all participating Member States, which would be jointly and severally guaranteed.	In abeyance	Likely to require a treaty base, but uncertain whether it would be full, limited or separate intergovernmental treaty
Closer integration of economic policies intended to promote sustainable growth, competitiveness and employment and improving the resilience of the economy to shocks	Already partly realised through macroeconomic imbalances procedure, Two-pack and coordination provisions for deeper policy coordination agreed in 2011–2013	Initially, secondary legislation and TSCG

Measure	Anticipated timing	Legal form
Further efforts to complete the Single Market, including by stimulating labour mobility across borders and possibly greater tax harmonisation	Continuing	Secondary legislation
A reinforced framework for ex-ante coordination of major policy reforms, notably those affecting the supply-side of the economy	Commission communication tabled March 2013	TSCG and secondary legislation
Contractual relationships between Member States and the Commission on economic strategies, with accountability to both the European Parliament and national parliaments	Proposals tabled in March 2013 for CCI and discussed at December 2013 European Council; pushed back to October 2014	Uncertain
Enhancement of democratic oversight of pooled economic policies	Longer term	Outside scope of present inquiry

19. Treaty change is a highly sensitive political issue. The history of EU referendums in countries such as France or Ireland, coupled with the high levels of political instability seen across much of the EU, suggests that popular approval could not be guaranteed. As a result, elements of 'Genuine Economic and Monetary Union' have been specifically designed to avoid the need for treaty change. This is notably the case in relation to Banking Union. This begs the question whether the proposals put forward will be sufficient to tackle the flaws they are designed to address.

20. One potential trigger for treaty change could be the outcome of the continuing legal investigation into the legality of the ECB's programme of Outright Monetary Transactions (OMTs). In a long-anticipated judgment, on 7 February 2014 the German Constitutional Court found that, subject to the interpretation by the Court of Justice of the European Union, the programme was "incompatible with primary law", because it "does not appear to be covered by the mandate of the European Central Bank". If so, that would create an obligation on the German authorities to refrain from implementing the OMT decision and a duty to challenge it. However, it added that, if the OMT decision were interpreted restrictively, it could be lawful. It therefore referred the questions to the Court of Justice of the European Union for a definitive interpretation of the relevant EU law, following which the German Constitutional Court will consider the implications.[21]

21 German Federal Constitutional Court (2014), 'Principal Proceedings ESM/ECB: Pronouncement of the Judgment and Referral for a Preliminary Ruling to the Court of Justice of the European Union', Press release no.9/2014, 7 February, http://www.bverfg.de/en/press/bvg14-009en.html. For the full decision see http://www.bverfg.de/en/decisions/rs20140114_2bvr272813en.html. See Wagstyl, S., and Jones, C. (2014), 'German court refers ECB bond-buying programme to European justice', *Financial Times*, 7 February.

21. **There is widespread recognition that some treaty change is necessary to underpin the scale of reforms needed to address EMU's flaws. But some of what the Commission proposes goes beyond what is strictly necessary to shore up EMU. Treaty change is both difficult to achieve and an unpredictable process. Instead, there has been a clear preference to look for ingenious, and at times complex, solutions within the current treaty framework, or to reach intergovernmental agreements outside it. The key test must not only be whether these solutions are politically achievable, but whether they are really needed and, if they are, whether they will be effective in tackling the weaknesses in EMU.**

Inoculating the UK?

22. A key question for this report is where all this leaves the UK. The Government have made clear that, while they support measures to increase eurozone integration as necessary to stabilise the eurozone, they will not participate in any element of 'Genuine Economic and Monetary Union'. However they will seek to engage in negotiations as the proposed reforms are discussed in the European Council, in particular to ensure that the Single Market is not undermined by eurozone integration.[22] We agree that a strong and sustainable eurozone is in the best interests of the UK. However the Government need to consider whether their semi-detached position is sustainable in the long term, or whether, in the words of one of our witnesses, the UK will ultimately need to choose whether to be in or out.[23] We consider this issue in more detail in Chapter 4.

Bottling the cure

23. The economic and political context of 'Genuine Economic and Monetary Union' prompts the following questions:

- How far towards this model is it politically realistic to expect the eurozone to move?
- Will this be far enough to ensure that the foundations of Economic and Monetary Union are stabilised and strengthened?
- Will this be sufficient to reassure the markets about the single currency's continuing viability?
- Which elements of 'Genuine Economic and Monetary Union' are required to bring this about? Which aspects should be pursued as a matter of priority? Which can be put to one side?
- How long will it take to achieve the necessary reforms?
- Will treaty change be required, and if so, for which elements of 'Genuine Economic and Monetary Union'?
- What will be the impact of all of this on the Single Market in general, and the UK in particular?

These questions form the basis of our report.

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22 EM 16988/1/12 (10 December 2012).

23 Manfred Zöllmer MdB, Q 295.

24. **The most effective cure to EMU's flaws, namely full fiscal and political union, is politically unachievable. Although a full and 'Genuine' Economic and Monetary Union as envisaged by the Commission may be beyond reach and would also entail more changes than are strictly necessary, a strengthened EMU is both vital and achievable.**

This report

25. In line with the remit of the EU Economic and Financial Affairs Sub-Committee, which conducted this inquiry, this report focuses on the first three pillars of 'Genuine Economic and Monetary Union':

- An integrated financial framework;
- An integrated budgetary framework;
- An integrated economic policy framework.

Our analysis of the first pillar builds upon and takes forward our December 2012 report, *European Banking Union: Key issues and challenges*.[24]

26. The fourth pillar, democratic legitimacy and accountability, is vital, in particular in the current context of political uncertainty and instability in a number of Member States. This issue is directly relevant to the EU Committee's current inquiry into the role of national parliaments in the EU. We will consider such important questions fully in the report on that inquiry.

27. Our findings are based on oral and written evidence collected between May and November 2013 from a range of witnesses including Nicky Morgan MP, Economic Secretary to the Treasury, politicians, academics, economists and media commentators. We also undertook two visits during the course of this inquiry. Our visit to Brussels in October 2013 enabled us to meet with Commission Vice-President Olli Rehn, members of the European Parliament Economic and Monetary Affairs (ECON) Committee, and a number of Brussels-based thinktanks and experts. Our visit to Berlin and Frankfurt in November 2013 enabled us to understand the German perspective on 'Genuine Economic and Monetary Union' and on the UK's position. We met with a cross-party panel of German politicians, leading economists and, in private meetings, with the German Ministry of Finance, the German Bundesbank and the ECB. We also sought to gain a sense of the perspective of other Member States, and our witnesses included academics, politicians and government representatives from France, Portugal, Spain and Italy. We are grateful to all of our witnesses for their assistance. We are also grateful to Professor Iain Begg, Professorial Research Fellow, European Institute, London School of Economics, who acted as Specialist Adviser for this inquiry.

28. **We make this report to the House for debate.**

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[24] House of Lords European Union Committee, *European Banking Union: Key issues and challenges* (7th Report, Session 2012–13, HL Paper 88).

CHAPTER 2: INTEGRATED FINANCIAL FRAMEWORK—BANKING UNION

Background

29. The first pillar of 'Genuine Economic and Monetary Union', an integrated financial framework, is more commonly referred to as 'Banking Union'. According to the original 'Genuine Economic and Monetary Union' proposals, Banking Union comprises three core elements:

- A Single Supervisory Mechanism to ensure that the supervision of banks in all EU Member States is equally effective in reducing the probability of bank failures and preventing the need for intervention by joint deposit guarantees or resolution funds;
- A Single Resolution Mechanism, with the aim of ensuring the orderly winding-down of non-viable institutions, thereby protecting taxpayer funds; and
- A Single Deposit Insurance Scheme to strengthen the credibility of the existing arrangements and serve as an important assurance that eligible deposits of all credit institutions are sufficiently insured.[25]

30. Together, these elements were intended to break the 'doom loop' between banks and sovereign states which has been so damaging during the eurozone crisis. In particular, they were designed to counter the threat that dealing with a banking crisis will overwhelm the fiscal capacity of vulnerable countries. However, as we explore below, the original three-pronged model of Banking Union was quickly watered down. A Single Supervisory Mechanism (which we considered in our December 2012 report on European Banking Union: Key issues and challenges[26]) was agreed in March 2013 and is scheduled to become operational in autumn 2014. However, proposals for a Single Resolution Mechanism, first published in July 2013, are proving highly contentious. At the time of writing, the Council and European Parliament were locked in fraught negotiations over the text agreed by the Council in December 2013. As we shall see, this agreement has a number of shortcomings, particular its failure to break the 'doom loop'. The third leg, a single deposit insurance scheme, has disappeared from view entirely.

31. Banking Union was universally recognised as the most urgent element of the package. The Economic Secretary to the Treasury told us that it should be the clear priority.[27] Professor Agnès Bénassy Quéré, University of Paris I Panthéon Sorbonne, explained it was important for the future in terms of improving the governance of the monetary union, and for the present in order to clean up the banking sector and break the vicious circle between banks and sovereign states.[28] Lorenzo Codogno, Department of the Treasury, Italian Ministry of Economy and Finance, argued that it was "urgent and essential" because the European financial system was still

25 'Towards a Genuine Economic and Monetary Union', June 2012, *Op. Cit.*

26 House of Lords European Union Committee, *European Banking Union*, *Op. Cit.*

27 Q 317.

28 Q 222.

broken, markets were still dysfunctional and there was very little financing across European borders.[29]

32. However, Fabian Zuleeg, Chief Executive and Chief Economist, European Policy Centre, described the likely outcome as "probably not ideal—and if I were to design an optimal banking union it would look very different from the one we are likely to get."[30]According to Sir Nigel Wicks, full Banking Union would not emerge any time soon because of the constraints of the present Treaty.[31] The key issues at stake include the need for a fiscal backstop, the question of mutualisation and the treatment of legacy debts, and whether Banking Union as envisaged would be sufficient to break the link between banks and sovereign states. We consider these issues further in relation to each of the three legs of Banking Union below.

Single Supervisory Mechanism

33. Our 2012 *European Banking Union* report welcomed the Single Supervisory Mechanism (SSM) proposals as a significant first step towards Banking Union, although we noted that there were a number of significant questions to be resolved, including in relation to the role of the ECB as a single supervisor and the number of banks to be directly supervised by the ECB. We thought it unrealistic for the ECB to engage in intensive supervision of all 6000 euro area banks, although it should have the power to assume responsibility for the supervision of any bank as required. We stressed that the SSM must not undermine the Single Market and the role of the European Banking Authority (EBA), the regulatory agency tasked with improving cooperation between national supervisors and continuing the development of the single rulebook for financial services for all 28 Member States. In particular, we stressed that the EBA's voting arrangements must not undermine the operation of the Single Market as a whole.[32]

34. Subsequent to the publication of our report, a deal was reached in March 2013 between the Council and the European Parliament on the SSM proposals, the key elements of which are set out in Box 5 below.

BOX 5

Key provisions of the Single Supervisory Mechanism

- The SSM was formally agreed in October 2013 through two regulations which confer supervisory responsibility on the ECB and modify the role of the EBA.
- The SSM is composed of the ECB and the supervisory authorities of the Member States and covers the eurozone and those other EU Member States which choose to participate, all of which will have full and equal voting rights on the supervisory board.

[29] Q 199.

[30] Q 142.

[31] Q 185.

[32] House of Lords European Union Committee, *European Banking Union*, *Op. Cit.*

- As explained in a Council Press release, "the ECB will have direct oversight of eurozone banks, although in a differentiated manner and in close cooperation with national supervisory authorities."[33] The ECB will also have overall responsibility for the functioning of the SSM, but will be obliged to separate its supervisory function from its monetary policy role.
- An element of the agreement especially important to the UK is that the EBA's voting 'modalities' were amended to prevent the countries participating in the SSM from having a dominant role in decisions affecting the Single Market.
- It was originally intended that agreement on the SSM, which is due to come into force late in 2014 following an asset quality review conducted by the ECB, should pave the way for the ESM to recapitalise banks directly, rather than acting through Member State treasuries. This was one of the changes considered necessary to break the link between sovereign states and banks.

35. The UK Government placed particular emphasis on the safeguards secured to protect the Single Market, notably the so-called 'double majority' voting mechanism in the EBA. Under this mechanism, key decisions, including on standards applying across the Single Market, will need to be approved by a simple majority of members of the EBA Board of Supervisors of both participating and non-participating Member States. However, there would be a review of voting arrangements if and when the number of non-participants fell to four.[34]

36. A number of our witnesses reflected on this deal. James Watson, Director, Economics Department, BUSINESSEUROPE, and Professor Luis Garicano, Head of the Managerial Economics and Strategy Group, London School of Economics, both stressed that all banks should be subject to direct supervision under the new mechanism. Professor Garicano pointed out that the SSM as agreed would "not have caught all these small savings banks, which were at the root of all Spain's troubles."[35] Sir Nigel Wicks felt that a treaty revision would put the SSM on a stronger footing, particularly since non-euro area Member States who wished to join would not be adequately incorporated into the governance arrangements.[36]

37. **We welcome the agreement reached in March 2013 on the Single Supervisory Mechanism (SSM). We note concerns about the limited coverage of the SSM. However we repeat our view that it is unrealistic to expect the ECB to engage in intensive supervision of all 6000 euro area banks. Given the dangers that smaller credit institutions can potentially pose to financial stability, it is imperative that the ECB is able quickly to intervene with any smaller banks as required. This requires close and positive cooperation between the ECB and national**

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33 'Council approves single supervisory mechanism for banking', European Council Press Release (15 October 2013).

34 Letter from Rt Hon Greg Clerk MP, the then Financial Secretary to the Treasury, to Lord Boswell, Chairman of the House of Lords European Union Committee (12 January 2013).

35 QQ 150, 192.

36 Q 180.

supervisors. Parties on all sides must do their utmost to ensure that the agreed mechanism is robust enough to ensure that this happens.

38. **While we welcome the safeguards to protect the Single Market that the UK Government secured, they can only be regarded as a temporary fix. The double majority voting mechanism will be reviewed once the number of non-participants falls to four. It is therefore incumbent upon the Government to do all they can to ensure that safeguards to protect the Single Market and the UK's position within it are retained as the situation evolves.** We explore the implications of Banking Union for the UK and the Single Market further in Chapter 4.

The role of the ECB

39. The SSM negotiations laid bare a key tension at the heart of the EU's response to the crisis—although it is acknowledged that its institutions need to be strengthened, there is trepidation at the political and economic ramifications of such reforms. This is particularly evident in the case of the ECB. In our *European Banking Union* report, we warned that the concentration of so much power in one institution meant that powerful safeguards needed to be put in place.[37] The ECB's growing and evolving role continues to prove contentious. We note three manifestations of this:

- The ECB's comprehensive assessment of the banking system;
- The conflict between its monetary policy and supervisory tasks;
- Its commitment to Outright Monetary Transactions (OMTs).

i) The ECB's comprehensive assessment of the banking system

40. Ahead of taking on its supervisory functions, the ECB is undertaking a comprehensive assessment of the banking system. The assessment began in November 2013 and will take 12 months to complete. The assessment has three elements: i) a supervisory risk assessment to review, quantitatively and qualitatively, key risks, including liquidity, leverage and funding; ii) an asset quality review (AQR) to enhance the transparency of bank exposures by reviewing the quality of banks' assets, including the adequacy of asset and collateral valuation and related provisions; and iii) a stress test to examine the resilience of banks' balance sheets to stress scenarios, to be carried out by the EBA. The comprehensive assessment will conclude with an aggregate disclosure of the outcomes, at country and bank level, together with any recommendations for supervisory measures.[38]

41. Several witnesses expressed anxiety about the ECB's task. Guntram Wolff, Director, Bruegel, thought that the ECB would "have to choose between a rock and a hard place". In his view, if its review was too tough, it could threaten financial stability by exposing a huge gap that nobody knows how to fill. If it was too soft, it could undermine the ECB's credibility.[39]

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[37] House of Lords European Union Committee, *European Banking Union*, *Op. Cit.*

[38] ECB Note, Comprehensive Assessment (October 2013): http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf.

[39] Q 115.

42. Some were sceptical as to how rigorous the assessment would prove in practice. Roger Helmer MEP was convinced that the objective of such an exercise was not to get to the truth but to reassure the markets.[40] Professor Mark Hallerberg, Hertie School of Governance, predicted that "somebody will be a little hurt, some country will be a little bloody, but that will not include the whole banking system."[41] On the other hand, Sharon Bowles MEP, Chair of the European Parliament Economic and Monetary Affairs (ECON) Committee, was confident that the comprehensive assessment would be conducted robustly.[42]

43. The biggest concern was that the ECB's assessment would be influenced by the lack of a sufficient fiscal backstop to plug any gaps in bank balance sheets exposed by the review. According to Professor Claudia Buch, President, Halle Institute for Economic Research, "if the ECB starts the asset quality review and we do not have proper fiscal backstops in place, it is highly unlikely that we will learn what is on banks' balance sheets."[43]

44. The Council issued a statement on backstop arrangements in anticipation of the comprehensive assessment on 15 November 2013.[44] This statement set out the hierarchy that would apply if a capital shortfall were revealed by the process. In the first instance, resources should come from private sources, followed by national and finally euro area/EU instruments. The Council indicated that, at the euro area level, the European Stability Mechanism (ESM) could provide, through its normal procedures, financial assistance to Member States. On direct recapitalisation of banks from the ESM, the statement was ambiguous. It appears that direct recapitalisation would be possible for a bank that passed the asset quality review, but was caught out with a capital shortfall in the stress test. Despite this, a number of hurdles would still have to be overcome: a country would have to be too indebted to afford an ESM loan, and bank investors would first have to take losses.

45. Roger Helmer MEP expressed concern about how sovereign bonds would be valued.[45] Marco Pagano, Professor of Economics, University of Naples Federico II, also stressed the importance of discouraging banks from holding too much risky government debt. He pointed out that the convention of regarding all sovereign debt issued by euro area governments as risk-free created the "perverse incentive for banks to engage in the purchase of risky, high-yield sovereign debt" and reinforced the toxic link between banks and sovereign states. He stressed the need for the reform to be phased in gradually. This could imply what is known as a grandfather clause; by which the old prudential rules continue to apply to existing sovereign debt holdings (until they mature), while the new rules would apply to all future purchases of sovereign debt. Yet even this arrangement involved significant drawbacks, such as a reduction in trading of existing sovereign debt.[46]

46. On 31 January 2014, the EBA announced the main features of the stress tests it will conduct later this year, in cooperation with the European Systemic

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40 Q 218.

41 Q 254.

42 Q 218.

43 Q 310.

44 Economic and Financial Affairs Council Press Release (15 November 2013).

45 Q 218.

46 Q 79; Professor Marco Pagano—Supplementary Evidence.

Risk Board (ESRB) and the ECB. They have particular importance this year because they will form part of the comprehensive assessment of risks being undertaken by the ECB in advance of becoming the lead supervisor in the eurozone under the SSM. The EBA guidance on how to treat banks' holdings of sovereign debt makes a distinction between bonds held in a bank's trading book, which will be valued at what they would fetch if sold at current market prices (very likely to be below their nominal value for bonds of vulnerable countries), and bonds expected to be held until they are redeemed by the country in question. The approach makes clear that, under different scenarios, the true worth of sovereign bonds will vary. It also confers discretion on individual supervisors (the ECB for the most important banks in the eurozone, national supervisors in other Member States) to judge how to take account of differences in the riskiness of sovereign bonds emitted by different Member States in assessing the overall capital adequacy of a bank. An EBA explanatory note states that the choice will be clear in the transparency of the results.[47] The EBA is expected to provide further elaboration on the stress test methodology by April 2014.

47. In the midst of such debates, it is important to keep in mind what should be the underlying purpose of the comprehensive assessment—to restore trust in the resilience of the banking system so that it can resume its core role of providing lending (notably to SMEs) to stimulate and support economic growth. The European banking system cannot be considered fixed unless and until banks have the confidence to resume their normal function within a thriving economy. The fragmentation of European financial systems along national lines has, moreover, resulted in new problems. A credit crunch has occurred in the more vulnerable Member States as banks retrench, while depositors move their money to safer jurisdictions. This adds to the cost of capital for small businesses in countries that badly need them to be investing more. It thereby risks accentuating disparities inside the eurozone.

48. **We recommend clarity on the backstop arrangements ahead of the ECB's comprehensive assessment of the banking system. Without this, the ECB may be inclined to temper its assessment of a bank's balance sheet to avoid creating financial instability in the short run, at the risk of undermining its credibility as a supervisor as and when the true state of affairs becomes apparent. Until confidence in the banking system is restored, its function as a stimulus and support to economic growth will remain impaired. That confidence depends in part on the credibility of the supervisor, which should not be put at risk through the current lack of clarity in the backstop arrangements.**

49. **Clearly, not all eurozone sovereign bonds are equally safe. The valuation of sovereign debt held by banks as assets should realistically reflect the risk of default in each Member State. The European Banking Authority (EBA) has recently offered general guidance to competent authorities on this issue. It remains to be seen how this will affect the ECB's forthcoming comprehensive assessment. We will continue to monitor the situation as further details emerge, notably in the elaboration of the stress test methodology expected by April this year.**

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47 European Banking Authority (2014), '2014 EU-wide stress test: Frequently Asked Questions', 31 January: https://www.eba.europa.eu/documents/10180/563711/2014+EU-wide+Stress+Test+-+FAQs.pdf.

ii) The ECB's monetary policy and supervisory roles

50. Several witnesses cited the tensions arising from the ECB's new supervisory tasks, in particular whether it was appropriate to bring together supervisory and monetary policy functions in one organisation. Thomas Wieser, President, Eurogroup Working Group, told us that "these issues actually follow fashion more than hard analysis", which in recent times had tended towards the functions being combined. He was not supportive of such moves since "while 99.9% of the time there is no conflict of interest, in the 0.1% of the time when there is, one of the two targets has to suffer."[48] Sir Nigel Wicks agreed, but said that the current Treaty was an obstacle to setting up a freestanding authority responsible for supervision.[49]

51. On the other hand, Marco Pagano told us that it was increasingly being recognised (including in the UK) that a key role for a central bank was to look after macroprudential stability since it was almost impossible to conduct monetary policy effectively if financial markets were in a state of turmoil.[50] Guntram Wolff believed that the risk of a conflict of interest had been overplayed. Indeed the positive benefit of a central bank fulfilling a supervisory function was that it would be able to act much earlier in the provision of liquidity to banks.[51]

52. We considered this issue in our *European Banking Union* report. Although we concluded that the ECB was the only organisation with the necessary credibility and authority to take on the role, we acknowledged that this was a momentous step, creating a significant concentration of power in one institution, with huge implications for the ECB.[52] These concerns were widely shared, and the March 2013 agreement sought to provide the following safeguards:

- A Supervisory Board, responsible for the planning and execution of supervisory tasks conferred on the ECB, would be established to ensure that the ECB's monetary tasks were strictly separated from its supervisory tasks and to eliminate potential conflicts of interest between the two;
- Membership of the Supervisory Board would comprise a representative from the national competent authority of each participating Member State, a Chair and Vice-Chair and four representatives of the ECB, all of whom would have voting rights;
- Decisions of the Supervisory Board would be deemed adopted unless they were actively rejected by the ECB Governing Council;
- The ECB would also establish a mediation panel, which would resolve differences of view where the ECB Governing Council objected to decisions made by the Supervisory Board. This would include one member from each participating Member State, each with one vote;

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48 Q 171.

49 Q 180.

50 Q 81.

51 Q 114.

52 House of Lords European Union Committee, *European Banking Union*, *Op. Cit.*

- A review panel would ensure the procedural and substantive legality of decisions taken by the ECB: decisions taken by the ECB could be referred to the European Court of Justice under Article 263 of the Treaty on the Functioning of the European Union (TFEU).

53. **We reiterate our view that, given the constraints of the existing Treaty, the ECB is the most appropriate body to take on the supervisory function. Indeed there are positive advantages to combining supervisory and monetary policy functions within one institution. However, we recognise that this is a contentious issue, and that it has created a significant concentration of power in one institution. As many safeguards as possible within Treaty constraints have been provided to ensure that the potential for a conflict of interest is minimised. Time will tell whether they prove sufficient.**

iii) Outright Monetary Transactions (OMTs)

54. Together with Mario Draghi's July 2012 commitment to "do whatever it takes" to save the euro, the ECB's commitment in September 2012 to engage in Outright Monetary Transactions (OMTs) in respect of troubled euro area economies has been widely acknowledged as a turning point for the euro area crisis. OMTs would function as a commitment by the ECB to buy up the debt of a vulnerable Member State, not directly from the national Treasury, but in the open market. This is on the condition that the Member State in question agrees to a reform programme aimed at correcting the problems which gave rise to the need to request support. Such conditionality, which was not a feature of previous ECB actions to stabilise bond markets, means that applicant countries would have to accept restrictions on their economic policy. As Mario Draghi put it in a speech in June 2013:

> "They can either reform without OMTs and retain economic sovereignty or they can reform with OMTs but give up some of their economic sovereignty. Either way, they have to persevere in their reform efforts. So it is quite misleading to compare OMTs to historical episodes in which governments relied on central bank support to replace fiscal consolidation."[53]

As yet, no country has sought to make use of OMTs. However the mere announcement was sufficient to convince financial markets not to take on the might of the ECB.

55. The Economic Secretary to the Treasury said that the ECB had "addressed one of the euro area's major systemic weaknesses", the need for a lender of last resort.[54] Marco Pagano saw the OMTs commitment as proof that the ECB was "the main institution holding things together in the European financial markets".[55]

56. The OMTs commitment is a matter of deep controversy, and is opposed by the German Bundesbank as going beyond the ECB's powers under the

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53 Mario Draghi, President of the European Central Bank, Speech to the 2013 International Monetary Conference, Shanghai (3 June 2013).

54 Q 317.

55 Q 81.

Treaty. On 7 February 2014, after several months' deliberations, the German Constitutional Court (by a six to two majority) concluded that the programme may be "incompatible with primary law", because "there are important reasons to assume that it exceeds the European Central Bank's monetary policy mandate and thus infringes the powers of the Member States, and that it violates the prohibition of monetary financing of the budget." One of the ECB's key arguments portrayed OMTs as a monetary policy instrument to improve the transmission of monetary policy decisions to the real economy, since this transmission mechanism works badly when there are large differences in interest rates across the eurozone. This was rejected by the German Court. However, it added that "the OMT decision might not be objectionable if it could be interpreted or limited in its validity in conformity with primary law." In an unprecedented move for this Court, it referred the case to the Court of Justice of the European Union for a definitive interpretation of the relevant EU law. The German Constitutional Court will then consider the outcome. Final resolution of the case is likely to remain some months away.[56]

57. Some of the immediate comment on the German Court's decision suggested that it would be easier for the Court of Justice of the European Union to agree with the ECB that OMTs are within its mandate, and that a concern not to accentuate instability may have influenced the German Courts' position. However, there is also a view that if the Court of Justice does not reject the use of OMTs, then the German Court could still prohibit the German Government and the Bundesbank from going along with them. Without a German contribution, OMTs as a policy tool plainly would not be viable. According to one prominent German commentator, Hans-Werner Sinn, head of the Ifo Institute, "the policy of closing one eye and approving ECB policy, with which Chancellor Merkel has contradicted the Bundesbank, has reached its limits."[57] It remains to be seen what the impact of such continued uncertainty will be. We will examine further developments closely.

58. Some of our witnesses also had concerns. Professor Otmar Issing, Centre for Financial Studies, Goethe University and a former member of the ECB Executive Board, was clear that the OMTs programme was not monetary policy, and "cannot be compared with the Bank of England buying UK government bonds or the Fed buying the US Treasury's" since it was a selective buying of bonds. He stressed that "this is something for which, in the end, you need a political decision, political support and, finally, democratic legitimacy."[58] Dr Clemens Fuest, President, Centre for European Economic Research (ZEW), said that OMTs was "an unusual programme" since it had led to the ECB taking on a function that was similar to the role

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56 German Federal Constitutional Court (2014), 'Principal Proceedings ESM/ECB: Pronouncement of the Judgment and Referral for a Preliminary Ruling to the Court of Justice of the European Union', Press release no.9/2014, 7 February, http://www.bverfg.de/en/press/bvg14-009en.html, *Op. Cit*. For the full decision see http://www.bverfg.de/en/decisions/rs20140114_2bvr272813en.html, *Op. Cit*. See Wagstyl, S., and Jones, C. (2014), 'German court refers ECB bond-buying programme to European justice', *Financial Times*, 7 February, *Op. Cit*.

57 *Ibid*.; See also: Comments by the Ifo Institute and Hans-Werner Sinn, http://www.cesifo-group.de/ifoHome/infoservice/News/2014/02/news-20140207-Stellungnahme.html;and Comments by Franz C. Mayer, Professor of European Law, http://www.bertelsmann-stiftung.de/cps/rde/xchg/SID-8B8001CA-944D4D8E/bst_engl/hs.xsl/nachrichten_119997.htm.

58 Q 306.

that should be fulfilled by the ESM, or the support provided by the IMF for countries in difficulties.[59] Nigel Farage MEP, Leader of the UK Independence Party (UKIP), also highlighted the political dangers, arguing that the relative success of the OMTs programme had encouraged complacency amongst EU leaders.[60]

59. Other witnesses were more sanguine. Fabian Zuleeg argued that a certain amount of pragmatism was necessary. While he accepted that the programme stretched beyond the remit that was originally envisaged for the ECB, there were not many other options on the table at the time.[61] Guntram Wolff argued that "its action is in my view fully within the treaty".[62]

60. Fabian Zuleeg added that it would be inefficient for this to become a long-term role for the ECB given that OMTs were effectively acting as a substitute for debt mutualisation. In his view, however, it might prove easier to continue it rather than addressing the political difficulties of debt mutualisation.[63]

61. **We applaud the ECB for its firm and decisive action in tackling the euro area crisis, starting with the provision of liquidity from the early stages of the crisis in 2007 and again in 2010. We note that its interventions have been crucial since Mario Draghi became President in November 2011. However, we recognise that it has stretched its remit under the Treaty.**

Single Resolution Mechanism

The Commission's proposal

62. The other most significant progress during the past year has been in relation to the second leg of Banking Union, the Single Resolution Mechanism (SRM). Bank resolution refers to the process by which a failing bank is dealt with so as to avoid knock-on effects on other financial intermediaries that lead to systemic problems in the financial sector. Various approaches can be adopted, usually starting by calling on shareholders to contribute to the costs, then asking major creditors (notably unsecured bondholders and depositors holding more than €100,000) to accept a write-down of the amount they are owed (sometimes referred to as a 'haircut'), selling off viable parts of the bank, injecting fresh equity (possibly by nationalisation) or providing cheap loans. The Commission's proposals for a Single Resolution Mechanism and Single Bank Resolution Fund were published in July 2013, with the intention of adopting them before the end of the current European Parliamentary cycle in spring 2014.[64] The main provisions of the Regulation are set out in Box 6 below.

59 Q 92.

60 Nigel Farage MEP.

61 Q 137.

62 Q 114.

63 Q 137.

64 European Commission (10 July 2013), COM (2013) 520 FINAL.

BOX 6

The Commission's original proposals for a Single Resolution Mechanism and Single Bank Resolution Fund[65]

As originally envisaged in the Commission proposals published on 10 July 2013, the Single Resolution Mechanism (SRM) was intended to complement the Single Supervisory Mechanism (SSM) and would be a significant step towards a Banking Union. Its key features were to be a new Single Resolution Board (SRB), bringing together pooled expertise, central decision-making able to avoid the dangers of uncoordinated national responses and a single resolution fund to act as a backstop.

Unlike the SSM, the resolution procedures would make no distinction between different types of banks, but would instead be applied in all cases. Part of the rationale for this was to avoid national differences in backstop arrangements which could give rise to difficulties in links between sovereign states and banks, as well as having the potential to distort competition.

All resolution decisions would be prepared and monitored centrally by the SRB "to ensure a coherent and uniform approach". The proposal also envisaged resolution processes being initiated by the Commission, either on a recommendation by the SRB or on its own initiative. There would be a sharing of tasks between the SRB and the national resolution authorities.

The proposal stated that "as a principle, the cost of resolution will be borne by bail-in and the banking sector. Therefore, the proposal ensures that the Commission, the Board and the national resolution authorities decide upon resolution funding arrangements in such a manner that the use of extraordinary public support is minimised."

The proposed decision-making sequence was as follows: the ECB would notify the SRB, the Commission and the relevant national authorities that a bank was failing; the SRB would carry out an assessment and decide whether to recommend resolution; the Commission would then initiate resolution and set the framework for applying resolution tools; and the SRB would launch a resolution scheme, in cooperation with national authorities (with the SRB retaining the power to override national authorities which did not comply).

The SRB would be accountable to the European Parliament and to the Council, but would also have a duty to inform national parliaments. It would be funded by contributions from the banking sector. It would consist of an executive director and deputy, representatives of the ECB and the Commission, and of the national authorities of participating Member States. The full board would deal with matters of general policy, while a reduced executive board comprising the Director and deputy, plus the representative of the ECB, the Commission and relevant Member States, would deal directly with individual banks. None of the board members would have a veto.

The proposal emphasised the protections for non-participating Member States to prevent anti-competitive discrimination. Where colleges of regulators were required, the SRB would replace the national authorities of participating countries.

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65 *Ibid.*

It was stated that the primary aim of the single bank resolution fund was "to ensure financial stability, rather than to absorb losses or provide capital to an institution under resolution. The Fund should not be considered as a bailout fund." The fund was intended to grow to be 1% of the covered deposits of all banks in Member States participating in Banking Union. Based on 2011 data, this would mean a fund of €55 billion, to be built up over ten years from levies on banks amounting to €5.5 billion per annum. However, if the banking sector grew, the annual levies would increase proportionally. There were also proposals to increase the levy if the fund made disbursements, and to extend the period of building-up to fourteen years if the fund disbursed more than half its target size.

63. The proposal sought to build on the Directive on Bank Recovery and Resolution (BRRD), which determines the rules for how EU banks in serious financial difficulties are restructured, how vital functions for the real economy are maintained, and how losses and costs are allocated to the banks' shareholders, creditors and uninsured depositors.[66] A key feature of this Directive is the bail-in instrument, which will force shareholders, bondholders and some depositors to contribute to the costs of bank failure. After shareholders, there will be a hierarchy of unsecured creditors with favoured positions for natural persons and small businesses. Deposits below €100,000 are excluded from losses, and are protected by national Deposit Guarantee Schemes. Political agreement between the Council and the European Parliament on the BRRD was reached in December 2013. The Directive should enter into force in 2015, and the bail-in regime will be introduced from 2016.

64. The Commission argued that, while the BRRD was a major step forward, it was not sufficient for those Member States participating in the Single Supervisory Mechanism. It argued that bank supervision and resolution needed to be exercised at the same level of authority, to overcome tensions between the supervisor and national resolution authorities as to how to deal with ailing banks. The Commission also cited the dangers of market perception of Member States' inability to deal with bank failures nationally, reinforcing the negative feedback loop between sovereign states and banks.[67]

65. The Commission therefore proposed a Single Resolution Mechanism, including a new central Single Resolution Board (SRB), as well as a Single Bank Resolution Fund with the ability to pool significant resources from bank contributions, thereby protecting taxpayers more effectively than national funds and providing a level playing field for banks across participating Member States.[68]

Timber-framed or steel-framed?

66. The Commission's proposals proved contentious, in particular with Germany, whose Finance Minister, Wolfgang Schäuble, wrote in the *Financial Times* in May 2013 that it would require treaty change and would take years to implement. He suggested instead a two-stage process, with the

66 European Commission (6 June 2012), COM (2012) 280 FINAL.

67 COM (2013) 520 FINAL, *Op. Cit.*

68 *Ibid.*

construction of a "timber-framed, not a steel-framed, banking union" in the first instance, with a resolution mechanism based on a network of national authorities and relying on national funds.[69]

67. Mr Schäuble's approach was supported by Professor Willem Buiter, Chief Economist, Citigroup, who believed that a network of national recovery, resolution and recapitalisation regimes would be adequate to the task of "dezombifying" the euro area banking sector.[70] However this was a minority view. Lorenzo Codogno stressed that a 'steel-framed' SRM was "absolutely essential".[71] Mats Persson, Director, Open Europe, told us that a resolution fund was vital, "otherwise you are stuck with the same situation that we have now, that the resolution fund, the backstop, is ultimately linked to the sovereign, a national government, which means that the sovereign bank loop is still very much there."[72]

Issues of controversy

68. Witnesses acknowledged a number of controversial issues arising from the Commission's proposals, notably:

- The Commission's proposed role as resolution authority;
- The resolution fund and the treatment of legacy debts;
- The legal base and the impact on non-participants and on the Single Market;
- The constraints posed by the existing Treaty.

The role of the Commission

69. Guntram Wolff was concerned that the proposal for the Commission to act as resolution authority would create a conflict of interest with its role in controlling the kind of state aid that would apply in the case of a bank resolution.[73] This is because resolving a bank may involve injection of capital from the public purse, something the Commission has to police in its capacity as the enforcer of competition policy.[74] He also noted that there was a lack of trust in the Commission in a number of Member States. He stressed that the ECB should "stay out of the process" because resolution decisions may involve fiscal resources. He therefore advocated a separate resolution authority which could draw on the ESM.[75] On the other hand, Graham Bishop thought that the proposal for the Commission to act as the single resolution authority was a model that "works perfectly well", in particular given that any other option would require treaty change.[76]

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69 Schäuble, W. (2013) 'Banking Union must be built on firm foundations', *Financial Times*, 12 May.

70 Q 56.

71 QQ 197, 203.

72 Q 2. See also Sir Nigel Wicks, Q 185; Dr Daniela Schwarzer, Q 237.

73 Q 113.

74 An example is the demand by the Commission that Lloyds TSB and Royal Bank of Scotland dispose of branches as a condition for allowing the state aid they received when rescued in 2008.

75 Q 114.

76 Q 26.

70. Perhaps the weightiest objection either to the Commission or the ECB acting as the resolution authority is the danger that they would face conflicts of interest with their core tasks, and also risk being over-loaded with too many governance tasks. Already, the ECB faces a daunting challenge in recruiting staff for its supervisory role. In the US, the Federal Deposit Insurance Corporation (FDIC) acts not only to insure retail deposits in banks, but also resolves failing banks, a model which Professor André Sapir, Free University of Brussels, regarded as the right approach. He stressed the importance of such a body being supranational, the implication being that it would be able to stand above national interests.[77] But the FDIC model is distinctive in that common deposit insurance is already a feature of the system, and the FDIC has established its legitimacy and independence over many decades since its creation in the 1930s. Moreover, the weight of opinion suggests that establishing something similar for the EU would require a treaty base. On the other hand, an arrangement by which the ECB took on responsibility for resolution would bear comparison with the new regulatory arrangements in the UK. Here, the Prudential Regulation Authority (as a subsidiary of the Bank of England) now has responsibility for such tasks.

The resolution fund and the treatment of legacy debts

71. Thomas Wieser said that the proposal to finance the resolution fund through industry contributions got around any constitutional issues because sovereign money was not involved. However, he did not believe that the markets would trust a resolution fund without a contingent liability guarantee from the Member States. They would only accept a joint and several guarantee of all Member States, "which would put your big toe firmly into fiscal union."[78] Sharon Bowles MEP warned that the proposed resolution fund would not cut the link between sovereign states and banks, because it did not involve "deep mutualisation". In her view, the fund as envisaged was simply not big enough to deal with a systemic bank crisis.[79]

72. Anton La Guardia, author of the *Charlemagne* column in *The Economist*, predicted that national backstops would be necessary for many years before the fund was at full power.[80] Agnès Bénassy-Quéré warned that, in the short term, national resolution funds would not have the means to resolve a bank. The tension between seeking to deal with legacy assets at national level because they had been under national supervision, and the danger of the vicious circle getting worse if responsibility remained at national level, had not been resolved. She stressed that the fiscal backstop for resolution was vital if the mechanism was to be credible.[81]

73. Luis Garicano told us that:

> "A banking union on the cheap is unlikely to work. You are going to need to acknowledge this. It is nice to think of legacy assets as something that is in a little barrel, which you put the word 'Legacy—Toxic' on and put in a corner and forget about. It is not in a barrel: legacy assets are

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77 Q 142.

78 Q 170.

79 Q 218.

80 Q 127.

81 Q 225.

being created today as the economy contracts and people cannot pay their loans."[82]

74. It is also relevant that the major creditors include the national central banks. There has been a lively debate, in particular in Germany, about the scale of the TARGET2 balances built up by the Bundesbank.[83] As Dr Daniela Schwarzer, Senior Associate, German Institute for International and Security Affairs (SWP), stated, these balances are "hidden losses that will surface and will not be hidden for long."[84]

Treaty base and the impact on non-participants

75. The legal basis for the proposal is Article 114 TFEU, which allows the adoption of measures for the approximation of national provisions aiming at the establishment and functioning of the internal market. The Commission argued that the uniform application of a single set of resolution rules, together with access to a single European resolution fund by a central authority, would restore the orderly functioning of EU banking markets, remove obstacles to the exercise of fundamental freedoms and avoid significant distortion of competition.[85]

76. In their Explanatory Memorandum on the Commission proposals, the Government stated that they were "continuing to consider the suitability of Article 114 TFEU as the Treaty base for the SRM proposal." This was on two grounds:

- In order for recourse to be had to Article 114 TFEU it must be demonstrated that the proposal a) genuinely has as its object the improvement of the conditions for the establishment of the Single Market, and b) genuinely harmonises, or at least clearly supports, the process of harmonisation;
- The SRM proposal is aimed at those Member States participating in the Single Supervision Mechanism. This is the first time that Article 114 TFEU has been cited as the Treaty base for a proposal aimed from the outset at a subset of Member States.[86]

77. In his letter to the Committee of 12 December 2013, the Financial Secretary to the Treasury, Sajid Javid MP, wrote that he was minded not to actively oppose the use of an Article 114 legal base for the measure, although the Government would reserve their position until the final shape of the proposal was clear.[87]

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82 Q 192.

83 TARGET2 settles payments related to monetary policy operations, interbank and customer payments, and payments relating to the operations of all large-value net settlement systems and other financial market infrastructures handling the euro (such as securities settlement systems or central counterparties). See http://www.ecb.europa.eu/paym/t2/html/index.en.html.

84 Q 238.

85 COM (2013) 520 FINAL, *Op. Cit.*

86 EM 12315/13 (27 July 2013).

87 Letter from Sajid Javid MP, Financial Secretary to the Treasury, to Lord Boswell, Chairman of the House of Lords European Union Committee (12 December 2013).

Treaty constraints

78. Underpinning these concerns was the knowledge that the SRM was being constructed in such a way as to avoid treaty change. Elisa Ferreira MEP told us that "if there is a political will to solve problems, we always find ways to solve them."[88] But Nigel Farage MEP argued that the decision to grant the Commission power as the resolution authority was "typical of the EU system of government that, when faced with the prospect of a decision that morally and legally requires a democratic mandate, the EU lawyers are called in to save the political elite from an embarrassing outbreak of democracy."[89]

79. The constraints of the Treaty were most apparent in relation to the complex proposed resolution mechanism. Although the Single Resolution Board (including heads of national resolution authorities and representatives of the ECB and the Commission) would lead on some aspects of the resolution process, such as agreeing resolution plans and conducting assessments of resolvability, it would prepare recommendations for resolution decisions to be taken by the Commission. This was necessary because of the Meroni Doctrine, under which EU Institutions may not delegate discretionary power that implies a wide margin of discretion which may make possible the execution of actual economic policy. Given the tensions over the proposed role for the Commission highlighted above, a number of Member States, led by Germany, made clear that they wished to maintain an influence on resolution decisions by providing for a formal role in the process for the Council. This threatened to create a hydra-headed resolution beast.

80. Sir Nigel Wicks thought that the Commission should be congratulated on its ingenuity and imagination in working within the constraints of the existing Treaty. However, he believed that as a result, the proposed mechanism was "immensely complicated". He warned that "when a bank gets into problems and has to go into resolution, you do not have much time." He suggested that the Commission knew as much and was "not really keen on being in this business of resolution. But it has no choice under the present arrangements." He feared that such a "timber-framed" construction would be found wanting.[90]

81. Such fears were compounded by reports in the *Financial Times* in the run-up to the crucial December 2013 European Council negotiations, which suggested that up to 126 people would be consulted on how to wind up a bank, even though agreement might need to be reached over the course of a weekend.[91] Mario Draghi told the European Parliament that "one can't have hundreds of people consulting on whether a bank is viable or not."[92] The Commissioner for the Internal Market and Services, Michel Barnier, also warned that the emerging deal was "too complex".[93]

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88 Q 161.

89 Nigel Farage MEP.

90 QQ 180, 185.

91 Barker, A. and Fleming, S. (2013) 'Red tape threatens Europe bank rules', *Financial Times*, 16 December.

92 Barker, A. and Carnegy, H. (2013) 'Draghi pushes bank union deal', *Financial Times*, 17 December.

93 'Red tape threatens Europe bank rules', *Op. Cit.*

Understanding the German perspective

82. The German position was key to the outcome of negotiations. During our visit to Berlin and Frankfurt, Mark Hallerberg told us that the big concern was to ensure Germany did not bear the legacy cost. The argument that "'We did not supervise these other banks. Why should we have to resolve them?' […came…] right out of the Bundesbank", who could not imagine "any scenario where the German taxpayer would be involved in paying for anything that the German authorities did not supervise, full stop."[94]

83. Ulf Meyer-Rix, Deputy Director, Planning Group, SPD Bundestag Group, and Manfred Zöllmer MdB pointed out that the SPD, in contrast to the CDU/CSU, were committed to a common resolution mechanism.[95] Mr Meyer-Rix said that if there was a resolution mechanism but no idea how to fund the resolution process, market instability would ensue.[96]

The 18 December 2013 Council agreement

84. The Lithuanian Presidency of the Council made monumental efforts to reach a deal in Council before the end of 2013 so as to keep alive the prospect of a final agreement before the end of the European Parliament term in the spring of 2014. After several weeks of detailed and intensive negotiations, a General Approach was finally agreed on 18 December 2013. The main elements of the deal are set out in Box 7 below:

BOX 7

Main elements of the General Approach agreement on the Single Resolution Mechanism, 18 December 2013[97]

- It was agreed that a regulation establishing the SRM would go ahead. The intention was to reach agreement before the end of the European Parliament's current legislature in May 2014. The SRM would enter into force on 1 January 2015. Bail-in and resolution functions would apply from 1 January 2016. The regulation was based on Article 114 TFEU;
- There were two significant departures from the proposal outlined in Box 6 above. The first was that the Resolution Fund elements were removed from the draft regulation. Instead, eurozone Member States agreed to seek to reach an intergovernmental agreement on the functioning of the Single Resolution Fund by 1 March 2014. It would come into force once ratified by Member States participating in the SSM/SRM that represent 80% of contributions to the Single Resolution Fund;
- Second, the Commission's role in initiating resolution was reduced to one of proposing to the Council an objection to a decision by the Resolution Board to put a bank into resolution;
- The intergovernmental agreement would include arrangements for the transfer of national contributions to the Fund and their progressive mutualisation over a ten-year transitional phase. It would endorse the

94 QQ 249, 255.

95 QQ 277, 292.

96 QQ 278–9.

97 Economic and Financial Affairs Council Press Release (18 December 2013).

bail-in rule established in the Bank Recovery and Resolution Directive. It would be financed by bank levies raised at national level. Mutualisation between "national compartments" would gradually increase over ten years, meaning the share of the cost of resolving banks (after bail-in) coming from the compartments of the Member States would gradually decrease as the contribution from other countries' compartments increased;

- During the initial build-up phase of the fund, bridge financing would be available from national sources, backed by bank levies, or from the ESM, according to existing procedures. Lending between national compartments would also be possible. During this transitional phase, a common backstop would be developed, which would become fully operational to a target of €55 billion after ten years at the latest. The backstop would enable the fund to borrow, and would ultimately be reimbursed by the banking sector through levies, including ex-post;
- Upon notification by the ECB that a bank was failing or was likely to fail, or on its own initiative, the Single Resolution Board (consisting of an Executive Director, four full-time appointed members and the representatives of the national resolution authorities of all participating countries) would adopt a resolution scheme placing the bank into resolution. It would determine the application of resolution tools and the use of the Single Resolution Fund. Decisions by the Board would enter into force within 24 hours of their adoption, unless the Council, acting by simple majority on a proposal by the Commission, objected or called for changes;
- Most draft resolution decisions would be prepared in the Board's executive session, composed of the executive director and the appointed members, with the representatives of Member States concerned by a particular resolution decision involved in a first stage;
- The plenary session would be responsible for decisions that involved liquidity support exceeding 20% of capital paid into the fund, or other forms of support (such as bank recapitalisations) exceeding 10% of funds, as well as all decisions requiring access to the fund once a total of €5 billion had been used in a given calendar year. In these cases, decisions would be taken by a two-thirds majority of the board members representing at least 50% of contributions;
- To guarantee the budgetary sovereignty of the Member States, the draft regulation prohibited decisions that would require a Member State to provide extraordinary public support without its prior approval under national budgetary procedures;
- The SRM would cover all banks in participating Member States. The Board would be responsible for the planning and resolution phases of cross-border banks and those directly supervised by the ECB, while national resolution authorities would be responsible for all other banks. National resolution authorities would be responsible for executing bank resolution plans under the control of the Single Resolution Board. Should it not comply, the Board could directly address executive orders to the troubled bank.

85. The immediate reaction to the proposal was mixed. Wolfgang Schäuble said that "the final pillar for the banking union has been achieved." Although Commissioner Barnier hailed the deal as a "momentous day for banking union", he said that there was still "room for improvement. … When I compare it with my original proposal I have regrets. I would like to have seen things done otherwise."[98] Concerns focussed on perceived inadequacies in the resolution process and the funding arrangements.

The resolution process

86. In terms of the resolution process, the agreement that the Council should be the ultimate authority on whether a bank was closed effectively cut out the Commission, which would simply trigger a decision by the Council if it objected to a Resolution Board decision. In the reported words of one Commission official, its role was reduced to that of a "filter". The European Parliament President, Martin Schulz, asserted that the European Parliament wanted the Commission to play a "central role" in the resolution process.[99] Yet in the Financial Secretary to the Treasury's view, the Council deal "provides for a more independent SRB than that proposed by the Commission or currently envisaged by the European Parliament which would give the Commission very broad rights to intervene in the decisions of the SRB."[100]

87. There was also widespread concern about the complexity of the resolution process. It was reported that, from the moment a bank was identified as having problems by its supervisor to the decision to wind up its operations, up to 200 people might need to be involved. Martin Schulz said that the proposal was "comparable to dealing with an emergency admission to hospital by first convening the hospital's board of directors instead of giving the patient immediate treatment." In his view, the agreement "will not only fail to have positive effects, it could have negative ones." However, Mr Schäuble was confident that the mechanism would be able to respond "quickly in an emergency, over a weekend." Jeroen Dijsselbloem, Dutch Finance Minister and Chair of the Eurogroup, said that the mechanism process would be "quite simple … If you go up the escalation ladder [of decisions] you will probably say it is complicated, but it will never go that far."[101]

88. The Financial Secretary to the Treasury expressed some sympathy with concerns about the complexity of the process. However, he emphasised that the Single Resolution Board was the key decision-making body in resolution actions, and that its decisions would enter into force within 24 hours if no objections were raised by the Council. He said that the Commission and

98 For media sources on the 18 December 2013 agreement, see Mahony, H. (2013) 'EU banking deal set for 'long, complicated' talks with MEPs' *EUobserver.com*, 19 December; Barker, A. and Spiegel, P. (2013) 'Europe agrees to pool control of bank wind-ups', *Financial Times*, 19 December; O'Donnell, J., and Santa, M. (2013), 'Europe moves to banking union with blueprint for failing lenders', *Reuters*, 19 December; Schmitz., G.P. (2013), 'Europe's brittle banking union', *Der Spiegel*, 19 December; (2013) 'Leaders hail banking union, anticipate fight with Parliament', *Euractiv*, 20 December; Fox, B. (2013), 'EU bank resolution, Schleswig-Holstein, and how to make sense of it', *EUobserver.com*, 20 December.

99 *Ibid.*

100 Letter from Sajid Javid MP, Financial Secretary to the Treasury, to Lord Boswell, Chairman of the House of Lords European Union Committee (7 January 2014).

101 Media sources, 19–20 December 2013, *Op. Cit.* See footnote 98.

Council were likely to be involved only in the most exceptional cases. In such cases, the Council would, on a recommendation from the Commission, address directives to the Board to reformulate the scheme within a set deadline. If the Board did not agree, it could, within that deadline, address a notice to the Commission and Council requesting their amendment. The Council could then amend its directives within 24 hours of receiving the notice from the Board. If it disagreed with the Board, or failed to respond, the Council's directives would be automatically incorporated. In the Minister's view, "these arrangements should prove workable in practice although, as ever, much will depend on the manner in which they are implemented and close co-operation between the Board, Commission and Council will clearly be vital."[102]

The funding arrangements

89. On the funding arrangements, ECB Vice-President Vitor Constâncio warned shortly before agreement was reached that an arrangement that lacked sufficient financing might not be credible on the markets.[103] Two fundamental flaws were identified with the agreement: a) the length of the transitional arrangements, and b) the size of the fund, even when at full strength.

90. Media analysis of the deal stated that there would be no eurozone-wide public backstop to the resolution fund while it was at less than full strength, i.e. possibly until 2026. In the meantime, a bank's home state would be largely liable if a bank's collapse overwhelmed the resources available. Wolfgang Schäuble made clear that no money from the ESM would be available directly to help deal with the resolution of banks. A government struggling to pay for a failing bank would have to ask for an ESM bailout, subject to strict conditionality. Although it would be possible for the resolution fund to borrow from private markets during the transitional period, this would probably require national guarantees from the likes of Germany.[104] Yet if new problems of bank solvency are revealed by the ECB's asset quality review, then many Member States may face renewed fiscal pressures and national backstops may struggle to cope. The scale of the potential problem is hard to judge, and estimates vary widely.[105] At the upper end of this range, or if a larger Member State faced significant problems, even the €500 billion resources available through the ESM would be likely to prove inadequate.

91. Even once fully operational, only €55 billion would be available via the SRM backstop. It was pointed out that the UK Government purchased £76 billion (€90 billion) of shares to keep Royal Bank of Scotland and Lloyd's afloat.[106] Even allowing for the fact that taxpayer funded backstops would only be called upon after shareholders and certain bank creditors had been 'bailed-

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102 Letter from Sajid Javid MP to Lord Boswell (7 January 2014), *Op. Cit.*

103 Media sources, 19–20 December 2013, *Op. Cit.* See footnote 98.

104 *Ibid.*

105 For example, a Bruegel paper by Silvia Merler and Guntram Wolff notes that the recapitalisation needs of the euro area banking system are thought to range from €50 billion to €600 billion. See Merler, S. And Wolff, G., 'Ending uncertainty: recapitalisation under European Central Bank Supervision', *Bruegel Policy Contribution,* Issue 2013/18.

106 Media sources, 19–20 December 2013, *Op. Cit.* See footnote 98.

in', such figures cast doubt on the sufficiency of the resources available under the SRM deal.

92. Given that it would be cut out of the decision-making process, the European Parliament opposed the proposed intergovernmental agreement on the Single Resolution Fund. In addition, Martin Schulz said that the Parliament wanted the resolution fund to be able to raise loans from a "European public instrument", including from the ESM and the EU Budget.[107] However, it is important to note that any resort to the EU budget would imply a potential burden on countries which were not part of Banking Union and would therefore encounter strong resistance.

The impact on the UK and other non-participants

93. The Financial Secretary to the Treasury pointed out that the agreement reached at the December 2013 ECOFIN ensured that non-participating Member States would be reimbursed for amounts paid in own resources arising from implementation of the SRM. He added that equality of treatment between participants and non-participants was secured through: provisions ensuring an equivalent application of State Aid rules to the Single Resolution Fund and to national resolution financing arrangements; an explicit requirement that the Commission and Single Resolution Board (SRB) cannot discriminate against entities in non-participating Member States; enshrining the relationships between the SRB and Commission and resolution authorities and national competent authorities in Memoranda of Understanding (including a separate one for the UK); and symmetry of powers between the Board and resolution authorities in non-participating Member States.[108]

94. It was agreed that non-participating Member States (including the UK) may exercise their right to vote in a manner which does not prevent the adoption of a decision by the Council under the SRM which reflects the majority view amongst participating Member States. The Minister stressed that the UK had not given up its vote in Council, but that the Member State declaration on voting modalities made clear that it reflected the exceptional circumstances of this legislation and "does not constitute a precedent for use in any other context."[109]

95. We assess the wider implications of Banking Union for the UK in Chapter 4 below.

Trilogue negotiations

96. Attention now turns to trilogue negotiations between the Council and the European Parliament. Mr Schulz has warned that negotiations would be "very long, very difficult, very complicated".[110] It remains to be seen if a compromise deal can be reached.

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107 *Ibid.*

108 Letter from Sajid Javid MP to Lord Boswell (7 January 2014), *Op. Cit.*

109 *Ibid.*

110 Media sources, 19–20 December 2013, *Op. Cit.* See footnote 98.

Our conclusions

97. **We acknowledge that the Commission and the Council have been striving to design a Single Resolution Mechanism (SRM) that is both effective and politically realistic. We also acknowledge the formidable obstacles to reaching such an agreement, and commend in particular the efforts of the Lithuanian Presidency to negotiate a deal in Council before the end of 2013.**

98. **Nevertheless, the Single Resolution Mechanism that is emerging from negotiations is suboptimal. It leaves the fiscal backstop in the hands of individual Member States, one of the governance weaknesses that Banking Union was supposed to cure. The best way to restore confidence would have been to build a truly European resolution mechanism, with a single central point of authority able to reach quick decisions, relying on a single and substantive source of funds. Anything short of this runs the risk of failing decisively to break the vicious circle linking bank and sovereign debt that has created fragmentation in the financial markets and undermined the viability of the eurozone.**

99. **We were sceptical about the original proposal that the Commission should assume the role of the resolution authority as there was a perceived lack of confidence in its ability to fulfil the task. The suggestion that the Commission itself was unenthusiastic about taking on the role was also a cause for concern. The preferable option would have been to establish a new, fully independent resolution authority, able to concentrate on its core task of ensuring the resolution mechanism works effectively. However treaty constraints rule out the Single Resolution Board fulfilling that role. The revised proposal is that the Council will take the final decision, but this runs the risk of political judgements clouding the economic analysis that should form the basis for any resolution decision.**

100. **One other option would have been for the ECB to take responsibility for the operation of the SRM. We acknowledge that such an arrangement would place yet more powers and responsibilities in the hands of one institution. However, such a model would be analogous to the new regulatory arrangements in the UK, where the Prudential Regulation Authority (as a subsidiary of the Bank of England) has responsibility for such tasks. It is also worth recalling that, through Outright Monetary Transactions (OMTs), the ECB has a policy instrument which could be used to deal with a fiscal problem encountered by any Member State which came under pressure because it retains responsibility for rescuing failing banks.**

101. **We are sceptical about the mechanics of the proposed resolution process. The roles for the Board, Commission and Council, potentially involving over 100 people in a resolution decision, make for a complicated system ill-suited to the swift decisions required in such cases. We have been told that the Commission and Council would only have an active role in exceptional cases. Yet it is these exceptional cases where resolution is likely to prove most difficult. We would have preferred a simpler, more streamlined approach.**

102. **We believe that the SRM needs to be based from the outset on a single eurozone fund. We wait to see what emerges from negotiations on the intergovernmental agreement on the establishment of the Fund. In light of the terms of reference for the negotiations agreed in December 2013, the acceptance of the case for progressive mutualisation over a ten-year transitional phase is no small achievement. But the fact that the new single resolution fund will not reach full capacity until 2026 means that there will be an extended period during which national fiscal backstops may prove to be inadequate. The interim arrangements risk reinforcing the fragmentation of the EU banking sector and the vicious circle of debt between banks and sovereign states. Given the limited size of the funds available, even when the backstop is fully operational, it remains likely that national governments will be called upon to foot the bill if a bank collapses. An operational and well-resourced fund is intrinsic to the effectiveness of the resolution mechanism.**

103. **The Government are understandably cautious about use of the Article 114 TFEU legal base given that not all Member States will participate. However, it may prove advantageous from the point of view of non-participants in making clear that the interests of the Single Market will need to be taken into account. The Commission, Council and European Parliament must ensure that the final agreement does not encourage any fragmentation of the Single Market or damage the interests of non-participating Member States. We welcome the safeguards secured by the UK thus far, and urge the Government to ensure that, so far as is possible, the final proposal satisfies the interests of participants and non-participants alike, and protects the Single Market as a whole.**

Single Deposit Insurance scheme

104. The third and final leg of the original vision for European Banking Union was a single deposit insurance (or guarantee) scheme. It was proposed on the grounds that it would strengthen the credibility of the existing arrangements and serve as an important assurance that eligible deposits of all credit institutions were sufficiently insured.[111]

105. As we explored in our *European Banking Union* report, this has proved by far the most contentious element of Banking Union.[112] The idea was kicked into the long grass under intense German pressure almost as soon as it was put forward. This is because a single deposit insurance scheme would represent a significant step towards debt mutualisation in the eurozone. It would require all participating countries to pay into the system and to accept responsibility for any ensuing liabilities of the scheme, with the corollary that the fiscally stronger would be expected to shoulder some of the burden of the fiscally constrained.

106. As a result, the Commission Blueprint made no reference to a common European Deposit Guarantee Scheme, stating instead that "effective and solid" national deposit guarantee schemes would put the banking sector back

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[111] 'Genuine Economic and Monetary Union' (June 2012), *Op. Cit.*

[112] House of Lords European Union Committee, *European Banking Union*, *Op. Cit.*

on a solid footing.[113] Political agreement on the Deposit Guarantee Schemes Directive, which sought to strengthen such national schemes, was reached in December 2013. The Commission now argues that this national structure could be consistent with Banking Union at least in a first phase provided there are appropriate lending arrangements between Deposit Guarantee Schemes.[114]

107. Our witnesses were divided as to the necessity of a single deposit insurance scheme. Rosa Lastra, Professor in International Financial and Monetary Law, Queen Mary University of London, provided a sound justification:

> "With perfect capital mobility, in order to prevent a flight of deposits from troubled countries to countries perceived to be 'safe', one needs to convince ordinary citizens that a euro in a bank account in one eurozone Member State is worth the same and is as secure as a euro in a bank account in another eurozone Member State".[115]

Marco Pagano told us that the model of the Federal Deposit Insurance Corporation (FDIC) in the USA was advantageous because "when you have to restructure a bank or shut down a bank, the issue of how to protect depositors of that bank immediately comes up, and it is very hard to actually cut across the line between resolution and how to deal with depositors."[116] Liêm Hoang Ngoc MEP indicated that many in the European Parliament were in favour of a deposit guarantee scheme.[117] Anton La Guardia said it made "eminent sense".[118]

108. Other witnesses struck a more cautious note. Sir Nigel Wicks told us that he needed to be convinced that there had to be common deposit insurance.[119] Lorenzo Codogno felt that while common deposit insurance would be desirable, it was not strictly necessary.[120] Dr Waltraud Schelkle, European Institute, London School of Economics, recognised the arguments for a joint guarantee scheme but thought that it would add to the risk of moral hazard already present in the financial industry.[121]

109. The implications in terms of debt mutualisation mean that the political obstacles to common deposit insurance are massive. Bettina Kudla MdB made clear that the CDU was opposed to such a mechanism.[122] The CDU/CSU and SPD coalition agreement reflects the cross-party antipathy towards the concept in Germany. Vice-President Rehn conceded as much when he told us that it was "music for tomorrow, or perhaps for the day after tomorrow, not least because we are well aware that there is significant political resistance to it among member states." Yet he was confident that the

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113 'Blueprint for a Deep and Genuine Economic and Monetary Union' (November 2012), *Op. Cit.*

114 European Commission—Supplementary Evidence.

115 Professor Rosa Lastra—Written Evidence to the Committee's *European Banking Union* inquiry.

116 Q 82.

117 Q 162.

118 Q 126.

119 Q 184.

120 Q 197.

121 Dr Waltraud Schelkle.

122 Q 289.

day would come when the case for a single deposit guarantee scheme would be accepted.[123]

110. The prospects of imminent progress are remote. Yet the economic case remains strong. The fragmentation of the banking system along national lines, which has undermined the Single Market in Financial Services, is likely to be accentuated by the perception that a euro in one country's banking system is less well protected than in another. Depositors must have confidence that a euro in one Member State is worth the same as in any other if the single currency is to thrive.

111. **It remains our view that a common deposit insurance scheme is necessary for Banking Union to succeed and for the eurozone to thrive. We understand the extreme political reluctance to countenance such a significant move in the direction of debt mutualisation. Nevertheless it is an important step if the foundations of the single currency are to be reinforced. Its continued absence risks reopening the financial crisis through capital flight, as depositors reach the inevitable and justified conclusion that a euro is safer in a strong Member State than in one facing economic difficulties.**

112. **Moreover there is already a problem of fragmentation in the eurozone banking market—the opposite of what was intended when the single currency was established. Credit for retail and commercial clients of equivalent risk has become more readily available, and at a cheaper price, in the northern countries of the eurozone than in the southern and eastern Member States. This perverse and dangerous trend would be exacerbated if retail deposit guarantee schemes were considered more robust in countries where the government standing behind them were seen as more fiscally sound and credit-worthy. Such a tendency would oblige banks in weaker Member States to offer higher deposit rates (and consequently to charge higher lending rates) in order to compensate for the perceived higher risk. This would be bound to have a negative impact on the economic performance of the disadvantaged countries. It would amount to a different and tighter monetary policy being pursued in those Member States which, if anything, required a more accommodating monetary stance than their peers. Such an outcome could create severe problems for the weaker economies already struggling to improve their competitiveness, and would undermine the principle of monetary union.**

Overall conclusion

113. **Banking Union is the most urgent pillar of the 'Genuine Economic and Monetary Union' proposals. It is vital to tackling the effects of the financial crisis and securing the long-term stability of the eurozone. It is also needed to repair the damage to the Single Market in Financial Services caused by the fragmentation of the banking system. While we acknowledge the significant progress that has been made so far, only a partial Banking Union is in prospect. Although the agreement on the Single Supervisory Mechanism is to be welcomed, the Single Resolution Mechanism proposals currently being finalised are**

[123] Q 103.

suboptimal. Furthermore, there is no prospect of progress towards a common deposit insurance mechanism in the foreseeable future. Consequently, the vicious circle linking bank and sovereign debt remains a threat. Confidence in the banking system and in the viability of the eurozone as a whole can only be fully restored when this link is demonstrably broken. A full and optimal Banking Union may not be politically realistic. Nevertheless, it is incumbent upon European leaders to move as close to the optimal model as possible if confidence is to be restored and the eurozone is to thrive.

Further steps to break the link between bank and sovereign debt

114. Some of our witnesses stressed that Banking Union, in and of itself, was not enough to break the vicious circle.[124] Nigel Farage MEP argued that the actions of the EU had, in a number of respects, actually reinforced the negative feedback loop between banks and sovereign states.[125] Professor Kern Alexander, Chair of Law and Finance, University of Zurich, provided concrete examples of this. He argued that the ECB's cheap three-year loans at 1% interest (known officially as Long-Term Refinancing Operations (LTROs))[126] had led governments to treat banks as "buyers-of-last-resort" who could use the ECB funding to invest in sovereign bonds. This had served to "heavily reinforce the link between sovereign debt and banks". He also highlighted that the newly developed direct bank recapitalisation programme requiring euro area national governments to contribute 10–20% of the total ESM contribution unless justified by exceptional circumstances had been criticised by some as defeating the tool's very purpose of breaking the link between failing banks and sovereigns.[127]

115. **Banking Union is not sufficient in and of itself to break the link between bank and sovereign debt. We recognise that Long-Term Refinancing Operations are an important crisis measure. Yet they may be reinforcing the link between bank and sovereign debt. Direct recapitalisation of banks by the ESM to break this link is vital, although the ESM Treaty's provisions on conditionality are a constraint. But so long as national governments are still involved in direct recapitalisation of their own banks, the risk of a banking crisis developing into a sovereign debt crisis remains.**

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124 See for instance Professor Rosa Lastra.

125 Nigel Farage MEP.

126 Long-Term Refinancing Operation (LTRO) is a cheap loan scheme for European banks that was announced by the ECB in 2011 to help ease the eurozone crisis. The loans must be repaid within three years at a rate of 1%. The objective of the LTRO was to boost cash flow to the market and avoid a severe credit crunch or collapse of the banking system.

127 Professor Kern Alexander.

CHAPTER 3: FURTHER STEPS—AN INTEGRATED BUDGETARY AND ECONOMIC POLICY FRAMEWORK

116. This chapter considers the second and third proposed pillars of 'Genuine Economic and Monetary Union': an integrated budgetary framework and an integrated economic policy framework. The Commission set out a number of proposals under these headings, which were primarily intended to be taken forward in the medium to long term. Given the timescale proposed and the relative lack of attention devoted to them in negotiations thus far, they are evidently regarded as matters of lower priority than the Banking Union framework.

An integrated budgetary framework

117. The Commission's proposals for an integrated budgetary framework are intended to lead to greater discipline in public finances, but also to extend the range of instruments available for fiscal policy at the eurozone level. They include the possibility of a central eurozone budget and common issuance of public debt.[128] These elements are linked: reinforced mechanisms to restrict laxity in public spending by debt-prone countries are a *quid pro quo* for additional fiscal capacities. Many of the reforms already agreed go some way towards creating a framework for more disciplined public finances, although net creditor nations are likely to remain sceptical about the likelihood of compliance by debtor nations. While more intrusive rules and tighter discipline are watchwords in the overall thrust of the reforms, some of the amendments to the Stability and Growth Pact give some latitude to Member States facing asymmetric shocks. This is important because, as Guntram Wolff stressed, national stabilisers can be effective in cases of small shocks.[129]

118. The Commission's Blueprint provided the most comprehensive outline to date of an integrated budgetary framework. The Commission proposed the creation of an autonomous fiscal capacity, distinct from the established EU budget. It would be autonomous in the sense that its revenues would rely solely on own resources, and it could eventually resort to borrowing. According to the Commission, it should "provide sufficient resources to support important structural reforms in a large economy under distress." (There is a clear link between this concept and the contractual arrangements discussed below.[130]) The Commission's longer term vision in this area involves a central budget dedicated to macroeconomic stabilisation.[131]

A eurozone budget?

119. The Commission Blueprint indicated that the main purpose of a central eurozone budget would be to provide necessary stabilisation. The size of the autonomous budget would depend on the magnitude or range of the stabilisation function envisaged.[132] Katinka Barysch, Deputy Director,

128 'Blueprint for a Deep and Genuine Economic and Monetary Union' (November 2012), *Op. Cit.*

129 Q 116.

130 See paras 144–9 below.

131 'Blueprint for a Deep and Genuine Economic and Monetary Union' (November 2012), *Op. Cit.*

132 *Ibid.*

Centre for European Reform, outlined the economic rationale. She argued that with a monetary union you lose a degree of flexibility to react to external shocks to your economy. As such there was a need for a stabilisation mechanism that could take the form of a central budget. She pointed out that "very few countries save enough money in the good times then to have enough cash available in the bad times to stabilise their economies".[133] Guntram Wolff told us that most monetary unions tended to have "some mechanism that temporarily helps to smooth such big shocks." He added that a centralised stabilisation mechanism was also needed because "with decentralised fiscal policies the euro area-wide stabilisation that will be offered will be less than optimal because basically everybody hopes that their neighbour is doing the stabilisation."[134]

120. A central eurozone budget could include a significant redistributive element. Temporary stabilisation would theoretically even out over time, but a redistributive budget would involve permanent transfers. Elisa Ferreira MEP told us that the most competitive eurozone countries benefit from an artificially low exchange rate *vis-à-vis* the external world whereas less competitive countries have an artificially high exchange rate. The lack of any means to achieve economic recalibration was creating "a permanent accumulation of surpluses in certain Member States and a permanent loss of competitiveness in others."[135] Liêm Hoang Ngoc MEP said that a system of transfers via a eurozone budget was therefore "crucial".[136]

121. Fabian Zuleeg thought that some form of eurozone budget was necessary. He agreed that one of the elements that was missing in EMU was "a formal transfer mechanism to deal with divergence in economic performance between different countries."[137] Lorenzo Codogno felt less strongly but indicated that it was desirable that "over time Europe builds up some fiscal capacity at the central level."[138]

122. Opinion differed as to how large the budget needed to be. Dr Federico Steinberg, Senior Analyst, Elcano Royal Institute, Madrid, suggested that a budget of around 7% of GDP would be required for 'Genuine Economic and Monetary Union' to be fully operational.[139] Guntram Wolff thought that it need not be larger than between 1 and 2% of GDP.[140] Vice-President Rehn recalled the report of the Delors committee published in 1989 which concluded that EMU would need a budget of around 3% of GDP.[141]

123. Professor Dr Ansgar Belke, Full Professor of Macroeconomics at the University of Duisburg-Essen, Director of the Institute of Business and Economic Studies (IBES), University of Duisburg-Essen, and Research Director for International Macroeconomics, German Institute for Economic Research (DIW), was not enthusiastic about a central budget. He stated that there needed to be competition between fiscal policies because "if you

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133 Q 12.

134 Q 116.

135 Q 159.

136 Q 167.

137 Q 143.

138 Q 205.

139 Q 72.

140 Q 116.

141 Q 105.

correlate these policies very significantly, you also correlate the mistakes." In his view, the 'Genuine Economic and Monetary Union' proposals went too far and amounted to an admission of defeat that "we cannot make markets more flexible".[142] Clemens Fuest and Mark Hallerberg believed that the eurozone could survive without permanent transfers, and that such outcomes could be achieved through greater labour market flexibility and labour mobility.[143]

124. Witnesses did not think that a central budget was likely to emerge any time soon because of the significant political obstacles.[144] Claudia Buch could not envisage countries being willing to give up control over fiscal policy to the European level.[145] Luis Garicano agreed that "the politics of transfer payments are horrendous". He highlighted the example of Catalonia: "If even inside Spain people do not want to make permanent transfers, how do you expect other countries to want to make transfers to you?"[146] On the other hand, Liêm Hoang Ngoc MEP revealed support among the Socialists and Democrats Group in the European Parliament for the long-term goal of a more integrated fiscal policy with a Minister of Finance and an executive.[147]

125. Some witnesses suggested that an unemployment insurance mechanism could be an appropriate way to enact a eurozone fiscal capacity. Daniela Schwarzer indicated that this could fulfil a useful stabilising function. She believed that it should provide unemployment payments only for a limited number of months.[148] We find that there is merit in considering this proposal further.

126. Whatever the arguments for and against a eurozone budget, there are additional means by which divergences in competitiveness can be addressed. Indeed, the rationale for the Europe 2020 strategy for smart, sustainable and inclusive growth is to implement reform programmes aimed at enhancing competitiveness.

127. **We do not believe that a system of permanent fiscal transfers via a centralised euro area budget is politically realistic in the foreseeable future. We note the argument that areas in receipt of payments tend to become reliant on them at the expense of undertaking necessary structural reforms. But such corrective mechanisms have so far been a characteristic of most currency unions. This is particularly relevant given the divergences in competitiveness which occurred in the first decade of the euro, as well as the current disparities in economic growth within the EU.**

128. **At the very least, an effective mechanism to cushion asymmetric shocks is needed. Where they occur, asymmetric shocks require rapid automatic or discretionary responses. There is now some provision for more flexibility in the new fiscal rules which make a distinction between cyclical and structural deficits and allow Member States**

142 Q 263.

143 QQ 98, 251.

144 See for instance Sir Nigel Wicks, Q 188; Professor Mark Hallerberg, Q 251.

145 Q 298.

146 Q 191.

147 Q 164.

148 Q 241.

some flexibility in a crisis. However this would still operate at the Member State level, rather than as an instrument of the currency union as a whole. Financial market integration in a common currency area itself will help. Such integration implies that savers in the negatively impacted Member States will increasingly hold claims on assets and revenues in the less impacted Member States (and *vice versa*) and the burden of the crisis will be shared more equally. But the main weight of adjustment must fall on labour markets and prices, involving a high measure both of labour mobility and of movement in the real cost (which in monetary union will also be the nominal cost) of labour. We have been struck by the effectiveness of this mechanism over the past few years, especially in Greece, Spain and Portugal. Wages, nominal and real, have proved to be far less rigid than was often assumed to be the case. These 'internal devaluations' can reverse some of the loss of competitiveness which led to imbalances, but there is a price to be paid in the negative effect on demand from lower consumer spending, not to mention the significant impact on the living standards of EU citizens.

129. **That said it is worth considering whether additional financial adjustment mechanisms could usefully be devised to aid the process further. Economic divergence can also be tackled through structural reforms, such as increasing the mobility of labour, investment in innovation and measures to stimulate productivity growth. We call on the EU institutions and Member States to step up their efforts to meet the targets set out in the Europe 2020 strategy.**

Debt mutualisation

130. The Commission Blueprint also suggested the introduction of debt mutualisation in the medium to long term. This could take a number of forms, although a possible model is the US Treasury bond. The equivalent to this would be a common eurozone bond, or Eurobond, which would then become the principal form of public debt open to all members of the eurozone, jointly and severally guaranteed by all participating Member States. Other less comprehensive forms of debt mutualisation could be an alternative. The Commission Blueprint suggested that the common issuance by euro area Member States of short-term government debt with a maturity of up to one to two years (known as Eurobills) could help foster the integration of euro area financial markets. In particular, it could stabilise volatile government debt markets. It also suggested that a Debt Redemption Fund (which would essentially partially mutualise the debt of eurozone countries) could be established, subject to strict conditionality. In the longer term (beyond five years) the Commission suggested that "a deeply integrated economic and fiscal governance framework could allow a common issuance of public debt".[149]

131. Agnès Bénassy Quéré pointed out that, in aggregate, the situation regarding public debt in the eurozone was better than in countries like Japan or the US: "the sovereign debt crisis really comes from the segmentation of this debt." She also highlighted the unique challenges faced by the crisis-hit Member States. During a downturn a country usually had the option to issue more

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[149] 'Blueprint for a Deep and Genuine Economic and Monetary Union' (November 2012), *Op. Cit.*

debt but this had not been the case during the crisis: these countries lost access to foreign financing at reasonable rates. She added that creating the equivalent of a US Treasury bond for the eurozone would normalise the ECB as a central bank since it could buy these bonds without worrying about discriminating between countries.[150]

132. Despite these benefits, discussion of debt mutualisation has caused a great deal of nervousness, particularly in Germany. Daniela Schwarzer indicated that Germany perceived "a high risk that it immediately invites moral hazard."[151] Clemens Fuest suggested that the German position would be that joint liability for government debt in the eurozone would need to be accompanied by effective control. This would involve the centralisation of the right to issue debt.[152] Claudia Buch only foresaw the introduction of a common liability instrument once Member States were willing to "concede sovereignty to the European level."[153] Megan Greene, Chief Executive, Maverick Intelligence, and Graham Bishop felt it unlikely that we would see mutualisation in the form of Eurobonds due to their unlimited nature (because they involve joint and several liability).[154]

133. A number of witnesses pointed out that, since the ECB had essentially achieved an element of mutualisation through the backdoor through its commitment to purchase the bonds of troubled countries on the secondary market (Outright Monetary Transactions[155]), the economic necessity of such proposals had receded.[156] Clemens Fuest told us that, as a consequence of ECB action, the huge differences in risk premiums that might have necessitated Eurobonds had almost disappeared.[157] We note that Ireland has now successfully returned to the bond market following its exit from its adjustment programme in December 2013, and Portugal may follow soon.

134. Some witnesses felt that a Debt Redemption Fund or Eurobills were the most politically palatable form of mutualisation given the short term nature of such bills.[158] A debt redemption pact was proposed by the German Council of Experts in November 2011.[159] This proposal would essentially mutualise the debt of euro area countries above 60% of GDP via a common redemption fund. The debt could then be paid down over 20–25 years. To counter the risk of moral hazard certain conditions would be attached to participation.[160]

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150 Q 228.

151 Q 243.

152 Q 91.

153 Q 306.

154 Q 30.

155 See above, paras 54–61.

156 See for instance John Peet, Europe Editor, *The Economist*, Q 13; Guntram Wolff, Q 118; Professor Agnès Bénassy Quére, Q 228; Professor Claudia Buch, Q 313.

157 Q 97.

158 See for instance Graham Bishop, Q 30. He proposed Eurobills limited to a maximum of two years.

159 Bofinger, P., Buch, C.M., Feld L.P., Franz, W., Schmidt, C.M. (2012), 'A Redemption Pact for Europe: Time to act now', *Voxeu.org*, 25 July: http://www.voxeu.org/article/redemption-pact-europe-time-act-now.

160 Another idea was put to us by Professor Luis Garicano and Marco Pagano. They proposed pooling together the existing sovereign debt issued by eurozone Member States, to be split into European Safe Bonds (ESBs) with a high level of safety, and European Junior Bonds (EJBs) with less safety. See QQ 78, 86.

135. Claudia Buch, a member of the German Council of Experts, explained that the debt redemption pact was proposed as an attempt to get from a situation where governments were heavily indebted to one where they were able to take responsibility for their own debt. She emphasised that it was never designed as a long-term mutualisation tool and conceded that, with OMTs in place and interest rates having narrowed, there was much less urgency for the debt redemption pact.[161]

136. In July 2013, Commission President José Manuel Barroso launched an Expert Group on Debt Redemption Fund and Eurobills, "to deepen the analysis on the possible merits, risks, requirements and obstacles of partial substitution of national issuance of debt through joint issuance in the form of a redemption fund and eurobills."[162] The Expert Group is due to report by March 2014. We await its findings with interest.

137. **German concerns over moral hazard and the assumption of liability without effective controls mean that debt mutualisation remains highly contentious and is likely to continue to be resisted. Proposals involving joint and several liability, such as a Eurobond, are therefore politically unrealistic at the present time. Nevertheless, some form of debt mutualisation may be inevitable if the single currency is to prosper. It would be a logical development in a more complete monetary union, and would be supported by many Member States. We will study closely the forthcoming report of the Commission's Expert Group on Debt Redemption Fund and Eurobills.**

An integrated economic policy framework

138. The third pillar of 'Genuine Economic and Monetary Union' is an integrated economic policy framework. The Commission's plans for the shorter term focussed on contractual arrangements between Member States and the EU institutions, described as a 'Convergence and Competitiveness Instrument'. For the medium term the Blueprint suggested deeper coordination of tax policy as well as labour policy, given the importance of well-functioning labour markets (and in particular labour mobility) for adjustment capacity and growth within the euro area. In the longer term, there was a suggestion that full fiscal and economic union could provide "a means of imposing budgetary and economic decisions on its members, under specific and well-defined circumstances."[163]

Progress so far

139. Much has already been achieved in terms of deeper economic coordination amongst eurozone Member States, as detailed in Box 8 below. The European Commission argued that "the surveillance of economic, budgetary and structural policies that has been brought together into the European Semester has made EMU more robust than it was at the onset of the crisis and better equipped for the future."[164]

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[161] Q 313.

[162] http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetailDoc&id=9455&no=3.

[163] 'Blueprint for a Deep and Genuine Economic and Monetary Union' (November 2012), *Op. Cit.*

[164] European Commission—Supplementary Evidence.

BOX 8

Deeper Economic Coordination

Coordination of economic policies is provided for in Article 121 TFEU, which states that "Member States shall regard their economic policies as a matter of common concern." Article 136 TFEU similarly provides for closer coordination among the euro area countries, and has been used as the legal basis for a number of the measures already agreed.

The Treaty on Stability, Coordination and Governance introduced the notion of ex-ante coordination, notably through Article 11 which commits signatories to discuss and coordinate major reforms with potential effects on partner countries.

Further details on deeper coordination were set out in a Commission communication which sought responses on a range of key issues.[165]

The approach to deeper coordination brings together a number of processes, drawing in part on the experience of the Lisbon and Europe 2020 strategies. The European Semester is pivotal, as it results in country recommendations and is seen as the channel through which reform proposals can be coordinated.

It is anticipated that Member States will provide relevant information on their own initiative. However, the Commission also envisages that it, or the Council, could request such information.

Among the areas likely to be subject to coordination are measures affecting trade and competitiveness, together with developments in financial markets. Product and labour market reforms, as well as tax policies, are seen as areas for further scrutiny. An aspect of coordination that is emphasised is the scope for mutual learning.

140. Not everyone was positive about these steps. Fabian Zuleeg indicated that the system of economic governance that had emerged over the last few years had become complex and suggested that this framework could be rationalised.[166] Agnès Bénassy-Quéré agreed that some of these schemes would have to be dropped. She suggested that the excessive macroeconomic imbalances procedure could be streamlined.[167]

141. Agnès Bénassy-Quéré also expressed concern that "there is a clear preference for discipline as compared to employment and growth" in the existing mechanism, since anything relating to employment and growth is non-binding while the rules that concern discipline are binding.[168] Daniela Schwarzer agreed that there was a "clear policy bias in the rules". In her view "the attempt to depoliticise economic policymaking is not compatible with the way national democracies should work."[169]

165 European Commission (20 March 2013), 'Towards a Deep and Genuine Economic and Monetary Union: Ex ante coordination of plans for major economic policy reforms', COM (2013) 166 FINAL.

166 Q 134.

167 Q 226.

168 *Ibid.*

169 Q 240.

142. **There are both economic and political challenges as to how economic policy coordination is undertaken. The imposition of so-called austerity policies runs the risk of aggravating the problems of weaker economies. It could push them into a downward spiral in which cuts in public spending and wages prolong recession by taking too much demand out of the economy. However, the policy prescription has two distinct components. The first is consolidation of public finances, for which the choice is not whether it is needed, but how rapidly it can be achieved. The second component in many Member States, boosting competitiveness, is more awkward, because it can be achieved simply by cutting wages (internal devaluation), but can also be achieved by increasing productivity through a range of growth-enhancing measures. The latter requires time and investment, but there is a mutual interest in ensuring that the troubled economies return to growth and are able to create employment. This facet of coordination deserves to be emphasised. Obviously, in practice both elements are in some degree required.**

143. **There is a risk that top-down control removes the power from citizens to determine at the ballot box how taxes are raised and public money is spent in their country. Ensuring democratic legitimacy for the evolving system of economic governance is crucial. Such issues lie at the heart of our current inquiry into the role of national parliaments in the EU. We will consider these important questions fully in the report on that inquiry.**

Convergence and Competitiveness Instrument/ Contractual arrangements

144. In the Commission's Blueprint, among the elements to be implemented in the short term to complete the governance framework for economic policy coordination were 'contractual arrangements' which would provide some form of financial support to encourage Member States to enact structural reforms.[170] The Commission published a Communication in March 2013 on a proposed Convergence and Competitiveness Instrument (CCI).[171] The CCI proposal received a lukewarm reception at the June 2013 European Council, which decided that further work was required.[172] In November 2013, it was reported that a leaked EU document had revealed that the financial assistance offered in exchange for structural reforms could take the form of cheap loans.[173]

145. The Economic Secretary to the Treasury stated that "the basic idea of having some sort of solidarity mechanisms whereby countries are incentivised to put reforms into place and they get recognised for having done that is potentially the right way to go."[174] Lorenzo Codogno said that there would be a strong incentive to use these instruments to "ease the possible social tensions and

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170 'Blueprint for a Deep and Genuine Economic and Monetary Union' (November 2012), *Op. Cit.*

171 European Commission (20 March 2013), 'Towards a Genuine Economic and Monetary Union: The introduction of a Convergence and Competitiveness Instrument', COM (2013) 165 FINAL.

172 European Council Conclusions (28 June 2013).

173 Baker, L. (2013) 'Euro zone mulls cheap loans as incentive for economic reforms—document', *Reuters*, 22 November.

174 Q 329.

potential social costs of painful reforms."[175] Ulf Meyer-Rix revealed that such an arrangement existed in Germany between the federal level and the Länder and that it worked quite well.[176]

146. Other witnesses were more sceptical. Hugo Dixon, Editor-at-large, Reuters, did not see it as "the main game in town"[177] while Willem Buiter regarded it as "tokenism".[178] Sharon Bowles MEP told us that the European Parliament did not think much of the CCI either.[179] Nigel Farage MEP highlighted that it would be difficult to enforce such contracts, as "the experience of countries breaching the Stability and Growth Pact with impunity" demonstrated.[180] Mats Persson argued that effective enforcement would require a rewriting of the treaties.[181]

147. We discussed with our witnesses whether conditionality (i.e. making financial assistance dependent on the implementation of structural reforms) would be effective in this context. Sir Nigel Wicks asserted that "a country doing something that it does not want to do and does not have the political will but takes money to do ... is not a good way forward."[182] Clemens Fuest warned that withdrawal of financial assistance could lead to financial collapse in the country in question. Nevertheless, if used properly, conditionality could help national politicians to implement reform programmes by giving them some leverage or argument in domestic debates.[183]

148. The December 2013 European Council Conclusions stated that further work would be pursued on the basis that mutually agreed contractual arrangements would be a 'home-grown' commitment, tailored to the needs of individual Member States, with economic policy objectives and measures designed by the Member States, and "full national ownership" including involvement of national parliaments. Contractual arrangements should be discussed and mutually agreed with the Commission, before being submitted to the Council for approval. Further work would also be taken forward regarding the nature, institutional form and volume of support in associated "solidarity mechanisms". President Van Rompuy was invited to carry this work forward and to report to the October 2014 European Council "with a view to reaching an overall agreement".[184] However, media reports stated that there remained considerable disagreement amongst Member States both on the principle of the proposal and on the specific detail of what it might entail.[185]

149. **We are not convinced that the Convergence and Competitiveness Instrument/contractual arrangements proposal is the best way to**

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175 Q 200.

176 Q 284.

177 Q 25.

178 Q 61.

179 Q 220.

180 Nigel Farage MEP.

181 Q 6.

182 Q 187.

183 Q 95.

184 European Council Conclusions (20 December 2013). Vanden Bosch, X. (2013) 'Contractual arrangements: the overlooked step towards a fiscal union', *European Policy Brief*, Royal Institute for International Relations, December.

185 Pop, V. (2013) 'Merkel's reform contracts pushed back until October', *EUobserver.com*, 20 December.

improve national policy-making and, thus, to achieve deeper economic policy coordination. Conditionality could prove counterproductive given the potential detrimental effect of withdrawal of support from a country in economic difficulties.

Deeper economic policy integration

150. The Commission Blueprint also proposed deeper policy coordination in the fields of taxation and employment policy. The Commission highlighted several existing proposals, such as the Common Consolidated Corporate Tax Base (CCCTB), the review of the Savings Directive and the new Energy Tax Directive, and added that "one might in future consider in the context of a Treaty change providing scope for legislation on deeper coordination in this field in the euro area." With regards to employment policies the Commission added that "discussion on concrete avenues for reform has not started yet."[186]

151. Ulf Meyer-Rix indicated that deeper integration in economic policy was inevitable to maintain monetary union in a case characterised by huge imbalances.[187] Sir Nigel Wicks thought that too much centralisation of microeconomic policy could be counterproductive: "if the euro area is to prosper, you are going to need as much flexibility in the euro area's microeconomy as you can get".[188]

152. It became evident in discussion of these further elements that there was little room for manoeuvre under the current treaties. Vice-President Rehn told us that the 'Six-pack' and 'Two-pack' had gone as far as was possible within these constraints. He highlighted a new power of requiring a revision of a national budget in line with European commitments as an example of an element that would require the introduction of a new legal base in the Treaty.[189]

153. **While deeper economic policy integration may be a legitimate long-term aim for the eurozone, it remains a remote prospect. More meaningful proposals are required before any realistic assessment can be undertaken.**

[186] European Commission—Supplementary Evidence.

[187] Q 282.

[188] Q 179.

[189] Q 102.

CHAPTER 4: IMPLICATIONS FOR THE UK

'Genuine Economic and Monetary Union' and the UK

154. The Government have adopted a consistent line in relation to 'Genuine Economic and Monetary Union'. Their response to the Commission Blueprint stated that:

> "The Government … recognises that the Euro Area Member States are likely to want to move towards a stronger, more stable currency union. Economic and financial stability in Europe is in the UK's interests. At the same time, the Government has been clear that the UK will not take part in measures designed to strengthen integration in the euro area. It has also been clear that proposals must take account of the interests of all EU member states, in particular with regard to the single market. The Government will always ensure that the UK's specific interests, especially on the single market, are protected."[190]

155. In our *European Banking Union* report, we concluded that, in any assessment of the proposals, it was necessary to "keep in mind the principle of variable geometry. These significant reforms will impact upon euro area and non-euro area Member States, and the banks and other credit institutions that operate within them, in different ways. Non-euro area Member States themselves will not approach the proposals in a uniform manner: it is not clear that many will follow the UK in staying out of banking union."[191]

156. The UK is not the only non-eurozone Member State to be affected by 'Genuine Economic and Monetary Union', and others are reacting in different ways.[192] Yet given the size of its financial sector, and the debate about its future within the EU, there are likely to be more extensive ramifications for the UK than for many other Member States.[193]

157. This chapter assesses whether the Government's position is sustainable, and whether more can be done to safeguard the interests of the UK and the Single Market as a whole. In particular, it examines:

- Whether the UK should be more actively involved in 'Genuine Economic and Monetary Union', and in particular Banking Union;
- The wider implications for the Single Market;
- The likely impact on the City of London;
- The nature of the UK's engagement with the rest of the EU on economic and financial affairs.

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190 EM 16988/1/12, *Op. Cit.*

191 House of Lords European Union Committee, *European Banking Union*, *Op. Cit.*

192 There are at present 10 non-eurozone Member States: Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Lithuania, Poland, Romania, Sweden and the UK.

193 In his 'Bloomberg Speech' in January 2013, the UK Prime Minister, Rt Hon David Cameron MP, announced that, if a Conservative Government was elected at the 2015 General Election, he would seek a renegotiation of EU Treaties, followed by a referendum in 2017 on whether the UK should remain part of a reformed EU. See para 175 below.

Greater participation in Banking Union?

158. As we have seen, the Banking Union proposals are the most significant and most developed elements of the 'Genuine Economic and Monetary Union' proposals. The UK's position is as follows:

> "The Government has consistently maintained that a comprehensive solution to the euro area crisis is necessary, but that the challenges facing the euro area should be dealt with primarily by the euro area itself. The UK, being outside the single currency, will not take part in new measures that are only necessary to strengthen the single currency. This includes the Single Resolution Mechanism and other banking union measures."[194]

159. Our witnesses were divided as to the merits of this position. In the view of Mark Boleat, Chairman of the Policy and Resources Committee, City of London Corporation, there was a "weak case" for the UK itself actively to participate in Banking Union. He did not see any prospect of the UK joining a Banking Union in the next 20 years.[195] Professor Tim Congdon asserted that British banks would be able to operate in the EU even if the UK had nothing to do with Banking Union, and indeed if it left the EU altogether.[196] The Economic Secretary to the Treasury said that UK taxpayers would not wish to accept liability for the resolution of a French or German bank based in London.[197]

160. However, Guntram Wolff said that the UK's relationship with a eurozone Banking Union was of utmost importance, given how many major eurozone banks had significant parts of their business in London. He warned that if the eurozone moved ahead alone, "we will all of a sudden see the City of London as an offshore financial centre which will be faced with a lot of regulatory and supervisory barriers, and basically be deprived of parts of its business market."[198]

161. Detlef Seif MdB thought that it was regrettable that the UK had not played a more active role in Banking Union given that the problems it was seeking to solve were not limited to the eurozone.[199] Waltraud Schelkle thought it inconceivable that the UK could completely stay out of the bank resolution process because of the integration of the City into the eurozone's financial markets, the size of the British financial sector and its vital interest in ensuring that the UK did not suffer from a spillover of financial turmoil.[200] Federico Steinberg went further still. He predicted that, if the eurozone undertook 'Genuine Economic and Monetary Union' successfully, at some point the UK would have to make a hard choice between being in or out.[201] Willem Buiter could not envisage the status quo of the UK remaining within

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194 EM 12315/13, *Op. Cit.*

195 Q 46.

196 Professor Tim Congdon.

197 Q 324.

198 QQ 110–1.

199 Q 294.

200 Dr Waltraud Schelkle.

201 Q 76.

the EU but yet staying outside the eurozone being sustainable 10 years from now.[202]

162. Even if the UK remains outside Banking Union, the relationship between banking authorities in London and the eurozone will still be of fundamental importance. Guntram Wolff asserted that the Bank of England would need to be involved with a centralised eurozone resolution authority.[203] Mark Boleat said that the Bank of England and the ECB would need to work closely together.[204] Mats Persson agreed, adding that they already had a very good relationship.[205]

163. Two distinct points of view can be discerned. The Government's stance, shared by some of our witnesses, is that Banking Union is, in essence, a measure necessary solely to strengthen the eurozone. From this perspective, the UK has no interest in any direct participation, let alone in accepting liability for the debts of weak Member States. The contrary view is that Banking Union has wider significance in terms of deepening the Single Market in Financial Services. According to this argument, the widespread fragmentation of financial markets that Banking Union seeks to correct is an EU-wide problem. As a member of the Single Market, and given the interlinked nature of its banking system with that of the rest of the EU, it would be in both the UK and the EU's interests for the UK to participate in some or all components of Banking Union.

The impact on the City of London

164. The balance between these arguments depends in part on the interests of the City of London. While it remains the leading financial centre for the EU and conducts a bigger proportion of eurozone transactions than any continental financial centre, it obtains a growing share of its business from other global markets.

165. We asked our witnesses about the likely impact of deeper eurozone integration on the City of London. Leading City figures were bullish. Mark Boleat told us that "London could happily survive not being within a Genuine Economic and Monetary Union." He thought that there could be positive advantages in terms of more trading on the euro if the reforms proved a success. In Mr Boleat's view, the uncertainty over British membership of the EU was far more of a risk than the moves towards 'Genuine Economic and Monetary Union'.[206]

166. Sir Nigel Wicks agreed that "we are still going to have a major international financial centre here, whatever happens in the euro." He could not envisage the eurozone asserting in the foreseeable future that "what happens in London doesn't matter". Equally, what happened in the eurozone mattered in London. He warned that any move towards UK exit from the EU would damage both the City and the eurozone. As a result, "we have to come to some sort of accommodation to meet our mutual interests."[207]

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202 Q 65.

203 QQ 110–1.

204 Q 44.

205 Q 18.

206 QQ 39, 45.

207 QQ 182–3.

167. The Economic Secretary to the Treasury stressed that "London is there for the whole of the EU". Peter Curwen, Director Europe, HM Treasury, said that more should be done to spread the message that "it is greatly to Europe's benefit that there is the City of London within the European Union".[208]

168. The question of the advantages and disadvantages for the City of EU membership is a matter of intense debate.[209] A key question is whether the City is doing enough to engage with the EU. Mark Boleat drew attention to the highly intensive nature of the City's interaction with the EU.[210] However, he also conceded that a lot of British business had not been good enough in getting involved in EU negotiations at an early stage.[211] While he noted that there was not always a single 'City perspective', Syed Kamall MEP told us that many in the City had tended to ignore the political driving force behind the EU, as its expectation that the euro would collapse demonstrated.[212]

The effect on the Single Market

169. We also asked our witnesses about the impact on the Single Market as a whole. Rosa Lastra warned that there would be an uneasy coexistence between the Single Market and the Banking Union. She wrote that issues of jurisdictional domain haunted the current Banking Union proposals, since the Bank Recovery and Resolution Directive and the single rulebook related to the EU as a whole, while the SSM and SRM were specific to the eurozone.[213]

170. Some witnesses argued that the UK's attitude had exacerbated these tensions. Anton La Guardia told us that the UK's decision to focus on the City and financial regulation rather than the Single Market during negotiations on the Treaty on Stability, Coordination and Governance in December in 2011 had made it difficult for supporters of the Single Market to ally themselves with the UK. He was not convinced that the UK was pushing very hard on the Single Market any more, citing the recent political controversy over the free movement of persons, one of the four freedoms of the Single Market.[214] Dr Holger Schmieding, Chief Economist, Berenberg Bank, warned that the endgame of continued UK disengagement could be that the eurozone, rather than the EU, became the genuine Single Market.[215]

171. Thomas Wieser acknowledged the importance of protecting the integrity of the Single Market. He stressed that the vast majority of regulations relevant to the Single Market in Financial Services were decided by all 28 Member States, and in those circumstances, "there is a very high likelihood that the UK will be on the winning side of the vote."[216] Vice-President Rehn was also at pains to stress that "we will continue to do everything we can within the

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208 Q 323.

209 See for instance Fleming, S. and Parker, G. (2014) 'City warns UK over loss of EU influence', *Financial Times*, 22 January.

210 QQ 49–50.

211 Q 44.

212 Q 217.

213 Professor Rosa Lastra.

214 QQ 130, 132.

215 Q 64.

216 Q 172.

unified framework of the European Union of 28. At the same time, the eurozone has certain clear needs to go deeper in its economic and policy integration. … In my view, it is possible to combine the two".[217]

172. The Government told us that they were aware of the dangers. The Economic Secretary to the Treasury said that "the single market is incredibly important to the United Kingdom. It is something very much at the forefront of all Ministers' and officials' minds when they go to Brussels."[218] Peter Curwen added that there was an increased need to be vigilant that the Eurogroup did not stray into Single Market matters.[219]

UK at the margins?

173. Underlying such debates is the question of where deeper eurozone integration leaves the UK. Some issues arise naturally from the UK's decision not to participate in EMU. For instance, André Sapir told us that the meetings of the Eurogroup the day before ECOFIN had created the sense that the UK was on the sidelines.[220]

174. Some witnesses believed that the UK had misjudged EU negotiations in recent years. Elisa Ferreira MEP observed that, although in the past the UK had been "a very active, intelligent shareholder in the project […now…] it is as if you are no longer a shareholder and have become a client."[221] Adam Marshall, Director of Policy and External Affairs, British Chambers of Commerce, told us that EU colleagues were "sick of our non-engagement early in the process but they are also sick of the demands we come with late in the day."[222] Citing its refusal to accede to the Treaty on Stability, Coordination and Governance in December 2011, Holger Schmieding said that "if the UK wants to use decisions about eurozone affairs to pursue its own agenda … we would be getting into very dangerous territory."[223] This Committee warned at the time that shifting discussions outside the main EU channels to forums where the UK has no voice risked marginalising the UK over time.[224]

175. Such observations reflect growing strains in the relationship between the UK and the EU. There have been a number of recent cases of EU governance reforms which have raised concerns in the UK. Examples are the proposed introduction of a Financial Transaction Tax,[225] regulations such as the Alternative Investment Fund Managers Directive, or, most recently, the rejection by the European Court of Justice of the UK's case concerning the legality of the power to ban short selling introduced by the European

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217 QQ 107–8.

218 Q 319.

219 Q 322. The Eurogroup is an informal body that brings together the finance ministers of countries whose currency is the euro.

220 Q 145.

221 Q 165.

222 Q 44.

223 Q 64.

224 House of Lords European Union Committee, *The euro area crisis* (25th Report, Session 2010–12, HL Paper 260).

225 See House of Lords European Union Committee, *Towards a Financial Transaction Tax?* (29th Report, Session 2010–12), HL Paper 287) and *Financial Transaction Tax: Alive and deadly* (7th Report, Session 2013–14, HL Paper 86).

Securities and Markets Authority. The Prime Minister's announcement in January 2013 that, if a Conservative Government were returned at the 2015 General Election, he would seek a renegotiation of EU treaties followed by a referendum on UK membership of the EU in 2017, has in turn raised fundamental questions about the UK's place within the EU.[226]

176. Anton La Guardia told us this overshadowed everything that the UK was saying in Brussels.[227] Mats Persson expressed particular frustration at the attitude of the UK Government, which had made a habit of lecturing the eurozone on the need to move ahead with a fiscal and banking union while at the same time threatening to veto any treaty change that was required. He thought that the Swedish approach of wanting "to be there and discuss this to the very end" was more productive.[228] These perceptions were shared by prominent EU figures. In a speech in London in February 2013, President Van Rompuy asked, with reference to the UK: "How do you convince a room full of people, when you keep your hand on the door handle?"[229] Vice-President Rehn told us that, if he was a UK citizen, he would "prefer to have my country as a playmaker in the midfield rather than being on the sidelines."[230] Thomas Wieser said that many in Brussels had the feeling that the UK had become "disinterested in Europe … we would all very much welcome a period of constructive engagement".[231]

177. This was not a universal view. Hugo Dixon emphasised that "we are the equal second largest economy in Europe. We house the City of London and there are a lot of people in continental Europe who are very interested in the British position."[232] Lorenzo Codogno agreed that the UK's influence was particularly important on matters related to the financial market, because the EU could not do without London, its most important financial centre.[233] The Economic Secretary to the Treasury stressed that the Government had a positive agenda, and that "we firmly believe in EU membership".[234]

The German perspective

178. During our visit to Berlin and Frankfurt, we asked our witnesses for their perception of the UK's position. Daniela Schwarzer told us that the "huge concern" in Berlin was that London would ask for things that Berlin did not want to be put into the discussion in any treaty negotiation. Although German policymakers would be open to exploring ways of strengthening the Single Market with the UK, they would not do so "at any price. If the UK is perceived as being unco-operative and preventing progress … the tolerance is pretty low to follow that line and help the UK to negotiate its way partially

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226 Rt Hon David Cameron MP, EU Speech at Bloomberg (23 January 2013): https://www.gov.uk/government/speeches/eu-speech-at-bloomberg.

227 Q 131.

228 Q 18.

229 Herman Van Rompuy, President of the European Council, Speech at the Annual Conference of Policy Network—'Britain in Europe: channelling change together' (28 February 2013): http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/135747.pdf.

230 Q 107.

231 Q 177.

232 Q 35.

233 Q 208.

234 Q 320.

out of the EU."[235] Ulf Meyer-Rix told us that Germany perceived the UK to hold "sceptical positions on everything concerning the European Union."[236]

179. On the other hand, Otmar Issing believed that "the contribution of the UK within EU concepts is so important that we should make regulation as light as possible."[237] Bettina Kudla MdB agreed that "we should try to find ways to bring the UK more into the boat", especially in areas such as the regulation of the financial markets.[238] Manfred Zöllmer MdB told us that "there is a point where you have to make a decision. … do you want to be in or out?"[239]

The need to be fully involved

180. Several witnesses stressed that the UK would enhance its influence by maximising its involvement in key EU negotiations. Adam Marshall told us that "we need to be in early, even if ultimately we do not participate in some of the resulting institutions that are for the eurozone countries … Perhaps we need to learn how to play the game a little bit better in order to protect our interests".[240]

181. Mark Boleat observed a "welcome increase in engagement" in EU negotiations by Government Ministers in recent times, and cited the safeguards achieved in relation to the Single Supervisory Mechanism as "an example of what can be done by quiet, behind-the-scenes, hard-work diplomacy over many months." Although there had been a "huge improvement" in the past year, in particular with Germany, he said that the UK needed to work harder at building alliances with other countries.[241]

182. On the other hand, Nigel Farage MEP believed that the eurozone would become increasingly well-organised as a single body, and feared that the UK would never be able to muster a blocking minority against it. In his view, the UK would have more influence over EU policy by leaving the EU and leading by example.[242]

183. The Economic Secretary to the Treasury told us that the UK's position should be to say "We will support you and we will offer advice, but at the end of the day it is very much for those involved in the system to take part in that system". Notwithstanding this, she told us that the UK had a place at the table in these discussions, and in her view the UK was very influential and listened to.[243] Peter Curwen added that the idea that the UK was never in the room was "a slight myth".[244]

184. Finally, Sir Nigel Wicks told us that the manner in which advice was offered was key:

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[235] QQ 231, 244.

[236] Q 286.

[237] Q 315.

[238] Q 294.

[239] Q 295.

[240] QQ 42, 44.

[241] QQ 46, 50.

[242] Nigel Farage MEP.

[243] QQ 319, 322.

[244] Q 321.

"If the tone is, 'We are here to help. We want to make it work well. We have certain expertise, because we have a very large international financial centre here in London', we will be heard. … If we approach the discussions in a sort of, 'Well it's so difficult. You're making a mess of it. It's all going to break up. You shouldn't be doing this', you will not be listened to … If we are strident, we will not be listened to. In fact, we will turn people off. If you do it in the right tone, often privately … we can have an impact. … The national interest is clearly that the euro area has to work. It is still our largest market, our major export market, and if it does not work we will be in trouble."[245]

Our conclusions

185. **The Government stress that the UK's influence has not diminished and that it continues to play an integral role in the EU, notwithstanding the fact that eurozone Members are pursuing an increasingly integrationist agenda. The evidence we have heard, in particular in Brussels and Berlin, tends to contradict this assertion. This diminished influence appears to have two root causes: first, the UK's decision not to participate in Economic and Monetary Union; and secondly, the nature of the UK's engagement with its EU colleagues.**

186. **The UK's non-participation in EMU inevitably has meant that it has had only a limited influence on some of the decisions which will shape the future of the eurozone as well as the EU as a whole. This is particularly important because the eurozone crisis has dominated the EU's agenda in recent years, and is likely to continue to do so in the period ahead. The UK's decision not to participate in 'Genuine Economic and Monetary Union', while understandable, could reinforce these trends.**

187. **The most important element of 'Genuine Economic and Monetary Union' is the move towards a Banking Union for the eurozone and other Member States who choose to participate. It is a moot point whether it would be in the UK's interests, as well as those of the City of London, to participate in Banking Union, at least at some level. The Government may be ill-advised to assert that Banking Union is the sole province of the single currency for all time. It would be wise not to close the door on the possibility of some level of participation in Banking Union in the future, in particular as a means of further promoting and shaping the Single Market in Financial Services and the UK's position within it.**

188. In the meantime, steps must be taken to ensure the single rulebook is implemented, that there is a level playing field between participants and non-participants and that there continues to be full and effective cooperation between banking authorities in the eurozone and UK. We were reassured to learn that the Bank of England and the ECB already have a strong working relationship, and we will examine the nature of their interaction further in the course of our future work.

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[245] QQ 182, 188.

189. The Single Market and the single currency are not incompatible. However, at this point they are uneasy bedfellows. The concerns raised by the Government about the interaction between Banking Union and the Single Market, and the impact on non-participants, are of vital importance. We wholeheartedly support the Government in their efforts to ensure that moves towards greater eurozone integration do not damage the Single Market nor the interests of non-participating Member States. The growing influence of eurozone institutions, notably the ECB and the Eurogroup, demonstrates the importance of the safeguards that the Government have worked hard to secure. Continued vigilance is needed to ensure that the EU Single Market is protected and enhanced in the years to come, and that the safeguards that have been obtained thus far remain robust.

190. Witnesses claim that the UK has too often adopted the wrong tone in EU negotiations, veering from lecturing on the one hand to a seeming lack of interest on the other. Yet the expertise that the UK possesses on such key concepts as Banking Union is recognised across the EU. The Government must counter the growing perception that the UK is becoming semi-detached from EU debates and demonstrate that the UK has much to contribute. **As negotiations continue on the Single Resolution Mechanism, we would urge the Government to consider whether the UK's interests would be best defended if their arguments were couched in terms of ensuring the overall stability and efficiency of EU markets and of the Single Market in Financial Services.**

191. **Responsibility for defending the UK's interests does not lie solely with the Government. The City of London has a key role to play in promoting the UK's priorities, and is often actively engaged in EU negotiations. The message must be conveyed that, as the foremost European financial centre, the City is of vital strategic importance not only for the UK but for the EU as a whole.**

192. **We also acknowledge our own duty as parliamentarians to enhance our engagement with EU colleagues to promote the best interests both of the UK and the EU in general. We are taking such discussions forward in the context of our current inquiry into the role of national Parliaments in the EU.**

193. **The EU institutions have their own obligations to ensure that the UK's concerns, and the concerns of all non-participating Member States, are not lightly dismissed. We welcome the evidence put to us by colleagues from other Member States that a greater effort should be made in the EU to take account of the UK's position.**

194. **Much of the 'Genuine Economic and Monetary Union' agenda is a distant prospect and some of the proposals were never realistic. Nevertheless, the eurozone remains on the road towards greater integration. The implications of this for the UK are immense. A strong and prosperous eurozone is in the interests of all EU members, as is a strong and engaged UK (and a strong City of London). Achieving all three outcomes simultaneously will require close care and attention, together with goodwill on all sides.**

CHAPTER 5: SUMMARY OF CONCLUSIONS

Summary

195. 'Genuine Economic and Monetary Union' is the EU institutions' vision for a strong and sustainable single currency, but its elements are highly contentious. Banking Union is vital to tackling the effects of the financial crisis. Yet what has been agreed is insufficient to break the vicious circle linking banking and sovereign debt. There is a strong case for some fiscal transfers and debt mutualisation, but proposals for an integrated budgetary and economic policy face widespread political opposition. Although the full vision remains a distant prospect, the eurozone is on the road towards greater integration. The implications for the UK are immense. A strong and prosperous eurozone is in the interests of all EU members, as is a strong and engaged UK (and a strong City of London). Achieving all three outcomes simultaneously will require close care and attention, together with goodwill on all sides. (Summary)

Chapter 1: 'Genuine Economic and Monetary Union'—Sticking plaster or miracle cure?

196. The asymmetry between a centralised monetary policy and decentralised fiscal and structural policies remains a fundamental flaw in EMU. This shortcoming was pointed out by many at the outset of the single currency project, but there was little political will to do anything about it. Instead, national central banks and regulators stood by while widespread mispricing of risk led to excessive borrowing in certain countries, most notoriously Greece. The mispricing of public debt may have been due in part to a false assumption by investors that there would be some degree of solidarity or ultimate common responsibility for governmental borrowing within the eurozone. The effect of this borrowing was to finance an expanding current account deficit in many countries which itself reflected a steady decline in their relative competitiveness. The outbreak of the financial crisis led to a crisis of confidence in the public debt of Greece, Portugal and to a lesser degree Italy, and in the real estate market and its principal lenders in Spain and Ireland. Because the obvious need of Spain and Ireland (and later of Cyprus) to recapitalise their banks was clearly beyond the capacity of these governments alone, a crisis of confidence in these countries' public debt was rapidly engendered. The resulting vicious circle linking banks and sovereign states is a defining symptom of the eurozone crisis. (paragraph 15)

197. The Commission has now acknowledged the flaws in Economic and Monetary Union. Yet there remains a clear conflict between the steps that are economically necessary to secure the eurozone and those that are politically realistic. Key EU players, notably the Commission, the European Central Bank (ECB), and Germany, have different priorities. Thus while the political commitment to maintaining the single currency is as strong as ever, there is a continuing failure to agree the steps necessary to address its flaws. The end result is what was described to us as "the euro continuing as an injured patient with a massive sticking plaster in the form of bailouts."[246] Whether the 'Genuine Economic and Monetary Union' proposals form a

[246] Syed Kamall MEP, Q 217.

realistic basis for overcoming such conflicts is a matter of considerable doubt. (paragraph 16)

198. There is widespread recognition that some treaty change is necessary to underpin the scale of reforms needed to address EMU's flaws. But some of what the Commission proposes goes beyond what is strictly necessary to shore up EMU. Treaty change is both difficult to achieve and an unpredictable process. Instead, there has been a clear preference to look for ingenious, and at times complex, solutions within the current treaty framework, or to reach intergovernmental agreements outside it. The key test must not only be whether these solutions are politically achievable, but whether they are really needed and, if they are, whether they will be effective in tackling the weaknesses in EMU. (paragraph 21)

199. The most effective cure to EMU's flaws, namely full fiscal and political union, is politically unachievable. Although a full and 'Genuine' Economic and Monetary Union as envisaged by the Commission may be beyond reach and would also entail more changes than are strictly necessary, a strengthened EMU is both vital and achievable. (paragraph 24)

Chapter 2: Integrated financial framework—Banking Union

Single Supervisory Mechanism

200. We welcome the agreement reached in March 2013 on the Single Supervisory Mechanism (SSM). We note concerns about the limited coverage of the SSM. However we repeat our view that it is unrealistic to expect the ECB to engage in intensive supervision of all 6000 euro area banks. Given the dangers that smaller credit institutions can potentially pose to financial stability, it is imperative that the ECB is able quickly to intervene with any smaller banks as required. This requires close and positive cooperation between the ECB and national supervisors. Parties on all sides must do their utmost to ensure that the agreed mechanism is robust enough to ensure that this happens. (paragraph 37)

201. While we welcome the safeguards to protect the Single Market that the UK Government secured, they can only be regarded as a temporary fix. The double majority voting mechanism will be reviewed once the number of non-participants falls to four. It is therefore incumbent upon the Government to do all they can to ensure that safeguards to protect the Single Market and the UK's position within it are retained as the situation evolves. (paragraph 38)

The role of the ECB

202. We recommend clarity on the backstop arrangements ahead of the ECB's comprehensive assessment of the banking system. Without this, the ECB may be inclined to temper its assessment of a bank's balance sheet to avoid creating financial instability in the short run, at the risk of undermining its credibility as a supervisor as and when the true state of affairs becomes apparent. Until confidence in the banking system is restored, its function as a stimulus and support to economic growth will remain impaired. That confidence depends in part on the credibility of the supervisor, which should not be put at risk through the current lack of clarity in the backstop arrangements. (paragraph 48)

203. Clearly, not all eurozone sovereign bonds are equally safe. The valuation of sovereign debt held by banks as assets should realistically reflect the risk of default in each Member State. The European Banking Authority (EBA) has recently offered general guidance to competent authorities on this issue. It remains to be seen how this will affect the ECB's forthcoming comprehensive assessment. We will continue to monitor the situation as further details emerge, notably in the elaboration of the stress test methodology expected by April this year. (paragraph 49)

204. We reiterate our view that, given the constraints of the existing Treaty, the ECB is the most appropriate body to take on the supervisory function. Indeed there are positive advantages to combining supervisory and monetary policy functions within one institution. However, we recognise that this is a contentious issue, and that it has created a significant concentration of power in one institution. As many safeguards as possible within Treaty constraints have been provided to ensure that the potential for a conflict of interest is minimised. Time will tell whether they prove sufficient. (paragraph 53)

205. We applaud the ECB for its firm and decisive action in tackling the euro area crisis, starting with the provision of liquidity from the early stages of the crisis in 2007 and again in 2010. We note that its interventions have been crucial since Mario Draghi became President in November 2011. However, we recognise that it has stretched its remit under the Treaty. (paragraph 61)

Single Resolution Mechanism

206. We acknowledge that the Commission and the Council have been striving to design a Single Resolution Mechanism (SRM) that is both effective and politically realistic. We also acknowledge the formidable obstacles to reaching such an agreement, and commend in particular the efforts of the Lithuanian Presidency to negotiate a deal in Council before the end of 2013. (paragraph 97)

207. Nevertheless, the Single Resolution Mechanism that is emerging from negotiations is suboptimal. It leaves the fiscal backstop in the hands of individual Member States, one of the governance weaknesses that Banking Union was supposed to cure. The best way to restore confidence would have been to build a truly European resolution mechanism, with a single central point of authority able to reach quick decisions, relying on a single and substantive source of funds. Anything short of this runs the risk of failing decisively to break the vicious circle linking bank and sovereign debt that has created fragmentation in the financial markets and undermined the viability of the eurozone. (paragraph 98)

208. We were sceptical about the original proposal that the Commission should assume the role of the resolution authority as there was a perceived lack of confidence in its ability to fulfil the task. The suggestion that the Commission itself was unenthusiastic about taking on the role was also a cause for concern. The preferable option would have been to establish a new, fully independent resolution authority, able to concentrate on its core task of ensuring the resolution mechanism works effectively. However treaty constraints rule out the Single Resolution Board fulfilling that role. The revised proposal is that the Council will take the final decision, but this runs the risk of political judgements clouding the economic analysis that should form the basis for any resolution decision. (paragraph 99)

209. One other option would have been for the ECB to take responsibility for the operation of the SRM. We acknowledge that such an arrangement would place yet more powers and responsibilities in the hands of one institution. However, such a model would be analogous to the new regulatory arrangements in the UK, where the Prudential Regulation Authority (as a subsidiary of the Bank of England) has responsibility for such tasks. It is also worth recalling that, through Outright Monetary Transactions (OMTs), the ECB has a policy instrument which could be used to deal with a fiscal problem encountered by any Member State which came under pressure because it retains responsibility for rescuing failing banks. (paragraph 100)

210. We are sceptical about the mechanics of the proposed resolution process. The roles for the Board, Commission and Council, potentially involving over 100 people in a resolution decision, make for a complicated system ill-suited to the swift decisions required in such cases. We have been told that the Commission and Council would only have an active role in exceptional cases. Yet it is these exceptional cases where resolution is likely to prove most difficult. We would have preferred a simpler, more streamlined approach. (paragraph 101)

211. We believe that the SRM needs to be based from the outset on a single eurozone fund. We wait to see what emerges from negotiations on the intergovernmental agreement on the establishment of the Fund. In light of the terms of reference for the negotiations agreed in December 2013, the acceptance of the case for progressive mutualisation over a ten-year transitional phase is no small achievement. But the fact that the new single resolution fund will not reach full capacity until 2026 means that there will be an extended period during which national fiscal backstops may prove to be inadequate. The interim arrangements risk reinforcing the fragmentation of the EU banking sector and the vicious circle of debt between banks and sovereign states. Given the limited size of the funds available, even when the backstop is fully operational, it remains likely that national governments will be called upon to foot the bill if a bank collapses. An operational and well-resourced fund is intrinsic to the effectiveness of the resolution mechanism. (paragraph 102)

212. The Government are understandably cautious about use of the Article 114 TFEU legal base given that not all Member States will participate. However, it may prove advantageous from the point of view of non-participants in making clear that the interests of the Single Market will need to be taken into account. The Commission, Council and European Parliament must ensure that the final agreement does not encourage any fragmentation of the Single Market or damage the interests of non-participating Member States. We welcome the safeguards secured by the UK thus far, and urge the Government to ensure that, so far as is possible, the final proposal satisfies the interests of participants and non-participants alike, and protects the Single Market as a whole. (paragraph 103)

Single Deposit Insurance scheme

213. It remains our view that a common deposit insurance scheme is necessary for Banking Union to succeed and for the eurozone to thrive. We understand the extreme political reluctance to countenance such a significant move in the direction of debt mutualisation. Nevertheless it is an important step if the foundations of the single currency are to be reinforced. Its continued absence

risks reopening the financial crisis through capital flight, as depositors reach the inevitable and justified conclusion that a euro is safer in a strong Member State than in one facing economic difficulties. (paragraph 111)

214. Moreover there is already a problem of fragmentation in the eurozone banking market—the opposite of what was intended when the single currency was established. Credit for retail and commercial clients of equivalent risk has become more readily available, and at a cheaper price, in the northern countries of the eurozone than in the southern and eastern Member States. This perverse and dangerous trend would be exacerbated if retail deposit guarantee schemes were considered more robust in countries where the government standing behind them were seen as more fiscally sound and credit-worthy. Such a tendency would oblige banks in weaker Member States to offer higher deposit rates (and consequently to charge higher lending rates) in order to compensate for the perceived higher risk. This would be bound to have a negative impact on the economic performance of the disadvantaged countries. It would amount to a different and tighter monetary policy being pursued in those Member States which, if anything, required a more accommodating monetary stance than their peers. Such an outcome could create severe problems for the weaker economies already struggling to improve their competitiveness, and would undermine the principle of monetary union. (paragraph 112)

Overall conclusion

215. Banking Union is the most urgent pillar of the 'Genuine Economic and Monetary Union' proposals. It is vital to tackling the effects of the financial crisis and securing the long-term stability of the eurozone. It is also needed to repair the damage to the Single Market in Financial Services caused by the fragmentation of the banking system. While we acknowledge the significant progress that has been made so far, only a partial Banking Union is in prospect. Although the agreement on the Single Supervisory Mechanism is to be welcomed, the Single Resolution Mechanism proposals currently being finalised are suboptimal. Furthermore, there is no prospect of progress towards a common deposit insurance mechanism in the foreseeable future. Consequently, the vicious circle linking bank and sovereign debt remains a threat. Confidence in the banking system and in the viability of the eurozone as a whole can only be fully restored when this link is demonstrably broken. A full and optimal Banking Union may not be politically realistic. Nevertheless, it is incumbent upon European leaders to move as close to the optimal model as possible if confidence is to be restored and the eurozone is to thrive. (paragraph 113)

Further steps to break the link between bank and sovereign debt

216. Banking Union is not sufficient in and of itself to break the link between bank and sovereign debt. We recognise that Long-Term Refinancing Operations are an important crisis measure. Yet they may be reinforcing the link between bank and sovereign debt. Direct recapitalisation of banks by the European Stability Mechanism (ESM) to break this link is vital, although the ESM Treaty's provisions on conditionality are a constraint. But so long as national governments are still involved in direct recapitalisation of their own banks, the risk of a banking crisis developing into a sovereign debt crisis remains. (paragraph 115)

Chapter 3: Further steps—an integrated budgetary and economic policy framework

An integrated budgetary framework

217. We do not believe that a system of permanent fiscal transfers via a centralised euro area budget is politically realistic in the foreseeable future. We note the argument that areas in receipt of payments tend to become reliant on them at the expense of undertaking necessary structural reforms. But such corrective mechanisms have so far been a characteristic of most currency unions. This is particularly relevant given the divergences in competitiveness which occurred in the first decade of the euro, as well as the current disparities in economic growth within the EU. (paragraph 127)

218. At the very least, an effective mechanism to cushion asymmetric shocks is needed. Where they occur, asymmetric shocks require rapid automatic or discretionary responses. There is now some provision for more flexibility in the new fiscal rules which make a distinction between cyclical and structural deficits and allow Member States some flexibility in a crisis. However this would still operate at the Member State level, rather than as an instrument of the currency union as a whole. Financial market integration in a common currency area itself will help. Such integration implies that savers in the negatively impacted Member States will increasingly hold claims on assets and revenues in the less impacted Member States (and *vice versa*) and the burden of the crisis will be shared more equally. But the main weight of adjustment must fall on labour markets and prices, involving a high measure both of labour mobility and of movement in the real cost (which in monetary union will also be the nominal cost) of labour. We have been struck by the effectiveness of this mechanism over the past few years, especially in Greece, Spain and Portugal. Wages, nominal and real, have proved to be far less rigid than was often assumed to be the case. These 'internal devaluations' can reverse some of the loss of competitiveness which led to imbalances, but there is a price to be paid in the negative effect on demand from lower consumer spending, not to mention the significant impact on the living standards of EU citizens. (paragraph 128)

219. That said it is worth considering whether additional financial adjustment mechanisms could usefully be devised to aid the process further. Economic divergence can also be tackled through structural reforms, such as increasing the mobility of labour, investment in innovation and measures to stimulate productivity growth. We call on the EU institutions and Member States to step up their efforts to meet the targets set out in the Europe 2020 strategy. (paragraph 129)

220. German concerns over moral hazard and the assumption of liability without effective controls mean that debt mutualisation remains highly contentious and is likely to continue to be resisted. Proposals involving joint and several liability, such as a Eurobond, are therefore politically unrealistic at the present time. Nevertheless, some form of debt mutualisation may be inevitable if the single currency is to prosper. It would be a logical development in a more complete monetary union, and would be supported by many Member States. We will study closely the forthcoming report of the Commission's Expert Group on Debt Redemption Fund and Eurobills. (paragraph 137)

An integrated economic policy framework

221. There are both economic and political challenges as to how economic policy coordination is undertaken. The imposition of so-called austerity policies runs the risk of aggravating the problems of weaker economies. It could push them into a downward spiral in which cuts in public spending and wages prolong recession by taking too much demand out of the economy. However, the policy prescription has two distinct components. The first is consolidation of public finances, for which the choice is not whether it is needed, but how rapidly it can be achieved. The second component in many Member States, boosting competitiveness, is more awkward, because it can be achieved simply by cutting wages (internal devaluation), but can also be achieved by increasing productivity through a range of growth-enhancing measures. The latter requires time and investment, but there is a mutual interest in ensuring that the troubled economies return to growth and are able to create employment. This facet of coordination deserves to be emphasised. Obviously, in practice both elements are in some degree required. (paragraph 142)

222. There is a risk that top-down control removes the power from citizens to determine at the ballot box how taxes are raised and public money is spent in their country. Ensuring democratic legitimacy for the evolving system of economic governance is crucial. Such issues lie at the heart of our current inquiry into the role of national parliaments in the EU. We will consider these important questions fully in the report on that inquiry. (paragraph 143)

223. We are not convinced that the Convergence and Competitiveness Instrument/contractual arrangements proposal is the best way to improve national policy-making and, thus, to achieve deeper economic policy coordination. Conditionality could prove counterproductive given the potential detrimental effect of withdrawal of support from a country in economic difficulties. (paragraph 149)

224. While deeper economic policy integration may be a legitimate long-term aim for the eurozone, it remains a remote prospect. More meaningful proposals are required before any realistic assessment can be undertaken. (paragraph 153)

Chapter 4: Implications for the UK

225. The Government stress that the UK's influence has not diminished and that it continues to play an integral role in the EU, notwithstanding the fact that eurozone Members are pursuing an increasingly integrationist agenda. The evidence we have heard, in particular in Brussels and Berlin, tends to contradict this assertion. This diminished influence appears to have two root causes: first, the UK's decision not to participate in Economic and Monetary Union; and secondly, the nature of the UK's engagement with its EU colleagues. (paragraph 185)

226. The UK's non-participation in EMU inevitably has meant that it has had only a limited influence on some of the decisions which will shape the future of the eurozone as well as the EU as a whole. This is particularly important because the eurozone crisis has dominated the EU's agenda in recent years, and is likely to continue to do so in the period ahead. The UK's decision not to participate in 'Genuine Economic and Monetary Union', while understandable, could reinforce these trends. (paragraph 186)

227. The most important element of 'Genuine Economic and Monetary Union' is the move towards a Banking Union for the eurozone and other Member States who choose to participate. It is a moot point whether it would be in the UK's interests, as well as those of the City of London, to participate in Banking Union, at least at some level. The Government may be ill-advised to assert that Banking Union is the sole province of the single currency for all time. It would be wise not to close the door on the possibility of some level of participation in Banking Union in the future, in particular as a means of further promoting and shaping the Single Market in Financial Services and the UK's position within it. (paragraph 187)

228. As negotiations continue on the Single Resolution Mechanism, we would urge the Government to consider whether the UK's interests would be best defended if their arguments were couched in terms of ensuring the overall stability and efficiency of EU markets and of the Single Market in Financial Services. (paragraph 190)

229. Responsibility for defending the UK's interests does not lie solely with the Government. The City of London has a key role to play in promoting the UK's priorities, and is often actively engaged in EU negotiations. The message must be conveyed that, as the foremost European financial centre, the City is of vital strategic importance not only for the UK but for the EU as a whole. (paragraph 191)

230. We also acknowledge our own duty as parliamentarians to enhance our engagement with EU colleagues to promote the best interests both of the UK and the EU in general. We are taking such discussions forward in the context of our current inquiry into the role of national Parliaments in the EU. (paragraph 192)

231. The EU institutions have their own obligations to ensure that the UK's concerns, and the concerns of all non-participating Member States, are not lightly dismissed. We welcome the evidence put to us by colleagues from other Member States that a greater effort should be made in the EU to take account of the UK's position. (paragraph 193)

232. Much of the 'Genuine Economic and Monetary Union' agenda is a distant prospect and some of the proposals were never realistic. Nevertheless, the eurozone remains on the road towards greater integration. The implications of this for the UK are immense. A strong and prosperous eurozone is in the interests of all EU members, as is a strong and engaged UK (and a strong City of London). Achieving all three outcomes simultaneously will require close care and attention, together with goodwill on all sides. (paragraph 194)

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

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

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

Declaration of Interests

Viscount Brookeborough
None relevant

Earl of Caithness
None relevant

Lord Carter of Coles
None relevant

Lord Davies of Stamford
None relevant

Lord Dear
None relevant

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

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

AREF Holdings (Bermuda) Ltd

Lord Harrison (Chairman)

None relevant

Lord Kerr of Kinlochard

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

Baroness Maddock

None relevant

Lord Marlesford

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

Lord Vallance of Tummel

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

The following Members of the European Union Committee attended the meeting at which the report was approved: Lord Boswell (Chairman), Baroness Corston, Lord Dear, Baroness Eccles of Moulton, Lord Foulkes of Cumnock, Lord Hannay of Chiswick, Lord Harrison, Lord Maclennan of Rogart, Lord Marlesford, Baroness O'Cathain, Baroness Quin, The Earl of Sandwich, Baroness Scott of Needham Market, Lord Tomlinson, Lord Tugendhat, Lord Wilson of Tillyorn. Lord Hannay of Chiswick declared interests as Member of the Advisory Board, Centre for European Reform, and Member, Future of Europe Forum, Advisory Board for Centre for British Influence through Europe. Baroness Quin declared an interest as Vice-President, European Movement.

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

APPENDIX 2: LIST OF WITNESSES

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

Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with * gave both oral evidence and written evidence. Those marked with ** gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

Oral evidence in chronological order

**	(QQ 1–18)	Centre for European Reform
**		Open Europe
**		John Peet
**	(QQ 19–38)	Graham Bishop
**		Hugo Dixon
**		Megan Greene
**	(QQ 39–54)	British Chambers of Commerce
*		City of London Corporation
**	(QQ 55–65)	Professor Willem Buiter
**		Dr Holger Schmieding
**	(QQ 66–77)	Dr Federico Steinberg
*	(QQ 78–88)	Professor Marco Pagano
**	(QQ 89–100)	Dr Clemens Fuest
*	(QQ 101–108)	European Commission
**	(QQ 109–120)	Guntram Wolff
**	(QQ 121–133)	Anton La Guardia
**	(QQ 134–147)	European Policy Centre
**		Professor André Sapir
**	(QQ 148–156)	BUSINESSEUROPE
**	(QQ 157–169)	Elisa Ferreira MEP
**		Liêm Hoang Ngoc MEP
**	(QQ 170–178)	Eurogroup Working Group
**	(QQ 179–188)	Sir Nigel Wicks
**	(QQ 189–196)	Professor Luis Garicano
**	(QQ 197–208)	Lorenzo Codogno
**	(QQ 209–221)	Sharon Bowles MEP
**		Roger Helmer MEP
**		Syed Kamall MEP

**	(QQ 222–229)	Professor Agnès Bénassy-Quéré
**	(QQ 230–247)	Dr Daniela Schwarzer
**	(QQ 248–262)	Professor Mark Hallerberg
**	(QQ 263–272)	Professor Dr Ansgar Belke
**	(QQ 273–286)	Ulf Meyer-Rix
**	(QQ 287–296)	Bettina Kudla MdB/MP (CDU)
**		Detlef Seif MdB/MP (CDU)
**		Manfred Zöllmer MdB/MP (SPD)
**	(QQ 297–315)	Professor Claudia Buch
**		Professor Otmar Issing
**		Professor Jan Pieter Krahnen
**	(QQ 316–331)	HM Treasury

Alphabetical list of all witnesses

	Professor Kern Alexander
	Association for Financial Markets in Europe (AFME)
**	Professor Dr Ansgar Belke (QQ 263–272)
**	Professor Agnès Bénassy-Quéré (QQ 222–229)
**	Graham Bishop (QQ 19–38)
**	Sharon Bowles MEP (QQ 209–221)
**	British Chambers of Commerce (QQ 39–54)
**	Professor Claudia Buch (QQ 297–315)
**	BUSINESSEUROPE (QQ 148–156)
**	Professor Willem Buiter (QQ 55–65)
**	Centre for European Reform (QQ 1–18)
	Professor Jagjit S. Chadha
	John Chown
*	City of London Corporation (QQ 39–54)
**	Lorenzo Codogno (QQ 197–208)
	Professor Tim Congdon
	Professor Michael Dempster
**	Hugo Dixon (QQ 19–38)
**	Eurogroup Working Group (QQ 170–178)
*	European Commission (QQ 101–108)
**	European Policy Centre (QQ 134–147)
	Nigel Farage MEP
**	Elisa Ferreira MEP (QQ 157–169)

** Dr Clemens Fuest (QQ 89–100)

** Professor Luis Garicano (QQ 189–196)

** Megan Greene (QQ 19–38)

** Anton La Guardia (QQ 121–133)

** Professor Mark Hallerberg (QQ 248–262)

** Roger Helmer MEP (QQ 209–221)

** HM Treasury (QQ 316–331)

** Liêm Hoang Ngoc MEP (QQ 157–169)

** Professor Otmar Issing (QQ 297–315)

** Syed Kamall MEP (QQ 209–221)

** Professor Jan Pieter Krahnen (QQ 297–315)

** Bettina Kudla, MdB/MP (CDU) (QQ 287–296)

Professor Rosa M. Lastra

Ruth Lea

** Ulf Meyer-Rix (QQ 273–286)

** Open Europe (QQ 1–18)

* Professor Marco Pagano (QQ 78–88)

** John Peet (QQ 1–18)

** Professor André Sapir (QQ 134–147)

Dr Waltraud Schelkle

** Dr Holger Schmieding (QQ 55–65)

** Dr Daniela Schwarzer (QQ 230–247)

** Detlef Seif, MdB/MP (CDU) (QQ 287–296)

** Dr Federico Steinberg (QQ 66–77)

** Sir Nigel Wicks (QQ 179–188)

** Guntram Wolff (QQ 109–120)

** Manfred Zöllmer, MdB/MP (SPD) (QQ 287–296)

APPENDIX 3: CALL FOR EVIDENCE

The House of Lords EU Sub-Committee on Economic and Financial Affairs, chaired by Lord Harrison, is launching an inquiry into EU "Genuine Economic and Monetary Union" and its implications for the UK. We invite you to contribute evidence to this inquiry.

Since the June 2012 European Council, the heads of the main European institutions have put forward several proposals for so-called "Genuine Economic and Monetary Union" (GEMU).

The European Commission's December 2012 report, *A Blueprint for a Deep and Genuine Economic and Monetary Union*, provided the most comprehensive outline of how greater integration amongst euro area countries might be designed. There is also the vision for GEMU set out by the President of the European Council, Herman Van Rompuy, in his *Towards a Genuine Economic and Monetary Union* paper. These proposals set out four essential building blocks for the future of EMU: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework, and strengthened democratic legitimacy and accountability. This inquiry intends to focus on the first three pillars, which fall within the Sub-Committee's remit.

These are ambitious and controversial proposals, reflected by the response to them at the 2012 December European Council, when the Commission's Blueprint received a lukewarm reception. Nonetheless, these proposals indicate a direction of travel towards an increasingly integrated EU inner core. The President of the European Council and the President of the Commission were invited to present to the June 2013 European Council possible measures and a time-bound roadmap on coordination of national reforms, the social dimension of EMU, mutually agreed contracts for competitiveness and growth, and solidarity mechanisms. In this context it is important for the implications of moves towards GEMU to be fully assessed, for those both inside and outside this inner core.

The Government have made clear that the UK will not take part in the majority of these proposals, arguing that they are intended to resolve the problems inherent in the euro area. Despite this, the changing shape of the EU that these proposals point to will have significant consequences for the UK and other non-euro area Member States, as well as for the single market as a whole. There are major questions for the Government to answer as to how the UK should best respond to these momentous developments.

The Sub-Committee welcomes evidence on the proposals that have been set out so far, but would also welcome further evidence on the proposals as they continue to take shape in the coming months.

Particular questions to which we invite you to respond are as follows (there is no need for individual submissions to deal with all of the issues, and witnesses are also invited to deal with any additional issues or proposals that emerge in the weeks and months after the Call for Evidence is published):

Genuine Economic and Monetary Union

(1) How realistic are the plans for Genuine Economic and Monetary Union (GEMU)? Do they go far enough to correct the flaws in EMU revealed by the euro area crisis, or do they go too far to be palatable for some Member States?

(2) Will the proposals work, and if not, what other steps need to be taken?

An integrated financial framework (Banking Union)

(3) Will the proposals for banking union decisively break the link between bank and sovereign debt? If not, what more needs to be done? Is the three-pronged model of a single supervisory mechanism, a common resolution mechanism and a common deposit insurance scheme realistically achievable, how long is likely to be needed to achieve it and what are the risks of long delays?

An integrated economic policy framework

(4) Binding contracts, known as "Convergence and Competitiveness Instruments", have been proposed as part of the plans for GEMU, which would encourage structural reforms through rewards or sanctions. Is such a proposal credible, would it be effective, and how could it be enforced?

(5) There are also indications that, in the longer term, there could be deeper economic policy coordination amongst euro area countries, particularly in the areas of taxation and employment policy. Which areas of economic policy would you regard as appropriate for deeper integration?

An integrated budgetary framework

(6) In relation to the Commission's proposal of the creation of a 'fiscal capacity' in the medium term and the creation of an autonomous euro area budget in the longer term:

(a) Why is such a budget necessary, and what would its purpose be? Are there any alternative models that would achieve central fiscal stabilisation?

(b) How would it be funded, and how large would it need to be?

(c) Would it require new institutions? How would it interact with the EU budget?

(d) How might non-members of the euro area participate (voluntarily) in such a mechanism?

(7) The creation of a European government bond ('Eurobond') jointly issued by euro area Member States has been suggested by a number of academics and commentators. What is your view on debt mutualisation? How plausible is it that such a scheme can be implemented?

(8) Do the varying levels of competitiveness and the presence of persistent imbalances across Member States make a system of permanent fiscal transfers inevitable if the euro area is to survive, or could the goals of fiscal union (or integration) be attained without transfers?

Institutional issues

(9) Does the current Treaty framework allow the euro area to go as far as is necessary in terms of integration within the current Treaty framework, or will GEMU inevitably require Treaty change? Should other mechanisms,

such as further intergovernmental arrangements or enhanced cooperation, be considered?

(10) How will EU institutional arrangements need to change in order to accommodate deeper integration?

(a) In the event that not all Member States choose to participate, would the need to ensure democratic legitimacy for contentious GEMU decisions require reform to the decision-making process, either in the European Parliament (e.g. through differential voting and Committee arrangements) or the Council?

(b) What are the implications of GEMU for the role of national parliaments?

Impact on the UK and the Single Market

(11) The UK Government have stated that any proposals must take account of the interests of all Member States, in particular with regard to the Single Market. How can this be achieved?

(12) The UK Government have made clear that they will not participate in the majority of these measures. Do you think this is the right response or are there specific elements of the proposals for which it would be in the UK's interest to take part—whether fully or partly?

(a) Are there alternative 'models' for banking union which the UK would find more consistent with its preferences?

(13) Since the majority of non-euro area Member States are likely to participate in many components of GEMU, are there particular risks for the UK finding itself in a small minority of non-participating Member States? How can the UK ensure that the voice of this minority continues to be heard? Do you anticipate any institutional changes that would prove problematic for the UK?

(a) What are the likely indirect impacts of non-participation on the UK's economic prospects, for instance in terms of its ability to attract inward investment and the impact on the position of the UK financial sector?

The deadline for written evidence is 24 June 2013.

Issued on 24 April 2013.

APPENDIX 4: GLOSSARY

AQR	Asset Quality Review.
Asymmetric shock	A shock which only affects one economy (or a small minority of economies), perhaps because a key industry encounters difficulties or there is a natural disaster.
Bail-in	The means by which shareholders, bondholders and some depositors will be required to contribute to the costs of bank failure.
CDU	Christlich Demokratische Union Deutschlands (the Christian Democratic Party of Germany).
Condititionality	Requiring a recipient of financial support to undertake specific policy actions in order to receive the funds.
Contagion	The spread of financial risk across borders.
Covered deposits	According to a definition from the Financial Stability Board: "Covered deposits are those eligible deposits that are actually covered or insured by a deposit insurance scheme (i.e. they comply with the eligibility criteria for inclusion and the value of the deposits fall within the maximum coverage limit)."[247]
CSU	Christlich-Soziale Union in Bayern (Christian Social Union in Bavaria).
EBA	European Banking Authority.
ECB	European Central Bank.
ECOFIN	Economic and Financial Affairs Council.
EFSF	European Financial Stability Facility.
EFSM	European Financial Stabilisation Mechanism.
EMU	Economic and Monetary Union.
ESM	European Stability Mechanism.
ESRB	European Systemic Risk Board.
Eurobill	The proposal for common issuance by euro area Member States of short-term government debt with a maturity of up to one to two years.
Eurobond	The proposed principal form of public debt open to all members of the eurozone, jointly and severally guaranteed by all participating Member States.
Eurogroup	An informal body that brings together the finance ministers of countries whose currency is the euro.
Four Presidents	The Presidents of the European Council, the European Commission, the Eurogroup and the European Central Bank.

[247] See Financial Stability Board (2012) 'Thematic Review on Deposit Insurance Systems', 8 February.

GDP	Gross Domestic Product.
Hierarchy	The order in which creditors are bailed in.
IMF	International Monetary Fund.
Legacy debts	Debt incurred in the past, often subject to more onerous conditions than newly issued debt.
LTROs	Long-Term Refinancing Operations.
Macroeconomic imbalances	These can be interpreted as features of an economy which are incompatible with a sustainable macroeconomic trajectory. They include asset bubbles, trade deficits, excessive debt and a range of other problems.
MdB	Mitglied des Deutschen Bundestages (Member of the German Bundestag).
MEP	Member of the European Parliament.
OMTs	Outright Monetary Transactions.
Resolution	The process by which a failing bank is dealt with so as to avoid knock-on effects on other financial intermediaries that lead to systemic problems in the financial sector.
Secured creditors	Creditors who have a legally binding claim on the assets of a borrower (or bank), and come before unsecured creditors in any bankruptcy (or bank resolution) proceedings.
Sovereign bonds	Bonds issued by national governments, often assumed (at least until the euro crisis broke) to be risk-free.
Sovereign debt	The aggregate debt of a nation's public sector.
SPD	Sozialdemokratische Partei Deutschlands (Social Democratic Party of Germany).
SRM	Single Resolution Mechanism.
SSM	Single Supervisory Mechanism.
Symmetric shock	A shock which affects all or most economies, examples being a sudden rise in the oil price or the demand shock that hit all countries in 2009 after the demise of Lehman Brothers.
TARGET2	TARGET2 settles payments related to monetary policy operations, interbank and customer payments, and payments relating to the operations of all large-value net settlement systems and other financial market infrastructures handling the euro (such as securities settlement systems or central counterparties).
TFEU	Treaty on the Functioning of the European Union. The Treaty entered into force on 1 December 2009.
TSCG	Treaty on Stability, Coordination and Governance.
Unsecured creditors	Creditors who have no direct collateral and who have no preferential position in bankruptcy or bank resolution proceedings.