HM Government

Review of the Balance of Competences between the United Kingdom and the European Union

Economic and Monetary Policy

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Executive Summary

This report examines the balance of competences between the European Union (EU) and the United Kingdom (UK) in the area of economic and monetary policy and is led by HM Treasury (HMT). It is a reflection and analysis of the evidence submitted by experts, non-governmental organisations, business people, and other interested parties, either in writing or orally, as well as a literature review of relevant material. Where appropriate, the report sets out the current position agreed within the Coalition Government for handling this policy area in the EU. It does not predetermine or prejudge proposals that either Coalition party may make in the future for changes to the EU or about the appropriate balance of competences.

While the Treaties give the EU institutions a relatively high level of competence in the area of economic and monetary policy, the UK also has very substantial opt-outs in this area of EU policy. Protocol 15 to the Treaties is clear that 'the United Kingdom shall not be obliged or committed to adopt the euro without a separate decision to do so by its government and parliament'. It goes on to state that 'the United Kingdom shall retain its powers in the field of monetary policy according to national law'.

As a result of this, the majority of monetary provisions and a number of economic and fiscal provisions in the Treaties, in particular provisions for sanctions for breaches of the rules, do not apply to the UK. As set out in the Call for Evidence, this report is based on the assumption that the UK's substantial opt-outs continue.

Responses to the Call for Evidence, and evidence from relevant public sources, suggest that in the areas covered the balance of competences in the EU, taking account of the UK's opt-outs, is mainly consistent with the UK's national interest. In particular, the Treaty provisions provide for euro area specific mechanisms to support the euro area's need to co-ordinate its policies and ensure stability, while the UK's opt-outs preserve the UK Government's ability to respond to developments affecting the UK's economic outlook. However, there are also areas where improvement is needed, and there are potential risks both to the success of the euro area and the UK's national interest. In particular, there is a need to ensure that policies work for all Member States, whether in the euro area or out, that caucusing is avoided, and that the integrity of the Single Market is protected.

A number of key points emerge from the report:

- The existing policy instruments (the Stability and Growth Pact, Europe 2020, and the Macroeconomic Imbalances Procedure) have had some impact in co-ordinating fiscal policy among Member States and in promoting stability and growth in the euro area and the broader EU;

- The current roles and responsibilities of the EU institutions (European Commission, Council and European Parliament) are generally appropriate for the purposes of outlining a broad economic agenda and co-ordinating economic policy within the Union;

- Euro area integration is driving fundamental change in the EU, in particular by increasing the number of proposals which are aimed primarily at those countries that share a single currency, by increasing the prominence of the Eurogroup, and by altering the governance framework of the EU;

- A strong and stable euro area is likely to require further strengthening of its governance structures, as well as structural economic reform in euro area Member States to increase their ability to adjust to economic shocks. As a result, the legal and institutional framework is unusually fluid, and a number of pieces of evidence suggested that Treaty change is likely to be required to resolve these tensions; and

- It is in the UK's best interests to encourage further integration in the euro area if this helps promote financial stability and if we can ensure that it does not damage UK interests. Even though the UK is not part of the euro area, and has its opt-outs, what happens with respect to euro area economic governance nevertheless matters significantly for the UK. This is partly because the UK has a direct interest in seeing the economic stability and performance of its major trading partners improve. But it is also because the precise approach adopted by the euro area in taking forward the reform process can impact on the UK's interests in the way that the broader EU works.

The report also highlights a number of key concerns:

- Current mechanisms have not always been effective in co-ordinating economic policy, in particular in exerting peer pressure on Member States to take forward necessary economic reform. Furthermore, there are concerns over the choice of scoreboard indicators used in the Macroeconomic Imbalances Procedure, whilst the Stability and Growth Pact process faces methodological difficulties in respect of *ex-ante* macroeconomic and fiscal projections of structural fiscal balances;

- The process of economic policy co-ordination blurs the boundaries between EU competences and domestic sovereignty, with the risk that policy co-ordination goes beyond clear EU competence;

- There is a tension between the effectiveness of the EU institutions and the need to enhance the accountability and legitimacy of policy decisions taken at the EU level. Some respondents suggested that national parliaments should play a greater role in policy-making while tensions between the Eurogroup and the Economic and Financial Affairs Council (ECOFIN) need to be managed carefully;

- It is particularly important that euro area related policy and integration is compatible with the Single Market, is non-discriminatory, and respects the fundamental freedoms and principles that underpin the whole of the EU. One example where this has not been achieved is the European Central Bank's (ECB) location policy, which requires that the clearing of euro-denominated financial products takes place inside the euro area, risking the fragmentation of the Single Market. This policy is currently the subject of a UK legal challenge;

- The growing prominence and responsibilities of the Eurogroup and the ECB, the growth in size of the euro area, and the implementation of new qualified majority voting rules agreed under the Lisbon Treaty, have increased the collective influence of the euro area and therefore the risks associated with euro area caucusing; and
- There is an increase in the complexity of economic governance in the EU through the use of a range of instruments to bring about reforms. The UK will need to continue to secure important safeguards to protect its interests. The nature of the reform process means there is a need for active UK engagement in all aspects of the EU decision-making process, including shaping the EU agenda through a greater presence in the EU institutions.

Structure of the Report

Chapter One sets out the historical development of economic and monetary policy in the EU. It provides a brief history of the EU Treaties, the legislative process and the historical development of economic and monetary policy in the EU. It looks at how the euro area sovereign debt crisis developed, highlighting that the seeds were sown in the years leading up to the crisis, reflecting weaknesses in the initial design and institutional structures of economic and monetary union.

Chapter Two focuses on the case for EU economic co-ordination, as well as some of the potential challenges. It highlights the importance of co-ordinating policy at the international level as a means of managing economic spillovers. The case for co-ordination in the euro area is even sharper given the potential for high levels of contagion and the relative lack of policy tools available to Member State governments to deal with shocks, as the ECB has to target price stability for the euro area as a whole. Although greater co-ordination has many potential policy benefits, the deeper the degree of co-ordination, the less economic policy freedom countries have and the less political ownership they have over reforms and policy choices.

Chapter Three provides an overview of the main policy mechanisms in the EU (the Stability and Growth Pact, Europe 2020 and the Macroeconomic Imbalances Procedure, all of which fall under the European Semester) and their objectives. It also provides a brief description of the various financial assistance mechanisms implemented during the crisis. In response to the sovereign debt crisis in the euro area, various measures have been undertaken to strengthen and improve the system of economic governance in the EU and to further euro area economic co-ordination. Measures have focused on the strengthening of fiscal surveillance, placing more emphasis on debt levels and preventive action, imposing minimum standards for national budgetary frameworks as well as setting up new processes, underpinned by sanctions, for detecting imbalances. This chapter contains a summary of the UK opt-outs and, based on the evidence received, assesses the effectiveness of the system for co-ordinating economic and fiscal policy.

Chapter Four considers the effectiveness of the current institutional structure in the EU in respect of economic governance. The current system gives different roles to different institutions. It consists of a high level legislative process, whereby the Commission has the right of initiative to propose economic governance legislation which is considered by the Council, with some matters decided by co-decision with the European Parliament and some by consultation. Respondents agreed that while the respective roles of these institutions are broadly appropriate there are areas for improvement. Respondents argued that if more power were given to the Commission and less to the Council, it would raise issues of accountability and national ownership that would need to be overcome.

Chapter Five provides an overview of likely future developments in respect of EU economic co-ordination. It considers future challenges relating to EU competences, in light of the concerns raised in the evidence submitted. It also highlights that there are tensions between euro area Member States, including on the implementation of the existing economic governance framework, the trade-offs between economic effectiveness and sovereignty, and the choice between co-ordination and adopting harmonised policies. It sets out the further integration foreseen in a range of areas, including economic, fiscal, financial and potentially political. Finally, it sets out the possible areas of concern for the UK in relation to the future development of policy in these areas, including: the growing prominence of the Eurogroup; the growth in size of the euro area; new qualified majority voting rules increasing the collective influence of the euro area; the risks associated with euro area caucusing; and an increase in the complexity of economic governance in the EU through the use of a range of legal instruments to bring about reforms. These challenges will need to be addressed by the EU if it is to continue to ensure that policies in the area of economic and monetary policy work for all Member States, taking account of the interests of those within the euro area and those outside.

Introduction

This report is one of 32 produced as part of the Balance of Competences Review. The Foreign Secretary launched the Review in Parliament on 12 July 2012, taking forward the Coalition commitment to examine the balance of competences between the UK and the European Union. It will provide an analysis of what the UK's membership of the EU means for the UK national interest. It aims to deepen public and Parliamentary understanding of the nature of the UK's membership of the EU and provide a constructive and serious contribution to the national and wider European debate about modernising, reforming and improving the EU in the face of collective challenges. It has not been tasked with producing specific recommendations, looking at alternative models for the UK's overall relationship with the EU, or considering whether UK membership of the EU is in the UK's national interest.

The review is broken down into a series of reports on specific areas of EU competence, spread over four semesters between 2012 and 2014. More information on the review, including the timing of publication of reports, can be found at: www.gov.uk/review-of-the-balance-of-competences.

The Nature of this Report

The analysis in this report is based on evidence gathered following a Call for Evidence from March 2014 to July 2014.[1] It draws on written evidence, notes of discussions, and existing material brought to our attention by interested parties, such as reports by Parliamentary Select Committees or the European Commission.

There were 18 submissions of written evidence by individuals and organisations, while five engagement events were conducted – a full list can be found in Annexes A and B and all submissions are published alongside this report. A review of relevant public material, as well as opinions received in the course of regular government business from a range of organisations, people and countries, has also been drawn on. Annex C sets out the references and sources that informed this report.

1 *Review of the Balance of Competences between the United Kingdom and the European Union: Economic and Monetary Policy Call for Evidence* (2014). Evidence and material submitted after the end of the Call for Evidence has, wherever possible, been taken into account.

The Objectives of this Report

A broad definition of competence is used for the purposes of the review. Put simply, competence in this context is about everything deriving from EU law that affects what happens in the UK. That means examining all the areas where the Treaties give the EU competence to act, including the provisions in the EU Treaties giving the EU institutions the power to legislate, adopt non-legislative acts or take any other sort of action. It also means examining areas where the Treaties set out specific rules which are directly binding on Member States without needing any further action by the EU institutions.

Definition of EU Competence

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

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

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

This report focuses on the competences and legislation that affect economic and monetary policy. HM Treasury (HMT) has led on this report as the government department responsible for economic policy within the UK.

Scope of this Report

Some issues associated with economic and monetary policy are considered in other Balance of Competence reports.

The Financial Services and Free Movement of Capital report, published in July 2014, covered banking union.

Chapter 1: Historical Development

1.1 This chapter sets out the historical development of economic and monetary policy and provides a brief historical overview of the EU Treaties and the EU legislative process.

A Brief History of the EU Treaties

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

1.3 The amending Treaties are:

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

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

- The TEU; and
- The Treaty on the Functioning of the European Union (TFEU).[1]

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

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[1] The Treaty of Lisbon amended both the Maastricht Treaty (also known as the TEU) and the Treaty of Rome (henceforth known as the TFEU).

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

EU Legislative Process

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

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

Historical Development of Economic and Monetary Policy

1.9 Economic objectives have been at the heart of the EU's historical development since the creation of the European Coal and Steel Community in 1951 (the forerunner of the EEC). The Treaty of Rome contained the first references to co-ordination of economic and monetary policy. Member States were to regard their macroeconomic policies as a 'matter of common concern', while the Treaty placed a number of constraints on the way Member States should run their balance of payments.

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

1.11 During the decade after the Treaty of Rome, although the European Commission had put forward the idea of a single currency, few concrete moves were made towards deeper economic and monetary co-ordination. That began to change, however, following a series of events which gradually undermined the prevailing international monetary framework, namely the Bretton Woods system, with the US dollar and gold at its centre. In Europe, the resulting market turbulence forced a devaluation of the French franc (after a period of inflation) in August 1969 and shortly afterwards, a revaluation of the German deutschmark, following major capital flight from the US dollar into the deutschmark.

1.12 It was against this background of the rolling disintegration of the Bretton Woods system that the then EU Member States called, at the Hague Summit of 1969, for the 'creation of an Economic and Monetary Union (EMU)' and the 'harmonisation of economic policies'.[2] Some immediate actions followed, such as the creation of automatic and unconditional short-term credits amongst Member State central banks in order to bolster exchange rate parities. But more fundamentally, the Hague Summit led to the establishment of the Werner Committee, under the then Luxembourg Prime Minister Pierre Werner, in order to map out the Community's path to its declared intention of EMU. The Werner Committee reported in 1970, recommending:

- Full currency convertibility with exchange rate parities irrevocably fixed;
- Centralised monetary policy with a single external monetary policy;
- Major aspects of fiscal policy to be co-ordinated at Community level;
- Completion of EMU by 1980, with early steps focused on reducing the margin of exchange rate fluctuation, alongside greater harmonisation of national economic policies; and
- Mechanisms for monetary support over the short-term and for financial aid over the medium-term.[3]

1.13 It was clear from the outset that monetary integration was to be taken in step with wider economic integration, including through the provision of the necessary monetary as well as financial mechanisms. The logic was that greater economic harmonisation should bolster the durability of the monetary arrangements. In addition, on the monetary side, exchange rate fluctuations would be reduced gradually, and within an overall zone of fluctuation against the US dollar. Initially, this objective was pursued via an arrangement that came to be known as 'the snake in the tunnel', created in March 1972.

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

1.15 Instead attention then focused on developing a less ambitious approach, namely exchange rate management through the European Monetary System (EMS), an idea put forward in 1977 by Roy Jenkins, the then President of the European Commission.[4] The EMS, created in March 1979 in a more limited form than that put forward by the Commission, involved a deliberate degree of flexibility, both in terms of the relatively wide bands that were permitted, and through the fact that collectively agreed devaluation and revaluations were permissible within the system. Such valuation changes happened on a number of important occasions, including the major French devaluation of 1983. Initially, a

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2 In 1969, the then EEC consisted of the six founding Member States: France, Italy, Germany, Belgium, The Netherlands, and Luxembourg.

3 The Werner Committee, *Report to the Council and the Commission on the Realisation by Stages of Economic and Monetary Union in the Community* (1970).

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

number of countries opted out of the Exchange Rate Mechanism (ERM) part of the EMS, including the UK. But by 1991, following the UK's entry in 1990, the only Member States to remain outside were Greece and Portugal.

1.16 Meanwhile, the European Council meeting in Hanover in June 1988 set up the Committee for the Study of Economic and Monetary Union, chaired by the then President of the Commission, Jaques Delors, and including all European Community Central Bank Governors. The resulting Delors Report on EMU, submitted in April 1989, set out, like the Werner Report nineteen years earlier, a plan of action to make a full EMU a reality. On the basis of the report, the December 1989 Strasbourg European Council called for an intergovernmental conference which eventually led to the Maastricht Treaty, signed in February 1992. This was the Treaty that laid out the architecture for the euro, and the process for its creation. Amongst other important measures it:

- Established that governments should avoid excessive deficits. A protocol to the Treaty specified the values of deficits and debts that countries should not exceed;
- Established a prohibition on the Union assuming the liabilities of Member States, or of Member States assuming the liabilities of other Member States;
- Abolished remaining capital controls; and
- Created a three stage process that Member States and the Union would have to go through to create (or join) the euro:
  - Membership of the ERM;
  - A period of centralising and building the monetary institutions, including creating the ECB, alongside testing the Member States against entry criteria; and
  - The introduction of the single currency itself.[5]

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

1.18 For the UK, the painful exit from the ERM in September 1992 came on top of an already ambivalent attitude to further economic and monetary integration that had resulted in the negotiation of an opt-out from euro area membership at Maastricht earlier that year. For the other participating countries however, the experience did not stop them, from 1994 onwards, pushing on with the 'second stage' of EMU (primarily focused on institution-building, and on meeting the macroeconomic convergence criteria) as envisaged in the Maastricht Treaty. Eleven countries adopted the euro formally at the start of 1999. Greece

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[5] At Maastricht, the UK secured an opt-out from joining the euro, which is set out in Protocol 15 of the TFEU. See Box 3A for further details of the UK's unique relationship on economic and monetary policy.

joined two years later, one year before euro notes and coins entered circulation. Since then, Slovenia, Cyprus, Malta, Slovakia, Estonia and, most recently, Latvia have also joined, with Lithuania expected to join on 1 January 2015.

1.19 Along with the rules on excessive deficits set out in the Maastricht Treaty, the euro was underpinned by detailed rules on fiscal policy. These were enshrined in EU regulations known as the 'Stability and Growth Pact' (SGP), alongside a degree of closer economic co-ordination, with surveillance of Member States' policies by the Council on the basis of Commission assessments. Additionally, a broader strategy for EU level growth and reform was agreed in the Lisbon Strategy in 2010, which set out a range of reform targets monitored largely through peer review and the open method of co-ordination.[6]

The Euro Area Crisis

1.20 The seeds of the euro area's sovereign debt problems were sown in the years leading up to the crisis, reflecting weaknesses in the initial design and institutional structures of EMU, which were obscured by the relative strength of growth through most of that period. From 1999 onwards, when the ECB began to set a single interest rate for the euro area as a whole, much of the euro area periphery enjoyed low (in some cases negative) real interest rates that fuelled excess demand. Market adjustments to the euro area's single interest rate did not function fully, with markets mispricing the risks attached to sovereign and private sector debt in a number of economies. This led to rapid consumption and credit growth, a build-up in debt, investment in non-productive assets including housing bubbles, and a steady erosion of export competitiveness against euro area partners.

1.21 The euro area sovereign debt crisis was, in many respects, the trigger that exposed and magnified these underlying problems:

- Even before the start of the crisis, trend growth had started falling under strain from adverse demographics, reflected in revisions to the Commission's trend growth projections. As growth weakened in light of the euro area's deleveraging challenge, it became increasingly clear that pre-crisis improvements in the real economy had been driven more by cyclical rather than structural factors than had previously been assumed. Furthermore, the structural fiscal balances of many economies (both within and outside the euro area) were materially weaker. Fiscal consolidation to address past mistakes and ensure that public finances were returned to a sustainable path became essential;

- This consolidation would also prove extremely challenging against a backdrop of deteriorating growth. Countries for which real interest rates had previously been low or negative experienced a rapid reversal, with real rates rising as growth and inflation fell, and the ECB, by definition, unable to respond optimally to economic conditions in every part of the euro area. Debt dynamics worsened markedly;

- In parallel, and as with many countries, banks came under immediate pressure as risks arising from bad debts, weak loan management and housing bubbles, began to materialise. The cost of the financial sector interventions that became necessary, allied with further market concern over the underlying health of many other banks,

[6] The open method of co-ordination is an instrument of the Lisbon Strategy. It provides a framework for co-operation between Member States whereby national policies can be directed towards certain common objectives. The Lisbon Strategy was agreed by the European Council in March 2000 as an economic development plan for the EU from 2000-2010 and was the forerunner of the Europe 2020 strategy. It aimed to deal with issues such as low levels of productivity and economic growth across the EU through close co-operation between the EU and Member States, but the main targets (such as 70 per cent employment rate, and three per cent of Gross Domestic Product (GDP) spent on research and development) were not reached.

represented a second, growing challenge to the public finances in a number of economies. This was true even in countries such as Ireland and Spain where general government debt had previously fallen progressively to very low levels;

- An adverse feedback loop developed between a number of sovereigns and their banking sectors, under which concerns over banking sector fragility and fear that problems had not been fully and transparently identified and addressed fed concerns over each government's ability to deal with pressures it might face. This, in turn, increased market concerns over the strength of the support that might be available to banks;
- These concerns were triggered in earnest in late 2009 when Greece made successive revisions to its 2009 deficit estimates from three per cent of Gross Domestic Product (GDP) to 12.7 per cent of GDP (Greece was subsequently assessed by Eurostat as having engaged in the 'deliberate misreporting of [public finance] figures').[7] For the first time, the Economic and Financial Affairs Council (ECOFIN) reprimanded a Member State (Greece) for policies that threatened the functioning of monetary union.

1.22 Collectively, these factors would represent a challenge to almost any economy. But four factors specific to monetary union lay behind the steady ratcheting of market concerns that led to the most acute phase of the crisis. The first factor was that, until the creation of temporary assistance mechanisms in 2010, and the permanent European Stability Mechanism (ESM) (which entered into force on 8 October 2012), the euro area had lacked any agreed means of providing medium-term financial assistance, by way of loans, to each other. Because of their size, International Monetary Fund (IMF) resources alone were insufficient to insulate euro area economies from market tensions. Furthermore, and as the crisis evolved, the size of the firewall available was arguably never large enough to convince markets that the euro area had the resources at its disposal to deal with the countries that might next come under market scrutiny.[8] Absent such a framework for the resolution of sovereign debt pressures, and with no precedent to draw upon, markets were unsure how and whether the euro area would address emerging pressures.

1.23 The second factor was uncertainty over whether a vulnerable economy would abide by the commitments embodied in the Treaty which referred to the 'irrevocable' fixing of exchange rates in EMU, or might try to negotiate an exit from the euro area. Even the suspicion of the latter would lead to markets seeking a higher reward for the redenomination risk they would bear on loans to any country unable, or unwilling, to make an unambiguous commitment to its future inside EMU.

1.24 The third factor was the absence of an effective and agreed system for addressing cross-border banking risk and resolving banking sector vulnerabilities. A sovereign's capacity to provide recapitalisation finance is limited by the constraints of EMU membership and the bank/sovereign feedback loop. The provision of liquidity support is effectively pooled, and is the responsibility of the Eurosystem (the ECB and national central banks), implying risk would be transferred, in extreme circumstances, to the euro area as a whole. Until the creation of banking union, the euro area lacked the institutional means decisively to break the link between weak banks and weak sovereigns.

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7 European Commission, *Report on Greek Government Deficit and Debt Statistics* (2010).

8 Although, see below on the European Central Bank (ECB), there is a legitimate question over whether it could ever have been large enough.

Table 1.1. The Euro Area Sovereign Debt Crisis: A Timeline

2009	
Oct	Greece announces 2009 budget deficit estimated at 12.7 per cent of GDP. Debt exceeds 120 per cent of GDP.
Dec	European Council agrees the European Economic Recovery Plan, a co-ordinated fiscal stimulus worth 1.5 per cent of EU GDP.
2010	
Mar	Euro area Heads of State/Government state willingness to provide *ultima ratio* financial assistance to Greece, in co-operation with the IMF.
May	Three-year €110bn financial assistance programme for Greece announced, comprising bilateral loans from euro area countries only, plus €30bn from IMF. As part of wider crisis response, euro area countries agree creation of the inter-governmental European Financial Stability Facility (EFSF), worth up to €440bn. EU finance ministers agree creation of the temporary, EU backed European Financial Stabilisation Mechanism (EFSM), worth up to €60bn. In parallel, ECB announces exceptional measures including secondary market sovereign debt purchases under its Securities and Markets Programme.
July	Results of the first EU wide stress test on the European banking sector published by Committee of European Banking Supervisors. The tests estimate that seven banks 'fail' in an adverse scenario, with an overall shortfall of €3.5bn of tier one capital.
Sep	Irish government estimates that interventions necessary to rescue Anglo Irish Bank alone will exceed €30bn.
Oct	EU leaders agree that a permanent financial assistance mechanism for euro area Member States is needed.
Dec	European Systemic Risk Board set up. IMF, EU, euro area and three bilateral lenders (including the UK) agree to provide €67.5bn of financial assistance to Ireland. European Council agrees to two-line Treaty amendment to Article 136 of TFEU, giving an explicit legal basis for the creation of a permanent euro area financial assistance mechanism (the ESM). UK secures commitment that, once the ESM is created, Article 122(2) TFEU should no longer be used for lending to safeguard the financial stability of the euro area as a whole.
2011	
Jan	Three European Supervisory Authorities begin operations: The European Banking Authority (London); The European Insurance and Occupational Pension Authority (Frankfurt); and The European Securities and Markets Authority (Paris).
Mar	Euro area agrees to lower interest rates on their loans to Greece and to increase their maturity to 7.5 years, in exchange for swift completion of €50bn privatisation plan. Euro area leaders agree 'Euro Plus Pact' (later known as the 'Pact for the Euro'), establishing stronger economic policy co-ordination.
May	IMF, EU and euro area agree to provide €78bn of financial assistance to Portugal.
Jul	EBA publishes results of 2011 banking stress tests. Euro area decides on new package of measures: a new assistance package for Greece (initially €109bn), with some private sector involvement; a further lowering of the interest rate on assistance loans and a further lengthening of maturities; and, agreement that EFSF/ESM can lend on a precautionary basis, as well as provide finance for bank recapitalisation through governments.
Aug	Market sentiment deteriorates markedly. Financing conditions facing banks tighten sharply.
Oct	Euro area agrees a further package of measures, focused on Greece and the EFSF. New, larger private sector involvement sought as part of a revised second programme; options for leveraging EFSF finance agreed in order to increase its capacity. Political uncertainty rises in Greece as a referendum on the second programme is offered, then withdrawn.
Nov	Spanish and Italian bond yields reach unprecedented levels. Greek PM resigns, replaced by an interim government under Lucas Papademos. Italian PM Berlusconi resigns, replaced by a technocratic government under Mario Monti. Spanish government loses office in general election.
Dec	'Six-pack' economic governance legislation enters into force.
2012	
Feb	Euro area countries sign the Treaty establishing the European Stability Mechanism (ESM) – the euro area's permanent financial assistance mechanism. Private Sector Involvement offer on Greek debt launched, seeking a 53.3 per cent reduction in nominal value of debt held by private investors.
Mar	Euro area increases size of its rescue funds (ESM plus EFSF) from €500bn to €700bn. 25 EU countries sign new fiscal compact – which requires government budgets to be balanced or in surplus.
Apr	IMF's International Monetary & Financial Committee welcomes euro area decisions on increasing its rescue funds, and notes pledges from its members to increase the IMF's resources of $430bn.
May	Parliamentary elections in Greece result in political impasse. Political uncertainty results in speculation about Greece's position in the euro area.

Jun	New elections in Greece allow New Democracy to form coalition government and recommit to programme. Spain requests financial assistance specifically for banking sector recapitalisation. Cyprus formally requests IMF led financial assistance. Euro area agrees principle of banking union to address the bank/sovereign link. European Council tasks the 'Four Presidents' to develop proposals for Genuine Economic and Monetary Union.
Jul	Euro area grants financial assistance to Spain. ECB President Mario Draghi says that ECB will do 'whatever it takes to preserve the euro', triggering market rally. Euro area bond yields fall. EFSF closed to new financial programmes or new loan facility agreements.
Aug	ECB announces intention to address 'exceptionally high risk premia' attached to sovereign debt due to redenomination fears, and that it may intervene on secondary debt markets.
Sep	ECB announces details of its Outright Monetary Transactions (OMT) programme.[9] Commission unveils proposal for Single Supervisory Mechanism (SSM) for banks. ESM Treaty enters into force upon German ratification.
2013	
Mar	IMF and euro area agree €10bn financial assistance package for Cyprus. Cyprus imposes a 10 per cent levy on deposits over €100,000 in Cypriot banks. Council, Commission and European Parliament agree creation of SSM for euro area.
May	'Two-pack' euro area only economic governance legislation enters into force, strengthening budgetary surveillance.
Jul	EFSF 'may no longer engage in new financing programmes or enter into new loan facility agreements'. Commission proposes Single Resolution Mechanism (SRM) to manage failure of any bank in euro area and other Member States in banking union.
Dec	Ireland and Spain exit their financial assistance programmes. European Parliament adopts Bank Recovery and Resolution Directive (BRRD). It sets new rules for all 28 Member States to relieve taxpayers of costs of bank bail-outs.
2014	
Jun	Portugal exits its financial assistance programme.
Oct	ECB President Draghi notes weak growth momentum, and weak credit growth, in the euro area, along with details of further unconventional policy measures. ECB publishes results of its Comprehensive Assessment: a detailed Asset Quality Review and stress tests completed with the EBA.

Source: HM Treasury compilation from various sources.

1.25 But probably the single most important factor was that the crisis revealed a significant gap in the euro area's macroeconomic policy architecture. There was an absence of a lender of last resort to sovereign governments, which allowed a lack of confidence alone to turn liquidity problems into solvency ones (as explained by De Grauwe).[10] In this context no individual euro area country had the firepower to prevent a self-fulfilling prophecy in which it could be forced by markets, through charging ever higher yields on its debt, towards needing external support. There was, in other words, no circuit breaker to prevent market concern pushing yields up, creating additional financing pressures, in turn further threatening the public finances and feeding further concerns. The ECB's announcement of its Outright Monetary Transactions (OMT) programme in autumn 2012 provided the euro area, for the first time, with such a circuit breaker. This was vital if the euro area was to be able credibly to convince markets that it could address problems in any of the largest Member States, including Italy, were they to emerge.

9 The Outright Monetary Transactions programme under which the ECB makes purchases in secondary, sovereign bond markets, under certain conditions, of bonds issued by euro area Member States.

10 P. De Grauwe,' Governance of a Fragile Eurozone', *CEPS Working Document*, 346, May 2011.

Recovery and Reform

1.26 As illustrated in Table 1.1, over recent years EU leaders and finance ministers have taken various steps to strengthen and improve the system of economic governance underpinning the EU's, and in particular the euro area's, economic co-ordination.

1.27 In response to the onset of the crisis, in March 2010 the European Council set up a Taskforce on Economic Governance to devise proposals for better budgetary discipline and an improved crisis resolution framework. The taskforce was chaired by the then European Council President Herman Van Rompuy and was composed of finance ministers from the then twenty seven Member States. The final report made a number of recommendations for strengthening economic governance in the EU.[11]

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

1.29 Despite these reforms, as the crisis deepened towards the end of 2011, the Commission published two further proposals (the 'two-pack') on economic governance that would apply only to the euro area Member States and which entered into force on 30 May 2013. These regulations introduced additional surveillance and monitoring for the euro area countries and put in place rules to govern the provision of financial assistance to euro area countries. Box 1B provides more detail on the 'six-pack' and the 'two-pack'.

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[11] Task Force to the European Council, *Report on Strengthening Economic Governance in the EU* (2010).

Box 1A: The EU and the International Community

The IMF has a number of important but overlapping roles. Primary amongst them are: expert surveillance of the global economy, both bilaterally via Article IV reports, and multilaterally via flagship publications such as the *World Economic Outlook, Fiscal Monitor, Global Financial Stability Reports* and spillovers reports; and official lending to its members who cannot meet their external balance of payments. Lending is accompanied by detailed surveillance and policy advice in order to restore economic stability. The UK contributes to the IMF's resources via its quota subscription and temporary resources, such as bilateral loans. The IMF draws on the contributions of its membership as a whole in order to finance its lending programmes.

Surveillance or analysis by the IMF often informs the work of the Group of Seven (G7) and the Group of Twenty (G20) on economic issues. There are also long-standing links between the IMF and EU mechanisms to address external imbalances amongst Member States, which have adapted and become stronger during the recent euro area sovereign debt crisis.

The G20 regularly calls upon the IMF as an expert, trusted and independent advisor on economic issues. Under the Australian G20 presidency, members have agreed to 'develop ambitious but realistic policies with the aim to lift our collective GDP by more than two per cent above the trajectory implied by current policies over the coming five years.' Each G20 member has produced a growth strategy, outlining how it will contribute to this target. The IMF was asked, alongside the Organisation for Economic Co-operation and Development (OECD), to help quantify the potential impact, both individually and collectively, of these strategies on growth over the next five years. They will continue to act as an advisory body into 2015, looking at the progress made in implementing the measures put forward by the G20.

Like the IMF, the EU is also able to provide financial assistance to Member States and third countries (non-Member States with whom the EU has close geographic, economic and political ties). These loans are subject to the recipient implementing a structural adjustment programme which aims to address the underlying problems. These assistance mechanisms have generally only been activated alongside financial and technical support from the IMF. During these programmes of assistance, both the IMF and the European Commission conduct regular reviews of the recipient to determine whether the implementation of reforms is satisfactory. In recent years, Commission proposals to provide EU financial assistance have only allowed for the disbursement of EU loans where the recipient has satisfactorily completed its most recent IMF review.

Finally, in order to co-ordinate the response to the euro area sovereign debt crisis, the IMF worked in close co-operation with the European Commission and the ECB. This informal relationship between the three institutions became known as the 'Troika'. The IMF notes that 'co-operation through the Troika is aimed at ensuring maximum coherence and efficiency in staff-level program discussions with governments on the policies that are needed to put their economies back on the path of sustainable economic growth'. However, the decision making processes of these institutions are independent of each other.

Box 1B: Fiscal Co-ordination: the Six-Pack and Two-Pack

In response to the euro area sovereign debt crisis, the EU has enacted a number of measures to strengthen budgetary and economic co-ordination for the EU as a whole and for the euro area in particular. In December 2011, a new set of enhanced economic governance rules, commonly known as the six-pack, entered into force. This contained six pieces of legislation, the main components of which were as follows:

- Strengthening the preventive arm of the SGP, requiring countries to make significant progress towards their Medium Term Budgetary Objectives (MTOs) and introducing expenditure benchmarks;
- Strengthening corrective action under the SGP, meaning an excessive deficit procedure can be launched on the back of debt developments and setting a benchmark for the reduction of debt above the EU's target of 60 per cent GDP;
- Introducing sanctions to the preventive arm of the SGP for the euro area Member States, and new sanctions at an earlier stage of the corrective arm;
- Setting out minimum standards for national budgetary frameworks and, for all but the UK, introducing the need for numerical fiscal rules to be respected in national frameworks;
- Introducing a new Macroeconomic Imbalances Procedure, which extends surveillance to the macroeconomy with the aim of identifying early risks and preventing the emergence of harmful imbalances; and
- Introducing sanctions for euro area countries for failure to adhere to corrective action plans under the MIP.

The six-pack was reinforced for the euro area through the adoption of the two-pack, a set of further economic governance measures which entered into force in May 2013. The main components are as follows:

- The introduction of additional surveillance for the euro area Member States, which must submit draft budgetary plans to the Commission by 15 October each year, set up independent bodies in charge of monitoring national fiscal rules, and base budgetary forecasts on independent macroeconomic forecasts. For those in the Excessive Deficit Procedure (EDP) there will be even tighter monitoring by the Commission; and
- A process for the approval and disbursement of financial assistance for euro area countries and for the monitoring of those in financial difficulty.

1.30 At the same time, in the face of the ongoing crisis, a number of countries decided to go further towards fiscal discipline by signing the intergovernmental Treaty on Stability, Co-ordination and Governance (TSCG).[12] Provisions include the requirement for a balanced budget rule and an increase in the role of independent fiscal bodies.

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

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

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

Chapter 2: The Case for EU Economic Governance

Introduction

2.1 This chapter considers the case for managing economic spillovers internationally, and the particular case for economic governance in the EU. It draws upon evidence submitted in response to the Call for Evidence (see Annex A) as well as reports and literature in the public domain (see Annex C).

2.2 Economic and monetary policy co-ordination at the global level can help to manage the impact of potential spillovers from economic shocks that can be transmitted through a range of channels from one economy to another. The global economy is highly interdependent and the global financial crisis showed how quickly contagion can spread from one economy to another.

2.3 Such spillovers are the main argument for policy co-ordination among countries. However, while global co-ordination mechanisms can play a role in managing these spillovers at international level, a greater degree of co-ordination is needed in the EU given the inter-linkages between Member States.

2.4 Within the EU, the case for deeper co-ordination is even stronger in the euro area. This is because of the potential for high levels of contagion and the lack of some policy tools; with countries sharing one exchange rate, one interest rate and a central bank targeting price stability for the currency area as a whole. Co-ordination can help offset the damaging spillover effects from economic shocks and national policies. The euro area sovereign debt crisis made this particularly apparent and (as detailed in Chapter Three) significant reform has been enacted to strengthen co-ordination in the EU and especially in the euro area.

2.5 Of course, it is important to recognise that the deeper the degree of co-ordination, the less discretion a country has over its economic policy stance and the less political ownership it has of reforms and policy choices. There is also a risk of a 'one size fits all' policy stance that does not appropriately take into account national specificities.

2.6 Most respondents agreed that co-ordination is needed in the EU, that a greater degree of co-ordination is required in the euro area and that an even higher degree of co-ordination than has presently been agreed is needed going forward.[1] They generally argued that it is in the UK's best interests to assist the euro area in strengthening the system. Chapter Five looks at proposals that may come forward in this area.

2.7 Respondents and the UK Government are of the view that the UK has a clear interest in the strength and stability of its biggest trading partners.[2] It is affected by problems in the euro area and therefore has an interest in economic reform in other Member States, and in ensuring the mechanisms of co-ordination and further integration operate successfully.

2.8 The UK also has an interest in sharing its own best practice and allowing scrutiny and peer review of its own policies, while ensuring domestic decisions on economic and fiscal policy are taken by the UK Government.

2.9 As detailed in Chapter Three, although the UK participates in co-ordination mechanisms such as the SGP it is not bound by the coercive elements and has carve outs from many areas (see Box 3A). This reflects the UK's position as a Member State with an opt-out from the commitment to join the euro. The same degree of co-ordination is not needed. So, while the UK participates in the EDP and is the subject of recommendations, these remain precisely that. No evidence suggested that the UK should be the subject of deeper economic co-ordination with the EU. Given its opt-out, some respondents questioned whether the UK needs to participate in these mechanisms at all.[3]

2.10 This chapter considers the reasons for policy co-ordination at international level and explains why policy co-ordination in the EU is particularly important.

The Case for Economic Policy Co-ordination

2.11 As international markets expand through better communication and transport technology, there are opportunities for firms and labour to specialise and increase productivity, so underpinning economic growth and rising living standards. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.

2.12 At the same time, an increasingly integrated global economy means that individual countries are less able to undertake their economic and monetary policy in isolation. Spillovers from policy choices or problems in one country can have a substantial effect on other countries through a range of channels.

2.13 Such spillovers and the associated impacts can be better managed through international co-operation and the co-ordination of economic and monetary policy. For example, the IMF was set up principally to provide short-term support to countries experiencing balance of payments problems, and to prevent spillovers from such problems causing much wider damage, both to that country and its trading partners.

1 *Record of 4 June 2014 stakeholder event* Bruegel; *Record of 25 June 2014 stakeholder event*, Chatham House; Michael Lloyd *submission of evidence;* British Bankers Association, *submission of evidence;* Stephen Pickford and Paola Subacchi, *submission of evidence*; John Springford, *submission of evidence;* CBI, *submission of evidence;* Kern Alexander, *submission of evidence;* IRSG, *submission of evidence*; and Business for Britain, *submission of evidence.*

2 Dermot Hodson, *submission of evidence*.

3 Iain Begg, *submission of evidence;* Paul van den Noord, *submission of evidence*; and *Record of 25 June 2014 stakeholder event*, Chatham House.

2.14 As financial markets have become more global, financial institutions have become involved in much more cross border lending. As demonstrated so clearly over recent years, this means that credit risks from either a banking system's claims on other countries, or a banking system's liabilities to another country, create risks that can result in very substantial negative macroeconomic shocks (Kim and Mita).[4]

2.15 To reduce the likelihood of a repeat of recent problems, new banking regulation has been introduced across the world over the last few years, co-ordinated (see Box 2A) through the G20 and the Financial Stability Board (FSB). It is critically important for such regulatory responses to be global in order to prevent regulatory arbitrage.

2.16 Therefore, whilst competition is an essential force driving innovation and productivity in the global economy, attention needs to be paid to the stability of the overall economy. If a competitive advantage can be achieved by one country (or company) in ways that create negative spillovers for others, or materially reduce international resilience to shocks, then there can be a strong case for an international regulatory response, so that competition can continue within a stable environment.

Spillovers: The Main Reason for Policy Co-ordination

2.17 According to the European Commission 'cross-border spillover effects are the result of a shock in one economy which is transmitted through different channels to (some variables of interest in) another economy'.[5] The Commission argues that spillover effects can be transmitted through four key channels; trade, finance, confidence, and institutional inter-linkages.

2.18 So for example, any shock leading to a change in income in one country is likely to result in a change in demand for imported goods and services, which will result in spillover effects on that country's trading partners. By the same token, a shock affecting a country's competitiveness is likely to change its trade patterns.

2.19 Financial market spillovers can operate through changes in the prices of financial assets, cross-border balance sheet exposures, and information flows. In globally integrated financial markets, changes to prices of a particular asset will generally transmit rapidly to asset prices in other economies. Spillover effects can affect balance sheets in other economies, or generate wealth effects through the direct transmission of loan losses or valuation effects from holdings of foreign assets. Information spillovers affect market participants' expectations of changes in economic fundamentals, and are closely associated with contagion effects.

2.20 In a paper looking at financial spillovers during the recent crises Poirson and Schmittmann tentatively conclude that direct financial spillovers from the euro area sovereign debt crisis transmitted through equity markets are likely to be confined to US banks and financial institutions.[6] However, given the role of the US as a global financial hub, these spillovers could be transmitted indirectly to systemically important banks in other regions.

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4 K. Kim, and S. Mita, 'Real and Financial Linkages from Crossborder Banking Linkages', *IMF Working Papers* Issue WP/14/136 (2014).

5 European Commission, *Cross-Border Spillovers: A Conceptual Framework* (2014).

6 H. Poirson, and J. Schmittmann, 'Risk Exposures and Financial Spillovers in Tranquil and Crisis Times: Bank-Level Evidence', *IMF Working Papers*, Issue WP/13/1 (2013).

2.21 Poirson and Schmittmann further argue that the confidence channel is of greatest importance between countries with close trade and financial links.[7] It involves the direct transmission of changes in consumer and business sentiment in one country to confidence in another, so affecting consumption and investment decisions. Shocks can also be transmitted through the sharing of common institutions or through common policy frameworks.

2.22 The size and sign of cross-border spillovers will depend specifically on the nature of the original shock, the transmission channels, and specific mitigating and amplifying factors in the originating and affected countries. Demand shocks tend to produce more tangible spillovers, as the transmission channels tend to go in the same direction. [8] Spillovers from supply side shocks tend to be more ambiguous, as the transmission channels tend to offset each other.[9] The Commission argues that if 'cross-border spillovers take the form of externalities due to market, policy, or institutional inefficiencies, there is a case for policy co-ordination'.[10]

2.23 Looking ahead, the IMF's 2014 Spillover Report recently identified spillovers which can be expected from 'normalisation', in particular the return to 'normal' interest rates in some advanced economies.[11] A key factor at play is the different pace of recovery in the UK and US compared to the euro area. The unwinding of exceptional monetary policy measures and higher interest rates in those economies recovering the fastest are likely to have spillover effects on countries that are at different stages in the recovery process. Furthermore, slower growth in emerging markets is likely to have spillover effects on the rest of the global economy. The report highlights a number of mitigating actions that can be undertaken at national level, but it also advises that national actions may not be sufficient because incentives and trade-offs vary between countries.

2.24 The OECD argues that the payoff from collective action to tackle unsustainable public finances and rebalance global growth through pro-growth structural reform is potentially large.[12] It argues that unless tackled, high government indebtedness can dampen medium-term growth prospects, through higher long-term interest rates and risks to future stability. The OECD paper further argues that through a combination of fiscal consolidation and structural reforms, a sustained reduction in global imbalances could be achieved.[13] In this scenario output is higher, due to lower long-term interest rates and the removal of distortions that constrain consumption and investment in surplus countries and savings in deficit countries.

7 Poirson and Schmittmann, 'Risk Exposures and Financial Spillovers in Tranquil and Crisis Times: Bank-Level Evidence' (2013).

8 Examples of demand shocks include, changes in savings rates, investment shocks, the bursting of real estate and stock market bubbles, and shocks to consumer or investor confidence. Demand shocks mainly operate via the trade channel, with demand and competitiveness effects reinforcing each other. Positive demand shocks typically have positive demand and competitiveness effects on foreign economies. Shocks affecting consumer and investor confidence can directly affect sentiment abroad via the confidence channel.

9 Examples of supply shocks include shocks to trade and financial partners in the tradable and non-tradable sector, wage shocks, and price shocks. Supply shocks are typically generated internationally via the trade channel, with spillovers which are likely to be the outcome of counterbalancing demand and competitiveness effects. A positive supply shock is expected to increase demand for goods produced abroad but also to exert a negative competitiveness effect on exports of competing countries.

10 European Commission, *Cross-Border Spillovers: A Conceptual Framework* (2014).

11 IMF, Multilateral Policy Issues, *Spillover Report* (2014).

12 OECD, *Making Global Policy Co-ordination Happen* (2010).

13 Idem.

2.25 Reflecting on the greater support for more international policy co-ordination, Bayoumi and Pickford argue that whilst there was a boost to economic co-operation at the height of the crisis, enthusiasm has waned as the crisis has abated.[14] They argue that the costs of not cooperating can be substantial if trust is lost between governments and that when economies are under severe pressure the potential for international spillovers is amplified and the gains from international co-operation are substantial. They agree with Blanchard et al that failure to agree on the size (or even direction) of spillovers is a major impediment to further policy co-operation, and that more work is needed to build greater common understanding of these effects.[15]

The Crisis, Co-ordination and the G20

2.26 The global financial crisis showed that there can be macroeconomic instability even when inflation is low and stable, and that low inflation limits the scope of monetary policy in deflationary recessions due to the lower bound of policy rates.[16] In addition, when countries are faced with spillovers from problems in other economies, policy makers may not have a sufficient number of policy instruments to address the spillovers as well as domestic challenges. For this reason there may be a case for greater international co-operation to minimise the impact of spillovers. Many, such as Frieden and Eichengreen, argue that governments needed to consider carefully the international spillovers of their domestic policies and to improve international co-operation.[17]

Box 2A: International Economic Co-ordination in Action

During the recent crisis, the international community took unprecedented steps to support financial stability and strong, sustainable and balanced global growth. The G20 and IMF acted as key forums in which to design, co-ordinate and implement economic measures that significantly expanded the global financial safety net and thereby bolstered markets' confidence.

At the meeting of G20 leaders in November 2008, members set out a commitment to enhance G20 co-operation to work together to restore global growth, avoid negative spillovers, achieve needed reforms in the world's financial systems and support emerging market economies and developing countries.

In 2009, the G20 established a Framework for Strong, Sustainable and Balanced Growth as a compact that commits G20 countries to work together to assess how domestic policies fit together, to evaluate whether they are collectively consistent with more sustainable and balanced growth, and to act as necessary to meet common G20 objectives. Further in 2009, the G20 established the FSB with a mandate to promote financial stability, recognising that intensified international co-operation among regulators and strengthening of international standards, where needed, and their consistent implementation was necessary to protect against adverse cross-border, regional and global developments affecting international financial stability.

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14 T. Bayoumi, and S. Pickford, 'Is International Economic Policy Dead', *Chatham House* (2014).

15 O.Blanchard, J. D. Ostry, and A.R. Ghosh, 'Overcoming the Obstacles to International Macro Policy Co-ordination is Hard', *Vox EU* (2013).

16 O. Blanchard, G. Dell'Ariccia, and P. Mauro, 'Rethinking Macro Policy,' *Vox EU* (2010).

17 J. A. Frieden, ' Avoiding the Worst: International Economic Co-operation and Domestic Policies', *Vox EU* (2009). Also, B. Eichengreen, 'The Content of Co-ordination,' *Vox EU* (2008).

At the April 2009 G20 summit held in London, world leaders pledged to support growth in emerging markets and developing countries by raising the IMF's lending resources to $750 billion. They also supported a general allocation of the IMF's Special Drawing Rights, which are an international reserve asset, equivalent to $250 billion in order to boost global liquidity. In 2010, the IMF then committed to double its quota-based resources to just over $715 billion at current exchange rates, while its temporary resources grew to include New Arrangements to Borrow (NAB) worth about $575 billion and bilateral loans totalling $461 billion.

The IMF also plays a crucial role in surveillance of the global economy and international monetary system, including joint Early Warning Exercises with the Financial Stability Board to spot emerging imbalances and systemic risks. In 2011, the IMF agreed an action plan to sharpen its surveillance of interconnectedness, risk assessments, financial stability, and balance of payments stability. Furthermore, its Integrated Surveillance Decision in 2012 clarified the importance of focusing on global economic and financial stability in the context of multilateral surveillance, and made Article IV consultations a vehicle not only for bilateral but also multilateral surveillance, thereby allowing the IMF to discuss the full range of spillovers from a member's policies that might affect global stability.

2.27 Some of the earlier work on macroeconomic policy co-ordination suggested international discussion forums such as the G7 or the OECD as the best place to discuss policy co-ordination. In fact, when the global financial crisis hit, the G20 replaced the G7 as the primary steering group for the world economy.[18] Pisani-Ferry argues that the G20 is a less suitable forum for the discussion of regulatory matters, as opposed to macroeconomic issues and their implications for the institutions of global governance.[19] The regulatory issues, mainly the responsibility of a small number of countries with sophisticated financial systems, may overshadow the macroeconomic dimension of the global agenda.

2.28 For Subacchi and Pickford the challenge for international policy-making involves managing a world economy with deep interdependencies and high potential for spillovers, whilst accommodating rising economic powers.[20] They highlight that although an internationally integrated economy generates benefits, it also increases countries' exposure to shocks from other countries. They argue that it is in all countries' national interest to manage the pressures in the system through a framework for multilateral policy co-operation. The alternative, they argue (ignoring external spillovers from domestic economic policy), would lead to international instability, and increased national exposure to high-impact shocks.

2.29 Whilst the benefits of economic policy co-ordination may be reduced spillover effects, agreeing to a set of global commitments to limit spillovers can involve costs if domestic policy makers lose domestic economic policy flexibility. This is certainly true in a euro area context, and is a recurring theme in the rest of this report.

[18] B. Eichengreen, *The G20 and the Crisis* (2009).

[19] J. Pisani-Ferry, 'International Governance-is the G20 the Right Forum?' *Bruegel Policy Contribution* (2009)

[20] P. Subacchi, and S. Pickford, 'Legitimacy vs Effectiveness for the G20: A Dynamic Approach to Global Economic Governance', *Chatham House* (2011).

Co-ordination at the EU Level

2.30 The EU's Single Market is built on a customs union with a common external tariff, and the free movement of the factors of production. It also involves the agreement of common product regulations. It is the world's largest single market, with a GDP of around £10.5 trillion and 500 million consumers.[21] It generates a range of benefits for participating economies, not least of which are lower consumer prices, an expansion in employment opportunities and increased national income.

2.31 The Commission estimates that the Single Market has increased EU GDP by between 4.8 per cent and 5.7 per cent since 1987.[22] Furthermore, EU countries currently trade twice as much with each other as they would do in the absence of the Single Market. As a result, the Single Market may be responsible for income gains in the UK of between two per cent and six per cent, equivalent to between £1,100 and £3,300 a year per British household.[23]

2.32 As a result, there is a greater degree of economic integration between EU Member States compared to the extent of integration across the G20 or OECD, for example. This sharpens the risks around spillovers, and the case for economic co-ordination.

2.33 EMU represents a major further step in the integration of EU economies, with the Member States concerned adopting a common currency and a common monetary policy. This section starts with a discussion of the economic rationale for a single currency, covering potential benefits as well as conditions necessary for those benefits to be realised. It then considers the case for co-ordination within the euro area.

The Economic Rationale for a Single Currency

2.34 Aside from any political imperatives, countries establishing a common currency area would hope to see additional economic benefits, such as:

- The elimination of transaction costs – a single currency reduces the transaction costs involved in changing currencies and benefits firms trading within a single currency area as well as tourists;
- The elimination of exchange rate uncertainty – volatile swings in exchange rates give rise to uncertainties for businesses as they can affect the price received for exports or the price paid for imports. Businesses can to some extent mitigate these risks through insurance, but only at a cost;
- The promotion of investment – greater inward investment from firms outside the single currency area could be expected as they are able to take advantage of lower transaction costs and lower exchange rate risks within the currency area;
- Reduced borrowing costs for countries with a history of high inflation and currency devaluation – it can be argued that such countries can import credibility by tying themselves to the monetary policy of others;
- Increased scope for the comparison of prices and associated competition benefits – it is easier to compare prices across different countries, and this should generate a more efficient allocation of resources; and

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[21] Eurostat, *Basic Figures on the EU* (summer, 2013).

[22] European Commission, 'Quantifying the Potential Macroeconomic Impact of the Single Market', *Note for the LIME Working Group* (2010).

[23] Departments for Business, Innovation and Skills, 'The UK and the Single Market' *Trade and Investment Analytical Papers* (2011).

- Increased mobility of capital and integration of financial markets with reduced costs of trading in bonds, equity and other assets.

2.35 When joining a single currency, countries commit to the same interest rate as all other members of the common currency area, and lose any discretion to use monetary policy and exchange rate policy in ways that are tailored to suit national circumstances. From the perspective of managing risks from potential economic spillovers this is helpful in so far as two (related) channels for the transmission of spillovers between members of the common currency area are removed.

2.36 However, it is the very flexibility to manage, *inter alia*, interest rates and exchange rates in ways that suit national circumstances that can alleviate pressures that might otherwise build. Absent those flexibilities, interest rates (and the associated exchange rates) that are set for the common currency area as a whole, could either be too high, or too low for any specific country. This need not be a significant issue if the countries that make up the common currency area are structurally similar and have flexible, well-integrated labour, product and capital markets. But if such conditions do not exist, as we have seen in the euro area over recent years, this can cause much more serious problems. The risk of negative spillovers may initially be lower. But deferral can allow economic imbalances to grow in ways that ultimately give rise to much bigger and more serious spillover risks, both within and without the common currency area.

2.37 Indeed, Stephen Pickford and Paola Subacchi argued that the experience in recent years has shown that big trade imbalances can emerge in the EU and within the euro area.[24] Such pressures led to disagreements, for example, about the right degree of fiscal retrenchment, the appropriate conditions for financial support and the economic governance arrangements within the euro area.

2.38 John Springford argued that the history and theory of common currency areas suggest that most do not survive in the long run without common instruments, such as debt mutualisation or a common budget, to prevent recessions from spiralling out of control (given that Member States do not have independent monetary policies).[25]

2.39 More fundamentally, under intense pressure, and as demonstrated during the recent euro area sovereign debt crisis, markets can start to ask questions about the commitment of countries to remain in the common currency area. For a common currency to survive, a clear and irrevocable commitment that the single currency will be maintained is needed.

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[24] Stephen Pickford and Paola Subacchi, *submission of evidence*.

[25] John Springford, *submission of evidence.* There is already a common budget, but its purpose (and its funding) is EU wide. See HMG, *Review of the Balance of Competences between the United Kingdom and the European Union: EU Budget* (2014).

Convergence

2.40 For a single interest rate to be appropriate across the whole of a common currency area, the economies of member countries need to be similar in the way that they develop (convergence). But it is not just a case of having a broadly similar structure at a high level of aggregation. Economies are regularly subject to a range of both positive shocks (such as technology advances) and negative shocks (such as shifts in consumer demand). So it matters whether different parts of the common currency area are prone to different sorts of shocks, and whether they respond similarly to common shocks. If there is insufficient convergence, any individual country may:

- Experience different shocks from the rest of the area;
- React differently to common shocks affecting the area; and
- Respond differently to changes in monetary policy.

2.41 The structure of an economy can vary in a range of ways. Examples include the sectoral composition of an economy, trade patterns, the structure of housing markets, and investment linkages. All of these factors will affect the way that movements in interest rates, or any other aspect of monetary policy, will affect the real economy. So structure matters. But so too does the flexibility of markets in the face of economic shocks.

Flexibility

2.42 Flexibility is about the capacity of an economy to adjust in the face of changing circumstances in general, and economic shocks in particular. Flexible land, labour, capital and product markets are important underpinnings of an efficient, productive economy irrespective of whether the country concerned is a member of a common currency area. But inside a common currency area they take on additional significance, because of the loss of two important mechanisms that would otherwise play a fundamental role in a process of economic adjustment. Countries in a common currency area do not have the benefit of an interest rate set to suit domestic circumstances and nominal exchange rate flexibility. The greater the degree of market flexibility, the quicker the reallocation of economic resources, and the lower the costs incurred (such as lost output and employment) whilst adjusting to any given shock.

2.43 Adjustment at the level of individuals could mean accepting a low pay increase, or even a pay cut, moving in to a different job or changing firm or location. Firms may adjust by changing their prices or the pattern of their output.

The Case for Co-operation within the Single Currency

2.44 The case for economic and monetary co-ordination is even stronger in the euro area than the rest of the EU. Economic policy spillovers in a single currency are different from those discussed in the first part of this chapter, as members share the same interest rates and exchange rates. This section discusses the case for co-ordination of fiscal policy, structural reform policy, and financial regulation and supervision. It also looks at the importance of having a lender of last resort.

Fiscal Policy Co-ordination within a Common Currency Area

2.45 In the absence of national discretion over monetary policy and exchange rates, greater weight falls on fiscal policy to address asymmetric shocks. However, fiscal policy in one country can cause spillovers in other countries in a common currency area. Smaller and more open economies are most vulnerable to such spillovers.

2.46 As explained by European Commission, fiscal spillovers can also arise from a so-called 'deficit bias' whereby each member of a monetary union has an incentive to run higher deficits than they would with flexible exchange rates. [26] This bias can result in higher interest rates and lower economic growth for all countries in the monetary union. The deficit bias arises as higher debt levels in one country in a monetary union do not translate into higher interest rates for that individual country in the same way as they do outside a currency union. Instead, the increase in rates is, at least to an extent, spread across all countries. This effect would be even larger if markets believed that any country facing financial difficulties within the single currency would ultimately be bailed out. Put another way, a relatively lax fiscal stance in some countries will, all else held equal, result in higher interest rates for all countries in a currency area, even for those countries whose fiscal stance would otherwise be consistent with lower interest rates.

2.47 In other words, fiscal policy in one country can cause negative externalities for other countries in the currency area. This is why some of the earliest economic governance in the euro area related to the size of Member State fiscal deficits and debt to GDP ratios. But there are also trade-offs between having robust fiscal rules and allowing fiscal policy to act as a shock absorber.

The Case for Structural Policy Co-ordination

2.48 There are also structural policy spillovers in a common currency area, making the case for structural policy co-ordination. As already noted, flexible land, labour, capital and product markets are important for improving the adjustment capacity of countries to asymmetric shocks. The absolute degree of flexibility matters, but in a common currency area the flexibility in one country relative to the flexibility of the rest of the member countries also matters. So, for example, if prices are flexible in one country, but inflexible elsewhere in the common currency area, the advantage to the country in question may be partially offset. The central bank for the currency area would have to take account of sluggish price adjustments in the currency area as a whole. As a result, interest rates in the currency area would not be appropriate for the country with relatively flexible markets and prices. Co-ordination within a single currency could help decrease these types of problems.

2.49 As Professor Andrew Hughes Hallett notes:

> 'Put simply, rigidities in one place spill over to constrain the performance of others. Hence asymmetries in the capacity of labour markets to adjust, asymmetric shocks, or asymmetric transmissions, all cause spillovers which damage others (unless price flexibility is perfect)'. [27]

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[26] European Commission, *EMU@10: Successes and Challenges after 10 Years of Economic and Monetary Union* (2008).

[27] Cited in HM Treasury, *UK Membership of the Single Currency: An Assessment of the Five Economic Tests* (2003).

2.50 Structural policies can also have more direct spillover effects. As the European Commission explains, any labour market policy which affects wages, or any tax reform package which impacts on the price of tradable good and services, affects the relative competitiveness positions of different countries.[28] For example, a country would improve its competitiveness position if it undertook reforms which put downwards pressure on labour costs and decreased the price of exports. At the same time, however, this would have a negative impact on the trade balance of partner countries. In the absence of any co-ordination, this could ultimately lead to 'beggar-thy-neighbour' policies. Co-ordination on structural policies could serve to contain any such behaviour.[29]

2.51 In the euro area, the Treaties only constrain national policy-makers on structural reform by saying that they should be conducted in accordance with 'the principle of open market economy with free competition' and considered as matters of 'common concern'.[30] And even though the institutional set-up for the co-ordination of structural policies has evolved over time, it is still more limited than arrangements related to fiscal policies. This may be because spillovers from structural policies are considered less important than those arising from deficits.[31]

Co-operation in Financial Regulation and Supervision

2.52 Well-functioning capital markets play a range of important roles, including ensuring that capital is allocated to its most productive use and offering a range of funding options for individuals and firms looking to invest in expansion or a start-up. Such markets also facilitate the sharing and management of risks. For example, they can help households smooth or stabilise consumption in the face of shocks, such as temporary unemployment or ill-health.

2.53 The institutional arrangements underpinning financial markets in a common currency area are among the most important. As Carney explains these include:

- Common supervisory standards;
- Access to central bank liquidity and lender of last resort facilities;
- Common resolution mechanisms; and
- A credible deposit guarantee scheme.[32]

2.54 Otherwise, *in extremis*, cross-border capital flows may be inhibited, with financial markets effectively nationalised. In practice, one unit of currency in a bank account in one country would be effectively worth less, because of the risk of uncompensated bank collapse, than the same unit of currency in a bank in another part of the currency area. Needless to say, this undermines the transmission of monetary policy across the common currency area. Furthermore, of course, both the efficient allocation of capital and adjustments in the face of economic shocks will be severely hampered.[33]

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28 European Commission, *EMU@10: Successes and Challenges after 10 Years of Economic and Monetary Union* (2008).

29 Idem.

30 Article 121 in the Treaty of the European Union, as amended by the Lisbon Treaty.

31 European Commission, *EMU@10: Successes and Challenges after 10 Years of Economic and Monetary Union* (2008).

32 M. Carney, 'Economics of Currency Union,' *Speech at the Scottish Council for Development and Industry, Edinburgh* (29 January 2014).

33 See also, for example, M. Draghi, *Speech by President of the ECB, Memorial Lecture in Honour of Tommaso Padoa-Schioppa,* London (9 July 2014).

A Lender of Last Resort

2.55 In addition to policy co-ordination in different areas, there is a strong case for having a lender of last resort in any currency area.

2.56 Within a currency union, governments issue debt in a currency for which they do not control the fiat. This means that governments cannot guarantee bondholders that they will always have the necessary liquidity to pay off the bond at maturity. In contrast, countries outside currency unions can provide such guarantees. And with the government providing an implicit guarantee, the central bank can act as a lender of last resort in the government bond market.

2.57 In the absence of such a guarantee, sovereign bond markets in a common currency area can become prone to liquidity crises and contagion. As discussed in Chapter One, this happened during the euro area sovereign debt crisis where the lack of confidence alone turned liquidity problems into solvency problems. Therefore, to avoid any such risks, there is a strong case for having the central bank of any single currency as a lender of last resort.

Implications

2.58 All of this helps to explain the imperatives, following the euro area sovereign debt crisis, to improve economic governance in a number of key respects, namely fiscal policy co-ordination and banking union. But it also helps to explain why it is imperative to improve the flexibility and efficiency of the land, labour, product and financial markets across the euro area as well as the wider EU.

2.59 It is also the case that such a policy agenda comes at a cost. Effective co-ordination results in a loss of freedom with regard to national level policy-making and can lead to a lack of political ownership of policies.[34] Dermot Hodson argued that there are serious economic risks to imposing one size fits all policies on heterogeneous economies.[35]

2.60 Failure by countries to agree on the size of policy spillovers is a barrier for further co-operation. Stephen Pickford and Paola Subacchi argued that the Council has been ineffective in reaching agreement on the size (and direction) of these spillovers.[36] They cited the example of Germany's reluctance to accept that intra-EU balance of payments surpluses (as well as deficits) are a problem for the EU. Attendees at the Cross Cutting Stakeholder Meeting argued that an ideal system would consist of full co-ordination under a common instrument to treat big spillovers and national discretion for areas that have smaller spillovers.[37] Attendees also argued that there is no economic case for co-ordinating in every area. For example most taxation policies need not be co-ordinated at the EU level.

2.61 John Springford argued that economic prospects in the euro area would improve if it moved towards further fiscal, financial and political integration.[38] An ideal system of co-ordination is one that secures changes in Member States that address spillover effects, where political ownership is improved and with a system that is less bureaucratic and does away with automaticity.[39]

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[34] Sharon Bowles, *submission of evidence.*

[35] Dermot Hodson, *submission of evidence.*

[36] Stephen Pickford and Paola Subacchi, *submission of evidence.*

[37] *Record of the cross-cutting stakeholder meeting,* 27 June 2014.

[38] John Springford, *submission of evidence*.

[39] *Record of the cross-cutting stakeholder event,* 27 June 2014.

Summary

2.62 In summary, there is a strong case for the co-ordination of economic policy to manage economic spillovers. Within the EU, the world's largest single market, large trade flows and other inter-linkages makes this all the more important.

2.63 The nature of economic policy spillovers in a single currency area make the case for deeper co-ordination even stronger. This chapter highlighted the case for co-operation on fiscal policy, structural reform policies, and financial regulation and supervision.

2.64 Of course, it is important to recognise that the deeper the degree of co-ordination, the less discretion a country has over its economic policy stance and the less political ownership it has of reforms and policy choices. This is a theme of the three remaining chapters and is discussed in more detail in Chapter Five. This helps to explain why, for example, co-ordination of structural reform policies has not gone as far as co-ordination of fiscal policies.

2.65 As noted, most respondents argued that an even higher degree of co-ordination than has presently been agreed is needed going forward. They generally argued that it is in the UK's best interests to assist the euro area in strengthening the system.

Chapter 3: EU Economic Governance Mechanisms and their Effectiveness

Introduction

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

3.2 The main Treaty provisions that underpin economic and monetary policy for the EU are contained in Part Three, Title VIII, Economic and Monetary Policy of the TFEU. They are supported by a number of EU regulations and directives which set out more detailed provisions and which include those agreed since the onset of the euro area sovereign debt crisis. More details on the legal framework can be found in Appendix B.

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

- Monetary policy;
- Banking union;
- Economic and fiscal policy; and
- Mechanisms for financial assistance.

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

[1] Article 2(3).

[2] Article 121(1).

[3] Article 119 (3).

Box 3A: The UK Opt-Out

During negotiations over what became the 1992 Maastricht Treaty, the UK secured an opt-out from the commitment to join the euro.

This opt-out, now set out in Protocol 15 to the EU Treaties, is clear that 'the United Kingdom shall not be obliged or committed to adopt the euro without a separate decision to do so by its government and parliament'. Protocol 15 paragraph 1 states that 'unless the United Kingdom notifies the Council that it intends to adopt the euro, it shall be under no obligation to do so'. Meanwhile, paragraph 3 is clear that 'the United Kingdom shall retain its powers in the field of monetary policy according to national law'.

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

In practice, this means:

- First, that the UK retains competence for its own monetary policy, which is decided by the Bank of England and not the ECB;
- Second, that the UK Government has a different legal obligation to all other Member States with regard to the EU's requirements on government deficits. For example, whereas all other Member States 'shall avoid excessive deficits', as set out in Article 126 of the TFEU, the UK shall 'endeavour to avoid an excessive government deficit'. In particular, and importantly, this means that the UK cannot be subject to sanctions under the SGP as the coercive provisions do not apply to the UK;
- Third, that the UK's voting rights are suspended in the areas that do not apply to it because of the opt-out. So the UK does not get to vote on areas of euro area policy, such as decisions on the Excessive Deficit Procedure and the appointment of the President and other members of the Executive Board of the ECB;
- Fourth, that as a result of the opt-out, there are a number of areas of secondary legislation which do not apply to the UK. For example, the 'two-pack' regulations, which were adopted under Article 136 TFEU and involve tighter surveillance over euro area fiscal policy, do not apply to the UK at all. Nor do the new sanctions provisions of the 'six-pack' which were also agreed under Article 136 TFEU. In addition, Articles 5 to 7 of Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, which place an obligation on Member States to have in place domestic numerical rules for meeting their EU fiscal targets, do not apply to the UK. Indeed, Recital 17 of the Directive explains that that the SGP reference values in Protocol 12 to the Treaties 'are not directly binding on the UK'. 'The obligation to have in place numerical fiscal rules that effectively promote compliance with the specific reference values for the excessive deficit, and the related obligation for the multiannual objectives in medium-term budgetary frameworks to be consistent with such rules, should therefore not apply to the United Kingdom';

- Fifth, that despite the above, the UK does participate in the EU mechanisms for surveillance and co-ordination of fiscal and economic policies. For example, the UK participates in the Stability and Growth Pact and the European Semester. However, this is often on different terms to euro area Member States and even some non-euro area Member States, in particular due to the fact that the coercive elements of these procedures do not apply to the UK; and
- Finally, the UK is not a signatory to the TSCG (the 'Fiscal Compact'), the ESM Treaty, or the Single Resolution Fund Treaty. These are all intergovernmental Treaties that apply to the euro area or signatory Member States only.

This different relationship to a number of important EU Treaty rules and pieces of legislation often means the UK takes a different approach towards this area of policy than many other Member States. Further details on legal provisions referred to in this box can be found in Appendix B.

Monetary Policy

Special Position of the United Kingdom

3.5 Article 3 of TFEU states that the Union shall have exclusive competence for monetary policy for the Member States whose currency is the euro. However, when provisions on economic and monetary union were introduced in the Maastricht Treaty, the UK gave notice that it did not intend to participate in full economic and monetary union or the introduction of the euro. Furthermore, the current UK Government, in its Coalition Programme for Government, stated that Britain will not join or prepare to join the euro in this Parliament.[4]

3.6 The UK therefore retains its powers in the field of monetary policy according to national law. As a result, a number of Treaty provisions (notably large parts of Title VIII of the TFEU as well as provisions of the ECB Statute) do not apply to the UK.[5] Protocol 15 to the TFEU specifically sets out where provisions do not apply to the UK, as shown in Appendix C.[6]

Convergence Process

3.7 As noted in Chapter One, the Maastricht Treaty set out the three steps that Member States need to take to join the euro. These include complying with a series of convergence criteria which are set out in Article 140 of the TFEU and can be found in Appendix B.

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

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

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4 The Coalition Government, *Our Programme for Government* (2010).

5 Protocol 4 to the Treaties on the Statute of the European Central Banks and of the European Central Bank.

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

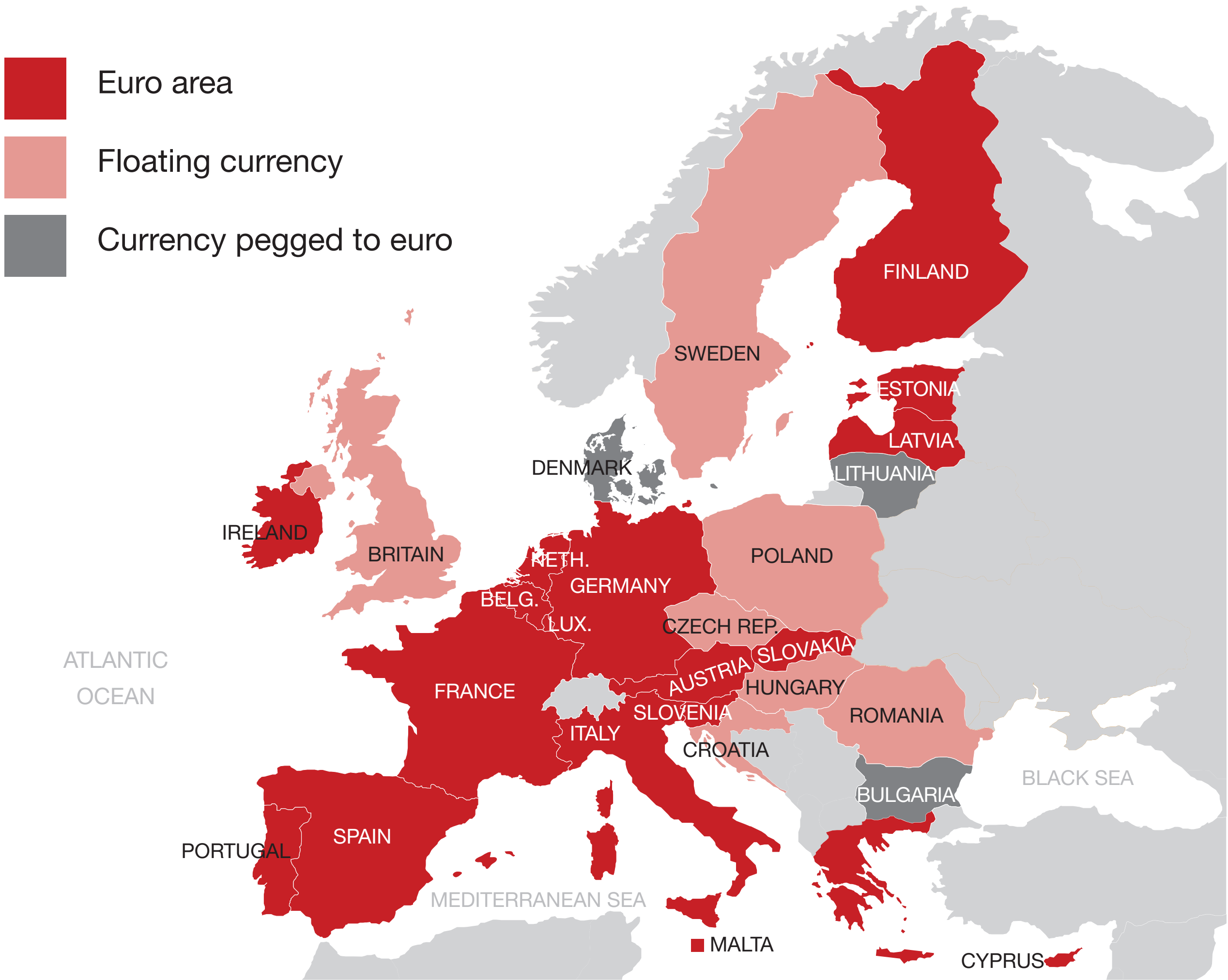
3.10 Member States with a derogation are those in respect of which the Council 'has not decided that they fulfil the necessary conditions for the adoption of the euro'. Technically neither the UK nor Denmark have derogations since they did not agree to join the euro from the outset. However, for many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

3.11 Chart 3A indicates which countries of the European Union are inside the euro area and which are outside of it.

The ECB and the Euro

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

Chart 3A: European Union Countries' Currency Status



Source: The Economist, *Taking Europe's Pulse,* (14 November 2014) available at: http://www.economist.com/blogs/graphicdetail/2014/01/european-economy-guide accessed on 26 November 2014.

3.13 For euro area countries, monetary policy is centrally and independently managed by the ECB whereas the UK's monetary policy is independently set by the Monetary Policy Committee of the Bank of England.

3.14 More detail on the powers and tasks of the ECB and ESCB can be found in Chapter Four and Appendix B. The majority of these provisions do not apply to the UK due to the opt-out.

Banking Union

3.15 Following the recent euro area sovereign debt crisis, there is now agreement that the euro area requires a banking union. This is due to the intimate interconnection between currency stability and the stability of banks within a currency union. Steps have already been taken to establish both a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM) so that failing banks can be restructured, sold off or wound down in an orderly way, with minimal cost to tax payers or the wider economy. The Commission has also envisaged that there will be a third element of banking union; a common system for deposit guarantees.

3.16 Banking union represents a significant change in the level of integration in the euro area. As set out in the Balance of Competences report on Financial Services and the Free Movement of Capital, the Government recognises it is an important development.[7] This is not just because it enhances the economic stability of the euro area but also because it will have potentially profound impacts on non-participating Member States, and the Single Market in financial services more generally. This will be particularly important for the UK given London's role as a global financial centre, the volume of trade between the UK and the euro area, and the degree of integration between the banking systems in the UK and the euro area.

3.17 Improved economic and financial stability in the euro area will benefit the UK economy and the banking sector in particular. Closer integration may also, over time, lead to an increasingly shared view on the future direction of regulatory policy with potential implications for the negotiating dynamics around future Single Market legislation in the banking sector. The Government has been clear that it supports increased integration in the euro area that improves economic stability, but that the UK will not join the banking union. However, given the potential impact on the Single Market and the UK banking sector, the Government has engaged closely with the SSM and the SRM negotiations, as outlined below. It will closely monitor future developments in this area, including the possibility of a single deposit insurance scheme for participants.

3.18 Non-participating Member States, including the UK, have secured a measure of protection against the risk that the members of the banking union ignore the interests of the Single Market. These protections include:

- A prohibition on discrimination by the ECB;
- A requirement by the ECB to enter into a memorandum of understanding with supervisory authorities of non-participating Member States;
- Voting safeguards in the European Banking Authority (EBA) to address the risk that banking union members vote as a bloc; and
- A requirement for EBA members to strive for consensus.

7 HMG, *Review of the Balance of Competences between the United Kingdom and the European Union: The Single Market: Financial Services and Free Movement of Capital* (2014).

3.19 It is possible that over time there will be a divergence of policy interests between participating and non-participating members. Whilst the ultimate impact of banking union is hard to predict at this stage, it will likely affect the UK's relationship with the EU on financial services. This will be especially pertinent if the number of non-participating states falls to four or fewer. At that point, the Commission will review the voting arrangements in the EBA designed to protect the interests of the Single Market (as perceived by non-participating Member States) from those of the euro area. The Balance of Competences report on Financial Services and the Free Movement of Capital sets out in further detail the views from stakeholders on the impact of banking union on the UK's relationship with the EU.

Economic and Fiscal Policy – the European Semester

3.20 The European Semester is the operational framework for the annual EU level cycle for co-ordinating the reporting on, and assessment of, the structural reform and fiscal and economic policies of Member States across the EU. The process was introduced in 2010 as a result of the euro area sovereign debt crisis, in order to ensure better policy co-ordination across Member States. The overarching objective of the European Semester is for the EU to support Member States' reforms to enable sustainable growth and employment. This involves a wide variety of surveillance, reporting and peer review of policies in Member States.

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

- The Stability and Growth Pact (SGP);
- The Europe 2020 Strategy; and
- The Macroeconomic Imbalances Procedure (MIP).

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

3.23 Since its first cycle in 2011, the use of the Semester process has evolved. For instance, the Commission has begun to extend the Semester into areas which are less economically focused, such as the inclusion of auxiliary social indicators in the Alert Mechanism Report 2014 and the introduction of a justice scoreboard. In the view of some, it has strayed into areas that are outside its competence. This raises important questions about the purpose and scope of the Semester that will need to be considered by Member States in the coming months and years. Chart 3B shows the process and timeline of the European Semester.

3.24 Respondents agreed that the European Semester helps Member State governments improve their performance in respect of structural reforms.[8] This mechanism is considered a 'softer' form of policy co-ordination conducted by the authorities of the EU Member States, in areas where they are competent. Although the European Semester is meant to increase national responsibility for action, Ruser argues that this process has resulted in a blurring of European competences and domestic sovereignty.[9] In particular, he argues that an examination of the CSRs from the past two years reveals that policy co-ordination under the new governance framework is far from limited to fields of clear European competence. Ruser further argues that national governments in all Member States are urged to follow policy advice that interferes with national sovereignty in order to demonstrate their solidarity with fellow members of the euro area.[10]

3.25 While the EU2020 strategy relies on peer pressure and consensus building rather than legally binding commitments, the SGP and MIP involve coercive instruments. Dermot Hodson noted that EU policy makers should take care to avoid the impression of bureaucratic overreach in this domain.[11] Inviting the Commissioner for Economic and Monetary Affairs, the Eurogroup President and the ECOFIN President to make routine appearances before national parliaments to explain the rationale for CSRs was regarded by Dermot Hodson as a welcome move.[12]

8 Michael Lloyd, *submission of evidence* and the Welsh Government, *submission of evidence*.

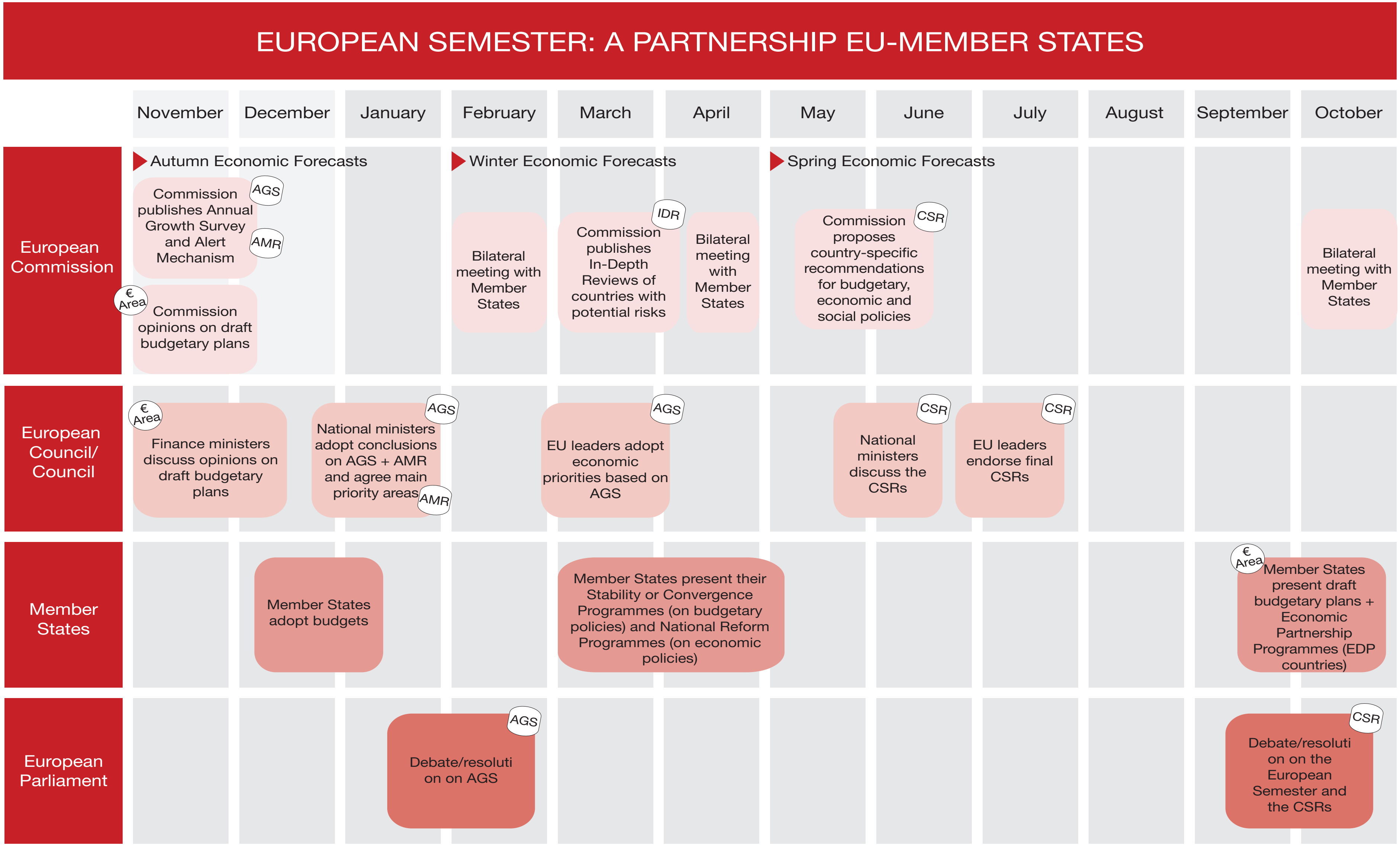
9 A. Ruser, *The EU's Economic Governance is Blurring the Boundaries between European Competences and Domestic Sovereignty* (2014).

10 Idem. This argument was based on the qualitative data analysis the author conducted of the 2012 CSRs.

11 Dermot Hodson, *submission of evidence.*

12 Idem.

Chart 3B: The European Semester



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

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

Box 3B: Key Components of the European Semester

The Annual Growth Survey

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

The National Reform Programme

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

Stability and Convergence Programmes

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

Country Specific Recommendations

CSRs to Member States take account of surveillance under Europe 2020, the SGP and the MIP. They are based on the Europe 2020 Integrated Guidelines, a Treaty-based instrument setting out broad orientations for Member States' economic and employment policies. The Integrated Guidelines were agreed by the European Council in 2010. The Commission may propose CSRs for all Member States apart from those subject to an economic assistance programme. This normally happens at the end of May each year. The CSRs are non-binding recommendations on policies to improve the position of public finances and to boost growth and jobs. In 2014 the UK's CSRs covered a wide range of different policy areas, including fiscal and economic policy, housing, unemployment/skills, access to finance, and infrastructure. Following negotiations on the exact text of the CSRs at both working and Ministerial level, the CSRs are then endorsed by the June European Council meeting. Member States are expected to make use of the CSRs as they plan their reforms for the year ahead.

3.26 A paper by Marzinotto et al looks into the effectiveness and legitimacy of the European Semester, looking at the first full cycle in 2011, and the beginning of the second cycle in 2012.[13] They argue that the legitimacy of the process is most effectively derived from the appropriate participation of democratically elected bodies, such as the European Parliament, or national parliaments. They further argue that economic policy co-ordination in a multi-governance system like the EU is effective only if early, accurate and transparent guidance is given, and if Member States are able to acquire national ownership of the process.

3.27 Dermot Hodson argued that it is beneficial for ECOFIN to comment on euro area Member States' medium-term fiscal plans through the Semester framework, before their presentation to national parliaments.[14] It enables the Commission and ECOFIN to intervene in debates about national and economic policy on expenditure, taxation and economic reform before they are finalised. However, he argued, whether this credibility comes at a cost for the legitimacy of EU economic governance is debatable.

3.28 Marek Dabrowski however was critical of the European Semester. He argued that this mechanism has:

> A limited impact on the real decision making process (determined by national parliaments and national politics) on the national level, although it may create some kind of useful benchmarks for the national debate and limited mechanism of peer pressure on countries which represent the worst performers.[15]

3.29 Marzinotto et al, from their country analysis, find that there is a good level of adaptation to the new reporting requirements imposed by the Semester.[16] They also find that on compliance, countries seem to have a similar approach. They are likely to follow fiscal recommendations, especially if they are in the EDP, but all score low in the implementation of recommendations in policy areas where vested interests tend to be concentrated (such as service market liberalisation). They conclude that the Semester is able to deliver procedural adaptation, but not much yet on actual policy compliance.

3.30 Dermot Hodson argued that:

> In a survey of the European Semester 2013, Claeys et al found that 14 out of the 25 Member States had either failed to consult or failed to report on consultation with national parliaments over stability and convergence programmes. This lack of engagement by and with national parliaments undermines both the credibility and legitimacy of EU economic governance and reduces national ownership over medium-term budgetary plans. This also makes it easier for national governments to deflect criticism from the Commission and ECOFIN by claiming outside interference from Brussels rather than explaining why policy commitments have not been enforced.[17]

3.31 Other respondents, including Kern Alexander, and Michael Lloyd raised concerns over the Semester being overly reliant on structural reforms and being primarily concerned with imposing binding obligations on Member States regarding fiscal consolidation. Less emphasis is placed on achieving economic growth.[18]

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[13] B. Marzinotto, G.B. Wolff, and M. Hallerborg, *An Assessment of the European Semester* (2012).

[14] Dermot Hodson, *submission of evidence.*

[15] Marek Dabrowski, *submission of evidence.*

[16] Marzinotto et al (2012).

[17] Dermot Hodson, *submission of evidence*.

[18] Kern Alexander, *submission of evidence* and Michael Lloyd, *submission of evidence*.

3.32 Although the CSRs highlight factors that constrain growth such as non-competitiveness and restrictive practises, Iain Begg and delegates at the 19 June Prague event argued that these recommendations are too short-term in focus to have any policy relevance.[19] Sharon Bowles suggested that on average only 10 per cent of the recommendations from the Council have been fully implemented by Member States.[20] This figure is derived from a study carried out by the European Parliament Secretariat which involves a somewhat simplistic 'traffic light' system for determining full, partial or incomplete implementation of CSRs. The Government's view is that the 10 per cent figure should be treated with a degree of caution. Separately, the Welsh Government argued that there are potential risks from the Commission proposing CSRs for budgetary, economic and social policies on the basis of economic forecasts, given that the recent performance of most economic models has been widely regarded as poor.[21]

3.33 Darvas and Vihriala argue that whilst the 2013 recommendations recognise a number of fiscal and macro-structural challenges they do not go far enough in exploiting the policy options offered by the European economic governance framework.[22] The recommendations are most comprehensive when they deal with structural reforms, and they emphasise the potential growth that could be generated by opening domestic markets to competition, particularly in the service sectors. However, for macroeconomic policies, certain recommendations are made for the euro area as a whole, but then these proposals are not properly reflected in the CSRs, making it unclear who will implement them.

3.34 To improve the effectiveness of the Semester Marzinotto et al argue that greater focus should be placed on countries with more significant problems, and countries with significant spillover effects.[23] In addition they call for CSRs directed at euro area Member States to explicitly link to spillovers in the euro area.

The Stability and Growth Pact

3.35 The SGP provides the framework for the co-ordination of national fiscal policies across the EU. It aims to ensure that Member States pursue sound government finances. The SGP has been significantly strengthened in recent years. It serves as the basis of EU fiscal surveillance and consists of:

- Numerical rules to ensure sound budgetary planning;
- Procedural rules which are followed when the numerical thresholds are breached; and
- Institutional arrangements to co-ordinate budgetary policies.

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

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[19] Iain Begg, *submission of evidence*. Also, *Record of 19 June 2014 stakeholder event*, Ambassador's Residence, Prague.

[20] Sharon Bowles, *submission of evidence.*

[21] Welsh Government, *submission of evidence.*

[22] Z. Darvas, and E. Vihriala, *Does the European Semester Deliver the Right Policy Advice* (2013).

[23] Marzinotto et al (2012).

3.37 The preventive arm requires Member States to be on track to achieve their Medium Term Budgetary Objectives (MTOs). The corrective arm consists of the EDP, under which Member States receive recommendations and regular assessment when they breach the deficit or debt targets. These are further explained in Appendix B. Charts 3C and 3D illustrate the preventive and corrective arm processes.

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

3.39 Although the UK is subject to the SGP, it has a unique position with regards to any excessive deficit it might incur. Whereas other Member States 'shall avoid excessive government deficits', the UK must undertake only to 'endeavour to avoid' an excessive deficit.[24]

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

3.41 In the context of the euro area sovereign debt crisis and the need to get debt and deficits on a sustainable footing, the appropriate approach to fiscal policy co-ordination in the EU, including the application of the SGP by the Commission and Council has been the subject of repeated and often contentious debate. In particular there has been, and remains, a significant debate amongst external commentators and policy makers about whether the EU's fiscal framework supports growth or has a structural bias towards austerity. This debate is likely to continue given the significant amount of fiscal consolidation still required in many Member States.

3.42 A number of respondents considered the SGP to be, for the most part, an effective fiscal framework for delivering sustainable economic growth across the EU.[25] However, while no respondents questioned the existence or necessity of the SGP, some, including Michael Lloyd, the Welsh Government, and Marek Dabrowski, raised issues relating to its effectiveness as an instrument of fiscal co-ordination.[26]

3.43 First, some respondents raised concerns regarding its fiscal targets.[27] They argued that although the three per cent deficit/GDP and 60 per cent debt/GDP targets are useful guidance parameters they have no actual validity as specific budgetary limits and do not allow for fiscal policy flexibility to take account of national circumstances. Some argued that these targets may not fully take account of the shift in debt levels following the euro area sovereign debt crisis and current low growth rates in many countries.[28] Furthermore

[24] Protocol 15, Article 139 of the TFEU.

[25] Scottish Government, *submission of evidence;* Welsh Government, *submission of evidence;* and CBI, *submission of evidence.*

[26] Michael Lloyd, *submission of evidence;* Welsh Government, *submission of evidence;* and Marek Dabrowski, *submission of evidence*.

[27] Michael Lloyd, *submission of evidence* and Welsh Government, *submission of evidence*.

[28] Marek Dabrowski, *submission of evidence;* Iain Begg, *submission of evidence;* and Welsh Government, *submission of evidence.*

they argued that in some cases it has appeared that stability has outweighed growth as the guiding principle, with rules that might be too stringent. Creel at al argue that the new debt reduction rules would certainly lead to lower debt levels, and larger room for manoeuvre in the future, but in contrast to the golden rules on public finance, they would be very costly to implement.[29] This is because the requirement to enforce a substantial consolidation in the short run would be considerably more burdensome than meeting a golden rule, and would worsen the output gap and the inflation rate.

3.44 Second, the Welsh Government raised the issue of the exclusion of some liabilities and obligations from the SGP's targets, including those relating to public sector pay-as-you-go pensions schemes, state pension schemes, private finance initiative schemes, contingencies, provisions and guarantees.[30]

3.45 Third, respondents, including Marek Dabrowski, noted that the SGP process faces methodological difficulties in using ex-ante macroeconomic and fiscal projections to estimate structural fiscal balances. He argued that:

> Governments of Member States (especially those being the subject of EDP) have the incentive to present the European Commission with projections based on over-optimistic assumptions.[31]

3.46 Fourth, there have been some questions over implementation. Marek Dabrowski saw lack of implementation as a result of the reluctance to apply peer pressure or sanctions on others given that a large number of Member States face (or may face) similar financial pressures.[32] Others highlighted the tension between implementation being led by national parliaments or EU institutions.[33] They suggested that one option was to implement the SGP via a network of fiscal councils, with an EU fiscal council, where national and EU bodies work together forming a network, working for the common interest like the ECB.

3.47 Stephen Pickford and Paola Subacchi argued that it is far from clear that the reforms have had a marked impact on fiscal outcomes.[34] They cited the example of the report on draft budgets for 2014 which found that the budgets for five countries (Spain, Italy, Malta, Luxembourg and Finland) were at risk of failing to comply with the provisions in the SGP. They argued that to date (although it is too early to see the full effects) these strengthened provisions have been unsuccessful in preventing and correcting excessive deficits. Rather, the pressures on countries to reduce their fiscal deficits stem from the terms attached to financial assistance programmes administered by the Commission, ECB and the IMF.

[29] J. Creel, P. Hubert, and F. Saraceno, 'The European Fiscal Compact: A Counterfactual Assessment' *Journal or European integration* 27(4) (2012), p. 537-563.

[30] Welsh Government, *submission of evidence*.

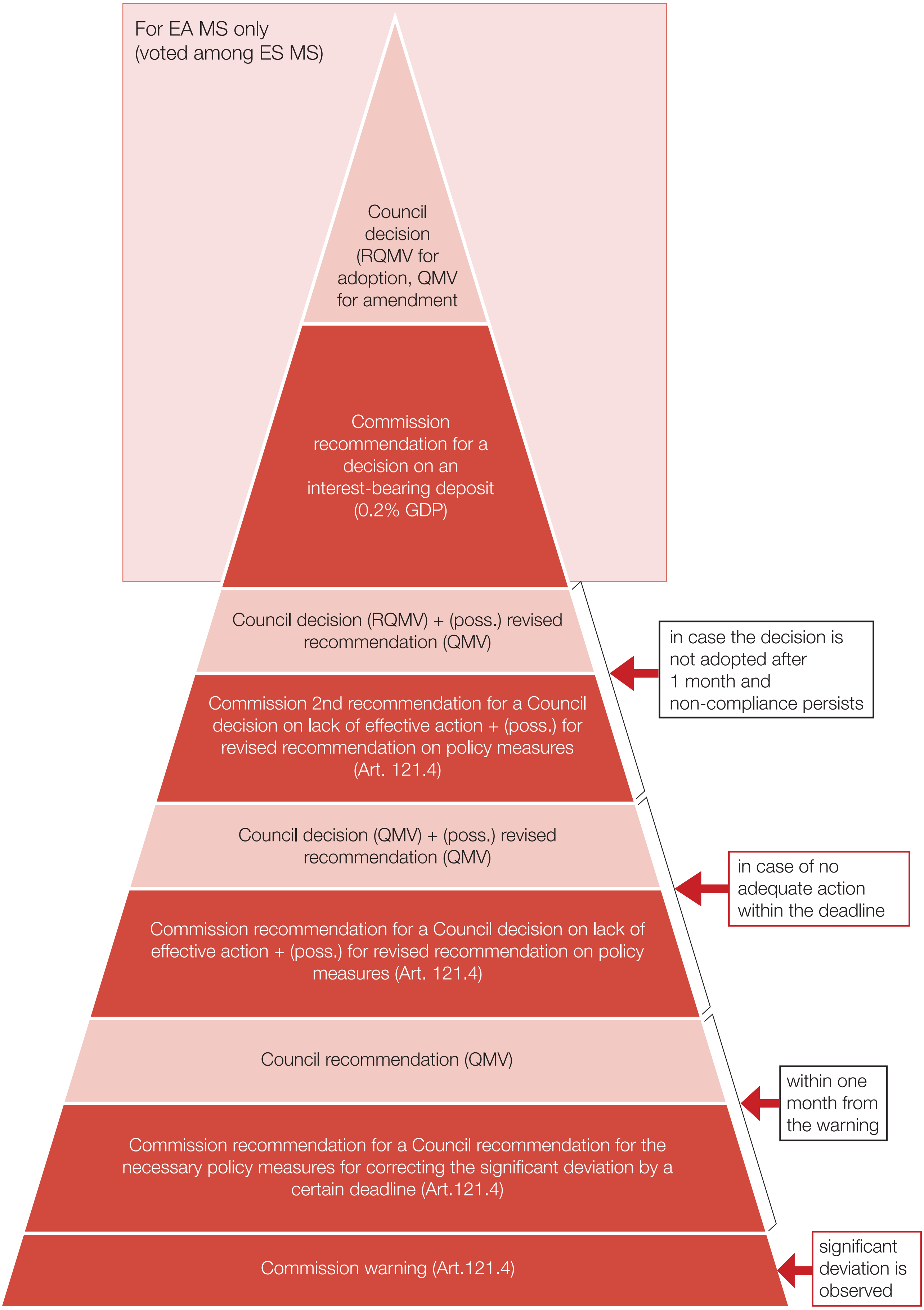
[31] Marek Dabrowski, *submission of evidence*.

[32] Idem.

[33] *Record of the 4 June 2014 stakeholder event,* Bruegel.

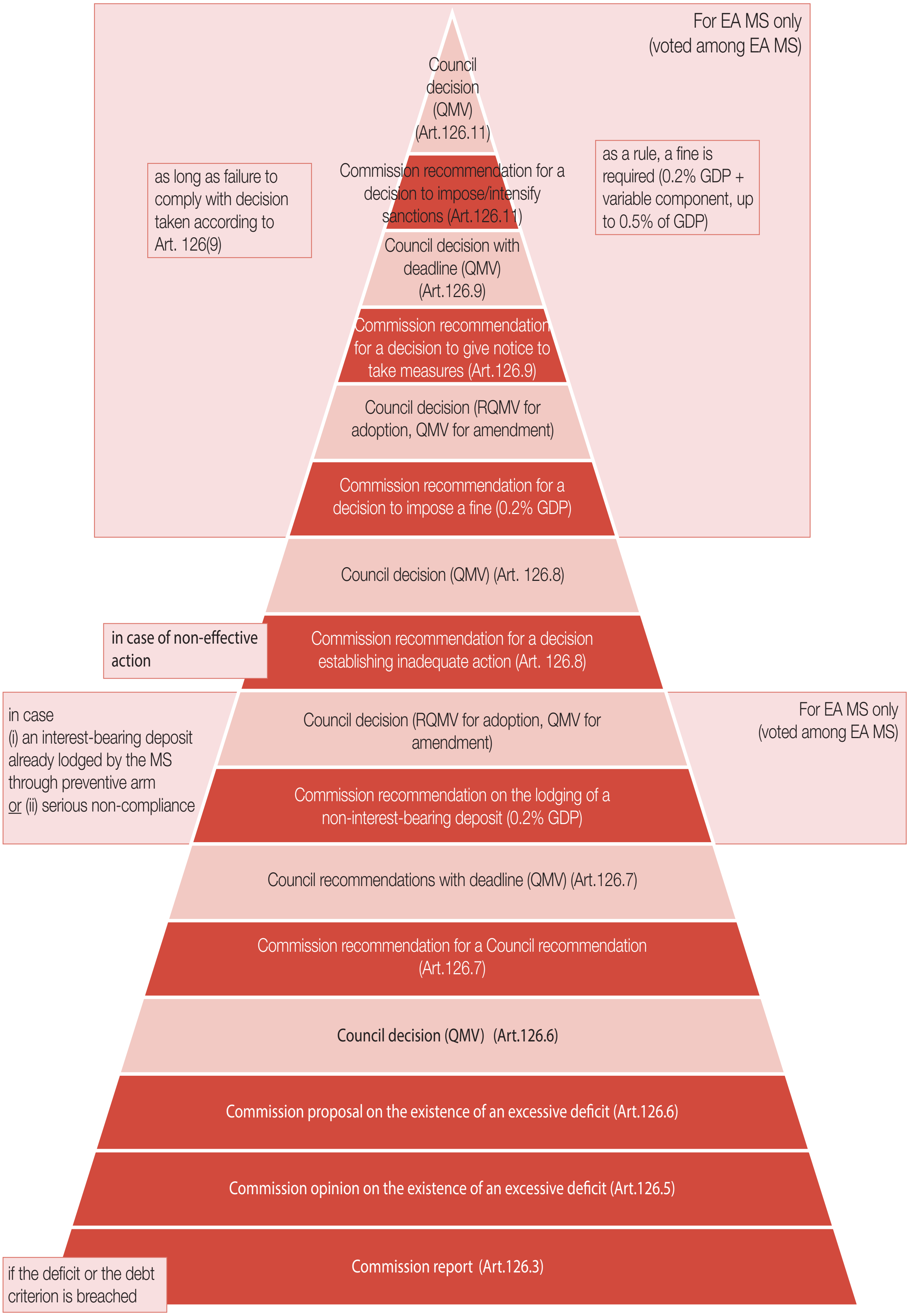
[34] Stephen Pickford and Paola Subacchi, *submission of evidence.*

Chart 3C: The Preventive Arm



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

Chart 3D: The Corrective Arm



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

3.48 Marzinotto and Sapir argue that EU fiscal rules are not as rigid as commonly thought and represent a sophisticated system of surveillance and ex-post control that does provide sufficient room for manoeuvre under exceptional circumstances.[35]

3.49 Finally, regarding the differentiated application of the SGP, Iain Begg argued that the SGP is appropriate for euro area Member States and those signed up to the Fiscal Compact who need to curb debt levels.[36]

The Treaty on Stability, Co-ordination and Governance (The "Fiscal Compact")

3.50 The Treaty on Stability, Co-ordination and Governance (TSCG) is an intergovernmental agreement which sets out additional rules for its signatories in relation to the co-ordination of fiscal policy. It was signed in March 2012 by the leaders of the then 17 euro area Member States and eight other Member States. The UK and Czech Republic did not sign the TSCG, which entered into force on 1 January 2013.

3.51 Signatories agreed to implement a balanced budget rule, whereby annual structural deficits would not exceed 0.5 per cent of GDP and would be in line with each country's MTO. Countries would also apply an automatic correction mechanism, which would be triggered in the event of significant deviation from the agreed budgetary targets and the TSCG reiterated the requirement to reduce debt by one twentieth per annum of the amount of debt above 60 per cent of GDP. The TSCG also included provisions for reverse qualified majority voting for euro area excessive deficit decisions, better co-ordination of economic reforms, and euro area summits (to be held at least twice a year). Finally, Article 16 of the Treaty stated; 'within five years, at most, of the date of entry into force of [the] Treaty […] the necessary steps shall be taken […] with the aim of incorporating the substance of [the] Treaty into the legal framework of the European Union'.

3.52 There was relatively little reference to the TSCG in stakeholder responses, perhaps reflecting the UK's non-participation. The TSCG was discussed by EU leaders in December 2011. Whilst recognising the need for the euro area to put in place measures for proper fiscal discipline, properly policed, the UK Government was clear that the TSCG, or actions taken under it, should not undermine the operation of the Single Market. Furthermore, it should not otherwise infringe on areas of policy that are properly for discussion by all Member States in the EU context. The Government was unwilling to allow changes to the EU Treaties without agreement to safeguards for the Single Market. These were not agreed by other Member States, so the UK vetoed agreement of changes to the EU Treaties. This led to agreement of the TSCG outside the EU Treaties.

3.53 There has been significant debate, in the context of discussions about the EU's fiscal rules, as to whether or not the TSCG rules properly support growth as well as fiscal sustainability. The best coverage of this debate, which was at its peak in 2012 at the height of the euro area sovereign debt crisis has been on the Vox EU website.[37] Essentially the debate is similar to that outlined above in relation to the SGP. Some consider that the EU's fiscal rules risk having a negative impact on long-run GDP. Others consider them necessary to ensure a return to fiscal sustainability as part of ensuring a return to growth. As Corsetti suggests, the debate is 'not about the desirability of restoring safer fiscal positions', but whether government's should slow down their efforts at a time of negative growth when policy credibility is still far from assured. He concludes:

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35 B. Marzinotto, and S. Sapir, *Fiscal Rules: Timing is Everything* (2012).

36 Iain Begg, *submission of evidence*.

37 Giancarlo Corsetti, *Has Austerity Gone too Far*, (2012) and G. Corsetti, and G. Muller, *Has Austerity Gone too Far* (2012).

There is an increasing tide in favour of reconsidering fiscal austerity programmes, in recognition of the persistent effects of underemployment of labour and capital on potential output. At the same time, however, it should be recognised that weak growth in countries facing precarious fiscal positions is not sufficient evidence against fiscal austerity. Where sovereign risk is high, fiscal tightening remains an important avenue to bring down deficits at a limited cost to economic activity, as risk premiums recede over time. In addition, fiscal austerity may well have important unobserved benefits, by preventing greater macroeconomic instability which tends to arise in the presence of high sovereign risk.[38]

3.54 In the euro area this is still very much a live debate, in the context of Italian and French calls for more flexibility under the existing rules of the SGP and the TSCG.

Europe 2020

3.55 Structural policies and the institutional context for growth provide the key determinant of long-term economic performance. Economic evidence suggests that reforms which result in more flexible and competitive markets for land, labour, and capital, as well as for goods and services, are central to an agenda for increasing productivity and economic growth, and sustainable improvements in household living standards across the EU. However, structural constraints in the EU appear to have held back the allocation of resources to sectors with high productivity growth prospects.

3.56 The degree of economic integration within the EU is such that economic problems in the euro area also have a negative economic impact on non-euro area Member States such as the UK. In the absence of an interest rate (or an exchange rate) that is set at levels to suit domestic circumstances, there is a need for other mechanisms (such as land, labour, capital and product markets) to work harder to facilitate adjustment to economic shocks in the euro area. However, the challenge of restoring growth, addressing labour market rigidities and streamlining product market regulation is common to all Member States, and the Government considers that growth will only return to Europe if the structural agenda is given sufficient priority by policy-makers across the EU as a whole.

3.57 In 2010, the European Commission proposed a ten year strategy aimed at achieving 'smart, sustainable, inclusive growth rooted in greater co-ordination of national and European policy'.[39] The focus of Europe 2020 is on the microeconomic structure of the economy and the promotion of structural reform. The framing document for Europe 2020 set out three mutually reinforcing priorities:

- Smart growth – developing an economy based on knowledge and innovation;
- Sustainable growth – promoting a more resource efficient, greener and more competitive economy; and
- Inclusive growth – fostering a high-employment economy delivering social and territorial cohesion.

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[38] Corsetti (2012).

[39] European Commission, *Europe 2020: A Strategy for Smart, Sustainable and Inclusive Growth* (2010).

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

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

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

3.60 By launching the Europe 2020 strategy in 2010, the Commission has sought to prioritise jobs and growth and address the shortcomings of the Lisbon Strategy, the predecessor to Europe 2020. In spite of this, EU-wide economic and labour market performance has continued to disappoint in recent years. In May 2014, the Commission launched a stakeholder consultation on the effectiveness of Europe 2020.

3.61 Europe 2020 has the potential to support the EU's return to sustainable growth, but currently does not play a strong enough role. Marek Dabrowski argued that:

> The medium-term economic strategies of the EU set very ambitious goals which are hardly achievable. This has been the case with both the Lisbon Agenda and the Europe 2020 strategy. The main weakness of this approach is that even if the EU strategy's goals are correct and realistic to achieve, it cannot offer effective implementation mechanisms because most of the policy areas involved remain in the national domains.[40]

3.62 Furthermore, Marek Dabrowski argued that a general lack of political will has meant that a number of Member States have only implemented structural reforms as a result of market pressure.[41] The Europe 2020 Strategy is therefore limited in its ability to impose peer pressure on the worst performing countries.

3.63 In response to the European Commission's public consultation on Europe 2020 launched in May 2014, the UK Government has submitted a response setting out concrete suggestions for refining the Strategy and enhancing its effectiveness in supporting jobs and growth.

3.64 The Government's view is that the Europe 2020 should fully recognise the role of the private sector as the primary driver of growth and jobs, both locally and globally. A fully-fledged strategy for growth and jobs should contemplate action in areas where EU level policy levers can support growth. These include pursuing ambitious Free Trade Agreements, strengthening the Single Market and creating a business-friendly regulatory climate. The Strategy could include concrete commitments by the Commission to complement the actions and policy levers of Member States.

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40 Marek Dabrowski, *submission of evidence*.

41 Idem.

The Macroeconomic Imbalances Procedure

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

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

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

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

3.69 The power to impose sanctions under the MIP applies only to euro area Member States. The UK is therefore not subject to sanctions under the MIP, although any potential non-compliance with the MIP by the UK could be made public.

3.70 Some respondents argued that the MIP process and the scoreboard system has the potential to develop into a warning system in respect of the drivers of future crises and to improve economic co-ordination within the EU.[42] Dermot Hodson argued that measuring excessive imbalances is a worthwhile exercise, as identifying the build of macroeconomic imbalances could have provided an effective early warning for the euro area in advance of the euro area sovereign debt crisis.

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[42] Sharon Bowles, *submission of evidence*; Dermot Hodson, *submission of evidence;* Michael Lloyd, *submission of evidence;* Paul van den Noord, *submission of evidence;* and Stephen Pickford and Paola Subacchi, *submission of evidence*.

3.71 Franco and Zollino argue that the MIP represents a major step forward in strengthening the EU's capability for managing the risks to macroeconomic stability.[43] In addition they argue that further progress requires the will to change at both the domestic and the EU levels in order to implement the new procedures effectively, and where necessary, reinforce their scope.

3.72 However, many of the respondents questioned the economic rationale behind the scoreboard.[44] In particular, they highlighted that the MIP applies more to fiscal imbalances than to broader imbalances, and has a greater tolerance for current account surpluses than current account deficits. They argued that the experience from the euro area sovereign debt crisis suggests that macroeconomic imbalances were more important than fiscal imbalances, and that having a balanced current account is not always evidence of macroeconomic health.

3.73 Guerrieri argues that the imbalances in the current account deficits of southern Member States did not receive sufficient attention prior to the euro area sovereign debt crisis.[45] Current account imbalances derived from both structural microeconomic factors, and from asymmetric macroeconomic effects of the EMU on creditor and debtor countries. He criticises suggestions that adjustment should be one sided with domestic spending falling in debtor countries, with no offsetting expansionary policy in creditor countries. He adds that as a consequence of this, growth has suffered and recession has hit all the peripheral economies, and that the right approach must combine more symmetrical macroeconomic fiscal adjustment with microeconomic policy measures aimed at encouraging productivity increases.

3.74 Dermot Hodson and Iain Begg questioned whether the MIP is sufficient to correct underlying macroeconomic imbalances.[46] Dermot Hodson argued that it is unlikely that the financial penalties provided for under the 'six-pack' will be levied against Member States that persistently post excessive imbalances. He argued that the key stumbling block in this regard:

> Is the complex transmission mechanism between government policy […] current account deficits or house price falls, will make it difficult to establish conclusively whether member states have taken corrective measures in response to earlier warnings.[47]

Co-ordination versus Common Policies

3.75 As discussed above, the European Semester is a potentially useful mechanism for the co-ordination of fiscal and economic policies, drawing together advice to Member States and identifying cross-cutting issues and challenges. However, there is a real challenge in securing national ownership of the necessary reforms, which is linked to poor implementation. This challenge may be exacerbated in instances where the Semester relies on peer pressure alone for enforcement, as is the case for CSRs issued to Member States.

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43 D. Franco, and F. Zollino, 'Macroeconomic Imbalances in Europe: Institutional Progress and the Challenges that Remain' *Applied Economics,* 46(6), (2014), p. 589-602.

44 *Record of the 4 June 2014 stakeholder event,* Bruegel. Also, Stephen Pickford and Paola Subacchi, *submission of evidence*; Iain Begg, *submission of evidence*; Marek Dabrowski, *submission of evidence;* and Dermot Hodson, *submission of evidence*.

45 P. Guerrieri, 'Intra-European Imbalances: the Need for a Positive-Sum-Game Approach,' *Chatham House* (2012).

46 Dermot Hodson *submission of evidence* and Iain Begg, *submission of evidence*.

47 Dermot Hodson, *submission of evidence*.

3.76 The SGP has been strengthened substantially to tackle the euro area sovereign debt crisis, with much more stringent requirements around debt, preventive action and financial penalties as an incentive to stick to the rules. Some respondents thought that it is a useful disciplining mechanism, but others highlighted issues with the fiscal targets.

3.77 Many respondents argued that it is too early to judge the effectiveness of the MIP but acknowledged that it is a potentially useful tool to detect imbalances which were key causes of the recent crisis. Concerns were raised in the evidence around the choice of scoreboard indicators and the willingness of the Commission to take corrective action against Member States with problematic imbalances. Respondents also suggested that the evidence base underpinning the Commission's recommendations could be clearer and more transparent.

3.78 Although it is not directly addressed by respondents, the Government considers that this mixed assessment of the current mechanisms for economic and fiscal co-ordination reflects the challenges inherent in the use of comparatively 'soft' policy instruments, such as those described above. For as long as responsibility for the development, conduct and implementation of economic and fiscal policy rests, primarily, with individual Member States, with the EU role to co-ordinate those policies to avoid damaging spillovers, there will always be room for discretion over national policies. This in turn can lead to the adoption of policies that are not suitable for the EU or euro area as a whole. Whilst common policies that are agreed and imposed centrally might be the logical response from a purely economic perspective, the Government's view is that such an approach would not be suitable or acceptable to all Member States given the loss of sovereignty that is implied.

3.79 Current debates about the extent to which Member States need to go beyond existing mechanisms of co-ordination are primarily limited to the euro area. Given the specific challenges and inter-dependencies created by euro area membership, the Government's view is that all Member States should be fully engaged in discussions about how to facilitate growth across the EU. However, it is also of the view that enhanced, and in particular coercive, economic governance arrangements are appropriate for euro area Member States only.

Financial Assistance Mechanisms

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

3.81 The EU Budget acts as a direct guarantor for the use of the EU Balance of Payments (EUBoP) facility and the European Financial Stabilisation Mechanism (EFSM) and as an indirect guarantor for the use of Macro Financial Assistance (MFA) to third countries via the Guarantee Fund for External Actions. As a result, each Member State holds a contingent liability for their use. There is therefore no direct impact on the EU Budget unless the recipient of the loan defaults on repayments.

3.82 More recently, these facilities have always been activated in co-operation with the IMF. Of the mechanisms for which the UK holds a contingent liability, only MFA and EUBoP remain able to engage in new programmes.

EU Balance of Payments Facility

3.83 The EUBoP facility is a financial assistance mechanism available to Member States where the currency is not the euro and which are experiencing balance of payments difficulties. It has most recently been used to support Romania, Latvia and Hungary. This facility has a maximum lending capacity of €50 billion. The EUBoP complements financing provided by the IMF in the context of a macroeconomic adjustment and reform programme.

Macro Financial Assistance Facility

3.84 The MFA facility is used to grant financial assistance to third countries in order to help them address acute balance of payments difficulties. The MFA facility complements financing provided by the IMF in the context of a macroeconomic adjustment and reform programme.

European Financial Stabilisation Mechanism

3.85 The EFSM was established in May 2010 to provide financial assistance to EU Member States facing financial difficulty. The mechanism was used alongside the IMF as part of the international adjustment programmes for Ireland and Portugal. The maximum lending capacity of the facility is €60 billion. It was later agreed, in December 2010, that there would be no new commitments from this facility once the ESM was established. The EFSM has completed disbursements to the assistance programmes of Ireland and Portugal.

Table 3.1: Total Committed Financial Assistance to Member States, 2008 to mid-2014

	EU Mechanisms		Euro-area Mechanisms			Other	
	EFSM	EUBoP	EFSF	ESM	Greek Loan Facility	IMF	Bilateral Loans
Ireland	€22.5bn		€17.7bn			€22.5bn	€4.8bn
Portugal	€26bn		€26bn			€26bn	
Greece I and II			€141.8bn		€52.9bn	€31.9bn	
Spain†				€41.3bn			
Cyprus				€9bn		€1bn	
Latvia		€2.9bn				€1.7bn	
Hungary		€5.5bn				€8.7bn	
Romania		€5bn				€13.6bn	
Romania II*		€1.4bn				€3.6bn	
Romania III*		€2bn				€2bn	

†Spain's financial assistance from the ESM was for the recapitalisation of financial institutions.
*Denotes a precautionary programme of assistance.

Source: Compilation of data from European Commission, *Financial Assistance in EU Member States* Available at: www.ec.europa.eu/economy_finance/assistance_eu_ms/intergovernmental_support/index_en.htm, accessed 5 November 2014.

European Stability Mechanism

3.86 The ESM is an international financial institution set up in October 2012 by euro area Member States to replace the temporary European Financial Stability Facility (EFSF) and create a permanent mechanism providing financial assistance to its members.[48] The UK does not participate in this mechanism and therefore holds no liabilities for its activities. The maximum lending capacity of the ESM is €500 billion, subject to a €700 billion ceiling on the combined lending capacity of the ESM and the EFSF. The ESM has previously been activated to provide support to Spain and Cyprus.

Assessment

3.87 The EU financial assistance mechanisms have helped Member States and third countries stabilise their fiscal and macroeconomic positions to provide the right environment in which to conduct the necessary economic adjustment reforms and deal decisively with the difficulties they have faced. This has been of particular importance during the euro area sovereign debt crisis.

3.88 Loans provided under these mechanisms are disbursed with strict oversight and conditionality in conjunction with the IMF. More recently, the IMF and the European Commission have been joined by the ECB in monitoring those euro area Member States receiving assistance and this informal relationship has been commonly referred to as the 'Troika.'

3.89 This enhanced co-operation through the Troika, in the IMF's view, is aimed at ensuring maximum coherence and efficiency in the implementation of assistance programmes. However, these institutions remain separate and the decisions are ultimately taken independently.[49]

3.90 Kern Alexander saw these facilities as examples of EU states working together to prevent financial contagion from causing financial instability in the EU.[50] He argued that the UK's financial liability to these mechanisms and its involvement with other EU countries in overseeing the related international adjustment programmes had benefited the UK economy and financial system, and had helped protect it from some of the economic repercussions from the euro area sovereign debt crisis. [51] He pointed out that the EFSM bailout of Ireland in conjunction with the IMF, for example, prevented negative impacts from the collapse of the Irish banking system on the UK's financial sector. He also argued that the UK economy's exposure to the near collapse of the Hungarian, Romanian and Latvian economies (three of the Member States that were not part of the euro area at the time) was minimised by the use of the EUBoP facility. Kern Alexander concluded that the UK's potential liability under the EUBoP, MFA and EFSM funds was therefore disproportionately small compared to the benefits received from a stable EU financial sector.

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

[49] IMF factsheet, *The IMF and Europe* (September 2014) p3.

[50] Kern Alexander, *submission of evidence*.

[51] In the event of a default on the loans provided under the EFSM or EUBoP, the EU Budget, acting as a direct guarantor, would become directly liable for the loans. As a result, the UK's estimated share of these loans is presented in the Consolidated Fund Account 2013-14 as a contingent liability. As at 31 March 2014, the UK's contingent liability with regard to the EFSM was £5.5bn and £1.4bn for EUBoP. MFA is primarily guaranteed by the Guarantee Fund for External Actions.

3.91 At the same time concerns were raised in relation to some of the EU financial assistance mechanisms. For example, Sharon Bowles highlighted the requirement for unanimity when agreeing programmes under the EFSF and ESM.[52] In her view this increased the risk that a programme would be held up because of the objections of a single Member State, potentially exacerbating any crisis. It should be recalled that programmes under the EFSF and ESM were not agreed by QMV. The EFSF and ESM procedures were agreed by euro area Member States at the time of their establishment.

3.92 Another point raised by Sharon Bowles related to the oversight of the use of the EFSM.[53] She was concerned that the EFSM is guaranteed by the EU Budget but deployed without consultation with the European Parliament. However, the EFSM was created as a temporary mechanism, and following the commitment made by Member States at the December 2010 ECOFIN meeting, there is to be no further use of the EFSM now that the permanent mechanism (the ESM) is in place.

3.93 Finally, Marek Dabrowski argued that:

> Financial assistance mechanisms may undermine the so-called “no bail out” clause in Article 125 of the Treaty of the Functioning of the European Union, thus risking moral hazard problems in the future.[54]

3.94 The Government’s view is that Article 125 does not preclude the EU or Member States from providing loans to one another. The EUBoP facility is a longstanding mechanism which has provided medium-term financial assistance to a number of Member States. Further, the regulations make clear that the assistance is strictly confined to either a loan or credit line, and would need to be paid back.

3.95 EU financial assistance mechanisms guaranteed by the EU Budget provide support and stability to Member States and third countries facing balance of payments crises which, in turn benefits the UK economy. The UK supports a strong and stable euro area. However it is for the euro area to solve the problems arising from the single currency. The UK should not be liable for these problems.

Overall Assessment of EU Economic Governance Mechanisms

3.96 The euro area sovereign debt crisis brought about an increase in EU level initiatives designed to co-ordinate national fiscal and economic policies to achieve stability and growth in the EU. Respondents noted that many of the reform efforts had concentrated on structures for the surveillance of fiscal policy. For example, both the preventive and corrective arms of the SGP have been strengthened with stricter conditions for all Member States and more automatic sanctions being applied to euro area Members States. Furthermore, the establishment of a common timetable for euro area Member States to submit their draft budgets to the Commission has had the effect of redefining national budgetary processes. At the same time, the Commission may also request revisions to draft budgetary plans of euro area Member States.[55]

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[52] Sharon Bowles, *submission of evidence.*

[53] Idem.

[54] Marek Dabrowski, *submission of evidence*.

[55] Stephen Pickford and Paola Subacchi, *submission of evidence*.

3.97 Taking into account the reforms that have been made, one attendee at the Bruegel event characterised the new economic governance structure as breaking down into four unconcentric circles:

- An EU circle (the European Semester);
- A euro area circle (for example, the two-pack regulations and sanctions provisions of the SGP/MIP);
- An intergovernmental circle (the ESM, the TSCG and the Single Resolution Fund Treaty); and
- A circle for opt-outs/exclusions (including the UK and Denmark's opt-outs of the euro).[56]

3.98 One of the biggest sources of instability in the euro area arises from shortcomings in the economic governance of the single currency and associated economic policies. The economic and financial crisis exposed shortcomings in the design of the euro and the EMU. The euro area has shortcomings due to the lack of economic convergence between its members. The rules determining membership were too weak. Stephen Pickford and Paola Subacchi argued that the governance structure supporting the EMU did not provide it with an effective mechanism to achieve proper convergence, or to compensate for the lack of convergence. As a result, prior to the euro area sovereign debt crisis the SGP, the fiscal surveillance mechanism in place to safeguard the stability of the EMU, did not provide sufficient incentives for the correction of fiscal imbalances in the euro area.

3.99 Furthermore, there was insufficient responsibility on surplus countries within the euro area to reduce imbalances. Stephen Pickford and Paola Subacchi noted that:

> Looking back at the period from 1999-2007, it is clear that wider economic policies were insufficiently co-ordinated to prevent the buildup of serious economic imbalances within the currency area.[57]

3.100 Stephen Pickford and Paola Subacchi argued that greater integration of euro area policy requires fundamental reforms to its governance entailing:

- A move towards a single fiscal authority;
- An effective mechanism to resolve failing financial institutions;
- Better incentives for the implementation of economic policy reforms;
- More effective co-ordination of the single monetary policy with wider economic policies; and
- An effective lender of the last resort for euro area Member States.[58]

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[56] *Record of 4 June 2014 stakeholder event*, Bruegel.

[57] Stephen Pickford and Paola Subacchi, *submission of evidence*.

[58] Idem.

3.101 Many of these governance issues do not directly concern the UK due to its opt-out, apart from instances where they interact with the Single Market (such as banking union).

3.102 Respondents agreed that it was in the UK's best interest to play a role in assisting the euro area to strengthen its system of governance.[59] The extent of economic linkages between the UK and the euro area and the wider EU (which account, for example, for almost half of UK trade in goods and services) are significant, as are the consequent spillover risks from the euro area that the UK faces.

3.103 Future challenges in respect of economic governance in the EU are considered in Chapter Five.

[59] Stephen Pickford and Paola Subacchi, *submission of evidence;* Sharon Bowles, *submission of evidence;* IRSG, *submission of evidence;* and CBI, *submission of evidence*.

Chapter 4: The EU Institutional Framework and its Effectiveness

Introduction

4.1 The current economic governance system gives different roles to each of the EU institutions; Commission, Council, and European Parliament. There is the high level legislative process, whereby the Commission has the right of initiative to propose economic governance legislation which is considered by the Council, with some matters decided by co-decision with the European Parliament and some by consultation.

4.2 There is then the detailed operation of the economic governance processes set out in the legislation. Broadly speaking, this gives the Commission the role of assessing Member States' economic and fiscal policies and putting forward recommendations for the Council to approve.

4.3 In parallel, other organisations and groups also play important roles. For example, the ECB implements monetary policy in the euro area, whilst the Eurogroup is increasingly prominent. This chapter considers in turn the role played by each of the various institutions with an interest in EU economic governance.

The Role of the Commission

4.4 The Commission plays a central role in the economic governance system. Although there are some variations between the different mechanisms, broadly the Commission has the following roles:

- Initiating legislation in the areas of economic and fiscal co-ordination in line with the competences set out in the TFEU;
- Preparing recommendations and decisions for approval by the Council in relation to economic and fiscal policies;
- Developing detailed methodologies, in consultation with Member States, for assessing progress against recommendations;
- Monitoring implementation and, where applicable, recommending the imposition of sanctions for those who repeatedly breach the economic governance rules; and
- In the case of financial assistance mechanisms, the Commission has a role in review missions to assess whether the conditions for receipt of assistance are being fulfilled.

4.5 While the Commission may issue Council recommendations under the European Semester, the Council is ultimately responsible for adopting these recommendations, subject to drafting refinements. The Council also has the final say on the imposition of penalties and on the approval of EU financial assistance (euro area only mechanisms are decided on in the Eurogroup).

4.6 Respondents did not identify significant concerns with the responsibilities given to the Commission.[1] They thought the balance between the Commission's role and the Council's role (whereby the Council has the final say on recommendations and proposals in this area) was broadly appropriate.

4.7 Sharon Bowles noted that the Commission's role had already been strengthened vis-à-vis the Council in the reformed governance system, in particular through the introduction of reverse qualified majority voting (RQMV) in relation to euro area sanctions.[2] This requires the Council to form a QMV against a Commission proposal in order to prevent it going ahead. She saw the strengthened role of the Commission as a welcome move given what she saw as a tendency of the Council to dilute the macroeconomic recommendations made by the Commission on political grounds. However, some respondents suggested that the Commission could be given even greater powers over the Council, in particular over policies in the euro area.[3] Stephen Pickford and Paola Subacchi argued that:

> There may be a case for even stronger powers for the Commission in the future, to deliver greater convergence and co-operation over macroeconomic policies within the euro zone. Of course, if the euro area moves eventually towards a single treasury function, this agency would acquire greater powers over policies which are currently the preserve of national governments.[4]

4.8 Attendees at the 4 June Bruegel event discussed the trade-offs between:

- The Commission's ability to provide rigorous and robust advice and to police properly the governance system; and
- The question of national ownership.[5]

4.9 Attendees argued that proper co-ordination and better analysis from the Commission would require giving up a level of national ownership that Member States were not willing to do.[6] This presented a problem and a trade-off between an effective system and subsidiarity concerns. They commented that different Member States or groups of Member States might be willing, or would need, to tolerate different levels of intrusiveness from the Commission depending on the level of integration between them. They also discussed the challenges that could flow from a lack of delivery on the part of Member States, which could lead to the Commission tightening the rules, but which could in turn lead to further lack of ownership because of the removal of discretion.

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1 CBI, *submission of evidence;* Kern Alexander, *submission of evidence;* Iain Begg, *submission of evidence;* Michael Lloyd, *submission of evidence;* and Stephen Pickford and Paola Subacchi, *submission of evidence.*

2 Sharon Bowles, *submission of evidence*.

3 Stephen Pickford and Paola Subacchi *submission of evidence,* and Dermot Hodson, *submission of evidence*.

4 Stephen Pickford and Paola Subacchi, *submission of evidence*.

5 *Record of 4 June 2014 stakeholder event*, Bruegel.

6 Idem.

4.10 One participant from the Bruegel event suggested that the authority of the system (the Commission) needed to find a better balance between rule implementation and the use of a certain amount of discretion.[7] For example, it was argued that the Commission needed to apply the SGP rules with an element of discretion as this was in the common interest of all Member States. This was seen as a difficult issue to get right. However, it was argued that if the right balance was not found, co-ordination would not work.

4.11 Finally, Sharon Bowles raised concerns about the role of the Commission vis-à-vis the Eurogroup and the Council with regard to financial assistance programmes.[8] She argued that the scope of the 'technical advisory' and 'Eurogroup agency' roles devolved to both the Commission and the ECB in the design, implementation and assessment of assistance programmes were not sufficiently defined.

4.12 The Commission's role was strengthened in some areas under the six-pack and the two-pack. For example, it was given the right to assess, and in certain circumstances to request a re-draft of, euro area Member States' budgets. In addition, RQMV has been introduced in respect of decisions on sanctions. Some respondents, such as Sharon Bowles, Kern Alexander and the CBI, welcomed this.[9]

4.13 Stephen Pickford and Paola Subacchi thought the Commission should have greater power to deliver convergence among the euro area Member States.[10] Some respondents thought the Commission's analysis was generally appropriate but could be improved. One way to achieve this objective would be for the Commission to share its analysis with Member State authorities prior to publication.

The Role of the Council

4.14 The Council formation that is given authority on economic and monetary policy is the Economic and Financial Affairs Council (ECOFIN). This is attended by the economics and finance ministers of the 28 Member States, budget ministers when budgetary issues are discussed, and representatives from the Commission, ECB and other relevant stakeholders depending on the issues for discussion. It meets formally nine times a year and informally twice a year.

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

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

4.17 The Council's main roles in this area are as follows:

- To agree (jointly with the European Parliament in some cases and in consultation with them in other cases) legislation in this area as provided for in the TFEU;

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7 Idem.

8 Sharon Bowles, *submission of evidence*.

9 Sharon Bowles, *submission of evidence;* Kern Alexander *submission of evidence;* and the CBI, *submission of evidence*.

10 Stephen Pickford and Paola Subacchi, *submission of evidence*.

- To approve, amend or reject Commission proposals, recommendations, and decisions on economic governance (for example under the EDP or the European Semester). In this sense the Council has the final decision making power on economic governance issues;
- To discuss economic and financial issues of relevance to the EU; and
- To provide political guidance in the form of Council Conclusions.[11]

4.18 Most respondents thought that the Council's role was broadly appropriate.[12] However, a small number argued that the Council should have less of a role, given the perception that it was reluctant to endorse disciplinary measures where large Member States were concerned, and that this had led to an undermining of the SGP with decisions being applied unevenly.[13] For example, Sharon Bowles argued that smaller Member States such as Ireland and the Netherlands had been forced to make painful adjustments, whilst France and Germany were spared such adjustments. Sharon Bowles also argued that the Council tends to dilute CSRs under the European Semester and that:

> They seem initially constructed to be stricter than needed in anticipation of watering down.[14]

4.19 Other comments focused largely on the relationship between the Eurogroup and ECOFIN in the governance system. The Eurogroup is an informal grouping with no legislative responsibilities and a specific focus on the euro area, while ECOFIN can take legislative decisions and is a formal Council formation.

The Eurogroup

4.20 Finance ministers of euro area Member States meet informally in Eurogroup meetings the day before ECOFIN to discuss issues relating to the specific responsibilities they share with regard to the single currency. The Eurogroup is not a configuration of the Council, and cannot take legislative decisions, but it is recognised in Protocol 14 of the TFEU. The aim of the Eurogroup is to 'ensure ever closer co-ordination of the economic policies [of the euro area] and promote financial stability'.[15] The Eurogroup also has a preparatory body known as the Eurogroup Working Group (EWG).

4.21 During the euro area sovereign debt crisis, the Eurogroup assumed a more prominent role, for example by discussing issues related to macroeconomic adjustment programmes for euro area Member States. Reflecting the perceived need to strengthen the Eurogroup, while taking account of its informal role, in October 2011 the euro area leaders agreed ten measures for improving governance of the euro area to 'improve the effectiveness of decision making' while 'fully respecting the integrity of the EU as a whole'.[16] These measures included the hosting of regular summit meetings of euro area

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11 For some issues, only the euro area Member States can vote on euro area recommendations.

12 CBI, *submission of evidence;* Kern Alexander, *submission of evidence;* and Iain Begg, *submission of evidence*.

13 Sharon Bowles, *submission of evidence* and *Record of the cross-cutting stakeholder event 27 June 2014*.

14 Sharon Bowles, *submission of evidence*.

15 Jose Manuel Barroso, *Speech at the European Council and Euro Area Summit Statement* (26 October 2011). Available at: ec.europa.eu/commission_2010-2014/president/news/speeches-statements/2011/10/20111027_speeches_1_en.htm, accessed 5 November 2014.

16 *Euro Summit Statement*, Brussels, (26 October 2011). Available at: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/125644.pdf, accessed on 25 November 2014.

leaders and a stronger preparatory structure. It was agreed that, in line with current practice between ECOFIN and the Eurogroup, non-euro area Member States would be kept fully informed of the preparation and conclusions from the summits.

4.22 Pisani-Ferry et al note that recent reforms in the EU have strengthened the role of the Eurogroup relative to ECOFIN.[17] Over the years, the Eurogroup has emerged with de facto decision making responsibilities in relation to euro area governance. The Lisbon Treaty has reinforced its role and arguably enables it to be engaged in economic policy co-ordination with limited involvement of other Member States.[18] Stephen Pickford and Paoloa Subacchi argued that:

> The interlinked nature of economic policy making and the fuzzy boundary between the responsibilities at the EU and euro area level mean that the Eurogroup can take common positions on matters, even if formally they are a decision for the ECOFIN.[19]

4.23 Dermot Hodson argued that the rising influence of the Eurogroup relative to ECOFIN is beneficial for euro area Member States as ECOFIN was ill suited to overseeing euro area governance.[20] He further argued that the Eurogroup's ambiguous position within the EU's institutional architecture raises concerns over procedural legitimacy in respect of EU economic governance. ECOFIN for example is subject to certain legal requirements regarding transparency and co-operation with other EU institutions whereas the Eurogroup is not.

4.24 Other respondents raised concerns about the interaction between the two groupings. The CBI for example noted that given the current division of responsibilities between ECOFIN and the Eurogroup it was vital that issues which impacted all Member States were discussed at ECOFIN to ensure that further euro area integration did not undermine the Single Market.[21] The submission from IRSG stressed that it was vital for UK interests to ensure that the right balance continued to be maintained between institutions of the euro area and those of the Council.[22]

4.25 Concerns were raised by some of the respondents about Eurogroup meetings being held in advance of ECOFIN.[23] These concerns related to the risk that certain policy issues that impacted all Member States would be agreed upon at the Eurogroup, so pre-empting discussion at ECOFIN. They argued that since economic issues are of common concern to all Member States, discussions should be held at the EU level first. When there was a subset of issues that concerned euro area Members States, these issues could then be discussed at Eurogroup meetings. Of course, there is a counter argument that ECOFIN meeting after the Eurogroup allows it to act as a check and balance on Eurogroup.

4.26 Finally, Iain Begg noted the historical background to the existence of the informal Eurogroup and the tensions with ECOFIN's role.[24] He highlighted that the Maastricht Treaty did not really envisage lasting derogations from euro area membership, meaning that euro area bodies started informally and were perceived as temporary until all Member States had joined the euro.

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[17] J. Pisani- Ferry, A. Sapir, and G.B. Wolff, 'The Messy Rebuilding of Europe' (2012).

[18] Dermot Hodson, *submission of evidence*.

[19] Stephen Pickford and Paola Subacchi, *submission of evidence*.

[20] Dermot Hodson, *submission of evidence*.

[21] CBI, *submission of evidence*.

[22] IRSG, *submission of evidence*.

[23] Sharon Bowles, *submission of evidence* and *Record of the cross-cutting stakeholder event,* 27 June 2014.

[24] Iain Begg, *submission of evidence*.

4.27 A further dimension is the relationship between ECOFIN and the Eurogroup in the economic governance system. A number of respondents (such a Dermot Hodson) argued that the informal Eurogroup had de facto assumed a more prominent role in the governance of the euro area during the euro area sovereign debt crisis (for example by discussing assistance programmes and fiscal policy positions).[25] Some respondents had concerns about this, arguing that it was important to ensure that the Eurogroup did not undermine the Single Market and establish a process of formal decision making.[26]

4.28 Some of these issues are considered further in Chapter Five.

The Role of the European Parliament

4.29 The European Parliament has an Economic and Monetary Affairs Committee (ECON) which is responsible for parliamentary work on economic and monetary policies of the EU, taxation and competition policies, free movement of capital and the regulation of financial services. ECON is therefore 'at the centre of the Parliament's work on the current economic and financial crisis'.[27]

4.30 Respondents argued that the European Parliament had a relatively limited role in the EU's economic governance.[28] It does not have a major role in the day to day operation of the governance system. The European Parliament's main role is to engage in the process of economic dialogue, set up under the six-pack. Under this process, the ECON may invite the President of the European Council or the President of the Eurogroup to discuss decisions and present their plans for the European Semester. The European Parliament can also offer a Member State that is subject to the EDP or that is in an Excessive Imbalances Position the opportunity to participate in an exchange of views. The European Parliament also expresses its views on the Annual Growth Survey and the ongoing Semester process.[29]

4.31 Despite measures to enhance the role of the European Parliament, some respondents believed that the Treaty still assigned it a too limited role in economic governance.[30] They argued that, although the European Parliament was kept informed of Council guidelines on Member States' economic policies, multilateral surveillance efforts and decisions taken in relation to the EDP, it was not given a substantive role.

4.32 Indeed, Iain Begg, Sharon Bowles and Dermot Hodson argued that the European Parliament should be given a stronger role to enhance legitimacy.[31] They envisaged the European Parliament holding both the Commission and the Council to account in the governance system, perhaps through an expanded economic dialogue role. Furthermore, as economic co-ordination deepened they considered that there might be calls for the European Parliament to be given a greater role to enhance the accountability and legitimacy of the decisions taken at EU level.

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[25] Dermot Hodson, *submission of evidence*.

[26] CBI, *submission of evidence*; Stephen Pickford and Paola Subacchi, *submission of evidence*; and Dermot Hodson, *submission of evidence*.

[27] European Parliament, *Committees* (2014). Available at: http://www.europarl.europa.eu/committees/en/econ/home.html, accessed on 5 November 2014.

[28] Michael Lloyd, *submission of evidence* and Dermot Hodson, *submission of evidence*.

[29] European Parliament, *Economic Governance,* (2014). Available at: www.europarl.europa.eu/aboutparliament/en/displayFtu.html?ftuId=FTU_4.1.4.html, accessed 5 November 2014.

[30] Dermot Hodson *submission of evidence* and Michael Lloyd, *submission of evidence*.

[31] Iain Begg, *submission of evidence*; Sharon Bowles, *submission of evidence*; and Dermot Hodson, *submission of evidence*.

4.33 Attendees at the 27 June Cross Cutting Stakeholder Meeting argued that given that it was national parliaments who must implement and agree reform plans they should be given a greater role, especially in the event of any strengthened process of co-ordination in the euro area.[32]

The Role of National Parliaments

4.34 National parliaments can scrutinise the European legislative process. They may request and take evidence from EU policy makers and representatives of the relevant EU institutions involved in initiating policy and deciding legislation.[33]

4.35 In the UK, for example, both Houses of Parliament must approve the information which forms the basis of the UK's Convergence Programme, submitted annually as part of the European Semester, and the EU Scrutiny Committees regularly hold debates on European Semester documents and recommendations.

4.36 Respondents highlighted the importance of national parliaments playing a greater role within the EU's economic governance framework and argued that greater involvement by nationally elected representatives could bring significant benefits.[34] Kern Alexander argued that domestically the House of Lords EU Select Committee played an important role in scrutinising proposed EU legislation and considering the impact on the UK. The CBI argued that in the UK:

> Both Houses of Parliament should be given greater time to scrutinise economic policy decisions taken at the EU level and analyse the decisions taken in informal trialogue negotiations. Proper scrutiny would increase legitimacy and raise public awareness of the economic policy decision taken at the EU level.[35]

4.37 The CBI also proposed that the UK Parliament could strengthen ties with other like-minded parliaments.[36] However, Sharon Bowles argued that policy co-ordination mechanisms such as the European Semester had reduced the engagement of national parliaments which had led to concerns among them that their role had been taken over.[37]

4.38 Iain Begg also argued for more co-ordination and co-operation between the European Parliament and national parliaments to understand their respective roles and work better together.[38] He further argued that only national parliaments could really monitor the requirement that Member States should regard their economic policies as a matter of common concern.[39]

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32 *Record of the cross-cutting stakeholder event,* 27 June 2014.

33 Kern Alexander *submission of evidence* and Dermot Hodson, *submission of evidence*.

34 CBI, *submission of evidence;* Michael Lloyd, *submission of evidence*; Dermot Hodson, *submission of evidence;* Sharon Bowles, *submission of evidence*; and IRSG, *submission of evidence*.

35 CBI, *submission of evidence*.

36 Idem.

37 Sharon Bowles, *submission of evidence*.

38 Iain Begg, *submission of evidence*.

39 Idem.

The Role of the European Central Bank

4.39 The ECB is the central bank for the euro and administers the monetary policy of the euro area. It is one of the seven institutions of the EU listed in the TEU. The central banks of the 28 EU Member States own the capital stock of the ECB, and as such they are the owners and shareholders of the ECB.

4.40 The ECB and the national central banks of those countries that have adopted the euro together constitute the Eurosystem. The main objective of the Eurosystem is to maintain price stability, safeguarding the value of the euro. The Governing Council in October 1998 defined price stability as inflation (according to the Harmonised Index of Consumer Prices) of below, but close to, two per cent over the medium-term. Beyond this, the basic tasks of the ECB are to define and implement the monetary policy for the euro area, to conduct foreign exchange operations, to take care of the foreign reserves and the promotion of the smooth operation of payment systems.

4.41 The Governing Council is the main decision-making body of the ECB. It consists of the six members of the Executive Board as well as the presidents of the eighteen national central banks of the euro area. From January 2015, when Lithuania joins the euro area, the national central bank governors will switch to holding rotational voting rights. The Executive Board will continue to hold permanent voting rights.

4.42 The Governing Council usually meets twice a month. At its first meeting each month, it assesses economic and monetary developments and takes its monthly monetary policy decision. At its second meeting, it mainly discusses issues related to other tasks and responsibilities of the Eurosystem.

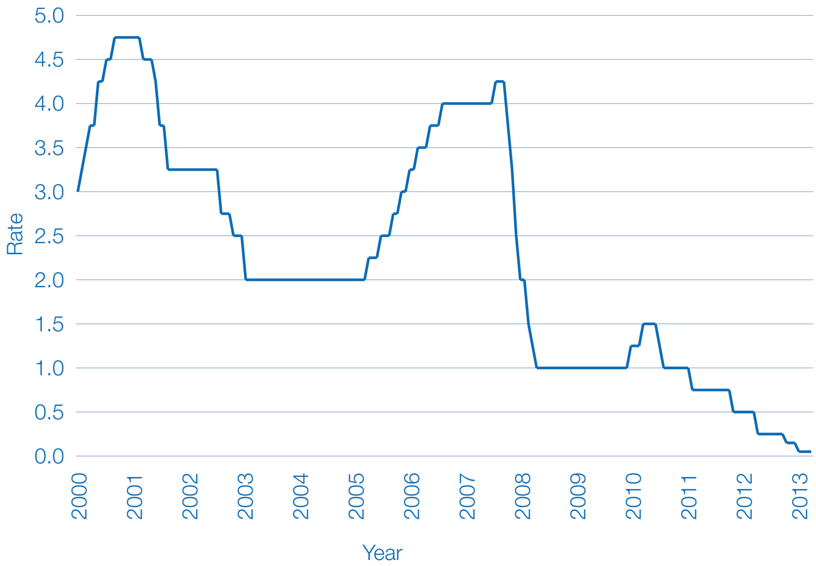
4.43 The legal basis for the single monetary policy is the Treaty establishing the European Community and the Statute of the European System of Central Banks (ESCB) and of the ECB. The TFEU generally refers to the ESCB rather than to the Eurosystem, since it was drawn up on the premise that all EU Member States would eventually adopt the euro. The ESCB comprises the ECB and the national central banks of all EU Member States.

4.44 The ECB has played an active role in managing the euro area sovereign debt crisis. Interest rates fell sharply in 2008, and have since fallen further, so that nominal interest rates in the euro area are now only marginally above zero (see Chart 4A). The ECB has also taken measures that go beyond conventional monetary policy. This section discusses some, but by no means all, of these measures.

4.45 As financial market turbulence unfolded and interbank lending slowed down, the ECB stepped in to provide liquidity to support the orderly functioning of money markets in August 2007. This was followed by joint action with the Federal Reserve in December 2007 to offer US dollar funding to Eurosystem counterparties.

4.46 In 2008, a number of further measures were undertaken to improve the overall liquidity position of the euro area banking system. The most important of these was a switch to a policy of ‘full allotment’ and fixed rates, whereby euro area banks were able to get unlimited liquidity from the ECB at the main refinancing rate provided they offered adequate collateral.

Chart 4A: Key ECB Rate/Eurozone



Source ECB.

4.47 In 2009, the ECB continued to make changes to its refinancing operations. In addition, it launched its first covered bonds purchase programme in June 2009, with the aim of encouraging banks to maintain and expand their lending.

4.48 The (now terminated) Securities Markets Programme (SMP) was introduced in May 2010 to ensure depth and liquidity in dysfunctional market segments. Under the programme, the ECB could start purchasing certain debt securities markets, notably government bonds, in the secondary market. The purchases were originally sterilised so that liquidity conditions in the interbank money market remained unaffected, but in June 2014 the sterilisation was suspended.[40]

4.49 In 2011, the ECB continued its active financial market engagement. It changed its main refinancing operations; reaching agreements on liquidity swap arrangements, both with the Bank of England and the Federal Reserve, and announcing a second covered bond purchase programme. Arguably, the most important of these were the two Longer-Term Refinancing Operations (LTROs) offered at a fixed rate and with a maturity of 36 months. This followed severe market tensions that threatened the functioning of the money market. Over €1 trillion were allotted to banks over the two operations in December 2011 and February 2012.

4.50 In July 2012, ECB president Draghi delivered a speech saying that

> Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.[41]

4.51 Six weeks later, the ECB announced the possibility of Outright Monetary Transactions (OMTs). OMTs are interventions in secondary sovereign bond markets, providing a backstop to avoid potentially severe challenges for price stability in the euro area. As of yet, OMTs have never been used.

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[40] When a central bank intervenes in financial markets via the purchase of assets, it increases the money supply. A central bank can decide to 'sterilise' this intervention by acting in a way to keep the money supply (and its own balance sheet) of constant size. This can be done by offering commercial banks interest to deposit money in its facilities (as is the case with the ECB and the SMP programme) or by selling other assets.

[41] Mario Draghi, *Speech at the Global Investment Conference in London* (26 July 2012). Available at: http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html, accessed on 25 November 2014.

4.52 Since 2012, the ECB has continued to support the market through refinancing operations and asset purchase programmes, as well as further interest rate cuts. Most recently, it has launched Targeted Longer-Term Refinancing Operations (TLTROs), and announced asset backed securities and covered bonds purchase programmes to facilitate new credit flows to the economy. Draghi continues to emphasise that, within its mandate, the ECB is committed to using additional unconventional instruments if needed.

4.53 These interventions have undoubtedly had a very important effect on the market. Perhaps most pertinently of all, many commentators have seen Draghi's 'whatever it takes' speech as a turning point in the crisis. In the hours following the speech, Italian and Spanish bond yields fell, the euro strengthened against the dollar and leading European stocks increased. And while the OMT programme was never used, its very existence improved confidence in the robustness of the euro area, which in turn meant that it did not have to be used.

4.54 Euro area Heads of State decided to establish a Single Supervisory Mechanism (SSM) in June 2012. The SSM will create a new system of banking supervision in Europe. The ECB will be responsible for the effective and consistent functioning of the SSM, co-operating with the national competent authorities of participating EU countries. The ECB assumed its full supervisory tasks in November 2014, 12 months after the SSM Regulation entered into force.

4.55 The SSM and the resolution of credit institutions under the SRM are the two components of the banking union. The key role for the ECB under the SRM is to decide whether an entity is failing or likely to fail. It can also express an opinion to the Single Resolution Board on whether an alternative private sector solution not involving a resolution process is feasible within a realistic timescale.

The European Systemic Risk Board

4.56 The European Systemic Risk Board (ESRB) has been a central part of the European System of Financial Supervision along with the European Supervisory Authorities since the global financial crisis. The ESRB is a non-decision-making body that provides macro-prudential oversight across all financial services sectors and across the whole EU. The ESRB has been criticised for not reacting more swiftly to emerging risks, with some pointing to the large membership of its General Board as a key reason for this.[42] However, its comprehensive membership, which is comprised of central bank governors and financial supervisors from all Member States, provides the authority and expertise that give weight and influence to its non-binding opinions or recommendations.

4.57 The authority and objectivity of the ESRB also derives from its oversight of all financial sector supervisors in the EU. Given that the ECB is now responsible for supervision of the banking union, it is critical that the ECB is subject to the ESRB's oversight in the same way as for all other financial services supervisors in the EU. For this reason, while there are benefits in the ESRB's close relationship with the ECB, including through the sharing of information and expertise, it remains important that the ESRB's independence is not undermined.

[42] European Commission, *Report from the Commission to the European and Parliament and Council on the Mission and Organisation of the European Systemic Risk Board (ESRB)* (2014).

Summary

4.58 In summary, respondents felt that the balance of responsibilities between the Commission and the Council were broadly appropriate. If more power is given to the Commission and less to the Council, it would raise issues of accountability and national ownership that would need to be overcome. Evidence from some respondents suggested that national parliaments should have a greater role and possible tensions between Eurogroup and ECOFIN should be kept under review. These and other potential future challenges are the subject of Chapter Five.

Chapter 5: Future Challenges

Introduction

5.1 The speed and depth of reform to economic governance since the onset of the euro area sovereign debt crisis in 2010, and the high likelihood of further integration in the future, are the main drivers of future challenges for the UK and the EU in this area. This makes for an unusually fluid policy and institutional environment.

5.2 This chapter begins by reflecting briefly on the UK's interest in EU economic governance, before looking at the policy agenda for a more integrated euro area. It then outlines a number of the structural changes in the EU which could put the interests of the UK (and others outside the euro area) at risk, in particular in relation to the Single Market. These changes include: a larger euro area; new voting rules; the rising influence of the Eurogroup; and legislation and Treaty changes. Coupled with moves toward closer integration, these developments present a number of significant challenges to the UK.

The UK Interest in EU Economic Governance

5.3 The UK, through its involvement in the Single Market, is very integrated with other European economies. The EU, and in particular the euro area, is the UK's biggest single trading partner, and the financial ties between the UK and the euro area are strong. The EU accounts for approximately 45 per cent of UK exports of goods and services and approximately 50 per cent of UK imports of goods and services. Over 80 per cent of UK firms that trade do business with the EU.[1]

5.4 The House of Lords Report on the Future of Economic Governance in the EU says that:

> The UK has a strong interest in seeing the euro area stable and prosperous. The Government has a vested interest in ensuring that proposals to increase stability in the euro area through increased economic co-ordination are effective.[2]

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1 IRSG, *submission of evidence*.

2 House of Lords, European Union Committee, *The Future of Economic Governance in the EU, Volume 1* (24 March 2011).

5.5 The House of Commons Report on the Future of the EU notes that the overarching direction of stated government policy since mid-2011 has been to support closer integration in the euro area, while continuing to distance the UK from the single currency area. In particular it argued that:

- The UK's economic interests will be best served if the euro area prospers;
- Greater financial sector, fiscal and economic policy integration in the euro area will support the long-term stability of the single currency area and is therefore desirable;
- Such greater policy integration in the euro area is inevitable, because it is demanded by the 'remorseless logic' involved in creating and sustaining a single currency;
- The UK's economic interest is best served by remaining outside the euro area; and
- The interests of non-euro area Member States regarding, for example, the operation of the Single Market, should be respected.[3]

5.6 The UK has a strong interest in the working of economic governance within the EU, whilst having a unique position as a result of its opt-out (secured in the Maastricht Treaty) from Economic and Monetary Union and the single currency.

5.7 UK opt-outs mean that the UK is not subject to the more onerous aspects of EU economic governance. But as EU economic governance arrangements have been strengthened, there have been implications for UK interests.

Box 5A: UK Government's Position on Euro Area Integration

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

Proposals for Deeper Euro Area Integration

5.8 Euro area integration is driving fundamental change in the EU in the area of economic and monetary policy, as well as financial services policy. As a result of the euro area sovereign debt crisis, and as detailed in previous chapters, the EU has undertaken significant reforms to strengthen its economic governance framework, in particular the rules applying to the euro area. However, there is a broad consensus on the need for further reform in the euro area to strengthen the single currency for the future. This makes for a particularly uncertain legal and policy context.

[3] House of Commons Foreign Affairs Committee, *The Future of the European Union: UK Government Policy* (2013).

5.9 A range of policy proposals to enhance deeper integration in the euro area have been put forward with varying levels of ambition. For example, in his December 2012 report 'Towards a Genuine Economic and Monetary Union', the then President of the European Council, Herman Van Rompuy, set out a roadmap with measures to create a stronger economic and monetary union for the euro area.[4] The Van Rompuy report highlights that further integration in the euro area is necessary in a range of areas. It argues that a more resilient and integrated EMU would buffer euro area countries against external economic shocks, preserve the European model of social cohesion and maintain Europe's influence at the global level.

5.10 The policy suggestions in the Van Rompuy report centre around four areas for reform:

- Financial integration – measures to create a banking union, including a single supervisory mechanism, a single resolution mechanism and a single deposit guarantee scheme;
- Fiscal integration – taking further the idea of a specific 'fiscal capacity' for the EMU, in particular a possible euro area budget. The new financial facility would ultimately be used to facilitate adjustment to economic shocks in specific countries, through an insurance system set up at the central level. The financial resources for the new fiscal capacity were expected to be taken from one or more of national contributions, autonomous resources such as a VAT or a financial transactions tax. The establishment of a treasury function for the new budget was also foreseen;
- Economic integration – 'Arrangements of a contractual nature' between countries using the euro and EU institutions to carry out structural reform, on a case-by-case basis. The report envisaged that these could be supported by the new powers to support reforms, in particular in the field of taxation and employment. These reforms would be mandatory for euro area Member States and voluntary for countries outside the euro area; and
- Accountability and legitimacy – the report argued that given the potential for powers to be given to the EU level, democratic accountability and legitimacy would need to be addressed. For example, provision could be made to take rapid executive decisions for the single currency and a unified external representation of the new Union, under a specific parliamentary supervision.

5.11 Also in late 2012, the European Commission produced a blueprint for deep and genuine EMU. It listed actions over the short, medium and long-term. Such actions range from stronger policy co-ordination, to enhanced fiscal capacity, and to greater pooling of decision-making on public revenue, expenditure and debt issuance (see Box 5B).

[4] H. Van Rompuy, *Towards and Genuine Economic and Monetary Union'* (2012).

Box 5B: Selected Examples from the Commission Blueprint for Deep and Genuine Economic and Monetary Union[5]

Short-term (6-18 months) – the existing framework for economic governance in the euro area would be strengthened through greater *ex-ante* co-ordination of major reform projects and through the creation of a Convergence and Competitiveness Instrument (CCI). This would provide a framework for political commitments to, and financial support for, the timely implementation of structural reforms.

Medium-term (18 months to 5 years) – the focus would be on further budgetary co-ordination, the extension of deeper policy co-ordination in taxation and employment, and the creation of a proper fiscal capacity for EMU to support the implementation of the policy choices resulting from deeper co-ordination. The Commission suggested options including the possible creation of a debt reduction fund to reduce public debt significantly exceeding the SGP criteria, or the common issuance by euro area Member States of eurobills (a short-term government debt with a maturity of up to 1-2 years). This would be a tool against fragmentation in sovereign debt markets, reducing the scope for a negative feedback loop between sovereigns and banks, while limiting moral hazard. Implementation of these policy suggestions however would require Treaty change.

Long-term (beyond 5 years) – the focus would be on the establishment of an autonomous euro area budget providing a fiscal capacity for EMU to support Member States in the absorption of shocks. The central budget would be aimed at providing an EMU level stabilisation tool to support adjustment to asymmetric shocks, and to facilitate stronger economic integration and convergence. At the same time, the Commission stated its intention to avoid persistent fiscal transfers between euro area Member States which it saw as politically difficult. The final stage of EMU reform could involve issuance of public debt to enhance the functioning of financial markets and the conduct of monetary policy. These approaches would require a fundamental overhaul of the Treaties.

The Commission's report also noted the intention of signatories of the TSCG to incorporate its provisions into EU law within five years of its entry into force and suggested that the ESM might also be integrated into the EU Treaty framework in due course.

Debates within the Euro Area

5.12 The Commission and the President of the European Council have put forward their suggestions for what further reforms may be required to create a stronger euro area in the future. The UK Government's view is that, in the final instance, the decision on what reforms to take forward will be a matter for euro area Member States, taking account of the interests of all Member States and the need to protect the integrity of the Single Market.

5.13 Clearly, within the euro area there is a range of views on these issues, and there continue to be debates about how best to handle issues related to the euro area sovereign debt crisis and the scope of reform required to strengthen the single currency for the future.

5.14 For example, there have been debates over the appropriate scale and pace of adjustment. Some countries have sought a faster pace while others have argued for a slower pace of adjustment. This debate has played out recently in discussions over the appropriate degree of fiscal flexibility within the rules of the SGP. France and Italy, for

5 A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate: A Communication from the Commission (2012).

example, have called for greater use to be made of the flexibility within the SGP, whilst Germany and the Netherlands have emphasised the importance of fiscal discipline.[6]

5.15 As well as the speed of adjustment, there have been tensions about how the burden of that adjustment should be shared among those countries running a current account surplus and those running a current account deficit. There has also been debate on the use of monetary policy, with differing views within the euro area on the extent to which the ECB should be more active in supporting those countries undergoing the sharpest adjustment. And there remain divisions on the extent and timing of structural reform. The Commission, the ECB and some Member States call for Member States to go further in their reform efforts, whilst others call for greater support from both fiscal and monetary policy, to assist them in undertaking reform.

5.16 These debates are sensitive because they are directly related to differences in views about how economies operate and how best to manage them. For example, some would argue that growth can best be encouraged through stimulating demand in the economy and an active monetary policy. At the same time, others suggest that improving the supply-side of the economy through structural reforms, while ensuring strict fiscal discipline, should be given greater emphasis.[7]

Box 5C: EMU-Related Controversies in the 1970s and 1980s

At the start of the EMU process many concerns were raised, regarding the consequences for participating countries, of a system of fixed exchange rates. Some of the main concerns as highlighted by Nyberg et al included that:

- It would exert deflationary pressures and that, to ward off the depletion of reserves, countries with higher inflation rates would have to adopt overly restrictive policies, with negative impacts on growth and employment;
- The obligation to intervene (to defend a given exchange rate) would deprive countries of the independence necessary to control domestic monetary expansion to contain inflationary price and cost developments;
- The existence of large credit facilities would encourage their use, and financing would have to be provided by countries with the strongest currencies, to allow deficit countries to avoid domestic adjustment measures. The fear was that the EMS would create more liquidity and inflation across participating countries; and
- The system would not be sustainable, as it was unreasonable to expect countries with highly divergent economic developments to be able to align their policies to the degree necessary to keep a system of fixed exchange rates functioning. As a consequence, speculative capital movements would disrupt foreign exchange markets and force authorities to make sudden and substantial exchange rate changes with adverse economic consequences for participating countries.[8]

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6 Jeroen Dijsselbloem, *Keynote Speech by Eurogroup President at the Atlantic Council, New Growth Deal for the Eurozone: Connecting Reform Agenda, Budgetary Consolidation and Supportive Investments,* (10 October 2014). Available at: http://www.eurozone.europa.eu/newsroom/news/2014/10/keynote-speech-jdijsselbloem-at-atlantic-council/, accessed on 5 November 2014.

7 John Chown, *submission of evidence.*

8 Nyberg, P., Ungerer, H. and Evans, O., ‘The European Monetary System: The Experience, 1979-1982’, *Occasional Paper 19, International Monetary Fund* (1983).

Black on the other hand argues that the move towards an EMU was characterised by a debate between 'economists' and 'monetarists' over the convergence conditions that should be required prior to monetary unification.[9] According to Black:

- 'The economists posited that deep-seated differences in wage and price behaviour and monetary and fiscal policies in different member countries should be removed prior to integration. Otherwise a single monetary policy could not fit all members';
- The monetarists' view was that that prior convergence was not necessary, since these differences would be eliminated by the monetary union itself; and
- The monetarists were of the view that 'money is a veil' that does not affect real economic behaviour, while the economists' view was that that monetary and real economic behaviour are inextricably intertwined.

In the end there 'was a compromise and synthesis between the ideas of the "monetarists", led by France, emphasising the importance of external stability (exchange rate stability) and of the "economists", led by Germany, advocating internal stability (price stability) and the co-ordination of economic policy'.[10]

5.17 For the euro area, these debates also relate to wider tensions between the desirability of further co-ordination and common policies at EU level and the limits of what may be acceptable from a political perspective. As noted earlier in this report, a fully integrated currency area would imply a significant degree of fiscal and economic integration to accompany the single monetary policy. However, whilst there have been active debates on the necessary degree of integration since before the establishment of the single currency (see for example Box 5C), greater integration implies that Member States give up a degree of control over national policy. The political willingness of euro area Member States to give up national sovereignty is likely to be a key determinant to how far such integration goes. At present, centrally imposed common policies do not appear to be acceptable, as discussed in Chapter Three.

5.18 These active debates make it hard to predict how the legal and policy environment will evolve.

Potential Benefits to the UK from Closer Integration in the Euro Area

5.19 Many respondents argued that it was in the UK's interests to support a more stable euro area, provided that the integrity of the Single Market is protected.[11] They highlighted that the main benefits to the UK of the existence of the euro area stem from the trade impacts. As already noted, the euro area is the UK's largest trading partner. The UK's financial markets are also highly integrated with those of the euro area. Dermot Hodson quoted the Bank of England's Financial Stability Report, and noted the exposure of major UK banks to so-called vulnerable euro area periphery economies (at around £140 billion).[12]

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9 Black, S., W., *Fixing the flaws in the Eurozone, Vox EU* (23 November 2010).

10 Maes, I. On the Origins of the Franco-German EMU Controversies. *National Bank of Belgium Working Paper No.34* (July 2002).

11 Dermot Hodson, *submission of evidence;* CBI*, submission of evidence;* Kern Alexander, *submission of evidence;* IRSG, *submission of evidence*; and BBA, *submission of evidence*.

12 Dermot Hodson, *submission of evidence*.

5.20 Of the reforms, respondents raised particular concerns about moves towards a banking union, arguing that banking union has the greatest direct relevance to the UK because of the potential effects on the Single Market for financial services.[13] Approximately 130 banks will be within the banking union, a majority of which will have branches and subsidiaries in London. Despite the UK remaining outside the banking union, a number of respondents made clear they consider it is important that the UK continues to be engaged in EU co-ordination of financial services decision making. Issues related to banking union are set out further in the Balance of Competences report on Financial Services and the Free Movement of Capital. Other reforms, for example institutional changes such as the creation of a permanent chair of the Eurogroup, or further economic and social policy co-ordination, will also be of great relevance to the UK.

The Future Performance of the Banking Union

5.21 Over the last twelve months important agreements have been reached to create a single supervisor for the largest banks and a single resolution mechanism for the euro area and other Member States that wish to participate. These agreements represent a significant step forward in ensuring the sustainability of the euro area.

5.22 It is too early to reach a judgement on how effectively the new arrangements will work in practice, with the ECB only having taken on its supervisory responsibilities in November 2014 and the SRM due to commence in 2015. Nevertheless, concerns have been expressed by some academic and market commentators about the effectiveness of the new arrangements. Two main strands to this critique can be identified.

5.23 Firstly, there is concern that the resolution decision-making arrangements are too complex, with the Single Resolution Board, Commission and Council all potentially involved in decisions which, in a crisis situation, may have to be made over a weekend.

5.24 Resolution decisions are extraordinary powers which can have profound economic, political, and social impacts. All resolution decisions are by their nature complex. From a non-participating Member State perspective, the resolution of banks under the SRM should ideally take place as swiftly and efficiently as possible.

5.25 In fact, the process under the SRM is less complicated than some have suggested. In the vast majority of cases, only the executive committee of the Single Resolution Board would be involved. Cases requiring a substantial amount of funding are rightly debated more widely in the plenary session of the Board. The roles of the Commission and Council are also tightly circumscribed, with the Commission able to object to, or require amendments to, the Board's resolution scheme in relation to discretionary aspects. This right of intervention ensures the decision-making arrangements are compatible with the *Meroni* principles, which prevent EU agencies such as the Board from taking policy decisions entailing a wide margin of discretion.

5.26 The Council will only be able to object to the Board's proposed resolution scheme when acting on a proposal of the Commission, and solely on public interest grounds, or to approve or object to a modification of the amount of the Fund proposed in the Board's resolution scheme. This framework ensures the right level of accountability of the Board. In short, the Government believes that the decision-making process is complex, but far from unworkable.

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[13] IRSG, *submission of evidence;* Pickford and Subacchi, *submission of evidence*; and Fresh Start, *submission of evidence.* Also HMG, *Review of the Balance of Competences between the United Kingdom and the European Union: Single Market: Financial Services and the Free Movement of Capital.*

5.27 A second line of critique has been that the size of the Single Resolution Fund (SRF) which is likely to be inadequate to deal with a situation where several major banks need to be resolved at the same time, particularly in the early years of banking union when the SRF is still being built up.

5.28 The extent to which the SRF will need to be called upon in a resolution situation depends critically on the ability and willingness of decision-makers to enforce the new pan-EU 'bail-in' rules set out in the Bank Reconstruction and Resolution Directive. In principle, this should ensure that the whole cost of a resolution decision is met by bank creditors. However, these rules are untested and there may be circumstances where bail-in arrangements are inadequate to resolve a bank and financing from the SRF is required.

5.29 It is worth noting that important decisions relating to backstops for the SRF have not yet been made. Discussions are continuing in the EU on, in particular, how to enhance the borrowing capacity of the SRF, possibly through the provision of Member State guarantees or credit lines to the SRF, and on developing backstop arrangements equivalent to the ESM for non-euro area participating Member States. A political commitment has also been made to develop a common backstop by 2024 for all banking union participants. In addition, for euro area banking union members, provision for the direct re-capitalisation of banks from the ESM also exists, separate from the SRF.

5.30 Ultimately, the Government believes this is an issue for the euro area. It is difficult to reach a judgement on the adequacy of the SRF and other backstopping arrangements when discussions on important elements are ongoing. However, the development of a common backstop along the lines of the ESM, providing resolution funding where necessary for all banking union participants would certainly be desirable.

Future Developments

5.31 Respondents highlighted a number of broad developments and structural changes that raise potential concerns for the UK in the area of economic and monetary policy.[14] These included:

- A larger euro area – Currently there are 18 Member States in the euro area and 10 Member States outside (see Chart 3A). However, the euro area is likely to grow in size in future years. All Member States apart from the UK and Denmark are committed to join the euro at some point in the future (when economic conditions are right). Lithuania will join on 1 January 2015;

- New voting rules – On 1 November 2014 new voting rules introduced under the Lisbon Treaty came into force. In particular euro area countries now have an in-built qualified majority under the EU's voting system. Euro area countries could, if they decided to vote together, out-vote those outside the euro area, although until 2017 the current voting rules will apply if a Member State requests it;

- The rising influence of the Eurogroup – The Eurogroup has grown in prominence since the euro area sovereign debt crisis began. There have been more meetings of Eurogroup ministers, euro area leaders have met at euro area summits for the first time, and they have been instrumental in taking decisions in the context of helping ensure the smooth functioning of the euro area; and

[14] *Record of the 27 June 2014 cross cutting stakeholder event*. Also: British Bankers Association, *submission of evidence*; Business for Britain, *submission of evidence*; CBI, *submission of evidence*; Stephen Pickford and Paola Subacchi, *submission of evidence*; IRSG, *submission of evidence*; and Sharon Bowles, *submission of evidence.*

- Legislative and Treaty changes – The crisis has seen the use of a range of legal instruments to bring about reforms, including secondary legislation, EU Treaty change and a number of intergovernmental agreements outside the EU Treaties. Recently there have been calls for changes to the EU's Treaties to enforce greater economic discipline in the EU.

5.32 Given the above, the reform path that the euro area will pursue is difficult to determine, and respondents highlighted a range of risks and potential challenges that the UK could face from these developments.[15] These included:

- Maintaining UK influence in EU decision making, in particular in relation to the Single Market;
- Risks of discriminatory treatment by EU institutions;
- The likelihood that the UK maybe drawn into participating in, or funding, measures for the euro area, raising subsidiarity concerns; and
- The increasing complexity of the governance system, including a rise in intergovernmental agreements and issues related to EU Treaty change.

5.33 The rest of this chapter considers each of these in turn.

UK Influence in EU Decision Making

5.34 Respondents felt that a larger, more integrated euro area, with an in-built QMV, and a more powerful and assertive Eurogroup, presented a challenge to maintaining the UK's current level of influence on economic and monetary policy issues, as well as to the integrity of the Single Market.[16] The British Bankers Association (BBA) argued:

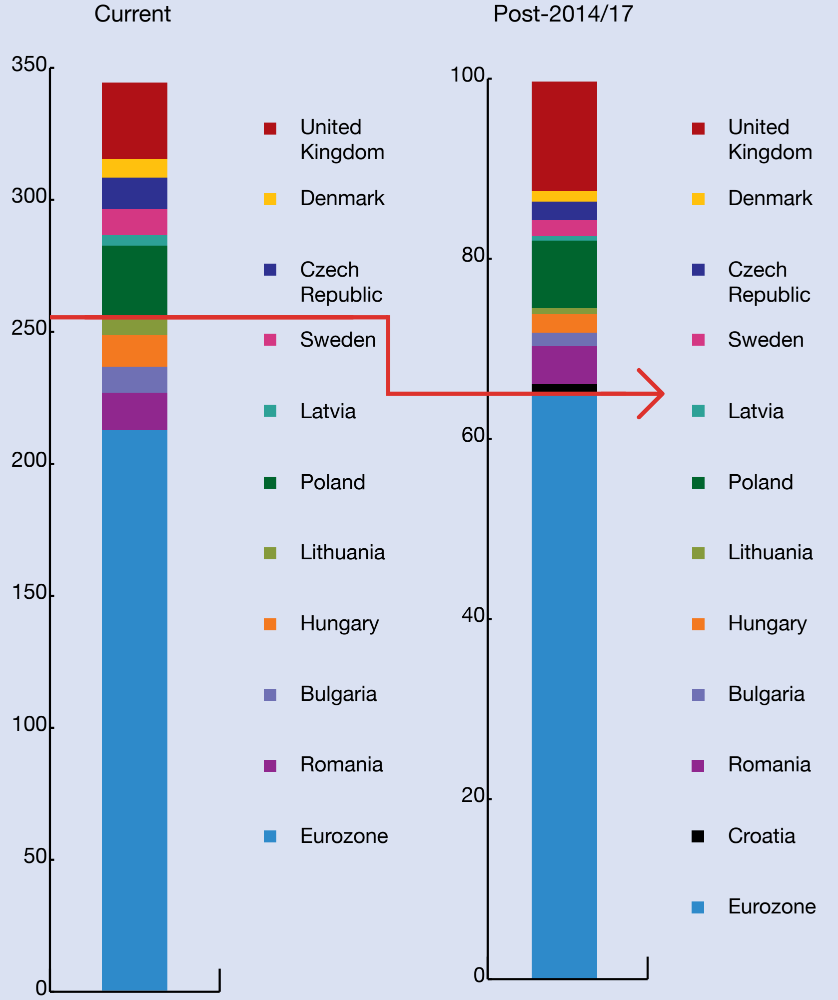
> New voting rules in the European Council that come into effect later this year will give the eurozone countries a clear majority for the first time. Coupled with the potential creation of a new full time President of the euro group this could create significant institutional and political momentum for greater eurozone caucusing.[17]

[15] *Record of 25 June 2014 Stakeholder event*, Chatham House. Also CBI, *submission of evidence*; IRSG, *submission of evidence*; Sharon Bowles, *submission of evidence*; Iain Begg, *submission of evidence*; John Springford, *submission of evidence*; and British Bankers Association, *submission of evidence*.

[16] Business for Britain, *submission of evidence*; British Bankers Association, *submission of evidence*; and CBI, *submission of evidence*.

[17] British Bankers Association, *submission of evidence*.

Chart 5A: Current vs. post-2014/2017 QMV voting weights



Under present rules, a 'qualified majority' requires 260 votes out of 352 in the Council of Ministers. At the moment the eurozone can muster 213 votes-meaning that the eurozone could obtain a qualified majority with the help of a few non-euro countries. After 2014 when the rules change (as specified by the Lisbon Treaty), a qualified majority would require 65 per cent of the EU's total population, which the eurozone would muster on its own (it would have around 65.5 per cent). In other words the eurozone would have a permanent majority.

Source: Open Europe, *Safeguarding the Single Market: How to Achieve a Balanced European Banking Authority* (2012).

5.35 Many of the respondents highlighted the risk that the euro area could use its in-built majority (from November 2014) to caucus on legislative issues of importance to the whole EU.[18] For example they could out-vote the non-euro area Member States, including the UK, on any dossier decided by QMV.[19] This would become more likely as more countries joined the euro area.[20] The Chancellor highlighted this concern in his speech at Open Europe's EU reform conference:

[18] *Record of the 25 June 2014 stakeholder event*, Chatham House. Also IRSG *submission of evidence*; Iain Begg *submission of evidence*; and British Bankers Association, *submission of evidence*.

[19] Fresh Start, *submission of evidence* and BBA, *submission of evidence* to HMG, *Review of the Balance of Competences: Single Market: Financial Services and Free Movement of Capital*.

[20] *Record of the cross-cutting stakeholder event 27 June 2014.* Also Sharon Bowles, *submission of evidence;* Business for Britain, *submission of evidence*; and British Bankers Association, *submission of evidence*.

> There is a danger that the euro members could start to use their collective voting weight in the EU to effectively write the rules for the whole EU by QMV.[21]

5.36 This was seen as a particular concern with regard to Single Market decision-making, especially in relation to financial services regulation, a major UK national interest.[22] The BBA explained that moves towards greater euro area integration could make it difficult for the UK to play a full and appropriate role in regulatory decision-making in the financial services sector. It argued that the development of euro area caucusing, outside the EU-28 format, on matters that impact directly upon the single financial market, could, however unwittingly, damage its integrity.[23]

5.37 Business for Britain argued that:

> The goals and scope of financial regulation in the EU is likely to increasingly serve the interests of the Eurozone – which is no longer closely aligned with the UK.[24]

5.38 Evidence highlighted a divergence between the UK and the euro area in respect of future goals and the approach to regulation, which could lead to a fragmented Single Market and, in the event that 'outs' opt-out of various measures towards deeper integration in the euro, a fragmented or two-tier EU.[25] This risk is put more starkly by Bruegel in a policy brief from 2012.[26] In discussing the possibility of a more fully fledged economic and monetary union, including a banking union, it said that:

> The euro area acting in a unified manner would presumably have a qualified majority within the Council. Thus the two speed EU might resemble the EEA, with the euro area playing the role of the EU and the non-euro area that of the non EU EEA countries. In other words the euro area might simply decide on single market issues, to which QMV applies, and the non-euro area would have to abide by the euro area's decisions. History has shown however that the EEA model is not really attractive and only a few non-EU countries have been willing to join it. Similarly most (but not necessarily all) non-euro area countries would probably not want to remain inside the EU if it meant that the euro area countries dictate single market policy.[27]

5.39 Similarly, Iain Begg argued that the UK decision to be exempt from many of the moves towards economic and monetary union risks distancing it further from the rest of Europe, which could 'raise the probability of a UK exit from the EU overall'.[28]

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[21] Rt. Hon. G. Osborne, *Speech at Open Europe Conference* (15 January 2014). Available at: https://www.gov.uk/government/speeches/extracts-from-the-chancellors-speech-on-europe, accessed 5 November 2014.

[22] In particular, the following respondents to HMG, *Review of the Balance of Competences between the United Kingdom and the European Union: Single Market: Financial Services and the Free Movement of Capital* (2013). The Bar Council, *submission of evidence*; BBA, *submission of evidence*; Sharon Bowles MEP, *submission of evidence*; CBI, *submission of evidence*; FCA PP, *submission of evidence*; HSBC, *submission of evidence*; IRSG, *submission of evidence*; JP Morgan, *submission of evidence*; and RBS, *submission of evidence.*

[23] British Bankers Association, *submission of evidence*.

[24] Business for Britain, *submission of evidence*.

[25] IRSG *submission of evidence,* and CBI, *Our Global Future: A Business Vision for a Reformed EU* (2013).

[26] Pisani-Ferry et al (2012).

[27] Idem.

[28] Iain Begg, *submission of evidence*.

5.40 A further concern outlined by respondents, in relevant literature, and noted by the Chancellor in his recent Open Europe speech, was the growing role of the Eurogroup.[29] The 2012 Bruegel policy brief notes that the Eurogroup has grown in influence relative to ECOFIN and become a *de facto* executive body, while the Treaty on Stability Co-ordination and Governance has set up regular euro summits to discuss fiscal and economic issues.[30] Bruegel suggests that while non-euro area countries recognise it is legitimate for euro area countries to discuss issues such as the Greek bail-out and fragility of the euro area banking system:

> Some deplore the absence of a real ECOFIN discussion on these matters, even though events…have clear implications for non-euro area countries.[31]

5.41 As the Chancellor noted:

> We've already started to see the Eurogroup discussing EU directives privately before involving other member states – like they did over the Bank Recovery and Resolution Directive last June. It means there's a very real risk that badly thought through legislation will be imposed on the UK.[32]

5.42 At the same time, John Springford cautioned about overplaying the risks of caucusing by euro area countries and the impact on UK interests.[33] He argued that a euro area caucus is unlikely as euro area Member States have less of a shared interest in co-operation on social, employment and immigration issues and policies that are considered as being trade protectionist.[34] The CBI report, though highlighting a large number of risks including caucusing, also agreed, arguing that:

> The journey to Eurozone membership is occurring at different speeds for different countries and, even when this collection of Member States grows, there is little evidence that the euro zone is likely to caucus as one bloc vote on every issue.[35]

5.43 The CBI suggested fears over the UK being side lined as a result of further economic integration in the EU so far have not been realised and cite the UK's success in securing safeguards through support from other Member States for a 'double majority' in the European Banking Authority as an example.[36] The IRSG submission argued that:

> There will be an ongoing need for safeguards in the future. Banking Union and any other policy or legal developments not involving all EU Member States should adopt the safeguards of the enhanced co-operation procedure that "such co-operation shall not undermine the internal market or economic, social and territorial cohesion. It shall not constitute a barrier to or discrimination in trade between Member States, nor shall it distort competition between them.[37]

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29 *Record of the 4 June 2014 stakeholder event,* Bruegel. Also: British Bankers Association, *submission of evidence;* Sharon Bowles, *submission of evidence;* IRSG, *submission of evidence;* Dermot Hodson, *submission of evidence*; and Stephen Pickford and Paola Subacchi, *submission of evidence*.

30 Pisani-Ferry et al (2012).

31 Idem.

32 Rt. Hon. G. Osborne, *Speech at Open Europe Conference*.

33 John Springford, *submission of evidence*.

34 Idem.

35 CBI, *submission of evidence*.

36 Idem.

37 Article 326, TFEU.

Risks of Discriminatory Treatment by EU Institutions

5.44 The euro area sovereign debt crisis has altered the decision-making structure of the EU. The House of Lords Report argues that authorities such as the ECB and the Eurogroup have grown in importance.[38] At the same time, the power of the Commission and its influence in determining the crisis response has decreased and the role of the European Parliament has been limited. It argues that:

> It is the euro area authorities, as opposed to those representing the EU 28, that have grown in power and influence.[39]

5.45 Further moves to euro area integration may strengthen this trend, although others have argued that the Commission's role has in fact been strengthened through the imposition of reverse qualified majority voting.

5.46 As the Chancellor set out in his Open Europe speech, as a result of attempts by the EU institutions to tackle the crisis, there have been 'problems with discriminatory treatment of non-euro zone Member States'.[40]

5.47 One example of discrimination is the ECB location policy, which restricts the clearing of euro-denominated financial products outside the euro area. IRSG and Raoul Ruparel highlighted the major issues this raises with regard to discriminatory treatment and fragmentation of the Single Market.[41] The IRSG argued that:

> This is an example of discrimination contrary to Article 18 of the TFEU, the principle underlying which the European Commission should address directly and propose rules on non-discrimination in line with Article 18.[42]

5.48 Raoul Ruparel (Open Europe) argued that 'politically this case is very significant. If the UK loses it could suggest a fragmentation of the single market'.[43]

5.49 However, John Springford pointed out the challenge that central banks may face 'if a clearing house gets into trouble…unless the central bank keeps it going with liquidity', and thus, in his view, the legitimate interest the ECB would have in the supervision of a clearing-house offering euro-denominated services.[44] Here, it is true that a central bank such as the ECB or Bank of England will have an interest in clearing services denominated in their currency. It will also be true of clearing services denominated in any currency where home banks have large exposures to a cross-border clearing-house. For this reason, in the EU, there is a common pan-EU risk management framework for clearing-houses provided for under the European Market Infrastructure Regulation (EMIR). This leaves supervisory responsibility with the national supervisor but establishes a collective supervision and oversight framework via a College of relevant EU authorities, and includes the ECB for relevant clearing-houses. However, the ECB does not have

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38 House of Lords (2011).

39 Idem.

40 Rt. Hon. G. Osborne, *Speech at Open Europe Conference* (15 January 2014). Available at: https://www.gov.uk/government/speeches/extracts-from-the-chancellors-speech-on-europe, accessed 5 November 2014.

41 IRSG, *submission of evidence.* Also The Financial Times, *UK and ECB Set to Clash in Court over Clearing Houses, (*9 July 2014). Available at: http://www.ft.com/cms/s/0/17c32a34-06bc-11e4-ba32-00144feab7de.html#axzz3K5XXp0XN, accessed on 27 November 2014.

42 IRSG, *submission of evidence.*

43 Financial Times, *UK and ECB Set to Clash.*

44 John Springford, *submission of evidence.*

supervisory responsibility for euro area or EU clearing-houses. This is prohibited under the Single Supervisory Mechanism enshrining the ECB as supervisor over Eurozone banks.

5.50 Steps have also been taken internationally to further deal with emergencies and the role of central banks, through the 'No Technical Obstacles' agreement.[45] Here, central banks across the globe have agreed to remove barriers that would prevent them offering assistance to the financial sector, which would be determined on a case-by-case basis. At Mansion House on 12 June 2014, the Governor of the Bank of England announced he would 'widen access to our facilities to include […] central counterparties authorised to operate in UK markets.'[46] This would, necessarily, be applicable to a clearing-house in the EU which will have been authorised as meeting the standards of EMIR.

5.51 Another example that has been cited is the Single Supervisory Mechanism where the original proposal caused concerns. In respect of the SRM it has been argued that the use of a Single Market legal base to take forward this proposal raised concerns regarding EU institutional decision making. For example, Open Europe in their flash analysis state that:

> If the eurozone is simply able to bend the meaning of the existing treaties as well as the use of EU institutions for the eurozone, rather than EU wide interests, the fear is likely to be, where does this stop.[47]

5.52 They further argue that:

> The biggest potential impact on the UK and those outside the Eurozone/banking union would be the precedent this proposal could set if it is allowed to pass under a single market Treaty base. This is a solution designed to solve financial fragmentation within the Eurozone, which is the direct result of the way the currency union was originally constructed.[48]

Increasing Complexity of the Governance System

5.53 As set out in the 2012 Bruegel paper, the EU governance system has become increasingly complex as a result of the crisis.[49] There are a number of inter-related elements to this complexity.[50] First, a range of instruments has been used to strengthen the EU's economic governance. This included secondary legislation ('six-pack', 'two-pack', SSM, SRM, EFSM), EU Treaty change (to provide the legal basis for the ESM) and intergovernmental agreements (Greek Loan Facility, EFSF, ESM, Fiscal Compact, Single Resolution Fund).

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[45] For example: Financial Stability Board, *OTC Derivatives Market Reform, Third Progress Report on Implementation,* (2012) p48. Available at: http://www.financialstabilityboard.org/publications/r_120615.pdf, accessed 5 November 2014.

[46] Carney, *Speech at the Lord Mayor's Banquet for Bankers and Merchants of the City of London*, (12 June 2014).

[47] Open Europe, *Flash Analysis: Controversial Second Pillar of Banking Union Looks Insufficient to Hold Up Eurozone Roof in a Crisis* (10 July 2013).

[48] Idem.

[49] Pisani-Ferry *et al* (2012).

[50] Idem.

5.54 Second, the groupings of countries that are participating in different mechanisms are not stable. As Bruegel suggests, this results in different attitudes, with countries not planning to join being keen to avoid spillovers and countries set to join in the future keen to ensure the governance system does not prevent their entry at some point in the future. And within different groupings views are not homogenous.[51] Ultimately, this is leading to a 'variable geometry' governance system, with some countries participating in all measures, and some in some measures but not others. Voting rules are also becoming more complex, and Bruegel even suggest this lack of clarity could lead to a 'significant drag on economic efficiency'.

A number of respondents also cited the increasing use of intergovernmental agreements to reinforce the EMU.[52] While these agreements at least provide clarity on participation, evidence suggested a number of concerns with this approach that may impact the UK's interests or wider EU interests.

5.55 The Commission view, set out in its Genuine Economic and Monetary Union (GEMU) report, is that:

> Intergovernmental solutions should only be considered on an exceptional and transitional basis where an EU solution would necessitate a Treaty change, and until that Treaty change is in place. They must also be carefully designed so as to respect EU law and governance, and not raise new accountability problems.[53]

5.56 Sharon Bowles, with reference to the euro area doing more things off-Treaty or via enhanced co-operation, argued that:

> Although occasional measures might be necessary, any systematic approach could risk damaging the single market and creating a two tier Europe in an unplanned manner.[54]

5.57 Some respondents also raised concerns that the European Parliament has no involvement in intergovernmental agreements. [55] In the creation of the ESM, the European Parliament emphasised the need for it to:

> Respect the core principles of democratic decision making such as transparency, parliamentary scrutiny and democratic accountability… the mechanism must not give rise to a new model of European governance which falls short of the level of democratic standards achieved in the Union.[56]

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51 Idem.

52 *Record of 4 June 2014 stakeholder event*, Bruegel. Also IRSG, *submission of evidence* and British Bankers Association, *submission of evidence*.

53 European Commission, *A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate: A Communication from the Commission* (2012).

54 Sharon Bowles, *submission of evidence*.

55 P. Ponzano, 'Community and Intergovernmental Method: An Irrelevant Debate?' *Notre Europe Policy Brief*, No 22. (April 2011).

56 European Parliament Resolution (2012/C 247 E/08) paragraph 8 as quoted in Gianni, L. S., L. S. Gianni, *The ESM Treaty; A New Form of Intergovernmental Differentiated Integration to the benefit of the EMU?* (2013).

5.58 Both the Van Rompuy and Barroso reports noted that Treaty change would be needed for the more ambitious proposals in their reports (final steps to full economic and monetary union would only be taken in the 'longer term' and would require 'major Treaty reform' suggests the Commission paper).[57] Many of the intergovernmental agreements have explicit clauses committing signatories to bring these Treaties within the EU Treaties in a time-limited fashion, and there have been indications from some euro area countries that Treaty change may be desired. The House of Lords Report also argues that some Treaty change is needed to underpin the scale of reforms needed to address the EMU's flaws.[58]

Other Developments

5.59 The Government's view is that there are a number of areas where action designed primarily for the euro area may impact the wider EU and the UK national interest in the future, especially in light of the developments and related risks outlined above. These include:

- Developments with regard to the banking union, including the SSM and SRM;
- Developments with regard to the proposed social dimension of EMU;
- Incentives to encourage structural reform; and
- Solidarity mechanisms or a euro area budget.

The Approach Adopted to Date

5.60 As the euro area has taken steps towards closer integration in a range of areas, the EU has adopted a number of *ad hoc* responses to safeguard the interests of the 'outs' and handle the interaction of the euro area and the non-euro area:

- EU leaders have repeatedly agreed in European Council Conclusions that as the euro area pursues closer co-ordination, the integrity of the Single Market must be protected and the process must be open and transparent towards non-participating Member States;
- EU leaders have also been clear on a number of occasions that further steps towards economic and social policy co-ordination would be voluntary for non-euro area Member States and that non-participating Member States would not be liable to fund these measures;
- Agreement was reached that the EFSM would no longer be used to bail-out the euro area when the new ESM was set up, removing UK liability for euro area bail outs;
- During the negotiations on a SSM, the ECOFIN and European Council agreed that a double majority voting system would apply to the European Banking Authority, as well as explicit recognition of the importance of non-discrimination and the integrity of the Single Market. The double majority voting means that certain decisions in the EBA now require a majority of both euro area and non-euro area countries to pass; and
- A new binding legal provision was included in the SSM regulations to prevent discrimination against financial services providers based on their location within the EU. This also ensured no liability for non-participants in the SRM and protected state aid rules.

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[57] Van Rompuy (2012); and Commission (2012).

[58] House of Lords (2011).

Summary

5.61 Euro area integration is driving fundamental change in the EU, in particular in the area of economic and monetary policy. A number of reforms have been implemented already, many of which impact on the relationship between euro area and non-euro area Member States, particularly around banking union and the ESM. The legal and policy environments are unusually fluid, and further integration is foreseen in a range of areas, including economic, fiscal, financial and potentially political, some of which would require Treaty change. Such integration raises possible areas of concern for the UK, which include:

- The growing prominence of the Eurogroup;
- The growth in size of the euro area;
- New QMV voting rules increasing the collective influence of the euro area;
- The risks associated with euro area caucusing; and
- An increase in the complexity of economic governance in the EU through the use of a range of legal instruments to bring about reforms.

5.62 A range of responses have been adopted to date to manage these concerns. The key future challenge for the EU's economic and monetary policy will be to resolve the challenges faced by the euro area in a way that protects the interests of those outside the single currency and, in particular, the integrity of the Single Market, as well as supporting growth and jobs in the whole EU.

Annex A: List of Evidence Received

British Bankers Association (Anthony Browne)
Business for Britain
City UK /International Regulatory Strategy Group (IRSG) (Richard Fernner)
Commission Contribution (Factual Material)
Confederation of British Industry (CBI)
Rev. Donald Prentice (former Foreign and Commonwealth Office staff)
Dr. Dermot Hodson (Birkbeck College – personal capacity)
Dr. Michael Lloyd (LCA Europe)
Professor Iain Begg (London School of Economics)
John Chown (Chown Dewhurst LLP)
John Springford (Centre for European Reform)
Dr. Marek Dabrowski (Personal Capacity – Centre for Social and Economic Research Fellow)
Paul van den Noord (Personal capacity)
Professor Kern Alexander (University of Cambridge)
Scottish Government
Sharon Bowles MEP
Stephen Pickford and Paola Subacchi (Chatham House)
Welsh Government

In addition, the following responses to the Financial Services and Free Movement of Capital Report raised issues that were of relevance to the subject matter of the economic and monetary policy report, in particular the relationship between the single currency and the Single Market and the issues raised in Chapter Five of this report;

Bank of America Merrill Lynch
Barclays
Bar Council
British Bankers Association
Building Societies Association
Business for Britain
CBI
Centre for European Reform

Communication from the Commission to the European Parliament and the Council, *A Roadmap towards a Banking Union*, September 2012

Financial Conduct Authority (FCA) Practitioners Panel

Fresh Start

HSBC

International Regulatory Strategy Group (IRSG)

JP Morgan

Lord Howard Flight

Nomura

Royal Bank of Scotland

Rt Hon John Redwood MP

Sharon Bowles MEP

Annex B: Engagement Events and Attendees

Bruegel, Brussels – Panel Event, 4 June 2014

Attendees:

- Banco Bilbao Vizcaya Argentaria, UK Representation to the EU
- Banco Santander
- Bank of Belgium
- Bruegel
- Centre for European Policy Studies (CEPS)
- City of London Corporation
- Committee of the Regions
- Confederation of Danish Employers
- Confrontations Europe
- Deutsche Börse
- ECB Office in Brussels
- European Council
- European Parliament
- General Secretariat of the EU Council
- Japan Center for International Finance
- Ministry of Finance – Belgium
- Mitsui & Co. Benelux
- Permanent Representation of Denmark to the EU
- Permanent Representation of Spain to the EU
- UCL & Facultes Universitaires Catholiques de Mons
- ULB – Free University of Brussels
- UniCredit
- UK Representation to the EU

Roundtable, Ambassador's Residence, Prague, 19 June 2014

Attendees:

CERGE-EI Institute
Ceskoslovenska Obchodni Banka
CEVRO Institute
Czech National Bank
EEIP (Consultancy Company)
Foreign and Commonwealth Office
Government of Czech Republic

Chatham House, London – Panel Event, 25 June 2014

Round table Cross Cutting Stakeholder Meeting, FCO, Friday 27 June 2014

Attendees:

Business for Britain
Council of British Chambers of Commerce in Europe
Energy UK
European Commission
European Foundation
Gapuma
Heathrow
Institute of Directors
London Chamber of Commerce
MHP Communications
TheCity UK

Round table event on Economic and Monetary Union and Single Market, CityUK, 24 July 2014.

Attendees:

Analytically Driven Ltd
Association of British Insurers
City of London Corporation
David Green Consulting
Deloitte LLP
DLA Piper
Embassy of Ireland
Embassy of Italy
Embassy of the Republic of Hungary
European Commission
Foreign & Commonwealth Office
Graham Bishop
House of Lords
J.P. Morgan

KPMG
Mayer Brown International LLP
Nomura International plc
Royal Bank of Scotland
SEB Private Banking
Standard Life Plc
TheCityUK
Zurich Financial Services

Bilateral meetings

Jean Pisani Ferry, Former Director of Bruegel. Currently the Commissioner-General of the French Prime Minister's Policy Planning Staff in Paris and Professor of Economics with Hertie School of Governance.

Iain Begg, Professorial Research Fellow, European Institute, LSE.

Raoul Ruparel, Head of Economic Research, Open Europe.

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Appendix A: List of Acronyms

AGS	Annual Growth Survey
AMR	Alert Mechanism Report
BBA	British Bankers Association
BEPG	Broad Economic Policy Guidelines
CBI	Confederation of British Industry
CCI	Convergence and Competitiveness Instrument
CJEU	Court of Justice of the EU
CSR	Country Specific Recommendations
EBA	European Banking Authority
ECB	European Central Bank
ECON	Economic and Monetary Affairs Committee
ECOFIN	Economic and Financial Affairs Council
EDP	Excessive Deficit Procedure
EEA	European Economic Area
EEC	European Economic Community
EFC	Economic and Financial Committee
EFC-A	EFC-Alternates
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EMP	Economic and Monetary Policy
EMS	European Monetary System
EMU	Economic and Monetary Union
EP	European Parliament
ERM	Exchange Rate Mechanism
ESCB	European System of Central Banks
ESRB	European Systemic Risk Board
ESRM	European Single Resolution Mechanism
ESM	European Stability Mechanism
EU	European Union

EUBoP	EU Balance of Payments Facility
EWG	Eurogroup Working Group
FSB	Financial Stability Board
FSFMOC	Financial Services and Free Movement of Capital (Semester 3 report)
GDP	Gross Domestic Product
GEMU	Genuine Economic and Monetary Union
IRSG	International Regulatory Strategy Group
IMF	International Monetary Fund
LTRO	Long Term Refinancing Operation
MFA	Macro Financial Assistance
MIP	Macroeconomic Imbalances Procedure
MTO	Medium Term Objective
NAB	New Arrangements to Borrow
NP	National Parliament
NRP	National Reform Programme
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transactions
QMV	Qualified Majority Voting
RQMV	Reverse Qualified Majority Voting
SGP	Stability and Growth Pact
SMP	Securities Markets Programme
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TEU	Treaty on the European Union
TFEU	Treaty on the Function of the European Union
TLTRO	Targeted Longer-Term Refinancing Operation
TSCG	Treaty on Stability, Co-ordination and Governance

Appendix B: The Legal Framework

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

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

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

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

Economic Policy: Articles 120 and 121

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

B.5 Article 121 requires Member States to co-ordinate their economic policies within the Council. Article 121 further provides a power for the Council to adopt Broad Economic Policy Guidelines for the Member States (BEPGs) and to monitor economic developments and consistency of economic policies by means of multilateral surveillance. Where it is established that the economic policies of a Member State are not consistent with the BEPGs or that they risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned and the Council may address the necessary recommendations to the Member State concerned. Article 121(6) contains a general power for the European Parliament and the Council to adopt detailed rules for the multilateral surveillance procedure. Article 121 applies to the UK. However, BEPGs which concern the euro area generally do not apply to the UK. Article 121 also provides the legal basis for the MIP.

Legal Basis of the SGP: Articles 121 and 126

B.6 Articles 121 and 126 of the TFEU provide the legal basis for the Stability and Growth Pact. Article 121 is the legal basis for the preventive arm of the SGP. This legislative power cannot be used on its own to adopt coercive measures. Article 126 forms the basis for the corrective arm and the EDP and Protocol 12 defines the reference values of 3 per cent of GDP for public deficit and 60 per cent of GDP for public debt.

The Preventive Arm

B.7 The first regulation of the SGP (Regulation (EC) No. 1466/97 and subsequently amended), on 'the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies', provides for the preventive arm of the pact and entered into force on 1 July 1998. It seeks to ensure that fiscal policy is conducted in a sustainable manner over the medium-term cycle, with a view to preventing countries breaching the debt and deficit values. The preventive arm requires Member States' fiscal positions to be 'close to balance or in surplus position'.

B.8 The preventive arm is centred around the country-specific medium-term budgetary objective (MTO), which Member States must aim to achieve.[1] The addition of an expenditure benchmark as part of the 'six-pack' reforms strengthened the preventive arm in 2011. This is designed to ensure that annual government expenditure is kept at a sustainable rate and allows the Council and Commission to assess whether 'sufficient progress' towards the medium-term budgetary objective is being made.[2]

B.9 Article 6 of the regulation states that in the event of significant deviation from the adjustment path towards the MTO, the Commission shall address a warning to the Member State concerned, in accordance with Article 121(4); a process which can ultimately lead to the issuance of sanctions for euro area Member States (as set out in Chart 3C).

The Corrective Arm

B.10 The second regulation of the SGP (Regulation 1467/97 and subsequently amended) sets out the framework for the corrective arm of the pact; 'speeding up and clarifying the implementation of the excessive deficit procedure'. It entered into force on 1 January 1999 and allows countries to take action to correct their excessive deficit. The excessive deficit procedure is triggered when a country is in breach of one or both of the rules that the deficit must not exceed 3 per cent of GDP and public debt must not exceed 60 per cent of GDP (or at least diminish sufficiently towards the 60 per cent) as defined in Protocol 12 of the TFEU.

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

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

B.11 The ‘six-pack’ introduced a new debt requirement to the corrective arm in 2011. This requires the general government debt of Member States to be less than 60 per cent of GDP or to be ‘sufficiently diminishing and approaching 60 per cent of GDP at a satisfactory pace’.[3] The Commission annually assesses the progress that Member States have made in meeting the EDP target and can find that ‘effective action’ has or has not been taken to reach the target by its deadline. Non-compliance with the corrective arm can lead to the imposition of sanctions for euro area countries. These can involve annual fines for euro area Member States and, for all countries, possible suspension of Cohesion Fund financing until the excessive deficit is corrected (as illustrated in Chart 3D).

B.12 The UK is subject to the SGP. However, in accordance with Protocol 15 and Article 139 TFEU, the UK undertakes only to ‘endeavour to avoid’ an excessive deficit and the sanctions provisions do not apply.

B.13 The SGP was reformed in 2011 and 2013 by the ‘six-pack’ and ‘two-pack’ legislative packages, which are set out in Box B1 and Box B2 below.

Box B1: The ‘Six-Pack’

The ‘six-pack’ is made up of the following five regulations and a directive:

- Regulation No. 1173/2011 on the effective enforcement of budgetary surveillance in the euro area;
- Regulation No. 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area;
- Regulation No. 1175/2011 amending Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies;
- Regulation No. 1176/2011 on the prevention and correction of macroeconomic imbalances; and
- Regulation No. 1177/2011 amending Regulation (EC) No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

The first two of these regulations apply only to euro area Member States; the remainder apply to all Member States.

- Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States. This applies to all Member States and sets out minimum requirements on accounting and statistical requirements, national fiscal rules, forecasting procedures and the transparency and scope of budgetary frameworks. Parts of this directive do not apply to the UK in view of Protocol 15.

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

Box B2: The 'Two-Pack'

The 'two-pack' consists of the following regulations:

- Regulation (EU) No. 472/2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability; and
- Regulation (EU) No. 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area.

Neither regulation applies to the UK.

Article 122

B.14 Article 122 provides for emergency measures in circumstances where a Member State may face 'severe difficulties' that arise as a result of the 'supply of certain products' (Article 122(1)), 'natural disasters' or other 'exceptional circumstances beyond its control' (Article 122(2)).

B.15 Article 122(2) was the legal basis for the adoption of Regulation 407/2010 of 11 May 2010 establishing the European Financial Stabilisation Mechanism, set up in response to instability in the euro area.

B.16 The European Council Conclusions of 17 December 2010 stated that once the new, permanent European Stability Mechanism was in place, Article 122(2) would 'no longer be needed' for the purpose of safeguarding the financial stability of the euro, 'and should not be used for such purposes'.

Articles 123 – 125

B.17 Article 123 prohibits European Union and Member State institutions from the use of overdraft or credit facilities with the ECB or the national central banks of Member States. It also prohibits the direct purchase of Union and Member State debt instruments by the ECB and national central banks.

B.18 Article 124 prevents European Union or Member State authorities from establishing measures not based on prudential considerations that would enable them to gain privileged access to financial institutions.

B.19 Article 125 states that the European Union and Member States shall not be liable for or take on the responsibility for the financial commitments made by other Member States and their authorities. This clause does not, however, prohibit loans from being made between the Union and Member States or between Member States themselves.

B.20 The application of these articles has been considered by the ECJ and by the German Federal Constitutional Court.[4]

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

Monetary Policy: Articles 127 – 133

B.21 Chapter two, Articles 127 – 133, define the powers and tasks of the ECB and the national central banks, which together form the European System of Central Banks (ESCB). The ECB and the euro area national central banks together form the Eurosystem. The powers and tasks of the ESCB are further spelled out in Protocol 4 to the Treaties on the Statute of the European Central Banks and of the European Central Bank.

B.22 The majority of these provisions do not apply to the UK by virtue of Protocol 15. The principal exceptions to this are Article 129, which concerns the governance of the ESCB by the decision-making bodies of the ECB, and Article 127(6), which is a power for the Council to confer specific tasks on the ECB concerning prudential supervision of credit institutions but not insurance undertakings. This power is exercisable by unanimity and requires the UK's agreement.

Articles 134-135

B.23 Article 134 provides for the setting up of the Economic and Financial Committee (EFC). This provision applies to the UK which is a member of this Committee. Article 134(1) establishes the EFC 'in order to promote co-ordination of the policies of the Member States to the full extent needed for the functioning of the internal market'. Article 134(2) outlines the main tasks of the EFC, which are to report to the Council and the Commission on 'the economic and financial situation of the Member States and of the Union…in particular on financial relations with third countries and international institutions'; to deliver opinions and help prepare the work of the Council; and to report to the Commission and to the Council, at least once a year, on 'the situation regarding the movement of capital and the freedom of payments', covering 'all measures relating to capital movements and payments'.

B.24 Article 135 provides a special power for the Council to call on the Commission to make recommendations or proposals as appropriate on economic and monetary matters. This provision applies to the UK.

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

B.25 Articles 136 to 138 contain provisions specific to euro area Member States. Article 136 confers powers to adopt measures specific to those Member States whose currency is the euro: (a) to strengthen the co-ordination and surveillance of their budgetary discipline; (b) to set out economic policy guidelines for them.

B.26 This power was used in conjunction with Article 121(6) TFEU to adopt the two instruments in the 'six-pack' involving sanctions for euro area Member States. It is also the basis with Article 121(6) for the 'two-pack' measures.

B.27 Article 136 provides a basis to ensure the proper functioning of the economic and monetary union. Secondary legislation for monitoring, assessing and resolving issues surrounding budgetary plans and imbalances amongst euro area Member States was adopted under this Article.

B.28 These articles provide for action by the EU, but where decisions are taken by the Council, only euro area Member States may vote. Article 136 does not apply to the UK since its scope is limited to Member States whose currency is the euro.

B.29 The power to impose sanctions under the MIP derives from Article 136. Failure to take sufficient corrective action under the MIP could therefore lead to sanctions for euro area Member States but those outside of the euro area are not subject to sanctions.

B.30 Article 136 was amended in 2013 following ratification by all Member States. The amendment created Article 136(3), which provided a permanent legal basis for the European Stability Mechanism (ESM). The UK is not a participant in the ESM Treaty and therefore does not have any financial exposure in relation to the operation of the mechanism, either directly or through the EU Budget.

Articles 139 – 144: Transitional Provisions

B.31 Articles 139 to 144 contain transitional provisions for Member States in respect of which the Council 'has not decided that they fulfil the necessary conditions for the adoption of the euro'. In particular, Article 139 makes it explicit that the coercive means of remedying excessive deficits (Article 126(9) and (11) TFEU) do not apply to Member States with a derogation and similarly acts of the ECB and measures concerning the euro do not apply. Article 139(4) makes it clear that voting rights of Member States with a derogation are suspended for the purposes of the same powers. So far as concerns the UK these disapplications and suspensions are reiterated in Protocol 15.

B.32 Article 140 spells out the procedure for ending a derogation, stating the following criteria which must be fulfilled by Member States:

- The achievement of a high degree of price stability – this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;
- The sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6);
- The observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System for at least two years without devaluing against the euro; and
- The durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels. It also provides the procedure for Denmark or the UK to join the euro if they wished to do so. Only Member States whose currency is already the euro may vote on the ending of a derogation. Additional details for the ending of the UK's opt-out are set out in Protocol 15.

B.33 Article 141 provides for a General Council of the ECB, in addition to the Governing Council and Executive Board provided for by Article 129, for the purposes of providing a forum with Member States with a derogation. Protocol 15 provides for the retention of this General Council whether or not there are any Member States with a derogation, so long as the UK opt-out remains. The UK's only financial contribution is to the administrative budget of the ECB.

B.34 Article 142 requires Member States with a derogation to treat their exchange-rate policy as a matter of common interest. This provision applies to the UK by virtue of Protocol 15.

Article 143: Balance of Payments Facility

B.35 Article 143 (formerly Article 119 TEC) provides a mechanism for granting mutual financial assistance to a Member State, whose currency is not the euro, experiencing or seriously threatened with balance of payments difficulties. The EU Balance of Payments facility provides the basis for such mutual assistance.

Protocols

B.36 The following protocols are referenced previously in the text:

- Protocol 4 on the Statute of the European System of Central Banks and of the European Central Bank;
- Protocol 12 on the Excessive Deficit Procedure. Article 1 provides the reference values referred to in Article 126(2) of the TFEU of:
  - 3 per cent for the ratio of the planned or actual government deficit to gross domestic product at market prices; and
  - 60 per cent for the ratio of government debt to gross domestic product at market prices. Protocol 13 on the convergence criteria that are set out in Article 140.
- Protocol 14 provides for the Eurogroup to consist of Ministers of the Member States whose currency is the euro to meet informally. The Commission participates and the ECB has a standing invitation to participate in meetings. The president of the Eurogroup is elected by majority of the Ministers of euro area Member States; and
- Protocol 15 provides the provisions specific to the UK.

Appendix C: UK Obligations under the Treaty

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

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

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

- Article 119(2): referring to EU monetary policy and the single currency;
- Article 121(2): on the broad economic guidelines that concern euro area countries;
- Article 126(1), (9), (11): on the avoidance of excessive deficits and the coercive means to enforce this;
- Article 127(1) to (5): on the European System of Central Banks and the European Central Banks;
- Article 128: on the issuance of euro bank notes and euro coins;
- Article 130: on the ESCB or ECB taking instruction from other institutions or organisations;
- Article 131: on the statutes for national central banks, ESCB and ECB;
- Article 132: Decision-making powers of the ECB;
- Article 133: on the laying down of measures necessary for use of the euro; and
- Articles 136 and 137: apply to euro area Member States only and hence do not include to the UK. This includes the first two six-pack Regulations (No 1173/2011 and No 1174/2011) and the two-pack Regulations (No 473/2013 and No 472/2013), which are based on Art. 136 as well as Article 121(6).Protocol 15 also refers to Articles 138, 140(3), 219, 282(2) (except the first and last sentences), 282(5) and 283 which do not apply to the UK. Corresponding provisions of the ECB statute are also disapplied.

Appendix D: List of Current Euro ‘Ins’ and ‘Outs’

Table D1: List of Member States that are currently in or out of the euro area

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