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Rt Hon Greg Clark MP
Financial Secretary
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Dear Greg,

The euro area crisis: an update

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

Introduction

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

agreed that it was too early to say if a corner had been turned and pointed out that a contraction in growth was forecast.

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

The ECB and Outright Monetary Transactions

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

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

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

European Stability Mechanism

Developments in relation to the European Stability Mechanism (ESM) have been one of the clearest signals of complacency amongst policymakers in relation to the euro area crisis. Last September the Finance Ministers of Finland, Germany and the Netherlands issued a joint statement indicating that "the ESM can take direct responsibility of problems that occur under the new supervision, but legacy assets should be under the responsibility of national authorities". To compound this, the *Financial Times* reported on 14 January that the

European Commission had discreetly proposed to have Member States make good the losses of private banks before they are recapitalised by the ESM. Professor Goodhart argued that these two developments were a clear move away from breaking the link between sovereign states and their banks. Mr Peet told us that "when market sentiment improves countries like the Netherlands, the Germans and others tend to take back what they have conceded". You agreed about the necessity of breaking the link between sovereigns and their banks. Does this mean you disagree with the statement made by the Finance Ministers of Finland, Germany and the Netherlands as well as the Commission's revised proposal? What steps do you believe now need to be taken if the link between sovereign states and banks is decisively to be broken?

The European Stability Mechanism and European Financial Stability Facility were downgraded by Moody's Investors Services in December, which cited a high correlation in credit risk present among the entities' largest financial supporters. Mr Bootle stated that this was not significant: whilst politicians took rating agencies seriously, markets did not. Professor de Grauwe added that, since rating agencies had made so many mistakes in the past, they had lost credibility. Professor Goodhart pointed out that rating agencies do have an impact on generalised public opinion if not on informed opinion. In your evidence you pointed out that agencies did not have access to any privileged information in making their sovereign credit rating assessment. The Chancellor of the Exchequer has previously placed great store by the UK's AAA rating. Given that the UK has been placed on negative outlook, how important is the UK's AAA rating from the Government's perspective? Is Mr Bootle right to state that they have more political resonance than economic importance? This Committee conducted an inquiry into Credit Rating Agencies in July 2011 and we were told¹ that some large institutional investors like mutual funds, pension funds and insurance companies could have specific investment funds which were restricted to bonds whose rating was no lower than a certain threshold (for example only 'investment grade' bonds). This indicates quite significant impact on the markets of a downgrade. However, has this assertion been borne out by subsequent developments?

Structural Reforms

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

¹ By Dr Marco Annunziata, in his previous capacity as Chief Economist at Unicredit Group

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

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

Austerity

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

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

Mr Peet did not reject the need for austerity but felt there had been an overemphasis on it. This, he believed, stemmed from the fact that the crisis began in Greece, "creating the impression that this was all about fiscal irresponsibility". Whilst many of the witnesses we spoke to were in agreement that some austerity was necessary, they stressed that this was

only part of the solution and did not warrant the disproportionate response shown by policymakers. We are concerned by the overemphasis on fiscal consolidation in response to this crisis. Do you think this emphasis will pay off in the long run? What is the evidence that it is having a beneficial effect? In our view there appears to be a growing body of evidence that suggests there will be years of stagnant growth in the euro area as a result. This could have extremely damaging consequences. What are your views of the prospects for growth for the euro area? What are the long-term prospects for the euro area and the EU as a whole, and for the EU single market, in the global economic context?

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

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

Political and social pressures

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

Country-specific issues

As well as discussing the experience of Ireland, our evidence sessions touched on the experiences of some other key euro area Member States. Greece has for so long been at the eye of the storm, and for a time Greek exit from the euro area seemed likely. Mr Peet believed that a key moment came last year when Germany and others in the euro area

reached the conclusion that it would be too dangerous and unpredictable to allow a country to exit the euro area. Despite this positive step forward, Ruth Lea, Economic Adviser, Arbuthnot Banking Group, pointed out that Greek debt levels were still dangerously high with very poor growth prospects, suggesting that Greece has little chance of hitting the target set by the IMF of 124% of GDP in 2020 unless there were further debt write-offs. Mr Bootle and Mr Wolf were also convinced that some sort of restructuring of Greek debt would take place. Mr Wolf argued that, if this coincided with "a situation in which Greece had no hope of growth", an exit from the euro area was still possible. Professor Goodhart suggested that an exit could be triggered through political miscalculation. He anticipated an "exaggerated game of chicken in which we get a politician elected not with a mandate to leave the euro but with a mandate to change and ease the terms on which they are going to be supported". How do you see events unfolding in Greece over the next few months? Has the threat of Greek exit now passed, or should EU leaders still be wary of the possibility? Is there still a threat of contagion, or could it be argued, given the problems experienced in other Member States such as Italy and Spain, that contagion has already occurred?

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

Genuine Economic and Monetary Union

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

Fiscal Union

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

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

Banking Union

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

You have told us that, in negotiations over the SSM, the UK Government were successful in securing safeguards, particularly the so-called "non-discrimination clause" and in relation to voting mechanisms in the European Banking Authority (EBA). As such, the principle of double majority voting will apply in relation to key decisions taken by the Board of Supervisors of the EBA. We do, however, note that there will be a review of the voting

arrangements if and when there are four or fewer non-participating Member States. You told us that two other Member States had so far publicly committed to not participating in banking union. In his recent speech on the UK's future in the EU, the Prime Minister cited the banking union deal as an example of the sorts of safeguards that the UK was seeking. How confident are you that the deal on banking union will safeguard the position of the UK and its financial sector in the longer term?

Implications for the UK

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

Conclusion

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

We would be grateful for a substantive response to each of the questions raised in this letter by 13 March 2013.

I am copying this letter to Rt Hon David Lidington MP, Minister for Europe, William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Paul Hardy, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Laura Hanoman, Kunal Patel, Robert Douglas, Thomas Kenny and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.

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The Lord Boswell
Chairman of the European Union Committee