**House of Lords, European Union Committee, Economic and Financial Affairs Sub-Committee A: Inquiry into EU "Genuine Economic and Monetary Union" and its implications for the UK**

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***Genuine Economic and Monetary Union: preamble***

1. ECB President Draghi's announcement to do "whatever it takes" in July 2012, backed up by the Outright Monetary Transactions (OMTs) programme in September 2012, has, however unproven and qualified, calmed the financial markets and resolved, at least for the time being, last summer's "existential crisis" in the Eurozone. The ECB's action was of crucial significance. Following on from the ECB's action I take the view, as my "central case", that the Eurozone could survive for the "foreseeable future", despite its many flaws and economic stresses, even without major surgery and/or policy changes.

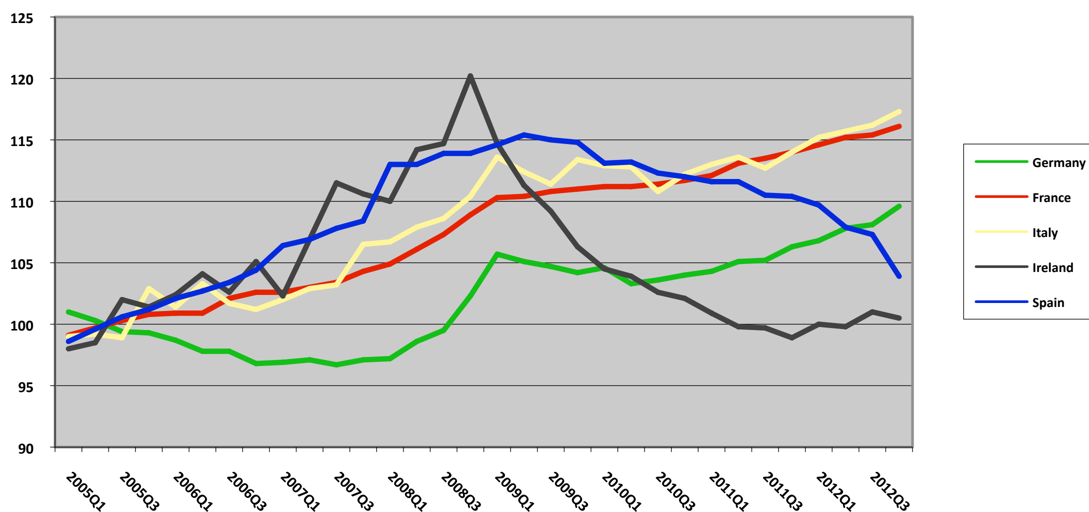
2. There is no question that the Eurozone is economically stressed and damaged. The economic situation in many of the Eurozone Member States is truly dire. Table 1a in the annex provides the Commission's May forecasts for GDP and unemployment. The Eurozone is expected to shrink by 0.4% this year after falling by 0.6% in 2012, with a weak recovery expected in 2014. Within the total Cyprus, Greece (for the 6th consecutive year), Italy, the Netherlands, Portugal, Slovenia and Spain are all expected to remain in recession in 2013. France is projected to border on recession and Germany, the EU's powerhouse, may only grow by a weak 0.4%.[1] Reflecting the poor growth outlook, the projections for the unemployment rates in 2013 for many Eurozone countries are horrendous: Spain (27%), Greece (27%), Portugal (over 18%), Cyprus (15.5%) and Ireland (over 14%). Rates in both Italy (nearly 12%) and France (nearly 11%) are also very high. Youth unemployment rates in Spain and Greece are currently over 50%.[2] There are also knock-on effects of shrinking economies on the Eurozone's public finances (see table 1b in the annex) and the bloc's shaky banks. Several countries were recently permitted delays in their deadlines for hitting their fiscal targets, though this represents a prolongation of austerity rather than abandonment. France, Slovenia and Spain were permitted a two-year delay whilst the Netherlands and Portugal were permitted a one-year delay.[3]

3. It is against this grim economic background that the Commission and the European Council are, sensibly, pushing the agenda for "Genuine Economic and Monetary Union (GEMU)". But before considering GEMU in more detail, there are the following general points to be made as background:

- It is a truism to say that changes within the EU require political acceptability. But this is especially relevant to Germany's position, the largest paymaster and now unequivocally the Eurozone's most influential Member State, partly reflecting the weakness of the other large countries. Very broadly, the German Government's strategy relating to the currency bloc is:
    - Unequivocal support for the Eurozone but, crucially, Germany's liabilities in supporting the rest of the bloc must be limited. Reflecting this there is, for example, no appetite for sovereign debt-pooling via "Eurobonds", or for significant fiscal transfers (via a transfer union) within the Eurozone to ameliorate southern Europe's economic problems or, indeed, for any substantial Eurozone budget.
    - Strong promotion of structural reforms in the weaker southern Eurozone countries so they improve their competitiveness and close the "competitiveness gap" between northern and southern Europe in the absence of the devaluation option. Improving competitiveness is the path to prosperity, albeit slow-burn. Structural reforms do not deliver growth overnight. The Commission's economic reform programme is therefore considered central. There is some German support

for “Convergence and Competitiveness Instruments”, enforceable contracts between the Commission and Member States on economic reforms.
    - In essence, Germany’s economic focus is to remain globally competitive – so the other Eurozone countries must be globally competitive too.
    - Unwavering support for the imposition of fiscal discipline, with some support for more EU oversight over national budgets.
    - Though officially committed to banking union, there is scepticism of elements, such as common deposit protection (insurance), that imply mutual guarantees.
- There are two further points to be made vis-à-vis Germany:
    - The Commission’s programme of promoting economic reforms and austerity plans could be described as the “German plan for Europe”, with rescue funds regarded as a means of buying time and encouraging structural and fiscal reform.
    - It is highly unlikely that the official German position will change radically after the September 2013 elections, even if there were a change of government - such is the broad political consensus of the major parties on economic policy.
- Political acceptability, or otherwise, of aspects of GEMU in the other major Eurozone Member States, especially France, must not of course be ignored. France is notably reluctant to cede more power over its economic policy to Brussels.
- Given their competitiveness problems, high indebtedness and damaged banking systems, the return to prosperity could be long and hard for several struggling Eurozone countries. As chart 1 shows Spain and Ireland have made progress in gaining some cost competitiveness vis-à-vis Germany since the Great Recession, whilst France and Italy have made none at all. But this aside, membership of the Eurozone for Greece, Spain and Cyprus, to name but three, will almost certainly continue to exact a painful social price, which will test the very social fabric of the countries. There is no quick or easy solution to the Eurozone’s problems. And even though my central case is that the Eurozone in its current configuration will survive for the “foreseeable future”, with the implications of any break-up considered to be too costly and disruptive, it cannot be ruled out that one or more countries may leave or even that the currency bloc breaks up altogether.

**Chart 1 Selected Eurozone countries, unit labour costs (2005=100), 2005Q1 to 2012Q4**

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Source: ECB, Statistical Warehouse, unit labour costs, seasonally adjusted data. NB: Greek ULCs in 2012 were 7½% lower than the local peak (2009-2010) and 4% higher than in 2005. Portuguese ULCs were over 5½% lower than the local peak (2009) and 3% higher than in 2005.

***Genuine Economic and Monetary Union (questions 1 and 2)***
*Question 1. How realistic are the plans for Genuine Economic and Monetary Union (GEMU)? Do they go far enough to correct the flaws in EMU revealed by the euro area crisis, or do they go too far to be palatable for some Member States?*
*Question 2. Will the proposals work, and if not, what other steps need to be taken?*

4. Far-reaching and comprehensive plans for GEMU were outlined by Commission in the "Blueprint",[4] whilst the President of the European Council Van Rompuy specified his, less far-reaching, plans in December 2012.[5] Taken together the proposals include:
- Banking union, discussed below.
- Contractual arrangements for encouraging structural reforms, discussed below.
- The establishment of "fiscal capacity", discussed below.

5. The proposals are an eminently sensible way of proceeding if the objective is to underpin the Eurozone with the integrated mechanisms to be found in currency unions such as, say, the UK or the USA. The "Blueprint" in particular, sees the final goal of GEMU as full fiscal and economic union, coupled with political union. Thus the Commission envisages the eventual political unification of the Eurozone bloc, vindicating the many critics of "early EMU" who claimed that monetary unions, especially those comprising disparate economies, do not last unless they have political unions backing them up. If the Blueprint's ambitions were to be fulfilled the Eurozone would have achieved the necessary political union to survive and the major flaw in the initial EMU plans, the absence of the institutions and mechanisms of political union, would have been corrected.

6. But I believe that it is most unlikely that the Eurozone will ever achieve this degree of integration. At one level there is no "demos" in Europe. More prosaically, one of the most obvious stumbling blocks is Germany which, as already indicated in my preamble, is unlikely to commit to "full fiscal and economic union" on the grounds that the implied liabilities of supporting the (presumably still) weaker economies would simply be too great for its economy to bear. And, even though its economic prowess is formidable, it is worth remembering that Germany's population is ageing and dependency ratios are rising. But Germany would not be the only block. Germany's northern allies, the other creditor nations, would surely baulk at political integration in a Eurozone which could cost them dear. And other countries, including France, are likely to find the loss of national sovereignty quite unacceptable.

7. Nevertheless there is some progress in mending some of the flaws most notably in the area of banking union (see below), but it is painfully slow. The lifting of last year's "existential threat" to the Eurozone has dulled the reforming, integrationist zeal. Whether a renewed crisis would trigger off a renewed sense of urgency towards Eurozone integration is impossible to say, but given my understanding of Germany's reservations and its northern allies, I would doubt it. It is therefore much more likely that integrationist developments will be modest, with the main thrust of policy remaining centred on structural reform and fiscal discipline for the "foreseeable future". For many Eurozone citizens it is not an attractive outcome.

***An integrated financial framework (Banking Union) (question 3)***
*Question 3. Will the proposals for banking union decisively break the link between bank and sovereign debt? If not, what more needs to be done? Is the three-pronged model of a single supervisory mechanism, a common resolution mechanism and a common deposit insurance scheme realistically achievable, how long is likely to be needed to achieve it and what are the risks of long delays?*
8. The combination of the Single Supervisory Mechanism (due to be operational in the second half of 2014, delayed from March 2014), a Single (or Common) Resolution Mechanism and a common deposit insurance scheme (common deposit protection), coupled with direct funding of banks by the European Stability Mechanism (ESM), could decisively break the "toxic link"

between the banks and the sovereigns. But there are reasons to believe that these comprehensive proposals will be only partly fulfilled, thus leaving some doubts that a comprehensive break will be achieved. In particular:

- Even though direct funding for banks from the ESM has recently been agreed, the €60bn limit is arguably quite inadequate, given the size of the Eurozone banking system. Moreover, national governments will still have to contribute some of the recapitalisation funds, thus partly retaining the link between sovereigns and banks (thus "diluting" rather than "breaking" the link). Legacy assets were however included, to be agreed on a case-by-case basis. The agreement suggested that "bail-ins" would play a significant part in any bank rescue.
- Concerning the resolution mechanism, progress is being made with the EU-wide Bank Recovery and Resolution Directive (BRRD), though there are disagreements on the details of the "bail-ins". But the Single Resolution Mechanism (SRM), with adequate common funds for resolution financing, is facing much opposition. The recent Franco-German merely made vague reference to a weak-sounding resolution board involving national resolution authorities.[6]
- Progress on common deposit protection seems to have stalled, the aforementioned Franco-German paper made no reference to it all.

***An integrated economic policy framework (questions 4 and 5)***

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

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

9. Convergence and Competitiveness Instruments (CCIs), binding contracts to encourage competitiveness-enhancing structural reforms, can be seen as logical extensions of the EU's economic governance agenda. The agenda has been developed since the beginning of the Eurozone crisis in 2010 and is now quite extensive. The European Semester, a yearly cycle of economic policy coordination, was introduced in 2011H1.[7] And the "Six-pack", comprising a set of rules for enhanced EU economic governance covering both fiscal surveillance and macroeconomic imbalances surveillance, entered into force in December 2011. The "Six-pack" applies to all EU27 Member States with some specific rules for the Eurozone, especially regarding financial sanctions.[8]

10. The Commission has already proposed that CCIs would be designed to implement the country-specific recommendations agreed as part of the European Semester, in particular those emanating from the macroeconomic imbalances procedure.[9] The main difficulties in implementing CCIs will almost certainly be political. Although there is some German support for the contracts, France is unlikely to agree to further Commission intervention in its policy-making. The country took particular exception to the Commission's recent criticism of their pension policies in this May's round of country-specific recommendations.

11. The areas of taxation and employment policy are potentially feasible areas to be considered for further coordination and/or integration, if that is where the Eurozone Member States believe they it should go. But there are also great dangers in pursuing further integration along these lines. The Eurozone members are highly disparate economies and, in the absence of the devaluation option, they must be given scope to achieve the competitiveness they need to thrive in their own ways. Only when the struggling Eurozone members achieve this level of competitiveness will they co-exist happily. But if corporate tax rates were ever to be "harmonised" then, for example, Ireland could lose the advantages of its

low and highly competitive corporate rate – which has already been under attack as "unfair competition" or "fiscal dumping". It is one thing to encourage Spain to reform further its labour laws (as in this May's country-specific recommendations) but another to harmonise tax rates so Ireland loses its competitive edge.

***An integrated budgetary framework (questions 6-8)***

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

- *Why is such a budget necessary, and what would its purpose be? Are there any alternative models that would achieve central fiscal stabilisation?*
- *How would it be funded, and how large would it need to be?*
- *Would it require new institutions? How would it interact with the EU budget?*
- *How might non-members of the euro area participate (voluntarily) in such a mechanism?*

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

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

12. The Commission's proposals for the creation of a "fiscal capacity" in the medium-term and an autonomous Eurozone budget in the longer-term are logical developments if the Eurozone is ever to become fiscally and politically unified. The notion of a "fiscal transfer" union, outside the EU27, has long been mooted as a long-term instrument for ameliorating the economic inequalities within the Eurozone, if not an absolute necessity. But, as already implied, there appears to be little German appetite for a robust Eurozone-only Budget of any significant size.

13. Similarly there seems little prospect for European government bonds ("Eurobonds"), helpful though they may be to the stressed Eurozone counties, given the opposition of Germany and other creditor countries. And, similarly also, I do not believe that permanent fiscal transfers of any significance are inevitable, in spite of the varying levels of competitiveness. More to the point, it appears they just will not happen. On current policies, the Commission hopes to achieve economic compatibility and prosperity for the members of the Eurozone, if this is what is meant by "the goals of fiscal union", through structural reform and fiscal discipline.

***Institutional issues (questions 9 and 10)***

*Question 9. Does the current Treaty framework allow the euro area to go as far as is necessary in terms of integration within the current Treaty framework, or will GEMU inevitably require Treaty change? Should other mechanisms, such as further inter-governmental arrangements or enhanced cooperation, be considered?*

*Question 10. How will EU institutional arrangements need to change in order to accommodate deeper integration?*

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

*What are the implications of GEMU for the role of national parliaments?*

14. I do not claim any special knowledge vis-à-vis institutional and/or treaty issues. And I merely point out that the Foreign Affairs Committee's report *The future of the European Union: UK Government policy,* surely known to the Committee, contained an excellent annex on possible treaty changes if the various stages of GEMU were to proceed.[10] The annex

indicated that many of the proposals in both the Commission's Blueprint and the Van Rompuy Report would probably require treaty changes.

***Impact on the UK and the Single Market (questions 11-13)***

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

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

- *Are there alternative 'models' for banking union which the UK would find more consistent with its preferences?*

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

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

15. I have not yet researched these issues in detail, though I would make some very general points:

- Concerning the need to take account of the interests of all Member States, in particular with regard to the Single Market, the UK should attempt to make alliances with like-minded Member States, both euro and non-euro. It does however have to be conceded that there could be specific difficulties concerning financial services, where the increased power of the ECB could undermine the influence of the EBA.
- The UK Government is broadly correct not to participate in the measures involved in banking union (though it will of course be subject the EU27 Bank Recovery and Resolution Directive). There is no need to be involved and [there are] potential downsides if we were. The UK's regulatory authorities should have as free a hand as possible to regulate the British banking sector.
- It is difficult to address the issue of alternative models for banking union that may suit the UK better, because no alternatives seem to be "on offer".
- There are inevitably risks that the UK will find itself in a small minority of non-participating Member States. But better this, than locked in the euro. And I suspect the UK will find it more difficult to ensure that its voice is heard as time goes on, assuming the Eurozone survives. Increasingly decisions will be taken solely by Eurozone members as they work to maintain the currency bloc and they will increasingly look to each other for guidance and influence. New Eurozone institutions of any nature are likely to accelerate the trends.
- Provided the UK remains domestically competitive and has a fully-functioning trading relationship with the rest of the EU, I would expect the UK to remain attractive to inward investors and the City to retain its supremacy as Europe's premier financial centre.

**Bibliography**


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4. *European Commission*, "A Blueprint for a deep and genuine Economic and Monetary Union: launching a Europe debate", 28 November 2012.
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6. "France and Germany – Together for a stronger Europe of Stability and Growth", 30 May 2013, available from www.bundesregierung.de.
7. *European Commission*, "European Semester: a new architecture for the new EU Economic governance", January 2011, available from the Commission's website, www.ec.europa.eu. The 2013 European Semester is in full swing.
8. *European Commission*, "Six-pack? Two-pack? Fiscal compact? A short guide to the new EU fiscal governance", available on Commission website.
9. *Communication from the Commission to the European Parliament and the Council*, "Towards a Deep and Genuine Monetary Union: the Convergence and Competitiveness Instrument", March 2013.
10. House of Commons: Foreign Affairs Committee, *The future of the European Union: UK Government policy*, June 2013. Annex 4: Possible future steps in the EU: do they require EU Treaty amendment?

**Annex**

**Table 1a Commission forecasts, Eurozone: GDP growth (%), unemployment rates (%)**

| | GDP (change, %) | | | Unemployment rates (%) | | |
|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2012 | 2013 | 2014 |
| Austria | 0.8 | 0.6 | 1.8 | 4.3 | 4.7 | 4.7 |
| Belgium | -0.2 | 0 | 1.2 | 7.6 | 8.0 | 8.0 |
| Cyprus | -2.4 | -8.7 | -3.9 | 11.9 | 15.5 | 16.9 |
| Estonia | 3.2 | 3.0 | 4.0 | 10.2 | 9.7 | 9.0 |
| Finland | -0.2 | 0.3 | 1.0 | 7.7 | 8.1 | 8.0 |
| France | 0 | -0.1 | 1.1 | 10.2 | 10.6 | 10.9 |
| Germany | 0.7 | 0.4 | 1.8 | 5.5 | 5.4 | 5.3 |
| Greece | -6.4 | -4.2 | 0.6 | 24.3 | 27.0 | 26.0 |
| Ireland | 0.9 | 1.1 | 2.2 | 14.7 | 14.2 | 13.7 |
| Italy | -2.4 | -1.3 | 0.7 | 10.7 | 11.8 | 12.2 |
| Luxembourg | 0.3 | 0.8 | 1.6 | 5.1 | 5.5 | 5.8 |
| Malta | 0.8 | 1.4 | 1.8 | 6.4 | 6.3 | 6.1 |
| Netherlands | -1.0 | -0.8 | 0.9 | 5.3 | 6.9 | 7.2 |
| Portugal | -3.2 | -2.3 | 0.6 | 15.9 | 18.2 | 18.5 |
| Slovakia | 2.0 | 1.0 | 2.8 | 14.0 | 14.5 | 14.1 |
| Slovenia | -2.3 | -2.0 | -0.1 | 8.9 | 10.0 | 10.3 |
| Spain | -1.4 | -1.5 | 0.9 | 25.0 | 27.0 | 26.4 |
| Total EU17 | -0.6 | -0.4 | 1.2 | 11.4 | 12.2 | 12.1 |
| | | | | | | |

**Table 1b Commission forecasts, Eurozone: General Government deficit and gross debt (% of GDP)**

| | Deficit (% of GDP) | | | Debt (% of GDP) | | |
|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2012 | 2013 | 2014 |
| Eurozone: | | | | | | |
| Austria | -2.5 | -2.2 | -1.8 | 73.4 | 73.8 | 73.7 |
| Belgium | -3.9 | -2.9 | -3.1 | 99.6 | 101.4 | 102.1 |
| Cyprus | -6.3 | -6.5 | -8.4 | 85.8 | 109.5 | 124.0 |
| Estonia | -0.3 | -0.3 | 0.2 | 10.1 | 10.2 | 9.6 |
| Finland | -1.9 | -1.8 | -1.5 | 53.0 | 56.2 | 57.7 |
| France | -4.8 | -3.9 | -4.2 | 90.2 | 94.0 | 96.2 |
| Germany | 0.2 | -0.2 | 0 | 81.9 | 81.1 | 78.6 |
| Greece | -10.0 | -3.8 | -2.6 | 156.9 | 175.2 | 175.0 |
| Ireland | -7.6 | -7.5 | -4.3 | 117.6 | 123.3 | 119.5 |
| Italy | -3.0 | -2.9 | -2.5 | 127.0 | 131.4 | 132.2 |
| Luxembourg | -0.8 | -0.2 | -0.4 | 20.8 | 23.4 | 25.2 |
| Malta | -3.3 | -3.7 | -3.6 | 72.1 | 73.9 | 74.9 |
| Netherlands | -4.1 | -3.6 | -3.6 | 71.2 | 74.6 | 75.8 |
| Portugal | -6.4 | -5.5 | -4.0 | 123.6 | 123.0 | 124.3 |
| Slovakia | -4.3 | -3.0 | -3.1 | 52.1 | 54.6 | 56.7 |
| Slovenia | -4.0 | -5.3 | -4.9 | 54.1 | 61.0 | 66.5 |
| Spain | -10.6 | -6.5 | -7.0 | 84.2 | 91.3 | 96.8 |
| Total EU17 | -3.7 | -2.9 | -2.8 | 92.7 | 95.5 | 96.0 |
| | | | | | | |

Source: *European Commission*, "Spring 2013 forecast: the EU economy – slowly recovering from a protracted recession", 3 May 2013. Net lending (+), net borrowing (-); General Government comprises central government & local government. The terms of the Stability & Growth Pact: government deficits of no more than 3% of GDP and government debt of no more than 60% (or moving towards 60%). 2014 forecasts based on unchanged policies.