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European Union Committee

25th Report of Session 2010–2012

The euro area crisis

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CONTENTS

	<i>Paragraph</i>	<i>Page</i>
Summary		5
Chapter 1: Introduction	1	7
The March 2011 report on <i>The future of economic governance in the EU</i>	3	7
Background to this report	6	8
Chapter 2: The Unfolding Crisis	11	10
Greece	13	10
Ireland	17	11
Portugal	19	12
Spain	21	12
Italy	24	13
The wider euro area and beyond	26	13
Chapter 3: Implementation of the 26 October 2011 Agreement	36	16
i) A writedown of Greek debt	37	16
a) What was agreed	37	16
b) Implementation and analysis	38	16
ii) Bank recapitalisation	39	17
a) What was agreed	39	17
b) Implementation and analysis	43	17
iii) Rescue funds	45	18
Box 1: The European rescue funds		18
a) What was agreed	45	18
b) Implementation and analysis	47	19
iv) Assessment of the 26 October agreement	51	20
Chapter 4: Other policy responses	54	21
An expanded role for the ECB	54	21
‘Eurobonds’	65	23
Chapter 5: The December 2011 European Council and the Proposals for Treaty Change	71	25
Background: developments during 2011	72	25
The emergence of the new treaty	75	25
Box 2: Summary of the draft treaty on stability, coordination and governance in the economic and monetary union		26
Box 3: Which treaty?		28
Legal and related issues	79	28
Relationship with EU law	81	28
Can the treaty confer new functions on EU institutions, and does it try to do so?	88	30
EU Court of Justice and the European Commission under Article 8	94	31
Transparency	98	32
Democratic accountability	100	32

Does the Treaty impose any new obligations on Member States?	102	33
Will the treaty help in the short-term?	105	34
Will the treaty help in the long term?	108	34
Conclusion	111	35
Implications for the United Kingdom	113	35
The approach to the December 2011 European Council	113	35
Why did the UK refuse to participate?	119	37
Safeguards	120	37
The future	126	39
Chapter 6: Beyond the Short Term	130	40
Leadership	131	40
Economic growth	135	40
Chapter 7: Summary of Conclusions and Recommendations	142	43
Appendix 1: Membership and Interests		46
Appendix 2: List of Witnesses		48
Appendix 3: Glossary		49

NOTE:

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References in footnotes to the Report are as follows:

Q # (Sub-Committee) refers to a question in oral evidence heard by the Sub-Committee on Economic and Financial Affairs and International Trade;

Q # (Select) refers to a question in oral evidence heard by the Select Committee;

Witness names without a question reference refer to written evidence.

SUMMARY

The euro area crisis is a complex blend of financial, economic, political and institutional problems. Over the past year, developments in these interwoven elements have dominated the political and news agenda. National governments and EU institutions have struggled to keep up with the pace of events. The EU, and the euro area in particular, face massive challenges and there is a need for effective and proactive leadership both from the EU institutions and Member States, in the interests of the wider Union.

Concerning the immediate economic and financial aspects of the crisis, it is essential that the outline agreement reached in October 2011 on Greek debt write-down, bank recapitalisation, and the financing of the European rescue funds, is implemented quickly and effectively. Although it should not be regarded as a panacea, additional action by the European Central Bank is likely to prove essential.

The proposed 'fiscal compact' and economic policy coordination measures for the euro area have been highly controversial. In December 2011 the United Kingdom indicated it would stand aside, and at the end of January 2012 the Czech Republic stated that it would not participate for the time being. Eight of the ten non-euro Member States are likely to join the 17 euro area states in signing the new treaty at the next European Council on 1–2 March 2012. The proposed treaty makes clear that the key provisions apply only to euro area states (unless a non-euro state indicates that it will choose to be bound by them).

The proposed treaty is outside the treaty architecture of the EU, though it cites within it several obligations arising under the EU treaties and legislation made under the treaties. Under the fiscal compact, each state will undertake that it will not have a structural deficit of more than 0.5 per cent of GDP (or 1 per cent if certain conditions are met); that it will put in place an automatic correction mechanism if it is not on course to meet that objective; and that within 20 years the ratio of general government debt to GDP should not exceed 60 per cent. The EU Court of Justice will be allowed to rule on whether states have met the requirement to put into national law the balanced budget rule and, if they fail to comply with a judgment that they have not, to levy a fine of up to 0.1 per cent of a country's GDP. There are also treaty provisions on economic policy co-ordination and governance, including for summit meetings of the euro area states and the President of the European Commission and President of the European Parliament to be held at least twice a year.

In the Committee's view it is vital that, while the euro area states take the steps they consider necessary to strengthen the euro, including on fiscal integration, matters relating to the internal market remain the preserve of all 27 EU Member States. We welcome the disclaimer on the face of the treaty which is designed to ensure that this point is respected.

The proposed treaty raises a number of other questions, particularly concerning the relationship between it and the EU treaties and laws made under those treaties; and the proper role of EU institutions. The history of the institutional development of the European Union is characterised by pragmatic flexibility, suggesting that some of the rough legal edges of the proposed treaty will be softened over time. With the United Kingdom reducing its objection to the use of the EU institutions under the proposed treaty, it might be argued that this process is already underway. But even so, the lack of clarity about whether it is legitimate for the proposed treaty to confer new functions on institutions of the European Union, and the extensive overlap between the provisions of this treaty and functions which have already been imposed by EU legislation, is undesirable.

The United Kingdom Government, together with the other Member States of the Union, and the EU institutions, must devise a means of securing the fiscal integration desired by some of the euro area Member States while at the same time protecting the integrity of the single market, including its provisions for financial regulation, as an engine of economic growth for all 27 Member States of the Union.

We agree with the assessment of the United Kingdom Government that the “optimum outcome” at the December European Council would have been an agreement at the level of all 27 EU Member States, with the interests of the United Kingdom protected. Shifting discussions outside the main EU channels to forums where the United Kingdom has no voice risks marginalising the UK over time.

For the longer term, we note that the proposed treaty states in Article 16 that it remains the intention for its provisions to be folded in to the main EU treaty framework. We can see no reason in principle why this should not in due course be achieved.

Article 16 of the proposed treaty also provides for an assessment of experience with implementation, well within five years. We hope that this assessment will encompass a reflection on what is, in the fiscal compact, a major development in the fiscal policy of the euro area states.

It is clear that improved budgetary discipline is necessary in order to make progress in resolving the euro area crisis, but ultimately the resumption of sustainable economic growth will hold the key: both in general terms across the EU, and in facilitating attempts to resolve the serious imbalances in competitiveness between different countries in the euro area. Therefore, while we acknowledge the great difficulty of devising measures to support economic growth in a period of austerity, we are concerned that the potential of the development of the single market to enhance growth has faded from view during the crisis. We are heartened by the emphasis on job creation and the single market at the EU summit on 30 January 2012, but the real challenge for policymakers will be the sustained implementation of measures which are both effective in developing the single market and thus supporting economic growth, and which do not threaten the drive to improve budgetary discipline.

The euro area crisis

CHAPTER 1: INTRODUCTION

1. The euro area crisis is a complex blend of financial, economic, political and institutional problems. Over the past year, developments in these interwoven elements have dominated the political and news agenda. Despite repeated attempts by European leaders, a solution has proved elusive. This Committee has observed these events with growing concern. In March 2011 we published a wide-ranging report on *The future of economic governance in the EU*. As the crisis deepened, we conducted a follow-up inquiry to examine how the crisis has evolved and how the response of European leaders has developed. This report is the result of that inquiry.
2. In chapter 2 the report examines the development of the crisis over the past year. We then assess in chapters 3 and 4 the policy responses relating to the financial and economic aspects of the crisis; and in chapter 5 we address the institutional aspects of the crisis—concentrating on the controversial proposed treaty based on a “fiscal compact” for budgetary discipline. Though the focus of the report is on shorter term measures to deal with the crisis, in the final chapter we highlight the importance of economic growth.

The March 2011 report on *The future of economic governance in the EU*

3. Our March 2011 report on *The future of economic governance in the EU* examined how the banking crisis in 2008 triggered a crisis of confidence in the financial health of Member States within the euro area. At the time the report was written, concerns over the level of Greece’s public deficit and debt had widened to include other euro area countries, notably Ireland, Portugal and Spain. One of the findings of the report was that the crisis had revealed shortcomings in the original architecture of the Economic and Monetary Union (EMU). An asymmetry between a centralised monetary policy and decentralised fiscal and supply-side policies, combined with a build-up of competitiveness imbalances among Member States, had left the future stability of the euro area in doubt. These problems had been exacerbated by a failure of the markets, and Member States themselves, to comprehend the implications of the way the euro area had been constructed. Until the crisis broke, the markets treated the euro area as a single entity without appreciating, and thus acting on, the financial health of individual Member States.¹
4. The report considered a series of legislative proposals brought forward by the European Commission, which focused on two elements: fiscal discipline and macroeconomic stability. The Committee found that, though these proposals did not constitute “the full fiscal union in the euro area that some of our witnesses suggested was necessary, the design of these measures is a step in the right direction.” However, the Committee expressed doubts whether the proposals would be implemented effectively, noting that previous attempts to enforce fiscal discipline in the euro area through the Stability and Growth Pact had proved ineffective.²

¹ House of Lords European Union Committee, 12th Report (2010–11), *The future of economic governance in the EU* (HL Paper 124-I), Summary.

² *The future of economic governance in the EU*, Summary.

5. The Committee also supported the establishment of the permanent crisis resolution mechanism, the European Stability Mechanism (ESM), to be created and funded by euro area Member States. The report concluded that “the problems in the euro area have, so far, been contained and no Member State has yet defaulted on its sovereign debt. However, the threat remains and the period until the new crisis resolution mechanism is introduced in 2013 is likely to be fraught despite reassurances from EU leaders. In particular, the willingness of taxpayers in countries subject to the most acute pressures to continue to shoulder the burden of adjustment cannot be taken for granted. If economic growth does not ease this burden they may be tempted to demand that bond-holders share the pain of adjustment, a prospect that could result in fresh financial turmoil.”³

Background to this report

6. The period since the report was published has showed this judgement to be prescient. Over the past year the euro area crisis has escalated at an alarming rate. Prospects in Greece continued to decline, to the point that a restructuring of its debt became inevitable. The crisis threatened not only smaller nations such as Portugal and Ireland, but also Spain and now Italy. With the fourth and third largest economies in the euro area under increasing strain, the entire euro area project was seen to be vulnerable. In November 2011 the German Chancellor Angela Merkel acknowledged that Europe is facing its biggest crisis since the Second World War.⁴
7. The scale and speed of changes present significant challenges to anyone seeking to understand and respond effectively to the crisis. There have been major developments while we conducted our inquiry and prepared this report, including the resignation of governments in Italy and Greece and their replacement with cross-party (or no party) administrations under the leadership of non-party-political Prime Ministers, and the agreement on 9 December for a new “fiscal compact” treaty. Almost every day there are significant developments. While it is inevitable that events will continue significantly to alter the political and economic landscape still further, we nonetheless hope that this report, which was finalised on 7 February 2012, will prove valuable in assisting understanding of the ongoing euro area crisis.
8. In the second half of 2011 our Sub-Committee on economic and financial affairs and international trade took evidence focusing on the agreements at the October EU summit on Greek debt writedown, bank recapitalisation, and the rescue funds; and also on other possible policy responses such as further European Central Bank (ECB) interventions, and the issuance by euro area states of mutually underwritten debt (‘eurobonds’). The Sub-Committee heard evidence from Georg Boomgaarden, German Ambassador to the UK; Sharon Bowles MEP, Chair of the European Parliament Economic and Monetary Affairs (ECON) Committee; Professor Willem Buiter, Chief Economist, Citigroup; the Financial Secretary to the Treasury, Mark Hoban MP and Michael Ellam, Director-General for International and EU Groups, HM Treasury; and from Professor Iain Begg, European Institute, London School of Economics, and Special Adviser to the Committee’s March report. The members of the Sub-Committee are listed

³ *The future of economic governance in the EU*, Summary.

⁴ Speech to the CDU party Conference, Leipzig, 14 November 2011.

in Appendix 1, together with the interests declared for this report by members of the Select Committee and the Sub-Committee.

9. The Select Committee itself took oral evidence which focused on the institutional aspects of the crisis, from the Rt Hon David Lidington MP, Minister for Europe, in November 2011 and January 2012; from Edward Carr of *The Economist* and Charles Grant of the Centre for European Reform in November 2011; and from Mr Giuliano Amato, former Prime Minister of Italy, and Professor Paul Craig, Professor of Law, University of Oxford in January 2012. We are grateful to all our witnesses, including those who took the time to provide written evidence, for their assistance. Full details are given in Appendix 2. Appendix 3 includes a glossary defining the technical terms referred to in the report.
10. **We make this report to the House for debate.**

CHAPTER 2: THE UNFOLDING CRISIS

11. The events of the past year have given ample demonstration of the complexity of the unfolding crisis. Professor Buitter described it as “a syndrome of multiple interdependent crises”, explaining:
- “It is a sovereign insolvency crisis for a number of countries in the so-called euro area periphery, most notably Greece, Portugal and Ireland. It is a sovereign liquidity crisis to other countries in what may be called the broader periphery—countries that one hopes and assumes are most likely solvent, as far as the sovereign is concerned, but at risk of being frozen out of the funding markets by markets panicking and refusing access to the sovereign. That is Italy and Spain. We also have a banking crisis throughout the EU, not just the euro area ... So we have this triple crisis: sovereign insolvency, sovereign illiquidity and bank undercapitalisation, which is significant enough among the three of them to pose a global challenge. What is being threatened here is not just the euro area banking system or even EU financial stability; there is no doubt ... [that it] could take down the European banking system and much of the world’s banking system with it.”⁵
12. In order to understand the crisis it is useful briefly to describe how it has evolved over the past year. By setting out the developments in terms of each of the main affected states, this chapter helps to identify the different elements of the crisis, before briefly outlining the series of policy initiatives which have thus far been put forward, both in the euro area itself and in the wider international community.

Greece

13. During 2011 the sovereign insolvency crisis in Greece emerged ever more clearly as the eye of the storm. As the Committee’s March 2011 report pointed out, the underlying problem was that the Greek public finances were in a far worse state than had previously been thought.⁶ In July 2011 the Greek Parliament narrowly voted in favour of further austerity measures; and the EU released a €12 billion tranche of a loan package agreed in May 2010 and agreed a new rescue package worth €109 billion, which also lowered the interest rate at which financial support was being provided. However, it was soon recognised that even this new package was unlikely to prove sufficient.
14. At the euro area summit on 26 October 2011 it was announced that, as part of a deal involving enhanced monitoring of Greece by the “Troika” (the European Commission, the ECB and the International Monetary Fund (IMF)), private sector banks holding Greek debt would consider a 50 per cent “haircut”,⁷ with the aim of reducing the Greek debt burden to 120 per cent of Gross Domestic Product (GDP) by 2020.
15. The surprise announcement on 1 November 2011 by Greek Prime Minister George Papandreou that the new rescue deal would be put to a national referendum sent shockwaves through the whole of Europe and beyond.

⁵ Q 30 (Sub-Committee). See the Glossary for definitions of some of these terms. See also *The future of economic governance in the EU* for further background information on the various affected states.

⁶ *The future of economic governance in the EU*, para 6.

⁷ A haircut occurs when a lender has to accept a reduction in the redemption value of a bond because of the inability of the borrower to pay it in full; for example, if only 90 cents is repaid per euro, the haircut would be ten cents (10 per cent).

Under intense political pressure both inside and outside Greece, including a statement by Chancellor Merkel and President Sarkozy that Greece needed to decide whether it wished to remain in the euro, Mr Papandreou was forced within days to withdraw his proposal for a referendum and to step down as Prime Minister. On 11 November a government of national unity (including ministers from three political parties) was appointed under the leadership of the former Governor of the Bank of Greece, Lucas Papademos. Mr Papademos sought to reassure European leaders and markets by stressing Greece's commitment to the October agreement and to the implementation of structural reforms, as well as its determination to remain within the euro area.

16. At the start of 2012, Prime Minister Papademos and the Greek government warned bluntly that there was a real danger that the country might default on its debt and have to leave the euro.⁸ As we completed consideration of this report on 7 February the situation in Greece remained grave and unresolved. Negotiations involving the Greek government and major political parties, the Troika, and key EU Member States such as Germany and France, had not yet produced agreement on further Greek austerity and structural reform measures, the finalisation of a new €130 billion rescue package, and the extent of a haircut for private sector holders of Greek debt.

Ireland

17. In the early days of the crisis Ireland was seen, alongside Greece, as the most vulnerable country within the euro area. As our last report pointed out, Ireland's current debt crisis is a result of its government's decision to offer a blanket guarantee to depositors caught out after the collapse of the Irish property bubble.⁹ In November 2010 this led to Ireland becoming the second country, after Greece, to accept financial support from the EU via the two funds established in May 2010, the European Financial Stabilisation Mechanism (EFSM) and the larger European Financial Stability Facility (EFSF), as well as from the International Monetary Fund (IMF). The overall support package (including a bilateral loan from the UK) totalled €85 billion, and aimed to support the banking system as well as to help fund Government expenditure. Soon after, Dáil Éireann passed what was widely described as the toughest budget in the history of the state, before Taoiseach Brian Cowen's Fianna Fáil-led Government were heavily defeated at a general election in February 2011.
18. The story since then has been a rare brighter spot in the crisis. Ireland has seen a measure of economic recovery, the Minister for Europe arguing in November 2011 that Ireland is "an example of how tough reforms can have a beneficial impact".¹⁰ On 19 January 2012 Ireland received a positive assessment from the Troika. Yet for all the progress that has been made, Ireland remains vulnerable. A further round of austerity measures was announced in the December 2011 budget, whilst GDP figures for the third quarter of 2011 suggested that the economy had begun to contract once more. As Professor Buiter told us: "Ireland, while doing heroically well in its

⁸ "Greece warns of euro-exit as EU economies drift apart", *EUObserver.com*, 4 January 2012; and "Greek PM says country faces risk of disorderly default in March", *Wall Street Journal*, 4 January 2012.

⁹ *The future of economic governance in the EU*, para 26.

¹⁰ Q 14 (Select).

attempts to honour its sovereign obligations, is still deep in the hole, especially with the global economy now slowing down”.¹¹

Portugal

19. The third “peripheral” nation seen to be at risk is Portugal. Portugal was under financial pressure even before the crisis erupted, as its appeal as a low-cost producer diminished in the face of competition from emerging markets in Asia and eastern Europe.¹² In May 2011 an assistance package of €78 billion was agreed, consisting of €26 billion each from the EFSM, the EFSF and the IMF. The resulting political crisis led to the defeat of Prime Minister Sócrates’ Socialist Government in an election in June 2011. Professor Buiter told us in October 2011 that “in all likelihood Portugal will follow” Greece in requiring a restructuring of its debt, because it is “most likely insolvent”.¹³
20. In November 2011 the newly elected centre-right Portuguese government put through a stringent austerity budget in order to meet the terms of the rescue deal, which was met by widespread public protest.¹⁴ By late January 2012, Portugal’s ten-year borrowing costs had soared, reflecting in part the forecast of a marked contraction in the Portuguese economy during 2012,¹⁵ and the downgrading of Portuguese debt, and leading to increased speculation that Portugal may be forced to default.¹⁶

Spain

21. The Spanish economy suffered badly in the financial crisis, as the inflated property market collapsed and the country struggled to emerge from a long recession. In common with other governments across the EU, Socialist Prime Minister José Luis Rodríguez Zapatero’s administration was forced into deep austerity budgetary measures. In August 2011 the European Central Bank (ECB) made the decision to begin purchasing Spanish sovereign bonds in the secondary markets, in an attempt to shore up Spain’s position. In September, the Spanish Parliament voted to add a “golden rule” to the Spanish constitution, to keep future budget deficits to a strict limit. In November a rise in Spain’s 10-year bond yield rates, close to the 7 per cent level widely considered as unsustainable in the long term, prompted the ECB to engage in further purchase of Spanish bonds, and the announcement of an even deeper austerity programme by the new government of People’s Party leader Mariano Rajoy.
22. Our witnesses highlighted the fundamental causes of Spain’s difficulties. Professor Begg told us that Spain has the “latent debt ... of the property boom and the possibility that that will deflate in a way that causes trouble for banks. Trouble for banks translates into problems for the sovereign.” He asserted that one of Spain’s problems was, in common with much of southern Europe, a lack of competitiveness.¹⁷ Professor Buiter stressed that the Spanish case was distinct from the situation affecting Greece and

¹¹ Q 37 (Sub-Committee).

¹² See <http://www.economist.com/node/15838029>.

¹³ QQ 37, 46 (Sub-Committee).

¹⁴ “Concern grows over Portugal’s commitment to radical reform”, *Financial Times*, 25 November 2011.

¹⁵ “Portuguese debt looms over Europe”, *Financial Times*, 31 January 2012; International Monetary Fund, *World Economic Outlook (Update)*, 24 January 2012.

¹⁶ “Portuguese debt looms over Europe”, *Financial Times*, 31 January 2012.

¹⁷ Q 93 (Sub-Committee).

Portugal, in that it was not a question of solvency, but rather of liquidity.¹⁸ This meant that the most urgent funding need was for Spain's position to be ring-fenced in order to protect it from contagion.¹⁹

23. Spain's position continues to look vulnerable. Concerns remain about its low growth prospects (with unemployment rising to over 5 million by the end of 2011²⁰) and high levels of debt, and although by January 2012 Spain's 10-year bond yields had fallen back to around 5.5 per cent, it remains to be seen whether enough has been done to protect Spain from contagion. In the light of the economic situation, at the end of January Prime Minister Rajoy called on the European Union to ease Spain's deficit reduction targets.²¹

Italy

24. Professor Begg told us in November 2011 that the "underlying arithmetic for Italy is not that bad. Their debt is high, yes, at 120% of GDP, but the deficit is only just over 4% of GDP".²² However, this level of public debt in an economy as large as Italy's adds up to a substantial amount: nearly €2 trillion. Furthermore, the Italian economy has specific structural weaknesses, such as an unreformed labour market, as the repeated calls from other EU leaders for reform to Italy's pension arrangements demonstrate.
25. In November 2011, as bond yields began to soar and market confidence in Italy collapsed, Prime Minister Berlusconi's government was defeated in a vote of confidence. He resigned on 12 November, after the Italian Parliament had agreed a new package of austerity measures. Former European Commissioner Mario Monti was appointed in his place as head of a non-party-political government, committed to reducing sovereign debt and restoring economic growth. Despite strong opposition, Mr Monti has quickly brought forward a package of economic liberalisation measures. As the third largest economy within the euro area, the future of the entire euro project could hinge on Italy's fate.

The wider euro area and beyond

26. As this chapter has illustrated, any solution to the crisis needs to address several distinct problems at once. The five nations described have long been seen as the most vulnerable to the effects of the crisis. Yet the rest of the euro area, and the broader EU including the United Kingdom, are far from immune from their problems. It has become more apparent than ever how, within the euro area and beyond, the fates of national economies are intertwined.
27. In this context, EU leaders have over the past year made repeated attempts to resolve, or at the very least contain, the crisis. Our previous report considered the proposal to establish a permanent replacement, the European Stability Mechanism (ESM), for the two temporary financial support packages, the EFSM and the larger EFSF.²³ The ESM was due to be

¹⁸ Q 30 (Sub-Committee).

¹⁹ Q 42 (Sub-Committee).

²⁰ <http://www.bbc.co.uk/news/world-16754600>

²¹ "Spain lobbies EU to ease austerity amid recession fears", *The Guardian*, 28 January 2012.

²² Q 78 (Sub-Committee).

²³ When set up, the EFSM provided €60 billion underwritten by all 27 Member States, whilst the EFSF, which was funded by and available only to the euro area, had funding of up to €440 billion. See *The future of economic governance in the EU*, chapter 5.

- launched in 2013, and aimed to make a total of €500 billion of financial support available to sovereigns in need.²⁴
28. In July 2011, euro area leaders agreed a new package, including €109 billion in new loans to Greece and the renegotiation of repayment terms—including voluntary private sector participation in a 21 per cent writedown, or haircut, on Greek debts. There was an extension of repayment terms of loans to Ireland and Portugal; additional powers were granted to the EFSF to buy bonds and make credit available to countries not at immediate risk of insolvency, such as Spain and Italy; and the EFSF's lending capacity was increased to €440 billion.²⁵
 29. The political process of approval of this package was not smooth. Long before the final state ratified the proposed additional powers for the EFSF on 11 October (which caused the fall of the Slovakian government), it was clear that the July package would not prove sufficient to deal with the crisis. A further EU summit was twice delayed, on the second occasion to allow Chancellor Merkel to seek a revised mandate to negotiate from the German Bundestag. When the summit finally took place in Brussels on 26 October, a three-pillared deal was agreed. First, private sector banks holding Greek debt agreed to explore a 50 per cent haircut. Second, a plan was announced that sought to boost the funding available through the EFSF to €1 trillion. Third, the finances of European banks were to be protected from contagion by being required to raise €106 billion in new capital by June 2012.²⁶ We explore this agreement in more detail in chapter 3.
 30. The package of legislative proposals on economic governance first set out in September 2010, the so-called “six pack”, was agreed in October 2011. These proposals were based on provisions of the EU Treaties.
 31. After the October summit events in Greece and Italy marked a dramatic escalation in the crisis. Pressure mounted for a more fundamental response. In particular, calls grew for action in three spheres: the possibility of joint ‘eurobonds’; a stronger role for the ECB; and enhanced fiscal integration including through treaty change. In November the Commission published a Green Paper on ‘eurobonds’, or ‘stability bonds’ (loans which would be in some way mutually guaranteed by the euro area states), but these were promptly dismissed by the German government. Since December the ECB has complemented its programme of purchasing sovereign debt in the secondary markets with a major operation to provide long-term loans to European banks. ‘Eurobonds’, and the role of the ECB, are assessed in chapter 4.
 32. The question of fiscal union came to the fore at the summit in Brussels on 8–9 December. At the summit the euro area nations agreed to “a new fiscal compact” moving towards a “fiscal stability union”, including the adoption by national governments of a “fiscal rule” to achieve a balanced budget, and stronger Brussels oversight of national budgets and surveillance of states not meeting their targets, including “automatic consequences” (unless a qualified majority were opposed) should a country's deficit exceed 3 per cent of GDP. The agreement also included measures on closer economic policy coordination. In addition, leaders agreed on an acceleration of the entry into

²⁴ http://ec.europa.eu/commission_2010-2014/president/news/speeches-statements/pdf/20110215_en.pdf; also <http://www.bbc.co.uk/news/business-12460527>.

²⁵ http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/123979.pdf.

²⁶ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf.

force of the ESM to July 2012, to review in March 2012 the level of funding available under the EFSF/ESM, and for euro area and other Member States to consider the provision of additional resources for the IMF of up to €200 billion.²⁷ Some of the agreed measures would be decided as EU secondary legislation, but the leaders decided that some should be achieved through a treaty. Because the UK Government would not agree to amending the EU Treaties, a separate international agreement would be adopted. The proposed agreement is examined in chapter 5.

33. Since the summit took place, the euro area has remained under intense pressure. The January 2012 credit rating downgrade by one of the ratings companies of a number of euro area countries, most notably France, as well as of the EFSF mechanism, came as little surprise. As forecasters have predicted that the euro area will slip into recession, criticism of the perceived “austerity agenda” championed by Chancellor Merkel has grown. Influential leaders including Mario Monti and the head of the IMF, Christine Lagarde, have pushed for a new emphasis on growth.
34. At the summit on 30 January 2012 EU leaders sought to respond, proposing a range of measures to support job creation, especially for the young; economic growth through developing the single market; and boosting financing for small and medium enterprises. Most attention was, however, focused on the agreement of 25 of 27 EU Member States to a treaty²⁸ embodying the December “fiscal compact” and measures on economic policy coordination. The Czech Republic decided not to participate for the time being. It is intended that the treaty will be signed at the European Council on 1–2 March.
35. The euro area crisis has worldwide implications, and actors outside the EU are playing an ever more prominent role. The IMF has contributed to each of the loans made to Greece, Portugal and Ireland, and has formed part of the Troika, alongside the European Commission and the ECB, monitoring developments in these countries. Both the G20 (at the Cannes summit in November 2011) and the Euro area (at the December 2011 summit) agreed that the firepower of the IMF should be increased. (The role of the IMF is considered further along with the European rescue funds, in chapter 3.) Speaking in January 2012 Christine Lagarde, head of the IMF, warned that if the euro area crisis was not solved “we could easily slide into a 1930s moment. A moment where trust and co-operation break down and countries turn inward. A moment, ultimately, leading to a downward spiral that could engulf the entire world.”²⁹

²⁷ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/126658.pdf.

²⁸ This has also been described by some as an intergovernmental agreement. Box 3 in chapter 5 provides further details.

²⁹ <http://www.bbc.co.uk/news/business-16689211>.

CHAPTER 3: IMPLEMENTATION OF THE 26 OCTOBER 2011 AGREEMENT

36. In the autumn of 2011 the key focus of a co-ordinated euro area response to the crisis was the European Council and euro area summit held in Brussels on 26 October. The summit statement described the agreement as a “comprehensive set of additional measures reflecting our strong determination to do whatever is required to overcome the present difficulties and take the necessary steps for the completion of our economic and monetary union.”³⁰ The agreement included three main pillars: i) a writedown of Greek debt; ii) the recapitalisation of European banks; and iii) strengthening of the resources available through the EFSF. This chapter examines what exactly was set out in this “comprehensive” agreement; the extent to which its elements have actually been implemented; and their contribution to resolving the crisis.

i) A writedown of Greek debt

a) *What was agreed*

37. The euro area summit statement said:
- “Together with an ambitious reform programme for the Greek economy, the PSI [Private Sector Involvement] should secure the decline of the Greek debt to GDP ratio with an objective of reaching 120% by 2020. To this end we invite Greece, private investors and all parties concerned to develop a voluntary bond exchange with a nominal discount of 50% on notional Greek debt held by private investors ... On that basis, the official sector stands ready to provide additional programme financing of up to 100 bn euro until 2014, including the required recapitalisation of Greek banks. The new programme should be agreed by the end of 2011 and the exchange of bonds should be implemented at the beginning of 2012.”³¹

b) *Implementation and analysis*

38. The summit deadline was not met, and 2011 finished with no deal in sight. Despite initially positive signals that a deal with creditors was within reach, negotiations have dragged on. In late January it was stated that European finance ministers were pressing private bondholders to accept higher losses through receiving lower rates of interest for the new bonds to be issued (and therefore an effective loss of some 70 per cent, with a consequential reduction in the Greek debt), on account of the deteriorating economic environment. It was also reported that private sector creditors were calling on the ECB to receive a reduced return on its holdings of Greek bonds.³² As this report was finalised on 7 February, agreement had not been reached on the writing down of Greek debt; nor on further Greek austerity and structural reform measures; nor on the finalisation of the €130 billion rescue package for Greece.

³⁰ Euro Summit Statement, 26 October 2011, para 2.

³¹ Euro Summit Statement, 26 October 2011, para 12.

³² “Lagarde presses ECB over Greek debt deal”, *Financial Times*, 24 January 2012.

ii) Bank recapitalisation

a) *What was agreed*

39. Professor Buiter stated that many European banks were undercapitalised even before the crisis and that, in much of continental Europe, losses both before and in relation to the crisis “were simply buried in the books of the bank ... in the hope that a bit of growth and a steep yield curve would allow them to recapitalise themselves out of the flow of profits over a decade or so ... That hope was ambushed by the global slowdown and the sovereign debt crisis.” He warned of “tail risks that ... could take down the European banking system and much of the world’s banking system with it”.³³
40. The run-up to the October summit was punctuated by a disagreement between France and Germany about how best to recapitalise European banks. France favoured the use of the EFSF to recapitalise institutions, including its own banks. Germany disagreed because this would increase the burden on euro area taxpayers (and on German taxpayers more than any others).
41. The 26 October agreement by the European Council indicated that Germany had won this policy argument, stating that private sources of capital should be the first port of call for additional capital. The section on “Capitalisation of banks” stated that:
- “There is broad agreement on requiring a significantly higher capital ratio of 9% of the highest quality capital ... to create a temporary buffer, which is justified by the exceptional circumstances. This quantitative capital target will have to be attained by 30 June 2012 ... National supervisory authorities, under the auspices of the EBA, must ensure that banks’ plans to strengthen capital do not lead to excessive deleveraging, including maintaining the credit flow to the real economy ... Banks should first use private sources of capital, including through restructuring and conversion to equity instruments ... If necessary, national governments should provide support, and if this support is not available, recapitalisation should be funded via a loan from the EFSF in the case of Eurozone countries.”³⁴
42. The EBA calculated that, on the basis of the data then available, European banks would require a recapitalisation amounting in total to €106 billion.³⁵ On 8 December, the EBA revised its estimate of the capital shortfall amongst European banks to nearly €115 billion.³⁶

b) *Implementation and analysis*

43. There was widespread scepticism as to whether the agreement reached in Brussels was sufficient. In a November 2011 article for the *Financial Times*, Professor Buiter asserted that bank recapitalisation worth €106 billion was likely to provide between a third and a quarter of what was ultimately required to bring about a fully functional EU banking system.³⁷ And in spite of the words of the Council statement, there was concern that the agreement

³³ QQ 30, 34 (Sub-Committee).

³⁴ Statement of EU Heads of State or Government, 26 October 2011, Annex, paras 4–5.

³⁵ <http://www.eba.europa.eu/News--Communications/Year/2011/The-EBA-details-the-EU-measures-to-restore-confide.aspx>.

³⁶ <http://stress-test.eba.europa.eu/capitalexercise/Press%20release%20FINAL.pdf>.

³⁷ “Eurozone bail-out needs a much bigger bazooka”, Willem Buiter, *Financial Times*, 1 November 2011.

would lead banks to reduce their proportion of debt by deleveraging rather than boosting their capital, with deleterious consequences for the availability of credit and therefore for the economic health not only of the euro area but of the entire EU. Edward Carr, Foreign Editor of *The Economist*, was particularly critical of the length of time—9 months—that banks had been given under the October agreement, arguing that this gave the banks the opportunity to reduce their capital requirement by cutting back on their lending rather than boosting their capital.³⁸ Since the October summit, the ECB and other central banks have implemented major operations to provide liquidity support to the European and global financial systems. These operations are considered in chapter 4.

44. **We are concerned about the extent of uncertainty that remains in the crucial area of bank recapitalisation. The 26 October agreement provided few details on exactly how recapitalisation will be achieved, and though the agreement was right to warn banks not to seek to reduce debt ratios by deleveraging, it is not clear whether and how they can be prevented from doing so—indeed, the long time period offered seems to facilitate rather than guard against this. A sustained restriction of credit, particularly in the current economic climate, would be highly damaging.**

iii) Rescue funds

BOX 1

The European rescue funds

This report refers to three European rescue funds. The **European Financial Stability Facility (EFSF)** was created following the May 2010 European Council to provide financial assistance to euro area Member States in financial difficulties. The EFSF, along with the smaller **European Financial Stability Mechanism (EFSM)**, are temporary solutions pending the establishment of the permanent **European Stability Mechanism (ESM)**. The creation of the ESM was agreed at an October 2010 European Council. Before it can come into force the ESM requires an amendment to the Treaty on the Functioning of the European Union, and a separate treaty between euro area countries. It was initially envisaged that the ESM would come into force in 2013, but this has now been brought forward to July 2012.

a) *What was agreed*

45. The 26 October summit statement outlined agreement on “two basic options to leverage the resources of the EFSF:
- providing credit enhancement to new debt issued by Member States, thus reducing the funding cost. Purchasing this risk insurance would be offered to private investors as an option when buying bonds in the primary market;
 - maximising the funding arrangements of the EFSF with a combination of resources from private and public financial institutions and investors, which can be arranged through Special Purpose Vehicles. This will enlarge the amount of resources available to extend loans, for bank recapitalization and for buying bonds in the primary and secondary markets.”³⁹

³⁸ Q 25 (Select).

³⁹ Euro Summit Statement, 26 October 2011, para 19.

46. It was proposed that the EFSF would have the flexibility to use these two options simultaneously, depending on the specific objective and market conditions, and that “the leverage effect of each option will vary ... but could be up to four or five” times the €250 billion remaining in the pot.⁴⁰ The Statement called on the Eurogroup⁴¹ to finalise terms and conditions in November. It also stated that further enhancement of the EFSF resources could be achieved through co-operation with the IMF.⁴²

b) Implementation and analysis

47. None of the three pillars of the Brussels agreement of 26 October is particularly secure, but the agreement on the EFSF was arguably the weakest. The impression was given that European leaders were reliant on other countries, and in particular China, to invest in the EFSF if its leveraging proposals were to be successful, an impression strengthened by the visit of the EFSF Chief Executive Klaus Regling to Beijing to make the case for investment. Yet China’s attitude has been cautious. And though it was agreed that the EFSF would protect only a proportion (20–30 per cent) of new sovereign bonds, Eurogroup President Jean-Claude Juncker conceded that the EFSF was unlikely to meet the €1 trillion leveraging target.⁴³ The shortfall prompted Mr Juncker to state that euro area ministers and officials were seeking to “rapidly explore an increase of the resources of the IMF so it can more adequately match the firepower of the EFSF.”⁴⁴
48. The 9 December Statement by the Euro Area Heads of State or Government acknowledged that there was a need for “immediate action to forcefully address current market tensions.” The agreed steps included rapid deployment of the leveraged EFSF; keeping the EFSF active until mid-2013, while at the same time bringing forward the coming into force of the ESM to July 2012; the removal of the requirement under the provisions of the ESM that private creditors would be forced to share the losses in future debt restructurings; and a reassessment of the overall ceiling of the EFSF/ESM of €500 billion to take place in March 2012. (At the end of January it was rumoured that European leaders were starting to consider the combining of the EFSF and the ESM (rather than the replacement of the EFSF by the ESM).) Finally, euro area and other Member States were to consider, and confirm within 10 days, the provision of additional resources for the IMF of up to €200 billion, in the form of bilateral loans, to ensure that the IMF has adequate resources to deal with the crisis. The statement also noted that euro area leaders were “looking forward to parallel contributions from the international community.”⁴⁵
49. The additional funding to the IMF was not confirmed within 10 days, in part because of the reluctance of the United Kingdom, and other countries outside the euro, to contribute. Indeed, in late January it had still not been agreed. European Commissioner Olli Rehn told the World Economic Forum

⁴⁰ Euro Summit Statement, 26 October 2011, para 20.

⁴¹ The Eurogroup is a body composed of the finance ministers of the Member States of the euro area.

⁴² Euro Summit Statement, 26 October 2011, para 22.

⁴³ <http://www.efsf.europa.eu/mediacentre/news/2011/2011-015-maximising-efsf-capacity-approved.htm>; and <http://www.bbc.co.uk/news/business-15933685>.

⁴⁴ “Eurozone finance ministers turn to IMF to help bailout fund”, *The Guardian*, 29 November 2011.

⁴⁵ Statement by the euro area heads of state or government, 9 December 2011. See also “Cautious leaders strengthen firewall”, *Financial Times*, 10 December 2011.

in Davos in January that “we also need support from our American and British friends in the sense that we need to increase the resources of the IMF.”⁴⁶ The view of the United Kingdom government on the provision of additional funding to the IMF was set out by the Minister for Europe in his evidence to us on 17 January. He explained that the Government is “ready to increase IMF resources, alongside other countries around the world, so that the IMF can play its systemic role in supporting its global membership, but we have always been clear, and this remains our position, that we will not participate in an increase in IMF resources that only comes from EU countries without the participation of other members of the G20.”⁴⁷ On 19 January, the IMF launched an appeal for \$500 billion in new lending capacity (including what was pledged by the euro area Member States in December), to help it cope with the effects of the EU debt crisis.

50. **Given the cost to the global economy of the prolonged recession which could follow sovereign defaults and further bank collapses, and therefore the cost to all countries of a failure to ease the euro area crisis, there remains an urgent need to establish a credible and well-financed system of rescue funding. Primary responsibility lies with the euro area countries. However, given the global implications it is necessary for the international community, including the UK, to contribute through the IMF. We welcome the Government’s willingness to contemplate this.**

iv) Assessment of the 26 October agreement

51. In November 2011, the Minister for Europe described the 26 October summit agreement as “welcome progress ... But it is also fair to say that on all three of those counts there was quite a bit of detail that remained to be filled in at the conclusion of those meetings.”⁴⁸ The weakness of each of the three pillars has been revealed in the months since the summit took place.
52. Two particular weaknesses have manifested themselves. First, the summit agreement was short on detail. This provoked scepticism as to whether the proposed measures would be rigorous enough to tackle the crisis. Second, the crisis escalated at an alarming rate after the summits took place (including Prime Minister Papandreou’s quickly-abandoned call for a referendum; the fall of his government and the appointment of a new government under Mr Papademos; spikes in bond yields; the resignation of Italian Prime Minister Mr Berlusconi and the appointment of a government under Mr Monti).
53. **It is imperative that rapid progress is now made in putting flesh on the bones, and drawing to a conclusion the outline agreements reached in October 2011 on Greek debt write-down; bank recapitalisation; and the financing of the European rescue funds. Even this package, though necessary, is likely on its own to prove insufficient.** The following chapter examines other key policy responses currently under consideration.

⁴⁶ <http://www.bbc.co.uk/news/business-16756779>.

⁴⁷ Q 71 (Select).

⁴⁸ Q 1 (Select).

CHAPTER 4: OTHER POLICY RESPONSES

An expanded role for the ECB

54. Member States that enter the European Monetary Union relinquish the capacity to issue debt in a currency they control and the ability to supply liquidity in times of financial distress through their national central banks. The existence of the European Central Bank (ECB) prevents national policymakers from using monetary policy in times of strain on public finances. Outside the monetary union (as in the UK), national central banks have the ability to provide liquidity to banks and governments.
55. The ECB does not consider financial stability as part of its core mandate. As its then President, Jean-Claude Trichet, put it in a press conference in August 2011, the ECB has “only one needle on [its] compass”, namely control of inflation.⁴⁹ Frequent reference has been made by the ECB to Article 123 TFEU, which prohibits the direct purchase of debt from euro area states.⁵⁰
56. The ECB’s reluctance to take on a more interventionist role prompted EU leaders to come up with alternatives. As we have seen, they created the European Financial Stability Facility (EFSF) and the smaller European Financial Stability Mechanism (EFSM) as temporary mechanisms, with a permanent European Stabilisation Mechanism (ESM) now to come into effect in July 2012.
57. Despite these limitations, the ECB has for some months been purchasing from the secondary market government bonds of those euro area countries in financial distress, while making it clear that it sees such a role as limited, temporary and aimed at ensuring functioning markets.
58. On 30 November 2011, the ECB took part in the announcement of co-ordinated actions with the US Federal Reserve, the Bank of Canada, the Bank of England, the Bank of Japan and the Swiss National Bank, to enhance central banks’ capacity to provide liquidity support to the global financial system, aiming to ease strains in financial markets and thereby to mitigate the effects on the supply of credit to households and business and so help foster economic activity.⁵¹
59. Then, in December 2011, the ECB announced a set of “additional enhanced credit support measures to support bank lending and liquidity in the euro area money market”, including unlimited loans lasting three years to euro area banks. ECB President Mario Draghi stated that “these measures should ensure enhanced access of the banking sector to liquidity and facilitate the functioning of the euro area money market. They are expected to support the provision of credit to households and non-financial corporations.”⁵² This ‘Long Term Refinancing Operation’ (LTRO) provided 500 European banks

⁴⁹ See <http://blogs.reuters.com/macroscope/tag/bank-of-england/> and <http://www.ecb.int/press/pressconf/2011/html/is110804.en.html>.

⁵⁰ See *The future of economic governance in the EU*, Box 10. TFEU refers to the Treaty on the Functioning of the European Union.

⁵¹ <http://www.federalreserve.gov/newsevents/press/monetary/20111130a.htm>. See ‘Central banks’ move lifts markets’, *Financial Times*, 1 December 2011.

⁵² <http://www.ecb.int/press/pressconf/2011/html/is111208.en.html>. See also “European banks’ shortfall hits €115bn as German system’s weakness exposed”, *Financial Times*, 9 December 2011.

- with a total of €489 billion in three-year loans at very low interest rates.⁵³ A second round is to follow at the end of February 2012: on 30 January it was reported that take-up for this operation might be twice as high as for the one in December.⁵⁴ The aim was to provide liquidity to the banking sector, thereby increasing the banks' ability and willingness to resume lending to the private sector and euro area states.
60. The escalation of the euro area crisis has led to intensified calls for the ECB to take more decisive action in the sovereign bond markets, notably through the widespread purchase of new sovereign bonds.
 61. We discussed the role of the ECB with our witnesses. Sharon Bowles pointed out that the ECB was the only institution that had the ability to respond swiftly to the markets, and stressed that it had been more "market savvy" and had more foresight than other key players. In her view, the ECB had already by its actions "saved the euro".⁵⁵ Professor Buiter made the point that "central banks are lucky institutions: they do not need equity"; that is, the ECB is not subject to capital requirements and its capacity to absorb losses is infinite if constraints on inflation are not considered.⁵⁶
 62. The fear of inflationary pressure is, in fact, a common argument against the ECB taking a more active role. This is in part a reflection of German fear of hyperinflation in light of the experience of the Weimar Republic during the 1920s. The reluctance of German leaders to countenance an enhanced role for the ECB was apparent in the evidence provided to us by the German Ambassador, who stated that "you have to keep in mind that the instruments of the Eurosystem are not designed and not intended to solve the structural problems of some [euro area] Member States. By buying certain government bonds the Eurosystem gave the [euro area] Member States enough time to address the problems where they should be addressed: at the fiscal level."⁵⁷ Mr Amato also sounded a note of caution, arguing that the ECB could not act in the same ways as the Federal Reserve in the United States, because "you cannot be the federal reserve without a federal state".⁵⁸
 63. Welcome and necessary as they have been, a note of caution should be sounded regarding the steps taken by the ECB. It has been argued that there is little evidence as yet that the ECB's lending is encouraging banks to inject much-needed credit into the economy. Furthermore, there is nervousness that such large-scale lending could spread the disease of over-indebtedness to the ECB itself, thus "undermining the global economy's last bastion of strength", and further prolong the distortion of normally functioning markets.⁵⁹
 64. **The ECB has already taken unprecedented steps in relation to the euro area crisis through the purchase of sovereign bonds in the secondary debt markets, and more recently through a massive operation to refinance European banks. There has been pressure for the ECB to play an even greater role, which the ECB has thus far**

⁵³ European Central Bank, Monthly Bulletin for January 2012, p 30.

⁵⁴ "Banks set to double crisis loans from ECB", *Financial Times*, 30 January 2012.

⁵⁵ Q 28 (Sub-Committee).

⁵⁶ Q 45 (Sub-Committee).

⁵⁷ Ambassador Georg Boomgaarden, German Ambassador to the UK (Sub-Committee).

⁵⁸ Q 99 (Select).

⁵⁹ "Super Mario's bank funding scheme is no panacea", *Financial Times*, 31 January 2012.

resisted, in particular citing the need to respect the Treaty provisions that bar the direct monetary financing of governments. In our view, although the ECB should not be regarded as a panacea, additional ECB intervention is likely to prove essential, at least to preserve the functioning of credit markets and thus to support economic growth, if progress is to be made in resolving the euro area crisis.

‘Eurobonds’

65. We explored the idea of ‘eurobonds’—bonds which are in some way mutually guaranteed by all of the euro area Member States—in our previous report.⁶⁰ Since then there have been increased calls for their adoption as a means of calming the markets by providing liquidity to the euro area.
66. Professor Begg argued that the proposal for a ‘eurobond’ was attractive in the eyes of many because, by mutualising the debt, “you would have a highly rated bond ... on a par with a US Treasury bond, with a coupon that is much lower, on average. It will not be the average of the German and Italian rates; it will be very close to the German rate.” He referred to the case of the United States where, despite their poor deficit and debt figures, which are higher than those for the euro area as a whole, the market was still liquid even after their credit rating was downgraded. He asserted that the Chinese would welcome European bonds as an alternative to investing in Treasury bonds in the US, and argued that other major creditors, such as the Gulf States, would see a ‘eurobond’ as a safe haven, especially with a strong commitment on inflation. In his view, “fully fledged eurobonds ... will almost certainly come.”⁶¹
67. Germany has been highly reluctant to countenance ‘eurobonds’. Ambassador Boomgaarden argued that they “are not a solution for the existing crisis. If there is any debate about eurobonds, this is not the time to have it. This is something that could be the crown of an existing full fiscal union, but it would have very great moral hazard in an incomplete monetary union.”⁶² Mr Amato stated that, even with the fiscal compact treaty in place, it was unrealistic to expect that Germany would accept fully fledged ‘eurobonds’; and that attention should be focused on mutually guaranteed ‘project bonds’ for specific pan-EU projects such as the development of a European power grid.⁶³
68. On 23 November 2011, the European Commission published a Green Paper for consultation which suggested that ‘stability bonds’ could be established to help all euro area members to meet their financing needs and to compete with US Treasury bonds as a global benchmark. The Green Paper assessed three potential options: (1) the full substitution of Stability Bond issuance for national issuance, with joint and several guarantees; (2) the partial substitution of Stability Bond issuance for national issuance, with joint and several guarantees; and (3) the partial substitution of Stability Bond issuance for national issuance, with several but not joint guarantees. It also raised the possibility of these approaches being combined.⁶⁴

⁶⁰ *The future of economic governance in the EU*, paras 211–7.

⁶¹ QQ 86, 89 (Sub-Committee).

⁶² Q 9 (Sub-Committee).

⁶³ Q 102 (Select).

⁶⁴ http://ec.europa.eu/commission_2010-2014/president/news/documents/pdf/green_en.pdf.

69. In spite of President Barroso's appeal for these discussions to be approached "with an open mind", Chancellor Merkel quickly denounced the Commission's proposals as "extraordinarily inappropriate".⁶⁵ And while in the December summit statement the euro area states undertook to "examine swiftly the new rules proposed by the Commission on 23 November" relating to budgetary surveillance in the euro area, there was no reference at all in the document to 'eurobonds'.
70. **It remains to be seen whether a 'eurobond' could be designed in such a way as to meet the concerns of nations such as Germany, so that it will not lead to a risk of moral hazard nor lower the cost of servicing the public debt for some countries in the euro area at the expense of a considerable increase for others. The Commission's proposals are at an early stage of development, and, though 'eurobonds' could relieve pressure in the bond market, they are only likely to become a mechanism available for use in the medium to long term. The lack of reference to 'eurobonds' in the 9 December statement might be taken to suggest that their introduction remains a distant prospect. Yet the question of whether they are a necessary step towards solving the euro area crisis needs to be addressed.**

⁶⁵ "Germany attacks Brussels Eurobond plan", *Daily Telegraph*, 23 November 2011.

CHAPTER 5: THE DECEMBER 2011 EUROPEAN COUNCIL AND THE PROPOSALS FOR TREATY CHANGE

71. In the European Union the most controversial issue of the past few months, indeed one of the more controversial issues in the Union's history, has been the proposal for a treaty on budgetary discipline and economic policy co-ordination centred on the euro area states. This chapter sets out the background and identifies the key features of the proposed treaty. We then examine some of the key legal issues including those created by the fact that the proposed treaty sits outside the EU treaty architecture. Finally we examine the implications for the United Kingdom.

Background: developments during 2011

72. Our March 2011 report on economic governance argued that the root cause of some of the problems currently being experienced within the euro area can be traced to the structural failings within the foundations of EMU.⁶⁶ One of the people involved in the construction of economic and monetary union, Mr Amato, agreed with this view and told us that in designing this architecture “we made a mistake”, because “we wanted to believe that co-ordinating national policies was enough, for the simple reason that nobody wanted to transfer national policies” to the EU. Mr Amato expressed surprise that the markets accepted this flawed design for so long, with lending rates to all euro states held at very similar levels until the crisis erupted in 2007–08.⁶⁷
73. In our March 2011 report we also found that the Stability and Growth Pact, which was meant to ensure discipline on fiscal policies at the national level, did not work as planned. In particular it lacked an effective enforcement procedure, as demonstrated when France and Germany both breached the Pact in 2002–03, and avoided any adverse consequences.⁶⁸
74. To remedy these structural deficiencies, calls grew for greater fiscal integration. Speaking to us in November 2011 Professor Begg said that a “union of rules” was already being put in place through the combination of economic governance measures described as the “six pack” that sought to put a better preventive system in place.⁶⁹ Further measures on closer monitoring and co-ordination were agreed at the October 2011 Brussels summit. And in November the Commission published two new proposals for “stronger economic governance”: the first to permit the Commission to ask euro area governments to revise their draft national budgets in line with their euro area obligations;⁷⁰ and the second to enhance surveillance for euro area countries being supported by financial assistance or that are threatened by serious financial instability.⁷¹

The emergence of the new treaty

75. At the European summit on the evening of 8–9 December 2011 the EU's leaders debated how to improve the co-ordination of fiscal and economic policy across the euro area, and whether agreement could be envisaged to

⁶⁶ *The future of economic governance in the EU*, paras 30–33.

⁶⁷ Q 98 (Select).

⁶⁸ *The future of economic governance in the EU*, chapter 3.

⁶⁹ Q 86 (Sub-Committee).

⁷⁰ http://ec.europa.eu/commission_2010-2014/president/news/documents/pdf/regulation_1_en.pdf.

⁷¹ http://ec.europa.eu/commission_2010-2014/president/news/documents/pdf/regulation_2_en.pdf.

the necessary amendments to the EU treaties. After a fraught meeting, and faced with the refusal of the United Kingdom to contemplate any such treaty amendments without certain safeguards, the 17 euro area countries agreed on a “fiscal compact”, to have the status of a formal treaty. Nine of the ten non-euro countries indicated the possibility of taking part in this agreement, subject to consultation with their national parliaments where appropriate.⁷²

76. At an informal summit on 30 January 2012 the euro area Member States finalised the text of the “treaty on stability, coordination and governance in the economic and monetary union”, with signature of the treaty expected to take place at the European Council on 1–2 March. Eight of the ten non-euro Member States indicated that they would sign the treaty. The Czech Republic declined to participate for the time being, but held open the possibility of signing the treaty at a later date. The United Kingdom maintained the position it had taken in December.⁷³ The text of the proposed treaty following the 30 January summit is summarised in Box 2.

BOX 2

Summary of the draft treaty on stability, coordination and governance in the economic and monetary union

Article 1(1) states the purpose of the treaty: “to strengthen the economic pillar of the Economic and Monetary Union by adopting a set of rules intended to foster budgetary discipline through a fiscal compact, to strengthen the coordination of economic policies and to improve the governance of the euro area, thereby supporting the achievement of the European Union’s objectives for sustainable growth, employment, competitiveness and social cohesion”.

Article 1(2) provides that the treaty applies to euro area states and (read with **Article 14**) to non-euro contracting parties when they adopt the euro. The latter may declare their intention to be bound by its substantive provisions earlier if they so wish.

Article 2 establishes the precedence of European Union law over the treaty, including in article 2(2) that “The provisions of this Treaty shall apply insofar as they are compatible with the Treaties on which the Union is founded and with European Union law. They shall not encroach upon the competences of the Union to act in the area of the economic union.”

Articles 3 and 4 set out the terms of the fiscal compact: that—

- government budgets shall be balanced or in surplus, with the annual structural deficit not to exceed 0.5% of GDP (unless government debt is very low, in which case the structural deficit can be up to 1%);
- there must be an automatic correction mechanism, triggered if the state deviates from a country-specific medium-term objective, or its adjustment path towards that objective;
- if the ratio of general government debt to GDP exceeds 60%, the difference between the actual ratio and 60% should be reduced by an average of one-twentieth per year.

⁷² http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/126658.pdf.

⁷³ Press remarks by the President of the European Council Herman Van Rompuy, following the informal meeting of members of the European Council, 30 January 2012.

Article 3(2) provides that the parties must put into national law the balanced budget rule “through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to”; and also to transpose the automatic correction mechanism specified in Article 3 (above).

Article 5 requires parties in breach of the deficit criterion and subject to the excessive deficit procedure to put in place a programme of structural reforms to reduce the deficit. The form and content of such programmes is to be defined in EU law.

Article 6 requires the parties to report their borrowing plans *ex ante* to the Commission and the Council, for the purpose of better coordination of debt issuance.

Article 7 provides that the parties undertake to support European Commission recommendations where a euro area state is in breach of the deficit criterion and subject to the excessive deficit procedure—unless a Qualified Majority of euro area states does not support the recommendation.

Article 8 provides that the EU Court of Justice may rule on whether parties have complied with the requirements of Article 3(2); and that the Court may levy a fine of up to 0.1 per cent of GDP if its ruling is not complied with.

Articles 9 to 11 cover economic policy coordination. Under **Article 9** the parties “undertake to work jointly towards an economic policy fostering the smooth functioning of the Economic and Monetary Union and economic growth through enhanced convergence and competitiveness”. **Article 10** encourages the parties to make use of existing procedures in the TFEU to take forward measures specific to the euro area states (Article 136 TFEU in relation to the euro area; and Articles 326 to 334 in relation to the enhanced cooperation procedure).

Article 12 provides for Euro Summit meetings to be held at least twice a year.

Article 13 provides for a conference of MEPs and national parliamentarians of the parties.

Article 14 provides that the treaty shall come into force when twelve euro area states have ratified it.

Article 15 provides that after it comes into force the treaty shall remain open to other Member States of the European Union.

Article 16 expresses the aim that within five years the treaty may be incorporated into the EU treaty framework.

Note: This summary, and this chapter of the report, refer to the sixth draft of the treaty, dated 31 January 2012

77. The treaty will come into force when 12 euro area states have ratified it. Ratification by all 25 states is not a foregone conclusion. For example, it is expected that France will not ratify until after the Presidential election in April (with Socialist candidate Francois Hollande expressing reservations about key features of the treaty); and Ireland may hold a referendum on it.
78. Six drafts of the treaty have been produced, several of them by a working group consisting of officials from the states involved, and three MEPs, plus an observer from the United Kingdom. This report does not parse the differences from draft to draft, and our comments relate to the sixth draft, dated 31 January 2012. We note that the changes in successive drafts, and the unusual

speed of negotiations in preparing new treaty provisions, have not made it easy to understand and analyse the provisions of the treaty. Evidence from witnesses has necessarily reflected the text of the treaty as it stood at that time: the oral evidence heard by the Committee relates to the third and fourth drafts.

BOX 3

Which treaty?

The following sections refer to three treaties. The first two listed are the principal EU treaties and are sometimes together called the Lisbon Treaty as they were most recently amended by the treaty signed in Lisbon in December 2007.

- **Treaty on European Union (TEU)** Sets out the broad principles for the European Union.
- **Treaty on the Functioning of the European Union (TFEU)** Sets out in greater detail the functioning and institutions of the European Union.
- **Draft Treaty on stability, coordination and governance in the economic and monetary union** (*usually referred to in this chapter as the proposed treaty*) This is the outcome of the decision by Member States at the December European Council to agree a new treaty on budgetary discipline and economic policy coordination.

Legal and related issues

79. The proposed treaty raises several critical legal and related issues, especially because it is separate from the EU treaty architecture. This section highlights the relationship between the treaty and EU law; whether the proposed treaty can legitimately confer new functions on EU institutions (and whether it does in fact seek to do so); transparency and accountability; and whether the treaty imposes any new obligations on participating states.
80. Professor Craig raised a point of legal principle which he argued did not appear to have been addressed. Under the EU Treaties, agreement among all 27 Member States is required for any additions or other changes to those treaties. The decisional rule is unanimity. The proposed treaty would, by contrast, be agreed by fewer than 27 states, in effect substituting a decisional rule permitting a majority of states to proceed. Professor Craig did not argue that this was unlawful, pointing out that Member States retain their inherent power to make an international agreement, but he questioned whether it is legitimate to proceed to an outcome desired by a majority of EU Member States by way of a treaty not agreed by all those states. The principle would be established that “a majority, whether it is 12, 15 or 26 states, could attain ends that are not attainable via unanimity and they can use the EU institutions in order to achieve their goal.”⁷⁴

Relationship with EU law

81. The fact that, because not all the Member States were willing to agree to it, the new treaty is outside the treaty architecture of the European Union raises several difficult legal and practical questions. Mr Amato made plain his own concerns, stating bluntly: “I do not like this treaty very much”.⁷⁵

⁷⁴ Q 86 (Select).

⁷⁵ Q 100 (Select).

82. The proposed treaty cannot amend the EU Treaties or their protocols. Nor may it affect the obligations of Member States and the functions of the EU Institutions under the EU treaties and other EU law. The proposed treaty repeatedly acknowledges the precedence of the EU treaties.⁷⁶ Article 2 provides that “This Treaty shall be applied and interpreted by the Contracting Parties in conformity with the Treaties on which the European Union is founded”, and that “The provisions of this Treaty shall apply insofar as they are compatible with the Treaties on which the Union is founded and with European law. They shall not encroach upon the competences of the Union to act in the area of the economic union.” The fiscal compact set out in Article 3 is to be applied “without prejudice to the obligations derived from European Union law”; Article 7 on sanctions for states in excessive deficit procedure is applicable “While fully respecting the procedural requirements of the European Union Treaties” and Article 10 on enhanced cooperation applies “In accordance with the requirements of the European Union Treaties”.
83. Despite these multiple disclaimers on the face of the treaty, the fact remains that a group of Member States has decided to establish a separate framework concerning the monetary union established by the EU treaties, which includes amongst other things provision for closer economic policy coordination.
84. For example, Article 9 provides that “Building upon the economic policy coordination as defined in the Treaty on the Functioning of the European Union, the Contracting Parties undertake to work jointly towards an economic policy fostering the smooth functioning of the Economic and Monetary Union and economic growth through enhanced convergence and competitiveness”.
85. Article 10 provides that signatories will make greater use of “enhanced cooperation” (a procedure under the Lisbon Treaty which permits a group of EU Member States to take forward initiatives under certain conditions) “on matters that are essential for the smooth functioning of the euro area”. The Article specifies that this must be done “without undermining the internal market”. The enhanced cooperation procedure in the Lisbon Treaty includes a number of procedural and substantive requirements in addition to the requirement not to undermine the internal market, for example that “Authorisation to proceed with enhanced cooperation shall be granted by a decision of the Council, on a proposal from the Commission and after obtaining the consent of the European Parliament”; and that “such cooperation 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”.⁷⁷
86. Article 12 provides for regular euro summit meetings to be held, with a President (who is currently Mr Van Rompuy, president of the European Council), in close collaboration with the President of the European Commission, and at whose meetings the President of the European Parliament may be invited to be heard.

⁷⁶ For a helpful summary, see Professor Peers (Select).

⁷⁷ Articles 329 and 326 TFEU respectively. The enhanced cooperation procedure is set out in Article 20 TEU and Articles 326 to 334 TFEU.

87. It is inevitable that there will be concerns about the possibility that the provisions on economic policy coordination and governance might impinge on matters related to the internal market, which should be the province of the full Union. There are also concerns that euro area states meeting together might informally reach common views on matters which would then fall to be decided by the full European Council (“caucusing”). All three current holders of the key posts of President of the Euro Summit / European Council, President of the European Commission, and President of the European Parliament, are from euro area countries. The question arises whether it might in practice prove difficult in future for the holder of any of these key posts to be nationals of non-euro area countries.

Can the treaty confer new functions on EU institutions, and does it try to do so?

88. The question of whether the proposed treaty can confer new functions on the institutions of the European Union caused immediate controversy in the aftermath of the December European Council. On 13 December the Prime Minister told the House of Commons that “we will look constructively at proposals to use the EU institutions with an open mind, but this is new territory which raises important issues”⁷⁸, while Commissioner Olli Rehn argued that, though a full EU treaty would have been preferable, “this fiscal compact treaty was bold and effective and legally viable”.⁷⁹
89. On 17 January the Minister for Europe clarified the Government’s position: “We think that the legal position is that any proposal to confer new tasks on the EU institutions requires the consent of all Member States”.⁸⁰ The Government have now indicated that they will not oppose the use of EU institutions under the proposed treaty provided that the interests of the United Kingdom are not threatened.⁸¹ On 31 January the Prime Minister explained to the House of Commons that “The new intergovernmental agreement is absolutely explicit and clear that it cannot encroach on the competencies of the European Union and that measures must not be taken that in any way undermine the EU single market. Nevertheless, I made it clear that we will watch this matter closely and that, if necessary, we will take action, including legal action, if our national interests are threatened by the misuse of the institutions.”⁸²
90. Professor Craig argued that the proposed treaty could not lawfully confer any new functions on the institutions of the European Union.⁸³ He explained that this clear view was based on Articles 5(2) and 13(2) TEU, which provide that:

“the Union shall 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” (Article 5(2) TEU)

“Each institution shall act within the limits of the powers conferred on it in the Treaties, and in conformity with the procedures, conditions and objectives set out in them” (Article 13(2) TEU)

⁷⁸ HC Deb 13 December 2011 col 757.

⁷⁹ “Rehn rejects British line on implementing fiscal treaty”, *Financial Times*, 13 December 2011.

⁸⁰ Q 67 (Select).

⁸¹ As reported in “Cameron U-turn over policing of tough new eurozone rules”, *The Guardian*, 28 January 2012.

⁸² HC Deb 31 January 2012 col 678.

⁸³ Q 92 (Select).

91. The functions of the EU institutions are governed by the EU treaties. The proposed treaty does not and cannot alter this position. It is less clear, however, whether the proposed treaty does actually seek to impose any new obligations (as distinct from recognising functions which are already exercised by the institutions under the EU treaties and legislation made under the treaties).
92. Commissioner Rehn indicated that the treaty would not confer any new functions on the Council or the Commission: “for the implementation of the agreement, the institutions of the Union will act within the framework of their powers as provided by the European Union Treaties”. Therefore, he argued, the question about whether or not it would be legitimate for the treaty to confer new functions on the Commission was “purely speculative”.⁸⁴ Commenting on the fourth draft of the treaty Professor Craig suggested that aspects of Articles 3, 7 and 8 did seek “in substance [to] confer new powers on the Commission”.⁸⁵ The Government have indicated that they share the concerns of some other (non-specified) Member States in relation to Articles 7 and 8 “which raise important questions of compatibility with EU law”.⁸⁶
93. It has been commonly assumed that no legal difficulty is caused by the proposed treaty setting out functions conferred on the EU institutions under the existing EU legislative framework in the context of the proposed treaty. But Professor Craig also raised the question whether it is in fact legitimate for the Commission to exercise existing powers in “this new setting” under the proposed treaty.⁸⁷ For example, Article 5(1) makes it clear that contracting parties subject to the excessive deficit procedure shall implement a programme the content and format of which “shall be defined in European Union law”; with the submission of such programmes to the Commission and Council for endorsement or monitoring to “take place within the context of the existing surveillance procedures of the Stability and Growth Pact”. Article 5(2) seems to give a (closely related) duty to the Commission and Council but without a reference to existing EU law: that “the implementation of the programme, and the yearly budgetary plans consistent with it, will be monitored by the Commission and by the Council”.

EU Court of Justice and the European Commission under Article 8

94. Considerable attention has been focused on Article 8, under which the EU Court of Justice may determine whether a party to the treaty has complied with Article 3(2). The first part of this Article requires transposition of the fiscal compact into national law “through provisions of binding force and permanent character, preferably constitutional”, implying that the role of the Court would simply be to assess whether or not this had been done. The Article goes on to require the putting in place at a national level of an automatic correction mechanism to keep states on the right path towards meeting the goals of the compact. If a state has failed to comply with Article 3(2), the Court can specify the time period within which the state must take the necessary measure to comply. If the state then fails to comply with this ruling, the Court may impose a fine “that shall not exceed 0,1% of its gross domestic product”.

⁸⁴ Commissioner Olli Rehn (Select).

⁸⁵ Q 92 and Professor Craig (Select).

⁸⁶ Minister for Europe (Select).

⁸⁷ Q 93 (Select).

95. A case may only be brought by another party (state), but there is also a role for the Commission. If the Commission concludes in a report that a contracting party has failed to comply with Article 3(2), then “the matter will be brought to the Court of Justice” by one or more of the other parties. This appears to be a requirement, but it is not clear how it will be decided which state or states will commence proceedings.
96. The preamble to the proposed treaty states that Article 273 TFEU gives the Court jurisdiction; and Article 260 TFEU empowers it to impose a fine. Article 273 provides “The Court of Justice shall have jurisdiction in any dispute between Member States which relates to the subject matter of the Treaties if the dispute is submitted to it under a special agreement between the parties”; Article 260 specifies the circumstances in which the Court may impose a fine.
97. Professor Craig agreed that Article 273 was sufficient to give the Court jurisdiction, but that Article 8 of the proposed treaty caused difficulties because even though the Commission would not bring a case in name, the provisions meant that it might do so in effect, and there is no provision under the EU treaties for the Commission to bring such a case.⁸⁸

Transparency

98. Concerns have been raised that the distribution of important rules regarding the economic governance of the EU’s Member States, and particularly the euro area states, between the EU Treaties, a range of legislation made under those treaties, and the proposed treaty, will cause confusion about what exactly is required. Professor Peers concluded that “the EU’s economic governance rules fail the test of transparency, because of their near-total complexity and unreadability”.⁸⁹
99. This lack of clarity, for Member States expected to follow the requirements and for anyone who wishes to have a clear understanding of the laws which are affecting them, is undesirable in principle. It is also causing some confusion in specific matters of interpretation. For example, commenting on the third draft of the treaty Professor Peers queried whether Article 3(1)(b) added anything to obligations that euro area states already have under the Stability and Growth Pact.⁹⁰

Democratic accountability

100. Under the EU treaties there is an established framework for democratic accountability, through national parliaments and the European Parliament. As the proposed treaty is outside the EU set-up, the framers have sought in Article 13 to introduce a role for parliamentary scrutiny:

“As foreseen in Title II of Protocol (No 1) on the role of national Parliaments in the European Union annexed to the European Union Treaties, the European Parliament and the national Parliaments of the Contracting Parties will together determine the organisation and promotion of a conference of representatives of the relevant committees of the national Parliaments and representatives of the relevant

⁸⁸ Q 95 (Select); see also Professor Peers (Select).

⁸⁹ Professor Peers, “Analysis: Draft agreement on reinforced economic union (REU treaty)”, for Statewatch, 12 December 2011; see also Professor Craig, Q 96 (Select).

⁹⁰ Professor Peers (Select).

committees of the European Parliament in order to discuss budgetary policies and other issues covered by this Treaty.”

101. This Article raises a number of questions.

- The opening words “As foreseen in” are puzzling. While the reference to the EU treaties is helpful, the Protocol was not drafted foreseeing its application outside the ambit of those treaties.
- The reference to the Protocol also creates an element of ambiguity. The United Kingdom Parliament (and the Parliaments of all EU Member States), of course, participate fully under Protocol 1, while it is not currently envisaged that the United Kingdom (and one other state) will be a party to this treaty—and the reference elsewhere in the Article to “the contracting parties” makes clear that non-signatories will not be involved.
- Given that the key subject matter of the treaty is national budgets, for which national governments are accountable to their national parliaments, and that this treaty sits outside the EU treaties, it is not immediately apparent why the European Parliament “will together determine the organisation and promotion” of the conference along with the relevant national Parliaments.

Does the Treaty impose any new obligations on Member States?

102. Witnesses gave two answers to the question of whether a new treaty is actually required in order to achieve the ends set out in it: one legal, and one political. Professor Peers argued that the treaty adds “very little to the measures already set out in EU law or which have been or could be proposed as part of EU law” but it “might nonetheless have a useful impact if it encourages Germany or the European Central Bank to take a more active role in saving the euro”.⁹¹ In December, Guy Verhofstadt, one of the three MEPS involved in the treaty negotiations, agreed that “it is for political, symbolic reasons that they want to do this agreement”.⁹² The legal aspects of the question are considered in this section; the political context in the following sections.

103. There was general agreement with Professor Peers’ view of the legal aspect, and our witnesses highlighted the ways in which provisions in the proposed Treaty were effectively mirrored in existing EU Treaty and legislative obligations.⁹³

104. It is worth considering further whether there is any significant element of the treaty which is not or could not be achieved within the existing legal framework, not least for its relevance to the ease with which the proposed treaty might in due course be integrated into the EU legal framework, as proposed in Article 16. The Minister for Europe cited two such points:

“there is no provision in the European Union treaties to make a balanced budget rule binding in a Member State’s national law or subject to the jurisdiction of the European Court of Justice. There is no provision in the existing treaties for an automatic correction mechanism where a Member State deviates from that balanced budget path”.⁹⁴

⁹¹ Professor Peers (Select).

⁹² Reported in EUObserver.com, 20 December 2011.

⁹³ e.g. Minister for Europe Q 79, Professor Craig QQ 88 and 97, Mr Amato Q 100 (all Select).

⁹⁴ Q 79 (Select).

Mr Amato broadly agreed with this analysis.⁹⁵ But the legal question, whether measures could be adopted under the EU Treaties to deal with both points, remains open.

Will the treaty help in the short-term?

105. Commissioner Rehn stated that the proposed treaty is aimed at targeting “weaknesses in economic governance and ... the lack of credible enforceable mechanisms for fiscal discipline”.⁹⁶ There was a widespread view amongst our witnesses that the treaty was necessary, but not sufficient; and that the direct impact of the treaty would be more about preventing future crises by hardwiring fiscal rectitude into the system, and not directly resolving the current crisis.
106. Giving evidence to us on 17 January the Minister for Europe described as the “prime justification” for the treaty the view of Germany that if you get the rules right for the future, “you therefore restore confidence about long-term stability, [and] that in turn will help you to secure confidence and recovery now”. He added that “even on the optimum assessment of what is likely to come out of the intergovernmental negotiations there is still a great deal more that needs to be done in both the short and long terms”.⁹⁷ Mr Amato agreed that in the short-term the proposed treaty “is not enough”, but that it “was and is necessary to restore trust” on the part of Germany. He explained, “trust may be the main outcome of this treaty, on which you can build what in the treaty itself is missing”.⁹⁸
107. In considering what else needs to be done, the Minister for Europe highlighted the need in the short-term for the effective implementation of the October 2011 agreement on Greek debt write-down; bank recapitalisation and rescue funds. This is consistent with chapters 3 and 4 of this report. Mr Amato emphasised the importance of increasing the capital of the European Stability Mechanism, and as noted in paragraph 102 Professor Peers highlighted the role of European Central Bank.⁹⁹

Will the treaty help in the long term?

108. There has been little questioning of the policy embodied in the balanced budget rules set out in the proposed treaty. To a degree this is unsurprising because, as has been identified, they are very similar to what is already required in recently passed EU legislation. And there is a universal desire to avert future crises by avoiding the accumulation of large government debts and an over-reliance of states on the debt markets.
109. However, it is worthy of note that the rules being implemented by the European Union countries, and the euro area states in particular, amount to a major innovation in fiscal policy. This is softened by the fact that the proposed treaty specifies that it is only the structural deficit that must be eliminated, allowing for some continued variation over the course of the economic cycle. Article 16 of the proposed treaty, which is considered further below, notes that there will be an assessment of experience with implementation, well within five years of its coming into force. **We express**

⁹⁵ Q 100 (Select).

⁹⁶ Commissioner Olli Rehn (Select).

⁹⁷ QQ 73 & 74 (Select).

⁹⁸ Q 102 (Select).

⁹⁹ Minister for Europe QQ 73 & 74; Mr Amato Q 102; Professor Peers (Select).

the hope that this assessment will encompass a reflection on this major development in the fiscal policy of euro area states.

110. There is also a tension between the desire to hardwire balanced budgets and automatic sanctions for excessive deficits into the system; and the desire to retain flexibility where that is justified. This has been highlighted during the negotiations on the various iterations of the proposed treaty. In January the European Central Bank issued a strongly-worded warning that too many get-out clauses were being written in;¹⁰⁰ while by contrast Mr Amato expressed satisfaction that one element of flexibility which was important in the case of Italy (regarding the reduction of excessive government debt) had been added into the fourth draft of the treaty.¹⁰¹

Conclusion

111. **It is vital that, while the euro area states take the steps they consider necessary to strengthen the euro, including on fiscal integration, matters relating to the internal market remain the preserve of all 27 EU Member States. We welcome the disclaimer on the face of the treaty which is designed to ensure that this point is respected.**
112. **The proposed treaty raises a number of other questions, particularly concerning the relationship between it and the EU treaties and laws made under those treaties; and the proper role of EU institutions. The history of the institutional development of the European Union is characterised by pragmatic flexibility and ‘finding a way’, suggesting that some of the rough legal edges of the proposed treaty will be softened over time. With the United Kingdom reducing its objection to the use of the EU institutions under the proposed treaty, it might be argued that this process is already underway. But even so, the lack of clarity about whether it is legitimate for the proposed treaty to confer new functions on institutions of the European Union, and the extensive overlap between the provisions of this treaty and functions which have already been imposed by EU legislation, is undesirable. The treaty aims to bring certainty about the fiscal rules that euro area states will follow, and anything that risks creating new areas of confusion should be avoided. Therefore the objective of bringing these provisions within the scope of the EU treaties, as provided for in Article 16, is one which we consider is in the interests of all Member States including the United Kingdom.**

Implications for the United Kingdom

The approach to the December 2011 European Council

113. Even though the UK is not a member of the euro area, it is far from immune from the effects of the euro area crisis. The size and importance of the financial sector to the UK’s economy makes it particularly vulnerable. As we have seen, part of the emerging solution to the crisis has been a move towards closer fiscal integration among members of the euro area, and there has been an understandable tension underlying the approach of the United Kingdom Government towards these developments.

¹⁰⁰ “ECB raps revisions to draft fiscal pact”, *Financial Times*, 13 January 2012.

¹⁰¹ Q 103 (Select).

114. On one hand, the Government have been supportive, accepting the “remorseless logic” of closer integration.¹⁰² The Financial Secretary to the Treasury explained in October 2011 that “The reason we opposed membership of the euro is we recognised that along with monetary union must come closer fiscal integration, and we are urging that on our eurozone partners to enable them to get the right institutional mechanism in place to support monetary union.”¹⁰³
115. On the other hand, there has been a fear that a closely integrated bloc based on the euro area might shape EU policies to benefit this core, to the detriment of the “periphery” including the United Kingdom. Before treaty change moved decisively up the political agenda the former, supportive, view tended to be to the fore. When asked on 8 November 2011 about the danger that euro area states might work together to ‘pre-cook’ matters for discussion at the Council of Ministers, the Minister for Europe accepted that “when the new voting weights provided for in the Lisbon Treaty come in in 2015, at that stage the 17 current members of the eurozone would have a built-in qualified majority, should they vote as a bloc. Clearly there is an inherent risk, just in that arithmetic”, but he added that “there is no evidence whatsoever that that is how eurozone countries themselves are thinking at the moment.”¹⁰⁴
116. The lead-up to the December European Council seemed to signal a hardening of the UK Government’s position, towards seeking explicit guarantees that any significant moves to further integration would not disadvantage the UK. Immediately before the 9 December summit, the Prime Minister set out the Government’s view of the crisis: “What matters most to Britain’s national interest now is that the eurozone sorts out its problems ... That requires three things. First ... there needs to be much tighter fiscal discipline and closer fiscal co-ordination within the eurozone ... Second, the members and institutions of the eurozone should take whatever action is necessary to prevent a second global credit crunch ... above all a big firewall to prevent contagion along with properly capitalised banks. Third, and more fundamentally, we need to see improved competitiveness ... a change in the treaty governing all 27 members of the European Union ... is the most comprehensive and credible way to provide tough sanctions to ensure that eurozone countries stick to the rules on debt”.
117. Significantly he added that “If we are changing the treaty that applies to all EU countries and allowing the eurozone countries to have new rules, it is also important that there are rules to keep the single market fair and open for key industries for Britain, including financial services.” In the event that a treaty of the 17 euro area members were introduced instead and they were applied through the EU Court of Justice and the Commission, then “their use outside the treaty of the 27 would clearly require safeguards.”¹⁰⁵
118. As we have seen, the UK Government refused to negotiate changes to the EU treaties. Soon after the break-up of the negotiations Mr Cameron explained his reasons for refusing to take part:

¹⁰² Mark Hoban MP, Q 55 (Sub-Committee).

¹⁰³ Q 51 (Sub-Committee).

¹⁰⁴ Q 8 (Select).

¹⁰⁵ “Yes to treaty change—but only on our terms”, by David Cameron, *The Times*, 7 December 2011.

“We want the eurozone countries to come together and solve their problems. But we should only allow that to happen within the EU treaties if there are proper protections for the single market, for other key British interests.”¹⁰⁶

Why did the UK refuse to participate?

119. In evidence to us on 17 January the Minister for Europe explained to us in some detail the reasons for the Prime Minister’s actions on 9 December. First, he reiterated that the Government had hoped to secure an agreement: “when the Prime Minister went to Brussels for the December European Council, he did so on the basis of an agreed government position that the optimum outcome would be agreement of all 27”, provided that certain safeguards could be achieved.

“The reason why we wanted the safeguards was that it was not at all easy to predict—even now it is not easy to predict—what the outworking of the new arrangements would be in practice. We accept that the economic logic of a common currency is that there should be a move towards greater fiscal and economic integration of the eurozone. Given those countries’ sovereign decision to take part and to commit themselves to the single currency, it is in our interest as a nation that they should be able to sort out their grave problems and to restore economic stability.

Clearly, also, the creation of a tightly integrated structure focused on the eurozone within the architecture of the EU would mean giving a higher priority in the activities of the European Union to the concerns of the eurozone ...

When it was clear that explicit safeguards were not forthcoming, the Prime Minister took the decision that it is not in our national interest to agree. We have as an outcome an intergovernmental structure that, whatever else it does or does not do, cannot create obligations on the United Kingdom, cannot form part of the European Union’s *acquis* and cannot be a treaty basis for future EU secondary legislation that is binding on us.”¹⁰⁷

Safeguards

120. The Government’s case is therefore that the events at the December European Council, including their inability to achieve what they describe as the “optimum outcome” of an agreement between all 27 Member States, were dictated by the failure of the other Member States to agree the safeguards sought by the UK Government.
121. We repeatedly asked the Minister for Europe to explain precisely what safeguards the United Kingdom had sought at the December European Council.¹⁰⁸ Members of both Houses of Parliament have done the same.¹⁰⁹ While Ministers have outlined in general terms the safeguards they say were sought, they have consistently refused to give a precise answer, or to make available to Parliament the text of the draft protocol they put forward at the

¹⁰⁶ <http://www.bbc.co.uk/news/world-16104089>

¹⁰⁷ QQ 53–54 (Select).

¹⁰⁸ QQ 58, 61, 83 (Select).

¹⁰⁹ e.g. HL Deb 12 January 2012 cols 322 and 334; and **uncorrected** transcript of oral evidence of Rt Hon George Osborne MP before the House of Commons Treasury Committee, Wednesday 11 January 2012.

- December European Council and which the other Member States declined to agree. The Minister for Europe argued that “I do not think that any Government have got into the habit of disclosing routinely the text of negotiating amendments that they suggested to European partners in a particular context”.¹¹⁰
122. The Government’s position on this point is regrettable, not least because the system by which Parliament scrutinises proposals for European legislation relies on the provision of often quite detailed information by the government about its views on matters to be discussed at forthcoming Council meetings, and the system usually works well. **It is unacceptable that the Government have not released appropriate details of the safeguards which the Prime Minister sought at the December European Council. This makes it impossible to form a balanced judgement about the outcome. Coming to the present, we invite the Government to indicate what necessary safeguards they think have yet to be achieved, and what provisions (if any) in the proposed treaty are objectionable to them.**
123. As there has been no authoritative detailed statement from the Government on this matter, we set out three suggested explanations of the safeguards sought. The first is from the Minister for Europe, who explained in general terms that the Government had focused on two areas, seeking: “some sort of general safeguard with respect to the integrity of the single market and ... something more specific on the issue of financial services” ... to protect “the financial services industry in every EU Member State against the risk of discriminatory legislation or protectionist legislation on financial services”.¹¹¹ The Minister denied that the Government was tilting at imaginary windmills: “We have had, in the European Central Bank’s location policy, an example already of a legislative initiative that we believe goes blatantly against single market principles and which has been brought forward because the ECB regards it as their priority to protect the interests of the eurozone. We did not want to see that becoming a trend.”¹¹²
124. The second explanation is from the *Financial Times*, which reported that the UK’s demands included: a clear statement that euro area integration would preserve the interests of the single market and would not undermine the common interest of all 27 Member States; a “protocol on financial services” in relation to the powers of the new European Supervisory Authorities (including a reassurance that the EBA would remain in London) and including a unanimous vote on any “user charges” in financial services regulation, which would have attempted to clarify that the UK would have been able to veto any variant of the financial transaction tax proposal; ensuring that stringent rules did not close off the EU to US or Asian financial groups; and allowing the UK the flexibility to raise capital requirements for retail banks, in reflection of the recommendation of the Vickers Commission.¹¹³

¹¹⁰ Q 61 (Select). The Government also declined to give their view on the draft proposed treaty as “the Government cannot comment in detail on a draft text on which we are not negotiating”. (Minister for Europe (Select), 27 January 2012.)

¹¹¹ Q 58 (Select).

¹¹² Q 56 (Select).

¹¹³ “Cameron’s demands over financial regulation spark French resistance”, *Financial Times*, 9 December 2011.

125. The third is from the French President Nicolas Sarkozy: “in order to accept treaty revision among the 27 EU states, David Cameron asked us—something we all judged unacceptable—for a protocol to be inserted into the treaty granting the United Kingdom a certain number of exonerations on financial services regulations ... We could not accept this, since we consider, quite on the contrary, that a part of the world’s woes stem from the deregulation of the financial sector.”¹¹⁴

The future

126. The proposed treaty would impose no new obligations on the United Kingdom as a non-member of the euro area, whether or not the UK chose to sign and ratify the treaty. Article 14 makes clear that the treaty applies to contracting parties whose currency is the euro; and that it does not apply to other contracting parties until they adopt the euro—unless, that is, they choose to declare their intention to be bound by the substantive provisions of the treaty.
127. The United Kingdom Government have consistently recognised the “remorseless logic” of further integration between the euro area states. In principle those states should be supported in their efforts, given the severity of the crisis and the implications for the United Kingdom of a failure to resolve it. However, this further integration does raise important questions about the future development of the EU, and in particular whether and how the internal market can be maintained and developed further as a level playing field across all 27 Member States when the majority, but not all, of those states are also engaged in the fiscal integration that must ultimately accompany monetary union. **The United Kingdom Government, together with the other Member States of the Union, and the EU institutions, must devise a means of securing the fiscal integration desired by some of the euro area Member States while at the same time protecting the integrity of the single market, including its provisions for financial regulation, as an engine of economic growth for all 27 Member States of the Union.**
128. **We agree with the assessment of the United Kingdom Government that the “optimum outcome” at the December European Council would have been an agreement at the level of all 27 EU Member States, with the interests of the United Kingdom protected. But the creation of mechanisms outside the EU treaties risks causing confusion, and we have sought to identify some of these issues in this report. Shifting discussions outside the main EU channels to forums where the United Kingdom has no voice also risks marginalising the UK over time.**
129. **For the longer term, we note that the proposed treaty states in Article 16 that it remains the intention for its provisions to be folded in to the main EU treaty framework. We can see no reason in principle why this should not in due course be achieved.**

¹¹⁴ “EU suffers worst split in history as David Cameron blocks treaty change”, *Daily Telegraph*, 9 December 2011, and “Cameron cold shoulders Europe”, *Financial Times*, 10 December 2011.

CHAPTER 6: BEYOND THE SHORT TERM

130. This report has focused on the more immediate measures which have been put forward to resolve the euro area crisis. It is worth briefly considering two vital broader points: leadership; and the importance of economic growth.

Leadership

131. Financial markets have tended to show little confidence in the ability of EU leaders to act decisively to contain the euro area crisis. In October 2011 Professor Buiter of Citigroup compared decision-making in the EU to “a caterpillar hurdling”.¹¹⁵ In the same month Ambassador Boomgarden made the interesting point that the EU desires “leadership but it wants no leaders”.¹¹⁶
132. As the crisis has intensified, French President Nicolas Sarkozy and especially German Chancellor Angela Merkel have emerged as the dominant political figures in seeking to deal with the crisis, to the extent that the phrase “Merkozy” has entered the political jargon.¹¹⁷
133. Professor Begg observed that, after the crisis began to escalate during the summer, there had been a “sea change” in the German attitude as they finally grasped the gravity of the crisis. One indicator of this change was the tough line taken by European leaders, led by Chancellor Merkel, in discussions with Mr Papandreou and Mr Berlusconi concerning their respective national crises.¹¹⁸ Witnesses also noted that the Commission has sometimes been sidelined in terms of dealing with the euro area crisis.¹¹⁹ At the time of the informal summit on 30 January it was reported that there was anger from Greek politicians about a suggestion “to impose a budget overseer”.¹²⁰
134. **National governments and EU institutions have sometimes struggled to keep up with the pace of events during the long euro area crisis. We do not underestimate the massive challenges facing the EU and the euro area in particular, and there is a need for effective and proactive leadership both from the EU institutions and Member States, in the interests of the wider Union.**

Economic growth

135. A comprehensive and lasting solution to the crisis will be impossible without addressing the question of economic growth across the EU, in which the development of the single market has a role to play; and the imbalances between different states within the euro area.
136. Mr Amato highlighted the danger of a “vicious circle” of austerity, unemployment, reduction of incomes and populist reactions against the austerity and against national governments and the EU.¹²¹ Emphasising the importance of economic growth to combat this problem, Mr Amato noted

¹¹⁵ Q 32 (Sub-Committee).

¹¹⁶ Q 8 (Sub-Committee).

¹¹⁷ See for instance Professor Begg, Q 92 (Sub-Committee).

¹¹⁸ QQ 78, 84, 88–9 (Sub-Committee).

¹¹⁹ e.g. Q 92 (Sub-Committee).

¹²⁰ “Greek fury at plan for EU budget control”, *Financial Times*, 29 January 2012.

¹²¹ Q 109 (Select).

the role of the single market in facilitating economic development, and gave the example of Nokia requiring 27 different licences in order to offer a single new service to their European customers.¹²²

137. The Minister for Europe identified as essential “the much more ambitious reforms of European Union practice to try to secure greater competitiveness and growth in the face of a shift of competitive advantage to Asia and Latin America”. He went on to express frustration that proposals for dealing with the euro area crisis have “absorbed so much time, attention and energy of policymakers around the European Union that not enough attention and priority have been given to how, collectively, we can develop growth through trade, we can have a digital single market and a single energy market, and we can make our industries more competitive”.¹²³
138. This fear has been given added urgency in recent weeks by a range of worsening economic indicators, including the recent downgrading by the IMF of its GDP forecasts for 2012: for the euro area countries, from 1.6 per cent growth (as predicted in September 2011) to a contraction of 0.5 per cent; for the United Kingdom from 1.6 per cent to 0.6 per cent growth; and for the world economy as a whole from 4.0 per cent growth to 3.3 per cent growth.¹²⁴ The human cost of this worsening economic situation is shown clearly in widespread protests against austerity measures, and rising unemployment in many EU Member States.
139. The informal European Council on 30 January agreed a range of measures on “stimulating employment, especially for younger people”, “completing the single market”, and “boosting the financing of the economy, in particular” small and medium-sized enterprises.¹²⁵ In relation to the single market these included undertakings to seek:
- agreement by the end of June 2012 on standardisation, energy efficiency and the simplification of accounting requirements; and agreement by the end of the year on the simplification of public procurement rules;
 - rapid implementation of the Commission Action Plan on e-commerce; and agreement on rules on online dispute resolution and on roaming by June 2012;
 - modernisation of Europe’s copyright regime;
 - agreement by June 2012 of the patent package.
140. Soon after the summit, several European think tanks expressed doubt that the measures announced would translate into any significant positive effects on jobs or growth; and voiced concerns about the growing risk of social unrest.¹²⁶
141. **It is clear that improved budgetary discipline is necessary in order to make progress in resolving the euro area crisis, but ultimately the resumption of sustainable economic growth will hold the key: both in general terms across the EU, and in facilitating attempts to resolve the serious imbalances in competitiveness between different countries in the euro area. Therefore, while we acknowledge the great difficulty**

¹²² Q 104 (Select).

¹²³ Q 76 (Select).

¹²⁴ International Monetary Fund, World Economic Outlook (Update), 24 January 2012.

¹²⁵ Statement of the members of the European Council, 30 January 2012.

¹²⁶ “EU crisis response not job friendly: think tanks”, www.euractiv.com, 2 February 2012.

of devising measures to support economic growth in a period of austerity, we share the concern of the Minister for Europe that the potential of the development of the single market to enhance growth has faded from view during the crisis. We are heartened by the emphasis on job creation and the single market at the EU summit on 30 January, but the real challenge for policymakers will be the sustained implementation of measures which are both effective in developing the single market and thus supporting economic growth, and which do not threaten the drive to improve budgetary discipline.

CHAPTER 7: SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Chapter 3: Implementation of the 26 October 2011 agreement

142. We are concerned about the extent of uncertainty that remains in the crucial area of bank recapitalisation. The 26 October agreement provided few details on exactly how recapitalisation will be achieved, and though the agreement was right to warn banks not to seek to reduce debt ratios by deleveraging, it is not clear whether and how they can be prevented from doing so—indeed, the long time period offered seems to facilitate rather than guard against this. A sustained restriction of credit, particularly in the current economic climate, would be highly damaging. (paragraph 44)
143. Given the cost to the global economy of the prolonged recession which could follow sovereign defaults and further bank collapses, and therefore the cost to all countries of a failure to ease the euro area crisis, there remains an urgent need to establish a credible and well-financed system of rescue funding. Primary responsibility lies with the euro area countries. However, given the global implications it is necessary for the international community, including the UK, to contribute through the IMF. We welcome the Government's willingness to contemplate this. (paragraph 50)
144. It is imperative that rapid progress is now made in putting flesh on the bones, and drawing to a conclusion the outline agreements reached in October 2011 on Greek debt write-down; bank recapitalisation; and the financing of the European rescue funds. Even this package, though necessary, is likely on its own to prove insufficient. (paragraph 53)

Chapter 4: Other policy responses

145. The ECB has already taken unprecedented steps in relation to the euro area crisis through the purchase of sovereign bonds in the secondary debt markets, and more recently through a massive operation to refinance European banks. There has been pressure for the ECB to play an even greater role, which the ECB has thus far resisted, in particular citing the need to respect the Treaty provisions that bar the direct monetary financing of governments. In our view, although the ECB should not be regarded as a panacea, additional ECB intervention is likely to prove essential, at least to preserve the functioning of credit markets and thus to support economic growth, if progress is to be made in resolving the euro area crisis. (paragraph 64)
146. It remains to be seen whether a 'eurobond' could be designed in such a way as to meet the concerns of nations such as Germany, so that it will not lead to a risk of moral hazard nor lower the cost of servicing the public debt for some countries in the euro area at the expense of a considerable increase for others. The Commission's proposals are at an early stage of development, and, though 'eurobonds' could relieve pressure in the bond market, they are only likely to become a mechanism available for use in the medium to long term. The lack of reference to 'eurobonds' in the 9 December statement might be taken to suggest that their introduction remains a distant prospect. Yet the question of whether they are a necessary step towards solving the euro area crisis needs to be addressed. (paragraph 70)

Chapter 5: The December 2011 European Council and the proposals for treaty change

147. We express the hope that the assessment of experience with implementation of the proposed treaty, provided for in Article 16, will encompass a reflection on this major development in the fiscal policy of euro area states. (paragraph 109)
148. It is vital that, while the euro area states take the steps they consider necessary to strengthen the euro, including on fiscal integration, matters relating to the internal market remain the preserve of all 27 EU Member States. We welcome the disclaimer on the face of the treaty which is designed to ensure that this point is respected. (paragraph 111)
149. The proposed treaty raises a number of other questions, particularly concerning the relationship between it and the EU treaties and laws made under those treaties; and the proper role of EU institutions. The history of the institutional development of the European Union is characterised by pragmatic flexibility and ‘finding a way’, suggesting that some of the rough legal edges of the proposed treaty will be softened over time. With the United Kingdom reducing its objection to the use of the EU institutions under the proposed treaty, it might be argued that this process is already underway. But even so, the lack of clarity about whether it is legitimate for the proposed treaty to confer new functions on institutions of the European Union, and the extensive overlap between the provisions of this treaty and functions which have already been imposed by EU legislation, is undesirable. The treaty aims to bring certainty about the fiscal rules that euro area states will follow, and anything that risks creating new areas of confusion should be avoided. Therefore the objective of bringing these provisions within the scope of the EU treaties, as provided for in Article 16, is one which we consider is in the interests of all Member States including the United Kingdom. (paragraph 112)
150. It is unacceptable that the Government have not released appropriate details of the safeguards which the Prime Minister sought at the December European Council. This makes it impossible to form a balanced judgement about the outcome. Coming to the present, we invite the Government to indicate what necessary safeguards they think have yet to be achieved, and what provisions (if any) in the proposed treaty are objectionable to them. (paragraph 122)
151. The United Kingdom Government, together with the other Member States of the Union, and the EU institutions, must devise a means of securing the fiscal integration desired by some of the euro area Member States while at the same time protecting the integrity of the single market, including its provisions for financial regulation, as an engine of economic growth for all 27 Member States of the Union. (paragraph 127)
152. We agree with the assessment of the United Kingdom Government that the “optimum outcome” at the December European Council would have been an agreement at the level of all 27 EU Member States, with the interests of the United Kingdom protected. But the creation of mechanisms outside the EU treaties risks causing confusion, and we have sought to identify some of these issues in this report. Shifting discussions outside the main EU channels to forums where the United Kingdom has no voice also risks marginalising the UK over time. (paragraph 128)

153. For the longer term, we note that the proposed treaty states in Article 16 that it remains the intention for its provisions to be folded in to the main EU treaty framework. We can see no reason in principle why this should not in due course be achieved. (paragraph 129)

Chapter 6: Beyond the short term

154. National governments and EU institutions have sometimes struggled to keep up with the pace of events during the long euro area crisis. We do not underestimate the massive challenges facing the EU and the euro area in particular, and there is a need for effective and proactive leadership both from the EU institutions and Member States, in the interests of the wider Union. (paragraph 134)
155. It is clear that improved budgetary discipline is necessary in order to make progress in resolving the euro area crisis, but ultimately the resumption of sustainable economic growth will hold the key: both in general terms across the EU, and in facilitating attempts to resolve the serious imbalances in competitiveness between different countries in the euro area. Therefore, while we acknowledge the great difficulty of devising measures to support economic growth in a period of austerity, we share the concern of the Minister for Europe that the potential of the development of the single market to enhance growth has faded from view during the crisis. We are heartened by the emphasis on job creation and the single market at the EU summit on 30 January, but the real challenge for policymakers will be the sustained implementation of measures which are both effective in developing the single market and thus supporting economic growth, and which do not threaten the drive to improve budgetary discipline. (paragraph 141)

APPENDIX 1: MEMBERSHIP AND INTERESTS

Declarations of Interest by the members of the European Union Committee

- Lord Hannay of Chiswick
Member Advisory Board, Centre for European Reform
- Lord Jopling
In receipt of funds under the Common Agricultural Policy
- Lord MacLennan of Rogart
In receipt of funds under the Common Agricultural Policy

Membership of the Sub-Committee on Economic and Financial Affairs and International Trade

- Lord Flight
 Lord Harrison (Chairman)
 Lord Hamilton of Epsom
 Lord Haskins
 Baroness Hooper
 Lord Jordan
 Lord Kerr of Kinlochard
 Baroness Maddock
 Lord Marlesford
 Lord Moser
 Lord Vallance of Tummel
 Lord Woolmer of Leeds

Declarations of Interest of the Sub-Committee on Economic and Financial Affairs and International Trade

- Lord Flight
Author of "All you need to know about Exchange Rates" published 1988
- Lord Harrison
None relevant
- Lord Hamilton of Epsom
Non-Executive Director, Jupiter Dividend and Growth Trust PLC (investment trust)
Director, IREF Global Holdings (Bermuda) Ltd (property fund)
Non-Executive Director, MSB Ltd, (management consultancy)
Non-Executive Director, IREF Australian Holdings (Bermuda) Ltd (property fund)
- Lord Haskins
Chair, Humber Local Enterprise Partnerships 2011 (LEP)
- Baroness Hooper
None relevant
- Lord Jordan
Chairman, Homes and Communities Agency Pension Scheme
- Lord Kerr of Kinlochard
Deputy Chairman Royal Dutch Shell plc
Director, Rio Tinto
Director, Scottish Power
Director, Scottish American Investment Co Ltd
Chairman, Centre for European Reform (London)

Vice President, European Policy Centre (Brussels)
Trustee, Carnegie Trust for the Universities of Scotland
President, UK/Korea Forum for the Future

Baroness Maddock

None relevant

Lord Marlesford

Advice on the world outlook is given to Sit Investment Associates Minneapolis (fund managers)

Independent National Director, Times Newspapers Holdings Ltd

Non-executive Director, Gavekal Research (Hong Kong) (financial services)

Lord Moser

None relevant

Lord Vallance of Tummel

Member Supervisory Board Siemens AG (engineering and services)

Lord Woolmer of Leeds

None relevant

Declarations for the Sub-Committee are complete up to the end of its inquiry on 13 December 2011.

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

APPENDIX 2: LIST OF WITNESSES

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

Evidence heard by the Sub-Committee on Economic and Financial Affairs and International Trade

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

Oral evidence in chronological order

- | | | |
|----|---------------------------|-------------------------|
| * | QQ 1–17 (Sub-Committee) | Georg Boomgaarden |
| ** | QQ 18–29 (Sub-Committee) | Sharon Bowles MEP |
| ** | QQ 30–49 (Sub-Committee) | Professor Willem Buiter |
| * | QQ 50–77 (Sub-Committee) | Mark Hoban MP |
| ** | QQ 78–104 (Sub-Committee) | Professor Iain Begg |

Evidence heard by the Select Committee

This evidence is published online at <http://www.parliament.uk/hleu> and is also available for inspection at the Parliamentary Archives.

Oral evidence in chronological order

- | | | |
|----|--------------------|-------------------------------|
| ** | QQ 1–26 (Select) | David Lidington MP |
| ** | QQ 27–52 (Select) | Charles Grant and Edward Carr |
| * | QQ 53–85 (Select) | David Lidington MP |
| * | QQ 86–97 (Select) | Professor Paul Craig |
| ** | QQ 98–109 (Select) | Giuliano Amato |

Alphabetical list of all witnesses

- | | |
|----|--|
| ** | Giuliano Amato, former Prime Minister of Italy, and Vice-President of the Commission on the Future of Europe 2001–2003 |
| ** | Professor Iain Begg |
| * | Ambassador Georg Boomgaarden |
| ** | Sharon Bowles, MEP |
| ** | Professor Willem Buiter |
| ** | Edward Carr, Foreign Editor, The Economist |
| * | Professor Paul Craig |
| ** | Charles Grant, Director, Centre for European Reform |
| * | Mark Hoban MP, Financial Secretary to the Treasury |
| * | Rt Hon David Lidington MP, Minister for Europe |
| | Professor Steven Peers |
| | Olli Rehn, Vice-President of the European Commission |

APPENDIX 3: GLOSSARY¹²⁷

Bond	A debt security. The bond states when a loan must be repaid and what interest the borrower (issuer) must pay to the holder. They can be issued by companies, banks or governments (“sovereign bonds”) to raise money. Banks and investors buy and trade bonds.
Contagion	A scenario where the financial difficulties of one economy spread to other economies.
Credit rating	The assessment given to debts and borrowers by a ratings agency according to their safety from an investment standpoint.
Deleveraging	A process whereby borrowers reduce their debtloads.
EBA	European Banking Authority.
ECB	European Central Bank.
Economic governance	A loose term that captures the different arrangements for running the economic and monetary union, and for coordinating economic policies within the wider EU.
EFSF	European Financial Stability Facility.
EFSM	European Financial Stabilisation Mechanism.
EMU	Economic and Monetary Union.
Equity	The value of a business or investment after subtracting any debts owed by it.
ESM	European Stability Mechanism.
EU	European Union.
Eurobond	A term increasingly used for the idea of a common, jointly guaranteed bond of the euro area governments.
Eurogroup	A body composed of the finance ministers of the Member States of the euro area.
European Council	A council of all the heads of state or government of the European Union.
Fiscal policy	Policies relating to government taxation and spending decisions.
Fiscal union	A generic term covering a range of proposals for closer fiscal integration amongst euro area countries. These might range from a situation where a euro area institution co-ordinated individual nations’ fiscal policies, to full fiscal union where a central authority would control fiscal policy for the entire euro area.
GDP	Gross Domestic Product.
G20	The group of industrialised countries and developing countries who play a major role in the world economy.
Haircut	A haircut occurs when a lender has to accept a reduction in the redemption value of a bond because of the inability of the

¹²⁷ Some definitions are taken from the following source, with thanks: <http://www.bbc.co.uk/news/business-15060411>.

	borrower to pay it in full; for example, if only 90 cents is repaid per euro, the haircut would be ten cents (10 per cent).
IMF	International Monetary Fund.
Leveraging	Using debt to supplement investment.
Liquidity	The ability to convert an asset into cash. A “liquidity crisis” is when it becomes more difficult to obtain cash.
LTRO	Long Term Refinancing Operation.
Macroeconomic imbalances	A macroeconomic imbalance exists where the trajectory of the economy is unsustainable and risks causing problems of volatility or instability, including financial instability. Such imbalances often manifest themselves in deficits or surpluses on the current account of the balance of payments.
Monetary policy	Policies regulating the money supply and interest rates by a central bank.
Moral hazard	Moral hazard arises when a contract or financial arrangement creates incentives for the parties involved to behave against the interest of others. See http://lexicon.ft.com/Term?term=moral-hazard
Orderly default	When a nation’s debts are restructured in an organised way.
PSI	Private Sector Involvement. (In the current context, this term concerns negotiations to involve private lenders, including banks, in efforts to reduce Greek debt.)
Recapitalisation	To inject fresh equity into a firm or a bank, which can be used to absorb future losses and reduce the risk of insolvency.
Secondary markets	A market where investors purchase securities or assets from other investors, rather than from issuing companies themselves. ¹²⁸
SGP	Stability and Growth Pact.
Sovereign liquidity	The ability of a government to obtain cash quickly.
Sovereign insolvency	A government’s inability to service or repay its debt.
SPV	Special Purpose Vehicle. A company created solely for the purpose of owning a particular set of loans or other investments, and distributing the risk to investors.
TEU	Treaty on European Union.
TFEU	Treaty on the Functioning of the European Union.
Troika	The collective term used to refer to the European Union, the European Central Bank and the International Monetary Fund.
Undercapitalisation	Where a firm, bank or institution does not possess enough equity to absorb future losses or to avoid the risk of insolvency.
Writedown	Reducing the book value of an asset.
Yield	The return to an investor from buying a bond implied by the bond’s current market price. It also indicates the current cost of borrowing in the market for the bond issuer.

¹²⁸ <http://www.investopedia.com/terms/s/secondarymarket.asp#axzz11axNZI2o>