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‘Whatever it takes’: the Five Presidents’ Report on completing Economic and Monetary Union

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SUMMARY

The Five Presidents' Report, published in June 2015, seeks to sustain the momentum of economic reforms put in place in response to the financial and euro sovereign debt crisis. It also proposes longer term solutions to achieve sustainable economic, financial and fiscal union by 2025, while bolstering democratic accountability. It raises the question of whether eurozone countries will move towards integration primarily by sharing risks or whether they will put the emphasis on better adherence to discipline. The evolution of integration will depend on the balance reached between risk reduction and risk-sharing measures. In either case, greater integration will require democratic accountability. All these measures will be problematic and time consuming. Nevertheless, we believe that significant political will exists to enable the euro to survive for the foreseeable future.

The Five Presidents' Report also proposes, albeit in broad terms, fundamental changes to the eurozone institutional structure, which would have implications for the position of the UK. However, treaty change would be needed for many of the proposed changes and so the UK, if it remains in the EU following the 23 June referendum, should stay closely involved to ensure that there is no threat to the integrity of the Single Market and that the outcomes are, as far as possible, in the UK's interests. A White Paper, developing the five Presidents' more ambitious proposals, will be published in 2017. As a thriving eurozone is in the interests of all EU members, including the UK, we look forward to its publication with interest.

The EU has made limited progress in reconciling the decisions made at national level with the requirements of assuring economic and fiscal stability at the European level. In recent years, fiscal rules have been strengthened, and coordination and surveillance enhanced. However, adherence to and implementation of the Stability and Growth Pact and other measures are unsatisfactory. Despite progress in recent years, the fiscal rules are, on the one hand, still prone to be pro-cyclical and, on the other, subject to political influence at the domestic level. We identify an inherent tension between strong enforcement and Member State ownership of reforms.

The Five Presidents' Report suggests some limited reforms aimed at strengthening existing structures. We welcome the creation of an advisory Fiscal Board but are sceptical that it will be effective without buy-in at Member State level. The right incentives also need to be put in place to allow Member States to view domestic fiscal policies as a matter of common interest. The Report also proposes the creation of Competitiveness Boards in each euro area Member State. We consider that these may have an insufficient effect in the countries where they are most needed.

The Report also launched the next stage of Banking Union. Although the UK is not currently a participant, strong links between UK and eurozone banks mean that measures to complete Banking Union are relevant to the UK. We support these efforts, but Banking Union remains incomplete and the bank-sovereign link is not fully broken. The proposed third 'leg' of Banking Union—common deposit insurance through a European Deposit Insurance Scheme (EDIS)—could serve as a useful addition to the Banking Union architecture but it is no panacea. In the short term, Banking Union is unlikely to be achieved without resolving the differences between the 'risk reducers' and 'risk sharers'.

Regardless of whether EDIS proceeds as envisaged we continue to support the establishment of a common backstop to the Single Resolution Fund. In addition, one of the real tests for the creation of a 'Financial Union' is whether the new financial supervisory and resolution structure is sufficiently robust to cope with future financial instability. We strongly support efforts to develop a Capital Markets Union (CMU) as a key tool to enhance private risk-sharing, but note that its effectiveness may be limited in a crisis. The CMU initiative is moving slowly and contentious issues such as tax and insolvency need to be tackled. CMU is a project for the whole EU, and not just the eurozone, and the UK stands to benefit through its role as a financial markets hub.

The Five Presidents' Report offers no clear definition of 'Fiscal Union', even though it will be a key area for discussion during the preparation of the White Paper. We were struck by the variety of interpretations of 'Fiscal Union' advanced by our witnesses. It can encompass many and various degrees of fiscal pooling and shared decision-making. Some form of fiscal stabilisation that responds to cyclical and asymmetric shocks is sensible but future discussion needs to focus on the degree. It is clear however, that any fiscal pooling or a system leading to permanent transfers in one direction will not be politically feasible in the short term. Sharing fiscal or financial risks, under a 'Financial Union' or 'Fiscal Union', which would involve greater decision-making or the pooling of national funds at the European level, will require appropriate mechanisms of democratic accountability.

The Five Presidents' Report provides some suggestions to enhance democratic accountability but is light on detail. The Report envisages the strengthening of the Eurogroup and the creation of a eurozone treasury but does not elaborate. Such a proposal could extend to the creation of a eurozone Finance Minister, at the head of a new institution disposing of a budget voted by a eurozone parliament. On the other hand, reform could be more limited. While it is for the eurozone countries themselves to determine the appropriate level of integration, the Government should remain alert to any changes and ready to act to protect the UK's interests. Treaty change would be necessary to create any new institutional structure: should the UK remain a member of the EU the process of treaty revision would also provide an opportunity to entrench the February 2016 renegotiation settlement in EU law.

‘Whatever it takes’: the Five Presidents’ Report on completing Economic and Monetary Union

CHAPTER 1: INTRODUCTION: WHY THE EURO MATTERS TO THE UK

The subject matter of this report

1. On 22 June 2015 the ‘five Presidents’[1] published their report *Completing Europe’s Economic and Monetary Union*.[2] The report is widely known as the ‘Five Presidents’ Report’, which is how we refer to it throughout this report.

2. The resilience of Economic and Monetary Union (EMU) and the eurozone have been tested since their inception but particularly since the financial crisis in 2008 which exposed shortcomings in their original mechanisms and the policies adopted in response. In October 2014 the Euro Summit issued a call to the European Commission for further work to “develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity”, and “to prepare next steps on better economic governance in the euro area”.[3] The response was the Five Presidents’ Report, which was released at the height of the negotiations on the third Greek bailout, also a time when there was intense speculation over the future of the euro itself.

Will the euro survive?

3. We asked witnesses about the future of the euro. Almost all of them could identify issues with the architecture but the majority concluded that so much political will was invested in the survival of the euro that it was likely to “muddle through”.

4. Professor Otmar Issing, President, Center for Financial Studies, Goethe University, was sure the euro would survive: “There is too much political investment in this project to allow the idea that the euro will one day collapse,”[4] a position echoed by Kay Swinburne MEP,[5] a member of the European Parliament ECON Committee. John Peet, Political Editor, *The Economist*, considered that “it will probably muddle on because one lesson of the last five years is that it is generally agreed that the costs of going back and breaking it up could be very large and therefore that is something everybody wants to avoid.”[6] David Marsh, Managing Director, Official Monetary and Financial Institutions Forum, was more sceptical: while Europe had a “remarkable facility for continuing to survive when all around think it is dead”, it was “limping on in a way that could well be thought of as terminal.”[7]

1 The five Presidents were: Jean-Claude Juncker, President of the European Commission; Donald Tusk, President of the Euro Summit; Jeroen Dijsselbloem, President of the Eurogroup; Mario Draghi, President of the European Central Bank; and Martin Schulz, President of the European Parliament.
2 European Commission, *Completing Europe’s Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf
3 Euro Summit statement, 24 October 2014
4 Q 209
5 Q 85
6 Q 70
7 Q 169

The challenge facing the eurozone was summed up by Fabian Zuleeg, Chief Executive, European Policy Centre:

> "I would not expect the euro to collapse any time soon, but if those structural issues are not addressed we can be fairly certain that some sort of crisis will recur. Then the question is how you deal with that crisis and whether the eurozone is robust enough to again find political consensus and the countries can pull themselves together to take whatever actions are necessary."[8]

Why the euro matters to the UK

5. We note that there are potential tensions between eurozone and non-eurozone countries and within the eurozone itself, some of which have been allayed by the outcome of the February 2016 European Council.

6. Although the UK is not a member of the eurozone there are two main reasons that further strengthening and integration of EMU and the eurozone are relevant to it.

7. First, the health of the eurozone economy has a direct impact on the health of the UK economy. We have consistently taken this view. For instance, in our 2014 report *Euro area crisis: an update* we concluded that "The economic fortunes of the UK and the euro area are intrinsically linked. Although the UK economy has suffered from the decline in business activity arising from the euro area crisis, it stands to benefit from a prosperous euro area".[9] The Government agrees. For instance, the Chancellor of the Exchequer said in an interview with the BBC in October 2014 that the UK would "not be immune" to a further eurozone crisis.[10] David Gauke MP, Financial Secretary to the Treasury, told us towards the end of our inquiry that: "It is in our interest that the euro area is a successful, strong currency area, so we do not want to stand in the way of the euro area resolving its difficulties."[11]

8. Second, the establishment of new mechanisms within the eurozone, or the enhancement of those that already exist, will have a range of impacts on the UK's interests within the EU or its institutions, or on the functioning of the wider Single Market. For instance, the establishment of Banking Union, in which the UK has chosen not to participate, has created an institutional and legislative framework that has the potential, even if indirectly, to affect the UK's banks and regulators.

Overview of policy developments since 2011

9. In response to the challenges it has faced the eurozone has developed a variety of policy responses. This Committee's predecessors followed those developments closely and reported on them.[12] This report seeks to build on previous work rather than repeating it, so in Box 1 we briefly list the major policies developed so far.

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8 Q 118
9 European Union Committee, *Euro area crisis: an update* (11th Report, Session 2013–14, HL Paper 163)
10 'Osborne warns eurozone slowdown will impact UK economy', *BBC* (9 October 2014): http://www.bbc.co.uk/news/business-29551541
11 Q 195
12 For instance, European Union Committee, *The future of economic governance in the EU* (12th Report, Session 2010–12, HL Paper 124) and *'Genuine Economic and Monetary Union' and the implications for the UK* (8th Report, Session 2013–14, HL Paper 134)

Box 1: Steps taken so far

1. November 2011: The conclusion of the 'six-pack', comprising five regulations and a directive, which aimed to provide for tighter discipline on public finances. This encompassed the recasting of the Stability and Growth Pact and an obligation to introduce stronger fiscal rules in national policy frameworks. It also introduced the macroeconomic imbalances procedure (MIP).
2. 2011: The establishment of the European Semester and the agreement of the (intergovernmental) Euro-Plus Pact, intended to promote better economic policy through a consistent sequence of monitoring measures.
3. 2012: The agreement of the Fiscal Compact, designed to reinforce the governance of fiscal and economic policies, incorporated in the intergovernmental Treaty on Stability, Coordination and Governance (TSCG).
4. May 2013: The conclusion of the 'two-pack', comprising two regulations that apply only to the euro area, ensuring closer oversight of the public finances of euro area members, notably through the obligation to submit draft budgets to the Commission for scrutiny.
5. The adoption of financial regulation and supervision measures, including the Capital Requirements Regulation and Directive IV (CRR and CRD IV), which transposed the Basel III agreement into the EU legal framework; reinforcement of the European Supervisory Authorities covering the banking, insurance and securities sectors; and the creation in 2010 of the European Systemic Risk Board (ESRB) to oversee risk in the financial system as a whole.
6. The establishment of funding mechanisms for bailing out countries in difficulty, including the temporary (eurozone only) European Financial Stability Facility (EFSF); the European Financial Stabilisation Mechanism (EFSM) (EU-wide and temporary, backed by the EU Budget); and the European Stability Mechanism (ESM) (eurozone and permanent). The ESM, based on a limited amendment to Article 136 TFEU, and a separate treaty, has a capacity of €500 billion backed by participating Member States. It obtains its funds by issuing bonds and is obliged to impose strict conditionality on any loans it makes to Member States.
7. The development of the role of the European Central Bank through the Securities Market Programme (through which the ECB purchased the debt of Member States on the secondary markets), access for banks to Long-Term Refinancing Operations (LTROs) to ensure liquidity, and the offer of Outright Monetary Transactions (OMTs) through which the ECB would purchase unlimited amounts of national debt on the secondary markets, provided that the country in question had agreed to a reform programme. In July 2012 ECB President Mario Draghi famously made a commitment to "do whatever it takes" to save the euro. The ECB has also joined the IMF and the Commission in 'Troika' missions to oversee the adjustment programmes of countries which have received a bailout, most recently Greece.
8. The creation of the 'Banking Union', following the proposals put forward by the four Presidents in 2012. This currently comprises a Single Supervisory Mechanism in which the ECB has overall responsibility for the supervision of Banking Union banks and a Single Resolution Mechanism run by a Single Resolution Board.

10. In our 2014 report on *'Genuine Economic and Monetary Union' and the implications for the UK*, we described the policy responses listed above as "a mix of crisis management and longer-term recasting of the system", and noted that the apparently *ad hoc* approach had been the result of the impetus for reform ebbing and flowing in response to the intensity of crisis.[13]

Genuine Economic and Monetary Union

11. Our 2014 report considered proposals put forward in 2012 by the 'Four Presidents' and the European Commission to create 'Genuine Economic and Monetary Union'.[14] Those proposals built on the achievements listed above and introduced a set of short- and long-term proposals to improve economic, monetary and financial governance in the EU.

Box 2: Genuine Economic and Monetary Union

The main elements of the Four Presidents' Report were as follows:

1. Banking Union: centralised bank supervision led by the ECB—the Single Supervisory Mechanism (SSM); a Single Resolution Mechanism (SRM); a framework to enable the ESM to be used for direct bank recapitalisation; and common deposit insurance.
2. Fiscal Union: mechanisms for better discipline in and coordination of fiscal policy; a new fiscal capacity for the eurozone to provide initially temporary support for countries undertaking structural reforms but in the longer term an instrument to deal with country-specific economic shocks; possible debt mutualisation including the introduction of a Eurobond.
3. Closer integration of economic policies: further efforts to complete the Single Market (including by stimulating labour mobility and possibly greater tax harmonisation); reinforced coordination of major policy reforms; and contractual relationships between Member States and the Commission on economic strategies with accountability to the European Parliament and national parliaments.
4. Enhanced democratic oversight of pooled economic policies.

12. These proposals were intended to be implemented to varying timetables. Banking Union should have been complete within six to 18 months, along with the creation of a "convergence and competitiveness instrument". Within five years, the Commission timetable foresaw further strengthening of collective conduct of budgetary and economic policy, alongside a dedicated fiscal capacity, such as a separate budget, for the euro area and the possible introduction of Eurobills or a Debt Redemption Fund. In the longer term, the Four Presidents' Report anticipated the creation of an autonomous euro area budget and fiscal capacity, alongside the common issuance of public debt. This would be dependent on an adequately integrated governance framework and associated pooling of sovereignty.

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13 European Union Committee, *'Genuine Economic and Monetary Union' and the implications for the UK* (8th Report, Session 2013–14, HL Paper 134), paras 8 and 9

14 The 'Four Presidents' were Herman Van Rompuy, President of the European Council; Jose Manuel Barroso, President of the European Commission; Jean-Claude Juncker, President of the Eurogroup and Mario Draghi, President of the ECB. There were in fact three reports: two by the four Presidents in June and December 2012, both titled "Towards a Genuine Economic and Monetary Union" and one by the European Commission in November 2012 titled "A Blueprint for a Deep and Genuine Economic and Monetary Union: Launching a European Debate".

13. Progress has taken longer than the eighteen months envisaged in the Commission blueprint that followed the Four Presidents' Report, although it should be noted that the first two 'pillars' of Banking Union (the Single Supervisory Mechanism and the Single Resolution Mechanism) were agreed quite rapidly in 2013 and 2014, respectively, and were then implemented as quickly as was practicable. The SSM became operational in November 2014 under a newly established part of the ECB, after a 'comprehensive assessment' of the major banks it will cover, and the SRM was largely in place by January 2016. Deposit insurance did not advance as originally hoped, but is back on the table as one of the key elements of the Five Presidents' Report.

The Five Presidents' Report

14. The Five Presidents' Report relaunched the debate on the future of EMU. It set out a series of policies to be undertaken between 2015 and 2025, arranged under four main headings: Economic Union; Financial Union; Fiscal Union and Democratic Accountability, Legitimacy and Institutional Strengthening. These are essentially the same headings as in the Four Presidents' Report. The Report proposes two stages. The first includes a number of short-term measures to be completed between 2015 and 2017, referred to as 'Stage 1'.[15] These would "build on existing instruments and make the best possible use of the existing Treaties". The second sets out a Stage 2 that would involve more ambitious measures to be put in place after 2017. A White Paper would be published in 2017 describing the way forward for Stage 2. Stage 3 would be from 2025 onwards.

15. The Commission took early steps to implement the Stage 1 proposals through the publication on 21 October 2015 of a Communication 'On steps towards Completing Economic and Monetary Union,'[16] accompanied by a set of more specific measures. Further proposals for the completion of Banking Union were published on 26 November 2015.

16. The short-term proposals involved completing initiatives already launched, such as Banking Union and Capital Markets Union, and enhancing coordination within, and the effectiveness of, structures already in place, such as the European Semester. A full list of the short-term measures, the steps taken to implement them and the progress made at the time of writing are set out in the table in Appendix 4. We consider them in more detail in the following chapters.

17. The long-term proposals envisaged for 2017–2025 are introduced by the five Presidents in much vaguer terms. They can be described as follows:

- The definition in EU law of binding standards and benchmarks focusing primarily on labour markets, competitiveness, the business environment and public administrations, as well as certain aspects of tax policy with the aim of formalising the convergence process;
- Shared sovereignty over areas of common economic and fiscal policy along with strong decision making at euro area level;

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15 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf, p 5 [accessed 6 April 2016]

16 Communication from the Commission to the European Parliament, the Council and the European Central Bank, On steps towards Completing Economic and Monetary Union, COM(2015) 600 [accessed 6 April 2016]

- The creation of a common macroeconomic stabilisation function;
- Integration of the European Stability Mechanism (which is currently intergovernmental) within the EU legal framework;
- The establishment of a full-time presidency of the Eurogroup with a clear mandate; and
- The possible creation of a euro area treasury as a "place for collective decision-making"[17] on fiscal policy.

18. There is much that remains unsaid in the Five Presidents' Report about how these proposals are likely to be taken forward and the implications of doing so. Our inquiry sought to explore some of those implications.

19. As noted, the Five Presidents' Report is 'a report of two halves', consisting of limited but potentially achievable short-term proposals and a series of broadly-described ambitious long-term goals. Some witnesses described this approach as "pragmatic";[18] others spoke of the eurozone "muddling through"[19] on the basis of the report. Several suggested that the proposed publication of the White Paper in 2017 was deliberately timed to take place after general elections in Germany and France[20]—although European Commission Vice-President Valdis Dombrovskis told us the Commission was "not currently adjusting [its] plans or work with a view to different elections, because in a union of 28 countries you always have elections of one kind or another in some of the countries".[21]

20. We consider the political realism of the proposals in greater depth later in this report, but note at this point that the Five Presidents' Report has not received the attention it might have, as the political focus in the EU has been elsewhere. Guntram Wolff, Director, Bruegel, told us that he sensed a desire for more concrete proposals to emerge before the 2017 elections, but noted that currently, "given all the other ongoing political issues, in particular the refugee crisis, political capital is very much in different quarters at this stage."[22] However, work continues on the basis of the report, and an expert group will soon be appointed to prepare the 2017 White Paper. While attention might currently be diverted the publication of the White Paper is likely to reignite the debate. We have prepared this report with a view to contributing to the informal stakeholder engagement process feeding in to the White Paper.

21. It is also apparent that any further financial or economic crisis would prompt action, and that the Five President's Report constitutes the best guide to the form such action might take. John Peet suggested that "the European Union moves in response to crises".[23]

22. We hope it does not come to that as the current architecture, much of it borne of crises, suffers from concerns about its legitimacy and democratic accountability, as we discuss in Chapter 4.

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17 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf, p 18 [accessed 6 April 2016]
18 Q 56 (Lorenzo Codogno and Reza Moghadam)
19 Q 28 (Sebastian Barnes); Q 68 (John Peet)
20 For example, written evidence from Professor John Ryan, EMU0007, Q 2 (Philippe Legrain), Q 17 (Baroness Bowles of Berkhamsted)
21 Q 159
22 Q 118
23 Q 68

23. **We strongly urge that the issues raised in the Five Presidents' Report, particularly those relating to democratic accountability, are addressed as part of a long-term strategy.**

24. **We welcome the publication of the Five Presidents' Report as a sign that the leaders of the EU institutions recognise that, despite the steps already taken, more needs to be done to ensure the long-term sustainability of the eurozone. We believe that there is sufficient political will to ensure its survival.**

This report

25. The Five Presidents' Report is wide ranging and contains proposals set out in differing levels of detail. We have tried to be comprehensive in our assessment of it, but inevitably certain areas received more attention than others. This report examines, in Chapter 2, the proposals put forward, both for the short and long term, to encourage economic coordination and convergence. Chapter 3 considers elements of risk-sharing and risk reduction, largely based on the five Presidents' proposals for 'Financial Union' and 'Fiscal Union'. Finally, we consider the democratic and institutional arrangements required to support a more deeply integrated EMU. While the proposals in the Five Presidents' Report were our starting point, we have considered alternative ways forward where evidence has taken us in that direction.

26. We acknowledge that this report will be published against the important background of the UK renegotiation of its relationship with the EU and the referendum due to take place on 23 June 2016. Some areas of the renegotiation, for instance those relating to economic governance, are relevant to the subject of the inquiry. The UK's relationship with the EU has been addressed in our report *The EU referendum and EU reform*[24], published on 30 March 2016, and in our ongoing detailed scrutiny of the European Council's agreement of 19 February 2016. This report does not offer a detailed analysis of the merits of the agreement, but touches on the renegotiation issues where necessary in the context of the five Presidents' proposals.

27. Our findings are based on oral and written evidence collected between November 2015 and March 2016 from a range of witnesses, including David Gauke MP, Financial Secretary to the Treasury, politicians, academics, economists and media commentators. We also visited Brussels in January 2016 and met Commission Vice-President Valdis Dombrovskis, members of the European Parliament Economic and Monetary Affairs (ECON) Committee, and a number of Brussels-based think tanks and experts. We are grateful to Professor Iain Begg, Professorial Research Fellow, European Institute, London School of Economics, who acted as Specialist Adviser for this inquiry.

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

24 European Union Committee, *The EU Referendum and EU Reform* (9th Report, Session 2015–16, HL Paper 122)

CHAPTER 2: ECONOMIC AND FISCAL POLICY COORDINATION

Introducing the EU's economic and fiscal policy coordination tools

29. The EU Member States agreed the Stability and Growth Pact (SGP) in 1998, in order to maintain and enforce fiscal discipline in EMU. The SGP was reformed in 2005 when some of the rules were relaxed. However, the 2008 financial crisis and the subsequent sovereign debt problems, especially in the eurozone, revealed severe weaknesses in the EU's economic governance framework. Since the crisis, a number of legislative measures have been implemented to enhance the surveillance of national budgetary policies and other sources of imbalance. Closer policy surveillance, monitoring and coordination are now in place for euro area Member States following the agreement of the six-pack, two-pack and the Fiscal Compact[25]. The rules are applied at Member State level and are embedded into the EU's annual economic policy coordination process, the European Semester. Nevertheless, most of the evidence submitted to this inquiry suggests that the European Semester has done little to encourage euro area Member States to implement fiscal rules more forcefully, while closer economic policy coordination has not reached the level desired.

30. In this chapter we consider the five Presidents' proposals to enhance the coordination of economic and fiscal policies, largely included in Stage 1 of the plan. These can be seen as attempts to reduce risk through increased discipline. We consider 'fiscal union' more broadly in Chapter 3, looking at the relationship between reducing and sharing risks including the issue of fiscal transfers between Member States.

Box 3: The Stability and Growth Pact and complementary policy instruments

Since the onset of the crisis, a succession of developments in EU economic governance have sought to strengthen fiscal discipline while also taking more account of the need for flexibility in fiscal rules.

The original Stability and Growth Pact (SGP) is derived from the Maastricht treaty provisions requiring all EU Member States to avoid excessive deficits, but takes the form of two regulations covering, respectively, its preventative and corrective arms. All Member States are supposed to be subject to the former, but the UK is not bound by the corrective arm and does not, therefore, face the possibility of financial sanctions.

As originally formulated, the SGP had a fiscal rule that countries should have a medium-term goal of public finances "close to balance or in surplus", but should avoid an annual deficit in excess of 3% of GDP. This was originally expressed purely in nominal terms, but the regulations were revised in 2005 to refer to structurally-adjusted deficits. In circumstances of serious economic downturn (originally a decline in GDP of 2 percentage points), the 3% rule could be waived. This was changed to any decline in GDP.

A country deemed to be in excessive deficit was expected to present a programme for curbing it and, if it failed to do so, could be subject to the corrective arm of the SGP, ultimately facing financial sanctions. Following a recommendation by the Commission, the Council would decide on the action to take through a qualified majority.

25 These are described in more detail in Boxes 1 and 3.

The 2011 reform (consisting of revision of the two regulations and constituting two of the components of the six-pack) saw the addition of a debt criterion of 60% of GDP and of 'reverse majority voting'. It emphasised the medium-term objective (MTO). The new voting system is designed to make it less likely that the Council will over-turn a Commission recommendation by obliging it to reach a majority to oppose the recommendation rather than, as in the past, to support it.[26]

In addition to the SGP revisions, the six-pack included a directive obliging Member States to introduce a domestic fiscal rule. The resort to a directive allowed the Member State to tailor the rule to its domestic constitutional norms, but the clear intent was to strengthen domestic commitments to fiscal discipline.

Separately, the Fiscal Compact requires signatories to spell out how they will reach their MTO and prescribes pathways.

Further obligations on eurozone countries arise from what became known as the two-pack. In particular, it requires members to submit their draft budgets for year 't' to the Commission for scrutiny by mid-October of year 't-1'. The Commission then assesses whether the plans are consistent with sound fiscal policy and the medium-term objectives of the country. The two-pack also requires eurozone countries to have a national Fiscal Council, independent of government.

Faced with objections from countries with weaker public finances, concerned about demands to tighten fiscal policy at an inappropriate time (in what would be a pro-cyclical manner), the Juncker Commission in 2015 issued 'guidance' about the circumstances in which a Member State could breach its obligations. Among the items that will be treated flexibly are contributions to the European Fund for Strategic Investment, one of the landmark innovations of the Juncker Commission, which aims to leverage EU and European Investment Bank funds to revive investment in strategic projects.

Although a considerable amount has been achieved in establishing this framework, implementation has not always been perfect.

The EU's fiscal framework: compliance and implementation

31. Some Member States have struggled to comply with the fiscal rules and to implement economic reforms. Notably, France and Germany breached the SGP rules in 2002/3 but were not subjected to sanctions, while by 2009 most EU countries were in the excessive deficit procedure and the UK remains in excessive deficit. Despite the proliferation of excessive deficits even the first, mild, stage of financial sanctions has never been used.

32. The 2016 Annual Growth Survey (AGS), and Alert Mechanism Report make clear that common fiscal policies should respect the common fiscal rules in order to reduce public debt, and to restore fiscal buffers while avoiding pro-cyclical policies. The AGS also notes that public debt remains very high in many Member States and that this in turn "acts as a drag on growth and makes them more vulnerable to adverse shocks".[27]

26 This means that a majority must be mustered to oppose a proposal. The standard practice of QMV requires the support of at least 55% of Member States (currently 16), representing at least 65% of the total EU population to agree to a proposal.

27 European Commission, Annual Growth Survey, Strengthening the Recovery and Fostering Convergence

The EU's approach to fiscal rules

33. Professor Erik Jones, Professor of European Studies and International Political Economy, Johns Hopkins University, judged that the fiscal framework, as currently applied by euro area Member States, was "completely optional", and even suggested that Economic and Monetary Union might improve without the framework, subject to financial rules bearing on how markets treated sovereign debt.[28] Dr Dermot Hodson, Reader in Political Economy, Birkbeck College, considered the SGP to be an "instance of soft economic policy coordination in which enforcement of rules relies for the most part, on peer pressure and persuasion rather than pecuniary sanctions."[29]

34. Megan Greene, Chief Global Economist at Manulife Asset Management, argued that fiscal policy should be set for Member States on a case-by-case basis, and did not agree with the rules-based framework.[30] In contrast, Sebastian Barnes, Economic Counsellor to the Chief Economist, OECD, welcomed the existence of fiscal rules, telling us that they "increase the focus on sustainability … since the six-pack, two-pack and Fiscal Compact, Governments are taking them more seriously, partly because they see they have more teeth." He added, however, that the rules were "essentially a mess; they are very complicated and in parts poorly thought-through, and that raises a question about sustainability of the rules going forward."[31] Martin Sandbu, economics leader writer of the *Financial Times*, echoed this, while Sylvie Goulard MEP, a member of the European Parliament ECON Committee, thought the complexity of the rules undermined their legitimacy."[32]

35. Some witnesses acknowledged that in practice it was difficult for a government to run a budget surplus in good economic times. Sebastian Barnes said:

> "There has been an increasing debt trend in basically every developed country. If you want to reverse that, fiscal discipline has to apply in the good times. There is a risk that, because of the flaws in the rules, in good times they will be ignored again and ineffective. That is partly because there are political pressures to ignore them, but also because the economics of the rules are sometimes very hard to defend."[33]

Flexibility within the SGP

36. The SGP rules have been designed with in-built flexibility. Megan Greene welcomed the fact that fiscal rules were sometimes "bent", and drew attention to the budget deficit in Spain, which stood at 5% of GDP in 2014. This explained why the Spanish economy was growing.[34] Sylvie Goulard MEP, however, supported balanced budgets with reduced debt.[35]

37. Further guidance on the best use of flexibility within the existing SGP rules was endorsed by the Council of Ministers on 8 December 2015. Martin Sandbu argued that, within the new guidance, there were "many ways to judge what count as the correct policies towards these medium-term

28 Q 73
29 Written evidence from Dr Dermot Hodson (EMU0002)
30 Q 73
31 Q 32
32 Q 32 and Q 97
33 Q 32
34 Q 80
35 Q 97

[structural reform] objectives." The interpretation of the rules could follow the political inclinations of whoever was in power at a given time.[36]

Pro-cyclicality of EU fiscal rules

38. A pro-cyclical policy is one that accentuates the economic cycle by increasing aggregate demand in periods of above average growth and cutting in periods of downturn. In the Five Presidents' Report, a reference is made to avoiding pro-cyclical policies in pursuit of 'responsible fiscal policies'. The Annual Growth Survey in 2015 also emphasised that responsible fiscal policies should "restore necessary fiscal buffers while avoiding pro-cyclical policies."[37] Megan Greene said that "for countries that have no control over their monetary policy or currency, countercyclical fiscal policies are all [they] have got."[38]

39. Several witnesses raised the problem of EU fiscal rules being pro-cyclical and highlighted the negative impact of austerity on growth prospects. In our previous report *Euro area crisis: an update* we concluded that the political ramifications of austerity were as alarming as they were uncertain.[39] John Peet criticised pro-cyclical policies as having "too much of a deflationary bias, because the pressure has always been on countries that have large deficits to reduce their deficits and there has been no pressure on surplus countries to offset that."[40] Christian Odendahl, Chief Economist, Centre for European Reform, regretted that strong countercyclical fiscal policies were absent from the Five Presidents' Report.[41]

40. Reza Moghadam, Vice-Chairman, Global Capital Markets, Morgan Stanley, criticised the SGP because of the inherent asymmetric burden placed upon debtor countries. He said that while the SGP left a lot of flexibility for Member States to conduct their own fiscal policy, there was no macroeconomic view at the eurozone level to interpret the effects for each individual country. Therefore, more painful adjustments were demanded of debtor countries than were needed. He argued that the adjustment had been "bottom-up"; it had been "driven by individual targets and by adjustment at country level, precisely because … it is being driven by concerns about debt and market access rather than a macroeconomic point of view."[42]

41. **While we welcome the existence of the rules set out in the Stability and Growth Pact and wider reforms as, at the very least, a framework within which Member States can consider their budgetary policy-making, we note that adherence to the rules is patchy and liable to be influenced by domestic political pressures. While the Pact's rules allow some flexibility for Member States, which may lessen the degree of pro-cyclicality, we recognise that they are still seen as excessively pro-cyclical.**

36 Q 32
37 European Commission, Annual Growth Survey, Strengthening the Recovery and Fostering Convergence [accessed 6 April 2016]
38 Q 73
39 European Union Committee, *Euro area crisis: an update* (11th Report, Session 2013–14, HL Paper 163)
40 Q 73
41 Q 45
42 Q 60

Strengthening fiscal coordination

42. Clearly more needs to be done. The Five Presidents' Report argues that fiscal policies are a matter of "vital common interest"[43] and that unsustainable fiscal policies in one or a few Member States can affect or spill over to others. The report maintains that responsible national fiscal policies must both ensure that public debt is sustainable and enable fiscal automatic stabilisers to act and cushion against country-specific shocks—it notes that "it is important to ensure also that the sum of national budget balances leads to an appropriate fiscal stance at the level of the euro area as a whole". The Report states that this is "key to avoiding pro-cyclical fiscal policies at all times."[44]

Coordinating an 'appropriate fiscal stance'

43. The Five Presidents' Report assumes that an overall fiscal stance at the euro area level is required. At a national level, a fiscal stance is a government's underlying position in applying fiscal policy—in other words, whether it is running a balanced budget, a budget surplus or a budget deficit. The reasoning behind concern about the fiscal stance is that an appropriate macroeconomic policy stems from the mix of monetary and fiscal measures. In periods of recession, the policy stance should be to stimulate the economy, while in periods of growth the opposite applies. However, there are differing views on whether monetary policy or fiscal policy should be used, although part of the policy challenge is to ensure that they do not conflict with one another.

44. Sebastian Barnes described a euro area fiscal stance as implying that "there should be a decision in the euro area about whether on average it is expansionary or contractionary"; such a stance was unnecessary, though, because in normal times, monetary policy should provide "area-wide macroeconomic management", while fiscal policy should set medium-term goals around which automatic stabilisers can act.[45]

45. Janet Henry, Global Chief Economist, HSBC, thought that "the risk of spillover effects is one reason why a coordinated fiscal stance is needed."[46] The eurozone needed to think about the influence that the actions of individual governments could have on the health of the entire euro area economy.[47] Martin Sandbu thought that a coordinated stance was not strictly necessary but acknowledged that it would be "economically beneficial because it would allow you to get an optimal, or closer to optimal, fiscal-monetary policy mix."[48]

46. In the context of macroeconomic stabilisation, Guntram Wolff thought that the aim should be "very much about coordination of these national fiscal policies and we need to step that up, improve it, and get a more symmetric notion there that considers the areawide fiscal stance." He considered, though, that the sum of national fiscal policies needed to be right for both the eurozone and individual Member States. [49]

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43 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf, p 14 [accessed 6 April 2016]
44 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf, p 14 [accessed 6 April 2016]
45 Q 30
46 Q 30
47 Q 30
48 Q 30
49 Q 120

47. **National fiscal policies have spillover effects on other Member States. In establishing a fiscal stance for the eurozone it is important to take into account the particular conditions of each Member State. Just as there may be between regions within particular countries, there may be a tension, in perception or reality, between what appears to be the right fiscal and monetary stance for the eurozone as a whole and what is right for individual Member States, at least in the short term. The effectiveness of this attempt at coordination will ultimately depend on political will at Member State level.**

Advisory European Fiscal Board

48. The Five Presidents' Report proposed the creation of an advisory European Fiscal Board to enhance the current governance framework. This was followed on 21 October 2015 by a Commission Decision to establish the board and set out its tasks. These are described in Box 4.

Box 4: The role of the advisory European Fiscal Board

The Board's tasks include providing the Commission with an evaluation of "the implementation of the Union fiscal framework", and of "the appropriateness of the actual fiscal stance at euro area and national level." The Commission Decision states that "in this evaluation, the Board may also make suggestions for the future evolution of the Union fiscal framework." It continues:

> "The Board shall advise the Commission on the prospective fiscal stance appropriate for the euro area as a whole based on an economic judgment. It may advise the Commission on the appropriate national fiscal stances that are consistent with its advice on the aggregate fiscal stance of the euro area within the rules of the Stability and Growth Pact. Where it identifies risks jeopardising the proper functioning of the Economic and Monetary Union, the Board shall accompany its advice with a specific consideration of the policy options available under the Stability and Growth Pact." [50]

Although formally established by the Commission Decision in October 2015 the Board is not, at the time of writing, operational, and its members have not been appointed.

49. Guntram Wolff told us that the creation of a European Fiscal Board was "a good and necessary step forward", but he warned that its independence relative to the European Commission was "not totally clearly defined."[51] Professor Issing told us that if the Board was to work, "the precondition is that it is an independent board with independent experts, but, as I almost expected, the Commission has already taken it over."[52] Raoul Ruparel, Co-Director, Open Europe, argued that it was unclear what form the Board would take, for instance whether it would be weighted according to Member States. He thought that it could contribute to the debate but not substantially change what was happening.[53]

50 Commission Decision (EU) 2015/1937 of 21 October 2015 establishing an independent advisory European Fiscal Board: http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1453282201556&uri=CELEX:32015D1937 [accessed 6 April 2016]

51 Q 120

52 Q 206

53 Q 15

50. Professor Jones believed that the Board would not be effective, because political decisions at the national level meant rules would still not be adhered to: "that kind of political problem will be there whether there is a five-person supervisory board or not. The idea that we will get more abidance because of that board is a political fiction."[54] Fabian Zuleeg agreed it was difficult to achieve coordination without European level decision-making, while "the political decisions linked to fiscal policy are still accountable at the national level."[55]

51. The Minister, David Gauke MP, concluded that it was too early to judge whether the Board would foster change. It was "difficult to say how much of a difference the board would make without seeing more detail of precisely how the board would undertake its duties." The Board would have an advisory role, and would not have "the ability to compel Member States to change their fiscal policies."[56]

52. Since the adoption of the two-pack in 2013, euro area Member States have had to establish an independent fiscal institution (or 'fiscal council') to assess compliance with fiscal rules. Guntram Wolff recognised that a fiscal board or a fiscal council would never possess the authority to take decisions, but he hoped that they would "push the debate a bit in the direction of a euro area fiscal stance and the better co-ordination of national fiscal policies." It was crucial that the Board made its recommendations in public in order to have an impact on the debate.[57]

53. Sebastian Barnes, a member of the Irish Fiscal Council in addition to his role with the OECD, was positive about the impact such bodies could have on the consideration of long-term fiscal policy: "You need real ownership of the public finances to counter the short-termism that can emerge within the political system. In my experience at least, that seems to be a very promising way of getting a culture of thinking about the public finances in the medium term, which is what you need."[58]

54. **We look forward to seeing how the advisory European Fiscal Board will work once it is operational. As the Board will be merely advisory, it will be for Member States to do the heavy lifting in implementing its recommendations, and we are not convinced that at present there is sufficient desire to do so.**

The coordination of economic policies

55. The eurozone has been suffering from inadequate growth since the financial and sovereign debt crisis receded.[59] While there are some signs of recovery, economic challenges persist. 'Economic convergence' and 'competitiveness' are emphasised throughout the 'Economic Union' section of the Five Presidents' Report, which acknowledges that important parts of economic policy should remain national. At the same time it argues that, because of the

54 Q 68
55 Q 121
56 Q 204
57 Q 120
58 Q 32
59 Euro area GDP fell by 4.4% in 2009. Since then growth has been slow or negative, peaking at 2.0% in 2010. The aggregate figure masks variations between Member States: over the 2007–11 period euro area growth averaged 0.5% per year; figures for Germany, France, Spain and Italy averaged 1.2%, 0.2%, 0.0% and -0.6% respectively.

interconnected nature of eurozone economies, it is in each Member State's self-interest, as well as the common interest, to be able to "cushion economic shocks well, to modernise economic structures and welfare systems, and make sure that citizens and businesses can adapt to, and benefit from, new demands, trends and challenges."[60]

56. The five Presidents accordingly propose the establishment in each euro area Member State of a 'Competitiveness Authority', to enhance the economic governance framework in the field of competitiveness. They also suggest measures to strengthen the European Semester through changes to its schedule and the strengthening of the Macroeconomic Imbalances Procedure.

The European Semester: stimulating reforms and managing imbalances

57. Each year, the European Commission undertakes a detailed analysis of EU Member States' plans of budgetary, macroeconomic and structural reforms, and provides them with country-specific recommendations for the next 12 to 18 months. Various measures to streamline the Semester were announced by the European Commission in a Communication published on 21 October 2015, including: the later publication of Country Reports so as to allow more time for genuine dialogue with Member States and stakeholders; an earlier publication of the Commission's proposals for country-specific recommendations (CSRs); and reduced and more focused CSRs. The new timetable for the annual European Semester is outlined in Box 5.

Box 5: The European Semester

The European Semester is a schedule of economic surveillance steps that first took place in 2011. Following the rescheduling undertaken in 2015 the Semester works as follows.

Autumn

- Euro area Member States submit their draft budgetary plans to the Commission in September. The Commission issues its opinions on them. These are then discussed in the Council.
- Commission publishes its Annual Growth Survey and Alert Mechanism Report. The AGS sets out the Commission's economic priorities for the coming year. The Alert Mechanism Report, which analyses the eurozone economy and those of Member States to identify potential imbalances, is the starting point for the Macroeconomic Imbalances Procedure.
- Commission issues a Recommendation on the economic policy of the euro area. It recommends that euro area Member States undertake certain policies individually and collectively.

December/January

- Euro area Member States adopt their budgets.

February

- Commission issues individual Country Reports on the economic policies and situation of each EU Member State.

60 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf p 7 [accessed 6 April 2016]

March

- European Council adopts economic priorities based on the AGS.

April

- Member States present National Reform Programmes or Stability or Convergence Programmes to the Commission.
- Council adopts euro area recommendations and agrees conclusions on the AGS and AMR.

May

- Commission proposes country-specific recommendations to each Member State. These are endorsed by the European Council in June.

58. In line with the Five Presidents' Report, the October 2015 Communication also suggests further adjustments to the European Semester. These involve: "better integrating the euro area and national dimensions, a stronger focus on employment and social performance, promoting convergence by benchmarking and pursuing best practices, and the support to reforms from European Structural and Investment Funds and technical assistance."[61]

European Semester: driving reforms?

59. Several witnesses doubted the ability of the European Semester to drive reforms in Member States. Thomas Wieser, Chair of both the EU's Economic and Financial Committee and the Eurogroup Working Group, set the scene:

> "On paper, the European Semester is an answer to the collective responsibility that all 28 Member States have under the Treaty for coordinating or closely cooperating on economic policies in general and in the fiscal area very specifically under the Stability and Growth Pact. Much of that is then enshrined in country-specific recommendations. The degree to which Member States follow or take seriously the country-specific recommendations differs enormously. That is already quite optimistic."[62]

60. Vice-President Dombrovskis admitted that there was a need to improve the "relatively weak" implementation of country-specific recommendations.[63] Gunnar Hökmark MEP, a member of the European Parliament's ECON Committee, was slightly more positive, suggesting that, while very few Member States were adhering to the rules, the framework still created an environment that stimulated reform.[64] Sylvie Goulard MEP said that ultimately the goal of the six-pack and two-pack was to restore trust.[65]

61. Bruegel referred to their European Semester reform index, which provided a gloomy picture. It showed that "implementation was already weak at the European Semester's inception, and has deteriorated since, despite the efforts made to improve the European Semester." They noted that "Even though recommendations related to the Stability and Growth Pact have the strongest

61 Communication from the Commission to the European Parliament, the Council and the European Central Bank On steps towards Completing Economic and Monetary Union, COM(2015) 600 [accessed 6 April 2016]
62 Q 113
63 Q 160
64 Q 97
65 Q 97

legal basis, their implementation rate is also modest. The implementation of recommendations related to the Macroeconomic Imbalance Procedure and other recommendations is even lower." The European Semester was not effective in enforcing the EU's fiscal and macroeconomic imbalance rules or fostering economic policy coordination.[66]

62. Vice-President Dombrovskis told us that under the 2016 European Semester, the European Commission took the approach of "paying more attention to the euro area's aggregate economic and fiscal performance." The decision to publish the euro area recommendations at the same time as the Annual Growth Survey would "allow for better discussions on appropriate euro area aggregate economic and fiscal positions, and [allow us] to reflect this thinking in country-specific recommendations for euro-area Member States."[67]

Implementing structural reforms

63. In its Communication of 21 October 2015, the European Commission encourages structural reforms in the "competitiveness domain." Competitiveness is seen as "essential for the resilience and adjustment capacity inside the monetary union and to ensure sustainable growth and convergence looking forward."[68] Vice-President Dombrovskis told us that Member States needed to be able to absorb shocks internally and that "resilient labour markets, flexible product markets and sufficient fiscal buffers would allow automatic stabilisers to play their full role and help to stabilise the economy." Larger shocks, however, might need to be shared with other Member States within EMU, through measures such as a stabilisation function or the integration of the financial sector.[69]

64. John Peet highlighted the importance of structural reforms: "if you lose the ability to devalue your currency and you lose your monetary independence then you need structural reforms to make your economy more flexible."[70] Sebastian Barnes thought their impact was uncertain: "Too often, particularly in the European context, it has been the view that structural reforms will somehow miraculously generate growth. They will over the long term, but we need the right demand conditions as well."[71]

65. Professor Lorenzo Codogno, Visiting Professor in Practice, European Institute, London School of Economics, criticised the Five Presidents' Report for failing to focus on how to achieve structural reforms. The emphasis was on monitoring, compliance and using existing tools, particularly with respect to fiscal rules, but this was not sufficient for successful implementation of reforms.[72] Veronica Nilsson, Confederal Secretary and Special Advisor to the European Trade Union Confederation (ETUC), argued that it was difficult to take a model from one country and apply it in another. She cited the Danish concept of 'flexicurity',[73] which was accepted in Denmark but

66 Written evidence from Bruegel (EMU0005)
67 Q 160
68 Communication from the Commission to the European Parliament, the Council and the European Central Bank On steps towards Completing Economic and Monetary Union, COM(2015) 600 [accessed 6 April 2016]
69 Q 158
70 Q 75
71 Q 28
72 Q 56
73 Flexicurity is an integrated strategy for enhancing, at the same time, flexibility and security in the labour market.

"when it is applied at the European level it becomes different and, in our view, more focused on flexibility than security."[74]

66. Reza Moghadam told us that structural reforms were "an important issue for the core of Europe" as well as the periphery.[75] He argued, though, that there would be political challenges: "There is a short-term cost, against a long-term benefit". His point was echoed by David Marsh, who pointed to a backdrop of low demand, high unemployment and significant political and social opposition.[76]

67. The Four Presidents' Report had suggested the introduction of a formal contract between individual countries and the rest of Europe, by which major structural reforms would be rewarded by benefits such as risk-sharing or more flexibility. Professor Codogno regretted its absence from the Five Presidents' Report, arguing that the core countries had "perceived it as a way to push for some form of mutualisation", while the periphery saw the contract as equivalent to being forced into a programme.[77] Dr Waltraud Schelkle, Associate Professor of Political Economy, European Institute, LSE, asked: "Why should Member States provide a public good for the euro area as a whole, such as taking the overall cyclical stance into account when planning their own primary deficit, if all they get in return is avoiding blame and shame and the threat of a fine?"[78]

The Macroeconomic Imbalances Procedure in focus

68. The Five Presidents' Report made two suggestions to strengthen the Macroeconomic Imbalances Procedure (MIP). Firstly "it should be used not just to detect imbalances but also to encourage structural reforms through the European Semester." The Report proposed that the MIP corrective arm should be used "forcefully", and that it should be "triggered as soon as excessive imbalances are identified and be used to monitor reform implementation." Secondly, the Report proposed to use the MIP to "better capture imbalances for the euro area as a whole, not just for each individual country" and to "foster adequate reforms in countries accumulating large and sustained current account surpluses if these are driven by, for example, insufficient domestic demand and/or low growth potential."[79] As with the SGP, we note that the sanctions available under the MIP have so far never been used.

69. Professor Codogno argued that "the Macroeconomic Imbalance Procedure is probably not enough to achieve major structural reforms in Europe. We saw that even during the crisis not many governments were able to deliver deep enough structural reforms to solve the structural issues."[80]

70. Many witnesses referred to the asymmetry of rules in the current MIP. For instance Professor Paul De Grauwe, John Paulson Chair in European Political Economy, LSE, referring to the current account of the balance of

74 Q 138
75 Q 56 "Periphery" is often used as shorthand to refer to countries such as Cyprus, Greece, Ireland, Portugal and Spain. This is in contrast to "core" countries such as Germany and France.
76 Q 174
77 Q 58
78 Written evidence from Dr Waltraud Schelkle (EMU0004)
79 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf p 8 [accessed 6 April 2016]
80 Q 58

payments, explained that the rules were not "fully symmetrical because … the thresholds for imbalances are asymmetric, in the sense that the threshold for the deficit countries is 4% and for the surplus countries it is 6%".[81] Janet Henry told us that the mantra was "deficits bad, surpluses good … a current account deficit of 4% of GDP is considered to be a problem, but a current account surplus has to go beyond 6% of GDP before it is considered a problem. Germany running on an 8% of GDP surplus has not been heavily criticised, or been the subject of action to address it."[82]

71. We welcomed the introduction of the MIP in our 2011 report on *The future of economic governance in the EU,*[83] in which we concluded that those countries in surplus should not be subject to the same procedure as those in deficit, but that they should come under pressure to contribute to the reduction of imbalances in a way that did not affect their global competitiveness.

72. In evidence to this inquiry, a more symmetrical approach to rebalancing was supported by a majority of witnesses, though they were divided on the extent to which a surplus was harmful and how far it could be addressed through the MIP. Many witnesses focused on the current account surpluses in Germany and the Netherlands.

73. David Marsh told us that, although eurozone deficit levels had improved somewhat, current account surpluses were still accumulating in some countries: Germany's was 8% of GDP, while the Netherlands' was 12%.[84] Martin Sandbu told us that Germany's current account surplus stood at €186 billion from January to September 2015; it was the largest in the world in absolute terms.[85]

74. John Peet believed that "German political and economic leaders are proud of their very large current account surplus. They think it is a sign of strength."[86] Professor De Grauwe told us that surpluses were considered to be "a reflection of virtuous policies".[87] This perception made it difficult to impose reforms on Germany:

> "We have the institutional infrastructure to deal with it, but politically the European Commission is paralysed. It can only go to deficit countries, to which it can say, 'You have a deficit and that's wrong' … It cannot go to Germany and say that it is wrong to have a surplus, as it would say, 'What? We are right' … The solution should be a symmetrical one."[88]

75. Martin Sandbu questioned the perception that imbalances were, in themselves, harmful, arguing that it was important to look at how deficits and surpluses were used. He believed that current account asymmetries "can often be a very good thing", and said that it made "perfect economic sense for an ageing and rich country to export capital to a younger and poorer country, which presumably has greater potential for growth." The problem was that: "Greece and Portugal [had] not invested [their imported capital] at all, but consumed. In Ireland and Spain, it was invested in houses nobody wanted".[89]

81 Q 185
82 Q 32
83 European Union Committee, *The future of economic governance in the EU* (12th Report, Session 2010–12, HL Paper 124)
84 Q 173
85 Q 33
86 Q 76
87 Q 185
88 Q 185
89 Q 33

76. Martin Sandbu also noted that only €6 billion of Germany's €186 billion surplus was a surplus with other eurozone countries:

> "to all intents and purposes, the current account surplus with the rest of the eurozone has disappeared. Those people who thought that that surplus was a particularly harmful problem for the rest of the currency union should presumably say that the elimination of it has been a very good thing and a boost to growth on the periphery. I do not hear them say that."[90]

77. Philippe Legrain, an independent writer and commentator, argued, in contrast, that this reduction in Germany's surplus with the eurozone meant "that it is exporting its capital elsewhere, draining demand from the eurozone and exporting deflation to the rest of the eurozone."[91] John Peet also believed that the eurozone was suffering from "insufficient demand", a problem "generated particularly by Germany, which is not doing enough to increase demand".[92] Philippe Legrain was disappointed that the Five Presidents' Report did nothing to "tackle the issue of a mercantilist German core and the deflationary impact of that."[93]

78. Vice-President Dombrovskis told us that large and persistent current account surpluses were seen as macroeconomic imbalances. Germany and the Netherlands were undergoing the formal, legal process of the MIP and they had been advised to stimulate investment and the demand side of their economies, as mentioned in the country-specific recommendations. He added however, that Germany's macroeconomic imbalance, so far, had not been found to be excessive.[94]

79. **The evidence we have heard suggests that the strengthening of the Macroeconomic Imbalances Procedure, proposed in the Five Presidents' Report, is unlikely to change the status quo or encourage more symmetrical adjustment between euro area Member States. We agree with those who have suggested that, in order to foster long-term structural reforms at the Member State level, it is necessary for individual Member States to take ownership. There is, however a tension between ensuring Member State ownership (whether in curbing imbalances or in disciplining public finances) and creating an effective enforcement mechanism at the EU level. Given that financial penalties have still not been used under either the SGP or the MIP, despite the introduction of reverse majority voting, in which a majority must be mustered to oppose a Commission proposal, we are sceptical that financial sanctions under the MIP are any more likely to be used in the future. As a result the still large macroeconomic imbalances in the euro area will probably continue to be a source of instability.**

National Competitiveness Boards

80. The Five Presidents' Report proposes the creation of independent and national bodies that would be in charge of "tracking performance and policies in the field of competitiveness." They would also "help to prevent economic

90 Q 33
91 Q 12
92 Q 75
93 Q 5
94 Q 160

divergence and it would help increase ownership of the necessary reforms at the national level".[95]

Box 6: The proposals for National Competiveness Boards

The five Presidents' suggestion

Competitiveness Authorities should be "independent entities with a mandate to 'assess whether wages are evolving in line with productivity and compare with developments in other euro area countries and in the main comparable trading partners'". The Commission would coordinate the recommendations of the Authorities and feed them in to the European Semester process.

The exact form of a Competitiveness Authority should be decided by each Member State, but based on a 'common template'. In addition, "they should be democratically accountable and operationally independent".

The aim of the authorities "should not be to harmonise practices and institutions in charge of wage formation across borders"; while "National actors, such as social partners, should continue to play their role according to the established practices in each Member State", they "should use the opinions of the Authorities as guidance during wage setting negotiations".

The Commission Recommendation

The Recommendation is aimed at euro area Member States but explicitly encourages other EU Member States to establish Competitiveness Boards.

The Boards should be structurally independent of "any public authority dealing with competitiveness-related issues of the Member State". Furthermore, they "should be underpinned by national legal provisions ensuring a high degree of functional autonomy and accountability".

They should be tasked with:

1. Monitoring competitiveness developments in the Member State concerned, taking into account factors that can affect prices and quality content of goods and services relative to global competitors in the short term (including labour costs), as well as longer-term drivers such as productivity and innovation capacity, which are relevant not only for the relative performance of the economy but also for its growth potential and the capacity to attract investment, businesses and human capital;
2. Informing the wage setting processes at national level by providing relevant information;
3. Monitoring policies linked to competitiveness in the Member State concerned, including contributing to ex-post evaluation of policies; and
4. Assessing policy challenges and formulating policy advice in the field of competitiveness. The advice of competitiveness boards should take into account the broader euro area and Union dimension. The boards should, *inter alia*, provide advice on the implementation of the Country-Specific Recommendations addressed to the concerned Member State by the Council in the context of the European Semester.

Source: Five Presidents' Report, p 8; Commission Recommendation for a Council Recommendation on the establishment of National Competitiveness Boards within the Euro Area, COM(2015) 601

95 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf [accessed 6 April 2016]

81. Witnesses were divided on whether the creation of a National Competiveness Board in each Member State would improve competitiveness. Dr Hodson judged the proposal to be a "modest attempt to deal with the perennial problems of adjustment in EMU". The Boards would have the potential to "increase peer pressure as an instrument of EU economic policy coordination," though previous EU initiatives in this area had been blunted through lack of national ownership of reforms. Drawing on the Dutch experience, Dr Hodson observed that a Board could sound "the alarm when prices and wages are slow to adjust to country-specific developments. Of course, sounding the alarm is not the same as putting out the fire."[96]

82. Raoul Ruparel agreed that the Boards could "provide some useful input", but argued that they would only produce recommendations and would have no extra power to bring about "substantial change."[97] Professor Issing criticised the intention to create "another bureaucratic level". He said that Europe had been dealing with this problem since the start of EMU and referred back to the 2000 Lisbon Agenda, where leaders decided to make Europe the "most dynamic region in the world". He said that the EU had no competencies in respect of structural reforms: this was the responsibility of Member States.[98]

83. Veronica Nilsson criticised the mandate proposed in the Five Presidents' Report: "it was very clear that they should influence the wage-setting process and [the ETUC is] very concerned, because we believe that this does not respect the autonomy of the social partners."[99] The Commission's subsequent Recommendation was not as far-reaching as initially proposed, but she remained concerned that the Boards would interfere with wage-setting.[100]

84. More broadly, Professor Paul De Grauwe cautioned that:

> "by focusing too much on competitiveness in its narrow sense, such as the development of wages, one can easily become trapped in a deflationary spiral where everyone watches national wage developments and then tries to reduce them relative to their neighbour. In no time you are in a deflationary spiral that prevents countries' economies growing. We have already seen some of that."[101]

85. Other witnesses also criticised the narrow focus on competitiveness in the Five Presidents' Report. Philippe Legrain said that competitiveness was irrelevant in responding to the eurozone's challenges, and favoured "boosting productivity growth". Focusing on 'competitiveness' meant: "you end up specialising in lower-end production rather than dynamically moving up the value chain and producing better goods for higher wages."[102]

86. Professor Jones offered an alternative perspective, pointing out that the countries often cited as losing competitiveness were ones that had in fact experienced "rapid financial disintegration" in which capital moved across borders with net foreign exposures building up as a result: "if you liquidate all those assets at once and pull the money out you end up with countries like

96 Written evidence from Dr Dermot Hodson (EMU0002)
97 Q 15
98 Q 205
99 Q 129
100 Q 129
101 Q 179
102 Q 5

Italy, Spain, Portugal and Greece that have no liquidity in their economies. That is what brought them down, not the loss of competitiveness *per se*."[103]

87. André Sapir and Guntram Wolff, of Bruegel, argued that in a monetary union where countries could not devalue their currencies the only options for some countries were internal devaluation and labour market reforms, while other countries had current account surpluses, which contributed to deflationary pressures. National Competitiveness Boards "would need to be coordinated … to ensure symmetric adjustment and prevent a deflationary race to the bottom."[104]

88. Several witnesses thought independent Boards would increase transparency, stimulate public discussion and increase national ownership. Many pointed to the success of the Dutch Central Planning Bureau while Thomas Wieser noted that "there are Member States where such issues are not publicly discussed and those are the Member States which, arguably, have the larger productivity problems."[105] Fabian Zuleeg echoed this.[106]

89. Hans Hack, Senior Managing Director, FTI Consulting, thought the Central Planning Bureau in the Netherlands provided "some sort of anchor to the political system", and he agreed that political 'buy-in' was necessary.[107] Though the creation of such boards is optional for non-euro area Member States, Mr Hack suggested that the idea would be "in alignment with the UK's view on how any economy should be managed."[108] Baroness Bowles of Berkhamsted, former Chair of the European Parliament ECON Committee, also thought that the UK should consider establishing such a Board, depending on its scope.[109]

90. The Minister supported in principle the creation of Boards within the eurozone. He explained that "competitiveness remains a big challenge for the European Union as a whole and in particular for the eurozone." He maintained that the proposal was still "high-level policy", and that Member States were still considering whether they would make an effective contribution: "if there is a view that it can contribute then it is certainly something that we would like to see."[110] The Committee's scrutiny correspondence with the Minister, reveals that the UK will be considering this Recommendation closely.

91. **We note the doubts expressed about the likely effectiveness of National Competitiveness Boards in Member States that do not currently have a similar body in operation.**

92. **We recognise that the establishment of a Board might bring with it the perception of another layer of bureaucracy being imposed by the EU, unless it is accompanied by a clear objective of how it will improve policy-making and increase national ownership of those policies. There may be a tension between national ownership and the consideration of eurozone-wide benefits, in addition to the inherent tension that exists between the need for Boards to be both independent**

103 Q 68
104 Written evidence from Bruegel (EMU0005)
105 Q 115
106 Q 123
107 Q 123
108 Q 119
109 QQ 15–16
110 Q 196

and accountable. If, on the other hand, National Competitiveness Boards are intended as a first step towards a nationally anchored but eurozone-owned institution, then their independent status could detract from national political accountability.

93. **The drive towards improving competitiveness in the eurozone must stress solutions that enhance productivity. We echo the conclusions of our previous report on *The future of economic governance in the EU* which stated: "It is unreasonable to ask successful Member States to reduce their competitiveness in a global environment. It is, however, in the interests of all Member States in the euro area that the proceeds of those countries in surplus are not deployed in ways which disadvantage their neighbours, and that those countries in deficit are supported in making the structural adjustments necessary to improve productivity and levels of employment."**

The path towards 'Economic Union'

94. The Five Presidents' Report states that in the medium term "the convergence process towards more resilient economic structures … should become more [legally] binding." It maintains that this could be achieved by "agreeing on a set of common high-level standards that would be defined in EU legislation, as sovereignty over policies of common concern would be shared and strong decision-making at euro area level would be established." The areas identified for common standards are in the fields of "labour markets, competitiveness, business environment and public administrations, as well as certain aspects of tax policy (e.g. corporate tax base)." The Report states that "progress towards these standards would be monitored regularly. Country-Specific Recommendations would continue to be used in this context."[111] Vice-President Dombrovskis told us that one of the main aims of the Five Presidents' Report was to "restart the process of convergence within economic and monetary union, which had unfortunately stalled since the crisis", and "to make sure this is convergence towards best practice and best performance."[112]

95. Professor Michael Wickens, University of York, said that achieving economic convergence was a "long-term goal."[113] Professor Codogno said that while "a country should try to achieve convergence of its economy, as when there was convergence for the entry into monetary union before 1999", there was "a serious issue here in terms of general equilibrium … you cannot achieve goals in all different aspects of the economy at the same time, and that will be very challenging. I am puzzled by the approach that has been decided."[114]

96. **The impetus towards economic convergence is laudable to the extent that it is intended to encourage common and shared aims among euro area countries and to instil discipline in policy-making. This matters as much for non-eurozone countries as for the eurozone. We recognise that any further steps towards economic and fiscal integration will require commensurate democratic and accountability structures to be put in place. The Expert Group's White Paper in 2017 will be**

111 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf [accessed 6 April 2016]
112 Q 159
113 Written evidence from Professor Michael Wickens (EMU0003)
114 Q 58

crucial to getting this balance right. Further changes in this direction are likely to require treaty change.

97. We explore the pathways towards greater democratic accountability and legitimacy structures in Chapter 4.

CHAPTER 3: RISK REDUCTION AND RISK-SHARING

Risk reduction and risk-sharing methods: complementary or conflicting?

98. There will always be differences between those who believe that there should be more extensive support for Member States facing difficulties and those who insist that Member States should be largely responsible for solving their problems themselves. Several of the reforms enacted since the onset of the 2008 crisis have been aimed at preventing problems arising in the first place, notably through better adherence to fiscal discipline. A division is now evident between those who see such prevention as the key to a more sustainable EMU, and those who believe that greater solidarity is the essential ingredient.

99. If risky policies are pursued, but the consequences fall on others where things go wrong, there is moral hazard. We argue in this chapter that many of the suggestions in the Five Presidents' Report propose a means of pooling the risks facing certain Member States, but that resistance to them reflects others' concern that they would face an unreasonable burden of responsibility for those risks. Common deposit insurance, common stabilisation policies and other forms of risk-sharing are more likely to be accepted if there is a balancing insistence on mitigating the risks in the first place.

100. This chapter distinguishes between risk reduction and risk-sharing, including the appropriate sequencing of the different stages of the two, as the lens through which to assess some of the more contested elements of the Report.

101. Vice-President Dombrovskis described the need to reach a balanced approach: "one thing seems to be emerging already: on the one hand, there is a demand for more solidarity, risk-sharing and mutualisation, while on the other there is a demand for more control and more sovereignty-sharing." He added:

> "If we are going to deepen economic and monetary union, those two elements, risk-sharing and sovereignty-sharing, will have to go hand in hand. The more we engage in risk-sharing, the more important it is that all Member States involved in those mechanisms follow the same rules. That is why we will need to find a balanced approach between those two tendencies."[115]

102. Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England, shared this view. He said that in order for a further transfer of sovereignty to take place, a balance between collective discipline and collective support had to be struck. Any sharing of risk would require an agreement on collective discipline.[116]

Financial Union

103. The 'Financial Union' pillar of the Five Presidents' Report proposes a number of risk-sharing and risk reduction measures. Among them, the development of a Banking Union is seen as key to deepening Economic and Monetary Union. The European Commission, in its Communication 'Towards the Completion of the Banking Union', notes that "the completion

115 Q 163
116 Q 189

of the Banking Union will reinforce financial stability in EMU by restoring confidence in the banking sector through a combination of measures designed to both share and reduce risks."[117]

104. In particular, the proposal to create a European Deposit Insurance Scheme (EDIS), published in November 2015, emphasises the simultaneous development of risk reduction and risk-sharing. It includes measures to reduce financial risks, such as implementing current legislation in full, as well as the possibility of further measures "in addition to and beyond the single rulebook". Elements of risk-sharing within EDIS include access to the Deposit Insurance Fund once national deposit funds have been exhausted. The proposal therefore attempts to tackle the moral hazard problem through the measures outlined in paragraph 117 below.

105. Fiscal sharing—that is, the pooling of public funds—is also introduced in Banking Union, in the context of a common backstop to the Single Resolution Fund. Action towards this goal is in step with the proposed transition timeline for the creation of the Single Resolution Fund. Private risk-sharing is also envisaged through the Capital Markets Union agenda.[118]

Fiscal union

106. Within the 'Fiscal Union' pillar, the Five Presidents' Report underscores budgetary responsibility and the creation of the 'European Fiscal Board', discussed earlier. Encouraging budgetary responsibility may be seen as a risk reducing measure, but the establishment of the Fiscal Board can also be seen as a step towards shared sovereignty in terms of its capacity to provide advice on the euro area fiscal stance.

107. The Report does not put forward concrete plans for how to develop a fiscal union, but instead refers to a "fiscal stabilisation function for the euro area", and sets a number of preconditions in the form of economic convergence, financial integration, as well as further coordination and pooling of decision making on national budgets.[119] This stabilisation function could be considered as a key risk-sharing measure. The Report states that when national budgets become strained in a crisis:

> "national fiscal stabilisers might not be enough to absorb the shock and provide the optimal level of economic stabilisation, which in turn can harm the whole euro area. For this reason, it would be important to create in the longer term a euro area-wide fiscal stabilisation function. Such a step should be the culmination of a process that, whilst avoiding moral hazard, requires preconditions commensurate with the strengthening of democratic accountability.[120]

108. Taking the Five Presidents' Report as a whole, some proposals are clearly intended as risk reduction measures. One of the core disagreements among Member States is whether progress on risk reduction is a pre-condition

117 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, 'Towards the completion of the Banking Union', COM (2015) 587 [accessed 8 April 2016]

118 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf [accessed 6 April 2016]

119 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf [accessed 6 April 2016]

120 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf [accessed 6 April 2016]

before more risk-sharing can take place. We explore the possible formation of a fiscal stabilisation function later in this chapter, but first we turn to the status of Banking Union and current forms of risk-sharing.

Banking Union: state of play

109. The evidence we received indicated, not surprisingly, that, while a significant amount of institutional change had developed to address some of the key risks in the European banking and finance sector, further action on risk reduction and risk-sharing was needed.

110. The European Commission's Communication, 'Towards the completion of the Banking Union', stated that: "a key objective of Banking Union was to reverse the fragmentation of financial markets caused by the euro crisis, by weakening the link between banks and sovereigns."[121] The aim was to break the negative feedback loop, whereby a failing bank endangers public finances and in turn the vulnerability of a sovereign further destabilises banks. In the past four years, EU legislators agreed to elevate supervision, resolution and resolution funding of significant banks to the Banking Union level.

111. Several witnesses recognised the achievement of EU authorities in setting up key pillars of the Banking Union in a relatively short space of time, while also arguing that important risks persisted. Kay Swinburne MEP, a member of the European Parliament ECON Committee, thought that the single supervisor was key to breaking the link between banks and sovereigns. The supervisor was working reasonably well, but there was room for improvement.[122] Thomas Wieser said that the most important element of Banking Union was the creation of the single supervisor, because it removed the "industry policy type of banking supervision that we witnessed."[123]

112. Professor Lucia Quaglia, Professor of Political Science, University of York, warned that the decision-making process underpinning the Single Resolution Mechanism seemed "quite convoluted", because so many bodies were involved in determining whether to resolve or wind up a bank. The big question was whether the resolution mechanism would "be effective enough in taking decisions in the heat of the crisis of, say, a major bank failing."[124] David Marsh was also cautious about the role of the Single Resolution Board.[125]

113. Sir Jon Cunliffe told us that, while resolution could be quite complex in practice, "it could be made to work, and in a crisis, you find ways of making things work." He continued: "the Single Resolution Board has only just been born, but they need to work through those issues as to how those different responsibilities and authorities would interact in a crisis."[126]

114. Sir Jon said he had always supported Banking Union, "because when you have a single central bank and you have a single currency, then your financial systems are linked together. They transfer risk, and we have just seen that happen in the crisis." He told us that Banking Union was "a necessary move for a single currency", and was "glad that it has at least been recognised."

121 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, 'Towards the completion of the Banking Union', COM (2015) 587 [accessed 8 April 2016]
122 Q 89
123 Q 110
124 Q 177
125 Q 177
126 Q 190

The benefit for the Bank of England was "the possibility of having a strong partner with similar concerns, the ECB, with whom we can build a relationship."[127]

Box 7: The Single Resolution Mechanism

The Single Resolution Mechanism replaces the coordination required by a network of national resolution authorities. The SRM has a number of key features:

- Strong central decision-making aims to ensure that decisions on resolution (dealing with failing banks) across participating Member States are taken effectively and quickly, avoiding uncoordinated action, minimising negative impacts on financial stability, and limiting the need for financial support.
- A central body with expertise and experience on bank resolution is intended to resolve banks more effectively, and with more limited effects on taxpayers, than individual national authorities with more limited resources and experience.
- A Single Resolution Fund is able to pool resources from bank contributions with the aim of protecting taxpayers more effectively than national funds, while at the same time providing a level playing field for banks across participating Member States.

Decisions by the SRM involve all relevant Member States. When the Board (consisting of a Chairman, a Vice Chair, four permanent members and relevant national authorities. Representatives from the ECB and the European Commission participate as permanent observers) has been informed that a bank is failing or likely to fail, it will adopt a resolution scheme for the failing bank using relevant tools, including the use of the Single Resolution Fund (SRF). National resolution authorities are closely involved in the process. The scheme should be in place within 32 hours so as to be able to rescue or resolve a bank over a weekend. Depending on the sums required by the SRF over one year, the Board will convene in its Plenary Session or in its Executive Session. The Commission, and to a lesser extent, the Council, has a role in "endorsing or objecting to the resolution scheme proposed by the Board." The scheme would need to be revised if one member disagrees. The Board actively follows the execution of the scheme, which is carried out by national resolution authorities.

The ECB has the competence to decide whether a bank is failing or likely to fail, providing a warning signal to the Board. If the ECB does not do so, the Board is able to request information from the ECB and ultimately has the responsibility and retains the power to make a decision on whether there are alternative solutions or whether a resolution is necessary in the public interest.

Risk-sharing and risk reduction arrangements in the Banking Union

115. A certain degree of risk-sharing already exists within the Banking Union, for instance the Single Resolution Fund (SRF), currently set up under the Single Resolution Mechanism (SRM), which was established to ensure the orderly resolution of failing banks.

116. Political agreement on the establishment of the SRF was reached in December 2014. The fund will be built up through contributions from participating banks over a period of eight years to reach a target level of at least 1% of the

127 Q 189

amount of covered deposits of all credit institutions authorised in all the participating Member States (estimated to be around €55 billion).[128] Within the wider crisis management framework for the eurozone, Roberto Gualtieri MEP, Chair of the European Parliament ECON Committee, and Guntram Wolff highlighted the existence of institutions set up to lend to countries in a crisis. Guntram Wolff said that the European Stability Mechanism was such a risk-sharing mechanism, which acted to "prevent excessive austerity in countries that lose market access."[129] The ESM can be used to recapitalise banks in certain circumstances through its Direct Recapitalisation Instrument.

Proposed methods to enhance risk-sharing and risk reduction: completing Banking Union

117. The European Commission Communication 'Towards the completion of the Banking Union' set out the following measures:

(a) Full and rapid transposition and implementation of the already agreed legal provisions;

(b) Swift agreement on an effective bridge-financing arrangement for the SRF and on a common fiscal backstop, which should be fiscally neutral over the medium term;

(c) A legislative proposal for a European Deposit Insurance Scheme (EDIS)

(d) A parallel effort further to reduce risks in the banking sector and weaken the link between banks and their national sovereign.[130]

Agreement on bridge financing arrangements

118. Bank contributions to the Single Resolution Fund began in January 2016, but an agreement on bridge financing was seen as key to avoiding a scenario in which the Fund would run out of funds while bank contributions were being built up. The agreement reached by the Council of Ministers in December 2015 introduces some degree of public support through the establishment of national credit lines that would provide a loan to the SRF. As well as providing support if necessary, the existence of the credit line is intended to enhance the credibility of the fund.

A common backstop to the Single Resolution Fund

119. A common backstop has been part of the design of Banking Union since its inception. The Five Presidents' Report said that "setting up a credible common backstop to the Single Resolution Fund and making progress towards a full level playing field for banks in all Member States should be a priority during the transition period to the creation of the Single Resolution Fund."[131] In 'Towards the completion of the Banking Union', the European

128 Council of the European Union, *press release: Single Resolution Fund: Council agrees on bank contributions* (9 December 2014): https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/146129.pdf [accessed 8 April 2016]

129 Q 120

130 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, "Towards the completion of the Banking Union, COM (2015) 587 [accessed 8 April 2016]

131 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf [accessed 6 April 2016]

Commission noted that the "extensive menu of prudential and crisis management measures cannot eliminate entirely the risk that public funding may be required to enhance the financial capacity of resolution funds."[132]

120. The Commission foresees a common fiscal backstop to acting as a last resort. This would "imply a temporary mutualisation of possible fiscal risk related to bank resolutions across the Banking Union". The Commission notes that the use of the backstop would be fiscally neutral in the medium term, as any public funds used would be reimbursed over time by the banks (via ex-post contributions to the SRF).[133] We supported the introduction of common fiscal backstop in our 2014 report on *'Genuine Economic and Monetary Union' and the implications for the UK*.[134]

121. Evidence from Guntram Wolff, Christian Odendahl, Professor Quaglia, Sebastian Barnes and the BBA agreed that a backstop to the Single Resolution Fund was essential.[135] Thomas Wieser told us that the general debate on whether to mutualise risks also applied when constructing the Single Resolution Fund, the Single Resolution Board and bank resolution. Pressure was mounting to develop a backstop for the short term and long term for the SRF, when the European Stability Mechanism could play this role. He implied that the consensus on the long-term backstop to the SRF had not yet been reached.[136]

122. Professor De Grauwe argued that the resolution fund lacked credibility, because "its capacity to act in times of crisis is limited". He told us that a "real banking union" presupposed some kind of fiscal union: "at some point, you need an institution with deep pockets that in a time of crisis is capable of resolving it. If you do not have that, a banking union has no credibility". He therefore maintained that a Banking Union would need to be "embedded in or part of a fiscal union". In times of crisis someone had to have the capacity to raise taxes and fund rescue operations.[137] Dr Schelkle believed a re-insurance mechanism that could "draw on deep pockets of central banks" was an alternative path. She noted that "the re-insurance capacity of the resolution mechanism could be enhanced if it were given a banking licence and could thus get access to the ECB as a lender of last resort."[138]

123. **Although the UK is not a participant in Banking Union we fully support its aims. Achieving consensus on the long-term backstop for the Single Resolution Fund will require a balance to be struck between risk-sharing and risk reduction, both between taxpayers and the banking sector and among the Member States participating in Banking Union. We stress the importance of working towards a common fiscal backstop to the Single Resolution Fund and welcome the agreement of short-term bridging arrangements as an interim measure.**

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132 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, "Towards the completion of the Banking Union" COM (2015) 587 [accessed 8 April 2016]

133 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, "Towards the completion of the Banking Union" COM (2015) 587 [accessed 8 April 2016]

134 European Union Committee, *'Genuine Economic and Monetary Union' and the implications for the UK* (8th Report, Session 2013–14, HL Paper 134)

135 Q 120, Q 49, Q 177 & Q 29 and written evidence from the BBA (EMU0008)

136 Q 111

137 Q 180

138 Written evidence from Dr Waltraud Schelkle (EMU0008)

A European Deposit Insurance Scheme

124. The European Commission published its proposal for a European Deposit Insurance Scheme for the euro area on 24 November 2015.[139] This was the third pillar of the original Banking Union proposal, which was postponed. The proposal aims to guarantee bank deposits in the euro area and builds on existing national deposit guarantee schemes. The scheme would work in three stages:

(a) The first stage, 'reinsurance', is proposed to last for three years until 2020, and will be available to those Member States that have complied with the Deposit Guarantee Scheme Directive. It will function by allowing a national deposit guarantee scheme to access joint EDIS funds only once it has exhausted its own resources. Funds from EDIS would complement the funds from a national scheme but funds would be limited to a certain level.

(b) The second stage is 'co-insurance'. The proposal is that in 2020, after three years as a reinsurance scheme, EDIS funds would become progressively mutualised. Appropriate limits and safeguards against abuse would apply. Importantly, when accessing EDIS funds, a national DGS would not need to be exhausted first. EDIS funds could automatically contribute to the share of the deposit owed to depositors. The share contributed by EDIS would start from a low level of 20% and would increase over a four year period.

(c) The third stage is 'full insurance', under which, from 2024, EDIS funds would guarantee 100% of the deposits previously guaranteed by participating national deposit guarantee schemes.

The risk reduction agenda accompanying EDIS

125. The European Commission announced in November 2015 that a risk reduction agenda would be pursued at the same time as contributions built up in the EDIS fund. The agenda is seen as essential to avoiding moral hazard among participants using the scheme. The fear is that wealthier Member States would have to pay for unstable banks in weaker euro area Member States. Some Member States, notably Germany, the Netherlands and Finland, have supported more risk reduction measures before any risk-sharing begins.

126. The risk reduction agenda includes reducing national options and discretions in prudential rules, harmonising deposit guarantee schemes, legislating to implement remaining elements of the Basel Accord, pursuing initiatives on the prudential treatment of banks' exposure to sovereign risk and full transposition of the Bank Recovery and Resolution Directive and the Deposit Guarantee Schemes Directive. An *ad hoc* Council Working Group has been established to consider both the EDIS proposal and the measures set out in the Communication.[140] Mike Vercnocke, head of the City of London office

139 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, COM(2015) 586 [accessed 8 April 2016]

140 See Outcome of the Council meeting of 8 December 2015: http://www.consilium.europa.eu/en/meetings/ecofin/2015/12/08/ [accessed 8 April 2016]

in Brussels, noted that this risk reduction agenda involved all 28 EU Member States.[141]

Sequencing of risk reduction and risk-sharing

127. Vice-President Dombrovskis told us that "before we engage in additional risk-sharing, we need measures to reduce risks." He maintained that the "exact sequencing" still needed to be discussed.[142] In addition, Thomas Wieser told us that "all the measures that would make all Member States agree to joint deposit insurance are just as important as deposit insurance itself." He continued: "I refer to anything that produces significant convergence to a level playing field, on the one hand, and what we are also talking about—the code word nowadays is 'de-risking'—on the other hand."[143] He also observed, with respect to deposit insurance, that there was "a very clear divide between what you could call the 'mutualisers' (in favour of instant mutualisation) and the risk reducers."[144] The Minister recognised that for the European deposit insurance to operate effectively, "those participating would need to consider measures to address risks and to develop a more consistent risk profile across Member States in the eurozone".[145]

128. Guntram Wolff was optimistic that the proposal could reduce and share risks simultaneously. Deposit insurance would happen over a substantial transition period of 10 years. In this same period, rules on risk weights or large exposures to sovereign debt would be introduced, while the insurance component built up. He believed the logic went in that direction and predicted political support would develop.[146]

129. Roberto Gualtieri MEP agreed that the risk reduction strategy should be undertaken in parallel with risk sharing, but he disagreed with the specific agenda to recalibrate banks' exposures to sovereign debt (which is currently treated as having zero risk, regardless of which eurozone Member State issues it). He did not think it would be acceptable to impose preconditions, and said he would "strongly discourage the frontloading of measures at the EMU level", as that would create imbalances. Work should continue, instead, at the international level through the Basel Committee on Banking Supervision. He maintained that single supervision and single resolution were already "strong elements of risk reduction", and believed the Commission proposal was "very gradual".[147]

130. On the issue of moral hazard, the BBA agreed that there should be a first tranche of losses borne by the national DGS before an EDIS intervention. They explained that "in this way national DGSs will be able to deal with idiosyncratic failures of domestic banks, and recourse to the EDIS would be limited."[148] Roberto Gualtieri MEP argued that current legislation and the new proposal met moral hazard concerns: "current recovery and resolution provisions are a very, very strong ingredient against moral hazard. I do not

141 Q 142
142 Q 164
143 Q 110
144 Q 111
145 Q 200
146 Q 124
147 Q 107
148 Written evidence from the BBA (EMU0008)

see that ensuring the same level of protection of deposit across the Banking Union would enhance this moral hazard."[149]

131. Vice-President Dombrovskis told us that the EDIS proposal had "received a mixed welcome. Some Member States very much favour this proposal and are willing to move forward; some are more hesitant or reluctant."[150] Several witnesses said that the proposal could be interpreted as transfer of resources taking place. Henning Christophersen, Senior Partner, KREAB, and a former European Commissioner and Danish Finance Minister, told us that the proposal introduced "common financing of banking crises, so the wealthier Member States will have to finance the recapitalisation of less profitable banks in some Member States".[151]

132. We note that the German position supports risk reduction measures being established before any risk-sharing can take place. Markus Ferber MEP, a member of the European Parliament ECON Committee, largely agreed with this position. He referred to the Deposit Guarantee Scheme Directive when assessing the EDIS proposal: "when all 28 Member States have proper systems in place, fully equipped, fully financed, then we can discuss an insurance mechanism." He added that money transferred from one scheme to another would constitute a 'bail-in', and this would need to be agreed unanimously by the Council, not by qualified majority, as would be the case under the legal basis of the EDIS proposal.[152]

133. Sylvie Goulard MEP thought it was a mistake to look at it as a German problem. She reflected, however, that "if we all share the idea that we will finance the economy and allocate the resources in a better way with more circulation of capital, then we should make sure that this pillar exists one day. It is the modalities and the rhythm that we then have to work on".[153]

134. Sir Jon Cunliffe argued that the reinsurance stage of the proposal was "a relatively small step", and predicted that "it may be possible to make progress". He also noted that "on the bigger issues of real risk-sharing that involve those questions of collective discipline and collective support, the political bargain has to be made first, and it has not been made yet."[154]

Is EDIS necessary?

135. Witnesses were divided on whether European deposit insurance was necessary to complete Banking Union. Janet Henry said that deposit insurance was "quite critical", at least "to show there is something in place to deal with asymmetric shocks … in the eurozone."[155] Christian Odendahl thought that deposit insurance was not necessary because the Cyprus crisis had demonstrated strong political will to protect deposits. He said that the ECB was "a strong defender of depositors, both internally and externally". He "would much rather have the resolution procedure reopened and for there to be a proper backstop for the resolution fund, which the European Commission also proposes in its action plan".[156]

149 Q 107
150 Q 164
151 Q 41
152 Q 89
153 Q 98
154 Q 189
155 Q 34
156 Q 49

136. Dr Andrew Lilico, Executive Director and Principal, Europe Economics, took a similar view, explaining that the most useful next step would be to achieve a common resolution framework and greater cross-border collaboration. He thought that moving towards increased collective risk-sharing in the form of common deposit insurance was "a mistake". His preference was to have "two kinds of deposits in every bank licensed to accept retail deposits." Those who wished merely to store their money could do so safely; those who wished for a greater return could use uninsured deposits at their own risk.[157] Kay Swinburne MEP judged that if both existing pillars—the SSM and the SRM—worked, "we will not need a deposit guarantee scheme; we are not going to get the failing institutions because we will have already had the early indicators and then the intervention by the ECB through the SSM."[158]

137. Guntram Wolff highlighted the problem of 'ring-fencing' in the absence of a cross-border guarantee. This meant that deposits and capital were "kept in the banks of the country concerned and cannot be shifted, in the banking group, across borders." He explained that it was felt that the deposits needed to stay ring-fenced, because national insurance was liable and could not be transferred.[159] The BBA also referred to this and thought it "contrary to the objectives of the efficient allocation of capital which underpins the EMU and acts as a deterrent to further integration of the banking market."[160]

138. The Bank of England and the BBA both drew attention to the new regulatory framework supporting national deposit guarantee schemes, and pointed out that deposit insurance would be unlikely to be used in the case of a large bank failing. The BBA explained that the implementation of provisions within the BRRD "reduce the circumstances in which it can be expected that a bank would be liquidated, with the DGS called upon to compensate eligible depositors."[161] Andrew Bailey, Deputy Governor for Prudential Regulation, Bank of England[162], drew on his experience of handling bank crises in the UK: "in many ways, if you look at big banks, the deposit insurance is there, but it is not the tool you use when the bank fails. That is why resolution is so important. It does come into play with smaller institutions, when you effectively want to use an insolvency tool, and you are not sure whether there is enough effective protection in the balance sheet."[163]

139. Roberto Gualtieri MEP recalled the steps that would need to be taken before a pay-out would take place, and emphasised the scale of risk-sharing required: "when we arrive, at the end of 2024, at mutualisation, we are talking about only a very limited percentage. It is not open-ended; it is 0.8% [of covered deposits]."[164]

140. Philippe Legrain and Professor Jones drew attention to the structure of deposit insurance currently in place. Professor Jones noted that "the different types of German banks have different deposit insurance. That is the biggest part of the problem. Sparkassen and Landesbanken do not want to get implicated in a European system because they have their own preferential

157 Q 177
158 Q 89
159 Q 124
160 Written evidence from BBA (EMU0008)
161 Written evidence from BBA (EMU0008)
162 Appointed CEO of the Financial Conduct Authority on 26 January 2016 though still at the Bank of England when he gave evidence.
163 Q 189
164 Q 107

arrangements."[165] Philippe Legrain predicted that one could imagine a 'carve out' for the very politically powerful Sparkassen banks, similar to their arrangements under the Banking Union.[166] Should EDIS be developed, the BBA supported it being embedded into the Banking Union framework, so that "the scope of banks mirrors closely the scope of single supervisory and resolution mechanism."[167]

141. Thomas Wieser thought that deposit insurance was "not one of the major constituent pillars of making banking and monetary union significantly more resilient … it would be good to have but one does not desperately need it."

142. From a UK perspective, Andrew Bailey and Sir Jon Cunliffe supported efforts to establish a European Deposit Insurance Scheme, because it added some stability and reassurance that the national deposit protection scheme would have the ability to pay out in a crisis. Andrew Bailey said that the solvency of the deposit protection scheme was important for UK depositors. Where a bank branched from a country in the euro area to the UK the deposit protection for the depositors in the UK branch came from the home state.[168]

143. **Efforts to reduce risk in the banking sector are in principle welcome. The European Deposit Insurance Scheme would be a useful addition to the Banking Union architecture. Although we note the significant moral hazard concerns of countries such as Germany, we believe that pursuing risk reduction and risk-sharing in parallel would both reduce any actual moral hazard and ensure political buy-in for the measure. For this reason EDIS should be encouraged, but should not be thought of as a panacea. As with other retail deposit insurance schemes, the value of EDIS may ultimately lie more in the reassurance engendered by its existence rather than its practical benefits.**

144. **We note that 'ring-fencing' of bank deposits continues despite the establishment of a single supervisor. This may have an effect on the efficient allocation of capital across the eurozone—insofar as EDIS may help to alleviate the concerns of the supervisor and allow deposits to move across borders, it is to be welcomed.**

145. **We welcome the risk reduction agenda for all 28 EU Member States. Our concern is that UK-based banks could be at a competitive disadvantage through not benefiting from the cover of European deposit insurance. We therefore urge the Government to remain vigilant in preserving the integrity of the Single Market.**

Proposed methods to enhance risk-sharing and risk reduction: Capital Markets Union

146. The Five Presidents' Report argues that capital markets can act as an important shock absorber as they do in the United States. The consideration of CMU in the Five Presidents' Report builds on work already undertaken through the Capital Markets Union Green Paper[169] in February 2015, which

165 Q 78
166 Q 14
167 Written evidence from BBA (EMU0008)
168 Q 193
169 European Commission Green Paper, Building a Capital Markets Union, COM(2015) 63: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=COM:2015:63:FIN&from=EN

led to the publication of the Capital Markets Union Action Plan[170] in October 2015. We reported on the Green Paper in March 2015[171], and our comments below are limited to the evidence we have received in this inquiry, specifically on the role that capital markets can play in absorbing shocks across the EU and particularly within the eurozone.

147. The Commission's Green Paper and Action Plan aim to ensure that alternative sources of non-bank finance are available in addition to existing bank finance. The Five Presidents' Report states that "truly integrated capital markets would also provide a buffer against systemic shocks in the financial sector and strengthen private sector risk-sharing across countries". It adds that this would in turn reduce the level of public risk-sharing that needs to be achieved. The Report acknowledges, however, that well integrated capital markets can create new risks to financial stability and, as a result, changes to the macroprudential toolkit and the supervisory framework may be needed. It notes that "this should lead ultimately to a single European capital markets supervisor."[172]

Private risk-sharing through capital markets union

148. A number of witnesses saw the immediate benefit of a CMU in helping to absorb shocks within the euro area. Examples were given from the United States, where capital markets make up a larger proportion of financing for business. Christian Odendahl said "capital markets in monetary unions such as the US play a very important role in spreading regional shocks. So truly integrated capital markets and more private risk-sharing would be a big step forward."[173] Megan Greene agreed.[174] Martin Sandbu thought that integrated capital markets could reduce the need for fiscal risk-sharing: "it is a mistake to think that the eurozone needs large fiscal risk-sharing in order to survive. It could do what the US does, which is to have large private risk-sharing."[175] He argued that the Five Presidents' Report did not place enough emphasis on this element and it was more important than deposit insurance for the euro area.[176]

149. A number of MEPs emphasised, however, that CMU should be seen as separate from Economic and Monetary Union. For instance, Kay Swinburne MEP said: "I do not see the CMU project as being a eurozone project; I see it as a project of the single market."[177]

150. Guntram Wolff was optimistic that CMU could achieve better risk-sharing across borders, and pointed towards research that indicated that it would be better for economic growth and for systemic risk. He also believed that the eurozone needed deeper capital markets "much more urgently than [non-eurozone countries]". This did not necessarily imply that the non-euro states

170 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union, COM(2015) 468: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52015DC0468&from=EN

171 European Union Committee, *Capital Markets Union: a welcome start* (11th Report, Session 2014–15, HL Paper 139)

172 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf [accessed 6 April 2016]

173 Q 45

174 Q 74

175 Q 30

176 Q 34

177 Q 90. Similar views were expressed by Roberto Gualtieri (Q 103) and Markus Ferber (Q 90)

would suffer from this: "on the contrary, they can actually benefit by being the hub that provides these services."[178]

Capital Markets Union: a long term project

151. Capital Markets Union covers a range of work streams, including securitisations, venture capital, tax and insolvency law among others. A large majority of our witnesses agreed that CMU would take time to achieve. Megan Greene highlighted the need first to address property rights and the legal enforceability of cross-border property rights.[179] Other witnesses drew attention to cultural and other differences between Member States that would need to be overcome.[180]

152. Some witnesses highlighted that the agenda depended on Member States driving it forward, particularly for complicated and technical pieces of legislation. Reza Moghadam, for instance, referred to the simplification of bankruptcy rules.[181] Thomas Wieser told us, however, that the 'CMU' label bundled initiatives together and helped to 'market' them among Member States. He described CMU as having a "ribbon around it": this was important "because it improves the quality of the debate, it makes it politically more visible and it increases the probability of rapid passing of legislative acts". He added that it created a "big picture into which you can fit the individual measure, such as securitisation, and it shows the wider audience how things hang together".[182]

153. Reza Moghadam hoped that progress on CMU could be made faster and infrastructure established that was better able to support it. In the US there was just one regulator to deal with, rather than several in the EU.[183] Professor Codogno said that to achieve real reform, there must be "an institution to take care of the project. The Commission cannot do it, because it is not in charge of all the aspects of this process."[184]

154. **The Capital Markets Union is an EU-28 project and we continue to welcome it, as we did in our 2015 report *Capital Markets Union: a welcome start*. We noted then that it is likely to benefit the UK in particular. We now note that, properly constructed, it should produce added benefits for the resilience of the eurozone through spreading risk more evenly across countries and acting as a shock absorber, as happens in the United States. However, private risk-sharing is not a panacea and may have limited effect in a crisis.**

155. **CMU is an aspect of risk-sharing—albeit private risk-sharing. Though included in the Five Presidents' Report, it is unlikely to be achieved in the short term. We are concerned that CMU will not make progress without agreement on tax and insolvency law, stimulating greater cross-border investment. We acknowledge that harmonising measures are likely and that a consequent need for additional institutional oversight may arise as a result of efforts to deepen financial integration.**

178 Q 126
179 Q 77
180 Written evidence from Anneliese Dodds MEP (EMU0006); Q156 (Mike Vercnocke) and Q90 (Kay Swinburne MEP)
181 Q 62
182 Q 116
183 Q 62
184 Q 62

156. **The Five Presidents' Report hints at the creation of a European Single Supervisor for capital markets, which would have ramifications for the UK and which we have previously opposed. However, the CMU Action Plan, presented by Commissioner Hill in 2015, did not mention this. Any ambiguity over the creation of a Single Supervisor is unhelpful.**

A path towards a fiscal union

157. The Five Presidents' Report acknowledges that there are many paths to a fiscal union, and argues that all mature monetary unions, while budgetary instruments may differ, have a common macroeconomic stabilisation function to help absorb the shocks felt at the national level. The Report envisages a euro area fiscal stabilisation function as a development under 'Stage 2' and in the longer term. It sees it as the "culmination" of work on economic convergence, financial integration and coordinated and pooled decision-making. The Report states that "the objective of automatic stabilisation at the euro area level would not be to actively fine-tune the economic cycle at euro area level. Instead, it should improve the cushioning of large macroeconomic shocks and thereby make EMU overall more resilient."[185] The Report makes it clear that further work needs to be done and refers to the "expert group" to carry this forward. The Report contains several options and guiding principles for a euro area stabilisation fund.

158. Vice-President Dombrovskis told us that sound fiscal macroeconomic governance and progressive joint decision making at the EMU level would go hand in hand with a euro-area fiscal stabilisation function to help deal with large asymmetric shocks: "both elements will need to be in place."[186]

Towards a fiscal union: definitions and current practices

159. Witnesses provided various definitions of 'fiscal union' which included a mixture of risk reduction and risk-sharing mechanisms. An example of risk reduction would be the imposition of stricter fiscal rules on Member States, while an example of risk-sharing would be the pooling or sharing of fiscal risks, perhaps through some sort of fiscal capacity in the form of a stabilisation fund. Several witnesses interpreted the development of fiscal union through the lens of a stabilisation mechanism, and some acknowledged that elements of a fiscal union were already in place. It was not clear how much more public risk-sharing would be needed to create a fiscal union, but most witnesses believed that the existence of permanent fiscal transfers would not be a feature.

160. Box 8 sets out some of the options for fiscal union. To demonstrate the range of possible interpretations of the term we include some accounts from our witnesses in Appendix 5.

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185 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf [accessed 6 April 2016]

186 Q 165

Box 8: Interpretations of 'fiscal union'

'Fiscal union' as a dimension of completing EMU has many possible interpretations, all of which are likely to imply differing balances between risk reduction and risk-sharing.

In nation-states, whether federal or unitary, it is both normal and politically accepted for there to be substantial flows of public money across internal borders. Usually (though by no means always), richer areas are net contributors, while poorer areas are net recipients. In most cases, the central government collects and distributes public money, although there can also be 'horizontal' equalisation mechanisms which, as in Austria and Germany, distribute resources from the fiscally better-endowed states or regions to the others.

At least five distinct forms of fiscal union, each reflecting different political compromises and strategic visions of the euro, can be envisaged for the eurozone (possibly for the EU as a whole).

- A first, comparatively narrow, variant is more intrusive oversight at EU level of governance of national budgetary policies. The reforms embodied in the six-pack, the two-pack and the Fiscal Compact effectively move the European Union (and more so, the euro area) in this direction, and the emergence of Fiscal Councils (linked to the Fiscal Compact and the two-pack) can also be seen in this light. Because their focus is fiscal discipline through adherence to rules, this form of fiscal union is manifestly about reducing risks. It is also largely in place (but not rigorously enforced) and could be characterised as a German/Dutch preference.
- The second interpretation is the provision of support by either EU institutions or partner countries for governments encountering financing difficulties, with the prospect that they will then be subject to high interest rates. The bailouts for Greece, Ireland, Portugal and Cyprus exemplify this approach, but are best thought of as providing liquidity. Bond purchases by the ECB have also, effectively, provided this kind of support and, by lowering the costs of servicing the national debt, have had a marked effect on the public finances of the more indebted countries. Although these actions are not strictly fiscal, the ECB has been criticised—notably in Germany—for engaging in quasi-fiscal policies. The creation of the ESM as a permanent source of funds is an important outcome of the crisis. However, while it is a means of sharing risk, the fact that ESM loans require stringent conditions to be met also entails risk reduction.
- Some form of stabilisation policy could be imagined as a third form of fiscal union. Rather than relying only on coordination of national policies to arrive at a common eurozone fiscal stance, either an additional fiscal capacity could be introduced, or there could be *ad hoc* funds (e.g. an unemployment related fund) that provide a degree of automatic stabilisation to counter asymmetric shocks.
- Risk-sharing would become more prominent if there were mutualisation, whether of public debt (some variant on Eurobonds) or more narrowly through common deposit insurance. In both cases, a collective fiscal backstop would be a logical complement to the existence of the mutualised risks. This fourth interpretation of fiscal union is, manifestly, strongly resisted by the net creditor countries because of moral hazard.

- Fifth, it could mean a system of transfers from Member States with relatively abundant public resources to fiscally-strapped parts of the European Union to pay for public services (a genuine transfer union). This would mean a rather different political objective of redistributing resources permanently, rather than pure risk-sharing. However, it is a well-known macroeconomic property of redistributive measures that they also have a demand stabilising effect.

In addition to all the above, which can be thought of as having macroeconomic objectives associated with how best to manage EMU, there could be moves towards harmonisation of taxes (for instance, on single market grounds), or harmonisation of expenditure entitlements.

A euro area stabilisation mechanism

161. The Five Presidents' Report suggests the establishment of a stabilisation fund, as set out in Box 9.

Box 9: Options and guiding principles for a euro area stabilisation fund

The Five Presidents' Report sets out the options and guiding principles as follows:

- It should not lead to permanent transfers between countries or to transfers in one direction only, which is why converging towards Economic Union is a precondition for participation. It should also not be conceived as a way to equalise incomes between Member States.
- It should neither undermine the incentives for sound fiscal policy-making at the national level, nor the incentives to address national structural weaknesses. Accordingly, and to prevent moral hazard, it should be tightly linked to compliance with the broad EU governance framework and to progress in converging towards the common standards described in Section 2 of the Five Presidents' Report (and in Chapter 2 of this report).
- It should be developed within the framework of the European Union. This would guarantee that it is consistent with the existing EU fiscal framework and with procedures for the coordination of economic policies. It should be open and transparent vis-à-vis all EU Member States.
- It should not be an instrument for crisis management. The European Stability Mechanism (ESM) already performs that function. Instead, its role should be to improve the overall economic resilience of EMU and individual euro area countries. It would thus help to prevent crises and actually make future interventions by the ESM less likely.

Source: Five Presidents' Report, p 15

162. Thomas Wieser said that "everybody who agrees with the concept of fiscal union would agree on the need for setting up a central budget that has a stabilisation function, with the presumption that asymmetric shocks, over time, will be more or less evenly distributed around the euro area."[187]

163. Janet Henry thought that a stabilisation mechanism could play a major role in offering financial support to countries undergoing structural reforms, though she acknowledged there would be opposition to big permanent transfers."[188]

187 Q 117
188 Q 31

164. Professor Quaglia said that the "construction of a stabilisation mechanism in a countercyclical way" would be politically more feasible than a transfer union of permanent transfers. Even that, however, "would be quite difficult to achieve, because there is concern in particular Member States about moral hazards and about being permanent net contributors, if you want, to this sort of euro-area mechanism for stabilisation and distribution."[189]

Transfer unions

165. Raoul Ruparel observed that transfer unions within countries like Italy and Germany did not promote economic convergence or development, and putting such transfers in place would require a political union or political acceptance.[190] Professor Codogno supported fiscal transfers "seen in the context of risk-sharing and in the context of providing facilities to compensate for asymmetric shocks that might happen in the area." He said they "should not be perceived as permanent transfers from one area to another", and argued that the existence of permanent transfers indicated that there was a fundamental problem that needed to be addressed. He acknowledged that some transfers in transfer unions were automatic and implicit, but said that if structural problems were not addressed, transfers became permanent: "permanent transfers should not be the rule; they should be the exception or should compensate for shocks. But if there are permanent transfers, it means you have a problem. You have to address the problem from the point of view of structural policies."[191]

166. Dr Lilico agreed that elements of a transfer union were already in place: "There is already a system of fiscal transfers within the European Union: the structural and cohesion funds." They were very small and at the regional policy level in the EU. He continued: "I agree absolutely that they need to get to something like 3%. I think they will get there in the end; I just think that there is a bit of political difficulty in getting there."[192] Roberto Gualtieri MEP said that it was possible to achieve a certain level of transfer within the existing EU budget of 1% of GDP but suggested that an additional 1% would allow enhanced investment and an automatic stabiliser.[193] Thomas Wieser said that a permanent transfer system existed through the operation of EU structural funds: "in the case of Greece, the present co-financing rate is 0% … it is not explicitly or even implicitly linked to monetary union, but Greece is getting 4% or 5% of GDP per annum in what, in balance of payment terminology, is called 'unrequited transfers'. Opinions may differ, but the reality is already partially there."[194]

Mutualised debt

167. Mutualised debt, though featuring in the Four Presidents' Report, is absent from the Five Presidents' Report. Several witnesses told us that they expected or believed mutualised debt would be needed to support a common fund in the future. Sir Jon Cunliffe thought that debt mutualisation was not completely off the table:

189 Q 174
190 Q 20
191 Q 65
192 Q 169
193 Q 104
194 Q 117

"I read the reference to the fiscal stabilisation mechanism, which 'could be financed in various ways', as a way of leaving open some of those possibilities. The stabilisation mechanism is not defined—it is going to be one of the most difficult things for the euro area and the states to agree—but it could be financed by debt, and there could be mutualisation underneath that. I did not think it closed any doors completely."[195]

168. Raoul Ruparel said that mutualised debt in the form of 'Eurobonds', whereby all countries jointly issue debt underwritten by each Member State, would reduce fiscal pressures on individual Member States and would benefit from the weight of the eurozone as a whole to issue debts.[196] Graham Bishop argued that his proposal for a 'Eurobill' fund would provide a good discipline mechanism for the enforcement of public finance and macroeconomic policies.[197]

169. Megan Greene told us that one key distinction between the US and EU was that the US issued mutualised sovereign debt while Europe did not issue Eurobonds. She said that US treasury bonds were the most liquid asset class in the world, and argued that the absence of mutualised debt would reduce the effectiveness of Capital Markets Union as a shock absorber.[198]

170. Professor De Grauwe supported the idea of a "budgetary union so as to be able to consolidate at least a significant part of national debt into common debt." He explained that in a recession, financial markets affected countries in different ways, and supported the idea of a fiscal union to prevent market instability:

"Instead of markets stabilising during a recession, they typically will be destabilising the system, forcing some countries into excessive austerity precisely at the moment that you do not want that and moving other countries into good times, thus intensifying conflicts within the Union."[199]

He argued that debts needed to be consolidated so that destabilising capital flows within the union were eliminated and also that financial markets could not be trusted to stabilise the eurozone during recessions.[200]

171. Dr Lilico did not think that debt mutualisation would need to take place, based on the current level of transfers within the union. He argued that a "relatively modest contribution" transferred to countries to enhance the growth of struggling eurozone Member States would be far less objectionable than exposing oneself to "two trillion-plus of debt mutualisation or debt risk." Future transfers would be "a natural extension of kinds of programmes that are already in place, you could transform the situation—not provide a final solution, because you need to be getting up to 3%-plus of GDP—merely by providing something of the same order of magnitude again as the structural and cohesion funds that are already in place."[201]

195 Q 186
196 Q 20
197 Q 9
198 Q 74
199 Q 182
200 Q 182
201 Q 174

Sequencing within a fiscal union

172. Several witnesses questioned the sequencing of a fiscal union. Baroness Bowles of Berkhamsted told us that she saw fiscal union forming in two stages, as suggested by the Five Presidents' Report: first, ensuring that rules are obeyed and second, "they want to move further together and maybe to fund some things out of some form of joint taxation."[202] Dr Marek Dabrowski, Fellow at the Center for Social and Economic Research (CASE), Warsaw, argued that the history of other fiscal federal arrangements suggested that the development of a macroeconomic stabilisation function "usually follows fiscal centralization."[203]

173. Roberto Gualtieri MEP told us that there were "conditions for enhancing the level of fiscal transfer and risk-sharing gradually, in parallel with the strengthening of our convergence and budget rules … The two things could arrive in parallel and gradually evolve: first, by making use of the current set of rules; secondly, by having legislative changes within the current treaty framework; and, thirdly, by arriving at treaty change."[204]

174. Professor Codogno believed that "a successful monetary union ultimately requires some form of fiscal risk-sharing. It is moving towards that, but in a gradual way." He predicted it was likely that we would see "halfway houses", or that "in the time of crisis you will have risk-sharing."[205]

175. Kay Swinburne MEP told us that the incentives to create a fiscal union could disappear as the economy became more normalised: "It will take the next crisis for us to get closer to any more fiscal union."[206] Mike Vercnocke told us that if one solved recovery and resolution of financial institutions in the financial sector, and the link between the sovereign and bank were broken, some of the "fiscal issues probably go away."[207] Sir Jon Cunliffe did not agree that "fiscal union necessarily means becoming a complete federal country, but there has to be a much higher level of fiscal integration that includes risk-sharing and collective support."[208]

176. **'Fiscal Union' is not defined in the Five Presidents' Report. Perhaps this was deliberate but we are alarmed that such a key component of that report remains such a nebulous concept and was interpreted in so many different ways by our witnesses.**

177. **Some form of stabilisation function would be necessary and this would entail transfers between Member States. The question is the level of those transfers and the trigger for making them. Because the EU does not have the sort of tax and expenditure powers that are the norm in Member States, it lacks a capacity for automatic stabilisers to function when there are cyclical upswings or downswings. Nor does it have permanent transfer mechanisms that provide equalisation. Neither appears to be politically feasible in the near future. The stabilisation mechanism proposed by the five Presidents, which would be automatic (so not contingent on a decision-making authority such**

202 Q 20
203 Written evidence from Dr. Marek Dabrowski, EMU0010
204 Q 105
205 Q 65
206 Q 91
207 Q 153
208 Q 192

as the Troika) but not permanent, and responding only to asymmetric shocks, seems a pragmatic way forward.

178. **We note that there may be higher political support for transfers responding to a cyclical shock rather than structural problems. Such an arrangement would need appropriate agreement at Member State level and some form of institutional oversight. The plans put forward at the moment are vague, although we note the suggestion of an unemployment reinsurance scheme to deal with cyclical, rather than structural, unemployment. A precondition for any such system would be appropriate structural convergence, or at least coordination.**

179. **Financial integration, through the completion of Banking Union and Capital Markets Union, may appear to be more achievable than a fiscal union in the short term. However, several challenges remain. These include a potentially ambitious risk reduction agenda before risk-sharing through EDIS takes place, and uncertainty surrounding the long term common backstop to the Single Resolution Mechanism. In addition, the opening of politically sensitive legislative agendas such as insolvency and tax, within the Capital Markets Union initiative, may limit private risk-sharing in the short term.**

180. **We welcome the fact that the initiatives and programmes aimed at financial integration are already underway and can be completed without a major revision of the Treaties, or the creation of significant new institutions. These projects largely aim to reduce risk, though we note that a single backstop for Banking Union and the EDIS proposal entail a degree of risk-sharing. It is the risk-sharing elements that have proved the most controversial, and this suggests that any further 'fiscal union' that entails pooling of funds will be unlikely to succeed in the short term, and certainly not before significant risk reduction measures have been put in place.**

CHAPTER 4: DEMOCRATIC ACCOUNTABILITY, LEGITIMACY AND INSTITUTIONAL REFORM

181. At the heart of any pooling of sovereignty—and a significant amount is envisaged in Stage 2 of the five Presidents' proposals—lie democratic accountability and legitimacy. The Five Presidents' Report suggests changes to improve the institutions and structures supporting EMU. It argues that greater integration, as discussed in the previous chapters, should go hand in hand with institutional and democratic strengthening, which is described as "both a condition for success and a natural consequence of the increasing interdependence within EMU".[209]

182. The events of summer 2015 exposed a tension between the conditions being imposed on Greece by the Troika in exchange for loans and the democratic mandate given to the Syriza government by the Greek people. Philippe Legrain summarised the problem facing the eurozone: "We have election after election in the eurozone in which voters reject the outgoing Government, and the first thing that happens is that voters are told that they have to stick to the old policies of the government they have just rejected because EU rules say so, and I do not think that is desirable or sustainable."[210]

183. As we have seen in the previous chapters, the proposals put forward by the five Presidents and the Commission are intended for both the short and long term. Our investigation has gone beyond the proposals in the Five Presidents' Report in considering the level of integration that is necessary or desirable for the maintenance of a robust EMU. Different levels and methods of integration may require different democratic institutions to support them, and we discuss some of the options in this chapter.

Short-term measures for parliamentary oversight

184. The Report notes that steps have already been taken to strengthen parliamentary oversight of EMU as part of the European Semester; that 'economic dialogues' have taken place between the European Parliament, the Council, the Commission and the Eurogroup, in line with the provisions of the six-pack and the two-pack; and that the European Parliament and national parliaments have been brought together to discuss economic issues within the European Parliamentary Week. It also notes the existing right of national parliaments to convene a meeting with a Commissioner for a presentation of the Commission's opinion on a Member State's draft budgetary plan.[211]

185. The Report argues that the right to convene a meeting with a Commissioner should be exercised more "systematically" than at present. It suggests changing the timings of the European Semester (as discussed in Chapter 2), proposes that Commissioners should take part in plenary debates in the European Parliament at certain points in the process, and encourages greater Commission and Council involvement in inter-parliamentary meetings such

209 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf p 17 [accessed 6 April 2016]

210 Q 4

211 Regulation 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area states that "At the request of the parliament of the Member State concerned or of the European Parliament, the Commission should be prepared to present its opinion to the parliament making the request, after it has been made public."

as the European Parliamentary Week. It also suggests that the "European Parliament should organise itself to assume its role in matters pertaining especially to the euro area",[212] but does not expand on this suggestion.

186. These proposals are largely exhortatory. We also note that the involvement of the European Parliament and national parliaments in economic governance, through participation in debates and hearings with Commissioners, is not the same as those organisations exercising control over the process. Our experience of attending the European Parliamentary Week suggests that it could be made more purposeful. We consider the role of parliaments below as part of our consideration of possible paths towards democratic and institutional integration within EMU.

External representation of the euro area

187. The Five Presidents' Report envisages a gradual consolidation of the external representation of the euro area, beginning in Stage 1 with the International Monetary Fund (IMF). It argues that the importance of the eurozone in international trade, backed by a unified trade policy, along with a single monetary and exchange rate policy, implies that the eurozone should have a single voice internationally. It argues that the current fragmentation of representation results in the eurozone punching below its weight.

188. Among the package of measures published by the Commission in October 2015 was a proposal for a Council Decision to unify the representation of the euro area at the IMF.[213] That proposal criticised the dispersal of euro area countries between appointed seats and several 'constituencies' (groups of countries represented by a single seat), along with the lack both of coordination through existing EU-wide channels and of a dedicated euro area representative on the Executive Board with an official mandate. Its aims in ensuring greater consistency in external representation at the IMF were (i) to strengthen the coordination of the euro area, including ensuring common statements on all IMF policy, country and surveillance issues that are relevant to the euro area; (ii) to improve representation of the euro area through a rearrangement of constituencies and the establishment of an observer status for the euro area as a whole; and (iii) to formalise representation of the euro area at the IMF's Executive Board and the International Monetary and Financial Committee. It sought to achieve this through rearranging seats at the Executive Board so that the euro area would be grouped into one or several seats instead of being spread out and grouped with non-euro area countries.

189. Dr Hodson criticised the proposal, arguing that in situations where Member States agreed on an issue there was little additional value in unified representation, while when they disagreed it would not work. He warned that the UK's influence within the IMF might be diluted by any reconfiguration of the EURIMF committee, on which the UK currently sits alongside euro area Member States. He also considered that more unified euro area representation might prompt a reaction from non-European members of the

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212 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf p 17 [accessed 6 April 2016]

213 Proposal for a Council decision, laying down measures in view of progressively establishing unified representation of the euro area in the International Monetary Fund, COM(2015) 603 [accessed 8 April 2016]

IMF, leading to a dilution of the eurozone's influence and breaking Europe's hold over the post of Managing Director of the IMF.[214]

190. Dr Lilico considered that some form of unified representation might be useful, were the eurozone to start issuing common debt. He pointed to the debt premium associated with the euro before 2007, and argued that individual euro area Member States were, mistakenly, viewed interchangeably. If common debt were issued, "there might need to be a distinction between the sovereign euro area dealing with the IMF and the individual sovereign area dealing with the IMF. I think that they would probably continue to issue at least some debt".[215]

191. Sir Jon Cunliffe saw the Commission's proposal as driven by the EU institutions with little support from Member States: "If you ask the question in the capitals of the major euro area Member States, you might get a different answer than if you asked it in Brussels". He did not believe that the proposal would undermine the UK's position within the IMF, although this might change as a result of wider trends towards increased representation for emerging markets.[216]

192. In 2010 the IMF Executive Board agreed to reforms of quota and governance arrangements, a reform currently blocked by the United States Congress. We raised this in scrutiny correspondence with the Minister, David Gauke MP, who considered that the Commission proposal would neither prevent those reforms coming into force nor affect voting weights.[217]

193. **It is unclear how unified representation of the euro area in international fora will be achieved, and there appears to be opposition at Member State level, which may be difficult to overcome. The Commission has not made a convincing case for unified representation at the IMF. We note, however, that any further integration of the eurozone, including the issuance of common debt, may require unified representation of eurozone interests at the international level.**

194. **While the proposal for external representation has been included by the five Presidents among their plans for strengthening democratic accountability, the proposal is in reality more of an institutional reform aimed at rationalising the eurozone's role on the world stage. However, what looks like a worthwhile administrative reform may be at odds with the desire to enhance democratic accountability, if it takes decision-making away from decision-makers at the national level. The challenge will be to establish appropriate and accountable eurozone-level decision-making structures.**

A strengthened Eurogroup

195. The Eurogroup is an informal meeting of the finance ministers of the eurozone, which takes place the day before the Council of Finance Ministers of all 28 EU Member States (ECOFIN). Since 2004 it has had a semi-permanent two-year presidency, voted on by the members of the group. The current President is Jeroen Dijsselbloem, the Dutch Finance Minister.

214 Written evidence from Dr Dermot Hodson (EMU0008)
215 Q 172
216 Q 194
217 Letter to Lord Boswell of Aynho, dated 5 January 2016

Eurozone heads of state or government also meet periodically as the 'Euro Summit'.[218]

196. The Five Presidents' Report recommends, as a short term measure, stepping up the role of the Eurogroup in the European Semester. In the long term it recommends "a full-time presidency of the Eurogroup … with a clear mandate within the framework of this report. With the support of all EU institutions, it could play an even greater role in representing the interest of the single currency, within the euro area and beyond."[219] The Report does not provide further detail, but the idea could conceivably lead to the creation of a 'eurozone finance minister', as proposed by German Finance Minister Wolfgang Schäuble.[220] Separately, President Hollande of France has spoken of a eurozone parliament with control over its own eurozone budget.[221]

197. Henning Christophersen went further than the Five Presidents' Report, in suggesting the creation of a 'Euro Council': "an institution with its own secretariat under the supervision of the elected eurozone members of the European Parliament [that] should have its own budget and with its own secretariat." He criticised the current arrangement, whereby countries in receipt of a bail-out are under the supervision of the Commission, responsible to all 28 Member States, rather than a euro-only configuration. He believed "that budget must be approved by the European Parliament and the Euro Council, and they must have their mandate from national parliaments to do it".[222]

198. Professor Codogno saw the proposal for a stronger role for the President of the Eurogroup as problematic: "As things stand, the so-called Treasury Minister for the eurozone in the future would be the head of the Eurogroup. That is not an elected position and it does not go to the European Parliament for confirmation, which is pretty odd, so it needs to be changed."[223] Dr Lilico considered that a role of "EU (or eurozone) President" might eventually be subject to popular vote: "the finance person would follow on from the political election of the head of the European institution as a whole".[224]

199. Dr Lilico also addressed the implications of further eurozone integration on non-eurozone Member States, although without the institutional separation advocated by Mr Christophersen. He said that he "would expect more and more Commission business to be devoted to euro-area matters to the exclusion of wider EU matters, which in due course would mean that the interests of non-euro members of the EU become increasingly marginal. So I do not see how, as things stand, there is any long-term future for any members of the European Union who are not members of the euro."[225]

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218 Donald Tusk, more normally thought of as President of the European Council, is described in the Five Presidents' Report as "President of the Euro Summit".

219 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf p.18 [accessed 6 April 2016]

220 Open Europe: http://openeurope.org.uk/today/blog/german-finance-minister-comes-to-the-table-with-his-own-eu-reform-plans-and-looks-for-uk-support/ [accessed 8 April 2016]

221 'Francois Hollande calls for eurozone government', *The Telegraph* (19 July 2015): http://www.telegraph.co.uk/news/worldnews/francois-hollande/11749947/Francois-Hollande-calls-for-eurozone-government.html [accessed 8 April 2016]

222 Q 38

223 Q 64

224 Q 172

225 Q 168

200. The five Presidents' proposals are not fully developed, and a strengthened Eurogroup could in principle be restricted to playing a more explicit role in economic convergence or coordination, enforcing fiscal discipline and representing the eurozone internationally. But when they are juxtaposed with the possible creation of a eurozone treasury and with some of conceptions of fiscal union discussed in Chapter 3, the proposals begin to sound more radical.

201. The role of the Eurogroup is of particular interest to the UK. The Government has long been concerned about caucusing among its members. Under the new Council voting rules it is possible for the eurozone, acting as a bloc, to outvote the non-eurozone countries. One of the Prime Minister's aims in the recent renegotiation of the UK's relationship with the EU was to protect non-euro area Member States against the possibility of the eurozone acting in such a way in Council negotiations.

202. Professor Quaglia told us that "the Eurogroup is generally seen as a smaller body in which Member States are better able to reach a consensus. Therefore, if there is a formalisation of this body, it will have implications for the outsiders. My impression is that increasingly important, or at least politically controversial, decisions are taken in the Eurogroup first and are then discussed in the ECOFIN council."[226] In contrast, Philippe Legrain considered that, in the immediate term, "there is little prospect of eurozone members caucusing together, simply because they disagree on so much.[227]

203. Thomas Wieser also thought concerns about caucusing were exaggerated:

> "I have been debating this with my British colleagues for the last 10 years or so. I have been in every single Eurogroup meeting since the setting up of the thing and I cannot think of a single instance where there was this sort of, 'How will we vote? What will we discuss tomorrow in ECOFIN?' It has never happened, but one has to realise that there is a concern and you have to deal with it."[228]

204. **The plans for strengthening the Eurogroup are currently very speculative and could develop in different ways, depending what is decided about a eurozone treasury and 'fiscal union'.**

205. **Although our witnesses were divided on the extent to which caucusing currently takes place (or might take place in the future), we note that a stronger Eurogroup, along with the forthcoming changes to the QMV procedure, may make mechanisms to protect the position of non-euro area Member States all the more important. Notwithstanding what was agreed at the February 2016 European Council, the Government should remain alert to the impact that a formalised Eurogroup might have on the UK's position and should do everything in its power to ensure that the UK is protected.**

A eurozone treasury

206. The Five Presidents' Report talks of a strengthened Eurogroup working "with the support of all EU institutions", which implies that it would not

226 Q 172
227 Q 5
228 Q 112

operate independently of those institutions. However, a separate suggestion from the five Presidents envisages the establishment of a eurozone treasury:

> "A genuine Fiscal Union will require more joint decision-making on fiscal policy. This would not mean centralisation of all aspects of revenue and expenditure policy. Euro area Member States would continue to decide on taxation and the allocation of budgetary expenditures according to national preferences and political choices. However, as the euro area evolves towards a genuine EMU, some decisions will increasingly need to be made collectively while ensuring democratic accountability and legitimacy. A future euro area treasury could be the place for such collective decision-making."[229]

207. As with most of the Stage 2 proposals, it is not entirely clear how the treasury is intended to function, nor is its relationship with the Eurogroup, the Fiscal Advisory Board and other current or proposed EU institutions spelled out. Our witnesses had differing interpretations. Baroness Bowles of Berkhamsted suggested it might take the lead in dealing with the European Stability Mechanism and the European Fund for Strategic Investments,[230] especially if future infrastructure funding were to be conducted much more at the European level. She considered that the addition of another body might alleviate the problem of the ECB and the Commission being 'judge and jury'. She also questioned how democratic oversight might be achieved: one option would be for eurozone members of the European Parliament to perform the function; another would be for national parliaments to convene in an assembly.[231]

208. Graham Bishop thought that a treasury could be responsible for mutualised debt, or Eurobills,[232] while Dr Lilico suggested it could have "tax and debt-raising powers and powers to spend":

> "Such a treasury function would clearly require political oversight … it has been suggested (obviously correctly) that the eurozone political union will need its own parliament. It will also need its own civil service functions, so as to guide its policymaking."[233]

209. Professor De Grauwe also regarded a treasury as an "institution that has the power to tax and to spend and is embedded within a democratic decision-making process", rather than "some kind of institution where Ministers of Finance come together and talk to each other." It was a mistake, he suggested, to think that the institutional structure was already or nearly in place to support EMU: "We have to move forwards much more radically, and that is precisely the problem because no one wants to do it."[234]

229 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf p 18 [accessed 6 April 2016]
230 It should be noted that the EFSI is an EU-28 initiative.
231 Q 20
232 Q 9
233 Written evidence from Dr Andrew Lilico (EMU0001)
234 Q 179

A eurozone parliament

210. The Five Presidents' Report suggests that "The European Parliament should organise itself to assume its role in matters pertaining especially to the euro".[235] Dr Lilico suggested that this might take the form of a "Grand Committee of the Eurozone members".[236] Graham Bishop also thought that the European Parliament would take a greater role in economic matters:

> "The way in which it is laid out in the communication suggests that that is up to the Parliament. The people I speak to there within their rules of practice can already see how ECON can meet in a eurozone-only format. That can be done within the existing framework."[237]

211. Philippe Legrain thought that the European Parliament would resist the creation of a new and separate parliament: "Such is the power of the European Parliament that it is inconceivable that you would create a separate structure … a eurozone parliament, if such a parliament were to emerge, would basically start off as a committee made up of members of the European Parliament from eurozone countries."[238]

212. Members of the European Parliament were reluctant to develop new parliamentary structures of any kind, at least in the short term. Anneliese Dodds MEP said that she had "resisted attempts within the European Parliament to hive Eurozone issues off from general economic decision-making, as would occur, for example, if a separate 'Eurozone' committee were to be created". She argued that it was important for British MEPs to engage constructively in eurozone issues as a means of building trust and ensuring that UK arguments were heard, "whether they relate to the City of London or other aspects of the UK's economy".[239]

213. Roberto Gualtieri, MEP, Chair of the ECON Committee, argued that differentiation between representatives of eurozone and non-eurozone Member States was currently prevented by the Treaties:

> "When we have to make a treaty change in order to have this fiscal capacity and then a treasury, it will then also be time for a specific arrangement whereby those specific actions connected to this function are voted on by participating euro area member countries. However, until we arrive at that point, any legal differentiation—which, by the way, is prevented by the current treaty—would be neither possible nor desirable."[240]

Ensuring accountability

214. The creation of a treasury would be a bold step, and could encompass a new body having control of economic coordination, fiscal coordination, the framework of a transfer mechanism, the implementation of transfers, taxation and (if the eurozone were given a 'fiscal capacity') spending. The

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235 European Commission, *Completing Europe's Economic and Monetary Union*: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf p 17 [accessed 6 April 2016]. It should be noted that only the UK and Denmark have a formal opt-out from joining the euro. The other Member States are committed under the Treaties to join in due course.

236 Written evidence from Dr Andrew Lilico (EMU0001)

237 Q 3

238 Q 4

239 Written evidence from Anneliese Dodds MEP (EMU0006)

240 Q 102

creation of such a body would entail the transfer of a certain amount of sovereignty from Member States to European institutions; the extent of such transfer, and therefore the extent to which new forms of explicit democratic accountability will be necessary to support it, would depend on the route taken. Two forms of accountability are relevant: the initial mandate given by Member States to create such a structure, and its day-to-day oversight.

215. Fabian Zuleeg argued that:

> "Fiscal integration is getting too close to the key issues of sovereignty within Member States, so there has to be some form of democratic accountability, and a mechanism that allows constitutional courts across the eurozone to sign off on some form of fiscal union. That is a major challenge. It does not necessarily mean there is only one specific way that that could be designed, but there has to be something in there about how you make that democratically accountable."[241]

216. Professor Issing was concerned that the report suggested "steps towards a fiscal union without democratic legitimacy, because without political union all transfers et cetera will lack European democratic legitimacy".[242]

217. Accountability could be achieved through the existing mechanism of national Ministers representing their citizens in Council, although the rules on QMV applies limit the scope for Ministers to achieve change in keeping with specific national interests unless they can muster a majority. It could also be achieved through a bolstered role for the European Parliament, acting either as a eurozone 'Grand Committee' or as a separate eurozone Parliament, or through greater, and more formal, involvement of national parliaments. Thomas Wieser, for instance, offered a "budgetary assembly or budgetary committees of national legislatures" as alternatives.[243]

218. Hans Hack was sceptical of the value that the European Parliament could bring:

> "The democratic accountability of the European Parliament is something that, in itself, is not a given, in my view, with voting once in five years and they do not have a constituency. Different political systems in Europe are different, but there is not a continuous dialogue between the European Parliament and its constituents. I find the UK push, as it were, for more involvement of national parliaments in European decision-making a very healthy one."[244]

219. Mike Vercnocke, of the City of London Corporation, said that the European Parliament was the most democratically accountable of the EU institutions, "yet no one in the populace, not just in the UK but in most countries, takes it very seriously".[245] Professor Codogno, though, was more positive:

> "To have full democratic accountability and address the democratic gap that is perceived to be in place in Europe, probably you need some kind of fiscal capacity in the centre and the European Parliament has to be in charge of deciding on a number of issues. The European Parliament is

241 Q 120
242 Q 208
243 Q 108
244 Q 128
245 Q 154

elected and therefore you probably address some of the issues. It is the intergovernmental approach in Europe that sometimes contradicts the democratic mandate."[246]

220. Dr Alex White, of the Economist Intelligence Unit, suggested that there was a more fundamental problem with establishing democratic accountability of the sort envisaged by the five Presidents. He argued that the original establishment of EMU had moved too quickly, without a 'European demos' to support it, and that the Five Presidents' Report, in attempting to repair the economic mistakes made at that time, risked "conflating and worsening the political error: moving too fast and going beyond what the European polities and voters are prepared to accept and implement."[247]

221. The Minister would not be drawn on the desirability of a eurozone parliament in any form, arguing that "it is a matter for the eurozone countries to determine whether they feel the need to make constitutional or accountability changes. But, if it is part of the European Union, it would require a treaty change, which would require the support of 28 Member States, including the United Kingdom."[248]

222. **We agree that it is primarily for eurozone Member States to decide the appropriate mechanism of democratic accountability that is needed to support their chosen level of fiscal integration. Fiscal integration as developed through the design of EMU and accelerated through crisis mechanisms has resulted in significantly more sovereignty pooling, yet democratic structures and processes have not developed commensurately. This lack of democratic structures or processes undermines the legitimacy of EMU in the eyes of the very citizens in whose name it has been developed.**

223. **It will be vital that the creation of any new accountability structure, whether that is a treasury, a finance minister, a new formation of the European Parliament, or a new role for national parliaments, should be accompanied by a clear mandate from the citizens of the eurozone countries.**

Political reality

224. Will any of the five Presidents' proposals to boost democratic accountability be implemented? Professor Issing was sceptical: "For the time being, the nations of the Union are probably further away from the idea of a political union than at any time in the past, so the idea of political union is at best a vision for the distant future". His concern was that fiscal union would precede political union.[249] John Peet said that he did not expect a treasury to "happen by 2025—or ever".[250]

225. Roberto Gualtieri MEP saw the major obstacle to the implementation of any of the five Presidents' proposals as "insufficient consensus about a higher level of fiscal transfer and risk-sharing."[251] Vice-President Dombrovskis, though, noted that the consultation leading up to the White Paper was

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246 Q 66
247 Q 179
248 Q 199
249 Q 208
250 Q 77
251 Q 101

intended to foster consensus between those Member States that favoured risk-sharing and mutualisation and those that advocated more sovereignty-sharing and control. He acknowledged that the Stage 2 proposals were likely to require treaty change.[252]

226. Thomas Wieser set out some of the challenges that lie ahead:

> "North of the Alps, the issue of how to increase fiscal discipline is dominant whereas the more conjunctural stabilising function is more to be found south of the Alps. Whichever side one is on, if you want a greater, binding say on national budgets or if you want to transfer budgetary competences to Brussels, you need to do something constitutionally. In my view, this would be a constitutionally larger step than actually joining the European Union. You would have to have treaty change, you would definitely need referenda in the vast majority of Member States, and then you would have to settle on what the democratically accountable body in 'Brussels' would be."[253]

227. **The challenges to achieving any of the proposals set out by the five Presidents for Stage 2 of completing EMU remain significant. Eurozone Member States must first reach consensus on the balance between risk-reduction (or fiscal discipline) and risk-sharing, and on the appropriate mechanisms to achieve that balance. They must then agree on the democratic accountability structures or processes to support those mechanisms. Treaty change will be required to implement any significant change and this will require referendums in many Member States, the results of which will not be guaranteed. We doubt this will be done quickly: the five Presidents' suggested target date of 2025 appears ambitious.**

Coda: the implications for the UK

228. The Five Presidents' Report focuses on the eurozone (or those committed to joining it) but, as we said at the start of this report, any further integration within EMU will have implications for the UK even though the UK (along with Denmark) has an opt-out from joining the euro.

229. The Minister spoke of the "remorseless logic" of economic and political integration in the euro area, while maintaining that the means by which integration would be achieved was up to those countries. He was clear that "It is in our interest that the euro area is a successful, strong currency area, so we do not want to stand in the way of the euro area resolving its difficulties". At the same time, "we will not let the integration of the euro area jeopardise the integrity of the single market or in any way disadvantage the UK."[254]

230. Certain aspects of the Five Presidents' Report directly affect the UK. Capital Markets Union is a Single Market project, and one from which the UK is likely to benefit. Were the capital markets supervisor suggested in the Five Presidents' Report to be established it could have a significant impact on the City of London (although we note that this proposal did not appear in the subsequent Capital Markets Union Action Plan). Banking Union is another area that goes beyond the eurozone. Although the UK is not a member of the Banking Union, it is open to non-eurozone members and the UK could,

252 Q 163
253 Q 108
254 Q 195

one day, choose to join. The UK banking system is closely linked to that of the Banking Union, and Andrew Bailey, Deputy Governor of the Bank of England, gave us one example of why this matters to UK citizens:

> "Where a bank branches from a country in the euro area to the UK, as it can do under the passporting regimes in the single market, the deposit protection for the depositors in that branch in the UK comes from the home state, which is wherever it is branching from … the solvency of a national deposit protection scheme depends upon the solvency of the sovereign of that country. They are inevitably inextricably linked. We have had incidents where the solvency of the banking system of the home country is a direct product of the solvency of the sovereign, and when both of those are called into question, you then get a situation where you say, 'Do the depositors in the UK really understand where their deposit protection is coming from?'"[255]

231. Perhaps the most significant implication of the Five Presidents' Report for the UK would be the creation of a new eurozone institution or role, be that a parliament, a treasury or a finance minister. The UK must ensure that its interests are not ignored by any new institutional structure. The renegotiation has sought to set out the terms of engagement between the euro-ins and the euro-outs: it will be important that those terms are preserved, for instance in the event that the Eurogroup were to be formalised or a treasury established as the primary decision-making forum for the eurozone.

232. **The creation of a eurozone parliament, treasury or finance minister will require treaty change; and any treaty change requires the unanimous consent of all 28 Member States including the UK. Thus there will be an opportunity for the Government of the day to ensure that UK interests are preserved if the UK remains a member of the EU after the referendum.**

233. In our recent report *The EU referendum and EU reform*[256] we concluded that the terms of the 'new settlement', while largely restating existing principles, provided welcome clarity on the future relations of eurozone and non-eurozone states, and ensured that the interests of both groups would be safeguarded.

234. We also welcomed the Government's commitment to "facilitate and support the proper functioning of the euro area and its long-term future" as recognition that the UK had a vital stake in the success of the eurozone, and would work to achieve that success.

235. **The UK renegotiation deal foresees its terms being incorporated into the Treaties at their next revision. The five Presidents' more fundamental proposals to enhance the functioning of the eurozone would, by requiring treaty change, provide an opportunity for the Government to entrench the settlement in EU law while at the same time ensuring that the protections secured were not undermined by the development of new institutions.**

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255 Q 193

256 European Union Committee, *The EU Referendum and EU Reform*, (9th Report, Session 2015–16, HL Paper 122)

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

1. We strongly urge that the issues raised in the Five Presidents' Report, particularly those relating to democratic accountability, are addressed as part of a long-term strategy. (Paragraph 23)

2. We welcome the publication of the Five Presidents' Report as a sign that the leaders of the EU institutions recognise that, despite the steps already taken, more needs to be done to ensure the long-term sustainability of the eurozone. We believe that there is sufficient political will to ensure its survival. (Paragraph 24)

3. While we welcome the existence of the rules set out in the Stability and Growth Pact and wider reforms as, at the very least, a framework within which Member States can consider their budgetary policy-making, we note that adherence to the rules is patchy and liable to be influenced by domestic political pressures. While the Pact's rules allow some flexibility for Member States, which may lessen the degree of pro-cyclicality, we recognise that they are still seen as excessively pro-cyclical. (Paragraph 41)

4. National fiscal policies have spillover effects on other Member States. In establishing a fiscal stance for the eurozone it is important to take into account the particular conditions of each Member State. Just as there may be between regions within particular countries, there may be a tension, in perception or reality, between what appears to be the right fiscal and monetary stance for the eurozone as a whole and what is right for individual Member States, at least in the short term. The effectiveness of this attempt at coordination will ultimately depend on political will at Member State level. (Paragraph 47)

5. We look forward to seeing how the advisory European Fiscal Board will work once it is operational. As the Board will be merely advisory, it will be for Member States to do the heavy lifting in implementing its recommendations, and we are not convinced that at present there is sufficient desire to do so. (Paragraph 54)

6. The evidence we have heard suggests that the strengthening of the Macroeconomic Imbalances Procedure, proposed in the Five Presidents' Report, is unlikely to change the status quo or encourage more symmetrical adjustment between euro area Member States. We agree with those who have suggested that, in order to foster long-term structural reforms at the Member State level, it is necessary for individual Member States to take ownership. There is, however a tension between ensuring Member State ownership (whether in curbing imbalances or in disciplining public finances) and creating an effective enforcement mechanism at the EU level. Given that financial penalties have still not been used under either the SGP or the MIP, despite the introduction of reverse majority voting, in which a majority must be mustered to oppose a Commission proposal, we are sceptical that financial sanctions under the MIP are any more likely to be used in the future. As a result the still large macroeconomic imbalances in the euro area will probably continue to be a source of instability. (Paragraph 79)

7. We note the doubts expressed about the likely effectiveness of National Competitiveness Boards in Member States that do not currently have a similar body in operation. (Paragraph 91)

8. We recognise that the establishment of a Board might bring with it the perception of another layer of bureaucracy being imposed by the EU, unless it is accompanied by a clear objective of how it will improve policy-making and increase national ownership of those policies. There may be a tension between national ownership and the consideration of eurozone-wide benefits, in addition to the inherent tension that exists between the need for Boards to be both independent and accountable. If, on the other hand, National Competitiveness Boards are intended as a first step towards a nationally anchored but eurozone-owned institution, then their independent status could detract from national political accountability. (Paragraph 92)

9. The drive towards improving competitiveness in the eurozone must stress solutions that enhance productivity. We echo the conclusions of our previous report on The future of economic governance in the EU which stated: "It is unreasonable to ask successful Member States to reduce their competitiveness in a global environment. It is, however, in the interests of all Member States in the euro area that the proceeds of those countries in surplus are not deployed in ways which disadvantage their neighbours, and that those countries in deficit are supported in making the structural adjustments necessary to improve productivity and levels of employment." (Paragraph 93)

10. The impetus towards economic convergence is laudable to the extent that it is intended to encourage common and shared aims among euro area countries and to instil discipline in policy-making. This matters as much for non-eurozone countries as for the eurozone. We recognise that any further steps towards economic and fiscal integration will require commensurate democratic and accountability structures to be put in place. The Expert Group's White Paper in 2017 will be crucial to getting this balance right. Further changes in this direction are likely to require treaty change. (Paragraph 96)

11. Although the UK is not a participant in Banking Union we fully support its aims. Achieving consensus on the long-term backstop for the Single Resolution Fund will require a balance to be struck between risk-sharing and risk reduction, both between taxpayers and the banking sector and among the Member States participating in Banking Union. We stress the importance of working towards a common fiscal backstop to the Single Resolution Fund and welcome the agreement of short-term bridging arrangements as an interim measure. (Paragraph 123)

12. Efforts to reduce risk in the banking sector are in principle welcome. The European Deposit Insurance Scheme would be a useful addition to the Banking Union architecture. Although we note the significant moral hazard concerns of countries such as Germany, we believe that pursuing risk reduction and risk-sharing in parallel would both reduce any actual moral hazard and ensure political buy-in for the measure. For this reason EDIS should be encouraged, but should not be thought of as a panacea. As with other retail deposit insurance schemes, the value of EDIS may ultimately lie more in the reassurance engendered by its existence rather than its practical benefits. (Paragraph 143)

13. We note that 'ring-fencing' of bank deposits continues despite the establishment of a single supervisor. This may have an effect on the efficient allocation of capital across the eurozone—insofar as EDIS may help to

alleviate the concerns of the supervisor and allow deposits to move across borders, it is to be welcomed. (Paragraph 144)

14. We welcome the risk reduction agenda for all 28 EU Member States. Our concern is that UK-based banks could be at a competitive disadvantage through not benefiting from the cover of European deposit insurance. We therefore urge the Government to remain vigilant in preserving the integrity of the Single Market. (Paragraph 145)

15. The Capital Markets Union is an EU-28 project and we continue to welcome it, as we did in our 2015 report Capital Markets Union: a welcome start. We noted then that it is likely to benefit the UK in particular. We now note that, properly constructed, it should produce added benefits for the resilience of the eurozone through spreading risk more evenly across countries and acting as a shock absorber, as happens in the United States. However, private risk-sharing is not a panacea and may have limited effect in a crisis. (Paragraph 154)

16. CMU is an aspect of risk-sharing—albeit private risk-sharing. Though included in the Five Presidents' Report, it is unlikely to be achieved in the short term. We are concerned that CMU will not make progress without agreement on tax and insolvency law, stimulating greater cross-border investment. We acknowledge that harmonising measures are likely and that a consequent need for additional institutional oversight may arise as a result of efforts to deepen financial integration. (Paragraph 155)

17. The Five Presidents' Report hints at the creation of a European Single Supervisor for capital markets, which would have ramifications for the UK and which we have previously opposed. However, the CMU Action Plan, presented by Commissioner Hill in 2015, did not mention this. Any ambiguity over the creation of a Single Supervisor is unhelpful. (Paragraph 156)

18. 'Fiscal Union' is not defined in the Five Presidents' Report. Perhaps this was deliberate but we are alarmed that such a key component of that report remains such a nebulous concept and was interpreted in so many different ways by our witnesses. (Paragraph 176)

19. Some form of stabilisation function would be necessary and this would entail transfers between Member States. The question is the level of those transfers and the trigger for making them. Because the EU does not have the sort of tax and expenditure powers that are the norm in Member States, it lacks a capacity for automatic stabilisers to function when there are cyclical upswings or downswings. Nor does it have permanent transfer mechanisms that provide equalisation. Neither appears to be politically feasible in the near future. The stabilisation mechanism proposed by the five Presidents, which would be automatic (so not contingent on a decision-making authority such as the Troika) but not permanent, and responding only to asymmetric shocks, seems a pragmatic way forward. (Paragraph 177)

20. We note that there may be higher political support for transfers responding to a cyclical shock rather than structural problems. Such an arrangement would need appropriate agreement at Member State level and some form of institutional oversight. The plans put forward at the moment are vague, although we note the suggestion of an unemployment reinsurance scheme to deal with cyclical, rather than structural, unemployment. A precondition

for any such system would be appropriate structural convergence, or at least coordination. (Paragraph 178)

21. Financial integration, through the completion of Banking Union and Capital Markets Union, may appear to be more achievable than a fiscal union in the short term. However, several challenges remain. These include a potentially ambitious risk reduction agenda before risk-sharing through EDIS takes place, and uncertainty surrounding the long term common backstop to the Single Resolution Mechanism. In addition, the opening of politically sensitive legislative agendas such as insolvency and tax, within the Capital Markets Union initiative, may limit private risk-sharing in the short term. (Paragraph 179)

22. We welcome the fact that the initiatives and programmes aimed at financial integration are already underway and can be completed without a major revision of the Treaties, or the creation of significant new institutions. These projects largely aim to reduce risk, though we note that a single backstop for Banking Union and the EDIS proposal entail a degree of risk-sharing. It is the risk-sharing elements that have proved the most controversial, and this suggests that any further 'fiscal union' that entails pooling of funds will be unlikely to succeed in the short term, and certainly not before significant risk reduction measures have been put in place. (Paragraph 180)

23. It is unclear how unified representation of the euro area in international fora will be achieved, and there appears to be opposition at Member State level, which may be difficult to overcome. The Commission has not made a convincing case for unified representation at the IMF. We note, however, that any further integration of the eurozone, including the issuance of common debt, may require unified representation of eurozone interests at the international level. (Paragraph 193)

24. While the proposal for external representation has been included by the five Presidents among their plans for strengthening democratic accountability, the proposal is in reality more of an institutional reform aimed at rationalising the eurozone's role on the world stage. However, what looks like a worthwhile administrative reform may be at odds with the desire to enhance democratic accountability, if it takes decision-making away from decision-makers at the national level. The challenge will be to establish appropriate and accountable eurozone-level decision-making structures. (Paragraph 194)

25. The plans for strengthening the Eurogroup are currently very speculative and could develop in different ways, depending what is decided about a eurozone treasury and 'fiscal union'. (Paragraph 204)

26. Although our witnesses were divided on the extent to which caucusing currently takes place (or might take place in the future), we note that a stronger Eurogroup, along with the forthcoming changes to the QMV procedure, may make mechanisms to protect the position of non-euro area Member States all the more important. Notwithstanding what was agreed at the February 2016 European Council, the Government should remain alert to the impact that a formalised Eurogroup might have on the UK's position and should do everything in its power to ensure that the UK is protected. (Paragraph 205)

27. We agree that it is primarily for eurozone Member States to decide the appropriate mechanism of democratic accountability that is needed to

support their chosen level of fiscal integration. Fiscal integration as developed through the design of EMU and accelerated through crisis mechanisms has resulted in significantly more sovereignty pooling, yet democratic structures and processes have not developed commensurately. This lack of democratic structures or processes undermines the legitimacy of EMU in the eyes of the very citizens in whose name it has been developed. (Paragraph 222)

28. It will be vital that the creation of any new accountability structure, whether that is a treasury, a finance minister, a new formation of the European Parliament, or a new role for national parliaments, should be accompanied by a clear mandate from the citizens of the eurozone countries. (Paragraph 223)

29. The challenges to achieving any of the proposals set out by the five Presidents for Stage 2 of completing EMU remain significant. Eurozone Member States must first reach consensus on the balance between risk-reduction (or fiscal discipline) and risk-sharing, and on the appropriate mechanisms to achieve that balance. They must then agree on the democratic accountability structures or processes to support those mechanisms. Treaty change will be required to implement any significant change and this will require referendums in many Member States, the results of which will not be guaranteed. We doubt this will be done quickly: the five Presidents' suggested target date of 2025 appears ambitious. (Paragraph 227)

30. The creation of a eurozone parliament, treasury or finance minister will require treaty change; and any treaty change requires the unanimous consent of all 28 Member States including the UK. Thus there will be an opportunity for the Government of the day to ensure that UK interests are preserved if the UK remains a member of the EU after the referendum. (Paragraph 232)

31. The UK renegotiation deal foresees its terms being incorporated into the Treaties at their next revision. The five Presidents' more fundamental proposals to enhance the functioning of the eurozone would, by requiring treaty change, provide an opportunity for the Government to entrench the settlement in EU law while at the same time ensuring that the protections secured were not undermined by the development of new institutions. (Paragraph 235)

APPENDIX 1: LIST OF MEMBERS AND DECLARATIONS OF INTEREST

Members

Lord Borwick
Lord Butler of Brockwell
Earl of Caithness
Lord Davies of Stamford
Baroness Falkner of Margravine (Chairman)
Lord Haskins
Baroness Kingsmill
Lord Lawson of Blaby*
Earl of Lindsay
Lord McFall of Alcluith
Lord Shutt of Greetland
Lord Skidelsky

* Resigned as a Member of the Sub-Committee on 4 March 2016.

Declarations of Interest

Lord Borwick

Directorships:

Partner, Federated Investments LLP (holding partnership engaged in real estate) with directorships in its subsidiaries: Bicester Lane Ltd and its 50% subsidiary Countryside Properties (Bicester) Ltd (housing development in Bicester, Oxfordshire); Federated Management Ltd (property management); Love Lane Investments Ltd (property investment); Mayfield Market Towns Ltd (housing development in Sussex).

Chairman, Poore Ltd (holding company).

Chairman, Second Poore Ltd (holding company) and Director of its subsidiary: Federated Trust Corporation Ltd.

Shareholdings:

Poore Ltd (holding company limited by guarantee).

Second Poore Ltd (holding company limited by guarantee).

Hansa Trust plc (investment trust).

Income is received from a London swimming school.

Farmland in Bellshill, Scotland, for future housing development.

The Member's wife worked part time as an administrator for Open Europe until March 2015, when she gave up that job to become an MP.

Trustee of a Trust which has given charitable funds for research to Open Europe in the past.

Lord Boswell of Aynho (Chairman of the EU Select Committee—attended the Sub-Committee's meeting on 2 March 2016)

Personal shareholdings in both UK and euro-area securities.

Lord Butler of Brockwell

Adviser to TT International.

Earl of Caithness

No relevant interests declared.

Lord Davies of Stamford

Owns a flat in France (sometimes rented out).

Land let for grazing in Lincolnshire.

In receipt of agricultural support provision under the Common Agricultural Policy in relation to land in Lincolnshire.

Baroness Falkner of Margravine (Chair)

House in Italy owned jointly with husband.

British Member, Anglo-German Conference (Koenigswinter).

Member, Advisory Board, British Influence (campaigning for leadership in Europe).

Lord Haskins

No relevant interests declared.

Baroness Kingsmill

No relevant interests declared.

Lord Lawson of Blaby*

President, Conservatives for Britain.

House in France.

Chairman, Vote Leave (Brexit campaign) (interest ceased 8 March 2016).

Earl of Lindsay

Chairman, United Kingdom Accreditation Service (UKAS).

Chairman, BPI Pension Trustees Limited.

Lord McFall of Alcluith

No relevant interests declared.

Lord Shutt of Greetland

Shareholding in Bank of Ireland (spouse).

House in Ireland, owned jointly with wife.

Lord Skidelsky

No relevant interests declared.

* Resigned as a Member of the Sub-Committee on 4 March 2016.

The following Members of the European Union Select Committee attended the meeting at which the report was approved:

Lord Blair of Boughton
Lord Borwick
Lord Boswell of Aynho (Chairman)
Earl of Caithness
Lord Davies of Stamford
Baroness Falkner of Margravine
Lord Jay of Ewelme
Baroness Prashar
Baroness Suttie
Lord Tugendhat
Lord Whitty
Baroness Wilcox

During consideration of the report the following Members declared an interest:

Lord Boswell of Aynho (Chair)

Personal shareholdings in both UK and euro-area securities.

A full list of Members' interests can be found in the Register of Lords Interests:

http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/

The Specialist Adviser to the Sub-Committee for the inquiry was:

Professor Iain Begg

Iain Begg is a Professorial Research Fellow at the European Institute, London School of Economics and Political Science. His main research work is on the political economy of European integration and EU economic governance. He has directed and participated in a series of research projects on different facets of EU policy and his current projects include studies on the governance of EU economic and social policy, the EU's Europe 2020 strategy, evaluation of EU cohesion policy and reform of the EU budget. Other recent research projects include work on policy co-ordination under EMU and the social impact of globalisation.

Professor Begg is a contributor to the UK in a Changing Europe initiative (funded by the UK's Economic and Social Research Council).

APPENDIX 2: LIST OF WITNESSES

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

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

Oral evidence in chronological order

*	Graham Bishop, Independent Consultant and Philippe Legrain, Independent Writer, Commentator, Consultant and Public Speaker	QQ 1–14
**	Dr Dermot Hodson, Reader in Political Economy, Birkbeck, University of London	
*	Baroness Bowles of Berkhamsted, Member of the House of Lords and former MEP and Chair of the Economic and Monetary Affairs Committee and Raoul Ruparel, Co-Director, Open Europe	QQ 15-26
*	Martin Sandbu, Economics leader writer, The Financial Times; Janet Henry, Global Chief Economist, HSBC; Sebastian Barnes, Economic Counsellor to the Chief Economist, OECD and Henning Christophersen, Senior Partner, Kreab and former Deputy Prime Minister of Denmark	QQ 27-44
*	Christian Odendahl, Chief Economist, Centre for European Reform	QQ 45-55
*	Professor Lorenzo Codogno, Visiting Professor in Practice, LSE and Reza Moghadam, Vice-Chairman in Global Capital Markets, Morgan Stanley	QQ 56-67
*	Megan Greene, Chief Global Economist at Manulife Asset Management, Professor Erik Jones, Professor of European Studies and International Political Economy, Johns Hopkins University and John Peet, Political Editor, The Economist	QQ 68-81
*	Markus Ferber MEP and Kay Swinburne MEP	QQ 82-91
**	Sylvie Goulard MEP	QQ 92-100
*	Gunnar Hökmark MEP	
*	Roberto Gualtieri MEP	QQ 101-107
*	Thomas Wieser, Chair of the Economic and Financial Committee, European Council	QQ 108-117
*	Fabian Zuleeg, Chief Executive, European Policy Centre, Guntram Wolff, Director, Bruegel, and Hans Hack, Managing Director at FTI Consulting Brussels	QQ 118-128
*	Veronica Nilsson, Confederal Secretary, ETUC	QQ 129-140

*	Mike Vercnocke, Head of European Affairs, City of London	QQ 141-157
*	Commissioner Valdis Dombrovskis, Vice-President for the Euro and Social Dialogue, European Commission	QQ 158-166
**	Dr Andrew Lilico, Executive Director and Principal, Europe Economics	QQ 167-178
*	Professor Lucia Quaglia, Department of Politics, University of York and David Marsh, Managing Director, Official Monetary and Financial Institutions Forum	
*	Professor Paul De Grauwe, John Paulson Chair in European Political Economy, LSE, and Alex White, Director, Country Analysis, The Economist Intelligence Unit	QQ 179-185
*	Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England and Andrew Bailey, Chief Executive of the PRA and Deputy Governor for Prudential Regulation, Bank of England	QQ 186-194
*	David Gauke, MP, Financial Secretary to the Treasury and Jonathan Black, Director - Europe, HM Treasury	QQ 195-204
*	Professor Otmar Issing, President, Center for Financial Studies	QQ 205-214

Evidence was also taken from the following witness off the record:

- Poul Thomsen, Europe Director, IMF

Alphabetical list of all witnesses

*	Andrew Bailey, Chief Executive of the PRA and Deputy Governor for Prudential Regulation, Bank of England (QQ 186-194)	
*	Sebastian Barnes, Economic Counsellor to the Chief Economist, OECD (QQ 27–44)	
	BBA	EMU0008
*	Graham Bishop, Independent Consultant (QQ 1–14)	
*	Jonathan Black, Director - Europe, HM Treasury (QQ 195–204)	
*	Baroness Bowles of Berkhamsted, Member of the House of Lords and former MEP and Chair of the Economic and Monetary Affairs Committee (QQ 15–26)	
	Bruegel (incorporating contributions from Zsolt Darvas and Álvaro Leandro; André Sapir and Guntram Wolff; and Dirk Schoenmaker)	EMU0005

*	Henning Christophersen, Senior Partner, Kreab and former Deputy Prime Minister of Denmark (QQ 27–44)	
*	Professor Lorenzo Codogno, Visiting Professor in Practice, LSE (QQ 56–67)	
*	Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England (QQ 186–194)	
	Dr Marek Dabrowski	EMU0010
	Anneliese Dodds MEP	EMU0006
*	Professor Paul De Grauwe, John Paulson Chair in European Political Economy, LSE (QQ 179–185)	
*	Commissioner Valdis Dombrovskis, Vice-President for the Euro and Social Dialogue, European Commission (QQ 158–166)	
	European Economics & Financial Centre	EMU0009
*	Markus Ferber MEP (QQ 82–91)	
*	David Gauke, MP, Financial Secretary to the Treasury (QQ 195–204)	
**	Sylvie Goulard MEP (QQ 92–100)	EMU0011
*	Megan Greene, Chief Global Economist at Manulife Asset Management (QQ 68–81)	
*	Roberto Gualtieri MEP (QQ 101–107)	
*	Hans Hack, Managing Director at FTI Consulting Brussels (QQ 118–128)	
*	Janet Henry, Global Chief Economist, HSBC (QQ 27–44)	
**	Dr Dermot Hodson, Reader in Political Economy, Birkbeck, University of London (QQ 1–14)	EMU0002
*	Gunnar Hökmark MEP (QQ 92–100)	
*	Professor Otmar Issing, President, Center for Financial Studies (QQ 205–214)	
*	Professor Erik Jones, Professor of European Studies and International Political Economy, Johns Hopkins University (QQ 68–81)	
*	Philippe Legrain, Independent Writer, Commentator, Consultant and Public Speaker (QQ 1–14)	
**	Dr Andrew Lilico, Executive Director and Principal, Europe Economics (QQ 167–178)	EMU0001

*	David Marsh, Managing Director, Official Monetary and Financial Institutions Forum (QQ 167–178)	
*	Reza Moghadam, Vice-Chairman in Global Capital Markets, Morgan Stanley (QQ 56–67)	
*	Veronica Nilsson, Confederal Secretary, ETUC (QQ 129–140)	
*	Christian Odendahl, Chief Economist, Centre for European Reform (QQ 45–55)	
*	John Peet, Political Editor, The Economist (QQ 68–81)	
*	Professor Lucia Quaglia, Department of Politics, University of York (QQ 167–178)	
	Professor John Ryan	EMU0007
*	Raoul Ruparel, Co-Director, Open Europe (QQ 15–26)	
*	Martin Sandbu, Economics leader writer, The Financial Times (QQ 27–44)	
	Dr Waltraud Schelkle	EMU0004
*	Kay Swinburne MEP (QQ 82–91)	
*	Mike Vercnocke, Head of European Affairs, City of London (QQ 141–157)	
*	Alex White, Director, Country Analysis, The Economist Intelligence Unit (QQ 179–185)	
	Professor Michael Wickens	EMU0003
*	Thomas Wieser, Chair of the Economic and Financial Committee, European Council (QQ 108–117)	
*	Guntram Wolff, Director, Bruegel (QQ 118–128)	
*	Fabian Zuleeg, Chief Executive, European Policy Centre (QQ 118–128)	

APPENDIX 3: CALL FOR EVIDENCE

The House of Lords EU Financial Affairs Sub-Committee, chaired by Baroness Falkner of Margravine, is conducting an inquiry into the steps laid out in the Five Presidents' report 'Completing Europe's Economic and Monetary Union' and particularly the possible implications for the UK. The Committee invites interested individuals and organisations to submit evidence to this inquiry.

Written evidence is sought by 25 November 2015. Public hearings will be held from December to February 2016. The Committee aims to report to the House, with recommendations, in May 2016. The report will receive a response from the Government, and may be debated in the House.

Background

Europe's Economic and Monetary Union (EMU) is often described as a house built over decades that is only partially finished. EMU is designed to bring the EU towards closer economic and political integration, but the recent financial and sovereign debt crisis has put greater emphasis on integrating euro area Member States further and on seeking agreement on the political direction of the Eurozone.

While EMU involves notably the single currency, the euro area, and an independent monetary policy run by the European Central Bank, EMU also sets fiscal rules for all EU Member States, including the UK. The EU has in recent years enhanced economic policy coordination and surveillance mechanisms to ensure macroeconomic growth and stability. While much of the Five Presidents' report and the Commission Communication of 21 October focuses on the euro area, both documents identify that the process of creating a deeper EMU is open to all EU Member States. The report and the Commission Communication argue that the process should be transparent and preserve the integrity of the Single Market in all its aspects. As the debate between members of the euro area progresses it is important that the interests of non-euro area Member States, including the UK, are also respected.

The Five Presidents' report "Completing Europe's Economic and Monetary Union" was published on 22 June 2015 and was presented at the June 2015 European Council. The report builds on a previous report 'Towards a Genuine Economic and Monetary Union' published by the Four Presidents in December 2012 that laid out plans to build an integrated economic, budgetary and financial framework, commensurate with progress on democratic legitimacy and accountability. The Five Presidents' report was prepared at the request of the Euro Summit of October 2014 and the European Council of December 2014. The Euro Summit in particular underscored the fact that closer coordination of economic policies was necessary to improve the functioning of EMU, while work should continue to look at mechanisms not only to support stronger economic policy coordination but to facilitate convergence and solidarity. The Five Presidents' report states that euro area Member States are undergoing 'Stage 1' reforms scheduled to run between July 2015 and 30 June 2017. They call the process 'Deepening by doing' and the five Presidents emphasise boosting competitiveness, structural convergence, completing the Banking Union and enhancing democratic accountability. The Commission Communication, published 21 October 2015, sets out the package of measures to implement these plans.

The European Commission has brought forward a revised approach to the European Semester, as well as plans to introduce National Competitiveness Boards and an advisory European Fiscal Board as tools to strengthen the economic governance framework. The European Commission has also published a proposal to move to a unified representation for the euro area in the International Monetary Fund with the President of the Eurogroup as the representative for the euro area. In addition, various steps are proposed to complete Banking Union.

The Committee will examine the new recommendations and proposals in the European Commission's Communication that seek to introduce mechanisms to improve and foster greater coordination and convergence in EMU and wish to identify the potential positive and negative impacts to the UK. At the same time, the Committee will explore how EMU can be completed over the long term to meet global challenges and lead to economic prosperity for all EU Member States through the economic, budgetary and financial frameworks. The initiatives the Commission has identified will be directly and indirectly relevant to the UK and this inquiry therefore seeks to:

- Take stock of the reforms that have been put in place further to integrate economic budgetary and financial frameworks in EMU and consider the degree of flexibility and conditionality in the economic governance framework;
- Review the steps proposed to improve the European Semester, and analyse how effective and credible the fiscal and macroeconomic coordination and surveillance tools have been since they came into force;
- Consider the design of National Competitiveness Boards and an advisory European Fiscal Board to explore how they aim to contribute to economic and fiscal convergence, and review possible paths for achieving fiscal union through a strengthened governance framework;
- Review forthcoming proposals to complete the Banking Union, and take note of any mechanisms to bolster the crisis management framework;
- Examine possible strengthening of euro area external representation in the IMF with a view to understanding the future role of the euro in the global financial architecture and to identify any direct or indirect impact to the UK;
- Reflect on the role of the ECB and whether it needs to be better codified in the economic governance framework;
- Contribute to the debate on enhancing democratic accountability, legitimacy and institutional strengthening;
- Establish whether the balance is right between what is required of euro area Member States and non-euro area Member States.

The Committee will be interested to examine the impact of these issues on the non-euro area Member States, particularly the UK including the City of London.

Issues

The Committee seeks evidence on the following questions in particular.

Economic Union: coordination, surveillance and convergence

1. Is economic and fiscal policy coordination and surveillance working effectively in the European Union, both for euro area Member States and non-euro Member States? Is greater 'structural convergence' necessary to build a resilient and smooth-functioning EMU?

2. What is your assessment of the European Semester? What can be done to strengthen the implementation of Country Specific Recommendations and boost national ownership of reforms? Should the Macroeconomic Imbalance Procedure be given greater importance?

3. What are the merits of the recommendation by the European Commission to introduce a euro area system of National Competitiveness Boards? How should non-euro area Member States participate in plans to enhance policy coordination and surveillance of competitiveness developments across the wider EU?

4. How should the European Commission reduce complexity and increase transparency of fiscal rules and the application of them? To what extent does the Stability and Growth Pact achieve a balance with respect to creating flexibility and maintaining credibility?

Completing Banking Union

5. How should the Banking Union be completed? Is there merit in the European Deposit Insurance Scheme proposed by the five Presidents?

6. In what ways can the EU's financial framework be strengthened to reduce the negative sovereign-bank feedback loop?

7. What is the ECB's role in the future of the EMU governance framework?

8. What solutions should be proposed to create an adequate bridge financing mechanism, should resources in the Single Resolution Fund not suffice in the short term? In what ways can the euro area create a resilient common backstop for the Single Resolution Fund?

9. What could EU institutions have done differently in the context of the instability in Greece in 2015 to respond to the escalating funding crisis?

A path toward Fiscal Union

10. What are the advantages and challenges associated with the creation of an advisory European Fiscal Board?

11. What is your understanding of a fiscal union? What type of fiscal union is appropriate or achievable for the euro area based on the political capacity available?

12. Is a fiscal stabilisation function necessary and achievable?

Democratic accountability, legitimacy, institutional strengthening and implications for the UK

13. What are the implications of the euro area unifying its external representation on issues such as programmes, reviews, economic and fiscal policy, macroeconomic surveillance, exchange rate policies and financial stability in the International Monetary Fund? How would this proposal affect the UK and other non-euro area Member States?

14. What areas of EMU governance are ripe for institutional strengthening? What are the consequences of introducing intergovernmental agreements (such as those establishing the ESM and the Single Resolution Fund) into the EU community framework? What are the implications for non-euro area Member States?

15. How should democratic accountability be enhanced if decision making is pooled across the euro area? Is democratic legitimacy weakened by the complexity of the crisis management framework?

16. How will the UK and other non-euro area Member States be affected by initiatives put forward by the European Commission and Five Presidents' report? What effects will this have on the City of London?

You need not address all of these questions.

APPENDIX 4: SHORT-TERM PROPOSALS EMANATING FROM THE FIVE PRESIDENTS' REPORT, TO BE COMPLETED BY JUNE 2017

Five Presidents' proposal	Thematic heading	Steps taken by the Commission	Timetable/state of play
Creation of a euro area system of Competitiveness Authorities	Economic Union	The Commission issued a Recommendation on 21 October 2015 on the establishment of National Competitiveness Boards within the Euro Area. Non-euro area Member States are also encouraged to establish such boards.	Ongoing. For instance, the UK is still considering whether to establish a board.
Strengthened implementation of the Macroeconomic Imbalances Procedure	Economic Union	The Commission Communication says that it will ensure greater transparency in the MIP through publication of more data and explicit justification of decisions taken. The Commission also calls for stronger follow-up of excessive imbalances. It will engage with Competitiveness Boards on how best to address imbalances.	Ongoing.

Five Presidents' proposal	Thematic heading	Steps taken by the Commission	Timetable/state of play
Greater focus on employment and social performance	Economic Union	Further emphasis is being placed on these aspects as part of the European Semester. "Social" indicators have been added to the Macroeconomic Imbalances Procedure Scoreboard.	Introduced in the current European Semester cycle.
Stronger coordination of economic policies within a revamped European Semester	Economic Union/ Democratic accountability	Following the October Communication the Commission introduced a specific discussion of the fiscal, economic, social and financial priorities for the euro area as a whole as part of its November Annual Growth Survey. The aim was to discuss overarching matters early in order to provide orientations for country-specific programmes in the spring.	Implemented in November 2015.

Five Presidents' proposal	Thematic heading	Steps taken by the Commission	Timetable/state of play
Setting up bridge financing for the Single Resolution Fund (SRF)	Financial Union	The Fund is designed to be built up gradually through Member State contributions raised from the banking industry. In the meantime bridge financing will be necessary. This was agreed by Ministers at ECOFIN in December 2015.	In place since 1 January 2016.
Implementing concrete steps towards the common backstop to the SRF	Financial Union	The Commission has encouraged discussion among Member States of the creation of a more robust backstop via the ESM.	Ministers agreed in principle to the creation of a common backstop, to be operational at the end of the transitional period, at the ECOFIN meeting of 8 December 2015. The Council statement makes no mention of the ESM.
Agreeing on a common Deposit Insurance Scheme	Financial Union	A legislative proposal to establish a European Deposit Insurance Scheme was published on 26 November.	Negotiations are ongoing and are being treated as a priority by the Dutch Presidency of the EU in the first semester of 2016.
Improving the effectiveness of the instrument for direct bank recapitalisation in the European Stability Mechanism (ESM)	Financial Union	This was not mentioned in the October or November documents.	None.

Five Presidents' proposal	Thematic heading	Steps taken by the Commission	Timetable/state of play
A new advisory European Fiscal Board	Fiscal Union	This was adopted by a Commission Decision on 21 October. Originally the Head of Secretariat was to be the Commission's Chief Economic Analyst. An amendment of 12 February 2016 separated the roles.	The Board has been established but not yet appointed and is therefore not operational.
Strengthen parliamentary control as part of the European Semester and Increase the level of cooperation between the European Parliament and national parliaments	Democratic accountability	The Communication notes work to enhance "Economic dialogues" between the EP, Commission, Council and Eurogroup, the participation of national parliament representatives in the European Parliamentary Week and the right of national parliaments to "convene a Commissioner" to present the Commission's opinion on a draft budgetary plan. It suggests further engagement by Commissioners with the EP and more efficient interaction with national parliaments.	This is largely in the hands of individual Member State parliaments and the European Parliament. The 2016 European Parliamentary Week took place in February. We are not currently aware of any national parliaments stepping up engagement with Commissioners in respect of draft budgetary plans.

Five Presidents' proposal	Thematic heading	Steps taken by the Commission	Timetable/state of play
Reinforce the steer of the Eurogroup (by increasing its involvement in the European Semester and "a reinforcement of its presidency and means at its disposal".	Democratic accountability	The role of the Eurogroup in the revamped European Semester is described above. No plans have yet emerged to reinforce the presidency.	None.
Take steps towards a consolidated external representation of the euro area	Democratic accountability	A Commission Communication was published on 21 October, alongside a proposal for a Council Decision on unified representation of the euro area at the International Monetary Fund (IMF).	No agreement has yet been reached on the IMF proposal.
Integrate into EU law the TSCG, relevant parts of the Euro Plus Pact and the Inter-governmental Agreement on the SRF	Democratic accountability	The Communication of 21 October mentions a review of the transposition of the Fiscal Compact into national law but nothing about incorporating the TSCG into EU law.	No review has taken place.

APPENDIX 5: INTERPRETATIONS OF 'FISCAL UNION'

Our witnesses provided a variety of interpretations of 'fiscal union'. A range of them is included below.

Dr Dermot Hodson told us that the term fiscal union did not have a "stable" meaning and that it was interpreted differently by different people. He said that for some, fiscal union meant "some sort of fiscal stabilisation mechanism, so a centralised budget; for others, it means strong, central oversight of national fiscal rules." He said "to the extent that [the Five Presidents' Report] talks about anything that looks like fiscal union, is talking about the possibility of some sort of stabilisation mechanism eventually, although it does not really go into detail on that."[257]

Christian Odendahl said that he saw fiscal union as some sort of "risk pooling or transfer".[258]

Sir Jon Cunliffe said that to him, "fiscal union", meant that "some of the sovereignty for taking fiscal decisions is moved up to the supra-national level, and, secondly, that those decisions that are taken at the supra-national level would include the fiscal choices that individual members of the monetary union make."[259]

Fabian Zuleeg told us that "a union implies a very high degree of integrated policy-making, which I am not sure fiscal union always refers to." He said there were some minimal requirements that include some form of risk-sharing and some mechanisms to deal with ex ante and ex post shocks. He considered that a transfer element was an essential part of fiscal union.[260]

Philippe Legrain told us that "people will use the phrase "fiscal union", which sounds to some people as though you are creating a common fiscal authority with tax-raising, spending and borrowing powers." He said "Wolfgang Schäuble is saying that you need a super-Commissioner, a eurozone Finance Minister, who will simply be able to enforce the existing fiscal rules more stringently on national budgets. That is not a fiscal union of the sort an economist would recognise."[261]

Gunnar Hökmark MEP took a similar line and said that "the discussion on fiscal union seems to me to be more centralistic than in the true meaning of the word "federalist". He told us "a lot of people are sure they know what fiscal union is until they are asked what it is, and a lot of people want it until they get it." He said that he supported having a fiscal union regarding the Stability and Growth Pact, with "clear rules on balanced public spending." However he maintained that "as soon as we enter other steps, you are in some way bringing up decisions about spending that are better on either a local or a national level. That is very much because our different welfare societies are looking very different."[262]

Dr Marek Dabrowski interpreted fiscal union as including a variety of mechanisms. He said fiscal union could be defined in very broad terms as a transfer of fiscal policy from the national to the supranational level. He noted that by using this definition, one could conclude that the EU budget was a form of fiscal union, albeit a very small one. Aside from the existence of a common budget, the EU

257 Q 9
258 Q 54
259 Q 192
260 Q 120
261 Q 3
262 Q 100

fiscal union included "cross-country fiscal transfers, some elements of federal taxation, partial tax harmonization, fiscal discipline rules … fiscal crisis resolution mechanism and federal bailout facilities."[263]

Guntram Wolff argued that the eurozone was "clearly not at a stage where we want to have large redistributions around the union, where money flows from one country to another" but supported an automatic stabilisation mechanism, such as an unemployment reinsurance scheme. He considered that a fiscal union might take the form of a stabilisation function because proposals to coordinate fiscal policy and to achieve a euro area fiscal stance, though desirable, were extremely difficult.[264]

The Minister told us that he thought fiscal union embodied "closer co-operation between Member States to ensure that the fiscal risks of having a common currency are more closely shared. Within that, there are different ways one can do that." He said "some would argue that this is about the Stability and Growth Pact and about ensuring that there are rules in place among members of fiscal union as to how they behave. Others would argue that it is more about fiscal transfers between richer parts of a fiscal union towards poorer parts."[265]

263 Written evidence from Dr Marek Dabrowski (EMU0010)
264 Q 120
265 Q 203

APPENDIX 6: GLOSSARY

AGS	Annual Growth Survey
AMR	Alert Mechanism Report
Asymmetric shock	A shock which only affects one economy (or a small minority of economies such as those within the eurozone) more than the rest, perhaps because a key industry encounters difficulties or there is a natural disaster.
Automatic [fiscal] stabiliser	Budgetary instruments that help to stabilise economic conditions and output without explicit intervention of a country's fiscal authority. Examples are taxes, unemployment benefits and interest rates.
Bail-in	The means by which shareholders, bondholders and some depositors will be required to contribute to the costs of bank failure.
BBA	British Bankers' Association
BRRD	Bank Recovery and Resolution Directive
Capital Markets Union	The Capital Markets Union (CMU) is a European Commission project to mobilise capital in Europe by breaking down barriers to investment.
CMU	Capital Markets Union
Conditionality	Requiring a recipient of financial support to undertake specific policy actions in order to receive the funds.
Counter-cyclical policy	A policy that opposes the trend of an economic cycle.
Covered deposits	According to a definition from the Financial Stability Board: "Covered deposits are those eligible deposits that are actually covered or insured by a deposit insurance scheme (i.e. they comply with the eligibility criteria for inclusion and the value of the deposits fall within the maximum coverage limit)."[266] Deposits are covered up to €100.000 in the EU.
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
CSR	Country-specific recommendation
DGS	Deposit Guarantee Scheme

DGSD	Deposit Guarantee Scheme Directive
Direct Recapitalisation Instrument	This instrument allows the European Stability Mechanism to recapitalise a systemic and viable euro area financial institution directly under specific circumstances as a last resort measure.
ECB	European Central Bank.
ECOFIN	Economic and Financial Affairs Council, the chief economic and financial decision-making body for EU government.
ECON	European Parliament Economic and Monetary Affairs Committee.
EDIS	European Deposit Insurance Scheme
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EMU	Economic and Monetary Union
ESRB	European Systemic Risk Board
ESM	European Stability Mechanism
EU	European Union
Eurobill	A proposal for common issuance by euro area Member States of short-term government debt with a maturity of up to one to two years.
Eurobond	A proposed principal form of public debt open to all members of the eurozone, jointly and severally guaranteed by all participating Member States.
European Fund for Strategic Investment	The Investment Plan for Europe or 'Juncker Plan' aims to revive investment in strategic projects around Europe by mobilizing €315 billion for the period 2015–2017.
Eurogroup	An informal body that brings together the finance ministers of countries whose currency is the euro.
European Commission	The executive of the European Union.
European Council	The European Council is the EU institution that defines the general political direction and priorities of the European Union.

Euro-Plus Pact	The Euro Plus Pact is an intergovernmental initiative that was endorsed by the European Council on 25 March 2011. All signatories are committed to implementing a set of reforms that address economic and financial imbalances.
European Semester	The European Semester is the EU's annual economic policy coordination cycle that involves policy guidance and surveillance.
Euro Summit	The Euro Summit brings together the heads of state or government of the euro area countries, the Euro Summit President and the President of the European Commission. Euro Summit meetings provide strategic guidelines on euro area economic policy.
Eurozone	Monetary union of European Union Member States.
Fiscal Compact	The fiscal part of the Treaty on Stability, Coordination and Governance. It is an intergovernmental treaty, signed on 2 March 2012, that aims to reinforce the economic pillar of Economic and Monetary Union by adopting a set of rules intended to foster budgetary discipline. The Fiscal Compact requires signatories to spell out how they will reach their medium-term objectives and prescribes pathways to achieving those objectives.
Flexicurity	Flexicurity is an integrated strategy for enhancing, at the same time, flexibility and security in the labour market
Four Presidents	The President of the European Council, Herman Van Rompuy, President of the European Commission, Jose Manuel Barroso, the President of the Eurogroup, Jean-Claude Juncker, and President of the European Central Bank, Mario Draghi.

Five Presidents	The authors of the Five Presidents' Report were: European Commission President Jean-Claude Juncker, the President of the Euro Summit, Donald Tusk, the President of the Eurogroup, Jeroen Dijsselbloem, the President of the European Central Bank, Mario Draghi, and the President of the European Parliament, Martin Schulz.
GDP	Gross Domestic Product
Green Paper	Green Papers are consultation documents produced by the Government or the European Commission.
IMF	International Monetary Fund
LTROs	Long-Term Refinancing Operations
Macroeconomics	A branch of economics that studies how the aggregate economy behaves
Macroeconomic imbalances	These can be interpreted as features of an economy which are incompatible with a sustainable macroeconomic trajectory. They include asset bubbles, trade deficits, excessive debt and a range of other problems
Medium-term objective	Medium term objective. In order to pursue sound fiscal policies and ensure a sustainable budgetary position over an economic cycle, each EU Member State is set a budgetary target, known as a medium-term budgetary objective (MTO). MTOs are defined in structural terms. This means that they take into consideration business cycle swings and filter out the effects of one-off and other temporary measures.
Mercantilism	An economic theory and practice whereby the government regulates an economy to increase wealth by maximising net exports.
MEP	Member of the European Parliament
MIP	Macroeconomic imbalances procedure
MTO	Medium-term objective
OECD	The Organisation for Economic Co-operation and Development
Oligopoly	A market or industry which is dominated by a small number of firms.
OMTs	Outright Monetary Transactions.

Pro-cyclical policy	A policy that accentuates the economic cycle by increasing aggregate demand in periods of above average growth and cutting in periods of downturn.
QMV	Qualified Majority Voting
Resolution	The process by which a failing bank is dealt with so as to avoid knock-on effects on other financial intermediaries that lead to systemic problems in the financial sector.
SGP	Stability and Growth Pact
Single Resolution Board	The Single Resolution Board has been created to respond to the Euro area crisis and establishes one of the pillars of the Banking Union
Six-pack	Five regulations and a directive aiming to create tighter discipline on public finances.
Sovereign debt	Debt that is issued by a national government.
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TFEU	Treaty on the Functioning of the European Union. The Treaty entered into force on 1 December 2009.
Troika	A decision group formed by the European Commission, European Central Bank and the International Monetary Fund
TSCG	Treaty on Stability, Coordination and Governance
Two-pack	These two regulations apply only to the euro area, ensuring closer oversight of the public finances of euro area members, notably through the obligation to submit draft budgets to the Commission for scrutiny.
White Paper	White papers are policy documents produced by the Government or the European Commission that set out their proposals for future legislation.

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