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THE EURO AREA CRISIS – AN UPDATE

Thank you for the opportunity to appear before the House of Lords European Union Committee on 5 February 2013 and discuss developments in the euro area, as well as your follow-up letter of 13 February 2013. I am writing in response to the questions you raised, although almost all of the questions were actually covered when I appeared before your Committee. Where this is the case, I have set out my oral answers below for the benefit of the Committee.

EU policymakers' commitment

You asked whether I perceived a degree of complacency amongst European leaders and policy makers and what needed to be done to ensure that the commitment remains to take the steps needed to tackle the crisis.

As I noted when I appeared before your Committee, a significant amount of progress has been made in a number of policy areas. The institutional framework for monetary union has already been strengthened; more recently, the ECB's announcement of its Outright Monetary Transaction (OMT) mechanism, and its clear commitment to stand behind the euro, made an important contribution to improved market confidence. There has also been some progress on Banking Union though we look forward to more.

I agree that the key issue for euro area leaders and policy makers is to maintain momentum, building on what has been achieved to date, and to stand ready to do more were the situation to deteriorate again.

The ECB and Outright Monetary Transactions (OMT)

You asked about the risks of the ECB's role under its Outright Monetary Transactions (OMTs) programme and what may happen if a country



engaged in an OMT bond-buying programme resiles on its agreed reforms.

You will be aware that the EU Treaty provides for the independence of the ECB from EU institutions and national governments, a principle which I will respect by not commenting on the relative merits of different policy options. However, as I said when I appeared before your Committee, I strongly welcome the ECB's commitment to do what they can to ensure the proper functioning of the euro area monetary union, and the reassurance that this appears to have given to markets – though, of course, it has not, to date, been necessary to test the programme's implementation.

I note that the ECB has made clear that its non-standard measures, including OMTs, cannot be considered an alternative to Member States undertaking necessary economic reforms and moving towards greater fiscal sustainability; OMTs themselves will only be considered to the extent they are warranted from a monetary policy perspective. This is one of the reasons why the ECB has decided that a necessary condition for OMTs is strict and effective conditionality attached to an appropriate European Financial Stability Facility (EFSF) or European Stability Mechanism (ESM) programme.

European Stability Mechanism (ESM)/Bank recapitalisation

You asked whether I disagreed with the statement made by Finance Ministers of Finland, Germany and the Netherlands as well as the Commission's revised proposal to have Member States make good the losses of private banks before they are recapitalised by the ESM. You also asked what steps I believed now needed to be taken if the link between sovereign states and banks was decisively to be broken.

As I said when I appeared before your Committee: I think the common ambition here has to be to break the link between banks and sovereigns and that is the purpose of a single supervisory mechanism and the further reforms that are being made. We have embarked on that. We have not completed it but our shared ambition has to be to make sure that you can have confidence that there will not be contagion between the two.

UK credit ratings and wider implications

You asked how important the UK's AAA rating was from the Government's perspective.

The credit rating is one important benchmark for any country, but the credibility of a government's economic strategy is tested continuously by financial markets. On 22 February 2013 Moody's downgraded the UK rating one notch to Aa1 with a stable outlook. The market reaction to the downgrade



was measured. UK gilt yields fell the first day of market trading after Moody's announcement. These near-historic low government bond yields continue to reflect the credibility earned by the Government's credible economy strategy.

Structural Reforms

You asked whether I accepted that structural reforms undertaken in Greece, Spain, Portugal and Ireland are creating significant short-term pain for their citizens and what measures I thought Member States should take to combat these impacts.

As I said when I appeared before the Committee: *I do not think it is right for a Minister of the Crown in this country to make an assessment of the domestic policies of another.*

Competitiveness

You asked whether I agreed that we are seeing improvements in competitiveness in those euro area countries most affected by the crisis or whether I was sceptical of the accuracy of the measures used.

As I said when I appeared before the Committee: *There is a challenge for the European Union to be competitive internationally and that involves looking at the components of competitiveness, of which labour markets are an important one. (...) One of the other things that we know is absolutely important to Europe's competitive position is the value added that individual workers can have. That takes you into training and skills—as to whether, in any particular country and across Europe, we are investing in particular in training, but also in research and development so that the value that we add to our activities competes with the rest of the world.*

One of the most important aspects of policy in this country, and I am speaking in my capacity as Minister for Cities—that is to say the principal cities outside London—is that we know that the connectivity, the infrastructure that connects important conurbations in this country and on the Continent is a very important contributor to their success in terms of attracting investment, in terms of keeping costs down, in terms of making it an efficient place for labour to be located. So infrastructure is an important aspect of it.

High deficit, low competitiveness countries in the periphery must continue to tackle their problems. The European Commission's latest Alert Mechanism Report of 28 November 2012, part of the EU-level Macro Imbalances Procedure which assess competitiveness imbalances across the EU, points to the challenges in correcting external and internal imbalances that will need to be addressed over a number of years but also notes that progress has been made in reducing current account deficits in recent years.



Deflationary policies in the euro area

You asked whether I was concerned by the deflationary policies being pursued across the euro area and if I thought Germany and others should be doing more to counteract this.

As I said when I appeared before the Committee: I do not think it is right for a Minister of the Crown in this country to make an assessment of the domestic policies of another.

Fiscal consolidation

You are concerned about the emphasis on fiscal consolidation in the crisis and asked if I thought this will pay off in the long run. You also asked for the evidence that fiscal consolidation was having a beneficial effect, my views on the arguments behind sequential deleveraging and whether I thought they justify an easing of fiscal consolidation.

As I said when I appeared before the Committee: Our view is exemplified in the policy that the Government is pursuing. I think it is a necessary position, in terms of conditions of stability and conflicts of business investment, that underlying problems are resolved in this country and in some other countries. It is evident in terms of the excessive deficit reduction procedures that have been introduced in other countries that bringing down what were unsustainably high levels of public sector deficits was something that needed to be done.

I think there is a general recognition that these things went out of control. There were contributory factors from the financial crisis but that was not, by any means, the sole cause of them and it is necessary to restore that degree of confidence. Most countries in the EU are embarked on journeys to do that but there are other things that need to be done as well, just as in this country we are trying to prioritise infrastructure investment within the envelope of the spending cuts that we have.

Periphery Member States have undertaken a significant fiscal consolidation and are starting to improve their current account balances as noted by the European Commission's latest Alert Mechanism Report of 28 November 2012, part of the EU-level Macro Imbalances Procedure, which assess competitiveness imbalances across the EU.

Growth prospects

You asked for my views on the prospects for growth for the euro area and the long-term prospects for the euro area, the EU and the single market in the global economic context.



As I said when I appeared before the Committee: *I think it is too soon to make a definitive assessment of whether the worst is over in terms of the eurozone economy. What I do think there is a recognition of (...) is that as well as the fiscal consolidation that most Member States have been engaging in, there are supply side reforms and there are questions of investment in infrastructure: for example, questions of completing the single market. Moving beyond that, the Prime Minister has talked about a free trade agreement with the United States of America. There are other reforms that at EU level, as well as in Member States, should be contemplated, which whatever the overall economic situation can only be good in terms of laying the foundations for future growth and prosperity.*

Ireland

You asked whether the progress shown in Ireland demonstrates that austerity and structural reforms can work, or if Ireland is a special case.

As I said when I appeared before the Committee: *The Troika, the IMF, the Commission and the ECB have made an assessment and it continues to be that the programmes are on track and that the Irish economy is beginning to recover.*

Political and social pressures

You asked about my concerns regarding the social and political repercussions of the crisis.

European prosperity at the levels many Europeans have come to expect, faces challenges. There are no easy solutions or shortcuts; an argument the Prime Minister and Chancellor have consistently made to European leaders. Sustainable European growth and recovery can only come from Member States reforming and boosting their productivity and competitiveness. For national governments this will require vision, leadership, resilience and a prolonged commitment to reform.

Greece

You asked for my views on the events unfolding in Greece over the next few months and whether the threat of a Greek exit has now passed or if EU leaders should still be wary of the possibility.

As I said when I appeared before the Committee: *it is too early to comment on whether the crises that have been faced in different countries have been resolved permanently. There is always the possibility of new exogenous shocks to the system that need to be absorbed. But what one does see in Greece is that it has been possible to make the next stage of disbursements, that Parliament has continued to endorse the reforms that have been*



introduced there, and it is widely accepted and understood that the period of transition has been very exacting.

Threat of contagion

You also inquired about the threat of contagion and if this is already occurring given the developments in Member States such as Italy and Spain.

Throughout the crisis, we have been clear that the euro area partners needed to develop a credible ring-fence to protect other vulnerable euro area Member States from contagion, and, properly recapitalise Europe's banks. As outlined above, some important steps forward have been made to reduce the risk of contagion, but a number of additional steps around banking union are also necessary.

France

You asked about my assessment of the outlook for France and what the consequences for the EU would be should France find itself in serious economic and financial difficulties.

As I said when I appeared before the Committee: I do not think it is right for a Minister of the Crown in this country to make an assessment of the domestic policies of another.

Genuine Economic and Monetary Union

You asked what I would identify as the necessary elements of 'Genuine Economic and Monetary Union' if it is to prove effective and how likely it was that the differences in opinions on EMU can be overcome to reach an agreement on greater integration. You also asked what the likelihood of an agreement on a system of political union being reached was and whether I thought EU solidarity can realistically transfer into a system of political union. You also asked whether I believed it is possible to achieve a viable economic and monetary union without a system of fiscal transfers.

As I said when I appeared before the Committee: The questions are clearly related and it is hard to say. In this country, one of the reasons why we declined to join the euro was that there was a worry that it might lead to fiscal consequences, but there is a view that it need not necessarily lead to that, nor to a permanent need for transfer payments. The doctrine of convergence was the driving reason—perhaps article of faith—that underpinned the idea that the eurozone could, in the long term, find its place and be a place of stability. (...) We are not going to be part of the eurozone, but members of the eurozone take the view that this does not require full fiscal union. That is for them to work out during the years ahead.



December European Council

You asked if I was disappointed with the progress made at the December European Council.

The Council marked significant progress in protecting the UK's interests as the euro area moves towards closer integration. As I discussed in my letter of 26 January 2013, the Prime Minister secured in the Council Conclusions, robust language on protecting the single market in its entirety but also more significantly, language agreeing specific safeguards to protect the single market in financial services and protect the interests of the UK's financial sector. I discussed these in detail in my letter of 12 January 2013.

Banking Union

You asked whether proposals for a common deposit mechanism were no longer part of the Banking Union negotiations and what the implications of this would be.

The agreed Council proposal for the Single Supervisory Mechanism does not include any reference to the common deposit insurance mechanism. I understand that the Commission intends to publish proposals on the Single Resolution Mechanism in 2013. Until they do that we do not know what form of funding or mutualisation arrangements are envisaged, or whether the proposals will include a common deposit insurance mechanism.

Separately, the proposal to update the Deposit Guarantee Schemes Directive (DGSD) remains on the legislative agenda. However, moving this forward will depend on the Presidency's capacity to resolve the deep differences between the European Parliament and the Council on this dossier. The current Presidency (Ireland) has a full agenda, including CRD IV, Banking Union and Recovery and Resolution Directive. It is not clear that they will prioritise the DGSD.

You also asked how confident I was that a deal on banking union will safeguard the UK's position and its financial sector in the longer term.

As I said when I appeared before the Committee: *discussions that took place before Christmas on banking union illustrated that it is possible, without rancour and without any flight to the lowest common denominator, to identify and agree a settlement that allows those countries that want to join together, at least their banking system into the initial places of banking union, while having very clear and, I would say, unambiguous protections for the single market and Britain's place in that. In particular, the text in Article 1 of the ECB Regulations making it absolutely clear that discrimination on grounds of*



currency cannot take place was agreed unanimously, as I say, without any great deal of trauma. I think it shows that where there are different conceptions of how countries want to engage in the future, this is not an inevitable recipe for deep contention and division. It is possible through good relations and a rigorous approach to policy to find outcomes that are mutually satisfactory.

Implications for the UK

You asked how confident I was that the UK will be able to secure the safeguards it desires as the euro area moves towards closer integration.

As I stated in my letter of 26 January 2013, the agreement at the December European Council of the Regulations on the Single Supervisory Mechanism and changes to the European Banking Authority provides a good example of how the Government can secure important changes to safeguard its interests.

As the Prime Minister made clear in his December Post-Council Statement:

"A single currency needs a single system for supervising banks, so Britain supported the first steps agreed towards a banking union, but in return we and others demanded proper safeguards for countries that stay outside the new arrangements. The European Council therefore agreed a new voting system that means that the euro area cannot impose rules on the countries outside the euro area, such as Britain, without our agreement. There is also an explicit clause that says that no action by the European Central Bank should directly or indirectly discriminate against those countries outside a banking union. That is vital for our financial services industry, which must continue to be able to provide financial products in any currency".

This agreement proved it is possible to find solutions that safeguard the interests of all as the euro area moves towards closer integration.

You also asked about the Government's priorities in any renegotiations, in particular relation to the financial sector.

The Government does not have assigned priorities for any renegotiation. The next Conservative Manifesto in 2015 will ask for a mandate from the British people for a Conservative Government to negotiate a new settlement with our European partners in the next Parliament.

Finally, I would also like to take this opportunity to update you briefly on the Proposal for new regulation governing financial assistance for Member States whose currency is not the euro. The timetable for discussing the Proposal has still not been agreed and there is no indication that the dossier is to be taken forward in the near future; it is not currently on



the Irish Presidency's Council work programme. I will of course write with an assessment of the Proposal and the Government's position as and when the issue is to be taken forward; in the meantime, I would note that there is, as yet, no further clarity on the read across to the Banking Union Proposals that would influence the Proposal, about which I have written previously.

I am copying this letter to William Cash MP, Chairman of the House of Commons European Scrutiny Committee; Sarah Davies, Clerk to the Commons Committee; Jake Vaughan, Clerk to the Lords Committee; Stuart Stoner, Clerk to Lords Sub-Committee A; Les Saunders, Cabinet Office; Rob Douglas and Thomas Kenny, HM Treasury.

A handwritten signature in blue ink, which appears to read "Greg Clark", is positioned above the printed name.

GREG CLARK MP
FINANCIAL SECRETARY TO THE TREASURY

