



SELECT COMMITTEE ON THE EUROPEAN UNION

The euro area crisis

Oral and written evidence

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Giuliano Amato, former Prime Minister of Italy – Oral evidence (QQ 98-109)

Evidence Session No. 5. Heard in Public. Questions 98 - 109

MONDAY 23 JANUARY 2012

Members present

Lord Harrison (Chairman)
Lord Bowness
Lord Dear
Lord Dykes
Lord Flight
Lord Foulkes of Cumnock
Lord Haskins
Lord Hamilton of Epsom
Lord Jopling
Baroness Maddock
Lord Marlesford
Baroness O’Cathain
Lord Teverson
Lord Trimble

Lord Flight
Lord Hamilton of Epsom
Lord Haskins
Baroness Maddock
Lord Marlesford

Examination of Witness

Mr Giuliano Amato, former Prime Minister of Italy

Q98 The Chairman: Onorevole Giuliano Amato, siamo molto contenti di averla qui con noi stasera.

Mr Amato: Molte grazie. It is very nice of you to do it in Italian.

The Chairman: Thank you very much indeed. In thanking you, I would like to also thank Counsellor Grandi for accompanying you today. We are very keen and anxious to hear your views on the euro area crisis and the new treaty. As you have just experienced, we are, as the House of Lords, required to vote from time to time and I rather fear that that may happen again, so please forgive us if we have to retreat. We are recording this. It will be a webcast conversation and we will make a transcript of what we say today, so perhaps you

will be kind enough to look at that and correct it. Indeed, if there are further thoughts that you have, Signor Amato, afterwards about what you would have liked to have said to us, we would be most grateful. Thank you very much for coming. I would be grateful for, as an opening gambit, your thoughts on how the European Union has handled the economic financial crisis hitherto. I would be very grateful if we could start there.

Mr Amato: First of all, thank you for inviting me. It is a real honour for me to be here. My opinion is that the best reports that we read throughout the Union, on whatever European documents, are coming from here. You deserve appreciation and esteem from everybody, because the analysis is very detailed with arguments that it is difficult to find anywhere else. So I consider myself a learner here and I can just give you my opinion on this matter.

Since the beginning of this crisis, if we summarise, less than needed and later than needed is correct, I would say. It has been somehow a very tortuous process that is going toward the direction that we should have but did not choose at the beginning of this story. In other words, my opinion is the following: when we decided to adopt a single currency, assuming that co-ordinating national policies would be enough for the single currency to sustain its life, we made a mistake. And quite likely we made the mistake because we wanted to believe that co-ordinating national policies was enough, for the simple reason that nobody wanted to transfer national policies to the higher level of European government. Despite the advice that we had—you remember, “What if there is an asymmetric shock in the eurozone, will you cope with it, will you have the instruments?”—our answer was purely ideological. We answered, “There won’t be any asymmetric shock in the eurozone because there won’t be any asymmetry. Due to our co-ordination there will be such a convergence that everything will be symmetrical and therefore no asymmetric shock.” Afterwards we discovered that asymmetry existed, that divergences have remained, and some of these divergences have grown.

Therefore, if you will allow me to add something, what I was surprised at was that somehow the markets took us seriously, much more seriously than you would have expected, because as soon as the euro arrived all the member states covered by the shield of the euro—do not forget the formula “the shield of the euro”—were treated more or less the same way by the markets, as if having the same currency meant having the same economic strength or the same fiscal balance or whatever. Only after the great crisis of 2007-08 did the markets open their eyes to the existing divergences and, quite likely due to the fact that with these huge public debts, competition in the market for selling treasury bonds was going higher and higher, they started treating member states according to their different situations and putting, of course, the safer ones above and the weaker ones below. At that point the magic of the shield somehow faded away and we were forced to do what we had never done, which was to look for common solutions and common instruments. It has not been easy. Why?

One of the main reasons, in my view, is the following: when the crisis arrived, when Greece, Portugal and Ireland were in difficulty, we started speaking of eurobonds, joint and several guarantees and so on—instruments and tools that imply a high level of solidarity. Mutualising debt implies trust, confidence and solidarity. But, to the contrary, the opposite feelings started prevailing in our public opinions. Italians and Greeks started being somehow not so fond of Germany, and of course German taxpayers were wary of paying the bill for the Italians and Greeks happily eating here and there, which is the way they saw it. In political

terms, this has made things very difficult. You needed more solidarity to introduce common instruments. Instead of solidarity you had mutual hostility.

If you look at the matters from this angle, aware of the fact that this kind of intangible solidarity is essential to change tangible directives and regulations, what the European Union has been doing is something that somehow points at future steps and begins to demonstrate that it is again perhaps, ready to be taken seriously by the markets.

Q99 Lord Dykes: Would it be in order at this stage to ask a question about the ECB, Lord Chairman?

The Chairman: By all means, but I thought that you might like to pursue the question of the past.

Lord Dykes: Yes. I apologise therefore to Signor Amato that unfortunately, because of the division, I did not hear all the remarks you have just made, so I am rather guessing about the stage that you have reached. If one takes the fiscal compact treaty contents in the latest revised text, there has been a common feeling, both in Britain and elsewhere, that the ECB is in an inherently weak position because it is not able to do conventional quantitative easing as national central banks do—the United States and Britain, are good examples—and therefore that is a problem. Also it has not become quite clear what the ECB itself can do as an institution in terms of specific direct aid to member states if they need help. Should it just be routed through the channels we have seen before, both the IMF and the bailout mechanism? Do you feel that those are legitimate complaints?

Secondly, Commissioner Olli Rehn was very critical about the rating agencies and the way in which some of them are operating. It is interesting that in France, when the downgrading took place with Standard and Poor's, the others did not follow suit at all. Indeed, the €8.5 billion raised in the latest auction in Monday of last week by the French was actually at a lower interest rate than on the previous occasions and so on. So it is all a bit conjectural, but Olli Rehn's comments immediately after that downgrading decision were very fierce indeed, unusually for a Commissioner, coming off the football field, incidentally, as we recall. I would be interested in what Signor Amato's views would be about that. So my questions are about, first, the ECB and its dual role in the future, and then Olli Rehn's criticisms about the rating agencies concentrating seemingly on European countries but never bothering about the United States.

Mr Amato: The ECB, as all of us know, follows the constraints that the Treaty of Lisbon clearly sets in terms of no bailing out and no direct aid to member states. They themselves explained repeatedly at the beginning of the crisis that they can buy bonds within the limits of their basic mission, which is to guarantee the stability of the markets. Liquidity has to remain, but they cannot go beyond that limit. There is a leeway that they have to have in interpreting this kind of mission, but I want to be very candid. You cannot be the federal reserve without a federal state and, therefore, if we do not have a federal state we cannot have a federal reserve. There are limits that the Central Bank has to accept in its role and we cannot expect our Central Bank to play the same role that the Federal Reserve is entitled to play.

That means that we had to use several sets of instruments, therefore, by creating a fund, transferring resources to this fund, possibly giving this fund a leverage that can be used to do

what a central bank can do and using the European Central Bank as the agent of the fund. This latter point is a good thing to do, because they have experience and reliability, saving time, but I would not go beyond this. If you ask me what I expect after this treaty agreement is approved, I would not expect Draghi to become the European Bernanke. I expect the capital of the European Stability Mechanism to be increased. The fact that with €500 billion you do not do what you should, while a trillion would be better, is something that I find convincing and this is exactly what I expect.

As to the rating agencies, I resent the fact, honestly speaking, that we have three only. I have always been in favour of competition. I chaired an anti-trust authority so I feel competition is one of my personal interests. A market with only three undertakings tends to be necessarily collusive, while of course there might also be collusion between the rating agency and the companies they advise. Having said so, having more rating agencies would be nice, but I am quite wary of creating one European agency under a sort of public patronage; I dislike this deeply. But I do not understand why the Americans have three agencies and we Europeans have none. It is a problem for the market, not for the states in my view. Quite obviously Olli Rehn has written reports approving what has been done by countries that were downgraded and therefore he was quite critical of Standard and Poor's.

If you want my personal opinion on Standard and Poor's, there is a bizarre phenomenon that is taking place now. All of us tend to say that we in politics have learnt short-termism from the markets, because financial markets are by definition mindful of the short term and we have learnt from them. It tends to happen where there is huge public debt, with this flood of long-term public bonds, that the markets are taking care of the long-term prospects, and the fact that our interest rates tend to be so high in the long term reflects a legitimate assessment that markets are making right now of the long-term prospects. Standard and Poor's have simply said, "Now, you Europeans, if you don't grow, in the long term you won't have the resources to repay your debts". This is a correct assessment after all.

Q100 Lord Dear: Mr Amato, good afternoon. Let me turn the focus on to the proposed treaty and ask you for your views about the implications of the move to agree the new treaty, which is outside, of course, the main EU institutional framework. Do you have any views to help us on that?

Mr Amato: I can tell you that I do not like this treaty very much, and I dislike calling it a treaty because I am a conservative and somehow for me treaties are, let us say, the output of intergovernmental conferences, convened and organised according to the rules of the original treaties. This is something that I could compare to Schengen. For Schengen we used the name "agreement and convention". The fact that somebody wants this thing to be called a treaty demonstrates that somebody wants to assimilate this thing that is different and to give this thing that is different the same kind of legal and political value that the treaties of the chain that started in Rome enjoy.

Having said that, throughout the efforts that have been made in these weeks, the content of this treaty tends to be somehow reabsorbed inside the principles and the procedures of the European Union as they are. Professor Craig rightly pointed out that Article 3 does not add much to the regulations adopted after the six-pack. The only addition, perhaps, is the balanced budget rules to be transferred into national constitutions or in binding regulations. What the Commission is empowered to do is substantially what the Commission already was empowered to do according to the existing treaties. Were it not so, I would find quite a

legal problem in using an institution whose terms and procedures are those of the Union treaty and of the Treaty on the Functioning of the Union. But I do not really see the problem because on the whole, even after the corrections that this article had, what the Commission is supposed to do is substantially what it was doing before. Only perhaps the proposal for correction mechanisms is new, but it is just a document. It is one of the many documents that the Commission in the past was asked by intergovernmental decisions to produce.

Since we are in this country, let me say that it is very unfortunate that the decision was taken to use this extraordinary kind of tool without adding anything significant to what could have been done by using Articles 126 and 136. By using those two articles, you could have the same kind of legal output and for the British Prime Minister the problem would have been much simpler.

Q101 Lord Dear: Thank you for that. Could I ask you to turn your attention to and give us a frank view of, if you would be so kind, how the stance taken by the United Kingdom is viewed in the rest of the EU following the position that we adopted in December? In effect, we turned our back on that part of the EU agreement and sailed off alone. How do you think that is perceived, not necessarily by your personally but throughout the Union?

Mr Amato: Somebody has written that being part of the minority happens and you have to accept it, but being part of a minority of one is quite hard. You are alone at that point and perhaps you should avoid remaining alone. I do not know enough about the reasons that led the British Prime Minister to decide this line of conduct. He might have thought that this agreement or treaty might be interpreted in the sense that there could be a transfer of power. This could have been very dangerous for him if he does not want a referendum to be held on these matters. He might then have thought that, as the content was not so clear, the best and most radical thing to do to avoid any risk was not to take part. This might be a reason. However, there is no transfer of power in this. Reading it carefully, you realise that at this point there is no transfer of power at all.

Lord Dear: Thank you for being so frank.

Q102 Lord Jopling: I begin by declaring an interest as I am in receipt of funds from the Common Agricultural Policy. Let us just look at the short-term effect of this fiscal compact treaty. We will come to the longer-term effects, I think, in a moment. In the short term, do you think that the fiscal compact treaty is going to be effective in resolving the current economic and financial crisis that faces the euro area? Do you think there is enough in this proposal to deal with the immediate crisis, which looks so difficult? With Greece, for instance, negotiating and pleading for a write-off of various debts, is this not going to ripple out over the longer term? We will come to that, but let us deal with the short term.

Mr Amato: My answer is no, it is not enough. There are several items that are important in the short term that are missing but, having said so and going back to my initial arguments, this was and is necessary to restore trust in Germany. We cannot build anything in the European Union, and particularly in the eurozone, without Germany being convinced. Now they have the perception of a eurozone in which discipline is missing.

Perhaps you will allow me a small anecdote. I was in Paris weeks ago at a conference and spoke of these matters, and afterwards a German colleague came and said to me, "I liked

your intervention because you are Italian and you used the word ‘discipline’”. Happily for me I had used it. But this is a necessity for Germany. I can understand that because they paid quite a price through restructuring their economy and changing their labour market after they broke the rules of the stability pact in 2003, and a Chancellor lost an election for the reforms that he adopted for the sake of a better future of his country. Therefore I can understand Germans who say, “We have done it and you want our solidarity without doing it yourselves. Please go ahead, get disciplined as we have been up to now”. So this is a legitimate request by Germany and trust may be the main outcome of this treaty on which you can build what in the treaty itself is missing, which basically is increasing the capital of the stability mechanism to be introduced as early as possible and starting together with actions promoting growth.

I would never nowadays ask Germany, “Why don’t we introduce the eurobonds with joint and several guarantees?” because I understand that it is, to say the least, too much. Whether it is fair or unfair I do not know, but certainly it is too much for them to accept. I would ask them. “Why don’t we discuss project bonds, those bonds that provide savings for investments that have a clear return for all of us, and have several investments in European infrastructures?” If I think of the European grid interconnecting our national grids there would be an enormous saving of money in the cost of energy for all of us and we could be much more rational in using the different sources, renewable and not renewable. Sorry, I do not want to become a politician.

Q103 Lord Flight: Turning to the long term, Signor Amato, I think that you somewhat echoed Jacques Delors’ comments that there was a failure of design from the beginning because there was a central monetary policy but no central fiscal policy. Surely the biggest single problem is the competitiveness issue in that, since the euro started, Germany has become 35% more competitive, give or take, against Italy. The fiscal compact is supposed to address that. That implies an internal devaluation required of Italy that seems to me to be impossible politically and economically. It is too great. So I just ask, given that the pact is not really that strong—it is almost the Stability and Growth Pact with one or two little bells and whistles on it—does it have the capability of enforcing the job and of enforcing the scale of internal devaluation needed to share a currency? Do you think it will work?

Mr Amato: Italy, which is one of the, let us say, main debtors in terms of public debt—not in terms of private debt because I think that in private debt you wipe the floor with us, and perhaps also in terms of overall debt—did accept with the previous Government, when Giulio Tremonti was Finance Minister, the clause that we find here now as Article 4. That is the clause according to which the total debt above 60% of GDP has to be reduced by one-twentieth per year—the excess in the case of Italy was another 60, because we are at 120%. This means that one-twentieth is three points of our GDP. In terms, roughly €45 million per year, which of course, should it be applied rigidly year after year, could cause us to collapse, you are absolutely right.

This is the reason why initially there was a negotiation on the six-pack that brought in Regulation 1177, adopted on 8 November, in which the one-twentieth per year is under the condition that circumstances somehow are not so critical. So there is an appreciation that will be somehow jointly exercised by the countries involved and by the Commission that allowed us to say that if there is a recession, as there will be a recession in 2012, the one-twentieth could become something less. Italy was happy that that kind of condition transferred also into this treaty agreement. If you read Article 4, initially it simply referred to

one-twentieth full stop. Now it makes reference to Regulation 1177, so the applicable rule is the one that Italy had agreed on. Having said that, without growth we cannot make it, which had to be said because without these conditions we would be dead men walking. But what Monti has begun to do is exactly increasing the competitiveness and productivity of our system with the measures adopted last Friday to have a higher level of growth.

Lord Flight: One of the problems has been that Italy has had very little growth for 10 years, because Italy was not competitive with Germany, and without a big devaluation I do not see how Italy can grow.

Mr Amato: No, I am not sure. Allow me not to agree with you. Let us say that our manufacturing industry is doing wonderfully in the world and we tend to be competitive with Germany. Not only in traditional fashion design and these sort of light activities, but also in capital builds, instrumental machineries and so on, we are second only to Germany and sometimes better than they are. Our companies are now paying a price in terms of competitiveness that depends on the Italian spread, not on their own costs. In services we are not competitive.

Q104 Baroness O'Cathain: Thank you, Signor. During the debate on how to respond to the crisis, has there been too much emphasis on austerity in public finances and too little on growth and the development of the internal market? I take from what you have just said that you believe that growth is the answer. Our Sub-Committee of the Select Committee deals with the single market, and we opened our investigation with Professor Monti so we feel very akin to his view on growth. But on the other hand, if you have this without any safe discipline, as has been apparent in some of the member states, you are never going to get back to the level of pre-crisis, or do you think so?

Mr Amato: I tend to agree with you in the sense that I am confident that there are several Europeans who say, “We have to accept this treaty because Germany wants it but it is pointless, it is damaging, we have to limit its damages,” and so on, and I do not share this view. Despite being an Italian, I think that discipline plays a useful role. These new pillars that are now introduced into all members of the Union—I think that, approve it or not formally, the UK also somehow shares this kind of key of fiscal discipline—are a sort of prerequisite, but it is a prerequisite, nothing more than a prerequisite, of actions for growth that are badly needed and that are badly needed also in Germany. I feel that the German Chancellor needs eventually to speak on behalf of growth and not only to use the words that she is using. That is why I do not want her to be forced to express appreciation for eurobonds or things like that.

Today we were discussing in another setting the following case, which was put by my former colleague, the former Finnish Prime Minister who is now the Deputy Chairman of Nokia. He said, “To offer a new service to our European customers we need 27 licences.” What a hurdle. How many costs in terms of procedure or wasting of time? What a burden on competition among these providers that cannot compete with each other really at the European level. These are things that have to be removed.

Q105 Lord Foulkes of Cumnock: I think that even some Greeks have been in favour of discipline from time to time in the past as well. You have been very helpful, Signor Amato. Am I right in saying that you said the Commission has been or is empowered by existing treaties? Our previous witness said that almost all that was included in this draft is included

in existing treaties. Are you saying that there is no legal requirement for this treaty and that it is really there to please the Germans? I think you used the phrase “reassure Germany”.

Mr Amato: Reassure Germany—I can tell you that I understand that the markets are appreciative of this agreement because of the automatically activated correction of deviations from the balanced budget rules. This is something that demonstrates that there is serious integration taking place among countries of the eurozone. They are realising this thing throughout this agreement. It is fine, even-though I am convinced that the same thing was already to be read and found in the regulations of the six-pack. So this agreement honestly does not add much.

Q106 Lord Foulkes of Cumnock: Could it cause confusion, because budgetary discipline is dealt with in this treaty now, if it is agreed, in the Lisbon Treaty and in a range of other legislation? Is that not bound to cause confusion?

Mr Amato: No, because in time there have been modifications of the stability pact and of the benchmarks that member states should somehow comply with. The latest, of course, becomes the source of law, because here the basic rule is that the new rule somehow replaces the old one. When this treaty is approved, this will be the source that all our countries, except one, look to.

Q107 Lord Foulkes of Cumnock: Is there any democratic accountability in relation to this fiscal compact treaty?

Mr Amato: You are right, but the problem of democratic accountability exists anyway in the European Union. In my view, the main reason lies in the following fact. In the Lisbon Treaty, and I feel responsible for it because it was set by the convention, we wanted the European Council to be an institution—not a gathering of Prime Ministers but an institution. We wanted this institution to be exclusively empowered to set the political guidelines for the whole of the Union. This has created quite an asymmetry because at this point we have, I say, two executives at the European level, one with a small “e”, the Commission, and one with a capital “E”, the Council, because setting the Richtlinien, as they call it in Germany, is the executive with a capital “E” but the European Parliament can call only the executive with a small “e”. So the real vacuum is that we have this European Council becoming more and more powerful, setting European policies without a parliament as a necessary counterpart. The old argument—we discussed this thing in the convention both for the European Council and for the Council of Ministers—of national government is that we responded to our national parliament, each of us. It is correct. Each of you responds to a national parliament but national parliaments care, quite rightly, for the destiny of national interests at the European level. It is not for them to challenge, in European terms, European policies. So here something more will have to be done for closing the gap and creating this relationship. We wrote in every clause that after every meeting of the European Council the European Parliament will be fully informed, and this is something I personally wanted. Going back to the history of this Parliament, this Parliament began by being informed and throughout the centuries became the first Parliament in the world, so perhaps throughout the centuries also the European Parliament will.

Q108 Lord Hamilton of Epsom: Signor Amato, I think that whatever our views on Europe we can all agree that we do not want another Lehman Brothers-type collapse, particularly of the banking system. You said that the ECB was not a federal reserve, but it

has been printing recently very large amounts of money to finance European banks, which, of course, is one of the reasons why interest rates have been so incredibly low on the bonds that are being issued by the peripheral states. Is it not quite worrying that much of this surplus money is being lent back to the ECB because they want a safe haven for it when it should actually be lent to businesses and be stimulating the economy, and we all want to see growth? That was my first question.

The second question is about the IMF. I was quite surprised to hear a view the other day that the IMF was steeling itself to play a much bigger role. This is something that has been advocated by George Osborne, our Chancellor. The IMF, up until now, has taken the view that the problems of the eurozone are for the eurozone to solve and that basically the IMF deals with sovereign countries that are in trouble and the eurozone should be dealing with its own countries. Do you see the IMF playing a much bigger role? I have heard that the Germans may put very large sums of money into the IMF because they can get away with doing that in a way in which they are not seen to be supporting the ECB, and that we may see €1 trillion in the IMF that could be used to alleviate the problems of the eurozone. If they do that, then of course the IMF is breaking its previous rules.

Mr Amato: The ECB has been lending money to our banks, doing much less than the Federal Reserve has done. The quantitative easing of the Federal Reserve was such that the requirements for their capital were somehow satisfied by using that kind of money, while in the European Union our banks had to raise €115 billion according to the decision of the European Bank Authority, which somehow could respond to the billions that the American banks had as part of that huge amount of liquidity. That demonstrates once more that our Central Bank is simply protecting the fluidity of the market but does not go beyond this. Mario Draghi wrote repeatedly, even before becoming President, that you might expect the bank to somehow guarantee the fluidity of the market when liquidity tends to disappear. At that point there is no market any more, so it is a problem of the Central Bank to assure that there is water somehow being poured in the pipes, otherwise the system gets stuck. But it does not go beyond that. It cannot be used to satisfy the needs of individual banks or of others. If they have problems of capital, they solve their problems by going themselves to the market.

This is one of the reasons why most of that liquidity has remained, perhaps, deposited in Frankfurt, because our banks nowadays consider it a threat—going to the markets now to raise money means giving an enormous discount, being discounted during the IPO procedures and losing money. Therefore, they preserve their liquidity, waiting for the EBA perhaps to loosen the requirements a little bit, as we are reading these days in the newspapers.

The IMF can support individual states, because this is a legal matter also. The treaty establishing the IMF is a treaty that was signed by states. No other entities can be supported by the fund and therefore we can associate the fund, if we want, to supporting Greece or other countries but we cannot use the fund as we may use the European Stability Mechanism.

Q109 Lord Marlesford: Signor Amato, I was very struck when you pointed out that the markets shuddered when reality struck and they suddenly found that in Europe, far from solidarity, there was suspicion. What do you see now as the political and economic factors

that are going to be limiting further fiscal and budgetary integration, which I think the markets are still expecting as the test for the survival of the euro area?

Mr Amato: Yes, I deeply agree with you that the markets now are giving us a sort of standstill these days, but as far as I understand it, speaking to people, they do not want us to remain in between. Either we continue and we equip ourselves with reliable tools to defend our single currency or, as far as they are concerned, the single currency might also not survive, which is a very pessimistic kind of expectation that would damage everybody. It would damage Germany. It would damage, I suppose, also Great Britain, because having only this one currency makes life much easier than it was in 1992. I still remember when I called John Major and I said, “John, I’m going to devalue by 3.5. What are you going to do?” and he said to me, “No need for the UK to do it”. I remember his last words, “Good luck, Giuliano”. Four days afterwards the pound was thrown off the monetary system, and my lira went after it of course, but this could happen because at the time the markets could target currency by currency and create difficulties for each of us, while having the euro, the pound, makes our defence easier.

But you are right, the markets are waiting for solid, reliable, credible, centralised instruments, not necessarily what a federal state would do. They understand that we are not federal and that we are never going to be such, but something is being done. Political obstacles might really be on the one side the short view. In countries where elections are imminent this might be a problem. Secondly, the perverse chain that is likely in the next months is austerity, unemployment, reduction of incomes and populist reactions, including populist reactions against Europe, which is quite unique. You can see it in this country. In my country at the moment, populism is against state officials and politicians because whatever happens is their fault—they are gaining too much and they have privileges that they should not have. In other countries, connected also to other matters, it is against Europe. So this is the kind of vicious circle we might fall into that might prevent us from completing what after all we have already started, but these are the interactions that we have to cope with. Generally when I speak informally, and you know that I tend to speak informally, I say that we have a beautiful future and we can already see that is close but we are not sure how to get there, and this is exactly the way I feel it now.

The Chairman: Signor Amato, perhaps we should say good luck to you as well with that vision of a beautiful future—the “sunlit uplands” that Winston Churchill talked about. I know from glances round the table that we have had a fascinating hour of conversation with you. We are most grateful to you for coming today. I remind you that we are compiling a report and would be grateful for any amendments that you have to what you have said when we send the transcript. I would like to thank also Counsellor Grandi for coming today. In the meantime, I wish you good luck and all the very best for the future, and thank you very much on behalf of the Committee.

Edward Carr, The Economist – Oral evidence (QQ 27-52)

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[Transcript to be found under Charles Grant](#)

Professor Paul Craig – Oral evidence (QQ 86-97)

Evidence Session No. 4. Heard in Public. Questions 86 - 97

MONDAY 23 JANUARY 2012

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Lord Harrison (Chairman)
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Lord Marlesford

Examination of Witness

Professor Paul Craig, St John’s College, Oxford

Q86 The Chairman: Professor Craig, we are most grateful to you for coming this afternoon to answer questions on the proposed fiscal compact treaty. We have before you the Select Committee on the European Union and some of my colleagues, are from Sub-Committee A, whose area of interest this is.

We will be televising this. There will be a webcast of it. We will make a transcript of the conversation that we have today, which will be sent to you; we would be very grateful if you could correct that and send it back. If there are further thoughts that you have, having listened to the questions, we would be most grateful if you would care to submit anything extra. I have asked colleagues to declare any interests as we go through the process of interviewing. Unless you want to make an opening statement, could I ask you what, if any, legal difficulties will be caused by the move to agree a new treaty that is outside the main European Union institutional framework?

Professor Craig: Thank you very much indeed. Thank you for inviting me to address the Committee.

There are certain legal difficulties with this draft treaty. The one point I really want to highlight at this juncture is a point that I do not think has been addressed, as far as I can see, anywhere thus far—maybe it has, but not to my knowledge publicly. It may be the biggest point of legal principle. It may be Banquo’s ghost in this particular room, as it were, or in the room more generally. It is a question of legal principle and it is an important one. I think I can set it out as follows. It is a pretty simple point once one gets it, but no one has raised it thus far.

The point is as follows. The treaty provides very clear decisional rules—rules about how it can be changed—and the basic rule has always been unanimity, whether the change is brought about through the ordinary revision procedure or through the simplified revision procedure. There are, in addition, rules about change that less than a unanimous number of members wish to embark on and there are detailed rules in the Lisbon Treaty, in Article 326 to 334 TFEU and in Article 20 TEU about enhanced co-operation.

What we have is a basic decisional principle that enshrines the idea of unanimity and then encapsulates the idea that, if you want to change something, then everybody has to agree. It is not novel, nor is it revolutionary. On the contrary, it is a standard rule in treaty interpretation and amendment. The rule could be otherwise than it is, but that is what it is in the Lisbon Treaty.

The assumption underlying the new treaty is in stark contrast. The assumption underlying the new treaty is that, even though it has not been possible to obtain unanimity, and even though the rules on enhanced co-operation have not been used, it is legitimate, legally legitimate, to attain the desired ends by a different route. Part of this argument is that member states retain an inherent power to make an international agreement that is consistent or not inconsistent with the Lisbon Treaty. I think there is force in that, but that does not do enough to legitimate the new treaty regime. It still leaves open the issue whether, as a matter of legal principle, it is legitimate to attain the desired end by a different route, with agreement among the states that wish to take part, when it is necessary to use the EU institutions as part of the route to attaining the desired end, and that is what the new draft treaty stands for. It stands for the proposition that it is indeed legitimate for a group of members states to do this—in this instance, it happens to be a significant majority, but the principle remains that a majority, whether it is 15 or 26 states, could attain ends that were not attainable via unanimity, and they can use the EU institutions in order to achieve that goal.

In substance what that means is that *de facto*—I am stressing “*de facto*”, not “*de jure*”—you are substituting a decisional rule of majority for a decisional rule of unanimity. What you are saying is that, provided that the majority want to do something and provided that somebody thinks that that coheres with the overall aims and objectives of the EU, then they can achieve that end and they can use the EU institutions as an integral part of attaining that goal. Again, I want to make it clear that I am not saying that what we have under the EU draft treaty, as I have just described it, is *per se* illegitimate. I am not making that point at all. What I am saying is this is the point of legal principle underlying this EU draft treaty—this new draft treaty—and it is a point of legal principle that we have never, to my knowledge, in the past quite faced in this way before. There have been instances in the past where some of the treaty rules have only applied to some member states—for example, the Schengen agreement. But the Schengen agreement only became part of the EU when everybody agreed in the EU that the Schengen agreement could be integrated into the EU treaty. So

everyone agrees that something can be done and will only bind a certain number of people—that is fine—and then you cohere with and meet the standard unanimity requirement. But in this instance the situation is different. That is the point of legal principle; that is, as it were, Banquo's ghost in this particular room.

Q87 The Chairman: Where we might have the view that these treaties, as it were, run parallel with each other—one not contaminating the other—the truth of the matter, which is what you are saying to us, is that it is a changed legal environment in the sense that QMV could then be used for policies or proposals that might otherwise be rejected on unanimity.

Professor Craig: Yes, to some extent I think that is right. The use of the EU institutions is something that we will be looking at in detail. I want to stress just once again, because I do not want to mislead anybody, that it is quite clear that the rules under this EU draft treaty are not going to be rules of the European Union. They are not EU treaty rules. The treaty contains no doubt about that. All four versions that I have seen are absolutely unequivocally clear about that.

None the less, they also make it clear unequivocally that they hope that the provisions of this treaty that presently are only agreed to by a majority of states will then be folded into and become part of normal Lisbon law, primary treaty law. In that sense, to modify slightly what I said earlier, what we have is a *prima facie* decisional rule of unanimity embodied in the Lisbon Treaty and then what we have is *de facto* a shift to a majority decisional rule that is going to be used as a stepping stone, so the framers of this treaty hope, in order to then incorporate the results thereof into the Lisbon Treaty *stricto sensu*.

Q88 Lord Dear: Professor Craig, good afternoon and thank you very much for the introduction that you have given. I will not ask you to open Pandora's box, but would you like to have a look inside it, assuming it has a transparent side, and tell us what you think the consequences would be for the UK if we were to sign the treaty?

Professor Craig: I do not think the consequences would actually—and I do not think this is at all inconsistent with what I said a moment ago—be that significant. A lot was made of this when the draft treaty was first posited back in December 2011. There was a lot made in the media about this being a fundamental shift in the EU and that it would be 26:1 or 25:2 and you would have two tracks and the tracks would be very radically different. I do not think that is borne out by the substance of what is now on the table. I do not think it is borne out by the substance of what is on the table. I do not think, in other words, that the consequences for the UK, if we signed the treaty, would be that dramatic for two reasons. First, the new treaty when you look at the detail—and the devil is always in the detail—does not advance matters in substance very much from what has already been achieved legally under the primary Lisbon Treaty and the legislation made thereunder. The rules in the Lisbon Treaty, in Articles 121 and 126, then also 136, combined with the package of legislation passed in 2011, attain—it depends on how you want to compute it—95% of what is in this draft treaty. If you look in detail, for example, at the revisions to the Stability and Growth Pact made in 2011, those revisions bind the UK already. I should just say for the sake of clarity, and maybe Members of the Committee know this, that a package of six measures were being put forward by the Commission and were worked on by the Commission throughout 2011 in part because of the financial crisis, before the financial crisis got worse and triggered the draft treaty. Some of those six or seven measures apply only to states in the euro area and some of them apply across the board to all members of the EU, including the UK. There have been significant changes to the Stability and Growth Pact—

there are amendments to regulations 1466/97 and 1467/97 and they are basically designed to tighten up the rules on budgetary balance and budgetary surveillance.

So, for example, in the rules in Article 3(1) of the new draft treaty, which contains the detailed meaning of the balanced budget rule, the detailed specification is very close to the detailed specification of the rule about balancing budgets that is already applicable to the UK in the revisions to 1466/97 brought about in 2011. There would be some minor differences; for example, there are some provisions of this new package that the UK has opted out of. There have been some elements of the new package, particularly of Directive 2011/85, that the UK opted out of it. If the UK were to sign up to this treaty, the relevant rules would be applicable.

The bottom line, the first point in answer to your question then, is that I do not believe in substance that there will be very much difference or very much impact on the UK because the UK is already bound, in effect, in substance and in law, to 95% or 90% of what this treaty is doing.

The second point is connected to the first in answering your question. Not only is the UK already bound by the legislation made pursuant to the Lisbon Treaty rules, but no one has tested how far you could go under the existing treaty rules. What we know is that we have a package of legislation there already made under the existing rules that goes almost as far as this draft treaty. That does not mean that that is the limit of where you can get to under the existing treaty rules in Articles 121, 126, 136 and so on. In my view, if you wanted to take the substance of what is in the draft EU treaty—the one that is on the table that we are considering—and convert it and put it into EU legislation, not all of it but an awful lot of it could get done via EU legislation pursuant to the existing treaty rules. In some ways that is not surprising because one of the main reasons why we went for a draft treaty and why we had all the fuss back in December is that Germany wanted the new rules enshrined in primary law, in treaty law. They were not happy with tighter fiscal rules and balanced budget rules enshrined in EU legislation. It was not that Germany believed that you could not do it by EU legislation; rather, it was that it was not satisfied with doing it that way. The second reason then is that if the EU were minded to do so and did not have this draft treaty, I think it could do even more than it has presently done under the existing treaty rules.

Q89 Lord Foulkes of Cumnock: I want to be clear about this. You are saying that it is less than 5% that could not be done under present rules, but in that 5% there could be something vitally important. Are you saying that there is nothing of great importance in that?

Professor Craig: Your point is well taken. When I said 90% to 95% I have not done a calculation in strict terms. What I really meant to convey was that the great majority of what has been achieved or done under the draft treaty is very little different from what is presently in the EU legislation and that I believe that, if you wanted to do so, you could achieve almost everything that is in the draft treaty under EU legislation. For example, I do not see any reason why a strict rule of balancing budgets as a matter of principle, as defined in Article 3(1)(a) of the draft treaty, could not be enshrined within EU legislation under the existing treaty rules if it was properly drafted.

Q90 Lord Foulkes of Cumnock: What you are saying, effectively, is that the Prime Minister walked out, refused to sign the treaty, created a huge fuss, came back, went to

Chequers, had a great celebration with the anti-Europeans, and there was not really any substance in what he did at all.

Professor Craig: I do not think it would be for me to—

Lord Foulkes of Cumnock: That is the interpretation.

Professor Craig: I take the point you are making except for this, which is that when the Prime Minister made the decision to veto in December, the detail of what would be in the draft treaty was not at all clear. I do not think it is fair in that sense to make the causal point that you are making, because what we had in December was some rough ideas, about four or five paragraphs, of general directions.

Lord Foulkes of Cumnock: Can I just clarify, because what Professor Craig is saying is that now it is—

The Chairman: No, we have other colleagues who are interested in this as well.

Q91 Lord Trimble: In December what the Prime Minister was seeking were additional safeguards to do with the single market and financial affairs which are not directly addressed in this treaty at all, so he was not indeed looking at those rough paragraphs that he got; he was looking at something that was analogous alongside that, which is a different matter entirely.

Professor Craig: Yes, I agree.

Q92 Lord Jopling: I must first declare an interest because I am in receipt of European funds under the Common Agricultural Policy. Do you believe that it would be lawful for the proposed treaty to confer functions on either the Council or the Commission and do you see any legal objection to the proposed treaty recognising functions that are already conferred on the Commission through either existing treaties or legislation adopted under those treaties?

Professor Craig: Thank you. This is the postgraduate legal exam question that will test the minds of lawyers up and down the country, and indeed academics, not just postgraduates. This is a difficult question. I think it is important at the outset to disaggregate three different issues that are contained within this question. Can the draft treaty confer new functions on the EU institutions? Can it legitimate the use of functions even if those functions accord with those already existing under the Lisbon Treaty? Thirdly, can it recognise functions that are already conferred on the Commission?

The third one I think we can deal with and push aside fairly quickly, since it is unproblematic. I think it is very important to disaggregate and distinguish the third from the second. The third one is: can it recognise functions that are already conferred on the Commission? What I mean by that is as follows. Within this draft treaty there are a number of instances where the draft treaty simply makes reference to existing powers when describing the legal schema under the draft treaty—for example, references made to the Stability and Growth Pact in Article 3(1)(b). There are a number of instances where that happens. That is not legally problematic in my view. There is no legal objection in a treaty making reference to provisions under the Lisbon Treaty.

We need to then keep that aside and concentrate on the other two questions. The other two questions then are, first, can the draft treaty confer new functions? In my view the answer is no. Article 13 of the Treaty on European Union stipulates that each institution must act within the limits of the powers conferred on it by the EU treaties and in conformity with the procedures and objectives set out. That is reinforced by Article 5(2) of the TEU, which tells us that the EU must act within the limits of its competence and that competence not conferred on the EU remains with the member states. It would therefore, in my view, clearly be wrong as a matter of principle if a treaty other than the Lisbon Treaty could confer new powers or functions on the EU institutions. That is my view as a matter of legal principle. I do not think that it is really arguable.

What is more contestable, is whether the draft treaty has conferred new functions or not. I think, from the analyses I have seen from expert colleagues of mine, that people take slightly different views on this. My own view is that it is at least arguable that certain provisions of the draft treaty do confer new powers, either of degree or kind, from those that existed before. I could explicate this in detail but in my view, if you want examples, I think there are aspects of Article 3(2) of the draft treaty that fall into this category. I also think there are aspects of Article 7 and aspects of Article 8 which in varying ways and varying degrees confer new powers or powers that are different in degree, if not in kind, from those that have existed hitherto. I do not want to take too much time with this question, but if Members of the Committee would like me to explicate in more detail why I think that, I am happy to do so. But I will leave that for questions if people wish to get back to me.

Q93 The Chairman: There may be the opportunity, Professor Craig, for something written in time, but I wonder whether you would go on to the second stage.

Professor Craig: Exactly, because I am mindful of other questions that Members of the Committee wish to put and limits of time, so let me go on to the other part of this question. Can the Commission under the draft treaty use powers that are the same or very closely analogous to those that it already has under the Lisbon Treaty or existing EU legislation? This is interesting, and the assumption in much of the commentary that I have seen is that what you do is you look at Articles 3(1) and 3(2) and the different provisions of the treaty, and you look at them in detail. If you can locate something analogous within the Lisbon Treaty or the legislation made under the Lisbon Treaty, then you say it is legally unproblematic. So the answer to the overall question is that the new powers for the institution are not fine, but use of existing powers is not a problem. I think that it is too quick for the following reason. There is no doubt that this draft treaty—whatever one thinks of its substance—cannot work without the Commission. The Commission is absolutely central to it. There is no doubt as well that the Commission is, even if not exercising new powers, exercising existing powers in this new setting. There is absolutely no doubt about it at all.

The question is—I come back to it and restate it again—can the Commission use powers under the draft treaty because it already has them under the Lisbon Treaty or legislation made thereunder? Is that per se lawful? The answer seems to me as a matter of principle that it is not necessarily unlawful but it cannot be per se lawful. You cannot say that merely because the EU institution has a power lawfully given to it under the Lisbon Treaty or legislation made thereunder that that in and of itself legitimates use of the same power in a different institutional setting. That just seems to me a non-sequitur. It seems to me that it is

a more complex issue. It does not mean that use of the same powers in a different institutional setting is necessarily unlawful. What it means is that in order to find that it is lawful you have to go back to the first institutional setting and interpret the powers given by the Lisbon Treaty to allow the Commission to use those selfsame powers in a situation like this draft EU treaty. You would have to construct an argument that the powers of the Commission to do X, whatever X is, under the Lisbon Treaty and the rules made thereunder also empower the Commission to do X under a treaty like this one. I am not saying it is impossible to construct that argument; I am simply saying that people have not done that yet and that is what needs to be done.

Q94 The Chairman: The anxiety of the Committee would surely be whether, if it were possible that in some way you might, using the new treaty, circumvent that which will be desirable under the de jure rather than the de facto, there would be a threat, as it were, that something could be introduced using the new treaty. I think I follow the argument that you give, but I think the concern would be whether something had been circumvented in the original legal treaties.

Professor Craig: I take your point entirely. I would go back, in a sense, to my answer to the first question, which is that in order to legitimate use of the same Commission powers under the new treaty, what you would in effect have to do is to stand back and say, “The Commission has certain powers over numerical reporting of budgets under the existing treaties or legislation made thereunder—Directive 2011/85 and other such rules.” Then what you would be saying is, “We think that, because of the importance of saving the euro and the importance of preserving balanced budgets, this same power must reside within the Commission when it is acting under this new treaty.” That is the kind of argument in substance one would have to put. I am not saying it is an impossible argument to put, but that is what would have to be done.

The Chairman: Let us take it one step further, Lord Bowness. I will bring other colleagues in shortly.

Lord Dykes: Forgive me, Lord Chairman. I apologise for raising a point of order in procedure, but I am just getting a little bit anxious because we are due to see President Amato at 5 pm, which is only 10 minutes away now.

The Chairman: Let us press on.

Q95 Lord Bowness: Professor Craig, would it be lawful for the proposed treaty to confer jurisdiction on the EU Court of Justice for actions between EU member states or, as the earlier draft proposed, for actions brought by the Commission? Perhaps more important, is it likely that the Court of Justice would decline to accept that jurisdiction?

Professor Craig: Thank you. My view is as follows. First, under the present version—what I am calling version 4, a copy of which came out on 19 January—the prospect of the Commission bringing an action in its own name has been dropped from Article 8. My own view is that that would not have been lawful; it would not have been a lawful reading of Article 273 of the TFEU. Article 273 is the article that is being used in order to give the court jurisdiction. I do not believe that Article 273 could accommodate an action brought by the Commission. So that provision is not there any longer in the current version of Article 8 and I do not believe it would have been lawful to keep it in. That is the first point.

The second point is that Article 273 is, I think, a lawful route for the court to have jurisdiction over an interstate dispute of the kind envisaged in Article 8 and under this treaty. I think that in principle the ECJ would say that the subject matter of this treaty relates to the subject matter of the EU treaties and that therefore, if parties agree, the ECJ would be willing to adjudicate on an issue brought before it by one of the parties. However, while I think that Article 273 is a possible legal route, I have none the less the following reservations about it. I have two reservations, which I will explain very briefly given the exigencies of time. First, I think that it is very unlikely that one state will wish to sue another state under this treaty. One of the main avenues that is posited by Article 8 is the idea that one state sues another state that is not compliant with the balanced budget rules. I think that there are all sorts of political reasons why that is very unlikely to happen and why states would be very reluctant for it to happen. Experience under the analogous provisions of the main Lisbon Treaty, Articles 258 to 260, indicate that interstate actions are very rare.

The second point I want to make is this. Under Article 8 as presently formulated, although the Commission cannot bring an action in its own name under Article 273, it is the Commission that in effect mandates a legal action brought by the state. The present formulation of Article 8 is quite clever but quite problematic, I think. The way that Article 8 is now framed is as follows. The Commission is invited to report on whether a state is meeting the requirements under Article 3(2) to have a proper correction mechanism for balancing budgets and, if it concludes that the state does not have a proper correction mechanism, what Article 8 now says is that a state will bring an action against the recalcitrant state. I think that that is deeply problematic for two related reasons. One is that in substance this still seems to me to be that the Commission is really bringing the action. It is brought in the name of a state but in substance it is the Commission holding the gun, pulling the trigger and just putting a state before the court. Secondly, difficult issues will have to be worked out about how you choose the state that is going to bring the action. If you think about it, what are you going to do? You have to have a taxi cab rank rule, which is that state X will say, “I sued Greece last week, let somebody else sue Greece this week,” or something like that. Clearly, in order to avoid that kind of thing, an invidious choice for the Commission, you will just have to have a line as to which state should bring legal action. It seems to me deeply problematic.

So, yes, 273 is a possible route, I do not see it as being very efficacious because states will not sue each voluntarily and if they are pushed into doing it by the Commission then in effect you have the Commission in substance really bringing the action.

Q96 Baroness O’Cathain: Professor Craig, do you share the concern expressed in some quarters that spreading important commitments on budgetary discipline and so on across this treaty, the Lisbon Treaty and a range of other legislation could cause confusion about what exactly is required in the event of a failed test of transparency?

Professor Craig: I can answer this question briefly. Yes, I think there are real concerns about transparency for the following reason. Even prior to the new treaty we had the following package of provisions that anybody would have to take into account when trying to understand the rules on budgetary discipline and surveillance. They would have to look at the Lisbon Treaty rules, they would have to look at the package of legislation that has become increasingly complex as a result of the 2011 reforms, they would have to look at the high-level soft law—meaning the broad economic policy guidelines produced by the

European Council which frames this whole process—and they would in addition have to look at other mechanisms such as the European Stability Mechanism and issues of that kind. So we already have, as it were, four layers to the cake, if one wants to put it that way, and this treaty is going to add a further layer of complexity in particular because there is going to be overlap between the provisions of this treaty and the provisions of the existing Lisbon Treaty and the legislation made thereunder. So, no, it is not going to be easy in terms of transparency.

Q97 Lord Teverson: Professor, in an article in *Statewatch* Professor Steven Peers concluded from the first draft of the treaty that legally it does not add very much to the obligations which are already present in EU law. He noted, however, that the political assessment may be different and that the treaty might serve a useful purpose if it ultimately facilitated greater intervention by the European Central Bank. I wondered what you felt about that and whether the measures to be included in the fiscal compact could be implemented through existing treaty provisions, although I think that you have covered that to a large degree already.

Professor Craig: Thank you. I share Professor Peers's view in the following sense and I have touched on this. I share his view that now that we have a detailed grasp of the treaty on the table, including version 4, the substance of what is being done under that treaty is not going to add anything very substantial to what is already there in terms of the EU treaty and provisions made thereunder. Steve Peers has gone into it in detail and I do not disagree with his assessment. That is point one.

Point two is that I do not believe that there is anything in the existing draft treaty that changes the treaty rule preventing the ECB from bailing out a particular state. In so far as the ECB's being reticent to engage in direct state bailouts is based on treaty provisions, which it is, there is nothing in this December treaty or any version made thereafter that touches that. In so far as they have a legal reticence, this is not, I think, going to be affected by this draft treaty.

The Chairman: Colleagues, I am conscious that three other colleagues have indicated that they would like to ask supplementary questions. What I propose to do is to ask Professor Craig if he will reply to them in writing. Professor Craig, we are most grateful to you. If there is anything supplementary that you wish to contribute and if there is any ground that we have not covered, please write to us. We would be most grateful to you.

Professor Paul Craig – Supplementary written evidence

1. Please clarify the basic legal principle to which you referred during your evidence.

This was a reference to the principle embodied in Article 48 TEU, viz that Treaty change requires unanimity. My comment also embraced the related principle viz that if some Member States wish to attain objectives over and beyond those that all were willing to agree to, then they should satisfy the conditions for enhanced cooperation laid down in Article 20 TEU and Articles 326-334 TFEU.

2. Article 126 TFEU provides that the European Council, acting on the basis of a recommendation from the Commission, can impose fines. A qualified majority vote is required to approve this (with the state in question not entitled to vote). Article 7 of the new treaty purports to create, in effect, a new ‘reverse’ QMV, “while fully respecting the procedural requirements of the European Union Treaties”. Can the new treaty over-ride article 126 TFEU, which is clear that QMV applies?

The reality is that a reverse QMV has already been put in place via Reg 1173/2011, Arts 5(2) and 6(2).

3. Concerning the problems of lack of competitiveness and the trade imbalances, is it right to conclude that articles 9, 10 and 11 of the new treaty are merely aspirational and do not add anything to the provisions of the Union Treaties that are referred to in these articles?

That is correct.

4. Is Article 10 of the proposed new treaty consistent with the procedural requirements governing the use of enhanced cooperation set out in articles 326 to 334 TFEU?

Art 10 is not consistent with the LT. If the contracting states wish to make use of enhanced cooperation they have to comply with all the conditions in Art 20 TEU and Arts 326-334 TFEU (ie in addition it must not undermine econ + soc cohesion, no barrier to trade, no discrimination etc).

5. Is there anything in the new treaty which is not achievable under the existing EU treaties. (One thing I have in mind here is the requirement in article 3(2) that the balanced budget rules must be implemented “through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be respected throughout the national budgetary processes”).

There are two points to note about the obligation in Art 3(2):

First, the obligation in Art 3(2) has been significantly watered down. The early version was framed in terms of a mandatory obligation to have the correction mechanism enshrined in national binding provisions of a 'constitutional or equivalent nature'. The wording of Art 3(2) in version 3, 10 Jan 2012, was weaker: the rules in Article 3(1) were to be enforced through 'provisions of binding force and permanent character, preferably constitutional, that are guaranteed to be respected throughout the national budgetary process'. Article 3(2) has in this respect been further weakened by version 4 of 19 Jan. It now provides that the rule in Article 3(1) must take effect in national law 'through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be respected throughout the national budgetary processes'. The change of wording is significant. Article 3(2) in its version 4 formulation means that national compliance can be through statute, the constitution or simply through guarantee in the national budgetary process.

Second, obligations akin to those in Draft Art 3(2) already exist. Thus Directive 2011/85, Arts 5-7, contain obligations on all Member States, except the UK, to have numerical rules in place in their national law to promote compliance with its obligations deriving from the TFEU in the area of budgetary policy over a multiannual horizon. These rules should promote compliance inter alia with reference values on deficit and debt set in accordance with the TFEU. In addition one of the remaining Commission proposals, COM(2011) 821, will, when enacted, impose obligations on Member States to have national rules 'preferably of a binding constitutional character' designed to implement in their national budget process the EU rules on multilateral surveillance. This obligation is contained in Draft Art 4 of this proposal. If this becomes law then the obligation in this regulation will actually be stronger than that in Art 3(2) of the Draft Treaty.

6. Conferral of new Functions on the Commission:

Two points to make about this:

First, there is room for disagreement as to whether particular provisions of this Draft Treaty confer 'new' functions on the Commission. However in my view there are aspects of, for example, Articles 7 and 8 that in substance confer new powers on the Commission.

Second, I reiterate the point that I made when I gave evidence: the mere fact that the Commission does have certain powers already under the Lisbon Treaty and legislation made thereunder does not in itself render lawful or legitimate the use of analogous powers outside the confines of the LT. The fact that, for example, Directive 2011/85, Arts 5-7, contains obligations on all Member States, except the UK, to have numerical rules in place in their national law to promote compliance with its obligations deriving from the TFEU in the area of budgetary policy over a multiannual horizon, does not in itself legitimate the use of the Commission to achieve analogous ends outside the confines of this legislation and pursuant to Art 3(2) of the Draft Treaty. Thus the fact that a power is recognized in the LT plus legislation made there under does not per se legitimate recognition and use of the same power in a different institutional context, viz under this Draft Treaty. Whether the same power can be used in a different institutional context must as a matter of principle depend on interpretation of the Lisbon Treaty. It would have to be argued that the proper interpretation of the relevant institutional provisions of the Lisbon Treaty was that the powers granted therein and in legislation made pursuant to the LT could also be used by the

Professor Paul Craig – Supplementary written evidence

institutions in a different Treaty setting. It might be possible to reach this conclusion, but it is by no means straightforward and the justificatory exercise has not to my knowledge even been undertaken.

26 January 2012

Charles Grant, Centre for European Reform – Oral evidence (QQ 27-52)

Evidence Session No. 2. Heard in Public. Questions 27 - 52

TUESDAY 29 NOVEMBER 2011

Members present

Lord Roper (Chairman)
Lord Bowness
Lord Carter of Coles
Lord Dykes
Lord Harrison
Lord Jopling
Lord Maclennan of Rogart
Baroness O’Cathain
Lord Plumb
Lord Richard
The Earl of Sandwich
Lord Trimble
Baroness Young of Hornsey

Examination of Witnesses

Charles Grant, Director, Centre for European Reform, and
Edward Carr, Foreign Editor, *The Economist*

Q27 The Chairman: First, I draw the attention of my colleagues to the fact that this is a session in public and they should declare any relevant interests when they speak. I welcome Mr Grant, the director of the Centre for European Reform, and Mr Edward Carr, the foreign editor of *The Economist*, both of whom have been writing very extensively on these matters in recent weeks. We are really using this session to get some background on the situation. This session is in public. A transcript is being taken. A copy of the transcript will be sent to you and you will have an opportunity to make minor amendments to it, though it will be published online in an uncorrected form first. There is a risk that the session may be interrupted by one Division. If so, it will be quite soon. I wonder if you would both like to make a brief opening statement. Perhaps we will take them in alphabetical order. Mr Carr?

Edward Carr: Thank you, Lord Chairman. I would like to make one brief point in my opening statement. Whether the euro survives or collapses, I think British foreign policy faces its severest test in many decades and possibly since Suez. I say that because I think the coming months will determine, possibly for decades, our relations with our closest allies and

our largest trading partners. Let me elaborate on that. Imagine that the euro collapses chaotically. Right now I think that chaotic collapse is really the only sort of collapse on offer. Under those circumstances, I think Europe will be totally undermined, and amid the recriminations and debris of broken treaties, a bank collapse and a deep, deep recession, the institutions of Europe, including the single market and even the existence of Europe itself, would be up for grabs. It is hugely important that Britain would immediately have a voice in determining what happened next.

On the other hand, imagine what happens if the euro survives. Under those circumstances, you would see a new treaty with new governance. I can imagine, under some circumstances, the 17 eurozone countries—that number might well increase over the years—beginning to act as a sort of caucus that would seize the European agenda. If that were to happen, I can imagine that the policy coming out of Brussels would not be particularly favourable to Britain. That would set in train a dynamic that would distance Britain from Europe and under some circumstances it could even lead to a rupture with Europe. That might sound alarmist to everybody here. If it does, I think that is because those kinds of events are obscured by the thing which has seized centre stage and which preoccupies us all: the question of whether the euro will survive. But I do not think that Britain will have a huge influence in determining that question. That will be decided in Berlin and Frankfurt, not London. But, and this is my point, it will be determined one way or another and it could be decided far sooner than we think. That is why your Lordships' Committee is so important right now because Britain needs to know what it thinks. It needs to think very clearly about where its interests lie and how to bring them about. I am not sure yet that there is a consensus among British policy-makers on where our interests lie and how to bring them about. I am not sure that we have very much time. Thank you.

Charles Grant: Well, I think that is an excellent tour d'horizon from Mr Carr. I basically agree with what he said. Let me just add one thing, my initial point, and then five very short points. My initial point is that the uncertainty is extraordinary. I have recently been in Paris and Berlin, talking to some of the officials there. They do not know what they want. So if, as Mr Carr says, British officials and politicians do not know what they want, it is probably the same in Berlin and Paris. As the French say, *c'est dans le flou*—everything is blurred. Nobody has quite worked out what their strategy is, objectives are or demands will be. It is a very fluid situation. My five brief points are this. If we were in this room a year ago, I would not have made these points but five things have changed in the EU in the last year and will continue to change. The first is that, for the first time in the history of the EU, Germany has emerged as the leader of the Europe. It has never been the sole leader before, in my view. It has often led together with France and sometimes it has been a bit stronger than France. Sometimes even the British have been in there as a very influential player, as arguably they were at the beginning of Blair's Government. We have not seen Germany leading before, taking the responsibility, the criticism and the flak which comes with leadership. It does not like being criticised for leading in ways that other people do not wish it to lead or are not happy with, but it will get used to that. In a sense, there is a new German problem in Europe, in that all across the EU there is great hostility to Germany. In the southern countries that is because they think it is imposing ridiculously strict budgetary discipline on them. Even in some of the countries closer to home, in Holland, Austria, Finland and France, there is, behind the scenes, strong criticism of Germany for getting its policies wrong—as they see it. That is the first thing.

The second change from a year ago is that France is not running the EU, for the first time in the history of the EU. It is not as important as Germany. Everybody in the French government knows this. They do not like to admit it in public but in private they admit it. As the French economy is so much weaker than the German economy and they know that they have to cut debt to reduce the spread between the French and German rates of borrowing, they know that basically they have to follow what the Germans say. They preserve the appearance of equality with Franco-German summits and talk of “Merkozy”, but the reality is that on all or most of the key questions—should there be a treaty change, should the IMF be involved in bailouts, should private sector bond-holders take losses—the Germans decide and the French follow. The third change from a year ago is that Britain is really moving to the margins of Europe, as Mr Carr said. The eurozone crisis is accentuating this both because it is leading, if the euro survives, to a more integrated eurozone, which is obviously less attractive to the British, but also because of the impact of the eurozone crisis on British domestic politics. My own view is that I would not be surprised if 10 years from now Britain left the EU or was very close to doing so. That is far from certain but I think that is the current trajectory. You may wish to discuss the reasons for that.

The fourth change from a year ago is the emergence of a two-speed Europe. We have always talked about it. When I was a journalist in Brussels 20 years ago, there was talk of a two-speed Europe but it never really happened. Now, if the euro survives, there will be a more integrated eurozone with its own institutions and decision-making procedures that are different from those of the EU as a whole. There will be, as Mr Carr says, some sort of caucus. This has potentially very damaging implications for the single market. It has implications for British influence in the EU.

The final change from a year ago, and perhaps the most alarming, is the increasing weakness of the European Commission. This is a long-term trend over 20 years but it has greatly accelerated in the last year. When you go to Paris and Berlin and talk to people there about the Commission, the terms of abuse that they use about it are much stronger than those you would read in British tabloid newspapers. They really have it in for the Commission. That is partly because they do not like its leader. It is partly because they think it has got too big for its boots and partly because they think it is incompetent. It is behind the curve, does not take initiatives when it should and takes them when it should not. It cannot do anything right and of course a lot of the angst is because Paris and Berlin do not like the Commission enforcing the rules of the single market and the strict competition policy. Undoubtedly, the Commission has made mistakes and is sometimes not wise but I am very worried because the weaker the Commission becomes, the more we move towards President de Gaulle’s Europe des patries—the Europe of fatherlands that he always wanted—and the less good for the single market. The weakness of the Commission is also very damaging to British interests.

The Chairman: Thank you. We have circulated the note that you wrote yesterday on Monnet losing to de Gaulle. I really would prefer not to take any questions on those remarks, because we already have quite a few questions. I would like to move to the first question, from Lord Richard.

Q28 Lord Richard: Thank you very much. The question that I want to ask fits in quite well with what we have just heard, at a general rather than a practical level. Both Presidents Van Rompuy and Barroso have agreed, at a meeting on 26 October, to produce an interim report on possible changes to the treaty. They are going to do that, as I understand it, by 9

December. This is, again I understand, in response to Chancellor Merkel's repeated calls for change. What sort of changes do you think we are going to be faced with in that interim report?

Edward Carr: I think that this is turning out to be a hugely important moment as people look forward to the meeting on 9 December. The latest signs we have are that there will be an attempt to create some sort of grand bargain. I have to say that things are changing so fast that this may well be out of date by the time we leave this room. But anyway, as I was speaking to our people in Brussels today before this meeting, the signs were that Van Rompuy, in particular, feels that in exchange for giving Germany the kind of discipline over EU members—eurozone members—that it wants, he will need to offer countries something to make that loss of sovereignty and that threat of discipline bearable. It looks at the moment as if it will be some combination of mutualisation of debt, or the promise to mutualise debt, I should say; the removal of the private sector involvement that was agreed on in Deauville, which was such a cause in precipitating the loss of confidence in eurozone debt; and then, thirdly, a hope—and I can say no more than that—that the ECB might be more inclined to intervene if it felt that there were some sort of discipline. So there is a making of some sort of bargain whereby countries have more discipline imposed on them, and in exchange they get some sort of reward. This is a difficult bargain for everybody to swallow, I feel.

Charles Grant: I have not been talking to people in Brussels in the last few days; I am sure that Ed is right in what he says. I think that the bargain is the only way forward and, certainly from my conversations in Paris last week, they do believe that in the long run there would have to be eurobonds of some sort, but only at the conclusion of a process by which you establish budgetary union and fiscal union, because it would not really make sense to have them without a lot of discipline first, otherwise they would create moral hazard.

There will be a Franco-German paper on treaty change for the 9 December meeting. I do not know what will be in it; the officials I spoke to last week had not yet decided, or did not know, what would be in it; but I think that if I was Van Rompuy, I would be doing that, and I think that some element of bargain is essential.

I think the difficulty is this: the Germans want the treaty change to focus on things to do with monetary union. They want it to be limited—a real treaty change, but only on monetary union. But the main procedure for treaty change involves a convention on the future of Europe, as we had last time. As some of the French officials said to me, “The Germans may think they can confine the treaty change to new rules on budgetary discipline and other matters pertaining to the euro but actually, once you open a convention, all sorts of countries will come up with all sorts of ideas.” Will the Germans really be able to limit it? That is a question.

Q29 Lord Richard: Where does all this leave the UK—on the outside looking in. How involved are we going to be in this?

Charles Grant: The most important question for Britain in the next few months or possibly years is: do we decide to be part of this new treaty or not? As we all know, the British Government are committed to repatriating powers in certain areas. If the demands for repatriation are significant in a number of areas, I have no doubt from talking to people in

Berlin and Paris that they will do a new treaty without us, which can be done. We can come on to the pros and cons of that. If our demands are moderate, I believe that we can be part of a new treaty of 27, which is better for Britain, for fairly obvious reasons. If you have a new treaty of 27 then, even though the eurozone countries will do their own thing—they may have their own institutions and procedures—the Commission will still play an important role and you will still have one single market without such an organised caucus.

I strongly believe that it is important that Britain prevents the others from going ahead with their own treaty, which would create huge legal complications. How could the Commission and the Court of Justice operate under the rules of a treaty of 17? Maybe they could, but that is a question for lawyers. They probably could, in my view, but it would be difficult. That gives Britain some leverage because the others—the Germans, certainly—want to keep it, if they can, at 27, because they want the Commission and the Court of Justice to play a role in the new eurozone governance procedures. The French are much more keen on an avant-garde core Europe that would be more intergovernmental, and less bothered than the Germans are about the losing the possibility of keeping all 27 involved.

Edward Carr: That is absolutely right. I would add just two very brief remarks to that. One is that, absolutely, the French see it as an opportunity to get the kind of Europe they want. In lots of ways the EU ran away from their original design with enlargement and this is a chance, as Charles said, to go back to de Gaulle's Europe des patries. The other thing is that I think that it is rather an interesting early test, and will be seen as an early test, of Britain's attitude to Europe. If the British see this as a fantastic opportunity to extract maximum rent then I think that that will signify a certain path. If, on the other hand, Britain—which, after all, says it is desperate to have a solution to this crisis, and it is very important to have this crisis—plays a constructive part, then I think that that sets up a different sort of post-euro-crisis politics.

Q30 Lord Maclennan of Rogart: Treaty change, Mr Carr, cannot be achieved overnight. Do you fear that the possible collapse of the euro might occur prior to that agreement being worked out or do you think that there is any relationship between them, so that the will of the German government not to see this collapse happen could overcome the difficulties of the time it would take to sort out the treaty?

Edward Carr: Yes, if you speak to people in Brussels, the opinion is that even an accelerated treaty change would take possibly three years, by the time you have had a convention and all of the ratification that is required after that. I think you are absolutely right. If you had asked me this question even six months ago, I would have said, "Yes, I think it is possible for ECB intervention to stop what is in effect a run on eurozone debt and to be able to contain the crisis." In the interim period you could see reforms beginning to take place in the peripheral and troubled economies of Europe, indicating the willingness to change, at the same time as the negotiations were going on. So you could keep the crisis at bay while this happened. I think that the really troubling development of the past few weeks is the sense that international investors are running from eurozone debt of all denominations. One can over-interpret the failed Bund auction very recently but even putting that aside you have widening spreads on, say, Dutch, Finnish and Austrian debts. What is worrying to me now is that I am slightly less sure that an ECB intervention would be adequate to hold things indefinitely while you negotiate these changes.

Q31 Lord Trimble: Just on this question of a treaty for 27—I noticed you gave the estimate of three years to carry that through—do you think there is any prospect of that getting through? I am thinking particularly of the Irish electorate, who feel very bruised at the moment. I would have thought that the chance of them approving any treaty is just about nil. I am not as well informed about other places but I think that there is a very serious risk that if you go for a treaty of 27 you will get nothing.

Charles Grant: I think that Lord Trimble is right. He knows Ireland better than I do but I believe that at the moment, given the mood of the Irish, whatever the referendum question was the answer would be no. This is a real problem. It is also a problem not just for a treaty for 27 but for a treaty of 17, because Ireland is part of the eurozone. I know people in Ireland who say to me that they think, because of this issue, that they may have to leave the euro and hook up to the pound again. One or two people are talking about this in Ireland. As you know, the current rules are that every new EU treaty must be ratified by every country. The French have long wanted to change this rule but, of course, to change the rule you need everyone to agree to it. This is a difficult situation. If the Irish were to refuse a new treaty of 17, 27 or 17-plus—another possibility that we have not mentioned, because there is talk in Berlin of a treaty for the 17 plus those who want to join, like Poland—then I think the others could find a way of getting round the Irish objection. They would just have to make a new treaty without the Irish. That would be very nasty and bloody. The Slovaks are also a great difficulty and a number of countries could be, but the Germans do not seem to recognise the difficulties. They are pushing the EU into another round of treaty change which nobody else really supports. Everybody is going along with it because of this putative grand bargain. They all understand that the safety of the eurozone requires Germany to change its policies. They think that Germany is more likely to change its policies if it is given the reassurance of a treaty that imposes strict budgetary discipline.

Q32 Lord Trimble: Is it possible that Germany is so anxious in this because of the difficulty that it has with its constitutional court?

Charles Grant: Yes, I think that is right.

Edward Carr: I just want to add one thing to that. I think the politics in the interim in these three years could evolve quite fast. You only have to look at how Greek politics has changed under austerity or at how quickly the new government in Ireland have lost support for their economic policies. Three years is quite a long time under those conditions. I think that it is quite hard to know how popular discontent in the peripheral countries will manifest itself in three years' time when the Greek Parliament, the Slovak Parliament et cetera have to vote on this. It could be very difficult indeed.

Q33 Lord Bowness: This is really a technical point. Mr Grant talked about there having to be a convention. Are the changes, even affecting the eurozone alone, too big for the simplified procedure?

Charles Grant: I believe so. That seems to be the view in Berlin and Paris. I do not have the legal expertise to tell you why but the general view seems to be that the treaty change would be big enough to require the full caboodle of convention rather than the quick procedure that they used for the current, little treaty changes that have been pushed through this year.

Edward Carr: I think also that everything pushes towards this grand bargain. If there is any doubt, the dynamic pushes you towards a larger and more ambitious change than a minimal one.

Q34 The Chairman: One way of having what one might call “treaty change light” is to use the powers of Article 136 of the Lisbon treaty, which allows the Council to adopt measures specific to the eurozone member states. It is a very special kind of enhanced co-operation. In the context of the crisis, have you any idea what would be the maximum that you would be able to do using that sort of procedure, which of course would not run into the problems we have just been hearing about?

Charles Grant: Well, opinions differ on this and I am not an expert in European law. I have heard Giuliano Amato, the Vice-President of the Convention on the Future of Europe, say, “You can do anything that you want with Article 136, so you do not need me to have an IGC to change the treaties. Do it through 136.” But the view in Berlin that I have heard on the Council is, “That is not good enough. It produces secondary laws rather than treaty change. That is not enough for us for what we want.” The view that I got in Paris is that if you read 136, it says you can use it to change the rules to strengthen co-ordination and surveillance of budgetary discipline, and also to set out economic guidelines. But the French think that it is too Germanic and disciplinarian. As part of their agenda for treaty change, they want to revise 136 to make it more Keynesian or to allow more general economic policy co-ordination. I think, even if technically you can change a lot through it, politically the Germans want a real treaty change.

Q35 Baroness O’Cathain: The Finnish Europe Minister, Alexander Stubb, has suggested strengthening the EU executive, for example by merging the presidencies of the Commission, the European Council and euro area summits. In your view, is this a feasible way to promote strong leadership in moving toward a resolution to this euro-area crisis and preventing any future crisis?

Edward Carr: I think that the Commission would love this because they are feeling rather marginalised and it would be a way of regaining centre stage. For that precise reason, I think that the people who really count in this, the French and the Germans, would resist it. Van Rompuy is in a key position to be able to mediate between everybody; he is in quite a good political position to frustrate it. I do not think that that is very likely to happen and, even if it did, I am not sure that it would make a huge difference to the crisis, so deep are we in a mess at the moment.

Charles Grant: Yes, I do not think that it would make a lot of difference to the issues that we are discussing. My own reticence about this move is that I very much value the independence of the Commission. I want it to be able to stand up to and resist pressure from national governments in order to be able to police the market, extend it, deepen it and employ a tough competition policy. If you sort of merge the Commission and the European Council, which would be partially the result of having one President for both, I am not sure that it would be so independent. You can argue it both ways. Some people on the intergovernmental side would fear that it was a Commission takeover of the European Council. The Commission could fear that it was a European Council takeover of the Commission. We have seen this double fear operating with the invention of the High Representative for foreign policy job, where both the Commission and the governments were paranoid about the other one taking over. In the long run, maybe it will happen but it is really not the key issue at the moment.

Q36 Baroness O'Cathain: It has been said that one of the five reasons for the disaster or chaos is the increasing weakness of the EU Commission and abuse by France and Germany saying that it is incompetent and behind the curve. Do you not think that they might use this to try to improve the Commission, or will they just let it go?

Charles Grant: Some people who want to shackle the Commission might think that it would be great to give Van Rompuy Barroso's job, for example. Both France and Germany believe that the Commission should be subordinate to the European Council. Chancellor Merkel made a speech in Bruges a year ago in which she put forward the so-called Union method as an alternative to the Community method. By that she meant that on big decisions the European Council should set the agenda and the Commission should implement it. That is the thinking in the Kanzleramt and in the Élysée. That is their thinking, but I have not heard the Kanzleramt or the Élysée produce this particular thesis as a way of implementing their wish to weaken the Commission. Indeed, Alex Stubb, whom you quoted, is a great federalist. He is a very competent and interesting man. He is also somebody who has worked in the Commission as an official and certainly would not want to see the Commission under the thumb of the European Council. He might see his own suggestion as the other way round—as an attempt to put the European Council under the thumb of the Commission.

Q37 Lord Richard: Why on earth should the Commission agree to this? It seems to me that the last thing the Commission would want to do would be to go into this sort of arrangement.

Charles Grant: I agree. I do not see why the Commission should agree to it. In a way, Mr Van Rompuy now plays a role that the President of the Commission used to play in the days of Jacques Delors; that is, to broker compromises in the European Council to engineer deals between governments who are arguing and not getting on well. He does that rather well. It is the job that Jacques Delors played 20 years ago. I think that Mr Barroso is very busy doing other things and is quite busy trying to run the Commission and make it an effective organisation. I do not see any particular reason for doing this.

Q38 Lord Trimble: A lot of people are calling for the ECB to stand in as lender of last resort, as central banks do generally. Is this possible? Is it desirable?

Edward Carr: Yes, I believe that it is both possible and desirable. What is more, it was possible and even more desirable six months ago. As we get closer to the collapse of the euro it gets harder, I think. I think that it is possible. It is objected to on the grounds that printing huge amounts of money is monetising debt and is therefore inflationary. But I think that just now the risks of inflation are tiny; in fact, all the risks are of deflation. So it would be much more like the policy of quantitative easing that we have seen in this country.

Q39 Lord Trimble: Quantitative easing takes the form of buying government debt. Is the ECB allowed to do that? Does that not fall foul of the no-bailout clause?

Edward Carr: You are allowed to buy government debt in the secondary market; you cannot buy it direct from governments. At the moment the purchases that go on are justified by the ECB in terms of making the transmission of interest rates efficient. So the ECB wants to set an interest rate but it finds spreads of Italian debt going way higher. It feels

that this means that it cannot conduct monetary policy efficiently. That is the official reason for doing it. I think that that is slightly disingenuous. I think that it is doing it because it is worried about the contagion and fear of what is happening in Italy.

I think that the ECB could intervene. The one feature of this crisis that one must not lose sight of is that although all the decisions we were talking about, like treaty change and redesigning the governance of the EU, seem to take ages—setting up the EFSF took months—the one thing that you can do instantaneously is have the ECB to intervene in this way. That is why I ultimately see the crisis heading to the moment when Draghi's finger is figuratively over the button and there is a failed bond auction in Italy or a bank run that is spreading across the eurozone. The ECB will have to decide whether to put its weight behind the currency or not. I still think, even at this hour, that if the ECB has to face a choice between monetary orthodoxy and depression, and the survival of the euro, and therefore its *raison d'être*, it will choose to intervene. It has said that it will not—it has said so countless times, so that is perhaps a controversial prediction—but I see that as the way we are going.

Q40 Lord Trimble: Would it be likely to do that if the Germans were vociferously difficult?

Edward Carr: It would be harder, but that is why this crisis is so hard to predict. Rather than it being a broad phenomenon, it ultimately comes down to the decision of very few people at one moment in time. Why is this not inflationary? I will very quickly say why. If there are signs of inflation, you can reabsorb all the money that you have printed. It need not be dangerous.

Charles Grant: I agree with Mr Carr's comments and would like to add to them. The German attitude to ECB bond purchases is a bit ambiguous. For a start, the ECB is buying government bonds; it has bought over €200 billion-worth, I think, until now. What it has not done is something that many of us would like it to do, which is to say, "We won't let the spread between Italy and Germany go greater than 4%. We will buy as many bonds as it takes to keep the bond market in a certain spread." It has not thrown a wall of money at the problem.

The Bundesbank, traditionally, and many people in Germany are very opposed to this, but there is a big debate going on in Germany and we should not forget that. There are many different viewpoints in Germany, even within the German government, about eurobonds and about ECB bond purchases. The line that I got in the Chancellery not long ago was, "We know that as a last resort it is there to buy bonds. At the moment the vote on the ECB's governing council is generally 17 in favour of bond purchases, four against. We are quite relaxed with that figure. But what the Anglo-Saxons must not do is lecture us and tell us what the ECB should do and put pressure on the ECB, because then we would have to stop it because German public opinion would not be happy to think of the ECB buying government bonds." There is ambiguity in the German government, and the German government are happy for it to be there, even if they have not understood that they should make a bigger political statement: that they welcome the ECB doing what it takes to support the euro.

Q41 Lord Maclennan of Rogart: The German attitude is a pretty formidable obstacle to the ECB doing what you said it might do. Has not the ECB been more concerned about liquidity than about default? Is it possible that countries that have behaved rather

irresponsibly about their deficits could not satisfy the Germans in time about the fiscal discipline that is required to satisfy their longer-term goals?

Edward Carr: On the point about liquidity versus default, the ECB should intervene only if it feels that there is a run on a solvent government; otherwise default is exactly what is required because you are never going to be paid back and so you are just monetising the debt. Part of the judgment—and it is a very difficult judgment in practice—is whether it is a liquidity problem with these countries. Ultimately, the solvency of a country is determined politically by the government’s capacity to raise enough tax to cover spending and pay debt. That is also a moving target. I would say that Greece’s capacity to raise taxes is not quite as one would wish. The point is exactly right: it is about liquidity, and it needs to be about liquidity. Your second point was about Germany. Could you remind me of it?

Lord MacLennan of Rogart: They are not necessarily going to get the fiscal discipline in time.

Edward Carr: Here we come to a real problem in this crisis. The German view is that you need to deal with the moral hazard that was present in the design of the euro, in the middle of the crisis. If you look at the pattern of the crisis you will see that the German attempt to try to limit moral hazard—first at Deauville when they insisted that in future private investors needed to pay some of the penalty, and then later on after the October summit when Papandreou wanted to hold a referendum and they said that if he did not want to put the plan through then Greece could leave the euro—introduced a foreign-exchange risk. Both these attempts to reduce moral hazard, although they were completely understandable for political reasons in order to keep pressure on countries to continue reforming, really scared investors and were responsible for a large part of the run, in my view, on the currency. They got some accountability with this pressure, and they kept the pressure up for reform, but I think that they bought that at an extraordinary cost.

Charles Grant: I do not have much to add to that. The Germans are quite right to be concerned about moral hazard, as they are. You need an element there of conditionality if the ECB is going to support Spain, Italy or whoever. The ECB is not the right institution to set that conditionality. It tried to do so with Berlusconi in September, I think, when it began to buy Italian bonds at a serious level and Berlusconi broke the promises that he gave to Trichet and Draghi on the structural reforms that he said he would undertake but did not. I guess that it has to be the Ministers who impose conditionality. You need a kind of informal connection between the independent ECB, which must be independent, and the Ministers who decide what conditions Italy or whoever has to meet.

Q42 The Chairman: The Ministers are not in the troika. The IMF is there, the Commission is there and the ECB is there, but, at the moment, the Council is not.

Charles Grant: Maybe it can be the troika, but I feel that the Ministers should be there too.

The Chairman: It is a very interesting point but perhaps we can move on.

Q43 Lord Harrison: I shall pursue the theme that you began with in your opening statements. The German ambassador in London, Ambassador Boomgaarden, said to our Economic and Financial Affairs Sub-Committee that Europe wants leadership but does not want leaders. I wonder whether you have a thought on that. That brings me to the eurobond issue. As you know, there has been a proposal to have eurobonds or, as they have

now been renamed, stability bonds. There are three types, each of which is more complicated than the other, though I am sure that you could parse them for us. I do not know what you think of those. Is not the essence of it—again coming back to Germany, through the eurobonds and collectivisation of the debt—that contrary to the expectation and hopes that they might have, that it would solve the problem of the debt experienced by Greece and others at very little cost, the truth is that there would be a kind of averaging of the debt? It would probably be at the lower end of the scale but, nevertheless, Germany would presumably pay more for borrowing than it had done hitherto.

Charles Grant: I have read a summary of the Commission's proposals for eurobonds but I am not expert on the minutiae. I have also read the original Bruegel proposal for so-called blue bonds and red bonds and the summary of the recent proposal by the German Council of Economic Advisers for eurobonds. I do not know which model is the best one but I have no doubt that something like eurobonds is needed in the long term if the euro is to be sustainable. We have to look at it in the short term and possibly the middle term and the long term. The short term must have the ECB playing a bigger role than it plays today. In the middle term, maybe the EFSF or the ESM has to develop into a kind of European monetary fund, an idea which is popular in Paris, so that it sets conditions in return for lending, like the IMF does. Then, in the long run, I think that you need a eurobond scheme. It would mean Germany paying more, without doubt, than it would otherwise pay, but given the economic benefits accruing to Germany from the euro system existing, I think that that is a small price to pay.

It is very interesting that the German government have not explicitly ruled out eurobonds in all circumstances. They seem to be more or less accepting the idea that, in the very long run, they might be a good idea. The view in Paris, as has been said, is that they only make sense at the end of a process of budgetary and fiscal integration, otherwise the moral questions and risks are very great. If you can convince the Germans that strict rules will stop Greece going on a party every time it issues eurobonds, then the Germans will be much more comfortable with the concept. I do not see any alternative in the long run, actually.

Edward Carr: I agree with what Charles has said. I think that in the long run the proposal for eurobonds suffers from all the problems of treaty change that we discussed earlier. I think that that qualifies their attractiveness. However, given how bad the crisis is, the idea of there being a liquid debt instrument that investors might want to buy is rather attractive, as people just do not want to buy the government debt of large parts of the EU. Ultimately that is a very big problem: you have to be able to issue debt that people want to buy. I think that this proposal by the wise men and the wise women—to be able to take the surplus debt, wrap it up in a eurobond with a finite life, and with a hypothecated tax to pay it off—is quite attractive. You take out the very toxic elements, rather like Brady bonds or something like that, though I think the idea originated with Hamilton in the US. You take this toxic debt and you create something that everybody can buy more confidently. You remove, you hope, the contagion from Europe, which makes everyone gain, since that is one of the main reasons why spreads have opened up, and you have something that is finite so that, if you like, the corresponding governance changes that you need to make people—i.e. the Germans—comfortable with it, are easier to get through. To my mind, that is a slightly more modest and therefore slightly more achievable way of getting some mutualisation of debt. Whether it is possible, I do not know, because you would be setting a precedent, and I think that that would worry the Germans.

Q44 Lord Dykes: The way things are going, one might begin to imagine that there will eventually be suggestions for new eurobonds to be linked to the value of land in the whole of the EU, rather as the Germans did with the Rentenmark after the inflation crisis. The Commission has now published its proposals for the eurobond system being able to oversee member states' budgets, and indeed even for putting a member state under some kind of administration or careful surveillance if there are specific problems. I choose my words with some care because we are not quite sure how this is going to work out. Do you both feel that there is a democratic deficit to these proposals, and would it prevent eurobonds or stability bonds from becoming a viable instrument?

Charles Grant: Yes. There is a whole issue about democracy in eurozone governance. I do not see the kind of solutions that the Commission is coming up with as inherently undemocratic so long as countries choose whether or not they want to stay in the euro. The Greek non-referendum may be the first of many such episodes, when a country may say, "Do we want to do this? Do we want to have parts of the Brussels bureaucracy controlling our budget deficits?" They may say, "No, let's leave the euro." One thing I think the new treaty will do is create an exit mechanism. It is obvious that no one would really be against that, to make it relatively easy—it would still be chaotic, as Mr Carr says, but relatively easy—for countries to leave the euro. I think that there is that fundamental choice that countries will make. If they want to stay in the euro they probably will have to accept much greater supervision of their budgets—not, I think, by the Commission; this Commission proposal is a non-runner; the French and the Germans are far too hostile to the Commission to allow that to happen—and some system of international bureaucracy running their government.

The one idea I picked up in Paris that is running very strongly there is for a new committee of national MPs to provide accountability to eurozone governments. It would definitely not be the European Parliament—the views in Paris and Berlin are no warmer to the European Parliament than they are in this town. Joschka Fischer, in Germany, has already floated this idea. He does not really represent anybody now but many of the French officials I spoke to mentioned this. I think it will be a French proposal in the intergovernmental conference for a new body of national MPs to quiz and supervise the new governance procedures, just like the European Parliament's Committee on Economic and Monetary Affairs tries at present to supervise the ECB.

The Chairman: The next question that we were going to ask is really about the bargain, which has been covered already. I would like to pass on to Lord Plumb and the question on the inner core.

Q45 Lord Plumb: I think that this has also been answered in many ways. Nevertheless, if we go back to the original proposal, we are well aware of the Franco-German suggestions from some time ago that an inner core should be formed within the eurozone. That has of course been strongly resisted. That we know. In the light of some of the things that you have said already—Mr Grant spoke of a two-speed Europe and Mr Carr said this is the biggest test since Suez, and we are in a situation where things could easily change and almost change overnight—is there a risk that a de facto inner core could form within the eurozone due to the loss of influence by those economically weaker states like Greece and Italy?

Edward Carr: You hear two ways in which this might come about. One is a falling away of states like Greece and Italy, leaving a core standing, and the other is a choice by the strong

countries to abandon and jettison the others. I think that the second of those is most unlikely because it is a denial of everything that German policy has been for decades. I think that it is not something that Germany would want. It would involve the wholesale breaking of European treaties. I do not think that Germany is about to do that, but it is an idea that is out there. More likely is the first of those. My doubts on that, though, are from thinking through the consequences of Greece leaving the euro. Greece is just about manageable but almost any other country leaving the euro would happen in an extraordinarily untidy way. You would have bank runs across the eurozone, even in Germany, because German banks would have to devalue all their eurozone assets. Europe is now so financially integrated that the stock of assets is substantial, not just in government bonds but corporate assets that, say, German banks hold in peripheral countries. You would get bank runs. It is not at all clear that governments can afford their deposit insurance schemes. I would foresee bank runs in all the peripheral eurozone countries. You would see capital controls, very bad blood between governments and possibly a suspension of the single market. In those circumstances, there is no nice, tidy, surgical creation of a core. It might come about but it would be a desperate act rather than something that can be nicely controlled.

Charles Grant: To some degree there clearly will be a core, because the eurozone will have its own rules and procedures to a greater extent than it does today. The question is whether that there is the risk of a de facto or de jure core. That is up to the British. If the British are perceived as too difficult, that will provoke other eurozone countries to have their core of 17—or 17 plus a few others—which obviously, as I said before, would not be in the British interest. Mario Monti has many times said that it is ironic that the countries which most believe in European economic union—the British, Swedes, Danes, Poles, Balts and Czechs—are, apart from the Estonians, outside the euro, while many of the leading countries in the euro do not believe in European economic union. He meant that they are the countries who blocked the implementation of the Bolkestein directive, which would have liberalised services across the EU. I think that he has a point. The risk is that, whether it is de jure or de facto—we do not know what it will be—you will have a group dominated by relatively illiberal countries that will have a view of the single market that is not the British view. They will caucus and, by the time the British turn up, we may find that we still have a vote but can be outvoted by QMV. We will have lost the argument because we will not be in the room when they argue. Even if, technically, the treaty at 27 still applies and so single market rules have to be decided à vingt-sept—by the 27—in practice, a whole group of countries will have got together first. This is a very serious risk to the single market.

Q46 Lord Dykes: The indications or hints yesterday and the day before from the IMF that there would be an emergency standby procedure for Italy certainly calmed markets and produced a very positive effect. That was quite a large amount of money, too. When you think of the Italian bond auction figures now, some 10 years ago they were at 8% and probably higher. There is no problem of liquidity in Italy. In your recent visit to capitals and to Brussels, do you get the impression of some kind of psychological role in the work of the IMF and the EU on these matters, with the possibility that the IMF will take a stronger role alongside and with the EU, as these things are worked out, or do you think it is a totally separate scenario?

Edward Carr: I do not have a sense of that.

Charles Grant: I do not have any inside information on that. It seems obvious to me that the IMF has a strong interest in being involved and should be. I do not think that its Asian

members would try to prevent it from being involved but it is not something that I have heard directly or recently, so I do not think I can answer your question.

Q47 The Chairman: Going back to the question that Lord Plumb asked, I think that the concept here was—it has perhaps been suggested again by Alex Stubb—that those countries within the 17 who have AAA ratings might form an inner core and would be able to do things together. We would be interested in your reaction to that idea.

Charles Grant: That is obviously happening to some degree. The Austrians, Finns, Dutch and Germans are obviously collaborating. Of course, the solidarity between what you could call the greater Germany has been reduced in the last few days because now these other countries have to pay more. I hear that some are urging the ECB in private—but also some in public—to take a more active role than it has done. So even Germany’s closest friends and allies are turning against it on this point, which takes me back to where I started. There is a German problem. Germany is very unpopular all across Europe. Many people in Germany are very worried about this.

Q48 Lord Plumb: Could I just ask: you said “they” are turning against Germany but who are “they”?

Charles Grant: I would say to some degree they are Austria, Finland and the Netherlands—countries that have been very much following the German strict-rules philosophy in the eurozone arguments are now becoming rather more critical of Germany.

Edward Carr: I would say that my former answer stands on that, but one thing to add is that I think those creditor countries are bound by common concerns—chiefly, the back-sliding among the periphery. That will get them to act together most of the time.

Q49 Lord Dykes: I have a quick question on personalities. Jean-Claude Juncker, who I think last year originally suggested eurobonds that would give a AAAA rating, was slapped down by the Germans at that time. Has his position and own personal role increased, although he is from Luxembourg, which has no weight? Is he active on the scene?

Edward Carr: His stock is not that high.

Charles Grant: He is not one of the most influential players in these discussions, as far as I am aware.

Q50 Lord Carter of Coles: I have a question about the role of the Commission in mediating between the core of 17 and the 27. Could you give some sense of where you think it stands and what influence and role it will have in this?

Edward Carr: I think that the pattern has been that the Commission has been excluded and then brought in at the last minute, partly to save face and partly because some of the smaller countries realised that the Commission is their ally. In this context of ins and outs—not eurozone but EU ins and outs—I think that it is very much in Britain’s interest that the Commission is involved. The Commission will see the interests of the 27 rather than of the 17 so I think that there is quite a lot at stake. It slightly dismays me that Britain is not really backing or promoting the Commission, even though it is in its interests to do so.

Charles Grant: I will just add a word to that. The Commission has always had a strong bias in favour of the 27 doing things together. It has never liked core Europe, partly because its own role would diminish in a core Europe. As Edward says, one of its key jobs is to protect the interests of the smaller countries. We have not really talked about that today. There has been a shift of power to the richer and larger countries in the EU. The smaller ones are very keen to maintain the Commission's role. In any battle over treaty change, the French and Germans will just have to concede to some degree. At every single stage of the eurozone crisis, when the French and Germans have dreamed up intergovernmental mechanisms, initially they have tried to exclude the Commission from the bailout mechanism of the EFSF but they have been forced to back down to some degree because of what the small countries want. Britain could win many plaudits and friends if it did as Mr Carr suggests and stuck up for the Commission against the French and Germans. We would have a lot of friends in smaller countries, but we do not play that game. We tend rather to ignore them and focus on just France and Germany—as we should, but we do not sufficiently focus on the smaller countries.

The Chairman: It was quite interesting that last week, when the Prime Minister went to Berlin and had breakfast in Brussels, he seems to have had a rather more satisfactory press conference with President Barroso after that meeting than he had with Chancellor Merkel after his meeting with her. That may perhaps be a positive sign for the future.

Charles Grant: Yes.

Q51 Lord Trimble: Could I just ask about the stability of the European banks? I get the impression that there is a sort of credit crunch developing there analogous to the one we experienced in 2008.

Edward Carr: Yes. I think that a really disastrous mistake was made in October. If you remember, they came up with the comprehensive package to solve the crisis. This mistake was to give banks nine months in which to raise their capital standards—their tier 1 ratios—to 9%, which was far too long. They should have done it very quickly. That would have forced the banks to go out and raise capital and, if they could not raise capital from the markets, to raise it from their own governments. Instead, by giving them nine months, the banks have another way of getting those ratios in shape, which is to cut back on their lending. That is what they are doing. There were agreements with governments that they would not do it at home, but they are doing it elsewhere. That is very bad for Turkey and bits of eastern Europe and it is only going to make the recession much worse. This only came about for the most cynical reasons, I believe. France was worried about losing its AAA rating and could therefore not afford to stand behind its banks. Germany refused to allow France to use the EFSF, so France bargained to get a long time to do it. That has just made the recession worse. It will make countries miss their debt targets, which will make markets scared. It was a very, very bad and self-defeating piece of policy.

Charles Grant: I have a footnote to add to that. We have not touched on the issue of bank regulation. There is a clear logic for the eurozone countries having a much more integrated system of financial supervision. They really need a single regulator for their banks, given how interconnected they are. We do not have to go along with that and probably should not, being outside the euro, but it creates potential clashes and conflicts of interest between what is good for the 17 and what is good for the 27. That is something that we in this country ought to be aware of.

Q52 The Chairman: Thank you very much. There has been a thread running through all your answers about what sort of position the UK should adopt to these problems over the next few months. In this closing question, would you summarise what position you feel the UK should take over the next few months?

Charles Grant: I have four brief points. First, the shopping list that we should bring should be modest and not provoke the others to make a treaty change without us, as I have already said. That means that we should forget most of the ideas about the repatriation of powers that we hear among Eurosceptics in this country. One thing that we should focus on is the City of London. There is a real risk that, because of qualified majority voting on financial regulation, France, Germany and others could support regulations that affect and are damaging to the City. I do not believe that it has happened yet to a significant degree but it might do. Therefore, if we must—I think we probably should—make some demand in this area for a so-called emergency brake, there should be some system whereby, if the others attack what we say is a vital national interest, we can call a halt and block things. Something in that area would be my suggestion to the British Government, plus a political agreement on the Working Time Directive, which many countries have problems with and which does not require treaty change. I hope that the Government do not try to enact the justice and home affairs opt-out in 2014, which the Lisbon treaty allows. Pulling out of Europol, Eurojust and the rest would be very damaging to the British national interest. It would horrify the police. But that is something that the Government can do without changing the treaty and it would be red meat to Eurosceptics. I fear that will happen but hope that, if it does, we immediately try to opt back in to as much we are allowed to. Finally, let us try to be positive. Let us not only think about repatriating powers. Let us take the lead in a new single market programme, a new attempt to liberalise services and e-commerce across borders and, another example, to liberalise energy markets further. We would have a lot of support there. Even the Germans might support us on that one. One or two countries would be less happy. If we had a positive agenda, and perhaps called it a growth rather than a single market initiative, then we would win some friends and allies.

Edward Carr: I think that that is an excellent summary. I will just add a couple of things. One is that I think present policy is quite self-defeating. We say to the eurozone that it really must solve the problem, that that is vital and essential. Yet we do not do anything ourselves to help, unlike, say the Swedes. We say that the single market is essential and really important, yet we just seem to want to find all sorts of exceptions and opt-outs that will only set a precedent. We say that we want a liberal Europe, yet we are driving Germany into the arms of France, which I think is a mistake. Instead, I reiterate what Charles said. I think that we need to embrace the Commission. I think that we need to pick our battles very carefully. We need to promote liberalisation, calling it growth, or it will not go very far with France. We need to look for allies to undermine what I think is the French vision of the way Europe will come on, which is not in our interests. I think that there are allies to be had.

The Chairman: The Committee really appreciates your coming and speaking so fully to us. This is not a very happy time but we are at least unhappy at a higher level thanks to the contributions that you have brought. Thank you both very much indeed. We will look forward to continuing to read you, sometimes explicitly when you have a supplement and other times anonymously—and from Charles in all sorts of places. Thank you both very much indeed.

The Rt Hon David Lidington MP, Minister for Europe – Oral evidence (QQ1 – 26)

Evidence Session No. 1. Heard in Public. Questions 1 - 26

TUESDAY 8 NOVEMBER 2011

Members present

Lord Roper (Chair)
Lord Bowness
Lord Dykes
Lord Harrison
Baroness Howarth of Breckland
Lord Jopling
Lord Maclennan of Rogart
Lord Plumb
Lord Richard
Earl Sandwich
Lord Teverson
Lord Trimble
Baroness Young of Hornsey

Examination of Witness

David Lidington MP, Minister for Europe

Q1 The Chairman: Minister, we are very pleased to see you and your colleagues. We should warn you there is a risk of a Division in our House, and I am afraid that it is something on which most of my colleagues will wish to depart and vote. We will adjourn for 10 minutes if there is a Division. I remind you that this session is in public, it will be televised and a transcript is being taken. You will have a copy of the transcript, and you will obviously have the opportunity to make minor amendments to it, although it will be published online in an uncorrected form first.

Perhaps I can ask you the first question. I wonder whether you could update us on developments on the euro area crisis, since the 26th/27th October package was announced, perhaps with regard to the outcome of the G-20 discussions in Cannes. Perhaps you might also in that say something about recent developments in Greece.

David Lidington: Thank you, Lord Chairman, and I am very conscious that, after the events of the last couple of weeks, saying anything on the basis that this is providing a completely up-to-date account of events in the eurozone is taking a pretty big risk, but I shall do my best. The Government's view was that what was agreed at both the eurozone summit and

the informal European Council was welcome progress. The conclusions reflected three essential elements that we had been calling for for some time: the reinforcement of the bailout fund by eurozone countries to create a proper firewall against contagion, recapitalisation of weak European banks and a decisive resolution to the unsustainable position of Greek debt. But it is also fair to say that on all three of those counts there was quite a bit of detail that remained to be filled in at the conclusion of those meetings.

As far as the G-20 summit in Cannes was concerned, Lord Chairman—I think the Prime Minister’s Statement was probably repeated in your House yesterday—there were three key aspects. The eurozone was the main subject of conversation. I will come back to that, but I think it is worth just pointing out in passing that the Cannes summit also agreed an action plan for growth and jobs and continuing work to identify and remove some of the key obstacles to growth, and those issues also featured in the European Council meeting. I have to confess that one of the really frustrating things for British Ministers is that, while there is a great deal of support around the Council table for the EU to focus much more on measures to create jobs and foster growth and global competitiveness, the inevitable consequence of so much top-level government time in Europe being absorbed with the eurozone crisis is that potential energy is being deflected from those crucial economic challenges.

Let me come back to Cannes and the eurozone. It was clear from the Cannes meeting that the major economic players in the world felt that concrete action needed to come from the eurozone and that there might be a case for specific eurozone countries to be helped internationally, in the way that any other country in the world might be helped internationally, but that could not be a substitute for the eurozone countries facing up to the prime responsibility for restoring stability to their own currency.

As far as Greece is concerned, there is no doubt that the political developments there have added to instability and to market uncertainty, which has affected not just Greece itself but wider confidence in the eurozone. Ultimately it is up to the Greek electorate and Greek political leaders to take their own decisions, but we think it is important that all parties stick to the deal that they agreed on 26 October.

As far as British risks are concerned, our direct exposures to Greece are relatively low, certainly low compared with our exposures to some other troubled eurozone economies. But the intertwined and interdependent nature of European economies means that we would not escape a dramatic collapse in Greece, or a prolonged recession in Greece, because there would be consequential effects on other countries and on individual companies and financial institutions where significant British interests were involved.

I would just add, Lord Chairman, that, as of the time I walked into this room, the word from our embassy in Athens was that there had still been no announcement of a new Greek Government. There are a lot of rumours but there is no confirmation of the name of a Prime Minister, the composition of a Cabinet or the timing of elections.

Q2 The Chairman: Thank you very much indeed. On the question of the exposure of British banks, although we may not be directly exposed to a very significant extent to Greece, in so far as we are exposed to banks in other eurozone countries that are themselves in turn exposed significantly to Greece, our total exposure may be somewhat larger than the BIS figures might suggest immediately.

David Lidington: Yes. That is certainly true. There are significant United Kingdom exposures, we believe, to some banks that have exposure to Greece, and that is before you get on to the question as to whether contagion from a Greek crisis could be adequately contained, and I do not need to tell the Committee that we have much bigger direct exposures to Ireland, to Italy and to Spain as well as, of course, very significant British interests at stake in Cyprus.

Q3 Lord Teverson: Minister, thank you very much for that update. That was very good. I suppose it is quite easy to identify with President Sarkozy and his comments on our own Prime Minister's comments on how the eurozone is sorted out. Does that change the way that we think about it, or how do we respond to that in terms of our own engagement with the eurozone and sorting out their problems, when clearly we want to keep clear blue water between us and them in terms of both financial commitment and, I suppose, future and further integration?

David Lidington: There are a couple of key points. First, we need to continue to make it clear, both privately and publicly, as we are doing, that our judgment is that it is profoundly in the United Kingdom's national interest that the eurozone finds a way through this crisis and is able to restore stability. I think that any hint of gloating or Schadenfreude would be damaging to our interests. There is a great deal at stake here.

Secondly, there is, as the Chancellor of the Exchequer has said, a remorseless economic logic to the need for greater fiscal and economic union to balance the monetary union that the eurozone already has. For those who, like me, have been critical of potential British membership of the eurozone in the past, this has been one of the key elements in that critique. You cannot have an effective single-interest-rate monetary policy currency union unless you have a more closely integrated economy and fiscal policy, and policy on borrowing and spending as well.

Thirdly, alongside that remorseless economic logic, there is a political reality, and that is that greater economic union means giving to some kind of supranational authority the power to take decisions over what we would regard as key elements of economic policy. So there are important questions for the eurozone countries as they move forward as to how they make these arrangements democratically accountable and how they secure public consent for what they are doing. I do not underestimate the challenge, whether we are talking about Greece or whether we are talking about Germany in different ways.

Q4 Lord Teverson: Can I just follow that up? How do you think Britain should start to address the fact that—the equivalent is the end of the Cold War—at the end of the eurozone crisis there will be one economic superpower in Europe, in the eurozone? Does that not destabilise power within Europe very strongly?

David Lidington: The European Union is a strange beast. It is not something that is trying to model itself upon a classical Westphalian-style nation state. One of the important challenges for the United Kingdom is to ensure that as the eurozone—as I expect—seeks to build this greater economic unity, the integrity of the single market is protected. I think that means, for example, us recognising and saying publicly that many of our strongest allies, on issues to do with the single market, with global trade and with less burdensome regulation, are countries inside the eurozone. I have come back this morning from the Netherlands. As a

British Minister talking to Dutch Ministers, there is a tremendous fellow feeling on much of this economic agenda, even though one country is in the eurozone and the other is outside.

The Chairman: I think that one of your colleagues from BIS had a meeting recently of seven Ministers from eurozone countries and seven from outside to discuss some of these competitiveness matters.

David Lidington: Ed Davey has been doing superb work on bringing together like-minded member states and, as you say, Lord Chairman, at the last meeting there were seven outs and seven ins sitting around the table.

Q5 Lord Richard: I wonder if I could draw your attention to paragraph 29 of the summit conclusions. I would like to have a look at that paragraph, if I may, in some detail. It starts off by saying, “We will further strengthen the economic monetary union and better co-ordinate macro- and micro-economic policies”. I assume that is fairly common language that one often sees in this sort of communiqué. There is nothing more definite than that in that sentence. “Building on the Euro-Plus Pact, we will improve competitiveness”; I suppose that is the same. Again, it is not quite Euro-babble but it is fairly normal Euro-language.

David Lidington: I will defer to Lord Richard’s much greater knowledge than mine of Euro-language.

Lord Richard: Mine is way out of date. The language has changed. Whether it has improved or not, I do not know. “Thereby achieving further convergence of policies to promote growth and employment.” Fine. It is the next two sentences I have problems with. “Pragmatic co-ordination of tax policies in the euro-area is a necessary element of stronger economic policy co-ordination to support fiscal consolidation and economic growth.” Pausing there for a moment, what is the thought behind that sentence?

David Lidington: It is a subset of the argument that the Chancellor of the Exchequer has advanced, that there is an economic logic in saying that if you have a single currency, you need to have much greater integration of fiscal and broader economic policy, and we do not have a problem with euro area members engaging in discussions about tax policy co-ordination. We think that, at the same time, where a tax policy issue could affect the single market, or indeed just all 27 member states, it is very important that discussions on that area of policy continue to include everybody, and not just the 17.

Lord Richard: Do you see the discussions on the co-ordination of tax policy within the eurozone being conducted with 27 members, and not just the eurozone members?

David Lidington: I think a lot will depend on exactly how they choose to take this forward. At the moment, the eurozone members are talking primarily about the common consolidated corporate tax base and they are also talking about a financial transaction tax, although we wait to see exactly what comes out of those discussions. Certainly on the common consolidated corporate tax base, we remain engaged in those discussions. If it goes beyond discussions—

Lord Richard: Sorry to interrupt. Discussions on tax co-ordination within the eurozone?

David Lidington: No. At the moment, those discussions are at the level of 27. Even if there were to be, at some stage, a 17 initiative only, that could have implications for British

companies operating across the national frontiers of Europe. So we have an interest in being participants in a discussion, but the point I want to make is that there is an important difference between a discussion which, in our view, should take place primarily in Council and the various official gatherings throughout Europe and so on, and a measure under enhanced co-operation—obviously it is possible within the treaty for a group of countries, nine or more, to take forward a measure under enhanced co-operation if they wish to do so and there cannot be the necessary agreement among the 27. Tax policy is, for the most part, a matter where unanimity still applies—and there is talk among some of the eurozone countries that perhaps they might want to go down this path of using enhanced co-operation. One hears that from their Ministers from time to time. Of course there are clear conditions written into the treaty—Articles 326 to 334 of the Treaty on the Functioning of the European Union make it clear that any enhanced co-operation measure must not infringe the single market or distort competition, and that it must respect the rights and competencies of non-participating member states, and those non-participating member states, while they do not have a vote, are entitled, as of right, to a seat at the table when those who are participating in enhanced co-operation are discussing and taking decisions about that measure.

Lord Richard: You see the impression one gets—at least that I get—is that the UK Government is saying—

The Chairman: I am sorry, we have to adjourn, I hope for no more than 10 minutes.

*The Committee was suspended for a Division in the House.
On resuming—*

Q6 Lord Richard: Minister, I think I was talking about impressions when we were interrupted by the bell. It does seem to me that the Government is presently giving the impression of saying, “Right, we are in favour of greater fiscal co-ordination, indeed, quite close fiscal co-ordination within the eurozone, and we want to be part of the discussions, as close as we can get to those discussions, in the hope of influencing them.” But in reality, almost everything that is likely to come out of those discussions, as the UK, we are almost certainly going to be against.

David Lidington: We have to see what comes up, because if we look back at the statement that was made by the Euro-Plus Pact member states earlier in the year on pragmatic tax co-ordination, they talked not about specific new taxes; they talked about exchange of best practice, avoidance of harmful practices and proposals to fight fraud and tax evasion. I do not want to prejudge what my colleagues in the Treasury will think of a particular idea, but it strikes me that there might well be ideas that come out of that discussion that fit the way in which we see the world. It is certainly the case that we are less enthused about some of the other ideas, and the Government has said publicly that it is not going to support new European-level taxes.

Q7 Lord Richard: That was diplomatically put, if I may say so. Would you agree with this, finally, that however you look at it the tectonic plates have moved, that power is not going to be the same in the future as it has been in the past if the eurozone gets its act together and co-ordinates, and apparently they do not have a group, so—

David Lidington: I think that it is going to be different however the current crisis pans out. It is too early to make firm predictions about future patterns of power within the European Union. To take one obvious example of that, those member states that are in financial difficulties are going to need to follow through with some very demanding programmes, not just of immediate austerity but of fundamental structural reform of their economies, if they are not to become a long-term drag on the prosperity of the eurozone overall. It is in our interests that the eurozone is very prosperous and growing fast, but there is a lot to be done before we can reach a firm view about how power will be disposed, and certainly the UK is not going to be sitting on the sidelines. We are going to be extremely active in engagement, both with euro-outs and euro-ins, in the way that best suits our national interest.

Q8 Lord Jopling: Minister, my recollection is that all members of the Council always have at the back of their minds how much support and how many votes you need to create a bloc within the meetings of the Council. Just for the record, because I have lost touch with this—and certainly I remember always being able to calculate very quickly whether I had enough for a bloc or not—of the 10 members who are not within the euro, how many votes is that, and how many more is that than you need for a bloc?

David Lidington: If your Lordships will forgive me, I will ask my officials if they will provide me with a note on the exact numbers, but I think the key point behind Lord Jopling's question is that when the new voting weights provided for in the Lisbon Treaty come in in 2015, at that stage the 17 current members of the eurozone would have a built-in qualified majority, should they vote as a bloc. Clearly there is an inherent risk, just in that arithmetic, that you could have, I suppose, a stitch-up of a single-market issue, but I would say by way of reassurance, Lord Jopling, that there is no evidence whatsoever that that is how eurozone countries themselves are thinking at the moment. It is quite the reverse. What many eurozone members are saying to us is that they very much want to defend the integrity of the single market. They do not want to have the European Union divided into rival blocs of those who are in the eurozone and those who are out. I think we certainly need, as the UK, to be looking for agreement on rules of process that protect our national interests and the interests of everybody who is not part of the euro.

The European Commission has an important role to play here. It is the guardian of the treaties and of the interests of the 27 as a whole, and we look to President Barroso and his team to live up to those responsibilities fully, but also it is about a culture of working, which is why I put huge stress upon the need for British Ministers to be actively working alongside and seeking common cause on various dossiers with not just fellow euro-outs but with euro-ins.

Lord Jopling: Minister, I saw a note being passed. I am very surprised these figures are not available. I hope that note says what they are, but it seems to me absolutely crucial on this arithmetic, and if that is what the note was, would you tell us what it says?

David Lidington: Yes. You want the numbers for euro-outs and euro-ins at the moment, and we will give those to you as soon as we have them. My point, Lord Jopling, though, would be that although the eurozone at the moment is short of a qualified majority, it does not get that until the Lisbon weighting comes into effect. The political reality would be that if the 17 wished to act as the core of the bloc, then, with the support of euro-outs that are

very keen to get into the euro as quickly as possible, it could be assembled, but I do not see any evidence at the moment that that is how they are thinking or that that is their intention.

Lord Jopling: We would like the figures for the present and post-2014.

Q9 The Chairman: Minister, can I just get you to repeat what I think you said? There is really not very much evidence of homogeneity either within the ins or among the outs, and I think there is an assumption too often that there is rather more homogeneity than is in fact the case.

David Lidington: I think that is certainly the case, Lord Chairman, and it is worth reminding ourselves that it is some years since the euro was created. When the euro was set up, there was a great deal of fear that this might prompt the division of the European Union into two blocs. What we have found—in the present Government and our predecessors in the Labour Government—was that when you went into Council meetings, the Ministers from the various eurozone countries came in and they were perfectly happy to disagree with each other where it was in the interests of one country to do so.

Q10 Lord Harrison: Minister, I, too, would like to submit you to some textual analysis, followed by inviting you to give your best intellectual punch. Paragraph 34 of the 26 October summit conclusions says, “The euro is at the core of our European project. We will strengthen the economic union to make it commensurate with the monetary union.” This morning, in interviewing and concluding our own evidence-taking sessions on this matter in the Economic and Financial Affairs Sub-Committee, I posed the question that there had been a change, in the sense that it had now been decided among the 17 that indeed they would repair the fault line of the origin of the EU, and in a sense bring together economic and monetary union and fiscal and monetary union. Our witness replied that indeed it was centred on Germany and that he had detected a sea change, so there may be Prime Ministers around the European Union doing this and doing that, but this change had occurred that now concluded and understood that there was a need for bringing together the two sides—the economic and fiscal side—with the monetary union. Is that your hunch?

David Lidington: I would say yes, up to a point, and of course I should start by saying, as Lord Harrison knows, that the paragraph that he quoted was from the eurozone summit conclusions rather than the summit of all 27, and yes, those words did demonstrate the commitment of the 17 to trying to make their monetary union work and to strengthening their economic union so that it matched it in the way that my colleagues and I in the present Government would argue needs to be done.

I am reluctant to be drawn too much into speaking on behalf of German Ministers. If I confine myself to those things that are in the public record, yes, I think you see in the statements and speeches of German Ministers an understanding that there has to be greater integration in order to keep their currency union stable, but you also see in the Bundestag, in particular, a great concern about trying to avoid moral hazards. There is still an understandable fear, when you look at Germany’s history in the 1920s, of them being expected to stump up for the debts and liabilities of other people. They are also, understandably, very conscious of the role of their constitutional court and the importance of democratic accountability within the German system for the key issue of where the power to take economic decisions should lie.

Q11 Lord Harrison: Let me then revisit some of the ground already covered by Lord Teverson and Lord Richard about the role of the United Kingdom in the EU 27, of which we are a part. It is surely more subtle than you describe. After all, we already rightly contribute to the element of the European semester in sharing our annual budgets, and that is right and proper. But when it comes to the division between 17 and 10, that is not subtle. There may be no great homogeneity among the 10 outside or the 17 inside, in some instances, but there are ins and there are pre-ins. They are not only determined, but it is part of the treaties for them to go in, and then there is us. Even the Euro-Plus Pact that you mentioned, there are now 23 countries signed up to it. So it is no longer 17; it is 23. Actually, on the Euro-Plus Pact, you may be wrong. I will go and check it myself. I think the CCCTB actually comes into that. That is one of the suggestions. I may be wrong, but I think it is, in which case it does begin to trespass into the area that you might think from the United Kingdom perspective is much more difficult. I think that you have said many of the right things. That, as the Government, is a positive approach, but the reality is that it is not quite that we are on the outside and the others are on the inside. It is much more subtle, and the waning of powers may develop as this begins to bed down and develop in time.

David Lidington: It certainly is the case that among the 10 euro-outs there are some who see themselves as on the verge of entry. I think Latvia and Lithuania would be the two I would point to in particular. It is not just the UK, but Denmark of course is not intending to join the euro. Sweden has the commitment in her accession treaty but her people voted against it, and the political reality is that that is not on the agenda at the moment in Stockholm. Different countries have to be understood individually, but I think the same is true of the countries inside the eurozone.

If I go into a discussion about, let us say, an EU free trade agreement with Canada or Japan, the division on that issue does not by any means fall neatly into euro-ins and euro-outs. The same is true when we get into a discussion about the extension of the single market, or a discussion about common foreign and security policies. I do not think that there is any reason to believe that there is some automatic trend that we are on for the eurozone to act as a cohesive bloc. It is certainly in our interest to be active players, and we are looking at multi-dimensional chess games here, but it is a cause for concern. We want to make sure that we do not get caucusing and the development of rival blocs, but it is not by any means a cause for panic. It is a cause for sensible active diplomacy.

Q12 Lord Harrison: Of course you are right, and we need to be graduated in our approach to the 17, but I am saying the world is such that we may find ourselves with Denmark at a very small table indeed, the others being gone. It may be that others are coming in. If you think about the seven countries described as the West Balkans, already three of those match their currencies to the euro. That is where things are moving, and it would be perilous indeed for the United Kingdom not to be awake to that and to respond to it in as graded a way as possible.

David Lidington: I am certainly not for one moment suggesting that we are going to be inactive in doing this. I want to make one further point, which is that it is not just a matter of United Kingdom policy, or Danish or Swedish policy, and it is written into the treaties that what ought to be discussed and decided at 27 should be discussed and decided at 27 using the methods for taking decisions and legislating that are set out there, which is why, as I said earlier, the Commission and, for that matter, the President of the European Council do have

important roles to play here in safeguarding the interests of the Community overall and in respecting what is in the treaties.

Q13 Lord Trimble: Minister, I will not be asking you to engage in any close textual analysis, but I will refer you to paragraph 6 of the 26 October paper, which is dealing with Italy. It refers to proposals of the Italian Government for structural reforms and fiscal consolidation and so on. What is the Government's view of those proposals?

David Lidington: We think that they are sensible proposals that the Italians should implement. It is fair to say that most if not all of the proposals that were in the Italian Government's letter were measures that had already been announced. They included labour market reforms, privatisations, pension reforms, a formal public administration of the welfare system, fiscal system, and a greater competition in fuel distribution vehicles, insurance and local public services. These are all measures which—with all the respect that I as a British Minister must give to Italian elected politicians to determine their country's future—it seems to me, as a friend of Italy, are in Italy's interests to implement in order to get Italy back on the path of increasing its rate of growth and finding jobs for its unemployed young men and women.

Q14 Lord Trimble: Minister, earlier on in another question you referred to how Europe has consistently failed to grasp the issues that would lead to increased competitiveness. It is the loss of competitiveness in these countries that is the root cause of the problem they now have. Is there any likelihood that these measures, which the Italian Government is currently putting forward, will lead in the near future to a significant increase in competitiveness?

David Lidington: While one cannot ever be certain about what impact any one particular measure will have, all of us these days are influenced not just by domestic political decisions but by what is happening globally. We believe that those measures would help to modernise the Italian economy and to provide for a better growth rate than they have at the moment.

Lord Trimble: In the near future?

David Lidington: I would not like to put a timescale on it, because I think that does depend on what is happening more generally in the eurozone and what is happening in the global economy.

Lord Trimble: If there is not an increase in competitiveness in the near future, the fiscal problem will just simply get worse.

David Lidington: That is true. If one is wanting to look for an example of how tough reforms can have a beneficial impact, relatively smoothly, of course it is the Republic of Ireland, where we have seen a return to growth in the relatively few years after desperately painful decisions were taken by the previous and present Irish Governments.

Lord Trimble: I note the example, but they started off very quickly with a very commendable energy that seems to be absent elsewhere.

David Lidington: That is why we are certainly urging all concerned in the common interest to demonstrate energy and commitment.

Q15 Lord Richard: I really wanted just to come back to one point on the co-ordination of fiscal policy, which I should have perhaps asked you about and did not. Paragraph 29 states, “Legislative work on the Commission proposals for a common consolidated corporate tax base and financial transaction tax is ongoing.” Does this mean that these are totally outside the eurozone movements? These are the ones that the Commission has been looking at for quite a long time.

David Lidington: Yes. The two things are different. On the CCCTB, we remain engaged in discussions to try to shape that, given the implications to UK companies operating across the EU. Whatever the outcome, it is important that there is clarity for businesses and tax administrations whether a particular country is taking part in this or not. The FTT is different. We are still engaged in the international discussions about this, but we have made very clear our view that the idea of a European financial transaction tax would be counterproductive, and again it is not just us. The Commission’s own impact assessment says that to introduce a financial transaction tax in the European Union would lead to a loss of economic growth of up to 1.76% and a loss of jobs as well. We are keen to see growth-enhancing measures, but not growth-reducing ones.

Lord Richard: Thank you.

David Lidington: Lord Chairman, let me briefly give the figures that Lord Jopling was asking me for, for the record. Under the current voting arrangements, the euro-outs have 132 votes and the euro-ins have 213. A qualified majority requires 255, and a blocking minority 91. So at the moment the 17 are a little way short.

Lord Jopling: You might say that is a comfortable cushion.

David Lidington: I never take any cushion for granted, however it looks.

Lord Jopling: No. That is fine.

Q16 Lord Dykes: Can we now, Minister, come to the rather delicate but fascinating area of possible treaty changes? You mentioned the Bundestag in Germany returning to the idea that was promulgated by them as a proposal that there might be a treaty change to incorporate a specific mechanism for handling any future euro-area crises, and indeed possibly including sanctions for those who do not follow budgetary or financial rules. Of course, you might say that the last few days’ developments have put that slightly back, but not very much. Would the Government support a proposal for a treaty change along those lines, applicable only to eurozone members?

David Lidington: The main effort should be on the immediate problem. The concern I have about some of the talk on treaty change—and of course we have not had any text tabled as yet—is that it simply distracts attention from the need for eurozone governments to sort out the package on bank recapitalisation on Greece and on the firewall. A treaty change cannot be a substitute for that because, by definition, a treaty change is—if historical evidence is a guide—unlikely to be either quick or straightforward. It risks being complex. The German Government have openly said that they want to see a treaty change to provide for automatic sanctions using the European Court of Justice. It seems likely that they are talking about Article 126, although there are various options on the table. We would look at

any proposal for treaty change on its merits. We are not saying that we will sit there and block it and veto it. We are saying, “We will look at it on its merits, but please, colleagues, don’t let this distract you from what needs to be done, and done urgently.”

Q17 Lord Dykes: Of course that sounds as though you are saying, rather encouragingly, that the Lisbon Treaty provides an ample framework anyway, with the modernisation procedures and the co-ordination implicit in that, and that that is mutual between the ins and the outs and so on. But as you were implying before, there is no automatic clash between them and, therefore, the Germans could think again about that and not have the idea of a separate new treaty change applicable just to themselves and the other eurozone members. It could be done under Lisbon.

David Lidington: I completely understand why German leaders, with the Bundestag and the Constitutional Court, are saying that they feel that they need to have the certainty of treaty change. It is also fair to say that there is no enthusiasm around the table for another round of treaty change because of all the uncertainty that that entails. What would be interesting to see, when Presidents van Rompuy and Barroso report in December, is what they say about the ability of existing instruments under Lisbon to address the problems that everybody has identified.

Q18 Lord Dykes: Are you implying that you are in favour of that and the Government is as well—I am not criticising at all; I quite understand—because that would be a convenient way of avoiding any difficult referendum decisions under the European Union, which might be more than a—

David Lidington: I think it is completely straightforward in what it requires. I do not think there is a huge appetite anywhere in the European Union to have a British referendum, but the—

Lord Dykes: Is there an appetite in Britain to have a British referendum?

David Lidington: That depends on whom Lord Dykes speaks to, but as far as the immediate issue is concerned, it is certainly argued, “Let’s see what can be done under existing instruments.” But more important than that, it is the view of a fair number of eurozone countries and the present European Council that one should look first at what could be done under existing instruments. Then, if there is a proposal for treaty change, let us consider that on its merits. If there is a debate and a negotiation about that, then clearly the issues that we have discussed earlier this afternoon about protecting the interests of the 27 and other various national interests are ones we would have in mind.

Q19 Lord Dykes: You would understand readily, Minister, that close observers of this complicated scene—and Members of this Committee are automatically close observers of this scene—would be a little bit puzzled, because the Government has to some extent proceeded from the original triumphalism of “Thankfully, we’re not in the euro” to now a much more earnest and serious decision to be supportive of eurozone members in finding solutions to this crisis, because it does affect us, and not just because of our possible exposure to the banks, which you described earlier on. The Chancellor spoke on 27 October, in the House of Commons discussion, on further limited treaty changes to rebalance Britain’s powers and Britain’s interests and powers of the European Union, and

maybe bring some back to Britain—repatriation. Could you guide us by telling us what this now means and what the Chancellor meant then, and what you now think this will mean?

David Lidington: When the Chancellor talked about rebalancing within the European Union, he was echoing a phrase used by the Deputy Prime Minister, when he coined it in an interview that he gave on Tuesday last week, and the coalition has a commitment, as the Committee knows, to look at the current balance of European Union competencies. That is work that is at its very early stages, and we will be taking that forward, and I am sure there will be opportunities to discuss that in detail as that work develops.

Lord Dykes: But that is bound to mean treaty change proposals for the UK, isn't it?

David Lidington: It depends on what the outcome of that examination is. I do not want to pre-empt that work at the moment.

Lord Dykes: Are you are returning to the original government position that you have no intention of using the European Act in this Parliament?

David Lidington: Again, I do not know. The European Act is being used already in this Parliament, not least because we have used it in order to make a judgment about the proposed legislation on the European Stability Mechanism and because that Act will require all changes to the Treaties to be ratified in this country by primary legislation, even if they do not require a referendum under the terms of the Act. So Lord Dykes is right; it has always been the intention of the Government not to support any transfer of power or competence from the United Kingdom to the European Union institutions.

Lord Dykes: I would like to thank you for restoring the powers of this Parliament.

Q20 Lord Bowness: Minister, do you think the statement by President Barroso and Commissioner Rehn, that they look forward to seeing a unity Government in Greece, amounted to a justified or unjustified intervention in domestic Greek politics, and does it suggest that Commissioner Rehn is ready to assume or has already assumed the role of European Finance Minister?

David Lidington: I think what those words indicated was the sense of real urgency that there is in the Commission, and in a sense is shared by countries both inside and outside the euro, that the political leaders in Greece decide on the way forward and then stick to it. We know that Commissioner Rehn is not a European Finance Minister. He has been appointed now as a Vice-President of the Commission for Economic and Monetary Affairs, and I think that is perfectly appropriate, given that he has taken on an enhanced role with the travails of the eurozone, and I would say he is doing a pretty effective job in doing it. Of course, it is worth noting that President Barroso, in appointing him as a Vice-President, specifically drew attention to the point that Commissioner Rehn would have a key responsibility for ensuring that the interests of all 27 member states and the integrity of the European Union as a whole were respected in the discussions about the future of the 17.

Q21 Lord Plumb: Minister, it is inevitable that the discussions so far and the questions posed have all been related to financial crises. You will be aware that we produced a report on the single markets a while ago, which had a good hearing when it was debated in the

David Lidington: I agree completely with Lord Plumb. This is a key priority, probably the single most important priority in European policy for a British Government, and what is heartening is that there is, in my experience, a growing recognition across the European Union, including from some countries that previously have been sceptical, about the need to develop the single market further, if we are not to condemn future generations of European citizens to a lower standard of living than that which we have taken for granted for so long. We have a detailed British agenda, which ranges from completion of the single market in services, through full implementation of the services directive, to subjecting restrictive practices that are permitted to a proportionality test, to reducing the number of regulated professions, to creating a fully functioning digital market in the EU by 2015 and a single market in energy by 2014. There is a lot of very important work that the European Union can do that could improve the chances of job creation and wealth creation in every one of the 27 member states.

If I may—if I have time to do it—it is worth drawing attention to and paying tribute to someone with whom the Government crosses swords on a number of occasions, Commissioner Barnier. I do not resile from the criticisms that we make of some of his initiatives, but last week he did announce that he was taking Germany, Austria and Greece to the European Court of Justice over their failure to implement the services directive fully, and I think that is a good example of the Commission acting as the guardian of the single market and of the treaties in the way that we hope they will continue to do.

Lord Plumb: Do you see this mostly in industrial growth, in development in different countries and cost compliance?

David Lidington: It depends very much on which country we are looking at, but what I am struck by is the degree of common accord across the European Union that, whichever sectors a particular country is strong in, to have a developed, single market will help us to deploy resources with greater efficiency.

Q22 Lord Dykes: Minister, subject to your time for consultation with your Treasury colleagues, there is one area where there does appear to be slowness. I think three years ago the Commission promulgated the single bank transfer system throughout the single market, that is bank transfers between banks, and so on. There are disturbing signs of that being very slow in a number of member states, and also that the costs of it still remain international, rather than in a single market context. There are much lower costs for what is really just pressing a button for an electronic transaction, as you know. Would the Government be able to pursue that to make sure that that single bank transfer in the market, particularly for ordinary customers but also commercial companies and SMEs, would be implemented quickly?

David Lidington: I can certainly see the attractiveness of that. I think the best thing, Lord Chairman, is if I consult with my Treasury colleagues and write to Committee Members.

Lord Dykes: Thank you.

Q23 Lord MacLennan of Rogart: Can I just ask how the consideration that has been given to repatriation of powers conforms to the objectives of achieving an improved single market?

David Lidington: The coalition Government's commitment is to examine the current balance of competencies between the EU and its member states. As the Committee knows, the Conservative Party manifesto in 2010 was committed to a given range of repatriation of competence. It is the coalition programme that forms the basis on which the Government is taking forward its policy, and that is what we are now doing, but when it comes to the single market, we have a very clear view that this is at the heart of what the European Union is about economically, and we want to see the single market enlarged and deepened further, not reduced in scope.

Lord MacLennan of Rogart: Sorry, I was trying to understand whether, in considering the commitments that parties have made in the past, their attitude to repatriation is affected by the priority that you have given in your evidence today, to the need to improve the single market.

David Lidington: If it may be a reassurance to Lord MacLennan, I am happy to send him a copy of the Conservative Party manifesto for 2010 if he is really short of reading, but the particular proposals that that manifesto included did not impinge upon the single market.

Q24 Earl Sandwich: Minister, can we move to asylum policy, which is back in the news today. We are not in Schengen, but the last Government had opted into the key three directives that form the cornerstone policy. Where do we stand in the UK at the moment? There are ways of taking part. Do you think, as the Minister for Immigration said to us the other day, that the policy is too prescriptive, and is that one reason for not opting in? Is it a major change of policy on our part?

David Lidington: No. We are actually to a great extent following, in this respect, the policies of the previous Administration. The decision not to participate in the recently amended directives had already been taken by the Labour Government. Those directives were re-amended versions of measures brought forward under the second phase, which that Administration did not opt into. So, when we decided in our turn not to opt into the re-amended directives published in June 2011, we were continuing with the policy that our predecessors had adopted.

Where there is a difference between us and our predecessors is that the present Government does not accept, in principle, that a common European asylum system is right for the United Kingdom. We think that practical measures of co-operation, rather than a common European system, are going to be more effective in helping us with the immigration and asylum system that we want. The UK has opted into two of the amended instruments, which are the Dublin and the Eurodac regulations, and those form the backbone of good migration policy, but we decided that opting into the other three was not going to be in the interests of the country. Obviously, as Lord Sandwich knows, there is the option under the treaties to opt in retrospectively at a later date by agreement of those who are taking part. If we were to consider doing that, we would need to have some clear and compelling evidence that this was going to be of positive benefit to the UK.

Earl Sandwich: So we have not taken any new direction, in your view. We are just sitting in on—

David Lidington: On the particular directives, our decisions not to opt in followed that of the Labour Government not to opt in. Where there is a difference is over the principle of whether to support a common European asylum policy.

Q25 Baroness Howarth of Breckland: Minister, I am told that before the last few weeks we thought that the major problem facing us, in terms of challenge, was climate change. It rather seems to have taken a back seat in the last few weeks. But the European Council of 23 October did discuss the preparation for the Durban Conference on Climate Change, and that underlined the need to agree on a process towards a comprehensive, legally binding framework and a clear timeline ensuring global participation, including from major economies. We were wondering how hopeful the UK Government is that this ambition will be achieved. In the light of the turmoil in the European Union, do you think it has established how it will work together to negotiate effectively in Durban?

David Lidington: On the last point, we agreed on a team EU approach that has been adopted in international climate negotiations before, and the framework agreement that all 27 have agreed on. Representation in external relations makes it clear that however you are represented at a particular meeting does not affect the competencies as laid down in the treaties. I think it is making it easier to come to pragmatic arrangements for external representation that work in the circumstances of particular gatherings.

In terms of how optimistic we are, the safest thing to say is that we remain very ambitious. There cannot be any getting away from the fact that the eurozone crisis has absorbed an enormous amount of top-level political attention and energy in recent months, but Lady Howarth is quite right: we must not forget about how serious the challenge of climate change is, particularly for some of the poorest and most vulnerable populations in the world, and we are failing in our duty if we lower our ambitions for Durban. So what we are hoping for is progress, at least, towards a legally binding instrument that would commit all major economies to binding targets on lower emissions. We do not think that is likely to be the fruit of Durban, but we hope that Durban can make considerable progress along that route, and we think that there needs to be global agreement also on a road map as to how we are going to meet the 2 degree goal and mitigate the impact of climate change that is already under way and unavoidable.

Baroness Howarth of Breckland: The timetable and road map are important in terms of ensuring that there is a level playing field and clear monitoring. Is the UK absolutely into that sort of detail of taking those issues forward within the strategic framework?

David Lidington: Yes, it is very important that we do so. Chris Huhne and his department are very committed to this, and you have a special envoy to the Prime Minister, who goes and bangs on the doors of the most senior Ministers of the Government to make sure that they do not forget about this.

Q26 Lord Teverson: Minister, we have a situation where the proof on climate change is getting stronger, given the number of studies that have been undertaken recently, yet it is quite clear there is no political will in the United States under the present Administration, let

alone any potential new one next year—or the year after, should I say—to actually go down the classic Kyoto route that the EU is following. Do you think there is going to start to be a plan B of any sort in the European Union in its approach to climate change, given the fact that the problem is still there but the present process is going to miss the bus, in terms of the plus 2 degrees centigrade, at the rate it is going at the moment?

David Lidington: I do not think we want to start talking about a plan B in the run-up to Durban. What we have to do is go in very determined and united to Durban to try to obtain the most ambitious optimum outcome from that meeting. Despite the fact that some member states are less enthusiastic for measures to combat climate change than others, the European Union has singled a willingness to commit to a Kyoto protocol mark II in the context of a wider deal that includes all the major emitters of carbon. That does mean parallel action from other economies, particularly the big emerging economies. The EU has to be pragmatic and nimble in trying to work out when it may be possible to clinch that sort of global deal. I do not want to pre-empt where detailed negotiations might take us, but the political will is certainly there on the part of British Ministers.

The Chairman: Minister, thank you very much indeed. We have taken up rather more of your time than we intended, but it is a very important opportunity for us to discuss these difficult and moving subjects. We are obviously hoping that you will be able to come back after the December Council and before the Christmas Recess to talk to us about that, but in the meantime we thank you again very much and wish you well for the next two months.

The Rt Hon David Lidington MP, Minister for Europe – Oral evidence (QQ 53-85)

Evidence Session No. 3 Heard in Public. Questions 53-85

TUESDAY 17 JANUARY 2012

Members present

Lord Roper (Chairman)
Lord Bowness
Lord Carter of Coles
Lord Dear
Lord Dykes
Lord Foulkes of Cumnock
Lord Hannay of Chiswick
Lord Harrison
Baroness Howarth of Breckland
Lord Jopling
Lord Maclennan of Rogart
Baroness O’Cathain
Lord Richard
The Earl of Sandwich
Lord Tomlinson
Lord Trimble
Baroness Young of Hornsey

Examination of Witness

David Lidington MP, Minister for Europe

Q53 The Chairman: Minister, as always we are extremely pleased that you are here and pleased to see that you are accompanied by Victoria Dean, who is Head of the European Directorate (Internal), and Alison Rose, Head of the European Directorate (Future of Europe), a heavy responsibility. As I say, we are obviously pleased to see you, although on this occasion the Committee had thought that the gravity of the situation was such that it would have been appropriate for the Foreign Secretary to come and account to the House through this Committee. We are therefore disappointed that he has been unable to accept our invitation. I should also warn you in advance that we are having quite a number of Divisions in this end of the building and we may therefore be interrupted by Divisions during this session.

The session is, as you can see, in public. It will be televised and a transcript is being taken. It will, of course, be sent to your officials, who will have the opportunity to make amendments to it, although it will be published online in an unamended form first.

I wonder if I can ask you the first question. In view of the fact that none of the measures in the proposed treaty, including the key measures on budgetary discipline and economic co-ordination, would have applied to the United Kingdom, even if the United Kingdom had signed the treaty, what would have been the adverse consequences to the United Kingdom of allowing negotiations on the treaty to proceed at European Union level?

David Lidington: Thank you, Lord Chairman. I would like to preface answering your question directly by making it clear that, when the Prime Minister went to Brussels for the December European Council, he did so on the basis of an agreed government position that the optimum outcome would be agreement of all 27. There was considerable discussion within the Government about this, involving both coalition parties, and various options were discussed, but that was the clear decision. We had always made it very clear to our partners, publicly and privately, that for us to agree to a treaty at 27 we would need certain safeguards in place. As the Committee knows, when those were not forthcoming—it was not possible to agree to those because of the opposition of a number of partners—the procedure went ahead on the basis of a coalition of the willing towards a separate intergovernmental agreement.

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

Clearly, also, the creation of a tightly integrated structure focused on the eurozone within the architecture of the EU would mean giving a higher priority in the activities of the European Union to the concerns of the eurozone and the objectives of restoring stability through the means decided on. Now, of course, the text of the declaration—not treaty, as the Committee understands—that came to the December European Council was only shared by France and Germany with others perhaps 24 hours before the Council convened. It was the day before. Even President Herman Van Rompuy was not informed until less than 48 hours before the Council convened. That in itself gave us very little time to undertake the sort of detail, scrutiny and intake of advice that one would normally want to do in these serious circumstances.

We did think that, while we could see the case of our colleagues for strengthening the euro area, we would want to see corresponding balancing measures to strengthen the single market. Of course, the declaration used language that in some respects went more widely than those matters that could be defined as being precisely of concern to the eurozone 17 and them alone. There was a reference in paragraph 9 of the declaration to a common economic policy and while the Committee knows that the subsequent texts of the treaty that the working party officials have been discussing have varied through their various iterations—it is still a work in progress—we had in some documents some quite sweeping words and phrases, such as “common economic policy”, “enhanced convergence” and

“competitiveness”, which was a concern. We wanted language that was going to make it very clear from the start that there would be protection for the single market, including protection for financial services, not to get a carve-out for the UK but because we certainly have an important national interest there. There was a fairly obvious risk that concerns about financial regulation would sit very closely to fiscal policy concerns and that therefore bringing one closely into the new treaty architecture could lead to EU measures being initiated that had an impact on our systems of financial regulation that might be discriminatory, as indeed we have seen with one or two measures that have already been brought forward under existing arrangements.

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

Q54 Lord Hannay of Chiswick: First of all, I have a purely factual question, which you have gone some way to answer already. Could you confirm that there was therefore no treaty and no binding text that we were asked to sign in Brussels, although many statements immediately after the meeting suggested that that was why the Prime Minister had taken the line that he did? Secondly, I wonder if you could explain why it is that the Prime Minister and the Government discarded the approach that was followed by Baroness Thatcher in the case of the Single European Act when there was a procedural vote to call an intergovernmental conference, which she disagreed with and voted against. She made it clear that she undertook no commitment whatever to the final outcome but was prepared to participate in negotiations and, if the negotiations did not safeguard British interests, she would have no hesitation to block them at the end. That was the same procedure that was followed by Mrs Thatcher in the context of the economic and monetary union treaty at Maastricht. Why was that tried and trusted approach discarded in this case?

David Lidington: There are two things that I would say in response. The first is that Lord Hannay is quite right: there was not a treaty text on the table, but there was the text of a political declaration that would not just express a political commitment by all 27 member states to treaty change but define the scope of that treaty change for a subsequent formal procedure. Of course, under the relevant article—I think it is article 48—of the treaties, it is the European Council that has to initiate a formal proposal for treaty change and determine the scope of any treaty amendments that are proposed.

The other thing, of course, that has made this very different from the procedures of the European Single Act, or other treaty amendments that we have seen in the last two decades, has been the timescale involved. What we had here was a determination from the very start that this was something that had to be completed within roughly three months. The intention was to get this sorted by spring and to get it done as early as possible within that timeframe. When I look at the situation that the eurozone Governments are facing, I can understand, if I put myself in their shoes, the need for urgency, but if we had adopted the course that Lord Hannay implies, we would have, from the start, been throwing all sorts of uncertainties into that subsequent very constrained negotiation.

The Prime Minister took the view that given that what we thought, and still believe, were perfectly reasonable, relevant and limited safeguards were not acceptable to everybody else

around the table—they were certainly acceptable to some—it was better to stand aside and to let those who wished to go ahead, otherwise we would have been faced with two or three months of semi-public wrangling and argument with the prospect of a blocking treaty text at the end of that time and a market crisis that that might well provoke. So we took the decision, primarily in our national interest, but with a view also to how this might play out otherwise, and I think it was the right one.

The Chairman: So we were doing them a favour.

David Lidington: I think that we would not have done any favours to anybody if we had had two or three months of continuous arguments and wrangling that would have left, I think, a very bad taste in everybody's mouths and would have given rise to considerable market uncertainty. As I said at the start of my remarks, Lord Chairman, the Prime Minister went into this believing that an agreement at 27 was the optimal outcome for our national interest but having always made it clear that for us to agree to a treaty amendment there were things that we in turn would require to be built in to that treaty amending process.

Q55 Lord Maclennan of Rogart: Was the Government not starting at shadows, particularly in respect of what you describe as safeguards—safeguards against proposals that have not even been tabled? We should bear in mind that one of the proposals that was most discussed after the event was the possibility of taxation on financial transactions, which could only be agreed by unanimity under existing law. Were you not just intending to be wreckers?

David Lidington: No, I do not think that anybody in the coalition was intending to be wreckers, and of course there was complete agreement within the Government in advance of the Council about the position that we were taking going into that discussion. I do not believe that any Minister has claimed that a financial transfer tax could be imposed without there being unanimity among all member states, but I think it was perfectly reasonable for us to be saying to our partners, "If you want to go ahead with this for eurozone reasons that we can well understand and have some sympathy with, then we want there to be safeguards for the single market." We think that it is important that there are safeguards against discrimination on the grounds of currency so that we can guard against the possibility that the new treaty basis, which would have been created by a new treaty at 27, would then lead on to subsequent legislative initiatives that would have that effect.

Q56 Lord Maclennan of Rogart: In what respect do you consider that protecting or enhancing the single market was at odds—or would have been potentially at odds—with what was being proposed?

David Lidington: What was being proposed was for an agreement whereby certain topics would be discussed, and initiatives taken, in the interests of economic convergence within the eurozone. We wanted to have language that made it absolutely clear that they were doing that and that that was distinct from the single market as defined in the current treaties unamended. We also believed that one aspect of the single market that would be particularly vulnerable and that was particularly important to the United Kingdom's interests was financial services. We have had, in the European Central Bank's location policy, an example already of a legislative initiative that we believe goes blatantly against single market principles and which has been brought forward because the ECB regards it as their priority to protect the interests of the eurozone. We did not want to see that becoming a trend. We wanted

from the very start to have agreement from all 27 that as part of the package the single market would have to be protected.

Q57 Lord Foulkes of Cumnock: I am totally confused, Minister. In reply to Lord Hannay you said that there was no treaty on the table at the European Council meeting. Is that right?

David Lidington: There was no formal treaty text on the table, no.

Lord Foulkes of Cumnock: So why did the Prime Minister in his statement say, “I did not agree to the treaty”?

David Lidington: What we were talking about, as I said a moment ago, was a political declaration which both defined the scope of a treaty change to which its signatories were all committing themselves to complete within a very short timeframe and which initiated the formal treaty amendment process.

Lord Foulkes of Cumnock: That is not what this says. This says, “I did not agree to the treaty”.

David Lidington: He did not agree to the treaty amendment at 27.

Lord Foulkes of Cumnock: It does not say the treaty amendment. It says, “I did not agree to the treaty”. All the publicity surrounding it indicated that, did it not?

David Lidington: I think that we are playing on words somewhat here, Lord Chairman, and I think that the Prime Minister’s decision was perfectly clear. He decided that at the start of the process it was going to be cleaner to say, “Sorry, we cannot go along with this in the absence of our safeguards,” than to have these two or three months of bad-tempered wrangling that I thought would have been the risk otherwise, since we were agreed in government that we were not going to accept any treaty amendment at 27 unless those safeguards were provided.

Q58 Lord Jopling: I would like to come back to Lord Maclennan’s question about safeguards. As for some of the safeguards, I would have thought, following what he said, we were protected in any case because they were subject to unanimity. I would like to ask what the safeguards were that we asked for that we were worried could have been imposed on us by the QMV system. To what extent were we trying to consolidate our existing position by making requests or demands that we could have already imposed on us under QMV? I wonder if you could list those latter ones, please.

David Lidington: Well, the situation with regard to single market legislation including financial services legislation is for the most part that that it is done under QMV. As Lord Jopling says, that was the position before 9 December and it continues to be the position after 9 December. The question that the Prime Minister had to face at that December European Council was whether to agree to a treaty amendment process that would alter the balance of how the EU does its business and to consider whether, by agreeing to that, that potential would open up the scope for discriminatory measures along the lines of that initiated by the EC. We will not make those risks greater than they are now. Certainly, we will continue and we are continuing, within the single market context and the financial

services reform context, to argue at ECOFIN meetings, COREPER meetings and so on for the best deal possible for the United Kingdom based on the need for there to be rigour in the regulation of financial services, but also to have a system which is open to international institutions coming to Europe, rather than trying to drive them away, and which does not discriminate on grounds of currency.

Lord Jopling asked what precisely did we propose at that meeting. As he will know, we do not normally publish negotiating texts that are floated in draft. We had talked to our partners in advance about the sorts of things that we might be wanting to have as safeguards but, as I have said in answer to previous questions, this was not a formal negotiation about the treaty. It was a less formal negotiation but it led into a formal process on the basis of a political declaration. What that amounted to were safeguards covering two matters: that we wanted some sort of general safeguard with respect to the integrity of the single market and that we wanted something more specific on the issue of financial services, the consequence of which would have been that it would have protected the financial services industry in every EU member state against the risk of discriminatory legislation or protectionist legislation on financial services of the sort to which I have alluded.

What happened that evening was that a number of countries made it very clear very early on that they were simply not prepared to enter into any discussion of what we were suggesting. The decision was taken at that point to move on to talk about an intergovernmental arrangement rather than an amendment of the Lisbon Treaty, not to engage in the sort of negotiation that one often gets on these occasions where you see if there is a way forward on which all 27 can agree, even if that was a decision on which other countries for reasons of their own took a very clear view, and they were not prepared to budge.

Q59 Lord Tomlinson: You have quite rightly given us a picture of a strategy that sought to avoid rows, recriminations and acrimony going on over a period of three months. Do you think that those desirable goals are now being achieved? I look particularly, for example, at negotiations that are taking place on the Solvency II programme, in which we have a very significant financial interest, and what I seem to be getting from public sources in Brussels, and even more clearly from private sources in Brussels, is that there are views being expressed that nobody is in a mood to do the United Kingdom any favours. When I see the discussion that is taking place in the European Parliament, there are views that seem to indicate that significant UK interests are being affected and that this is payback time. Could you comment on that as being a reaction?

David Lidington: I think that there were clearly some bumpy hours and days in the immediate aftermath, that a lot of countries were disappointed and that it was not possible to have agreement at 27. Yes there were some people—let us be frank about this—in various parts of Europe, not necessarily in other Governments but among commentators, who do not have much regard for the United Kingdom, or the United Kingdom's approach to Europe under successive Governments, and wanted to take advantage of this. But if I look at what has happened in practice since then, I see something different.

Lord Tomlinson: Stick to the Solvency II programme, because that is a specific example where we are up to our necks in mire at the moment but in which we have a significant United Kingdom financial interest.

David Lidington: When I last talked to the Financial Secretary about what has been going on in respect of particular financial services directives, he was certainly saying that there was no reservoir of ill will. What we are facing, it is true, in respect of a number of items of financial services legislation is an assumption in a number of other countries' Governments that what they describe as Anglo-Saxon capitalism, and the speculators in London, New York and elsewhere, is responsible both for the financial crisis of 2008 and for the travails of the euro at the moment. I think that those assumptions are misplaced, but they are real. That is not something new; that is not something that sprung into being on 9 December. The detail of that negotiation is really a matter for the Chancellor and the Financial Secretary to discuss.

If one looks at Council meetings more generally, certainly my colleagues in the Treasury, in BIS and in Defra have all said to me that they have gone to Council since the 9th and that the discussions have continued and negotiations have been pursued in the normal way. The Foreign Secretary has been in close touch with French, German and other colleagues about things like a new sanctions package against Syria and about further action that might be taken in respect of the Iranian nuclear programme. We have worked very closely with France and Germany on fisheries reform, again since the 9th. Even if one looks back at the day itself, despite the feelings that boiled up at and immediately after the meeting, if you look at the language of the declaration of the 27 at the end of that European Council, you have substantial paragraphs there on the single market, on trade and on regulation that could have been drafted in London and on which we have worked with the support of many countries, both eurozone and non-eurozone. I am very confident that we are going to play a very positive, reactive role in EU negotiations.

The Chairman: I realise that some of the supplementaries are slightly pre-emptive questions to which we will be coming, but Lord Richard and Lord Hannay both have supplementaries that I hope do not pre-empt later questions.

Q60 Lord Richard: I am a bit mystified by all these comments. These were an extraordinary set of negotiations. In 30 or 40 years I have never come across anything quite like it. You took fright, according to you, at a declaration that you did not like. The treaty, as it is on the table at the moment, does not affect UK interests adversely. You then say, "Oh well, there are safeguards but we won't tell you what the safeguards are, we don't normally do things like that and in any event it was all done to help the eurozone sort its affairs out." Minister, with respect, that is not credible. I ask the simple question: what on earth was the point of this exercise? It seems to me that we are now in a situation where we have upset a lot of people needlessly in Europe; we are faced with a text that we do not really particularly object to; and we were totally isolated in the process leading up to this. Let me ask you another question. Were you surprised that nobody else joined you in this great campaign to save the euro and to help the eurozone sort its affairs out? None of the others felt that. Were they demanding safeguards?

David Lidington: On the last point, I think that it is fair to say that there was a fair amount of unhappiness among a lot of member states that they were being asked to contemplate any new treaty at all. That certainly is what was being said at the General Affairs Council meeting earlier in the week of the European Council. For reasons of their own, those Governments—and it is a matter for them—decided at the end of the day to go along with that declaration, despite those doubts and hesitations and concern about the political capital that they would be required to spend at home. We do not know how many countries are

finally going to agree to whatever is tabled in the final text. We do not have a final text as yet. We also do not know what problems there may or may not be in terms of ratification in individual states. Some countries certainly have to carry a parliamentary vote; some may require a two-thirds parliamentary vote; some may require a referendum. We just do not know the outcome of that.

It is also not right to say that this would not affect the United Kingdom at all. If this had been part of the European Union treaties, legislation could have been brought forward on those bases to bind the United Kingdom and the duty of sincere co-operation would have applied too, because this would be part of the EU acquis. I think that the judgment that the Prime Minister made—it was a difficult one on the night, I do not pretend otherwise—was that our national interest was best safeguarded by standing aside and saying to the others, “You go ahead. That is a matter for you, but in the absence of the reasonable safeguards that we have always said were going to be necessary for a treaty change, this is not something we can sign up to.”

Q61 Lord Richard: Can I just interrupt you there for a moment? You keep talking about reasonable safeguards. In order to give credibility to the position that you are taking up, you have to tell us what safeguards you were demanding. To say that it was only part of the negotiating documentation frankly is not good enough. How are we supposed to judge whether the Prime Minister is right or wrong in what he did unless we know what it is that he was asking for and was being denied?

David Lidington: I do not think that any Government have got into the habit of disclosing routinely the text of negotiating amendments that they suggested to European partners in a particular context and I am not going to move from that position. But going back to the point about whether this would have affected the United Kingdom, what we already have in some of the texts of the intergovernmental treaty are measures that go beyond the fiscal compact. They include more general provisions dealing with economic policy co-ordination and convergence. If that had been in the European Union treaties rather than in a self-standing intergovernmental document, there could have been direct implications for the United Kingdom as legislation was brought forward on those bases.

Q62 Lord Hannay of Chiswick: You spoke about the now-called Sarkozy approach just before the Council and said that one of the main objections to it was that there were some unfortunate references to single market matters, or matters that could be considered to be single market matters, and I would agree with you. Is it not the case that all those references have now been removed from the treaty, presumably by a process that you would call wrangling but that I would call robust negotiation, by countries other than the United Kingdom?

David Lidington: There is still language in the most recent drafts that I have seen. There are likely to be other reiterations of the text before it is finally agreed that talk about competitiveness, that talk about common economic policy and that stretch further than what is needed to deal with the narrower issue of eurozone fiscal convergence. So it is for those reasons that we wanted not just to exclude language of the sort that Lord Hannay has referred to but to have some explicit safeguards to say, “Whatever you do in this particular treaty amendment, that may not cut across the single market arrangements that we have in place in the current Lisbon architecture.”

Q63 Lord Hannay of Chiswick: Do we not want them to be more competitive?

David Lidington: We certainly want them to be more competitive, which is why we were delighted by the language in the December Council conclusions about strengthening the single market, about keeping Europe open to trade with the rising global economic powers and about cutting the costs of complexity of regulation, especially on small and medium-sized businesses. We think that the micro-business exemption from EU regulation that was in those Council conclusions is potentially a really important if limited step forward because it opens up the prospect of applying that exemption not only to new regulation but retrospectively to the *acquis* by requiring the Commission to examine its existing rulebook and considering a micro-business exemption from *acquis* measures as well. The fact that those things were included in the December Council should encourage all of us to be confident—I acknowledge with a disagreement on the night of the 9th—that we will continue to play to a very active part. If one looks at what Chancellor Merkel had said since 9 December, what she has reiterated—and it is not something that we phoned up and asked her to do—is that the United Kingdom remains an absolutely key partner within the European Union, particularly on these issues.

Q64 The Chairman: But in the draft that is currently circulating as far as some of those particular articles are concerned the final words I read are, “Without undermining the internal market”. Surely that is quite a substantial safeguard as far as the United Kingdom is concerned.

David Lidington: That language is certainly welcome. As I said, not only are there other things in there that at least cause some concern on our part but we are not at the final text yet. We do not know what the eventual form of this will be.

Q65 Lord Harrison: Mr Lidington, I think that it was Heisenberg who last successfully introduced the principle of uncertainty. I think that it has been bettered now by the Government in introducing uncertainty into the single market, as I understand, stepping outside of signing EU 27 and allowing a fiscal compact treaty to emerge that in itself will threaten the viability of the single market, because you have other procedures such as the enhancement procedure that might indeed undermine it. My understanding is that the Prime Minister was concerned about financial services in particular and that one of the areas that he was concerned about—the reasons he gave for not signing up—was his fear that the European Banking Authority might be moved outside of the London. The other fear that he had was that with the emergence of the three European Supervisory Authorities, which as you know are being set up as a result of the European Systemic Risk Board and are there to observe and monitor the market, our ability to supervise our own financial services would be wrenched out of the hands of the UK Government. Is it not the case with the European Securities and Markets Authority that when it came to bans on credit default swaps and short selling we have through that medium already taken an EU-wide decision to have such a ban? The Prime Minister was asking for something that had already failed to be realised. In other words, we have acknowledged as the United Kingdom within the European Union single market that such a market—a financial services market—has to be properly policed and implemented. I would be very grateful if you could answer the point about the CDS bans and the short selling as something that has already been done under single market rules.

David Lidington: Certainly we accept that there needs to be a single rulebook of minimum standards. It is true that the United Kingdom—not just London, of course, but other cities

too—has a particularly important financial services industry. We do not want to see regulatory arbitrage taking place across Europe and I have always argued very strongly that the City of London should be seen not just as an asset to the United Kingdom but as one of the greatest assets that the European Union collectively has available to it.

Lord Harrison: I agree with all that, but what has happened is that under what we have already agreed to, the establishment of the European Securities and Markets Authority, decisions have already been made under single market rules that take away from the desire that we understand the Prime Minister has to ensure that national supervisory authorities would prevail over the single market authority.

David Lidington: We think that it should be primarily for national regulators rather than European regulators to deal with institutions, particularly when there is a risk that getting the regulation of your banking sector wrong could lead to fiscal consequences for your national taxpayers. So there is a question of accountability here. When one thinks back to our position in 2008 and when one thinks back to what happened in the Republic of Ireland, you had things happening in the banking sector—I will not go into the history now—that had consequences for taxpayers. The national regulators that are democratically accountable through Ministers and therefore to Parliament—

Lord Harrison: When you say “primarily” you are quite right, but is there not a deception being practised from time to time? As you rightly describe it, there is the need within the curtilage of the single market to be able to act as the unanimity of 27. That world is being lost when we step outside of the treaty that was proposed and we move into uncertain and uncharted waters where we do not know what our colleagues will be doing under the fiscal compact treaty.

David Lidington: No, I do not agree with that interpretation. Yes, it is certainly true that there is a role for European regulators. Those exist and we will need a measure of supranational regulation if there is a European single market, but we think that that role should be limited and the primary importance of national regulators should be retained. Of course, the differences that we had with some other EU countries over capital ratios give an illustration of that. One of the problems that we have had with our partners is that they are wanting on a particular item to impose what we see as laxer standards than those that we want to require.

Q66 Lord Harrison: Could you just confirm that that was one of the items that worried the Prime Minister?

David Lidington: Yes.

Lord Harrison: It was?

David Lidington: Yes, that was certainly one of the items that did that—the precedent set by the ECB’s location policy and whether that would be the harbinger of a more general discriminatory approach. Where I think I differ in my interpretation from Lord Harrison is that the regulation of financial services at the level of 27 will remain something that has to be undertaken by the procedures laid down in the European treaties themselves and not by the intergovernmental treaty. The intergovernmental treaty is not creating some parallel

European Supervisory Authorities. Those are creatures of EU legislation and we expect the negotiations to continue to take place in ECOFIN and at official level about the precise content of financial services regulations.

Q67 Lord Richard: Minister, you know that in an interview on 6 January the Prime Minister indicated that EU institutions should not be used to support the arrangements in the new treaty and especially that they should not be used for matters relating to the single market and competitiveness. He then went on to add, I think rather sensibly, that the legal position is unclear. Does the Government consider that the European Commission and the European Court of Justice should have a role under the proposed treaty in relation to the fiscal compact rules?

David Lidington: We are obviously studying the evolution of the text very carefully. It will depend on what is in the text and what the parties to that intergovernmental treaty actually want to do. There is a fair amount in the text. Lord Richard will know that it talks about action under European Union treaties by means of secondary legislation. So the intergovernmental pact or treaty includes political commitments by the parties that they will support particular forms of initiative but brought forward under the current EU treaties. If a piece of legislation is brought forward under the current European Union treaties, then the institutions already have authority to act. Questions arise over whether the institutions are being asked to take on additional new tasks that go beyond what is already provided for in the treaties. There is, of course, provision within the treaties for all member states collectively to request the institutions to carry out certain work that is outwith the scope of the treaties. We think that the legal position is that any proposal to confer new tasks on the EU institutions requires the consent of all member states and has to be compatible with the role and responsibilities of those institutions as laid down in the European Union treaties.

Q68 Lord Richard: Could I interrupt you just for a moment? You say that it requires all 27 to agree. Does the UK agree with it? Would we agree to the use of the institutions?

David Lidington: We will want to see what exactly is proposed.

Lord Richard: Sorry, I do not follow that at all, with respect.

David Lidington: At the moment we are dealing with a text that has not been finalised, let alone ratified, and we need to go beyond the text and see what precise initiatives the parties may wish to embark on.

Lord Richard: This is where I slightly lose you. Either the institutions are legally capable of being used or they are not legally capable of being used. If they are not legally capable of being used, the fact that they would be being used in ways that you would not find too outrageous does not alter the legal position. If, on the other hand, they are capable of being used, well, they are capable of being used. There has to be a view on that. I am blown if I can see how you can do that.

David Lidington: The position on use is that, if the institutions are being asked to do new things that go beyond the scope of the treaties, that requires the consent of all 27 member states. That is a separate question from whether we would consent in a particular circumstance to the institutions being used. One is our interpretation of the law and the other is a political judgment on the basis of a particular proposal for action.

Lord Richard: Give me your interpretation of the law then. What is the Government's view?

David Lidington: The Government's view is that any new responsibilities that the institutions were being asked to undertake would require the consent of all 27 if that went beyond what is in the EU treaties. I do not really see how I can be clearer than that. I am sorry if I am not providing sufficient clarity for Lord Richard but I genuinely think that I have explained the Government's position on this. Perhaps it would help if I indicate to you the areas of concern in the text. We have some concerns, for example, about the proposed role for the Commission and the Court around the introduction of the balanced budget rule in the fiscal part of the arrangements, but the draft text is changing and those changes have included references to the institutions. It is difficult for me to get into detailed discussions about our exact position on a text that may or may not be the final one, but that perhaps gives an indication of where our concerns have been.

The Chairman: We will have something about this when we come to the end of our questions, but Lord Hannay has a supplementary on this.

Q69 Lord Hannay of Chiswick: I imagine, Minister, from what you have just said, that you would not disagree that this is a problem that we have created for ourselves since it would not have arisen if we had not decided not to participate in negotiations.

The Chairman: Lord Hannay, I wonder if you could speak up. It is not easy to hear you from here.

Lord Hannay of Chiswick: I am sorry. I said I imagine that the Minister would not disagree that this is a problem that we have created for ourselves since it would not have arisen if we had agreed to an amendment to the treaty. If we had agreed to proceed down the treaty amendment road we would of course, I imagine you would agree, have the application of Article 136 of the treaty, TFEU, which says that all member states would be present and participate in all decisions although the non-members of the eurozone would not take decisions that related to the eurozone.

David Lidington: It is certainly true that if this had been an agreement to amend the treaties at the level of 27 then those amendments incorporated into the body of the Lisbon Treaty would mean that the institutions were empowered to act on the basis of those amendments. But if we had had the safeguards that we had sought, we would have been prepared to go along with a treaty at the level of 27. So I accept the factual point that Lord Hannay is making but there is a slight element of finger pointing that I think came in there.

Q70 Lord Dykes: Following on from what Lord Hannay was saying, were there specific figures, such as leading personalities in the City, who actually expressed strong support for what the Prime Minister did on that occasion? Can you name them?

David Lidington: I have not gone thorough my list of people who have expressed support and opposition. I know that there have been competing round-robins going to newspapers from both supporters and critics of the Government's position.

Q71 Lord Tomlinson: Let me turn to UK contributions to the IMF. Under what precise circumstances—and I emphasise the word “precise”—will the Government provide additional funding to the IMF?

David Lidington: I do not think that the Chancellor of the Exchequer would thank me if I was too precise on this matter.

Lord Tomlinson: If we take the Chancellor of the Exchequer’s speech that he made during his visit to Hong Kong, he seemed then to be much more explicitly clear than he was in his earlier statements. Let me I quote it to you. He says: “Members also have a responsibility to ensure the IMF has the resources it needs to promote the global economic stability from which we all benefit”. I would have thought that restoring the health of the eurozone is a major and significant contribution to restoring that global economic benefit. In his next sentence, he went on to say: “The capacity of the IMF may also need to rise to ensure that those risks can be addressed but this cannot be a substitute for action by the eurozone. Britain stands ready to play its part.” Now, if we are playing our part, not as a substitute but complementary to the actions in the eurozone, and we stand ready to play our part, what precisely does that mean? Are we recognising that we have no capacity to provide an embargo to the IMF in using IMF resources to assist without funds being earmarked specifically?

David Lidington: I am tempted to say that I agree with the Chancellor of the Exchequer, but let me try to go a bit further. Lord Tomlinson is tempting me on to dangerous territory here. The position that we are in now is the same that we outlined at the time of the Cannes summit, the meeting of G20 in the autumn. We are willing to consider further resources for the IMF, but that has to be for its global role as part of the global agreement. We welcome what the euro area committed itself to on, I think, 19 December, saying that they were going to boost IMF resources by €150 billion, but that is a commitment from the euro area and we are not part of that commitment. We are ready to increase IMF resources, alongside other countries around the world, so that the IMF can play its systemic role in supporting its global membership, but we have always been clear, and this remains our position, that we will not participate in an increase in IMF resources that only comes from EU countries without the participation of other members of the G20. As the Chancellor said in the comments from which Lord Tomlinson quoted, we have also been utterly consistent in saying that IMF action, while it may be necessary—and on the basis of the IMF’s previous working methods it would be on the basis of country programmes, not some sort of help for the eurozone as a bloc—cannot be a substitute for the action that is needed from the eurozone countries themselves.

Lord Tomlinson: But it can be a complement to it.

David Lidington: It could be a complement to that, and there is a G20 process in place at the moment to discuss the IMF’s resources. That is due to report to the February meeting of G20 Finance Ministers, and the Chancellor and his officials are taking a full part in those discussions.

Q72 Lord Harrison: This afternoon in the Chamber, Lord Sassoon said that the Government’s position was that they would use the IMF not to support currencies but to support individual countries. What is the fine distinction between an application from the euro area or eurozone and one that is put in by the EU 17?

David Lidington: The IMF's practice has always been to work on the basis of country programmes and of course what the IMF requires is that the Government of the country that it is assisting signs up to particular commitments and conditions and is held accountable to those.

Lord Harrison: If the 17 individually as countries in the form of the eurozone did that, would you be prepared to help?

David Lidington: That is inviting me to comment on a hypothetical situation, but the IMF has always in the past worked on the basis of individual countries with their own Finance Ministers, Parliaments and Exchequers, and not every eurozone country, to put it mildly, is in the same condition economically. That is one of the structural problems that they have, after all.

The Chairman: I now turn to Lord Jopling on the relevance of the fiscal compact to the current economic and fiscal crisis.

Q73 Lord Jopling: I should begin by doing what I should have done earlier, which is to declare an interest as a recipient of funds under the common agricultural policy. The question is this. If the draft treaty is implemented promptly, would you like to paint a picture as to how it would contribute or even solve the current economic and financial crisis that bothers us so much, which is centred on the eurozone? I wonder if you feel that the proposals as they stand now go far enough to resolve this crisis.

David Lidington: Of course, I preface my comments by saying that there is still no final text so there is an inherent element of uncertainty about both the content and the implementation of the intergovernmental agreement, but we know the outline. We know in particular that it sets an absolute ceiling on the structural deficit that a country can run of 0.5% of GDP and says that that rule should be made binding in constitutions or equivalent legislation. The balanced budget rule had a sensible motivation—that of containing structural deficits—and I think that we would agree that it is sensible to focus on structural deficit, which at least gives Governments some leeway for fiscal policy to support national economies during a recession or to cope with a sudden external shock. Whether that rule will be effective and credible as a fiscal rule depends heavily on how it is implemented in practice country by country. So far there has been no agreement on the key parameters and procedures for implementation. There seems to be emerging an agreement on this principle but exactly what that is going to mean in terms of budget making and fiscal policy country by country is very far from clear yet.

The other main area covered by the pact is economic co-ordination. A lot of this, if I am honest, Lord Chairman, represents existing practice. That includes the use of enhanced co-operation to pursue economic policy and sharing best practice by member states. These are things that already exist within the framework of the European Union treaties.

I would certainly say that even on the optimum assessment of what is likely to come out of the intergovernmental negotiations there is still a great deal more that needs to be done in both the short and long terms. Some countries—and Germany in particular makes this case—argue that if you get the rules right for the future, and you therefore restore confidence about long-term stability, that in turn will help you to secure confidence and

recovery now. That is the prime justification for this whole business of treaty change proposals. It may be true, but it does not remove the need for eurozone countries to take actions now on the basis of implementing what they agreed in October primarily, but also for the EU collectively to do much more on growing single market trade and so on.

Q74 Lord Trimble: Minister, that just sets up nicely a very simple little question. Looking to the next two months or so, what do you think should be done?

David Lidington: Right. I think that we need action by the eurozone countries to implement their October agreement in full. I think that it is inescapable that the delay in finalising what was described at the time as an historic breakthrough that would secure the stability of the eurozone adds to market uncertainty. There are three elements to that agreement: the firewall, the recapitalisation of banks and dealing with Greece. They agreed in October that the banks should hold more and better-quality capital that could be used quickly to absorb losses. The jargon was 9% of at least tier 1 capital. We think also that there is a need for banks to mark their eurozone debt holdings at the current relatively low market prices and not to try to keep them on the books at the original purchase price, which is now an unrealistic estimate of their value. On the EFSF, what the eurozone agreed in October was to set up two things: the special purpose vehicle and increased EFSF capacity. Mr Draghi, the President of the ECB, has said recently that the swift deployment of these tools is now urgently needed.

Lord Trimble: Is the EFSF still a viable tool now that it has been downgraded?

David Lidington: I am loath as a British Minister outside the eurozone to speculate, but I refer to a statement made I think today by Klaus Regling, the Chief Executive Officer of EFSF, who said that the downgrade to AA+ by only one credit agency will not reduce the EFSF's lending capacity of €440 billion. He argued that the EFSF has sufficient means to fulfil its commitments under both current and potential future adjustment programmes until the ESM becomes operational, which he assumes will be in July this year.

Q75 Lord Trimble: The second thing that I wanted to draw your attention to is the ECB. In the course of the last few months, the ECB has greatly expanded its activities to the point where its balance sheet is now up to €2 trillion, and an awful lot of that has come in just the last six months. There was in particular the long-term refinancing operation designed to help European banks where nearly €0.5 trillion was made available and made available for almost any sort of collateral at all. The ECB says that it is going to repeat this LTRO operation at the end of February and there are rumours circulating that the next time the ECB might be making available another trillion, again for almost anything in terms of collateral. Is this not quite a risky situation that is developing? If the ECB gets into difficulties, which I think is quite possible, what is going to happen with regard to the refinancing of the ECB and on whom will that burden fall?

David Lidington: Lord Trimble is raising important and interesting questions on which, again, because we are not part of the eurozone and we do not sit on the ECB governing body, I do not think I want to speculate about in detail. I do not think that it is a secret that there are different views within the eurozone itself about the future of the ECB, and certainly any difficulties into which the eurozone came are things that it would be the responsibility of eurozone Governments to resolve. From the British point of view, we continue to say to our friends and partners in the eurozone that we want them to succeed

in extinguishing this fire and we want to see stability restored. What is happening now, this on-going crisis, is bad for our national interests as well as everybody else's. But I do not think that for me to speculate publicly about the ECB is going to help.

Lord Trimble: Just on a technical question, if the ECB calls on member states to refinance it, does that call go just purely to eurozone countries or does it go to the EU generally?

David Lidington: It applies to eurozone countries.

Q76 Lord Bowness: Minister, in the early part of last year we published a report that argued that there was a weakness in the architecture of the euro area in that monetary policy has been centralised yet fiscal policy has been left to the discretion of member states, and that there are also underlying macroeconomic weaknesses, especially the severe imbalances and competitiveness between the states. While the draft treaty is still a draft—I know you have been reluctant to comment on it because it is not in its final form—as it currently stands do you believe that it forms a coherent and effective longer-term response to the weaknesses or does more need to be done? If more does need to be done, rather than telling us what is in it that you do not like, what would you like to see in it?

David Lidington: We are attending the working group of officials. It is not a sort of formal institutional process. We are offering our observations on things, but we are not part of the actual negotiation. The fiscal compact seems to fit into a pattern of new arrangements to try to remedy problems with the design of the euro. Let me give a couple of examples. The first is the excessive imbalances procedure that was brought in under the six-pack legislative measures last year. The Committee will be familiar with the system. The Commission publishes a regular scoreboard of macroeconomic and structural indicators. If any member state exceeds predetermined thresholds, it is then subject to qualitative analysis by the Commission. Any member state can be placed in the excessive imbalance procedure but only eurozone members can be subjected to fines for failing to correct an excessive imbalance. The second illustration that I would give is the Euro Plus Pact. Again, that is about addressing imbalances in competitiveness, assessed through wage and productivity developments. Interestingly, of course, it concentrates focus on matters that are the competence of member states rather than the European Union. So what the Euro Plus Pact is about mostly is a political commitment by participating member states to introduce concrete reforms at national level to become more competitive and to secure economic conversion. They have to put those measures in their national reform and stability programmes, so that then links into the EU economic governance procedure.

Does more need to be done? Yes. Those measures taken last year are part of the answer. It looks as if the measures that may be emerging from the intergovernmental treaty may provide an additional element, but dealing with the short-term challenges that Lord Trimble has been questioning me about is absolutely critical. So too are the much more ambitious reforms of European Union practice to try to secure greater competitiveness and growth in the face of a shift of competitive advantage to Asia and Latin America. One of the things that I have found very frustrating about EU work in the last year has been the extent to which, understandably, the eurozone crisis has absorbed so much time, attention and energy of policymakers around the European Union that not enough attention and priority have been given to how, collectively, we can develop growth through trade, we can have a digital single market and a single energy market, and we can make our industries more competitive with those that we see in Brazil or Mexico or Indonesia.

Q77 Lord Hannay of Chiswick: Minister, I was delighted to hear your warnings over the Euro Plus Pact. You will remember that we discussed this matter in an earlier meeting of this Committee and you very helpfully said that if we were to decide to join it would only require a political decision and would not require a legal decision, triggering referendums, primary legislation and so on. Why are not we joining the Euro Plus Pact if it is such a bloody good idea?

David Lidington: I think that the Euro Plus Pact is helping eurozone members to achieve the convergence and the structural reforms that they need to. We do not need to do so, but obviously we keep under review how the Euro Plus Pact develops.

Q78 Lord Dykes: In that familiar context, of course, we have just had either the widest ever trade gap figures or the widest for many, many years. It is just a recent one and we have devalued in recent years by 20% to 25%. So where is the absence of competitiveness in the British economy? While the Minister is considering that point, if he wishes to answer it—he may not wish to answer—in the context of our discussion so far, Treasury Ministers at the moment are often saying about the rating agencies, “Well, that’s all very well, their reputation with institutions in America and hedge funds and mortgage companies and so on was pretty awful when they gave them AAA a few days before they actually collapsed, but when they are doing sovereign Governments it is very different, they are separate departments, very respectable”. We have seen since Friday Standard & Poor’s rating, but of course Fitch and Moody’s disagree with that. The French auction yesterday of €8.5 billion went to I think the lowest interest rate since before December. So the British Government can say, “Well, we are unscathed by all this business of rating agencies”, and the United States hopes to remain unscathed, apart from one downgrade to A+. So what happens then if it happens to us in the coming months as the recession in Britain produces an absence of growth, which is the thing that they are concerned about, as you know?

David Lidington: I think that Lord Dykes is tempting me to go way beyond my responsibilities here. There is no complacency on the part of the UK Government about our position. We are very conscious every day of the gravity of the economic challenges that face this country, both the immediate one in terms of paying down the debt but also the bigger challenge of competitiveness. That is why we are focusing on reforms to try to change the nature of our economy. Whether one looks at the proposals that the coalition Government have brought forward on educational reform, on training or on giving higher priority in our diplomacy to trade, one sees that commitment coming through.

I would just say to Lord Dykes on the trade gap to which he has alluded that one just needs to be a bit careful about that. First of all, it fluctuates from year to year. I know that the last time I gave a response in the House of Commons about this subject the figures that were available to me showed that it actually narrowed during 2011 compared with the 2009 and 2010 figures. Of course, the current account gap is balanced by what is happening with capital, and even within the current accounts there are differences between sectors. Our financial services industry has come under some criticism from some quarters recently but it is a very big export earner for this country and it has produced a very big current account surplus with other European Union countries.

Q79 Lord Maclennan of Rogart: Minister, I wonder if you could give us your best legal opinion, and that of your department, as to whether or not this fiscal compact actually required a treaty or whether or not most of the measures could have been implemented

under its existing constitutional requirements, such as Articles 126 and 136 of TFEU. If you took the view that it was possible to go that way—

David Lidington: As I always say in letters to constituents who ask me about legal questions, I cannot give legal advice. I advise people to consult a qualified solicitor, but I will do my best as a politician. It depends on which bit of the emerging intergovernmental agreement one looks at. A lot of it does not need a treaty. A lot of it is about a political commitment to economic policy co-ordination and convergence, and those are things that could be done without a treaty. Germany in particular, for reasons about sending a message over long-term stability, felt that a treaty binding in international law was what was needed to give effect to this and to secure the discipline in individual Governments that it understandably wanted to see. But there are elements in the emerging text that require a treaty and go beyond a political commitment. For example, there is no provision in the European Union treaties to make a balanced budget rule binding in a member state's national law or subject to the jurisdiction of the European Court of Justice. There is no provision in the existing treaties for an automatic correction mechanism where a member state deviates from that balanced budget path. So some elements of what they appear to be agreeing would require a treaty, while others would not.

Lord Maclennan of Rogart: Prior to the discussions on the night of 9 December, had the Government discussed these issues with the German Government in particular, which did appear to want this treaty?

David Lidington: We certainly discussed with the German Government their wish for a treaty. It had been discussed, I think, in fairly general terms. We discussed with the Germans in some detail what we would be asking for by way of treaty change ourselves if there was a formal negotiation of this kind, but we did not get early sight of the Franco-German draft that was tabled the day before the December European Council—nor, I believe, did anybody else.

Q80 Lord Foulkes of Cumnock: I just wanted to follow up Lord Maclennan's excellent point about discussions with other Governments in the run-up to these meetings to make sure that there are not misunderstandings at the meetings. The next one is 29 January. Is that right?

David Lidington: It is on 30 January, the Council.

Lord Foulkes of Cumnock: Is that to be attended by the Prime Minister?

David Lidington: The meeting on 30 January is an informal European Council that President Van Rompuy has convened. I presume that we are talking about the same meeting.

Lord Foulkes of Cumnock: Yes. Is that to be attended by the Prime Minister?

David Lidington: Yes. It is a meeting of the European Council.

Lord Foulkes of Cumnock: Will the Deputy Prime Minister be there?

David Lidington: The intention is that the Prime Minister will represent the United Kingdom, because the Council is for heads of state and government. I am certainly not aware of any change to that normal arrangement.

Lord Foulkes of Cumnock: What discussions are now taking place with other Governments—of Germany, of France and all the other Governments—in preparation for it? Do you talk to your European counterparts? Are there meetings of officials to try to make sure that we do not end up in the mess that we ended up in at the last one?

David Lidington: As I have said in response to earlier questions, I think that one has to look at the reasons. I would challenge the reasons why some other member states were so insistent that they would not countenance the sort of safeguards that we wanted to see adopted, but that is water under the bridge. Yes, is the straightforward answer. We have our officials sitting in the working group that is involved with drafting the intergovernmental pact. Obviously, as usual there are discussions between permanent representations and their teams in Brussels. At ministerial level, the Foreign Secretary talks face to face with his colleagues and on the telephone to his counterparts. I do the same. I was in Finland last week where I saw the Finnish Foreign, Europe and Finance Ministers. In all three meetings we discussed these issues. I was on the phone to my Polish opposite number yesterday. So at both ministerial and official levels there are serious discussions taking place.

Lord Foulkes of Cumnock: So you can predict to us that at this meeting on the 30th there will not be the kind of hysterics that we saw at the last meeting.

David Lidington: I do not know against whom Lord Foulkes is directing that charge but I do not think that hysterics characterised what happened on 9 December. I think that there was a disagreement. I do not expect any hysterics on 30 January.

Lord Foulkes of Cumnock: Maybe it was the wrong word. Histrionics, sorry.

David Lidington: What I expect on 30 January is what President Van Rompuy has tabled, which is a very serious discussion about these longer-term issues of competitiveness. I know from my conversations with the Commission that President Barroso is intending to come to that Council to give a presentation to heads of state and government about the importance of these measures that involve single market trade regulation. I have had the opportunity to meet President Barroso and talk these matters through with him in some detail. What comes through is his commitment to seeing Europe as a whole becoming more competitive. We may not agree with the Commission on absolutely every particular initiative that they come forward with, but I think that in terms of the challenge of global competitiveness there is a huge amount of agreement round the table.

Q81 Lord Hannay of Chiswick: Minister, you gave, if I may say so, a very precise description of who attends and who does not attend European Councils, which precludes the Deputy Prime Minister. Why was the Foreign Secretary in Brussels on 9 December, in that case, for a meeting that he did not attend?

David Lidington: The Foreign Secretary was in Brussels anyway the previous day, into the evening, attending a NATO ministerial meeting and it was convenient for him to stay over to assist the Prime Minister during the course of the European Council.

Q82 Lord Hannay of Chiswick: More importantly than that, if I may, you said that the protocol, which is so exciting that we are not allowed to see it, is now water under the bridge. Does that mean to say that since the 17-plus—as many others as wish to—are negotiating a separate treaty and the protocol that we were proposing was an amendment to the existing treaties, this is now completely historic?

David Lidington: Is Lord Hannay inviting me to say whether there is a chance of folding the intergovernmental agreement into the treaty structure—

Lord Hannay of Chiswick: No, I was not asking that. I believe that that will be part of the treaty.

David Lidington: The safeguards that we asked for were in the context of a negotiation at the level of 27 and there was obdurate opposition from a number of colleagues to doing that. I do not think that those countries have changed their positions, nor have we changed ours about the need for safeguards if there were to be any question of reopening the position at 27.

Q83 Lord Richard: I want to come back to safeguards. Have you seen a document from Open Europe in December 2011, which is headed “Cameron’s EU Veto: 10 lessons that need to be learnt”? On page 5 of that there is a little box that says, “What did the UK ask for?” and underneath it says, “A leaked copy of UK’s negotiating requests”. I know that it would not be in common usage for you to comment on a leaked document, but just let me put to you the individual items. The first is, “Unanimity over major transfers of power to the European Supervisory Authorities”. Can you say whether that was one of the safeguards? You cannot? The second is, “Unanimity over the use of maximum harmonisation”. Can you say anything about that?

David Lidington: I think that I have said before that I do not think that the Government in which Lord Richard served had the habit of commenting on leaked documents.

Lord Richard: “Unanimity on decisions within ESAs with impact on fiscal policy”. No? “Unanimity on the location of the ESAs”. No? “Safeguards against ESA mission creep. Exemptions from some EU rules for third country firms based in one state if they do not wish to passport into the single market”. Then we come to the one that I think you agree with, which is, “Preservation of the single market”. Do you accept the market?

David Lidington: Not if it is leaked.

Lord Richard: Not if it is leaked, no, but I think that is accepted, the preservation of the single market.

David Lidington: All I can say is what I said earlier in the Committee’s proceedings. We were not asking at the meeting for a UK opt-out or for a special exemption or for some kind of generalised emergency brake on financial services legislation. We were asking for safeguards, both on the single market and on financial services—I think that I made that clear earlier on—that were modest, reasonable and relevant and we were not trying to create an unfair advantage for the United Kingdom.

Lord Richard: Minister, you keep on saying what you did not ask for. At some stage you are going to have to tell us what you did. It seems to me inescapable that at some stage or another your safeguards are going to have to be made public.

David Lidington: Well, I hear the point that Lord Richard is making.

The Chairman: We have noted what the Chancellor said in his evidence to the Treasury Committee earlier in the week where he recognised some of these things as among the sorts of issues that had been discussed.

David Lidington: That sounds a pretty good phrase.

Q84 Lord Jopling: Minister, when I was a member, and later President, of two of the Councils, I always found that by the time one got downstairs after a negotiation to meet with the press they knew exactly in detail what had gone on upstairs. Why is there this extraordinary secrecy, which I do not recognise, frankly?

David Lidington: It has been a custom, I think, of successive British Governments that we do not disclose the detail of things that we table and discuss in the course of ongoing negotiations. Other people sometimes have a different practice in their political systems. Brussels is not a place where things stay unlearned for very long, in my experience.

The Chairman: We have taken a great deal of your time. We have one further question on the internal markets and enhanced co-operation, but perhaps that could be replied to in writing rather than taking too much of your time.

David Lidington: I am happy to respond to that. That is the easiest thing to do.

Q85 Baroness O’Cathain: I am very heartened that throughout this session, which has been very varied and roamed over a very big area, you have kept coming back to the importance of the single market. When we try to justify the situation that occurred on 9 December, it is still terribly important to remember that this is still the single most important thing of the whole European Union at the moment and has been stated like that only last Thursday by the Irish Prime Minister when he was over here at a meeting. He gave a speech, and I was there, and the very first thing he said was about the single market and the fact that we are committed to the single market. The third draft of the treaty states that the euro area states will make a greater use of the enhanced co-operation procedure without undermining the internal market, but the Lisbon Treaty also requires that enhanced co-operation must not undermine economic, social and territorial cohesion or distort competition between member states. Do the euro area member states accept these limitations on the use of enhanced co-operation?

David Lidington: Yes. What the discussions in the working group of officials have made clear is that our partners interpret the references in the draft pact to enhanced co-operation as meaning the enhanced co-operation procedure provided for in the treaties themselves and compliant with all the safeguards and procedural steps that that entails. The latest—the third draft—that somewhat clearer than the earlier iterations did. Again, we will have to see what comes out in the final version but, as Baroness O’Cathain knows, Article 329 protects the Commission’s role. It says that enhanced co-operation must be on a Commission proposal granted by the Council and with the consent of the European Parliament. Article

326 says any enhanced co-operation measure must not undermine either the single European market or economic cohesion, or create a barrier to trade, or discriminate in trade between member states, or distort co-operation between member states. Our clear understanding is that all those safeguards continue to apply. Enhanced co-operation is a technical term defined in the treaties. Article 334 says that, “Activities taken under enhanced co-operation must be consistent with the policies of the Union”. Again, that is another important principle.

Baroness O’Cathain: So really, despite all the brouhaha that has gone on over the last few weeks, there are no member states who do not buy into the point of enhanced co-operation for the single market.

David Lidington: No. You look at enhanced co-operation measures as they are brought forward. We have been among those who have been pushing very hard for agreement on the patent system under this procedure. It is a relatively untested procedure still so we will need to look case by case at what is proposed.

The Chairman: Minister, thank you very much indeed for having been so generous with your time. I think that we have covered quite a lot of ground but, as we have said, in view of the rapidly changing scene and the fast pace of events it may well be that the Committee, not necessarily in terms of oral evidence, may want to be in touch and ask for some further written evidence on final drafts of the proposals before we prepare our report. Again, thank you very much indeed for your evidence to us this afternoon.

The Rt Hon David Lidington MP, Minister for Europe – Memorandum

EURO AREA CRISIS AND THE PROPOSED FISCAL COMPACT TREATY

Thank you for your letter of 20 January, following my appearance at the Committee meeting of 17 January, where I gave evidence for the Committee's inquiry into the Euro area crisis and the proposed fiscal compact treaty.

In response to your request for commentary on the draft Treaty and on the Chairman's note, you will appreciate that we are studying the proposed draft Treaty carefully and are keen to work constructively with our European partners to achieve our shared aim of restoring stability to the Eurozone. However, the Government cannot comment in detail on a draft text on which we are not negotiating.

As the UK will not be a party to the proposed agreement, the agreement cannot create obligations for the United Kingdom nor will the agreement form part of the *acquis* of the European Union. The UK agrees with those Member States which have expressed concerns to ensure that the Agreement does not undermine the operation of the Single Market, or otherwise infringe on areas of policy that are properly for discussion by all Member States in the EU context.

The UK has further stressed that nothing should be done which cuts across the provisions and procedures in the EU Treaties, or seeks to by-pass the prescribed procedures for amending the EU Treaties, and in this regard shares the concerns of some other Member State in relation to Articles 7 and 8 which raise important questions of compatibility with EU law. Respect for EU law is fundamental to legal certainty which is key to the shared aim of restoring stability in the Euro-zone.

I will be pleased to provide whatever further information I can following the informal European Council at the beginning of next week.

27 January 2012

Professor Steve Peers – Written Evidence

Introduction

1. The following comments update my analysis of the first draft of the treaty on reinforced economic union (the ‘REU treaty’), online on the Statewatch website, in order to take account of the circulation of the second and third drafts of this proposed treaty.

Title and preamble

2. The text is now referred to (as from the second draft) as a ‘Treaty’, rather than an ‘Agreement’, but this distinction is immaterial from the perspective of public international law. The third draft also drops the word ‘international’, but this is not a substantive change: by definition, a treaty is ‘international’. Furthermore, the third draft has altered the name of the treaty, which is now the treaty on ‘Stability, Coordination and Governance in EMU’. This is not a crucial change, since the revised title simply reflects the content of the main three Titles of the treaty. For the sake of brevity, I will continue to refer to the draft treaty as the ‘REU treaty’.

3. As for the amendments to the preamble, the most significant are: the new clause referring to (but not itself affecting) the role of the social partners as regards the implementation of the treaty; the new clause stating that the REU treaty will not affect the conditions for financial assistance granted by the EU/IMF; and the revised final clause, which states that obtaining assistance under the ESM treaty will depend on compliance with Article 3(2) of the REU treaty. The latter change makes a direct link between the two treaties, and will likely in practice encourage any eurozone Member State which is receiving support from the ESM, or believes that it might need support under the ESM, to ratify the REU treaty. It might also encourage Member States which lend funds pursuant to the ESM treaty to ratify that treaty and the REU treaty, on the basis that the ‘moral hazard’ of lending will be reduced.

Title I

4. Article 1(1) has been amended in both the second and third drafts. The second draft added a reference to the ‘internal market’ but the third draft removed it. While some comments on the latest draft have suggested that the removal of this reference is a victory for the UK government, this is a political rather than a legal assessment, since the general clause in the REU treaty protecting the pre-eminence of EU law (Article 2) would in any event have prevented the treaty from having any impact upon EU primary and secondary law concerning the internal market.

Title II

5. In Article 2(2), the reference to the primacy of EU law was dropped in the third draft. However, this is not really a substantive change, since the REU treaty does not purport to overrule the primacy of EU law. The general wording of the rest of Article 2 could easily be understood as encompassing the principle of primacy, particularly since the

Court of Justice has linked that principle to the obligation of loyal cooperation now found in Article 4(3) TEU, which is expressly referred to in Article 2(1) of the REU treaty. Presumably this amendment has been made either for ‘presentational’ reasons, ie to avoid upsetting those who question the principle of the primacy of EU law by dropping an express reference to that principle.

Title III

6. The ‘balanced budget’ rule in Article 3(1)(b) has been clarified by a reference to the specific provisions of the Stability and Growth Pact (in the first sentence), and by a general reference to that Pact in the third sentence. While there is no reference to the Pact in the second sentence, arguably there is no difference between the Pact and this provision, due to the other references to the Pact in this clause. This is a fundamental question which ought to be clarified, as otherwise it is not clear whether the obligation to ‘ensure convergence’ is any different from the obligations that eurozone Member States already have under the Pact. It should again be noted that the 0.5% deficit rule in the REU Treaty is more stringent than the 1% deficit rule set out in the current EU legislation; but if the obligation to ensure convergence to that end is no different under the two sets of rules, then the more stringent deficit rule in the REU treaty would have a limited impact in practice.

7. The exceptions to the balanced budget rule have been moved from Article 3(1)(a) to Article 3(1)(c). The latest draft defines a ‘severe economic downturn’ and (apparently) an ‘unusual event’ by reference to the Stability and Growth Pact, so makes it clearer that the content of these exceptions has not changed as compared to the Pact. While the reference to ‘exceptional economic circumstances’ in the first draft has been dropped, this is not a substantive amendment since ‘exceptional economic circumstances’ were anyway defined by reference to an ‘unusual event’ (see Article 3(3) of the first draft). Finally, the latest draft has dropped the reference to calculating the deficit in light of the ‘economic cycle’, which allowed for some flexibility, but it might be argued that the reference to a ‘structural’ deficit in Article 3(1)(b) still encompasses this concept. It would be useful to clarify this point.

8. The flexibility offered to eurozone Member States with lower levels of overall public debt (now Article 3(1)(d)) has been clarified by adding a specific reference to the 1% deficit ceiling which such Member States will be subject to. However, this is not a substantive change, because, as noted in the original Statewatch analysis, that ceiling already applies due to EU law.

9. The ‘debt brake’ rule in Article 3(2) has been subject to some important amendments. First of all, it will only apply one year after entry into force of the treaty. This will encourage Member States which have not yet made the necessary changes to national law to ratify the treaty before having to make such changes; perhaps this amendment is intended particularly to take account of the French elections this spring. Next, the debt brake must be ‘permanent’, although surely that was previously implicit. Third, the debt brake need not be of a constitutional or ‘equivalent’ nature, but must only ‘preferably’ be of a constitutional nature. This will make it easier to ratify the treaty for countries like Denmark and France which clearly faced difficulties adopting a constitutional amendment to this effect. However, the first and third changes may have the effect of reducing financial markets’ confidence that the treaty will have much effect in practice upon restraining government deficits. Next, the latest draft states that the correction mechanism as regards the debt brake will be based on principles agreed on the basis of a Commission proposal. It

is not clear if this will be a proposal for EU legislation and if not, which decision-making rule will apply to its adoption. It is also questionable whether the treaty can give a new role to an EU institution, going beyond simply referring to the roles of the institutions as already provided for by EU law. Finally, the end of the second sentence makes clear that the substance of the correction mechanism as regards deviations from the deficit obligations does not differ from the Stability and Growth Pact.

10. The drafting of Article 4 is greatly improved, as it now confirms that the reduction in the total debt must take place in accordance with the Stability and Growth Pact legislation. This provision has also become more binding than the first draft, which referred instead to Member States 'undertak[ing]' such debt reduction. However, the latter change is not significant because the substance of the obligation in Article 4 is no different from the substantive obligations under the EU legislation anyway.

11. There have been some significant changes to Article 5(1). The second sentence is new, but does not add new roles for the EU institutions, referring only to the adoption of EU legislation on this issue. There are also new references to endorsement and monitoring, but there are also new provisions making clear that the EU legislative rules on this issue will apply.

12. On the other hand, there would apparently be a new role for the EU institutions in Article 5(2), added in the second draft, which does not refer to EU legislation. The legality of this provision might therefore be questioned, unless it is amended to refer to the EU institutions' role under that legislation.

13. Article 6 has been amended, comprising between the first draft version, which only referred to reporting of debt issuance plans, and the second draft, which referred to coordinating them. While this clause gives a new role to the EU institutions, it is harder to doubt the legality of a provision which merely provides for those institutions to be passive recipients of information.

14. Article 7 has been amended slightly, but these amendments have not made many substantive changes. The second draft referred also to supporting the Commission's proposals or recommendations also as regards debt, but this was dropped in the third draft. As pointed out in the Statewatch analysis, the EU economic governance legislation does not aim to control the total amount of public debt as such, but only to take the levels of debt into account when assessing the existence of an excessive deficit.

15. Finally, Article 8 has been amended significantly. First of all, the first sentence now provides for an option to invite the European Commission to give its opinion on whether a Member State has complied with the debt brake rule, and the new second sentence sets out a procedure similar to the pre-judicial stages of the infringement procedure in such a case. The second sentence also seems to require the 'Contracting Parties' to bring an action against a Member State which has breached the debt brake rule, in the Commission's view. This is presumably a compromise position as compared to the second draft, which had provided for an option for the Commission to act on behalf of the Contracting Parties by bringing an action. The legality of this provision of the second draft was rather questionable, since it conferred powers on the Commission, whereas Article 273 of the TFEU only refers to giving the Court jurisdiction to rule on actions between Member States. However, there must still be some legal doubt over the third draft, since the Commission would be given a

new role which moreover would have a binding effect in the sense that a negative opinion by the Commission would trigger an action by the Contracting Parties. Presumably this does not mean that the Member State which has allegedly breached Article 3(2) would be joining in the action against itself; this point should be clarified.

16. Secondly, the reference to national courts' jurisdiction over the implementation of the debt brake rule has been dropped. This could mean that the Court of Justice would have broader jurisdiction over the debt brake rule. On the other hand, the third draft, like the first draft, confines the scope of Article 8 to Article 3(2), whereas the second draft would have applied it to all of Title III.

17. Two objections made to the proposed Article 8 should be examined further. First of all, it has been argued, according to press reports, that the MEPs participating in the discussions believe that this provision is antithetical to the nature of the European Union and will lead to its destruction. In response to that argument, it need only be pointed out that Article 273 provides for dispute settlement between Member States; so does Article 259 TFEU (which is occasionally used) and the prior Article 35 TEU (still applicable on a transitional basis). Obviously, these provisions have not led to the destruction of the EU. Neither have similar provisions for dispute settlement in the context of the WTO, the UN, the Law of the Sea Convention et al led to the destruction of their constituent organizations.

18. Secondly, it has been argued that Article 8 of the REU Treaty exceeds the scope of Article 273 TFEU, since the 0.5% debt brake rule is new to EU law, and is therefore outside the 'subject-matter' of the Treaties. However, this argument is not convincing. Article 344 TFEU subjects all disputes concerning the 'interpretation or application' of the Treaties to the exclusive jurisdiction of the Court of Justice. Since Article 273 provides for only *optional* jurisdiction of the Court of Justice, the two provisions cannot overlap. So Article 273 cannot apply to EU law as such, since Article 344 applies to EU law; it follows that Article 273 applies (only) to disputes regarding measures which are *not* part of EU law as such, but which are *connected* to the 'subject-matter' of the Treaties. Obviously the debt-brake rule meets that criterion.

Title IV

19. Article 9 has been amended: a) to strengthen the role of the existing economic policy coordination rules; b) to focus on the impact upon EMU; and c) to limit their obligations exhaustively to the Euro Plus Pact. The second draft added a second sentence, which was then dropped, but this primarily referred to the subject-matter of the Euro Plus Pact in any event.

20. Article 10 has been amended a) to refer to all requirements in the Treaties, not just procedural ones; b) to extend its scope beyond enhanced cooperation, to include also measures adopted for eurozone States only pursuant to Article 136 TFEU; and c) to refer expressly to the Treaty rules on both forms of differentiated integration. Only the second amendment is genuinely substantive.

21. Article 11 has been clarified to refer to: a) the objective of a common economic policy; and b) discussions being held 'ex-ante' and 'where appropriate'. Neither change appears very significant.

Title V

22. Articles 12 and 13 have switched places, so the provision on parliamentary control has not (as claimed in one press report) been dropped.

23. Article 12 has been amended only to clarify expressly that the reporting obligation in Article 12(4) applies also to Contracting Parties which have not adopted the euro. This was probably already the intention of the first draft, which referred to the ‘other Member States’.

24. Article 13 has been amended to drop an express reference to parliamentary committees. Presumably it will still be open to national parliaments to focus on linking the relevant committees if they wish to do so.

Title VI

25. Article 14(2) now has a target date of entry into force, but this not really a substantive amendment as the treaty will still enter into force one month after it has sufficient ratifications. The bigger issue is the number of ratifications – originally nine eurozone States, then fifteen, and now twelve.

26. The prospect of integrating this Treaty into the EU legal framework, in Article 14(6) of the second draft, has not been dropped (as some press reports stated), but moved to Article 16. Of course, any Treaty amendment will still require the UK’s ratification. Note that Article 16 does not require a Treaty amendment as such, but refers instead more generally to integration into the EU legal framework.

27. Article 15, which is new, opens the treaty to EU Member States which are not ‘contracting parties’. The latter phrase is not defined, but presumably refers to all States which sign the treaty initially. It remains to be seen whether all 26 States which expressed an interest in signing the treaty will do so. If they do not, then Article 15 would also be applicable to some other Member States as well as (obviously) the UK.

General Comments

28. The later drafts of the treaty have, on the whole, introduced only a modest number of substantive amendments. These changes would not cause me to change my initial assessment in the Statewatch analysis, which was that the REU treaty added very little to the measures already set out in EU law or which have been or could be proposed as part of EU law. The treaty might nonetheless have a useful impact if it encourages Germany or the European Central Bank to take a more active role in saving the euro – although it would have been preferable by far for them to take a more active role as soon as the ‘six-pack’ legislation on economic governance had been adopted.

29. On the whole, the amendments are welcome in that they add necessary legal clarity on a number of points referred to in my initial analysis. There is scope for more improvement on this point though, as referred to above.

30. A more fundamental point should finally be raised. It has been assumed throughout this analysis that giving any role to an EU institution outside the scope of its current powers

under EU law would be legally questionable. However, the law on this point is not clear. The Court of Justice has in fact said that the EU's institutions *can* be given a role outside the scope of EU law – see Case C-316/91 *EP v Council* and C-181/91 and C-248/91 *EP v Council and Commission*. These cases involved collective action by *all* Member States, but the Court did not limit its remarks to this circumstance. The Court has also said that it can be given extra jurisdiction not referred to in the Treaties as long as it does not affect its core nature (see, for instance, *Opinion 1/00*). The latter case-law concerns the EU's external relations, but it is open to argue that it applies equally to measures adopted by a group of Member States. Certainly the Member States have assumed that it does, for example when they conferred jurisdiction on the Court of Justice to interpret the Rome Convention on conflict of law in contract.

31. Therefore the doubts about the legality of the use of the EU institutions outside the framework of EU law which are set out in my comments above assume that the Court of Justice would take a strict approach, and rule out all such use when only some, rather than all, Member States make use of the EU institutions. But it is quite possible that the Court *would* accept in principle that some Member States can make use of the EU institutions, although this would probably be subject to conditions, for example concerning the supremacy of EU law.

13 January, 2012

Olli Rehn, Vice-President of the European Commission - Written evidence

I would like to thank you for the letter on behalf of the House of Lords European Union Committee. I take note with much interest of your intention to publish a report on the crisis and the international agreement including the fiscal compact. You will find below my answers to your questions, which I hope will usefully contribute to your report.

1. Would it be legal for the proposed treaty of up to 26 member states to confer functions on either the Council or the Commission (as distinct from recognising functions which are already conferred on the Commission through the existing Treaties or legislation adopted under them)? If so, what is the basis for this view?

For the implementation of the agreement, the institutions of the Union will act within the framework of their powers as provided by the European Union Treaties. The question raised is therefore purely speculative at this stage.

2. Article 17 TFEU provides that "The Commission shall promote the general interest of the Union". How is the Commission managing any potential conflict of interest between member states using the euro, and member states not using the euro?

It is already the task of the Commission under the Union Treaties to guarantee the consistency between the actions of the Union as a whole and those of the euro area. Due to the closer economic links among the Member States whose currency is the euro, the Treaties include some provisions which only apply to these Member States. However, while deeper integration of the euro area is essential, it must be done in a way that keeps the entire Union strong and fully maintains the integrity of the Single Market. The envisaged agreement does not modify the situation in this respect.

3. If it is implemented promptly, what contribution would the "fiscal compact" treaty make to resolving the current economic and financial crisis centred on the euro area?

Part of the economic and financial crisis centred in the euro area is due to the concurrence of previously existing weaknesses in economic governance and to the lack of credible enforceable mechanisms for fiscal discipline. To target precisely these elements, the Commission proposed a comprehensive reform of the Stability and Growth Pact as part of the so-called 6-pack of legislation, which entered into force in December 2011.

As the difficult times continue and in response to the evident spill-overs between euro area Member States' economic and budgetary situations, further proposals to strengthen surveillance in the euro area, namely for a "Regulation 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" and for a "Regulation on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area" (together sometimes referred to as the 2-pack), have been presented by the Commission on 23 November 2011.

The "fiscal compact" proposed by euro area Heads of State and Government, enshrined in the intergovernmental agreement and to be complemented through EU law, will allow additional improvements to fiscal coordination and discipline in the euro area. A main contribution of the fiscal compact will be the strengthening of fiscal rules at a national level for budgets in balance or surplus, in line with the European medium-term budgetary objectives of the Stability and Growth Pact. The 26 European leaders have committed to adopt such a balanced budget rule, including correction mechanisms to be automatically triggered, at national level, through laws of constitutional or equivalent nature.

The international agreement also envisages "budgetary and economic partnership programmes" for Member-States in Excessive Deficit Procedure. These would allow taking care of structural aspects of budgetary policies and beyond, necessary to ensure a durable correction of excessive deficits.

Also, *ex ante* monitoring of national debt issuance plans should improve the monitoring of the fiscal situation.

These proposals strengthen the provisions contained in the 6-pack and complement the proposals of the Commission on 23 November 2011. Accordingly, all these decisions concur to the design of a comprehensive framework of economic governance.

4. What other key policy steps should be taken in the short term (within the next two months) to address the current crisis? (Policy debates have, of course, focused on the need for bank recapitalisation, greater intervention by the European Central Bank, and the issuance of 'Eurobonds')

On 13 October the Commission published a Communication "A roadmap to stability and growth" consisting of five key actions:

1. Give a decisive response to the problems of Greece
2. Enhance the Euro area's backstops against the crisis
3. Strengthen the banking system, namely through recapitalisation
4. Frontload stability and growth enhancing policies
5. Build a more robust and integrated economic governance

Specific actions under each of these headings have been taken or are underway. This includes for example the decisions to increase the flexibility and effectiveness of the EFSF and the ESM as well as the comprehensive package on growth and governance presented by the Commission on 23 November containing the 2012 Annual Growth Survey, a green paper on Stability bonds and two proposals for legislation to further strengthen surveillance in the euro area (the so-called 2-pack).

5. This Committee has previously argued that there has been a weakness in the architecture of the euro area, in that monetary policy has been centralised yet fiscal policy has been left to the discretion of member states. There are also underlying macroeconomic difficulties, especially the imbalances in competitiveness between

states. (House of Lords, European Union Committee, *The future of economic governance in the European Union*, published March 2011.) In your view will the fiscal compact treaty form part of a coherent and effective longer term response to these weaknesses? Or will more need to be done?

Work to strengthen economic governance in the EU and the euro area is ongoing. The adoption of the 6-pack of legislation represented the most comprehensive reinforcement of economic governance in the EU since the launch of the Economic and Monetary Union. One of the 6-pack's key components is the new framework to prevent and correct macroeconomic imbalances such as the divergences in competitiveness you refer to. The Commission will shortly publish a so called Alert Mechanism Report, in which it will identify countries that it regards would be candidates for an in-depth review. These reviews can lead to preventive or corrective recommendations.

More is necessary, however, to strengthen the governance of the euro area. Work continues through the international agreement, which eventually will be incorporated into the legal framework of the European Union, but also through secondary legislation on the basis of the Treaties on which the EU is founded, such as the 2-pack.

6. During the debates on how to respond to the crisis, has there been too much emphasis on austerity in public finances, and too little on growth, and the development of the internal market? If so, what steps need to be taken to encourage growth and to strengthen the role of the internal market?

The crisis revealed three main challenges: the financial sector, economic growth, and public finances. All three, including growth, need to be addressed in a determined and coherent way. Several key initiatives have been incorporated to this regard, including new regulation and supervisory structures for the financial sector, the Europe 2020 Strategy for smart, sustainable and inclusive growth, backstops in the shape of EFSF, EFSM and ESM, and the six-pack to strengthen economic governance. Also, in the context of the European Semester, Member States are issued policy recommendations in all three areas in an integrated manner.

The attention for fiscal consolidation is fully warranted. In view of the current instability in financial markets, countries should persist in the ongoing consolidation efforts, as ensuring sustainability is the most promising strategy to underpin economic stabilisation and restore credibility. In a number of countries delaying consolidation would probably result in higher risk premiums and consequently worse economic prospects. Hence, fiscal consolidation is a precondition rather than an obstacle for medium-term economic growth and accordingly the consolidation measures will eventually contribute to restore markets' confidence.

In line with the Commission's Annual Growth Survey, consolidation should be pursued in a growth friendly manner, for example by prioritising growth-friendly expenditure, such as education, research, innovation and energy which are an investment in future growth, and ensuring the efficiency of such spending, as well as shifting taxation from labour towards taxation that is less detrimental to growth.

Consolidation efforts should also be differentiated. Not all Member States are in the same position. On 4 October 2011, the ECOFIN Council reiterated the principle that the speed of fiscal adjustment should be differentiated according to country specific fiscal and macro-

financial risks. In particular, countries benefitting from a financial assistance programme and those under close market scrutiny should ensure that their budgetary targets are made robust to growth prospects. In other countries under excessive deficit procedure, limited downside revisions to the macroeconomic scenario should not result in delaying the correction of the excessive deficit. Member States that do not have an excessive deficit can let their budgetary balances fully play a stabilisation role, as long as their medium-term fiscal sustainability is not put at stake.

With regard to specific growth initiatives and the internal market, in 2010, the Commission introduced a programme for switching to smart, sustainable and inclusive growth, the so-called Europe 2020 Strategy. The Strategy aims to maximise the EU's assets and equip it for success in a rapidly changing world. Under this Strategy, the European Council endorsed country-specific recommendations in each Member State in June 2011. In November, the Commission published its Annual Growth Survey, focusing on five priorities, which efforts at the EU and national level should focus on:

- Pursuing differentiated growth-friendly fiscal consolidation
- Restoring normal lending to the economy
- Promoting growth and competitiveness for today and tomorrow
- Tackling unemployment and the social consequences of the crisis
- Modernising public administration

A well-functioning internal market is a foundation stone of the EU as it is key to delivering growth and employment and promoting competitiveness. With the express purpose of strengthening the internal market, the Commission, in partnership with the Council and the European Parliament, and following extensive public consultation and discussions with other European institutions, presented the Single Market Act last April. In it, priority objectives to put in place before the end of 2012 were defined and grouped into twelve levers. One of the priority objectives, given the size of the sector, is to create a Single Market in services. That necessitates the complete, full implementation of the Services Directive in all Member States, including the establishment of Points of Single Contact.

7. What has been the effect of the events at the 9 December European Council on the UK's relations with the Commission, and with other EU member states? Do you perceive any change in attitude, on the part of the UK Government, other member states, or the Commission, since the Council meeting?

As regards the outcome of the December Summit, the Commission would have certainly preferred a solution agreed by all 27 Member States. Deeper integration of the Euro area must be done in a way that strengthens the EU as a whole and avoids divisions between the euro area and other Member States. It is the Commission's role to ensure coherence between the euro area and the Union as a whole, particularly when it comes to the need to maintain a level-playing field in the internal market. We will continue to play this role for all Member States of the European Union, including of course the the UK. The Commission's attitude has not changed in that respect.

8. It has been widely suggested that most or all of the measures to be included in the proposed treaty could be implemented through existing treaty provisions. Is a new treaty legally necessary to achieve these measures, or could these things actually be implemented through the existing treaty provisions?

Several of the measures in the international agreement can be operationalised through secondary legislation on the basis of the Treaties on which the EU is founded. However, where the contracting parties would like to take their commitments beyond the Treaties on which the EU is founded – whilst ensuring they are compatible with these Treaties – they will have to lay these down in the international agreement. This is the case in particular for the adoption of specific voting commitments between contracting parties.

9. Does the Commission share the concern expressed in some quarters that spreading important commitments on budgetary discipline etc. across this treaty, the Lisbon treaty, and a range of other legislation, could cause confusion about what exactly is required?

The framework on budgetary discipline consists of several key components. There are the provisions as well as a protocol in the Treaty on the Functioning of the European Union, secondary legislation (which was recently revised in the context of the 6-pack) and a Code of Conduct. The international agreement will include further commitments to budgetary discipline. The Commission aims at incorporating, to the greatest extent possible, the elements of the international agreement in secondary legislation. This could be done at least in part through the adoption of the Commission's 23 November proposal for a new "Regulation 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".

In addition, the commitment of the signatories of the international agreement to incorporate the substance of its provisions into the European Treaties is enshrined in the agreement itself. This should avoid any confusion and ensure the consistency of the framework for fiscal discipline in the euro area and in the Union at the highest legal level.

The Commission stands ready to provide information or explanations on the framework if and as required.

10. How can sufficient democratic oversight of the obligations in the fiscal compact treaty be put in place?

The democratic oversight has been ensured since the beginning of the discussion on the fiscal compact. Member States' Governments are all accountable to their respective national Parliaments, which have control over the ratification and implementation of the fiscal compact. The European Parliament, with its representatives, is actively and constructively participating in the discussion on the new agreement. The fiscal compact will fully respect the responsibilities of national Parliaments. The European Parliament will play its strong role in the negotiation on the secondary legislation needed to put in place the obligations of the fiscal compact and national Parliaments exercise full oversight over the actions of their Governments in that respect.

26 January 2012