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Rt Hon Greg Clark MP
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Dear Greg,

The euro area crisis: an update

Thank you for your evidence before the House of Lords European Union Sub-Committee on Economic and Financial Affairs at its meeting on 23 July 2013, on developments in the euro area crisis. This letter forms the latest of our regular six-monthly updates in relation to the euro area crisis. You will be aware that the Sub-Committee also heard oral evidence on 2 July from: Ruth Lea, Economic Adviser, Arbuthnot Banking Group, Professor Stephen Haseler, Director, Global Policy Institute, and Vicky Pryce, former Joint Head of the Government Economic Service. In addition, the Sub-Committee held a private briefing with Reza Moghadam, Head of European Department, International Monetary Fund.

Introduction

A great deal has happened since we last explored the euro area crisis in February 2013. There was the poorly handled bailout of the Cypriot banking sector in March, a flare-up of the crisis in Portugal and Greece and more back-tracking by EU leaders from the important reforms necessary to mend the flaws in the euro area. In our previous letter to you on this subject we wrote that relative calm had been restored following ECB President, Mario Draghi's commitment to do "whatever it takes" to stop the euro breaking apart. However we also warned against any false assumptions that the worst of the crisis was over. **As we set out below, we are pleased to note indications of incipient improvements: though debt levels have increased, so has consumer confidence, and the squeeze on real incomes appears to be easing. But it is still far too soon to be complacent.**

The key theme that emerged from our most recent discussions was the concept of "muddling through": in other words, EU leaders were only motivated to act when a flare-up of the crisis occurred, and even then, they were only willing to do the bare minimum to tackle the most immediate problem. **We are concerned that sufficient progress has yet to be made in truly reforming the euro area to ensure that crises do not continue to plague the EU.**

You felt it unfair to accuse EU leaders of just muddling through, since the difficulty in reaching agreement was simply a reflection of the complexity of the negotiations. You pointed out in your evidence to us that progress had been made, with agreement on the Single Supervisory Mechanism (SSM) and the Bank Recovery and Resolution Directive (BRRD), as well as the recently published proposal for a Single Resolution Mechanism. Whilst some progress has been made, implementation of these agreements will take much longer. The SSM will not be operational until mid-2014 at the earliest and the BRRD will not come into effect until 2018. Given the significant disagreement already evident on the SRM, progress on this dossier seems unlikely any time soon.

Ms Pryce pointed out the irony that we need "another good crisis" for any progress to be made. **It should not have to come to this. Whilst we accept the difficulty of a group of sovereign states reaching agreement on such complex issues, it is imperative that the euro area moves towards a position of stability (let alone growth) as soon as possible.**

Austerity and structural reforms

An issue that our previous update focused on was the poor performance of the euro area economies. Whilst there had been proclamations that the crisis was over, we argued that in some respects it was only just beginning. Austerity as a response to the crisis had been overemphasised and we highlighted the short term pain that structural reforms were inflicting on these economies. The real challenge now, we stressed, was how to restore much-needed growth and competitiveness to the euro area, and by extension, the EU as a whole.

The Commission has since eased its stance on austerity. In May 2013, the Commission announced that France, Spain, Poland, Portugal, the Netherlands and Slovenia would all have more time to complete their austerity plans. The June European Council conclusions confirmed this change of emphasis by stating that "for some Member States, the pace of fiscal consolidation has been adjusted to respond to economic conditions". **We welcome this shift.** On 22 July 2013, Eurostat reported that euro area government debt had increased from 90.6% of GDP in the fourth quarter of 2012 to 92.2% of GDP in the first quarter of 2013[1], demonstrating that the emphasis on austerity had been self-defeating.

This flexibility was welcome but Ms Lea felt that it was merely a "prolongation of austerity rather than an abandonment of it". There was a unanimous view in the evidence we heard that a short term stimulus was required. You highlighted the Commission's work with the European Investment Bank (EIB) to increase support for small businesses as an example of where growth enhancing measures were being undertaken. Ms Lea was unimpressed with the Commission's "feeble" effort to restore growth. She described the Commission-EIB initiative as a "very good idea" but it had come "pretty late in the day". In her view "there is a terrible reluctance to grab hold of this thing and really make some serious difference to it".

We have however seen some brighter economic data emerge from the region recently. On 25 July we learnt that euro area PMI data[2] was at its highest levels in 18 months. Many have taken this as an indication that the euro area may return to growth this year. In addition, the

[1] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22072013-AP/EN/2-22072013-AP-EN.PDF

[2] Markit's composite Purchasing Managers Index (PMI) is a key benchmark indicator for measuring business and economic conditions and is based on data from thousands of companies across the region.

reduction of the pressure on bond yields since the ECB's commitment to "do whatever it takes" last year should not be underestimated. This may in turn enhance the economic performance of the countries in question. **What further measures would you suggest the EU could take in order to promote growth?**

In exchange for easing the terms of fiscal consolidation, there was a renewed drive for these economies to undertake structural reforms. In our previous correspondence we indicated that, whilst structural reforms would likely benefit these economies in the long run, they would create significant short term pain. **We have seen progress in terms of structural reforms: there is a clear indication, for example, that real wages have fallen to more sustainable levels and competitiveness has improved in many of these countries. However, we remain concerned about the impact of structural reforms, not only on short-term economic growth, but also on the political stability of the Member States affected. In countries like Cyprus, Greece and Portugal there are warning signs still that citizens' tolerance of austerity is being sorely tested. The political ramifications of this are as alarming as they are uncertain.**

Direct bank recapitalisation

The meeting of the Eurogroup on 20-21 June reached agreement on the main elements of direct bank recapitalisation. At this meeting, the strict terms under which the European Stability Mechanism (ESM) could provide funds directly to euro area banks were agreed. Banks must have "an appropriate level" of bail-in applied, the country requesting assistance must not be able to perform the recapitalisation itself without "very adverse effects" on its fiscal sustainability, and the institution being bailed out must be systemically important. Furthermore, the bail-out must be viewed as indispensable to the stability of the euro area as a whole. If these criteria are met, a maximum of €60 billion can be used for direct recapitalisation.

Despite this agreement, there are still a number of hurdles to overcome before direct recapitalisation can be used. The instrument will not be finalised until national parliamentary scrutiny procedures have been finalised and the Single Supervisory Mechanism (SSM) is in force. Securing national approval could be a major stumbling block since, for example, Article 2 of the German implementation law of the ESM treaty explicitly excludes direct bank recapitalisation. In addition, the SSM was seen as a prerequisite to direct recapitalisation, but it is not anticipated to come into force until mid-2014 at the earliest.

The figure of €60 billion was described as a "drop in the ocean" by Ms Lea. In her view it was "a pretty small number considering the size of the European banking system". Ms Pryce indicated that the delay in reaching agreement on this had already been extremely costly. If Spanish banks, for instance, had been directly recapitalised much earlier, it would have eased the situation and prevented a great deal of pain. **What is your view of the delay? Given the delay, and given the small amounts involved, how meaningful is this agreement in practice?**

In your evidence to us you emphasised that the €60 billion should not be viewed in isolation, since the resources available to a country during a crisis would be much greater than this figure implied. For instance, an appropriate level of bail-in has to be arranged before direct recapitalisation can take place and sovereign states can also borrow directly from the ESM. **We accept this but worry that relying on sovereign states to borrow from the**

ESM would increase their debt burden (i.e. the exact problem that direct bank recapitalisation was trying to avoid). Does this concern you? Can you provide further clarity on your view that the Eurogroup, if needed, can bring substantially greater resources to bear than just the €60 billion available from the ESM itself?

Greece

The crisis in Greece has recently reignited. In June 2013, the Democratic Left party pulled out of the coalition government forcing the Greek Prime Minister, Antonis Samaras, to reshuffle his cabinet in order to avoid a snap election. At the same time, there was concern that the IMF might have to suspend its disbursements to Athens after a shortfall of €3-4 billion opened up in Greece's bailout programme. This shortfall was eventually met but only after last-minute negotiations with the troika.

Meanwhile, the Greek economy remains in a dire condition. The economy is in its sixth year of recession, unemployment is near 27% and nearly two out of three under-25s are out of work. According to economists, current forecasts of GDP growth of 0.6% in 2014 are realistic, but this is far from the 3% annual growth rate the country needs to achieve from 2015 to 2021 to makes its debt affordable.

Ms Pryce highlighted the problem of unemployment and the "continued disquiet of the population about things being imposed on them undemocratically by the Germans and others". She stated that there was an impasse: "There is no way that Greece can actually get itself out of the problems it is finding itself in now". She indicated that "the pressures that are coming from an economy that is really collapsing are too great for any politician to deal with, and with such a wafer-thin majority, we are going to get into trouble". Ms Pryce called for a high degree of infrastructure spending by the EU. She accepted that structural reforms, in terms of reform of the public sector and pensions, were necessary but a proper industrial strategy was also key. Ms Lea was sceptical about the possibility of an industrial strategy being enacted. She instead foresaw major defaults, a third bailout and prolonged social pain.

The situation in Greece is arguably unsustainable and a change in approach is necessary. Further significant debt restructuring now seems inevitable. Do you have a view on what could be done to restore sustainable debt levels as well as decent growth and employment levels to this economy? We have noted your reticence in commenting on the domestic policies of other Member States, most recently in the context of Latvia's accession to the euro. Yet as Greece's own accession to the euro demonstrated, the consequences of such "domestic policies" can be dramatic indeed for all Member States. Given that a number of these policies are essentially imposed by the troika, and the fact that what happens to the Greek economy has systemic implications for the rest of the EU and the UK, we hope that you will be willing to engage in this discussion.

Cypriot bailout

One of the most alarming events since we last explored this issue was the inept handling of the Cypriot bailout. In March 2013, the troika agreed a €10 billion bailout with Cyprus. As part of the deal, a one-off bank deposit levy of 6.7% for deposits up to €100,000 and 9.9% for higher deposits was announced on all domestic bank accounts. This deal was subsequently rejected by the Cypriot parliament. The final agreement involved protection of

deposits below €100,000 but forced losses on deposits over €100,000 in Bank of Cyprus and Laiki Bank. The deal also demanded the closing of Laiki Bank and a fundamental restructuring of Bank of Cyprus.

The negative reaction to the original deal and the ensuing uncertainty that it has created has been worrying. Capital restrictions imposed to prevent a run on Cypriot banks have been eased, but remain in place. Ms Pryce described this incident as the "worst bit of muddling through", and said that the idea that insured deposits should foot the bill was "crazy". You told us that everyone had learnt their lessons from this incident and the deal on the Bank Recovery and Resolution Directive would reflect the fact that deposits below €100,000 should be protected. Ms Pryce argued that, despite the protection now afforded to deposits below this threshold, there remained a problem of confidence in the Cypriot banking sector. A number of businesses, for example, have deposits above this threshold and so any kind of depositor bail-in has a huge impact on confidence. **How would you respond to these concerns? How can the confidence that was shaken by these initial serious errors be restored?**

Role of the ECB

The role of the ECB during the euro area crisis has been crucial, both as part of the troika and in terms of its commitment to buy unlimited amounts of bonds in the secondary market of a troubled country (known as Outright Monetary Transactions (OMT)). There was unanimous agreement that the ECB's announcement last year had been instrumental in taking the heat out of the existential crisis that had engulfed the euro area. A recent *Financial Times* article[3] highlighted the success of OMT in keeping a lid on markets in the context of the recent political and economic problems in Portugal. Unlike in the past, the issues in Portugal did not translate into increased borrowing costs elsewhere in the euro area.

Ms Pryce was complimentary about Mario Draghi's role at the helm of the ECB in comparison with his predecessor, Jean-Claude Trichet, "in the sense that he lowered interest rates at a time when there was a recession ... whereas Trichet raised them at the time of a recession". Though everyone celebrated the ECB commitment to OMT, Ms Pryce pointed out that "there has not been any serious purchase of bonds" implying that this relative calm may not last if no action is taken. The same *FT* article highlighted this and indicated that OMT may have to be tested soon. It also pointed out that few details had emerged on how the mechanism would operate; Mario Draghi shifted his stance from saying the ECB would publish OMT's legal documentation "soon", to saying it would only publish it once a country had applied. Going beyond OMT, Professor Haseler put forward the interesting suggestion that there might be a role for the ECB to undertake some form of quantitative easing as other central banks, such as the Federal Reserve, were considering tapering off this type of support. **Does it concern you that the ECB has not been clear exactly how OMT would operate if it were to be used? Do you believe there could be scope for the ECB to undertake Quantitative Easing? Would you advise this in the right circumstances?**

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[3] 'Draghi's 'Dirty Harry' act keeps euro crisis at bay', by Michael Steen and Ralph Atkins, *Financial Times*, 22 July 2013

Role of the IMF

The IMF recently published a report evaluating the success of the first bailout programme for Greece, where it admitted that mistakes were made. In this it said it had been too optimistic in its growth assumptions and that a debt restructuring should have been considered earlier. This report was particularly critical of the European Commission, claiming it lacked experience of managing financial crises and fiscal adjustment programmes.

Ms Pryce was clear that the IMF "did not distinguish themselves in the way they handled the Greeks". She did, however, highlight the inexperience the IMF had with dealing with developed economies, and the scale of the bailouts that such countries required. Whilst the IMF made a lot of mistakes, Ms Pryce applauded them for coming out and saying "perhaps we did not get it quite right".

On a more general point, Ms Lea was unclear "why the IMF got involved in the first place", since the euro area was a rich part of the world and not the usual target for IMF programmes. Professor Haseler agreed but added that it gave the European institutions some political cover. **How would you assess the IMF's performance during the euro area crisis? Is it both necessary and desirable for the IMF to continue in its role as part of the troika? If so, how can its interaction with the other troika members be enhanced?**

The implications for the UK

It is clearly important for the UK that the problems of the euro area are resolved. Reports that the existential crisis has receded along with the risk of euro area break-up are therefore welcome. The euro area is pursuing deeper integration in order to resolve its flaws and prevent another crisis, an issue that we are spending considerable time exploring as part of our current inquiry into *Genuine Economic and Monetary Union*. Given the vital importance of the German position, we will be visiting Berlin and Frankfurt, as well as Brussels, in the autumn to explore these issues. **Leaving aside the question of how necessary and realistic these proposals are, they pose considerable implications for the UK.**

Professor Haseler suggested that the UK should participate in this integration process. He highlighted that, whilst the euro area countries are talking about greater integration in the euro area, the UK is talking "the exact opposite language". In his view, the UK's participation in the single market but not the single currency was "ultimately unsustainable". Ms Pryce disagreed with this. She argued that the UK was more integrationist than many realised. Indeed, the UK was often more open to integration in a number of areas than those in the euro area. For example, it was partly through the UK's encouragement that integration in the retail banking, energy and services sectors had taken place. It was her view that the UK could continue to be part of the single market without being a member of the euro.

The UK has managed to maintain its position within the single market but outside the single currency for many years. Part of the reason for this co-existence has been the fact that, as many people often claim, the single currency has not been a 'genuine' one. As the single currency area becomes more integrated, it will be a huge challenge for the UK. Key euro area institutions, such as the Eurogroup, are becoming increasingly influential. There is a desire to build on this and create similar separate institutions elsewhere. **In your evidence to us you touched on your relationship with the Eurogroup. Can you expand on how you interact with this group? To what extent are you able to influence its**

discussions? How will you ensure your voice continues to be heard as the euro area Member States contemplate deeper integration? How would you respond to suggestions that other non-members of the euro area seem to manage a more effective and constructive relationship with the euro area?

You emphasised the safeguards the UK Government secured in recent negotiations as evidence that it was possible for the single market to be preserved as deeper integration in the euro area progressed. **How long can the protections for the single market and for non-participating Member States, secured for instance in the context of the Single Supervisory Mechanism, persist? Can you provide details of the types of safeguards you will be seeking during the negotiations on the Single Resolution Mechanism? Has thought gone in to developing a 'blueprint' for such agreements? If so, could you provide details of this?**

It is important that the UK Government seriously consider how this country can continue to work effectively within an evolving European Union. The UK's unusual position as a member of the single market but not of the single currency is coming under strain. It remains to be seen whether it can be maintained.

We would be grateful for a response to this letter by 30 August 2013.

I am copying this letter to William Cash MP, Chair of the Commons Committee; Sarah Davies, Clerk to the Commons Committee; Paul Hardy, Legal Adviser to the Commons Committee; Les Saunders, Cabinet Office, Kunal Patel, Thomas Kenny and Gary McMillan, International Tax Strategy & Co-ordination, HM Treasury.

Yours,

Tim

The Lord Boswell
Chairman of the European Union Committee