HOUSE OF LORDS

EU Economic and Financial Affairs Sub-Committee
Euro area crisis: Follow up Inquiry
Oral and Supplementary Written Evidence

Contents

Dr Richard Corbett, Member of the Cabinet of Herman Van Rompuy, President of the European Council - Oral evidence (QQ 31-57)

Evidence Session No. 2 of 3. *Heard in Public.* *Questions 31-57*

TUESDAY 10 JULY 2012

Members present

Lord Harrison (Chairman)
Lord Dear
Lord Flight
Baroness Hooper
Lord Jordan
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Prosser
Lord Vallance of Tummel

Examination of Witness

Dr Richard Corbett, Member of the Cabinet of Herman Van Rompuy, President of the European Council.

Q31 The Chairman: Richard Corbett, it is an enormous pleasure to welcome you to the Committee this morning. It is a while since you and I shared responsibilities in the European Parliament for Merseyside. It is great to see how far you have gone in the interim. We are most grateful to have the attention, too, of Lord Boswell, the Chairman of our Select Committee, who I know will attend one of our later meetings to discuss matters.

I would like to tell Dr Corbett that, at the back, there is a list of the interests that have been declared by Members of the Committee for consultation. As you know, we take a transcript of this exchange of views. We will pass that transcript on to you. Please do correct it. As I always say, there may be further thoughts that you have as a result of the exchange, and we would be most grateful for any kind of update, especially as, even as we speak this morning, the euro area crisis, which we are investigating—this is the second session of three—is such a moving target. As I say, we are most grateful for your coming at short notice.

I take the opportunity to invite you either to make a statement at the beginning or just to respond to my opening question about whether you indeed believe that the euro will survive in the form that it is in. What is your view on the endgame that might ensue over the next months, years or whatever?

Dr Corbett: Thank you, Lord Chairman. First, an apology: you can hear from my voice that I am recovering from a cold. I lost my voice completely the other day. It is coming back, and I hope that it lasts throughout, but if there are any really difficult questions, I fear it might give way again before I can give an answer!

Yes, certainly, I think that the eurozone can and will survive. The question is how well it survives. It is not just a yes or no; it is that we want the eurozone and the euro to be a success and not to lose any members on the way. But survive it will!

Some aspects of the crisis are not simply related to the eurozone as such. The sovereign debt issue is certainly one that affects a number of eurozone countries, but also some countries outside the euro, which we rarely talk about. There have been bailout loans, , to Romania, Hungary and Latvia, if I remember correctly. In the UK, we all remember the effect that tiny little Iceland had when it went belly-up, if I can put it that way. We are all interdependent, whether we like it or not, and a disorderly default in any country, inside or outside the euro, can have repercussions right across Europe. Maintaining a separate currency has not made the UK immune from that. We are all interdependent to an extent that is becoming more obvious than it was a few years ago.

Q32 Lord Kerr of Kinlochard: The President's report—the Van Rompuy report—which the summit looked at, talks about, "Four essential building blocks: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework, and ensuring the necessary democratic legitimacy and accountability". The European Council called for the development of a "specific and time-bound roadmap for the achievement of a genuine economic and monetary union", presumably on that basis. Do you think it is realistic? Do you think it is sufficient?

Dr Corbett: There was no specific agreement on all the elements of that report, but it was agreed that these are the areas that need to be taken forward over the next few months and explored in detail. The President, in his report, had identified the correct subjects for that. One subject is of course going to be taken on a fast track; that is, banking supervision. All the other aspects will be looked at in a new report: an interim report in October and a final report in December.

The President's intention—working closely with the other three Presidents, whom he must consult, and consulting all the member states at the same time—is to try to identify those subjects on which there is the necessary degree of political support to go forward. Some of those subjects, as you will be aware, are ones where that is not, at this point, self-evident. It will not be an easy process to tease out the details to find what there is a sufficient level of support on across all the member states involved—sometimes that involves a discussion as to whether we are talking about the 27 or the 17, or the 17-plus—and see whether there is sufficient political agreement to move forward and how far. That being said, the general climate of opinion around the table of the European Council, on everyone's side, was that the economic and monetary union needs further deepening if it is to work better. That is the endorsement, as it were, for this process to move forward.

Q33 Lord Flight: Is not the key ingredient for the economic and monetary union to succeed transfer payments from the more successful to the less successful economic areas? That has been the case throughout history in the US and the UK, and it is not here.

Dr Corbett: That is one of the matters that is subject to a lot of debate, as I am sure you are aware. Many people think that is indeed the case. Those who take the opposite view would say that the European Union does do a little bit of transfer payments through its structural funds, which are of course, in relative terms, small. The whole of the EU budget is just 1% of GDP. On the other hand, structural funds are now of a size that is far greater than the Marshall funds at the end of the Second World War, which proved crucial for European economic recovery. For some of the countries that benefit the most from it, it represents a significant percentage of their GDP. There is then the question whether it has been put to good use, which you could have a big debate on.

The second thing that has been provided, which is a new instrument that did not exist before the crisis, is the ability to give emergency loans through the so-called bailout funds. Those are loans, not grants, but they give the recipient countries much more time. They are long-term, low-interest loans, with the aim to give countries that have to undertake very difficult reforms a much longer time horizon than would otherwise be the case.

Q34 Lord Kerr of Kinlochard: It feels to me as if the can has been kicked down the road again. Already commentators are a bit cynical. It seems a regular cycle. The European Council meets. It is a triumph—problem solved—but within two weeks, lo and behold, the markets are not happy. You pointed out that the priority they devoted most attention to was obviously the banks/sovereign risk nexus. The eurozone statement comes up with a call for breaking the vicious circle; there is delight in Spain and 10-year money drops below 6%, but now it is back up at 7%. Have they done enough to break this link? How soon do you think the proposals will be brought forward? It seems to me there is a nasty August risk here; the proposals sound good, but they are not yet on the table.

Dr Corbett: On the Spanish—and, by implication, Italian—situation, the eurozone Finance Ministers were meeting last night. On one aspect of that there is already agreement now to move quickly to a loan of €30 billion by the end of this month and going up to €100 billion later, if I am correctly informed of what was discussed last night.

The other aspect of this, though, is to break the link, as you said. The problem with lending via the sovereign to the banks is that it went on the books of the Spanish sovereign—the Spanish state—with seniority, so that anybody else lending to Spain thought that was an extra element of risk and therefore they wanted a mark-up to compensate for that. Being able to lend directly to the banks takes it off the sovereign and takes away that element of the problem. Even if that takes time to come through, there will be a Commission proposal at the beginning of this autumn, and hopefully agreement on legislation by the end of the year on the banking supervision side, which is the necessary counterpart to this. You then need a bit of time to set it up. Knowing that this is coming may well relieve market pressure already. As you rightly said, market pressure relented somewhat straight after the European Council, although it crept up again when doubts were expressed, at least in two member states, about whether the agreement would stick. It may well be going down again after last night. The key thing is the direction of movement in the long term. What is being done here is to take an existing instrument and make it more flexible in how we use it. It is not the creation of a new instrument.

Q35 Lord Kerr of Kinlochard: I understand the argument about needing a road map, we need to know where we are going and that will restore confidence. However, this particular measure of being able to lend directly to the Spanish banks, not via the Spanish Government, already seems controversial in Germany, with all these people telling Mrs Merkel that this is not possible. Is there confidence in the markets that this is actually going to be delivered?

Dr Corbett: You have put your finger on a point that has dominated many aspects of this whole process for the last two years—political processes, which are democratic processes, move more slowly than markets and usually with more hiccups. Markets can move at the click of a mouse; democratic processes take somewhat longer. That is not a reason to give up on democracy, of course, but it is one of the features of the crisis, especially in the situation that we have been in of having to create new instruments that did not exist before. The Maastricht treaty had not foreseen the situation in which we find ourselves. When President Van Rompuy took office, he said, "I found an empty toolbox". New tools had to be created and that requires, in many cases, consensus and unanimity—at least of the 17 if not of the 27—and, in several cases, national ratification or parliamentary approval as well. Fair enough, but that means, on this whole road, there are several swords of Damocles hanging above you. The fear that any one of those might fall can trigger apprehension in the markets, even if they do not fall.

I remember the process of initially agreeing on the first loans of the EFSF. There were hold-ups and questions about whether it would be ratified at all in Slovakia and Finland, for instance. In the end, it was ratified everywhere, but the apprehension caused as we went through that process has been one of the challenges throughout this crisis. Gradually, we are getting there. Those new instruments have been set up. We have more tools than we had before. We have more means of co-ordinated economic governance than we had before. We would perhaps not get into this mess again in the future.

What we have not managed to do entirely is deal with the legacy of past mistakes that are still hanging over us, but I think we can be reasonably confident that we have an improved system to make sure we do not get into such difficulties again in the future.

Q36 Lord Vallance of Tummel: I will come at this from a slightly different angle and take you back, Dr Corbett, to a comment that you made in your introductory remarks, that the impact of a disorderly default, even in a small sovereign state, could be very great and could impact on all of us. Could you tell us what you think are the characteristics of an orderly default? Can that be planned for in advance? Have we not reached the time when that sort of plan B needs to be addressed?

Dr Corbett: Depending on one's definition of an orderly default, we have of course had one, to a degree, in the case of Greece, in that there was a substantial private sector involvement in writing off a very substantial amount of Greek debt. That was planned, in a way. It happened and, in one sense, it was successful. The downside of that being seen as a potential solution in other cases could itself, spook the markets—as they say—with the fear that a loan to another sovereign might, in the end, be partially defaulted on, even if it is in an orderly way, making lenders more reluctant to lend to that country.

In principle it was agreed—and everybody has stuck firmly to this line—that Greece was a one-off. The idea of having even a partial and orderly default—again, that depends on your definitions—or, in the case of any other member state, going through a PSI, has been firmly ruled out.

Q37 Lord Vallance of Tummel: Do you not think it is possible that the markets might be less spooked if they have agreed that the elephant in the room—a major eurozone country that might go into default—was planned for in advance, even in theoretical terms?

Dr Corbett: I suppose there is no doubt—in a sense what happened in Greece showed this—that an orderly default is better than a disorderly default, but the very idea that there is a significant likelihood of default can, in the immediate short run, have very negative consequences on the kind of rates that a country has to pay to borrow. The prevailing view is that there is no reason to assume that any other member state would have to be in that situation. If you consider the case of Spain, which was raised earlier, it went into this crisis with far lower overall levels of public debt than Germany and it still has that, I believe. It has a margin of manoeuvre before it gets into a situation that is comparable to ones that other countries are in. It is certainly nowhere near the Greek situation. The immediate problem it has is a banking problem, for which it needs finance, but the overall situation for Spanish sovereign debt is by no means comparable to that of Greece.

Q38 Lord Marlesford: My concern about trying to break this vicious circle is that it is a huge difference to move from financing sovereigns to the direct financing of banks, because it is an open-ended commitment. It simply does not exist at the moment. Indeed, one would say it is an open-ended obligation. It seems to me that there are two disadvantages. One is that, at the moment, the sovereigns have some influence and responsibility for their banks. Secondly, in a way, once you go into the business of directly financing banks centrally, you are going to lose some of the control you have over sovereigns.

Dr Corbett: You are verging on going beyond my field of expertise, but lending directly to banks would be subject to conditionality as well. There would have to be a memorandum of understanding with the banks and agreement would also have to be reached with the Government and member state concerned. It would not be an open-ended commitment in that sense. Also, it cannot be open-ended in another sense. The resources available to the EFSF and the future ESM are not unlimited. You cannot take on an unlimited liability in the way that, theoretically, a central bank could.

Lord Marlesford: There is a direct responsibility to respond to the need—however disreputable the need—of the bank and that does not exist at present.

Dr Corbett: But within certain limits.

Q39 The Chairman: Before I invite Lord Flight to ask a question, could I return to Lord Kerr? Given that Angela Merkel has repeatedly said that solving this crisis would necessarily be incremental, what, in your view, is the nature of the political leadership that is required at the moment to calm the markets in this period when those incremental steps are taken? Who should be providing that political leadership?

Dr Corbett: To the extent that much of this has required new instruments to be created and agreements to be reached on macroeconomic policy—which is up to member states, because the EU budget is too small to have any macroeconomic influence—it has inevitably been a matter for the heads of state and government at the European Council to reach agreement.

The advantage of the European Council as an institution is that if you reach agreement at that level—that of the leading political figures in each member state and the President of the Commission—you usually have sufficient political momentum for it to be carried forward. There can be a reasonable degree of confidence that what is agreed there will be implemented.

The difficulty at the European Council is that it is a body that works by unanimity; it is unanimity of people not who are working together day in, day out, but who meet only periodically. It is by the nature of such people that they are normally used to getting their own way in a national context, but when they come to a meeting where they must agree on every element, it is often a challenge, especially when views diverge, to build the necessary degree of consensus. I submit that that is what is none the less being done, step by step. In a sense, you can indeed say that that "kicks the can down the road" but, none the less, that gives you time to take the next step. It is almost unavoidable that it has to be step by step because of that challenge.

Some things have been done more quickly, when the EU already had the competence and powers to do so. But, so much in this crisis required the construction of new tools, new mechanisms and new rules or changes to the rules that it was unavoidable that things had to be done step by step.

Q40 Lord Flight: Today we have looked at the Commission's proposals for a directive for bank recovery and resolution, preceding the Van Rompuy report. They very much reflect, if you like, like solving yesterday's problem, the banking crisis of 2007—it is somewhat continuing—which was about mistaken monetary policy, excessive money supply and failed regulation, as a result of which banks are losing lots of money on loans. How does this package relate to the Van Rompuy report? Van Rompuy must face the issue of banks potentially being in trouble because of capital flight, default on government bonds and different sorts of problems. We are not at all clear on whether the Van Rompuy proposals have superseded the directive, which will be pushed to one side. If not, how are the two going to be combined?

Dr Corbett: The current Commission proposals should be seen not as having been superseded, but as being a first step. They are focused on ensuring that all member states have proper banking resolution systems in place, preferably compatible, whereas the next Van Rompuy report will be looking at whether you should shift banking resolution to a European level rather than a national level. When I say "European", there is a subsidiary debate as to whether that is at the level of the monetary union or at the level of the single financial market. These are two steps and two different stages in the process. One is more or less en route, as we say, and the other is still to be debated and agreed.

Q41 Lord Flight: In the context of this being about the European level, is it the intention that this should really be at a eurozone level or European level? To the extent that it is about dealing with all the problems caused by the euro itself, the UK is very much not part of that.

Dr Corbett: There are two views. There are those who say that we have a single market, including for financial services, we are highly integrated and highly interdependent, and that it would make sense to have common rules for the common market at the level of the 27 on this matter. There are others who take the view that this is particularly important and urgent at the level of those who share a common currency, and that it is at that level that it is taken. Which route is taken will be a matter for the member states concerned, in particular for this country, whether it chooses to take the view that this should be done at the level of the European Union and the single market, or whether it chooses to take the view that this is a matter for the eurozone.

Q42 Lord Dear: Good morning, Dr Corbett, and thank you for coming. I will ask a question that everyone—even the man on the omnibus—wants to know, which is about the implications for the UK. I will start you off with a quotation from the Prime Minister's statement to the House of Commons on the summit, within the last few weeks. He said: "I do not believe that the status quo is acceptable, but just as I believe it would be wrong to have an immediate in/out referendum, so it would also be wrong to rule out any type of referendum for the future". We are all, in a sense, in anticipation. The doors are open. I suspect we are not too sure, in this country, how that is going to play. Your views on how that is going to play, and is playing, in the eurozone would be very helpful to us. What is our position, do you think? What should our position be vis-à-vis the eurozone? What is the view of us in Europe as a result of that stance? In other words, where are we going and what are the implications for the UK? It is a fairly general question, but one that is constantly a preoccupation, even down to the man on the street. Even the man on the street has a preoccupation with this sort of question, and it would help us to know your views on it.

Dr Corbett: I think in the position that I currently occupy I should refrain from commenting on the internal political debates of an individual political party or member state, which is where this debate is primarily focused at the moment.

The Chairman: Lord Kerr.

Q43 Lord Dear: I am sorry, but do you not want to answer at all?

Dr Corbett: No, I do not think that, in the position that I am occupying and in which capacity I am here, I should comment on that.

Q44 Lord Dear: Let me try to rephrase it. I am certainly not seeking to compromise you in breaking confidences, but you surely have a view—I hope you have a view—on how this is playing out in Europe and on what the view in Europe is that you have noticed, as a result of our decision. Can you help us with that?

Dr Corbett: I can certainly say that, in other parts of Europe, there is perhaps a growing fear that the UK might not participate as fully in the European Union as many other member states would wish us to. I have heard people express the fear that a UK exit from the European Union is an accident waiting to happen. Debates of this nature can sometimes take on a life of their own and, in difficult times, when unexpected events are occurring, such debates could move in a direction that was not intended by those who initiated them. I have heard that view expressed by people from a number of other member states.

Q45 Lord Kerr of Kinlochard: I understand Dr Corbett's position. Going back to Lord Flight's question on banking resolution, why should it be any easier for Germans to accept that they should have to bail out Spanish or Italian banks than it is for Germans to accept that they should have to bail out the Italian or Spanish state? I would have thought that it is actually more difficult. On banking supervision, do you think that the French are now ready to see their three great banks come under the supervision of a common European authority, which would have Colbert and a number of French thinkers from down the years spinning in their graves? Why would the Germans buy common resolution and why would the French buy common supervision?

Dr Corbett: It is a common interest in the system working, working better and not falling apart. After all, most member states in the eurozone have taken decisions in the last few years or have accepted agreements that five years ago would have been thought inconceivable. Yet the challenges that have been faced have led them to change position. That is the pressure that the crisis has brought to bear.

Q46 Lord Kerr of Kinlochard: I strongly agree with you on your point about democracy. It is a hard sell in both countries, particularly in Germany, surely.

Dr Corbett: It has been a hard sell to the national Governments involved, but also within national Governments, some of which are coalitions, and between Governments and

Oppositions in some countries. That is one of the complicating factors that I alluded to earlier in building up the necessary political agreements to the extent that they will stick and can be carried forward. It is the pressure of events that has been a powerful force in focusing minds on the need to move beyond the status quo.

Q47 Baroness Hooper: I share the Merseyside connection. I was MEP for Liverpool, as you know, after the first direct elections.

Returning to the euro area summit statement, it included a statement on a "strong commitment to do what is necessary to ensure the financial stability of the euro area, in particular by using the existing EFSF/ESM instruments in a flexible and efficient manner in order to stabilise markets for Member States". This means that the EFSF/ESM will be able to purchase sovereign bonds from countries where interest rates are high. How do you assess the consequences and the impact of this particular proposal?

Dr Corbett: On the Merseyside connection, I remember when I was first elected for Merseyside West there was a play on in Liverpool about Merseyside unilaterally declaring independence from the UK. One of the alleged advantages was to have a separate currency. Of course, if all the UK's regions had separate currencies, one rapidly sees that there are disadvantages as well as advantages. But that is hypothetical.

On your question, Baroness Hooper, this makes the existing instrument more flexible in how we use it. There has been discussion about that for some time. The agreement in principle at the European Council at the end of June would enable it to intervene in this way, which was previously not possible.

Q48 Baroness Hooper: Do you think that is a good thing?

Dr Corbett: All 17 heads of state and government in the eurozone certainly thought it was a good thing and agreed that that extra element of flexibility would be useful. It will inevitably lead to the question whether the funds available—the firewall, as it is sometimes called—are sufficient in size to do that on a sustainable basis if it requires a large amount of money.

Q49 Lord Vallance of Tummel: In our February report on the euro area crisis, we concluded that additional ECB intervention was likely to be needed to resolve or to help resolve the crisis. The euro area summit statement envisages the ECB taking on some new responsibilities, including serving as an agent to the ESM in conducting market operations, and with its new supervisory role. Could you tell us a little bit about the intention behind those proposals and how they are likely to work in practice? What further steps, if any, does the ECB need to take to help alleviate the crisis? Bond purchases, perhaps?

Dr Corbett: This supervisory aspect will be fleshed out in the coming months. Initial thinking is that it would be done on a day-to-day basis by an agency under ECB supervision. Much will depend on size and scope. I have seen the figure of 9,000—that regards the number of banks in the eurozone. Presumably, nobody envisages the ECB directly supervising 9,000 banks. Even through an agency, there is still a question of size. Some are saying that it should just be, say, the top two dozen or 25 banks in Europe, the rest being subject to national supervision. Others argue that, no, that is insufficient. Spain was proof enough that even small regional banks can have systemic effects if they run into difficulties, therefore the scope should be wider. In any case, and whatever the scope of it, the initial discussions point in the direction of it being an agency under the aegis of the ECB.

With regard to the other sort of ECB intervention on bond markets, for instance, or perhaps a repeat of the LTRO—the long-term low interest lending to banks—the ECB is independent, and famously so. It takes its own decisions. The European Council would not seek to instruct the ECB how to act. In a number of discussions, especially at the eurozone summit, the president of the ECB has been present, he is very aware of the discussions that are going on, he is informed and he exchanges views. Then, it is up to the ECB to take its decisions in complete independence. It is significant that the ECB's own decision-taking procedure does not involve any national vetoes by anybody. Even if it has been rather reluctant to do a certain number of things, I think its track record over the past two years has shown that if it feels that there is a necessity to use instruments that it would not normally use—non-standard measures, as they call them—it will do so when the crunch comes.

Q50 Lord Vallance of Tummel: On a matter of fact, do they have the power to make bond purchases if they wish?

Dr Corbett: On the secondary market, yes, but they cannot buy directly. That was a matter of debate at the time, but the precedent is now there.

Q51 Lord Jordan: We saw our own Prime Minister posturing over this in/out of Europe to quell rumblings in his own ranks. Did Chancellor Merkel say, "eurobonds over my dead body" for the same reasons, or are there what she believes to be good economic reasons for not doing it? The road map said that there should be proposals for eurobonds. More and more commentators say that the road is leading to eurobonds. Are eurobonds now a necessity if the euro area is to survive?

Dr Corbett: One of the difficulties of this debate is, what is your definition of a eurobond? There is no single agreed definition. Countries emit bonds denominated in euros so, in a sense, they are euro-denominated bonds or eurobonds. In the context of an issue of bonds at European level, even then there is a wide variety, a wide range of possibilities. The eurobond could, at one extreme, mean simple project bonds on which there is agreement already, at least for a pilot phase, linking the issue of bonds to particular economic or infrastructure projects, for instance. At the other end of the range there are fully-fledged eurobonds, as it were, with complete mutualisation of all existing sovereign debts on a joint and severally liable basis. Between those two extremes there are a huge range of possibilities: some limited pooling of debt, or bonds to emit new debt, or new debt of a certain type. There are suggestions for a redemption fund for pooling existing debt above the level of 60% of GDP. There was a proposal for "red and blue" bonds, such that debt below 60% of GDP would be emitted in common, presumably attracting more favourable rates; debt above that level would be each country's own liability, presumably at higher rates.

There is a wide range of ideas floating around. I suspect that those who have said things like, "Over my dead body", "Never" and so on are referring to some of those formulae rather than to all of them. One of the tasks for President Van Rompuy over the next period in drawing up his report, in consultation with others, is to explore exactly what is acceptable in the medium term and subject to what conditions. That will be one of the most interesting parts of his task over the next few months.

Q52 Lord Jordan: My final point is: is one of those varied bonds that you describe inevitable?

Dr Corbett: We already have agreement on the project bonds, at least for a pilot phase.

Lord Jordan: More will come.

Dr Corbett: One should certainly not say that this will never happen. The other argument is that the joint emission of debt is a powerful signal of joint commitment and of the irreversibility of the euro, which some have sometimes been put in doubt.

Q53 Lord Jordan: In our February report, we concluded that, ultimately, the resumption of sustainable economic growth will hold the key to solving the crisis. Do the steps announced by EU leaders of a €110 billion compact for growth and jobs, including an extra €10 billion of capital for the European Investment Bank, mark any real shift in policy?

Dr Corbett: It was an important decision by the heads of state and government, partly to make more visible things that were happening anyway, and partly containing new elements. You mentioned yourself the extra scope for the European Investment Bank, which, through leveraging, can provide a substantial extra amount.

The debate about growth is sometimes conducted as if it has been newly discovered. In fact, we have yet to find a single member of the European Council who says that he or she is against economic growth. Everybody is in favour of it. It has always been part of the debate. President Van Rompuy's first-ever European Council that he convened, ahead of the first steps of the Greek crisis, was focused on how to improve Europe's structural growth rate over the medium term. He was of the view that, Europe-wide, our structural growth rate was too low to cater for ageing populations in the context of the modern global economy and we needed to focus on that. That has never disappeared, but it has been overshadowed by controversial debates on other aspects of some of the things that we have been discussing now and of what has been discussed over the last two years. Understandably, people have tended to think that we are not even discussing growth, because the debate has been so overshadowed by other controversial issues. The agreement last month was partly about visibility, to show, no, we have not forgotten growth; there is a lot that can be done.

It also had some new elements to it. It is not just a question about extra finance, important as that is; it is also about structural measures that can do a lot. We can further deepen the single market on energy, the digital market and services. We have potential in some of our trade agreements. We have potential to do more in terms of the common programmes that we have on research and development and in terms of use of structural funds. All this is important. Most of those things are structural, they take time to produce results, which is one of the challenges, but they are important.

Q54 Lord Jordan: Lisbon was supposed to be a sort of road map for growth. Would you claim that it was a success?

Dr Corbett: It was not a failure, but it did not live up to its expectations or ambitions. What we have now instead is the Europe 2020 exercise, looking ahead for the next eight years. What is the difference with Lisbon? The general criticism is that it relies on peer pressure, just as Lisbon did, but peer pressure has itself changed, because of the crisis. Whereas, a few years ago, a Minister would perhaps think that his neighbour's problems were just his neighbour's problems, not his, there is now a much higher awareness that your neighbour's problems today can become your problem tomorrow. Peer pressure has been stepped up, and there are new mechanisms for that, for instance the European Semester, with the possibility of addressing countriy specific recommendations and with more follow-up to it. Peer pressure has been intensified.

The Lisbon strategy used to have 60-odd objectives if you added them up. Europe 2020 has a much smaller number in order to better focus and produce better results. I am hopeful that the Europe 2020 part of this economic strategy will be more productive than the Lisbon strategy was.

The Chairman: My own Peer pressure is I have three colleagues who wish to speak before we conclude.

Q55 Lord Flight: How can you combine growth with policies to have an internal devaluation largely across southern Europe when those policies clearly result in shrinking those economies?

Dr Corbett: Since the 1930s, the traditional response to economic downturn has been deliberate fiscal stimulus, deficit spending. We find that, across Europe, this is constrained. There are some countries that do not want to go further down that road, even though there is a debate about whether they might be able to. Germany is the country that is most often quoted in that context. But for the bulk of member states, it is because they are not able to, because of excessive levels of accumulated public debt. The reasons for that excessive debt vary from one member state to another. It is not all because of profligate spending or tax evasion. In some cases it is because of bailing out banking sectors that needed rescuing. Ireland springs to mind in that context. In several countries, it is arguably because Keynesianism was applied asymmetrically over a 50-year period. You had your deficits in a downturn, but they were never balanced in an upturn. The levels of public debt gradually went up and up, and there was nothing left in the locker, as it were, when it was needed. That is one of the great difficulties of this crisis. Although there is still deficit spending in some countries, the ability to use it as a deliberate tool is constrained.

That brings us to the difficulty of internal devaluation. It would be easier with the counterpart of internal revaluation in other countries, notably in Germany. Let us not forget that, in Germany, Finance Minister Schäuble recently said that, yes, we accept that Germany has to have a higher inflation rate than the eurozone average, and wage settlements in Germany will have to be higher than the eurozone average. That can help make it easier to make the necessary adjustments.

Q56 Baroness Prosser: It is interesting that Germany has come up in almost every question. The thinking behind my question goes back to some extent to the point being made about the speed of political decision-making not being in sync with the speed of markets. Mats Persson from Open Europe has said, in his view, that Germany now stands alone as Europe's leader. Would you agree with that? If you do agree, what do you think are the implications of that fact? What assessment would you make of the current policy position of the German Government, and what steps do you think it needs to take, and is likely to agree to, in order to solve the crisis? You have alluded to some of this already.

Dr Corbett: I disagree with Mats Persson. I can understand the perception of Germany's role in the crisis as being the key lynchpin, which has been driven by the fact that Germany is the one that has said no to quite a number of proposals. Other member states would like Germany to agree greater lending, greater mutualisation of debt or other measures, which Germany has been reluctant to do. The focus has been on Germany.

My first point is Germany is not alone in that viewpoint. Finland, the Netherlands and some other member states spring to mind. Secondly, that impression has been created because of the focus on this issue. If you take a different subject, such as the crisis that we faced this time last year concerning Libya, it was the UK and France that were in a key position. Germany was almost marginal, in a sense. To take another subject, our response to climate change, CO_2 emissions and so on, it is said that Poland is the member state that is currently the most reticent to move and a lot of attention is focused on whether Poland might change position.

The perceptions of a country as being the one in the lynchpin position vary from one subject to another but, at the end of the day, one of the reasons for the European Union is to have an institutional system that does not just depend on summits and power play among states when they come together, but to have an institutional system where everybody is represented, everybody has their say and everybody has a role in the decision-taking process with democratic representation at the Council and in the European Parliament. That sort of system of checks and balances is a far better way of doing things than pure power play between big countries.

Q57 Baroness Prosser: But that almost idyllic situation that you have just described does not really sit with the point that you made earlier about the difference between political decision-making and markets. The politics of countries are such that reaching that nirvana can be pretty difficult, can it not?

Dr Corbett: It would always be difficult, but it is easier in a context where you have institutionalised co-operation, mechanisms for constantly talking to each other and, when you reach agreement, you have the ability to use the legal framework that the European Union provides to put certain agreements in legislation. That brings greater assurance that agreements that are reached will be followed up and that commitments made will be implemented afterwards.

The Chairman: Dr Corbett, we are moving towards concluding. We were interested in a number of other member states. Spain has been identified as a problem, as has Italy, potentially. This afternoon, under Lord Boswell, we meet the Cypriot President, who is very involved with the Greek situation.

I think I had better move towards concluding it there. Thank you very much indeed for coming in this morning. We very much understand—and I sympathise—why some of your replies have been more sotto voce than normal, but we are grateful for that sweep of the horizon. As I said, we prepare a transcript and we will send it on. We would be very grateful if you could check that. In the interim, if you have any further thoughts that will help us to elaborate our report, which we conclude by meeting Minister Mark Hoban next week, we would be most grateful.

Perhaps when we come over in October to pursue some of the banking questions that were illustrated by Lord Flight earlier, we can meet the President himself in order to take this matter further, as it is a crucial issue. In the meantime, many thanks indeed for stepping in so smartly and for giving us your replies.

Dr Richard Corbett, Member of the Cabinet of Herman Van Rompuy, President of the European Council - Supplementary written evidence

Reforms have, unavoidably, been gradual, and step by step, as they required new tools and instruments to be agreed and/or existing legislation to be modified. Some of this needed consensus and national ratification. So, what has been done? What new tools are there that did not exist before the crisis?

- The EFSF and the ESM, able to provide long-term low-interest loans to give Eurozone Member States having difficulties time to turn the corner. The loans are subject to the powerful tool of conditionality

- Legislation establishing or strengthening common rules for our common market in the financial sector: on capital requirements, legal certainty of securities, derivatives, naked short selling, deposit guarantee schemes, market abuse, UCITS, remuneration principles, and others -- increasing transparency, creating a level playing field (single rule book) across Europe, avoiding the multitude of problems (and costs) that arise from divergent standards and rules

- The establishment of the three financial sector supervisory authorities (European Banking Authority, etc) and the European Systemic Risk Board. We previously left supervision almost exclusively to national authorities with insufficient coordination, despite having a highly integrated market with vast trans-border integration.

- The reform of the Excessive Deficit Procedure (EDP), providing for shorter deadlines, greater focus on debts (and not just on deficits), and on prevention. Furthermore, the procedure is now triggered automatically unless there is a qualified majority against: a reversal of the onus compared to the previous situation where a qualified majority was needed to establish that a country had an excessive deficit, making it all too easy, for larger Member States in particular, to organise a blocking minority (as France and Germany did in 2003-2004)

- The requirement in a new Stability Treaty that euro area members (and others who joined this) have a "golden rule" and a "debt-break", preferably in their constitution. The transposition of this requirement into legislation (but not annual budgets) can be tested at the European Court of Justice. Member States should in due course not normally have a structural deficit (over the economic cycle) of more than 0.5% of their GDP (or 1% if they have lower overall debts of under 60% of GDP)

- Adding a new Macroeconomic Surveillance Procedure, looking at other imbalances, recognising that debt is only a part of a wider economic picture. We will now jointly monitor asset bubbles, current account divergences, trends in employment, unit labour costs, and other factors that were simply overlooked in the past. This is a key (yet rarely mentioned) development.

- Requiring that statistical offices be independent from ministries and that national budgets are based on independent growth forecasts.

- New tools for peer pressure, in context where all governments more acutely aware than before of how the conduct of others can have an enormous economic impact on them, notably through:

  - The European Semester (including comparing economic assumptions on growth, trade, inflation etc before national budget plans are drawn up by governments to present to their parliaments)

  - The Europe-2020 programme, on improving key structural aspects of our economies: employment rates, R&D spending, climate change targets, education and reducing poverty and social exclusion.

  - The "Euro-plus Pact" on issues affecting competitiveness (agreed by 23 Member States -- Hungary, UK, Czech Rep and Sweden stayed out).

  - Agreement to consult before the adoption of any major fiscal and economic policy plans with potential spillover effects.

  - Regular Euro Summits, so that peer pressure will be exerted at the highest political level.

  These forms of peer pressure have been enhanced by a more rigorous procedure for Country Specific Recommendations (CSRs), encompassing a "comply or justify" rule and more systematic evaluations.

Market pressure will complement the above. The markets slept during the first decade of the euro, rating Greek bonds at the same level as German bonds. Markets may now be over-reacting, but they will not go to sleep again! This in turn enhances institutional and peer pressures, because even a Commission warning could have a market effect.

…and now possibly more…

- financial framework (banking supervision, deposit insurance and bank redemption at European level?),
- budgetary framework (stronger common rules, common debt issuance - eurobonds?)
- economic policy framework ("real economy" coordination)
- and consequences of the above for mechanisms for decision taking and accountability.

Friday 13 July 2012

Mark Hoban MP, Financial Secretary to the Treasury, and Mike Glycopantis, Deputy Director, Head of EU Budget, HM Treasury – Oral evidence (QQ 58-93)

Evidence Session No. 3 of 3. Heard in Public. Questions 58 - 93

TUESDAY 17 JULY 2012

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Flight
Baroness Hooper
Lord Kerr of Kinlochard
Lord Marlesford
Baroness Maddock
Baroness Prosser
Lord Vallance of Tummel

Lord Boswell of Aynho

Examination of Witnesses

Mark Hoban MP, Financial Secretary to the Treasury, and **Mike Glycopantis**, Deputy Director, Head of EU Budget, HM Treasury.

Q58 The Chairman: Minister Mark Hoban, it is a joy as ever to welcome you to Sub-Committee A to discuss familiar subjects, which we sometimes feel are outpacing us. I have to offer the usual caution that this is being transmitted. A transcript will be made of what we say in today’s conversations and it will be sent to you. Any indiscretions that you make on behalf of the Government may be then corrected or thought about. We would be very grateful if you would introduce your team, including Mr Glycopantis next to you, and you may want to make an opening statement. As you know, I am keen to try to divide the session between the euro area crisis, on which this is our third and final session of witness-taking, and thoughts about the 2013 EU budget. We have a couple of other questions to throw in at the end. I am being reminded that there is a full list at the back of the room of the interests of each of the Members, which they have declared on the website as well and which can be referred to by members of the public, if they so wish. We are very happy to see you. We are sorry that we did not see you last week, although it was for very understandable reasons, as you were substituting for the Chancellor, but we welcome you this morning. Perhaps you would introduce yourself and I will start the ball rolling.

Mark Hoban MP: This is Michael Glycopantis. He is a deputy director in the Treasury. Mike leads our work on the EU budget and the multiannual financial framework, so I thought he would be a good person to bring along, given the second part of the session. I apologise for not being here last week but it means that my answers on your questions on the banking union will be much fresher and honed, following a discussion that we had last week in ECOFIN. Lord Harrison, you say that this is the final session of your inquiry, although I suspect that this is not the final inquiry into the crisis in the eurozone. I fear that it has some way to run. However, we are keen to work with the Commission and other member states to ensure that the right structures are put in place to ensure that stability returns to the eurozone. It is the Government's position that a stable eurozone is in our interests and we have sought, through our support for closer fiscal integration and banking union, to play our part in enabling other member states to develop the institutions that are needed to create the long-term framework. But that long-term drive towards closer union does not mean to say that the eurozone does not need to take steps in the short term as well to resolve the crisis. Clearly, there is still uncertainty around Greece—certainly about the size of the ESM—so I think that there are still huge measures that are needed to return the eurozone to stability and to ensure that growth continues not just in the eurozone but elsewhere in the global economy. I am now very happy to move on to questions if you would like to put them.

Q59 The Chairman: From your perch—your position where you can judge these things—do you think that the euro area will indeed survive? Is there any kind of end game developing? Do you think that matters may well muddle on, or will our European colleagues come together around a coherent set of steps forward? Again, from the particular vantage point that you have, what are the implications for the United Kingdom?

Mark Hoban MP: Based on the conversations that I have had with eurozone member states over the past two years about the future of the eurozone, it is very clear to me that there is a very strong political will within the eurozone to see it continue and to continue to see it intact. At every stage of this crisis, there has been a demonstration by eurozone heads of state and government that they are prepared to take the necessary steps to ensure its survival. While the length of the crisis indicates that those steps have not been sufficient in themselves, I think that they are taking steps. The outcome of the last June Council meeting, where there was very clearly support for a banking union for the 17 and a recognition that there has to be even closer fiscal and economic integration, was a sign to me that that commitment to the integrity of the eurozone continues.

Q60 The Chairman: May I be so bold as to suggest that that is something that you have learnt over the two years because you have mixed and mingled with colleagues in the European Union? I think you are right in your perception about the political will but it is often ill understood in the United Kingdom polity that that is the case.

Mark Hoban MP: I think, Lord Harrison, that often in the UK the debate is seen in economic terms, and people will judge the debate on whether it is economically right for the eurozone to continue. We obviously had our own debate about joining the euro some years ago. We decided, for economic, constitutional and fiscal reasons, not to join, so we see it through that lens. But there is a different approach in the eurozone. They are where they are and they have to find the best way of making it work. There is that difference of view on this side of the channel compared with the other side of the channel.

Q61 Baroness Prosser: Good morning, Minister. It is interesting that you make the point that the discussion takes place solely in an economic framework. The Prime Minister in the House of Commons the week before last, I think, talked about Britain not being in the euro and the fact that we are not going to join the euro, and nor should we pay for short-term measures, which people would no doubt feel some kind of sympathy for. But then he said that nor should we take part in longer-term integration. Given that we are inextricably linked with European states both in terms of trade arrangements and financially in terms of the indebted nations, how do you think we are going to be in a position to influence the debate on the future of Europe and the eurozone?

Mark Hoban MP: I would make a couple of points. First, we see monetary union being complemented by closer fiscal integration and banking union. You cannot separate those three components. The eurozone states need to move on both banking union and closer fiscal integration to provide that stability to monetary union. So I do not think that we should feel a need to be part of that, given that we are not part of the single currency. Once you get into a banking union and pooling the fiscal risk among eurozone member states, that requires a single supervisor, for example, for the eurozone banking system. However, because we are not pooling our fiscal risk, as we are not part of the monetary union, we do not need to be part of that mechanism.

The second point that you made about engaging with the single market is a very important one too, and that was reflected in the conclusions of the June Council meeting. People wanted to see a banking union proceed but not in a way that put the single market at risk. The single market is important to all 27 member states and I think there is a strong commitment to its maintenance. Once you start to fragment the single market in one area, it starts to fragment across a whole range of areas. There is a very clear desire—I saw this myself at last week's ECOFIN—on behalf of the eurozone but also within the Commission for the UK to be engaged in the design of banking union. How is it going to work? How is it going to be consistent with a single market for 27? I think that they are looking for us to be involved for some practical reasons—we have probably done more work on how you resolve a failing bank than anybody else in Europe.

Baroness Prosser: Not at home, maybe.

Mark Hoban MP: And we are engaged in working on that, so we contributed very fully to the most recent European directive on resolution recovery. Therefore, they do want our participation. It is also fair to say that we divide the European Union between eurozone and non-eurozone, but there is also a group of member states, both in and out of the euro, which share a very similar view to ours. They are outlooking and want to export, and they see the benefit of open markets. I think that there is a group of like-minded member states which can work together to ensure that a Europe of 27 continues to function while, at the same time, there is closer integration on banking union and other matters.

Q62 Lord Kerr of Kinlochard: I think that could get difficult over time. I understand the distinction that you are making, Minister, and it was very clearly spelt out to us in a letter that Lord Sassoon wrote on 5 July to the Chairman of the EU Select Committee, Lord Boswell: "A euro area banking union will not change the fundamental Treaty freedoms that underpin the single market, including freedom of establishment and free movement of capital ... Clearly, rules for financial services are required at the level of the single market and it is very important that we have a say over them ... the fundamental elements of banking union flow from the single currency, not the single market. That is why that union should be put in place at 17, not at 27". How does that work? Supposing that the 17—or it might be 18, 19 or 20; we do not know many will go for the common supervisor—are meeting the day before the ECOFIN, which is to pass a piece of banking regulation: what will prevent them discussing regulation? It is clearly closely linked to supervision. The supervisor checks that the regulations are being enforced. Is there not a risk that they will caucus? If they reach an agreed view, even at 17, they need to buy only one more middle-sized state and they will have a qualified majority in ECOFIN the following day. So our insistence that the regulation should be done on a 27-wide single market basis could be undercut by an informal process which the Commission could not prevent, and which three or four years later we could take to the Court of Justice if we wanted to; nevertheless, the regulation could in practice be made by a consensus among these people. Is it not dangerous not to be in the room?

Mark Hoban MP: Lord Kerr, you certainly raise one of the challenges in the design of the banking union. It is something that not only we but the Commission are alive to. One of the strands of debate at ECOFIN last week was around ensuring that the EBA still acts as a binding mediator, looking at the quality of supervision and developing binding technical standards for all 27 member states, but asking how we ensure that there is that role at the 27 and how that sits with the ECB operating on behalf of the 17. That is one of the key areas of work for the Commission. Michel Barnier is committed to producing a blueprint by early September, and that mandate was given at the June European Council meeting. I know from talking to him that that is one of the issues that he needs to work through and we will help to contribute to how that is done. But it is a very real risk and one that we need to ensure we think about in the design of the banking union.

Q63 Lord Kerr of Kinlochard: Leaving aside whether we are paragons of performance in banking supervision, the die is clearly cast. The Prime Minister was quite clear that we wanted to have no part in any common supervisory arrangements. We stand alone, convinced that the way we supervise our banks is unimprovable. But they have decided to have a banking union, and you, the Government, have agreed with that. Do you think that the steps taken at the European Council towards the establishment of a banking union and a fiscal union are necessary and sufficient, and will they succeed?

Mark Hoban MP: There are two points there. The first is why we should not be part of a common supervisor for the eurozone. It is not because we are so convinced about the strength of the reforms that we do not think that the system can be improved—we recognise that it can be improved—but that the supervisor of the banking sector takes decisions on supervision that are linked to the fiscal position. So we in the UK have gone through a series of reforms to financial regulation and we have the Vickers Commission recommendations because we want to reduce the implicit taxpayer guarantee behind the banking system. The way in which banks are supervised will be linked to that. If you have in the eurozone a greater appetite for that fiscal risk, your supervisor has a very different approach to the supervision of banks. I think that there is a very strong link between supervision and fiscal risk. So our participation, with our desire not to be part of the common supervisor, is not down to the merits of different supervisors but to a recognition that supervision leads to fiscal risk. We are not prepared to share the fiscal risk within the eurozone, so we should not be prepared to be covered by the same supervisor.

Q64 Lord Kerr of Kinlochard: I understand that that is the position, but I do not understand that position. It seems to me that the fiscal risk that you are talking about is clearly linked to bank resolution, to bank recovery and to deposit guarantee schemes. I quite understand why you would not want to play a part in these. I am not an advocate of full banking union. I believe that chances of the 17 achieving a genuine common resolution mechanism in the next year or so are very low, and I would not wish us to take part in that. My point is quite a different one—it is about supervision.

On the resolution point, Minister, I wonder whether you would clear up a small point. The Chairman of the EU Select Committee, Lord Boswell, wrote to you on 10 July—and we await a reply—on the proposed directive on bank recovery and resolution. The immediate issue is whether it is in breach of subsidiarity. You will recall that, under the treaty, there is a very short period in which member states and Parliaments may signal whether they believe that the Commission proposal breaches subsidiarity. You told us in an explanatory memorandum about this proposal that you were considering the subsidiarity question. We believe that we are now very hard up against the deadline and may even be past it, which is why Lord Boswell wrote to you last week asking that you very urgently tell us your view on subsidiarity. Could you tell us now?

Mark Hoban MP: First, I just want to go back to the point about supervision. I think that the role that a supervisor plays is very closely connected with issues around resolution and recovery. If a supervisor takes a very lax view on, for example, capital standards and whether a bank has particular capital standards, that potentially increases the risk of that bank failing and of it being required to call upon deposit guarantee schemes or resolution funds or the taxpayer guarantee. So I do not think that you can separate out supervision from those aspects of resolution, recovery and deposit guarantee schemes. That is why it is important to recognise that supervision is intimately bound up with banking union and its fiscal consequences. That is what we need to focus on in this. The directive that set up the EBA, ESMA and EIOPA was very clear about the provision within that directive around fiscal safeguards, recognising that supervisors can have a fiscal impact with the decisions that they make. That is why it is very important that we see a single supervisor for the euro area and that member states are able to continue their own supervisory arrangements.

Lord Kerr of Kinlochard: It is clear from the European Council document that what is proposed for the common supervisor is not the abolition of national supervision but a two-layer structure with national supervision and an upper layer which is common, based on the principle of a supervisor of the supervisors. I do not myself see that that is very difficult or dangerous. However, as I say, the die is cast, with the Government having clearly decided that it is.

The Chairman: Lord Vallance and Lord Flight have supplementary questions. We will hear from Lord Vallance first, then would you come in, Lord Flight?

Q65 Lord Hamilton of Epsom: We have not had an answer on subsidiarity.

Mark Hoban MP: Can I come back to you on subsidiarity? I think that you need to think quite carefully about how the resolution and recovery directive proceeds now. It and a deposit guarantee scheme directive and, to an extent, CRD4 now all sit slightly uncomfortably with banking union. There are some aspects of the deposit guarantee scheme directive, for example, around mutual borrowing from deposit guarantee schemes, which one could say is a sort of "banking union lite" for the 27. We need to work through which matters in those directives are linked to banking union and which are issues for all 27. A relatively straightforward example would be that it is important that consumers across the European Union know the extent of their protection under the deposit guarantee scheme. They should know that they have £85,000 or €100,000 of coverage for their bank deposits. That is a single market issue. On the question of how you fund that scheme, we are now moving more closely to banking union and so we do a lot of work going through those three directives just to understand how they sit with banking union. I think that the subsidiarity argument is linked to that.

The Chairman: I think that our material point is to ensure that we have parliamentary practice, in conjunction with the Government, so that we can respond athletically to questions that are raised. I am anxious to press on. Can we have the supplementary questions from Lord Vallance and Lord Flight? Then Lord Marlesford will come in after that.

Q66 Lord Vallance of Tummel: This goes back to supervision. Would it not be possible to tease out macroprudential supervision and to handle that at a European level, given the interconnectivity between financial services markets across Europe?

Mark Hoban MP: I know that some work is being done on that through CRD4, and I think you are right to identify that issue. Our view has been that there are interconnections between markets, and I would respect that, but there are also big differences between national economies. A single interest rate across the eurozone can lead in some places to excess liquidity and in other countries to a housing boom. We need to get the balance right between what discretion you provide to national authorities for macroprudential supervision and macroprudential interventions and what should be done at a European level, and CRD4 helps to get towards that. But one of the big lessons from the financial crisis is the need for macroprudential tools.

Q67 Lord Vallance of Tummel: Is the Government's mind open as to whether that should be done at a European level or at a eurozone level?

Mark Hoban MP: Through the Financial Services Bill, which is currently in the House of Lords, we are setting up the Financial Policy Committee. It will have macroprudential tools, and we will be consulting on those later in the year, but they will be exercised within the framework of CRD4. We sought to ensure in CRD4 that there is flexibility at a national level. Clearly there needs to be discussion about the spill-over effects but we should not avoid the need for national-specific tools and measures, given the diversity of economies within the European Union and particularly within the eurozone.

Q68 Lord Flight: For political will to win—speaking as a currency economist—surely it needs more than the present Van Rompuy package. It needs something more like what exists in the US, where the two crucial things are, first, sufficient transfer payments from the better-off to the poorer to keep the latter afloat and, secondly, addressing the competitiveness issue, where the question is: are the German-led plans for internal devaluation likely to succeed or, rather, to drive these economies into the dirt?

Mark Hoban MP: On the latter point, clearly Europe cannot afford to lose sight of the need for economic reform. Over the last decade a number of countries have not instituted structural reform; rather, they have relied on low interest rates to build up quite significant levels of public sector debt, or private sector debt through the banking system, and they have powered their economies in that way. We need to see economic reform across Europe. A number of the member states—Ireland and Portugal spring to mind—have reformed their economies, and that is important for them to do.

On your first point, there is a debate about, for example, Eurobonds. There is an issue about the mutualisation of debt.

Lord Flight: That is not transfer payments but money to keep living standards up.

Mark Hoban MP: But there is then a question of how the eurozone manages its level of debt. We had a whole series of debates about economic governance linked to the mutualisation of debt. I think that at one level those are matters for the eurozone to pursue but, clearly, where we could have a role to play in this is in ensuring that we encourage the eurozone to take the necessary steps to tackle its problems, but we should not lose sight of the greater agenda in Europe. The June Council set out a number of measures that can help to promote growth. We need to push that agenda and the Prime Minister has been very vigorous in doing so, working with like-minded states.

Q69 Lord Marlesford: Minister, the euro area conference summit came to two very important specific conclusions: first, that the ESM should be able to recapitalise euro area banks directly and, secondly, that the EFSF and ESM would be able to purchase sovereign bonds of countries whose borrowing rates are high. I should like to ask you three points on that. First, am I right in thinking from the Prime Minister's statement that the UK will have no liability for the risks or consequential liabilities or obligations which will arise from that? Secondly, when it comes to recapitalising the euro area banks, I am not really sure what the difference is between that and the traditional role of a central bank to be the lender of last resort. I should like you to tell me how you think that is going to operate in practice. Thirdly, when it comes to buying sovereign bonds, this strikes me, in any other language, as a liability for sovereign debt—in other words, a bailout. How do you think that is going to be containable within the funds that are available in the euro area? In particular, what is strange about borrowing rates being high? Borrowing rates normally reflect risk. Is there any indication that, when this fund comes in to help sovereigns, no account will be taken of risk and the rates will be whatever the countries can afford?

Mark Hoban MP: On your first point, Lord Marlesford, we are not part of the ESM. The Prime Minister has been very clear in the negotiations over the ESM that we will not contribute to that, so there is no liability for us from that. There is a scheme that we are part of at the moment, but that will be superseded by the ESM. There is a second scheme in existence—the stability mechanism—which is a eurozone-only scheme and which, again, will move into or become part of the ESM.

Lord Marlesford: So our liability would be removed subsequently.

Mark Hoban MP: Which I think is the right outcome. Again, it is very much for the eurozone to sort out its own problems on this.

On the direct recapitalisation of banks, one of the issues that has led to this debate—we see it in Ireland and partly in Spain—is that the tradition has been to recapitalise banks through lending to the sovereign, and that has led to high levels of debt relative to GDP and questions about the sustainability of that. That is why in some cases it has made the countries' fiscal positions significantly worse—the higher levels of debt are necessarily driven by bank recapitalisation but the deficit is on their public finances. So the ability of the ESM to recapitalise banks directly helps to reduce some of the pressure on the sovereigns. That was proposed at the June Council meeting. There is still a debate about how that will work in practice and there is seen to be a quid pro quo: if banks are recapitalised directly then there needs to be a single supervisor. This is a link that the Germans have very clearly made between these two aspects of banking union.

Q70 Lord Marlesford: I can see that but do you accept my suggestion that somebody needs to be the lender of last resort for those banks?

Mark Hoban MP: It gives a much stronger role to the ESM as standing behind those banks, and that is not a role that the ECB is undertaking.

Mike Glycopantis: I think that this comes back to the question of why the European Council addressed banking union with such urgency. The strength of the spill-overs from one banking system within the euro area to another banking system within the euro area has been exposed by the crisis. It is the tension in the banking system that is putting tension on the sovereigns. The idea of the banking union is to break that link. The purpose of the ESM directly going in and giving support to a banking system is to support that system and prevent the spill-overs to the banking system in the other member states. So it is to target the problem directly in the banking sector rather than via the sovereign. As the Minister said, that then creates a dynamic. If you mutualise risk across the different banking systems of the member states, then you have the dynamic for common supervision.

The Chairman: Mr Hoban, do you want to answer the third point?

Mark Hoban MP: Yes indeed. There are two ways of trying to help to tackle the issue of sovereign debt if sovereigns seek to go out of the market to raise funds. One is through a financial assistance programme, in the same way as the funding needs of Greece, Ireland and Portugal are being met for a two to three-year period by the IMF, the ESM and others contributing towards meeting those financing needs. The alternative is for a body such as the ESM to buy bonds in the market and to help to push down yields and demonstrate that there is a commitment to stand behind those sovereigns. There is clearly a decision that you might take on that in terms of risk but those are two different ways of trying to achieve the same end of enabling member states to raise the money that they need to finance their borrowing requirements while also using that time to restructure their public finances and their economy.

Q71 Lord Marlesford: They would be buying them in the market. In other words, countries would not be able to ask the new body to pay for the bonds they wish to issue. They would have to issue the bonds and then the body would buy them in the market. That is a very important distinction.

Mark Hoban MP: Yes, I think that distinction is important. It is generally a case of buying bonds on the secondary market but I think that it helps to address the issue of their bond yields. At the moment, the ESM could do both: it could buy them either in the primary market or the secondary market and it would need to choose the most effective route.

Q72 Lord Kerr of Kinlochard: On the previous point, do the Government know how exposed British banks are to sovereign and private debt in the eurozone?

Mark Hoban MP: Yes. Data are produced regularly by, I think, the Bank for International Settlements.

Q73 Lord Kerr of Kinlochard: Could you tell us what that is?

Mark Hoban MP: At the moment I cannot off the top of my head, Lord Kerr, but I will write to Lord Harrison, who perhaps will circulate it. I would say that our exposure to places such as Greece and Portugal is relatively limited but obviously there is a much greater exposure to Ireland. RBS is a good example. Its subsidiary, Ulster Bank, operates on both sides of the border.

Q74 Lord Kerr of Kinlochard: Minister, could you give us the numbers and could you do that this week in a reply to Lord Boswell's letter about bank resolution and recovery?

Mark Hoban MP: I am sure we will try to do that. I shall certainly make sure that you get the figures.

Q75 Viscount Brookeborough: Before I ask my question, you seem to portray this Government and this country as being an unbiased facilitator—the great facilitator for these brainstorming debates in Europe. Do other people see us as that, or do they see us as having to be included in some of these debates but not as part of the eurozone, and therefore how do we keep it going? Are we a useful facilitator by being outside?

Mark Hoban MP: I think that we are. When we have discussions about the banking union or the fiscal compact, there is an appetite for our engagement. Although we sometimes ask difficult questions, and we are perhaps not the easiest of neighbours, we ask some good questions, and that helps them to refine some of their ideas. If we are talking about banking union, my experience over the past few weeks is that there is a very strong appetite from the Commission, in particular, to engage with us. It wants us to deal with the question that Lord Kerr raised of how you reconcile the 17 and the 27. The Commission is the guardian of the interests of all 27 member states, so it is keen to engage with us and keen for us to be engaged in this. So I would say that there is a desire for us to be part of this.

Q76 Viscount Brookeborough: I am reassured that we are not just talking about it and it is not going into a vacuum. In our February report on the euro area crisis, we concluded that there would be additional ECB intervention, and perhaps we are now seeing it. The euro area summit statement envisages the ECB taking on key new responsibilities, some of which we have addressed already, including serving as an agent to the EFSF/ESM in conducting these market operations and taking on a core oversight role in the new banking supervisory mechanism. What is your assessment of the ECB's new responsibilities? What further steps, if any, does the ECB need to take to help to alleviate the crisis?

Mark Hoban MP: I think that the ECB is willing to take on these new roles. Of course, the interesting thing about banking supervision is that, of the 17 member states, in 14 the European Central Bank is the supervisor of the banking system, so in a sense people are quite comfortable for that to happen. Obviously the ECB will need to do some work on how to introduce those mechanisms. Going back to a point that Lord Kerr made earlier, one question is: what are the bodies or banks that the ECB supervises? A point that has been made on several occasions is that banks that have got into trouble have not always been the largest ones. We could look at our own experience of Northern Rock as the first bank that got into trouble. We had Dexia in Belgium, Bankia in Spain and the Landesbanks in Germany. So simply narrowing the scope of ECB supervision to the very largest banks rather misses the point. These are issues of scope and reach that need to be resolved, and my experience last week at ECOFIN was that Mario Draghi was, to use an idiomatic expression, up for it, and that is welcome.

Q77 Viscount Brookeborough: Do you think that we are muddling through and chasing this problem and that we are not making, in military terms, a clean break to get ahead of it? Are we trying to provide a safety net beyond which we really know and the people believe the crisis will not go, or are we always chasing this, like trying to catch a falling ball?

Mark Hoban MP: Viscount Brookeborough, there is a frustration, certainly on our part in government, and it comes across in the interventions that the Prime Minister, the Chancellor and others make. We would like these problems to be resolved more quickly, because we see the drag that they are having not just on our economy but on economies across Europe. But of course member states need not only to satisfy markets and external participants but to ensure that their electorates are happy.

Q78 Viscount Brookeborough: So it is the politics that it is slowing things down.

Mark Hoban MP: I would not say that it is about the politics per se; it is about how you ensure that the changes we are seeing in the eurozone, which are fundamental and far-reaching, have some legitimacy in the eyes of the electorate. We are seeing, through some economic governance measures, a move of power away from national Parliaments towards the centre for the eurozone in a way that we in the UK would not be happy about if it was happening to us.

The Chairman: Colleagues, can we be brief in the three final contributions? We will hear from Lord Hamilton, followed by Lady Hooper and then Lord Vallance.

Q79 Lord Hamilton of Epsom: Minister, you have already made some reference to mutualisation and, in that context, Eurobonds. On the other hand, Chancellor Merkel has said that she will not entertain the idea of Eurobonds during her lifetime. By "her lifetime", does she mean until May 2013, when she has won an election in Germany? In that context, perhaps I may quote Professor Patrick Minford, who says that at the end of the day Germany cannot actually afford to underwrite the whole of Europe. If we are talking about Spain and Italy, Germany just does not have the money to do it. There was an interesting vignette of Germany on the news this morning, in which it was said that it has very serious demographic problems with very low birth rates. It has a declining population, so perhaps it needs all the money it has to survive into the future.

The Chairman: I should tell the Minister that we had Patrick Minford before us in our first session on this.

Mark Hoban MP: I think that there is a real challenge here, and in a way it goes back to Viscount Brookeborough's question about the politics. Creditor nations need to be able to explain to their electorates why this will not happen again. I think that closer fiscal integration, greater checks on, for example, the size of budget deficits and greater scrutiny of economic policies by the Commissioners for the eurozone member states all point towards tighter fiscal and political integration, which then sets the scene for a greater willingness by creditor nations to contribute to elsewhere in the eurozone. It is very interesting that, in terms of direct recapitalisation and the mutualisation of debt, Chancellor Merkel sees banking supervision as intrinsically linked with that but as a precursor to that mutualisation. I think that political integration is probably seen as a precursor to other measures to enable the mutualisation of debt. However, I cannot comment on what she sees her lifetime as being.

Q80 Baroness Hooper: Last week, the compact for growth and jobs was announced, which included a financial commitment of €110 billion, of which, I understand, €10 billion goes to the EIB. What is your assessment of the steps that were announced? Do you see this as a shift in policy and, in that context, has the new French presidency had a major influence on that? You may remember that in our February report we also concluded that ultimately the resumption of sustainable economic growth will hold the key to solving the crisis.

Mark Hoban MP: I do not think that this is entirely attributable to President Hollande. In our own Government's economic strategy there has been a clear twin-track approach around tackling our fiscal deficit and laying the foundations for economic growth. I think that the same approach should be applied across Europe. The Prime Minister, in advance of the

March summit, wrote with 11 other heads of state and government a letter setting out some of the measures that we should be taking towards promoting growth, including the inclusion of more bilateral free trade agreements and completeness of the market. That work has been in train. The compact that was announced at the June Council meeting brings together several strands. It brings together that Europe-wide approach to structural reforms; it highlights the need for national Governments to take action; and there is complementary spending. We have been supportive of the increase in capital. However, the EIB needs to maintain its AAA status in terms of its activities, but we in the UK benefit from EIB loans. It is a good package, but it does not remove the need for us to make strong efforts at home and abroad to crack on with reform. I think that the Commission is seized of that. Commissioner Barnier has identified 50 measures that will help to encourage growth. He has implemented something like 40 of them, which is good progress.

The Chairman: Our last question on the euro area is from Lord Vallance.

Q81 Lord Vallance of Tummel: Are there any contingency plans for the possibility that one or more countries, either small or large, will find themselves obliged to leave the eurozone at some stage?

Mark Hoban MP: A wide range of contingency planning is undertaken by government.

The Chairman: In the airport hub that is Sub-Committee A, we now change flights from the euro area crisis to the draft EU budget for 2013, and what finer questioner could there be than Lord Flight?

Q82 Lord Flight: Minister, you state that, "a 6.8% increase in EU spending is unacceptable and fundamentally undermines the tough action that is being taken across Europe to curb excessive spending". Can you expand on these concerns and what you expect the outturn to be? Let me just add that, a few months ago, it was reported that in 2013-14 Britain's contribution was going to rise to £31 billion, which astonished me. I took that up with our clerk Stuart Stoner, who took up the issue with the Treasury, but the Treasury confirmed that that was the right figure. Do you know what the plans look like going out beyond the short term?

Mark Hoban MP: These debates take place along twin tracks, of which the first is the 2013 budget. The Commission's proposal of a 6.8% increase is unacceptable. At a time when member states are having to make significant savings in their domestic budgets, the fact that the Commission is not sharing that burden is disappointing. Where we are at in the moment in the EU negotiations is that the Council agreed last week to a 2.79% increase. We opposed that—we still think that is too high—but the dynamics of the annual budget are such that the decision is made under QMV and clearly there were two blocking minorities, which is not a very satisfactory situation. One of those comprised net recipients, who would be unhappy if the budget increase was too low. Another comprised net contributors like ourselves, who would be unhappy if the increase was too high. So 2.79% is a compromise between those two positions, on which we were able to reach agreement under QMV.

In the aftermath of that Council meeting, we have agreed with like-minded member states quite a strong statement saying that in the next round of negotiations—once the Council agrees its positions, we then enter a conciliation process with the Parliament and the Commission, and that takes place in November—we are not prepared to see an increase beyond 2.79%. That was a very clear statement by a blocking minority of member states that includes France, Germany, ourselves, the Netherlands, Sweden, Austria and Denmark—a very strong group.

The second strand is the multiannual financial framework covering the period from 2014 to 2020. To continue the flight analogy, we are still in the departure lounge on that one—we are not yet at take-off—but all the issues for negotiation around the budget were set out at the June Council and we are expecting the Cypriot presidency, in conjunction with Herman Van Rompuy, to continue to work on that.

Q83 Lord Vallance of Tummel: You say that 2.79% is a compromise that is on the high side. What would you have wanted to settle for?

Mark Hoban MP: Our aim was for a real-terms freeze, which would have been about 1.9%. That is what we achieved last year, but the dynamics did not work for us this year.

Q84 Lord Vallance of Tummel: In your letter, you say that "by spending more smartly, the EU budget can meet the key challenges without soaring expenditure". In what specific ways do you think the EU budget needs to be spent more smartly?

Mark Hoban MP: I think that there is a lot that we could do around reducing the administrative costs, which come partly under heading 5 of the budget but there are also administrative costs scattered throughout the other budget headings. In this country, we have achieved a 30% saving in the administration costs for the running of central government; the Commission is nowhere near that. The Commission said that it would try to reduce the number of posts by 1%, but it ended up reducing the total by 0.7%, which was 286 people. However, the Commission then decided that it needed another 280 people to deal with the consequences of Croatian accession, so we ended up with a net change of just six. The week before last, the Commission put forward proposals to increase spending by a further €15 billion, of which €10 billion was related to Croatian accession. We have been very clear that those costs should be absorbed within the existing spending—without increasing that. To my mind, Lord Vallance, there is a mindset there that says, "Someone else picks up the bill, so we are not that interested in how well the money is spent." It is really important for member states in the sectoral negotiations to ensure that the priorities set for each budget line are sensible and provide demonstrable value for Europe and are not simply an opportunity to waste money on pet projects.

Lord Vallance of Tummel: That is not smart spending but just basic budgetary control.

Mark Hoban MP: As you will know from your career in business, Lord Vallance, with proper budgetary control you get better value for money.

Lord Flight: You did not answer what the UK contribution for 2013-14 will be.

Mark Hoban MP: Mike Glycopantis will answer on that.

Mike Glycopantis: The Office for Budget Responsibility now makes those forecasts. The gross contributions after the abatement are forecast to rise from £13 billion in 2010-11 to £13.6 billion in 2016-17.

On the question of smart spending, it is worth noting that the Council position—although it is higher than we wanted—made cuts to heading 5, "Administration", for which the overall Council position is €146 billion. That took the increase to heading 5 down, from the Commission's proposal for a 3.23% increase above last year to an increase of 1.47% above last year. Obviously, we voted against that because we felt that it was still too high, but I just wanted to tell you what progress the Council made under heading 5.

The Chairman: Minister, I think that you are going to be asking Mr Glycopantis to do a lot of hasty homework. If he could incorporate those figures in the letter to us, we would be most grateful.

Q85 Baroness Maddock: In the Government's explanatory memorandum on the draft budget, you also mention that it is essential that "EU spending delivers high added-value, which will require strict and rigorous prioritisation". Which areas and headings do you think ought to be prioritised and why? Which areas of the Commission's proposals do you think are acceptable?

Mark Hoban MP: Within the context of a constrained multiannual financial framework, we should be looking at ensuring that we spend more on areas that promote economic growth and look very carefully at those projects that will deliver an improvement in productivity or capacity. The slightly curious way in which this has developed means that discussions about the overall spending envelope take place at heads of state and government level—ultimately, they are the ones who make that decision—but at the same time there is a bottom-up process, whereby at each of the sectoral Councils on issues such as competitiveness and agriculture we engage in debate about the regulations that determine how money will be spent. One way in which we can try to deliver more efficient spending under each of the budget headings is by getting the sectoral negotiations right to make sure that the programmes deliver economic benefits to the UK.

Q86 Viscount Brookeborough: I think that we have addressed a lot of my next question, which is about the savings to be made in administrative spending. To what extent do we agree with other nations in determining what counts as waste? We have argued about administrative spending; do other member states have views about other targets that they wish to look at?

Mark Hoban MP: I think that there is broad agreement on waste in administrative spending, and we work with other member states on that. There are different priorities in different member states. For example, I know that the Scandinavian member states are much more interested in spending on R&D, whereas when I talk to my Italian counterparts, they are much more interested in CAP—

Viscount Brookeborough: The CAP is the biggest single—

Mark Hoban MP: Sometimes waste is in the eye of the beholder, and obviously you will look at your own national priorities in deciding what you think is wasteful spending. Clearly, where there is common agreement is around administration. Another point that demonstrates the impact that the co-operation among net contributors is having on the overall budget debate is that net recipients—the people who benefit from the structural funds and other funds—said in drawing up the negotiating blocks that, if there are to be cuts, they wanted to see cuts across the board.

Q87 Viscount Brookeborough: Might it not be an idea to get everybody to focus on scrutinising a different segment of the budget each year, so that we get agreement on that, rather than everybody fighting a different corner—as you said, "Let us take a little bit off everything"—which allows someone surreptitiously to push in an increase?

Mark Hoban MP: The challenge that we face is that the multiannual financial framework sets the spending envelope for the next six years, so we need to get the prioritisation and the sectoral negotiations right now because, if we do not, we will face the consequences over the course of the next few years. For example, over this Parliament we are paying £10 billion more towards the EU budget as a consequence of decisions that were taken in 2005 on the shape of our rebate. While there may be more elegant ways of achieving the same outcome, the reality of how the negotiating process works is that you need to focus this year on getting that framework right if you want to try to minimise the long-term costs to the taxpayer.

Q88 Baroness Hooper: May I just follow up on that last point? Was not this the area that Lord Kinnock was responsible for when he was Commissioner? There is nothing new in this thing about cutting waste. He started a programme of doing that some years ago.

Mark Hoban MP: I do not think that the Commission attack these issues with the vigour that we would like them to. You see a situation where people who have been working in Brussels for the last 30 years still get an expatriate allowance, which is an extraordinary situation to be in. Staff costs are just unbelievable. Teachers in European schools are paid significantly more than teachers in our own schools. It is something that the Commission do but I do not think that they do it as vigorously we would like them to. I do not think that they think about it as being "our money" in the same way as the Government think about it being taxpayers' money that we are spending. They are one stage removed.

Q89 Lord Kerr of Kinlochard: But teachers pay would hardly make a real difference to a budget on the scale that we are talking about. Supposing staff did not have expatriate allowances. The number of public servants in Brussels working for the European Union is smaller than the number of staff working in the London Council—it is about the same as Croydon. You are dealing with billions in the budget. The slogan about waste comes up every year, but we never produce anything concrete that would make any real difference.

Mark Hoban MP: But it is emblematic in a way of some of the issues that we have. There are programmes where we think that the amount that the Commission have identified is excessive. There is something called the connecting Europe facility, where huge sums are being projected to be spent without a very clear indication of the value to Europe. We shaved €0.5 billion off the CAP in this year's budget debate. It is not just the small items; it is the big items, too. So, Lord Kerr, in terms of how this debate is portrayed and how we perceive it, I think that people understand much more about pay and rations, perhaps, than about multi-billion-pound projects and it is right to make sure that we attack all of those, so that people understand where we are coming from.

The Chairman: Minister, before we turn to Baroness Hooper, I tried to find this out from your colleague Justine Greening when she came before us on the 2011 and 2012 budgets. I asked her to demonstrate what had been achieved in the subsequent 12 months where the Government had started off with the ambition of reducing waste and making savings, which I never had identified to me or to this Committee. Without wishing to add more homework for Mike Glycopantis, the Committee would be most grateful if we could have examples from the earlier two budgets where real savings were made or waste was cut—real examples, not just theoretical models, of what was achieved in the 12 months by the United Kingdom harrying the Commission on the requirements of making savings where savings could be made. I would be very grateful if you could tackle this issue. I return to Baroness Hooper.

Q90 Baroness Hooper: My real question goes back to growth. In your letter, you cite the need to "send the clearest possible signal about orienting the 2013 EU budget towards growth and competitiveness". In what specific ways can this be achieved? From the UK point of view, would this be different from what I think you referred to as the 40 measures that were announced by Michel Barnier? Would it be over and above those measures?

Mark Hoban MP: Michel Barnier's measures are generally around regulation and completeness of the market rather than around spending. But on structural cohesion funds, for example, there is much greater emphasis in some areas where you will see a real change. All our long-term strategies are to ensure that more of the structural cohesion funds are spent in countries with way below the average European Union economic performance. How should that transfer from the richer member states to the poorer member states take place to ensure that the poorer states can build up their capacity? How do we ensure that, for example, projects around connecting Europe through road networks deliver real economic change rather than bridges to nowhere? It is those areas that we need to get right. That is why the sectoral negotiations are really important to get right, as they lay the foundations for spending in the right areas. The Government have pushed on that and have worked on connecting Europe in terms of energy, telecommunications and transport. The Ministers in each of those departments are working together on how you get the overall strength of that right, so that it delivers economic growth rather than simply something new and shiny with a European Union badge on.

Q91 Baroness Hooper: Just to follow up on that, I remember an example that was quoted about the CAP to do with the traditional tobacco farmers in Greece and Italy. They needed specific help, which was brought in under the CAP heading. It resulted in countries growing tobacco that had never previously done so, including France. That seemed an absolute anomaly to me. It would be a question more of taking that sort of thing out of the CAP budget and putting it into the social budget—the structural funds—specifically to help the people who needed the help and not to have an across-the-board solution.

Mark Hoban MP: That is a very good point, Baroness Hooper. How do we put measures in place that encourage growth and change rather than simply allowing the status quo to continue? It is like the old adage that international aid is not about giving someone a fish but about giving them a fishing rod to get that fish. The question is how we transform the EU budget so that it helps to drive economic growth, which we know is so important.

Q92 Lord Kerr of Kinlochard: You gave me great pleasure with your description of the two blocking minorities in the Council. Ah, you have it so easy these days. I remember the days when there were only two net contributors, and one of them believed that the bigger the EU budget, the better. Credit is due to John Major's European Council in Edinburgh exactly 20 years ago, which changed the whole landscape. Tell me how you expect this negotiation to end. In your letter you helpfully described your blocking minority as the net contributors who on the whole favour a smaller budget, whereas on the whole the net recipients favour a larger budget. Will the net contributors—now about a dozen of them in all—hold together? Where will France go, with President Hollande now on a rather different policy? France is now a net contributor. Where will Italy go? Italy is now a net contributor. Mario Monti is arguing for growth. Will he also argue for austerity on the EU budget? I expect that he will, but what is the Government's view? How strong do you believe your coalition of the hard men is? It was clearly very effective last year. Will it be as effective this year?

Mark Hoban MP: I do not want to tempt fate but I offer you a prediction. This is my second budget round. I was present at the budget at ECOFIN last November where, as you put it, the hard men did stick together. I should like to think that the combined efforts of the Treasury and the Foreign Office helped to deliver that outcome. A very clear statement was agreed in the aftermath of the 2013 budget discussions at the Council last week that we would stick together. Italy is not necessarily part of our group but most of the member states who are net contributors are, and we have been working with our allies, so we do stick together. Last year, the Parliament caved in during conciliation. If we stick together, I think that we will get a satisfactory outcome this year, albeit one where the increase is higher than we would prefer.

Q93 The Chairman: Minister, my concluding question again involves a change of gear. We published our report on MiFID II last week, and I recommend it to you on whichever sunny beach you find yourself this summer. It is a good read—a real page-turner—and I am sure we will get a reply from you in due course. However, if you have anything to report to us in terms of the negotiation and the timetable, that will be useful.

On the financial transaction tax, we held a debate in the House of Lords and my colleague Lord Flight, who contributed, pressed your colleague Lord de Mauley, who was answering on behalf of the Government, on why we had not had a reply to our second letter on the financial transaction tax. I wonder whether you have any notice of when we might receive that. We would also be very grateful to you if you could reflect on the desire of some of our colleague member states which are in any case proposing to enact a financial transaction tax under enhanced co-operation, having, I believe, not fully understood the report that this Committee issued at the time.

Mark Hoban MP: I think it is fair to say that we have made relatively slow progress on MiFID in the Council. We expect to reach a general approach in the autumn around October. The European Parliament has made faster progress in its negotiations on MiFID but it does not expect to vote on it until September or October. There are some quite difficult issues to resolve in MiFID about OTFs, high-frequency trading and matters relating to inducements for consumers. But I think our arguments will get a good hearing and I think that the Parliament's position has changed somewhat over recent months. I am sure that when it reads your report on the beach it will be further emboldened to change its views.

On the transaction tax, I apologise for not having responded to your second letter. I thought that the first draft was not up to usual Treasury standards and I just want to make sure that we give you a good answer—perhaps a better answer than the one that I gave to the Committee on this matter. The FTT is an issue where we clearly have a view. It comes back to the multiannual financial framework. It was seen by the Commission as a way of increasing the resources at the Commission's disposal. I notice that those member states which are willing to go forward with the financial transaction tax are not offering it to the Commission; they want to keep the money themselves, which is perfectly understandable. However, I think that it is the wrong thing to do. I think it is damaging to the economy and to growth for member states to go ahead in isolation from the rest of the global debate on the transaction tax. We have made it very clear that we are not in principle against the financial transaction tax but it needs to be done at a global level. But clearly those member states have chosen to go ahead and they feel that there is a political imperative to do so. They will have some challenges in forming up the transaction tax but they want to go ahead under enhanced co-operation and we are not going to stand in their way.

The Chairman: Minister Hoban, as I told you, we will make a transcript of this conversation, which we will send to you and ask you to correct. As a result of some of the inquiries and questions, we are looking forward to further replies on the points raised. However, you may have further information that you wish to convey to the Committee, which will be writing you a letter next week on the euro area crisis. We will come to a considered view on the 2013 budget, which we will also convey to you.

You have shown both sides of your character, Minister Hoban: both the hard negotiator, who is sometimes the noisy neighbour to our colleagues, and the softer side—a man willing to provide fishing rods for those in poorer countries to fish as and when the occasion arises. As ever, you have shown the Committee a diligence in the replies that we have had from you, although we may not always agree with you. However, we are very grateful to you for appearing before us and for being well armed and able to respond to us in a way that this Committee finds very useful in arriving at a view on some of these very important and testing issues. We do not envy you your role in Brussels and Strasbourg of ensuring that those issues come to a good finish. We thank you and Mike Glycopantis for coming this morning. As I said, if we can keep in touch, I am sure that we will be able to operate in a way that Parliament desires us to do for the benefit of all.

Mark Hoban MP: Thank you very much. I always enjoy coming before the Committee. I explained to Michel Barnier last night that he ought to come in front of a Lords Committee rather than going before the Treasury Select Committee, as he would get a better quality of debate going. Thank you very much.

The Chairman: You are an accomplished flatterer and we are very grateful to you.

Patrick Minford, Professor of Applied Economics, Cardiff Business School – Oral evidence (QQ 1-30)

Evidence Session No.1 of 3. Heard in Public. Questions 1 - 30

TUESDAY 3 JULY 2012

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Lord Flight
Lord Hamilton of Epsom
Baroness Hooper
Lord Jordan
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford

Examination of Witnesses

Gideon Rachman, Chief Foreign Affairs Columnist, *Financial Times*; **Mats Persson**, Director, Open Europe; and **Patrick Minford**, Professor of Applied Economics, Cardiff Business School.

Q1 The Chairman: Colleagues, I have given my very warm welcome and thanks to our witnesses who are before us here today, and particularly to Patrick Minford for coming at a very late stage. We are most grateful to all three of you.

I remind colleagues that this is broadcast on webcast. I would be grateful for any declarations of interest that are required from Members. The list of interests is kept in a book upstairs and is made available to our witnesses, if they so wish.

We will make a transcript of this exchange. We will send the witnesses that transcript. We would be most grateful if you could check it for accuracy. There may also be thoughts that you feel you have not developed, and the Committee would be most grateful if you could write and amplify these to us in the subsequent sessions. Next week we will be speaking to the Minister, Mark Hoban, on this very short reassessment of the euro-area crisis, having done our major report—which Mats Persson will remember—in March last year, and one that was done by us and the Select Committee in February of this year. We are very much aiming at trying to look at and assess what is happening and whether we can find some solutions in the future.

If any of you want to make an opening statement, please do. I am going to start by asking a very open-ended question. Do you think that the euro will survive in its present form? Do you believe there is any particular end-game that might happen or develop over the coming months or years? If you want to make a statement and reply to that I would be most grateful. Let us start with you, Professor Minford.

Patrick Minford: Thank you, Chairman. Although I have never been a supporter of the euro, and I thought it was a mistake to do it, I think that the situation is one that was created by the founders of the euro, in a way that perhaps none of us anticipated. I am particularly thinking of the role of the European Central Bank, which was set up under the Maastricht Treaty basically as a keeper of the money supply and of inflation. The idea was that if a national banking system needed bailing out, the Central Bank branch of that country, that part of the European Central Bank, would bail it out. What nobody anticipated was how it would operate in the crisis. In the crisis what it has done is to operate as the shadow fiscal authority of Europe by lending massively to the south and basically borrowing from the north. This is the so-called TARGET2 balances set-up, which of course happens automatically in a federal system. If the ECB survives, of course, then it will simply get swept up into the general operations of the ECB long term. If the euro were to break up, then these balances that are owed by the southern countries to Germany as the major creditor, which are now of the order of €1 trillion, would all have to be settled and effectively this would make a big hole in Germany's balance sheet. I think that what the founders of the euro did was create an enormous commitment strategy for the euro, which makes it very, very hard to go back on it. In fact, the way I see it is that it will survive, and the way it will survive is through this enormously powerful institution, the ECB, which I think will be licensed to act on a free-wheeling way. Obviously it has to have political agreement to do whatever is necessary, pretty much as it has done so far.

The thing that could destabilise all this would be public opinion, either in Germany, because they feel that they cannot cope with this any more—they are not willing to throw good money after bad or some such argument—or in the south where they get austerity fatigue. As I say, the Germans are so thoroughly committed by these TARGET2 balances, as well as the ESM and the FSA on top of that, and also by their own domestic politics—the elite are thoroughly committed to this strategy—that if the euro were to break down there would be all sorts of problems for Germany.

Q2 The Chairman: Shall we leave it there, and I will come to Mr Persson, because we are going to explore those questions.

Patrick Minford: Yes. I will just say that in the south there is a similar public opinion situation where they are terrified of the chaos.

The Chairman: Thank you very much. Mr Persson.

Mats Persson: I agree with quite a bit of that assessment. I think the immediate battle will probably be over the ECB because at the moment the ECB is the only institution in Europe that can act swiftly enough, and with deep enough pockets, to actually move markets. As we have been reminded time and again over the last two-and-a-half-plus years, when EU leaders agree on something it takes quite a bit of time to implement it. I think that will also be the case for the summit that we saw last week. Therefore, what the ECB does will very much determine the short-term prospects for the euro.

In terms of the outlook for the euro, we would say that nothing is inevitable in the eurozone crisis, but it is quite clear that, in the long term, the eurozone will not survive in its current shape and form absent some sort of permanent mechanism that subsidises the periphery. The shape and form of that mechanism may vary, but clearly there has to be something in place that can compensate for the huge divergences, not only in fiscal positions but also competitiveness between the different eurozone members.

If you look at the individual countries, I would say that Greece is too far behind. It is very difficult for it to get out of its current position. No country has ever achieved what is being asked of Greece at the moment in terms of meeting its austerity targets. Portugal is in slightly better shape, but there too you probably need to see some permanent fiscal transfer in some shape in order for Portugal to remain inside. Italy and Spain are different. Spain is not in particularly good shape, but it can just make it, and I think Italy as well actually. The two most problematic countries are clearly Portugal and Greece, but I do not think there is anything inevitable about Italy and Spain.

Having said that, I think that within the next year there will need to be a fundamental decision about whether Greece can remain inside the euro. The other eurozone countries could be subject to muddling through for quite some time but Greece is an imminent—

Q3 The Chairman: That is very helpful. Mr Rachman, can we have your gloss on it? You did write that there is a possibility that there might be a return to national currencies. I would be very grateful if you could explore that idea?

Gideon Rachman: I suppose it is the obvious corollary: if you think the euro cannot last, they are going to have to go back to something, and so you would get people returning to national currencies. In the case of Greece, there has been discussion about the drachma, and so on. Clearly it is formidably hard to do, and we have had your colleague, Lord Wolfson, setting up a prize to try to work out whether this is possible. I do not think that he has yet found the silver bullet. Unfortunately, that has tended slightly to shut down the debate because people say, “Gosh, this is so difficult, so dangerous; we just have to plunge on with this euro because all the alternatives are unthinkable”. I suspect that, as the euro gets further and further bogged down in difficulties, we will perforce have to come back to thinking about that. I would prefer that they did it in as controlled a fashion as possible, as opposed to a chaotic breakdown where Greece leaves the euro and then you suddenly have border guards trying to stop people taking euros out of the country; the kind of scenario that people have talked about.

I will briefly try to give my answer to the broader question of why I think we are going to end up with a euro break-up. If you go back to the origins of the single currency, many theorists at the time said, “Look, there has never been a monetary union that is not ultimately backed by political union”. There tended to be two responses. The first was, “Just because it has never been done does not mean that we cannot do it, and we have set up all these mechanisms—the stability and growth pact and so on—which will make this new system work”. I think that argument has fallen by the board as the stability and growth pact failed and as we have entered a crisis. The second argument was that the very creation of the monetary union will foster economic and then political convergence. It was a kind of deterministic argument: you change the economy and the politics will change with it. It is that argument that I think is in the process of being falsified. It was too deterministic. It believed that if you had the single currency political union would follow, and it factored out that people have to make very profound decisions about, “Who controls our national budget? What do we feel about big fiscal transfers across the EU?” As it turns out, public opinion, as reflected through politicians, is much more resistant to this than people thought, and so they are kind of stuck. There are those who believe—you hear this a lot in Brussels—that Europe only ever advances through crisis and that in the end this crisis will force Germany and the others, and the southern Europeans, to take these very difficult decisions and we will end up with political union. Therefore, we will have this mechanism for transfers, which Mats refers to, and we will have a working system more akin to that of the United States.

My feeling is that actually we will not. I do not think this is politically feasible. I do not see that in the end the Germans—and far less the Dutch or the Finns, who are even more hard-line on this because they do not have the historic German sense of guilt and obligation to the rest of Europe—will sign up for what they regard as subsidising feckless southern Europeans. Nor do I think the French—particularly the French, who are quite souverainiste and believe in the power of the Government in Paris—will accept the kind of deep control from Brussels that is implied by what the Germans would say is a quid pro quo for a transfer union. The Germans say, "Sure, we are still the believers in political union, but you in southern Europe have to understand what this means. This means that you cannot control your national budget in the old way". Incidentally, I think it would mean harmonisation of social systems across Europe. For example, you see the arguments about, "Why should we send money to Greece when they can retire at 60 and we retire at 67?" So it has all sorts of implications.

In the end we are all making a judgement based on the politics we see before us. I do not believe that it is feasible that they will get there. If the chain of logic is right, monetary union cannot ultimately work without political/fiscal transfer union. If political union is not achievable, then you come back to saying, "This thing will break up in the end".

Q4 Lord Flight: Gideon has in part answered the questions that I was about to ask concerning his response to and assessment of last week's EU summit and its road map, allegedly, toward genuine economic and monetary union. It seems to me that the four ingredients—an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework but only strengthened democratic legitimacy and accountability—rather missed out two really crucial elements. One is what I would call political integration. It can only work if you are really going to become a European USA. Secondly, the crucial issue, which both Mats Persson and Gideon have raised but no one seems to have talked about, is the extent of transfer payments required largely from Germany to keep the south afloat. The assessment I have seen is of the order of 30% of German GDP per annum. I wonder whether any of you has actually done any work or made any assessment of the extent of the transfer payments that would be required. It seems to me that that is absolutely fundamental to the issue of whether you can turn Europe into a USA and bail out the euro.

The Chairman: Let us ask Mr Persson. Has any work been done on that?

Mats Persson: Yes, work has been done on it. I think 30% sounds a bit high, does it not? That would most certainly lead to an immediate euro break-up if that was presented to the Germans. Certainly there will be a price to pay for the Germans, a fiscal price. There has been some work done on eurobonds; for example, the additional borrowing costs to Germany of introducing eurobonds. I think estimates put it at between €35 billion and €50 billion per year in extra borrowing costs for Germany, which is not pocket change. Of course that could be even higher. We are actually doing some work on that at the moment. So, yes, there will be a substantial cost. I totally echo Gideon's point about the difficulties in selling this to the German electorate and the electorates in other AAA countries, in addition to selling it to the southern member states that will have to see their budget decisions being taken by people sitting in foreign capitals. I do not know whether that answers the question, but I think there is a real cost to Germany here, absolutely.

Q5 Lord Flight: What about the political unification required?

Mats Persson: The political unification comes down to one question: do Europeans like each other enough to actually belong together in a full political union? That is very much an open question. I do not think it is necessary. For example, if you look at this idea of having supranational budget rules in a full political union, already of course that is crumbling. The eurozone has been trying to achieve strict budget rules for the euro for a decade or more. The Germans and the French were the first to break them. We have seen Spain allowed slack on its budget targets. Even the Dutch had a very difficult situation over EU budget targets, and the Government there fell partly because of them. So it is extremely difficult to achieve. I give the example of Spain as a microcosm of the eurozone as a whole. Madrid has difficulties in controlling spending in its own regions. One of the reasons why Spain was missing its budget or its EU austerity targets was that the regions kept on spending. They take regional autonomy and identity very seriously. If that is true for Spain, then I think we will be looking at something very similar, if not worse, for the eurozone as a whole, so it is very difficult to sell.

Just to add very quickly, banking union and fiscal union are two sides of the same coin. It is very difficult to have one without the other. I think it is right to discuss them in tandem, and I am more than happy to go into that if we look at the specifics of the summit.

Q6 The Chairman: Professor Minford, have you been doing work on the future of the euro in that respect, or the economics of it?

Patrick Minford: Not serious work at all, no. But I would say that the difficulty about this is it is all about debt and whether it gets repaid, and you can always roll it over and live in hope. That is the way Europe works; it lives in hope. I think we underestimate the tenacity of these institutions if we say that they will suddenly keel over in the face of public opinion. The thing about public opinion that is so striking is that if you go to Greece, which is the most austerity-hit country, 80% of public opinion want to stay in. The same is true in Portugal, Spain and Italy. If you go to German public opinion, yes, of course you have the same thing. You have *Bild-Zeitung* representing the common man and expostulating, but the truth is that the German elite politician class does not reckon it is going to be derailed by this at all.

The Chairman: I am going to invite Lord Marlesford for a supplementary, but I would be very grateful if some of you could elaborate on Professor Minford's point that, punch-drunk though they might be, they still do seem to want to stay in the euro and vote with the same enthusiasm as in the Eurovision Song Contest or the recent Euro football.

Q7 Lord Marlesford: I wonder whether we should look separately at the euro area and the euro because, after all, the euro is now a major international currency. If you take the foreign exchange reserves reported to the IMF, the US dollar is 48%, gold is 23%, the euro is 19% and then you have dropped to just over 3% for sterling, just under 3% for the yen and only 1% for Swiss franc. Those are the ones that are reported. Therefore, I wonder whether one should be saying that the euro must survive as an important world currency, but that does not necessarily mean that the countries have to stay in the euro area. Nor does it necessarily mean that if they leave the euro area they invent their own Mickey Mouse currency. They could continue to use the euro with the advantage that that has of not having a printing press to print it and the ECB would no longer have a responsibility for that country, although it would probably have had to pay off the debt up to the date at which it leaves.

Gideon Rachman: I can see the attraction of that in avoiding the financial chaos involved in a break-up, and affecting reserves and so on. But it seems to me that if there is an attraction for any country to leave the euro, it has to involve restoring the ability to devalue and also, frankly, to inflate your currency and all those things that economists might say are not a great idea. They are an option that has been taken away from countries. Arguably, that is partly what is plaguing Italy and Greece, which in the past have allowed their currencies to lose value and retained competitiveness that way. I am not sure that would work.

But just to return to the point of why the Greeks actually want to stay in euro, I think they had quite a mind-concentrating debate where people said, "Look, if we leave the euro the banks could run out of money. You could go to the cashpoint and your savings have disappeared". Faced with that, they made a rather unhappy decision that, "We do not like what is going on now but we prefer it to the potential of chaos later". I do not think that means that public opinion will always come to the same conclusion right across the eurozone, because people face different sets of choices. For example, I think it is interesting that in Italy there is this new political force, run by Beppe Grillo, which is coming out for getting out of the euro. Berlusconi is beginning to toy with it as an idea. In the Netherlands there are political forces that are arguing for it. Maybe it is the AAA countries that you have to watch, because they may be less spooked by the idea that if the euro breaks up they are going to be faced with national bankruptcy, a run on the currency and the closure of banks. It is their reluctance to continue to fund southern Europe that could be the break point.

The Chairman: We have talked about countries such as Greece and Portugal leaving, but there is an argument about the AAA countries absconding.

Q8 Lord Kerr of Kinlochard: Yes, I was thinking about the 80% of Greeks. I think it is true right across Europe. Very few people want the euro to come to an end, but very few have yet accepted that it would be a good idea to have a bit of austerity and a bit of fiscal union. So it is having your cake and eating it at present. Actually, I am in the Minford school. It seems to me that the chaos of break-up is a powerful deterrent to people wanting to break up. Professor Minford, am I right that if the currency went then obviously freedom of movement of capital would go for a time and you would need to have exchange controls? Freedom of movement of persons would have to go too. In addition, it seems to me that the scale of the devaluations and revaluations would be such as to mean that a single market in goods and services would at least be in abeyance for a time. When we fell out of the ERM and had our sharp devaluation, it took a very strong President of the Commission to stop trade measures being imposed against us in 1993. Am I right that the chaos would not just be a currency chaos; it would extend much more widely?

Patrick Minford: Yes, I think you are right. The difference with us leaving the various currency arrangements in Europe, the EMS, was that we already had a currency. All we had to do was devalue it and get out. They do not have a currency. They have to create a currency. They have to decide on what debts they are going to repudiate, which are going to be denominated in euros still and which are going to be denominated in drachmas or escudos. There will be complete chaos in those terms and obviously a lot of uncertainty for the banking system. It would be very hard to predict exactly what would happen. Therefore, I think this accounts for the situation in public opinion. Leading Greek economists think that it would be pretty disastrous for Greece to leave the euro in terms of the domestic chaos that would follow in all sorts of unspecified ways.

Q9 The Chairman: Mr Persson, would you like to pick up Lord Kerr's point but also Lord Marlesford's?

Mats Persson: I will do my best. In terms of Greece leaving and public opinion, the Greeks are fairly rational, actually, because if Greece left today, it would leave when it has a wholly undercapitalised banking sector. The banking sector would collapse, and Greece would still be hugely reliant on external support in order to see that through. Secondly, it will not have a primary surplus, which will not allow it to run its day-to-day business, so it would also need external support for that. It would still be reliant on EU aid effectively or IMF aid. It is a very difficult mix for Greece, so I think it is absolutely right that Greece is not leaving now. If it is to leave, it needs to first restructure and recapitalise its banking sector, and, secondly, achieve a primary surplus. Then it will be more rational for Greece to leave. I also agree with the point that of course it will have an impact on the single market, but it depends on which country we are looking at. If it is only Greece being shaved off, then it is bad for Greece, but it would not necessarily have a major impact on the European Union as a whole. Of course if Italy and Spain leave that would fragment the single market. It does not mean that it will be like that for ever, but no doubt you will have to rewrite the EU treaties to accommodate for a temporary period where free trade in Europe needs to be managed very carefully, including capital controls.

Q10 Baroness Maddock: Carrying on with last week's summit, the statement said that it is imperative to break the vicious circle between banks and sovereigns. The Commission will present proposals for a single banking supervisory mechanism shortly. It is envisaged that once this is established the European Stability Mechanism will be able to recapitalise euro banks directly. I wonder what your assessment is of this conclusion? How do you think the supervisory mechanism will work? Do you think that these steps will be sufficient to break this vicious circle, so described?

Gideon Rachman: I do not think it is particularly encouraging that they do not seem to have agreed on what they have agreed. They issued a statement and then instantly there were different interpretations of it. One way of looking at it is that when people were talking about banking union they were talking about two main elements. One was the supervisory thing, which they talk about putting in place, and the other was deposit insurance. Again, the AAA countries are, for understandable reasons, highly reluctant to underwrite the banks of southern Europe and the deposits there, because that is a potentially unlimited liability. You do not know what you are in for there. If what you are worried about is bank runs in the short term, it does not seem to me that what they agreed over the weekend addresses that concern. It does not say to the depositor in Italy or Spain, "Do not worry, Europe is behind these banks".

On the supervisory front, we will have to see what they come up with. I am a little sceptical that a supervisor would be powerful enough to go in and close institutions that have enormously strong political backing in individual companies, like German Landesbanken or Spanish La Caixa. It is quite hard to see that. If the supervisor is lodged within the ECB, which is the most powerful institution, maybe it will work. But it is easy and necessary to make the commitment on paper. How quickly they get there, how effective it will be and what powers it will have all have to be sketched out. As I say, it still does not address the fear of bank runs from weak banks in southern Europe.

Patrick Minford: This is going to be going on for an awfully long time. I think we are going to be looking at this in five years' time, maybe 10. This is going to continue, and there are going to be incremental steps like this. You are right to be sceptical of how much this means.

Essentially this has been triggered by Bankia, which the ECB felt it could not deal with because essentially it was an insolvent bank due to political interference in these local authority areas. The ECB was not really allowed to deal with insolvent banks so the banking union is, in effect, another bit of institutional structure that is going to deal with things like Bankia. What we are seeing here is a move towards what I will call an East German model of the south, where essentially, in return for this huge underwriting that Germany is doing, she will expect reform—labour-type reform, `a la Germany, which is Hartz reform—strong unions and all that sort of thing that we know in Europe is what Europeans like, more flexible markets willing to take wage cuts, agreed wage cuts and so forth. Labour contracts would be more flexible. Privatisation would be greater. This is the conditionality that Germany is extracting, and because of the political background this will happen. It will take an awfully long time, though.

Q11 The Chairman: I would like Mr Persson to answer about the single banking supervisor, but I want to put a question to you, which I will particularly aim at Mr Rachman afterwards. Professor Minford says that this will be a slow process, an incremental process, which Angela Merkel keeps reminding us is the route to finding some kind of solution. Do you think that is the case and do you think that our 24/7 media, TV and newspapers, can in some way misunderstand that that is a necessary process of evolution of the European Union to arrive at that point? Mr Persson first, and then I will come to Mr Rachman who I am particularly eager to hear from.

Mats Persson: I do not think markets understand it either, to be fair to the 24/7 media. To address the very short term point first on the EU summit, just on the solution side, I think the agreement to allow the ESM to directly recapitalise banks was progress, in the sense that it can serve to stabilise the situation a bit. At least in theory it does break one side of that vicious circle, of the banking sovereign loop. Now the debt does not have to go through the Spanish Government; you can circumvent the Spanish Government. Of course it does not hinder Spanish banks from loading up on Spanish sovereign debt, which would still have that vicious circle or that link in place. But at least it has the potential of breaking one side of it and that is potentially a good thing. In the long term on the banking union, just to illustrate how difficult it will be to achieve it, there are three elements to the banking union: regulation, supervision and resolution. Regulation is partially covered by the single market. Supervision is hopelessly fragmented along national lines, and resolution is not even close. In order to actually achieve a proper banking union, you still need the spending controls that the Germans are talking about; not only harmonised regulation of the banks themselves but also spending controls, because otherwise you will effectively subsidise banks in Spain and elsewhere, which will be allowed to lend money to the Governments at very cheap rates. That would act as a subsidy for these countries at the expense of German taxpayers. You need a perfectly harmonised system, both on the regulation side and also on the spending and fiscal side, before the Germans will be comfortable to move to a proper resolution and supervision system. Of course, that will be very difficult to achieve, and that will take years. Europe has already tried to achieve a resolution fund. It has already tabled a proposal for a partial deposit guarantee scheme. That ran into massive political obstacles.

On the supervision front, I agree with Gideon. Will the Germans really agree to give up control of Landesbanken, and will the French agree to give up control over their three major banks? That is a massive transfer of sovereignty, so you are back to the original question: the one on national democracy versus the need for the eurozone to press ahead with further integration. In short, it will be a process, and I do not think that either the media or the markets for that matter quite appreciate how drawn out this could be, if ever it will be achievable.

Gideon Rachman: There are two ways this could evolve. One is the process that Professor Minford was talking about, where we are talking of literally a decade or more where this is a very gradual, rather painful process. I do not think one should discount the possibility of a sudden crisis. As a journalist I have often found that when the papers are screaming about something you go and see people in power, in the Treasury or whatever, and they say, "Oh no, it is not nearly as bad as that". In this crisis I tend to find it is the opposite. The papers seem relatively calm, but then you go and see people running banks and they are really on tenterhooks and quite often very, very anxious.

Lord Kerr and I were both at a meeting in America about three weeks ago, where you had top bankers, top government officials from all over the world talking about this whole thing unravelling within weeks—some were saying days. In fact they were freaking themselves out and it was not that bad. But there is a sense that we are kind of on a tightrope, and when they think about, "How could things go very suddenly wrong?" I think what was worrying people, say, three or four weeks ago, was a bank failure and people were making a comparison with Credit-Anstalt in Austria in 1931 and how that had led to a second leg of the Great Depression. Because people's savings disappear in one bank, and you have a Lehman Brothers-plus, basically, where the whole financial system freezes up. That has been something that the head of Deutsche Bank and others are talking about quite seriously; it is a real possibility. I do not think that possibility has gone away. But the strategy seems to be to always do just enough to avert that without ever quite getting to the point where you can say, "We have sorted it out".

The Chairman: Mr Rachman, of course this Committee and others will always think of the *FT* as a still small voice of calm in these matters.

Q12 Lord Kerr of Kinlochard: I remember the conference in America. I thought that Ken Clarke silenced the Americans with great skill, predicting that we would kick the can down the road, doing not nearly enough to end the crisis but enough to keep the crisis running for many more years, which seems to me to be the case so far. My worry is about how this supervision authority will affect the United Kingdom. I was struck by Mr Persson in *The Times* last Saturday, "A eurozone banking union is probably necessary in the long term, but is also a potential minefield for the UK. First, will it create barriers to UK financial firms doing business in the eurozone, in turn fragmenting the single market? Secondly, will supervision spill over to regulation, with the eurozone effectively writing the rules for all 27 countries?" Very good questions, Mr Persson. Could you give us answers?

Mats Persson: No, I cannot because I do not have the gift of prophecy. I wish I had. Those are the relevant questions, and if I were in the Treasury those are the ones I would look very closely at. It is a bit difficult because the risk is unknown, but the objective for Britain should be to try to keep the gap between a eurozone banking union and the single market as narrow as possible. That should be the objective. What that means is very difficult to specify, because the proposals for a banking union are so embryonic at the moment. We do not know exactly how it will develop. Also, as I said in that article, there is a strong case for there to be a supervised eurozone and to have a single banking supervisor in the eurozone. That makes sense. But that also has risks for Britain.

The worst case scenario, I suppose—if I may offer a bit of doom and gloom—for Britain and for the City of London would be if you have a supervisor in the eurozone that will pursue a relocation policy, so that in order for a firm to do business or to be active in the euro area it also has to be supervised by the ECB. For example, we saw that with the pressure from the ECB for clearing houses to relocate to the eurozone in order to clear over-the-counter derivatives, which the UK Government has acted over and taken the ECB to court over, could be a potential test. I am not saying it will necessarily happen. I am just saying that is one we have to look out for.

The second risk is if supervision spills over to regulation and you have a strong incentive for the eurozone, led by a single supervisor, to start writing bank regulations that are designed for the eurozone but they have to be implemented through single market procedures—i.e. the European institutions—where Britain and other non-eurozone members will be in a very weak position all of a sudden. Again, that may not be a problem, but you can see that happening over capital requirements, over bank bonus, leverage levels and market access. These are the areas that we have to look out for. That was merely the point I made in that article, and it was an attempt was to focus minds rather than provide solid answers.

The Chairman: Given that very useful apposition, I wonder if colleagues would just hold fire on the UK, which we will come to shortly. I am keen to exhaust some of the other elements of last week's summit.

Q13 Viscount Brookeborough: Just before I come on to my question, it seems that the consistency of what the population think in different countries, whether they really have a chance of retaining the euro and those that may not, it seems extraordinary that on the one side it is held by that and on the other side it is sheer desperation. That is not necessarily a very good basis. But perhaps we are lucky that that is so because there could be serious social unrest. We do not have that at the moment, and that is surely where the disintegration might start. Mr Persson says that we are breaking the vicious circle, perhaps by having the ESM recapitalise Spanish banks. This whole thing is like a falling ball and we are chasing it. Is this not the sort of thinking that should go on? How do we actually get ahead of it and catch it? Are we doing enough? Are we being brave enough? I have been on the EU Committee for quite a long time and this is the first time I have ever been on this one. I am amazed that we do not have anybody who thinks they know the answer. It is extraordinary.

The Chairman: It is not normally the position of the Committee to think it has all the answers.

Viscount Brookeborough: Is there not scope for really making a break? I do not mean destroying the euro. Are there not more opportunities?

Patrick Minford: This is the thing. We get Mr Cameron telling Angela Merkel, "Do something, woman", as it were. She says, "It is not my money, and I have to be cautious with the money of my taxpayers. Therefore, I am not going to do anything in a hurry". You are saying, "Surely something can be done?" Obviously something could be done if Germany was willing to put up huge amounts of money on the table unconditionally. Clearly that is the issue. Germany has determined on a strategy where it will not be bullied into doing something. In your analogy, to rush after footballs, pick them up and solve the problem before it has hit the ground, because they see the process of the ball—I will carry on with your analogy—falling slowly to the ground as concentrating the minds of the various other teams who are involved here and getting them to be serious about carrying out reform. Look at Italy. Italy looked in the eye of the storm and pleaded that they were going to do all sorts of things, and they still have not done any of it. More or less the same is true in Greece, and Spain is more or less the same. None of them has actually done anything that the Germans regard as remotely serious. None of them has reformed its labour market, begun to deal with contracts or begun to privatise. The privatisation process in Greece just has not got off the ground, and one could go on.

The Chairman: I am going to ask Lady Hooper and Lord Jordan—because I want to exhaust this element before we return to the position of the United Kingdom and the implications for other countries.

Q14 Baroness Hooper: In fact, we have heard from our witnesses on the subject of the role of the ECB, and the fact that the summit statement envisages these new responsibilities in relation to serving as an agent to the EFSF/ESM in conducting these market operations and the oversight role in terms of the new banking supervisory mechanism. But is there any other step that you think the ECB could take and is that likely to help to alleviate the crisis?

Mats Persson: So what are the steps the ECB could take to stem the crisis, in addition to those that it has already taken? The ECB can do a lot of different things. It can intervene with more cash in the market, primarily by buying more Government bonds. In theory, I think that could quite easily stabilise the eurozone in the short term. Imagine if the ECB says, "We are now willing to start buying up hundreds of billions of Italian and Spanish Government bonds". I am sure markets would quite like that. It could also do more with liquidity operations. You know, what was known as the LTRO: the long term refinancing operation. It has done two of them this year, at around €500 billion each, which gave banks unlimited credit which the ECB and others then hoped that the banks would use as credit to lend to both Government but also small businesses. It did not quite happen like that, but that was the hope. It can do all these kinds of things. It is a central bank and, as I mentioned earlier, as such it has very deep pockets and the ability to act swiftly.

Of course the problem with that is that most of that is not within its mandate, particularly buying Government bonds. It seems like such an easy solution, particularly if you are the UK Government, and that is why they are calling for it. But I would be very careful in calling for the ECB to buy Government bonds, because that is one of the situations where German support for the euro will start to evaporate because they do not see the ECB as a lender of last resort for the euro. They see all kinds of risks from that situation, including money losing value, including moral hazard, free-riding off German taxpayers and the ECB turning into a bad bank. The ECB currently has €1 trillion worth of exposure to weak eurozone economies. It is approaching that. It is loading up on all this relatively poor-quality debt. Of course that has an implication for its credibility in the markets, but more importantly for how it is being perceived by stronger economies, including Germany. It is a political minefield if you ask the ECB to do that.

So, yes, it can do a lot of other things but it is still very much subject to politics.

Q15 The Chairman: I am going to ask our two other witnesses about the ability of the ECB to help. Bear in mind the role of the constitutional court, which may or may not have things to say on moving outside of what is acknowledged within the treaties. Perhaps Mr Rachman and then Professor Minford?

Gideon Rachman: Mr Persson has put the possibilities and the constraints on the ECB very well, actually. I do not have much to add to that. Perhaps I may return to Viscount Brookeborough's question about what the solution might be. It also relates to this question of how right or wrong the Germans might be. I have quite a lot of sympathy for the German position that when we talk about austerity it is not just a mindless process of cutting budgets, but it is also about structural reforms. As the Chairman said, a lot of the structural reforms have not even begun. I was very struck when I was in Greece a few months ago now talking on their education reform. They have this whole university reform going through. No Greek student pays fees. As somebody whose children are going to university, we are subsidising Greece—their kids—essentially. We are paying for their university education, and they stay an average of seven years. I said, "Why do you not introduce just a nominal fee, something?" and the reply was, "Oh, that is against the constitution. We cannot do that. We would need to change the entire Greek constitution to charge Greek students fees". Another example is that they have only just moved to a system where the health service there buys generic drugs rather than hugely costly patented drugs. So there are real reforms that would be good for Greece, would be good for Italy and would be good for Spain. In pushing these reforms, I do not think the Germans are being sadistic occupiers. They are arguing for things that would improve the competitiveness of the individual countries and of the European Union as a whole.

Unfortunately, of course, in the process of structural reform, particularly structural reform that is done in a hurry, there are people who suffer who do not deserve to. But I do not think there can be any question that there is actually a lot of gain out there in the kind of reforms that they might now be compelled to do.

Patrick Minford: The ECB is the key to seeing why the euro is very likely to survive in its present form, plus all the things that have been talked about—this evolution of banking and other sorts of union—simply because, as was shown when it did this long term refinancing operation, it has enormous firepower in the markets. It can go out and buy and it can do open market operations in any bonds it likes. It is completely permitted to do that. Of course, if it says, "Spanish Government bonds are not good enough to do open market operations in", it would be completely outside its permissible zone. It is perfectly allowed to do open market operations in any sovereign bonds in the eurozone area, and any eurobonds, so it has enormous freedom of action. As has been pointed out, they have already done €1 trillion worth of support in the south, buying large amounts of southern debt to the tune of €1 trillion. This kind of amount was originally talked about as the "big bazooka", but they have done it anyway.

The Chairman: Let us come to Lord Jordan who might pursue that point.

Lord Jordan: I wanted to talk about eurobonds but—like my colleague here—I want to hark back to something that has been said now. We have all sympathised with the German position about the reforms that are needed. What I have less sympathy with Germany about is their unwillingness to take an eventual stand on this position. When the banks that are too big to fail or the countries that are too big to fail say "No" to the solution, we then start talking—as we now start to talk—about systems that will enable the present situation to carry on but enable the market to back that situation. The eurobonds were put forward as one solution and we are told that never, never will that come about. But the way we are going, unless we tackle the original problems, eurobonds will be as certain as all the other things they said would never happen.

Q16 The Chairman: Mr Persson, you expressed the view, in particular, that eurobonds feel awfully like solving a debt crisis with more debt. Do you hold to that?

Mats Persson: Yes, I stick to that comment. Absent the strict budget controls that we have been discussing, which are very difficult to achieve politically, introducing eurobonds would be suicide for Europe. It would do two things. First, it would take away pressure for reform as we discussed: structural reforms, labour market reforms, supply side reforms—all those things that are needed in southern Europe in particular. But secondly, it would provide an incentive for spending. Remember, for a great part of the last decade, the markets treated Greece and Germany as the same. They borrowed at similar rates. It did not work out quite as well as perhaps we had hoped.

The eurozone pressing ahead with eurobonds would be déjà vu; you would repeat similar mistakes. I have sympathy with the Germans here as well. The Germans are right when they say, "We need very strict controls and an effective veto of your budgets if you are going to piggyback off our credit rating". That is the only way it will work. I am not saying it is politically achievable, but I am saying that not having that in place will possibly be even worse.

I would say that there are eurobonds and there are eurobonds. We have to separate them when we talk about the concept. Full eurobonds would involve no national borrowing at all, but there are versions of eurobonds that are milder. The Germans could potentially be receptive, eventually, to something known as a debt redemption fund, a proposal that stems from Germany, which would see any debt above 60% of a country's GDP being underwritten jointly, but also then being subject to a wind-down plan or a phasing out plan. Basically, the Germans and other AAA countries would take control over the share above 60% of GDP and then say, "If we take control of this now we will wind it down. We will get rid of it. But we will also underwrite it". That is something that could potentially fly at some point in the future in Germany; but full eurobonds? At the moment absolutely no way. It is just not going to happen and to talk about it and to plan grand schemes around it I think is a waste of time.

Gideon Rachman: Yes, I tend to agree with that. You may have noticed that Angela Merkel said recently, "Eurobonds will not happen in my lifetime". One of the reasons I do not think they are inevitable is that they are too easy to understand. I am not being entirely facetious, because I think that the political presentation of mutualisation, if it is done through a eurobond, is very, very hard to get through, as I say, in Germany. But also not just the Germans, the Dutch and the Finns, and since the EU operates at unanimity they matter.

I do not think you will do it that way, and possibly one of the reasons that the ECB is the only institution that can act is because the understanding of central banking is fairly shallow among the public. They can do all sorts of things, and people do not really realise what they have done or what they are doing. One odd wrinkle is that Germany is one of the few countries in which central banking is a hot political topic for historic reasons. So, by a curious twist of history, it may be one of the few countries where the central bank doing unorthodox things could become highly contentious quite quickly. Nonetheless, the ECB exists. It does have all sorts of powers. Exactly how those powers are being stretched or abused is difficult to understand unless you are very versed in that world. That gives them the wriggle room to act fast. Also, they are not subject to direct political control because of ECB independence. I do think the ECB is probably the only player in town if we get that sudden crisis.

Q17 The Chairman: Professor Minford, do they talk about eurobonds in the pubs of Cardiff and Liverpool?

Patrick Minford: I must say I love this talk about eurobonds, because it seems like it is magic speak for ways to get Germany to pony up more money. The idea is that they might fall for it in eurobonds but they will not fall for it in more overt ways. Clearly, they are not going to fall for it. Germany is perfectly clear about this. I have said this already and I am in agreement with what Mats Persson and Gideon Rachman have said. The basic point of Germany's position is that it will not agree to put any money on the table until it has agreement to these various reforms. But the thing that is making it impossible for Germany to leave the table is the fact they have already had €1 trillion put on to the table by the backdoor, through the TARGET2 balances. Hans Venhuizen—who was the one who crawled over the ECB's balance sheet and brought this out in Germany—has been saying, "The Germans should not put up with this", but of course it has happened to them. There is nothing they can do about it unless they were to withdraw from the euro, in which case these things would become a hole in their balance sheet, pretty much.

Q18 Lord Marlesford: From Germany's point of view, is there any difference between eurobonds and printing euros?

Patrick Minford: Yes. The point is that one they can control, the other they cannot.

Mats Persson: That was the right question, actually. That is a good question, because it may come down to that: which red line is the strongest for Germany? Is it ECB intervention or is it debt pool?

Q19 Lord Jordan: Do any of you think that Germany has a breaking point? Is there something that is on the horizon that would be seen as the deal breaker? Where is it? What is it? At the moment the Macbeth statement has dominated this issue: "I am blood stepped so far". It seems as though there is nothing that can happen that will not stop them carrying on.

Mats Persson: I think that is the right question to ask. The honest answer is we have no idea. We have no idea how far we can push the Germans, but I think it would be quite risky to test that—to test how far we can actually push them. There are three limits that we are approaching quickly in terms of how far we can push the Germans. The first limit, of course, is political. We already see a massive change in tone and rhetoric out of Germany over Europe in general. At Open Europe we have this exercise where we go through the European media every single day and send out a press summary. If you are not already on that, you should be. One of our key sources is the German media, and to see the kind of change in tone in the German media over the last year and a half has been quite extraordinary. Now you see very critical pieces coming out of the German media about Europe and about the need for less Europe. One of the main daily newspapers a couple of weeks ago said, "Let us dare to have less Europe". That would have been unthinkable a few years ago. Meanwhile, the UK Government is calling for more Europe for everyone apart from themselves, so it is quite interesting how that has changed.

I think there is a political limitation. According to an opinion poll last week, 80% of Germans are against eurobonds. That is a greater share than the share of British people who are against the UK joining the euro. There is more opposition to eurobonds in Germany, according to some opinion polls, than there is opposition to the UK joining the euro among the UK public.

The second limitation is economic. It is interesting, because we had an event last week, with Thomas Silberhorn who is one of the German MPs who voted against the bailout. He made the point that if you take contingent liabilities into account, Germany is actually poorer than Italy. He said that Germany has a debt to GDP of 192% if you take those liabilities into account, whereas Italy has a debt of 146%. Clearly, the perception in Germany is, "We cannot carry Europe alone". Particularly as Germany gets older, and its demographic turns against it, that limit will come back and haunt them.

The third one of course is constitutional. The Constitutional Court has said explicitly that debt pooling, involving joint and several liabilities, is not allowed, so that is a constitutional limit. You are looking at those three limits. It is a very long-winded way of saying that those limits are approaching very quickly, and we have no idea whether the Germans will allow them to be stretched.

The Chairman: Lord Flight, I am going to ask you to pursue the last element arising from the summit before we move on to the question of the United Kingdom.

Q20 Lord Flight: I want to ask you about growth. In our paper in February, we made the obvious point that the resumption of growth is the only solution to the financing problems longer term. First of all, what do you think about the compact and the need to pay for a €100 billion programme? Secondly, €10 billion of extra capital for the EIB, I assume, means that the UK will have to subscribe its proportion, but the bigger issue is: can you get growth going while you are having a German haircut and internal devaluation programme, which tends to grind these economies into the dirt and produce social unrest?

Gideon Rachman: Yes, I think that is absolutely the question, and I suspect the answer is "No". The paradox is embodied by François Hollande, who campaigned as the man who would reverse Austerity Europe, add growth to the fiscal pact and so on, and will be claiming victory after the summit saying, "We have this added". But the figure, €100 billion spread across the whole of Europe, is not really going to amount to very much. Indeed, if Hollande sticks to his pledge to try to balance the French budget by 2017, he would be the most austere president in French history. France has not balanced its budget since the mid-1970s, and the Court of Accounts has come up with really quite alarming figures about the soaring levels of French debt, the amounts they will have to cut back. If he makes a good faith effort to do that—I do not know whether he will—far from being the man who restored growth, he would be Mr Austerity.

Patrick Minford: The eurozone has not been a dynamic economy for a very long time, and it is not going to change as a result of anything that came out of the summit. If this is seen in terms of a sort of Keynesian stimulus, clearly it is not possible in the present environment anyway and the amounts are trivial. But because of its situation, it is locked into austerity and the only way to break out of it would be to make the eurozone a dynamic economy, which would mean basically tearing up most of its institutions. It is basically a highly socialised economy—this is the problem—and therefore that is the source of its lack of dynamism. To solve that would be an extremely hard thing to do; in fact, impossible, because of the politics of Europe.

Mats Persson: I would just add very briefly on this so-called growth package—€55 billion of that is old money. It is structural funds that have not been used. For example, if you look at where this is supposed to go in Greece, a lot of the projects that are now being selected for funding are infrastructure projects. The same is the case in Spain and Portugal. A lot of this stuff goes on infrastructure. Spain needs a lot of things. More roads is not one of them. This cash is not equipped to deliver the kind of growth that Professor Minford was talking about. The European Investment Bank is great in theory if you can target investment. But, remember, the ECB just sprayed the Continent with €1 trillion worth of credit through the LTRO programmes. That did not trigger massive lending to small businesses. Why should €10 billion leveraged to €60 billion through the EIB do that? To me, this is just a way to finance or at least a way to meet Hollande's election promises.

Q21 Lord Marlesford: In its conclusions last week the European Council said, "The EU will continue to do everything necessary to put Europe back on the path of smart growth". What does the word "smart" mean?

Mats Persson: It is the opposite to dumb growth—

The Chairman: That is a smart answer, at which point I will ask Lord Kerr to come in.

Q22 Lord Kerr of Kinlochard: Chairman, you wanted us to turn to the impact on the UK and the implications for the UK, and here our witnesses are already on the public record. Mr Persson, you have been saying that UK advice in the crisis is misguided and that we risk locking ourselves into a weak negotiating position. The *FT*—not, I think, Mr Rachman—last week was reporting that the Prime Minister's list of safeguards sought in December, and I think dropped now, may have damaged the UK's standing as Europe's financial centre. Today, Mr Rachman wrote a piece mildly critical of Government policy, and perhaps rather more critical of Mr Fox's proposals for Government policy. I would like to know how you feel we can avoid getting ourselves again into the situation we were in on 9 December.

The European Council this time looked at a text provided by the four presidents, which said, for example, on banking supervision, "The current architecture should evolve as soon as possible towards a single European banking supervision system with a European and national level. The European level would have ultimate responsibility". Now, in his statement to Parliament yesterday, the Prime Minister took great pride in saying that we had ensured—he had ensured—that supervision of British banks would be done by the Bank of England, not by this structure. So we had stepped away from it.

The European Council conclusions show that member states sharing a single currency, and others willing to join the effort, plan to go ahead with this, establishing a supervisory structure under article 127 of the Treaty, which requires Council measures, which means with the Brits in the room. We are not talking about eurozone measures here. In your view, is it likely that we will see most non-eurozone EU members anxious to remain part of this negotiation and possibly even part of that supervisory structure, if it ever comes into existence? Will we again find ourselves stuck with only the odd Czech for company? Did you notice that the last Galapagos Pinto turtle, Lonesome George, died the other day, the last of his breed; nobody to have intercourse with for 35 years? Are you looking forward to our position with ECOFIN?

Gideon Rachman: I think I was slightly less alarmed than you by what happened in December. I do not think Britain handled it particularly well. But the reason I was less alarmed by this is that, as many people have said, this is a process that is unfolding over a decade and, although a particular Council meeting might seem like it has a very dramatic outcome, the idea that this is going to be set in stone and that everything they say will actually happen I am not so sure. You yourself will have bitter memories of sitting through a constitutional convention for two years, which then eventually the Dutch and the French vote against and things that seemed terribly important do not become so important. So I do not think the British handled it well, but the idea that this marked some catastrophic breakdown, I am not so sure, because I think there are other catastrophes going in Europe that may be more serious than that.

There are a couple of paradoxes, though, in British policy at the moment as regards the City and banking supervision and all that. The first is—if you just pick up the papers here—there is an anti-City, anti-banks frenzy going on inside the UK, that we go to Brussels and say, "But we must defend these institutions at all costs", and we do not appear to have resolved that rather peculiar dichotomy in our minds. The second is that I do not think that the Government has acknowledged, maybe even fully to itself, what is entailed in urging deeper integration on the Europeans while saying, "We want to stand aside". I can see why they are doing it. I do not want to psychoanalyse the Prime Minister and the Chancellor, but my guess is they are eurosceptics but that they have been told, "If the euro collapses, it is an economic disaster for us. The only way to avoid this is to have close integration, so you have to back that", and that is what they are doing. But if the Europeans succeed in this deeper fiscal transfer/political union, inevitably that becomes the centre of the European Union and our argument that, "We are full members of the single market and that is really what the EU is all about, and therefore our privileges and rights are not affected", whatever the legal position. If you really do have a political union of 17 nations within the EU, surely that sets the rules. Then, at a certain point, how long are they going to be prepared to tolerate their major financial centre not being inside that core Europe? As powerful states do, will they not start throwing their weight around and pressurising the neighbours? I think that is an inevitable process. I do not know how we resolve that paradox, but we should at least be acknowledging the trade-offs more openly, rather than simply saying, "They can proceed with this political union. It does not affect our status within the EU or our bargaining power within the EU at all".

Patrick Minford: I very much agree with what Gideon Rachman said. It is extremely difficult for us because this is going to be an ongoing process, and I think that, while the single market will stay there in name, there will be enormous pressures on it from this process. Because of this process of the eurozone coming together, all these regulations will be put on the various member states and with the enormous urgency of getting them to grow somehow and sell stuff to people, I think it will become a very protectionist organisation, and the single market will be under huge pressure from the protectionism that the main members of it, the eurozone members, will feel they want to create.

There will also be all sorts of regulatory pressures inside the eurozone, obviously including the banking area that has been talked about. I think this will spill over through qualified majority voting into the institutions of the EU itself. I do not think there is any way of insulating us from the pressures that will emanate from this eurozone integration process, and I do not see this as at all good for our interests in the UK. We would benefit from free trade, we benefit from competition, we benefit from the extension of the single market to services, but we already have a very free market in services. We are already very much penalised economically by being members of the EU unfortunately, and this will increase the penalty substantially. I am not surprised that neither Mr Cameron nor Mr Osborne wants to talk about this very much, because the logic of it is extremely uncomfortable. The logic leads to exit from the EU. That is the thing they are wrestling with, and nobody wants to put that on the table too early and nobody wants to cry wolf either, because obviously nobody knows what is going to happen in the future. As has been pointed out, some huge crisis could engulf the whole thing and it might just all break up, as Mr Rachman has said. But if we are talking about probabilities of how this thing might evolve, I think the evolution towards an inward-looking euro-zone a strongly probable outcome.

Q23 The Chairman: Mr Persson, could you take on board Lord Kerr's point, that this may not be restricted to EU 17 but may gather other non-euro members as well so that Britain alone will be there without even a Czech mate?

Mats Persson: Yes. This is such a big discussion. It is difficult to know where to put the focal point, but these are legitimate points. I would say three things. The first one is on Cameron's

December veto. It was interesting because he gave a taste of where we may be headed. It was not ideal; it was not handled particularly well. Open Europe published a little note shortly afterwards that said, "Ten lessons from Cameron's EU veto", which I highly recommend you to read, Lord Kerr, where we basically set out what the UK Government could have done better diplomatically in the preparation and the rest of it. We were never unreservedly in support of this December veto.

However, it is very interesting to see the very, very strong reactions from all kinds of people saying that, "This is it. Britain is now falling out of the EU. Britain has lost all credibility. Its influence has gone", and so forth. The broadcast media in Britain, for all the Euroscepticism that Britain is supposed to represent, descended on Cameron's decision like a ton of bricks. But I always ask this question: name one concrete policy area where Britain has lost influence since December. Can someone do that? Give me one concrete policy example, one proposal where Britain has lost influence?

Lord Kerr of Kinlochard: Where Britain has—

Mats Persson: Where Britain has lost influence since the December veto. Can you name me one area?

Lord Kerr of Kinlochard: I am quite sure the whole area of banking regulation. There is absolutely no doubt about that.

Mats Persson: But give me one specific proposal.

Q24 Lord Kerr of Kinlochard: It used to be the case—and it is still the case historically—that the Germans have never voted the British down on any financial services directive or regulation, never. Because if the British had been in a tight corner and had difficulty creating a qualified minority, it was always possible to appeal to the Chancellery and that always worked, just as, sadly, the French could do the same in agriculture and the Germans never voted them down.

Mats Persson: Yes, but is there any specific example?

Q25 Lord Kerr of Kinlochard: It is perfectly clear that Mrs Merkel takes a different view. When some of the pieces of legislation that we look at it in this Committee—MiFID, for example—come to a vote in Brussels, it is perfectly clear that the Germans are going to vote against us. I do not say that is only because of 9 December, but it is because the Germans have lost sympathy with the British. They are not sure that we want the game to succeed.

Mats Persson: I agree with that. But my point is simply that it is very difficult to pinpoint concrete examples. The debate needs to move on beyond abstract influence to specifics. Yes, go on; sorry.

Q26 Lord Jordan: The financial transaction tax has become more of a reality than it was before that.

Mats Persson: The financial transaction tax has become more of a reality, but Britain has a veto there.

Lord Jordan: I am not sure—

Mats Persson: My point is simply this: too long has the debate in Britain been about the abstract, back and forth, Westminster concept, such as influence and sovereignty. What a banking union and further fiscal integration will require of Britain is to focus its mind on what exactly it does want to influence. It is not enough to say, "Whatever we do, we are going to lose influence". I agree that the December veto was not ideal, but the reaction to it was ridiculous. Instead of informed debate, we talked about loss of influence or, "We are now falling out of the EU". Let us step back and have a mature, grown-up discussion about what Britain needs to influence as the eurozone integrates further.

This is where the legitimate questions come into the picture, and this is where I come back to my previous point: that the banking union has two risks. On the one hand, potential discrimination against UK firms; on the other hand, supervision will spill over to regulation with the 17 writing rules for all 27. Is there anything Britain can do to prevent that? Because clearly Britain cannot join a banking union, right, or do you propose that Britain should join the banking union?

Q27 Lord Kerr of Kinlochard: Would I?

Mats Persson: Yes, would you propose that Britain join the banking union?

Q28 Lord Kerr of Kinlochard: I would want to be in the Swedish position. I would want to be in a position to be in the room and taking part in the negotiations. I would predict that the Swedes will go in with the ECSB's supervisory structure and will take care to make sure that the central element of it is not too strong, relative to the national element of it. It is a great pity that we have said we want absolutely no part in it. Fortunately, the discussion is going to take place in full Council, because the proposal is going to come under an existing Treaty article. There is no question about a new inter-governmental discussion from which we will be barred, so it is a better situation than December.

Mats Persson: You need to go to Stockholm more often, because the Swedes have said they absolutely will not take part. They will open up at some point in the future, but they will never take part in a resolution scheme, because they have a paid-up system already to backstop the funds. They would be crazy to go into that. Are you saying that they will go in, as one of the few countries that has a paid-up resolution fund? It is not only based on theoretical guarantees, it is actually paid-up because they have learnt their lessons from the 1990s. They will not go into a resolution fund—no way—but you are right of course that the Swedes are better at cultivating a relationship with Germany and I think that is where the discussion should be at. How can the UK try to secure the single market by moving closer to the Germans and other AAA economies? In order to do that, it has to get away from this ridiculous position that it is in at the moment, where it is actively calling itself for banking union, for fiscal union, for eurobonds and the rest of it. That makes its negotiating position contradictory because it then says, "We wanted to press ahead with the banking union and the Treaty changes entailed with that, but we will veto the Treaty changes if you press ahead with it in return for safeguards". It does not make sense. It is what we call "Eurosceptic fiscal federalism". It is a new belief system, so that is my point. My point is we just have to say, "What exactly do we want to influence and what is the best diplomatic route to achieve influence over the single market?" and keep the gap between the single market and banking as narrow as possible. I think that is possible. I am an optimist.

Q29 The Chairman: Colleagues, we are in the home run, so I am going to shortly invite our witnesses to offer one or two concluding thoughts. We had intended to talk a little more about individual countries, but I feel for the most part you have responded to the position of Italy, Spain, Germany and Greece. But, Mr Rachman, you said you would not psychoanalyse the Prime Minister. I am going to be daring enough to make some psychoanalysis, which is that I get the sense, both with him and with the Chancellor to some degree and with Mr Lidington, that they go over and they talk and meet their colleagues—

our colleagues in the other 26 member states—and they come back slightly infected with the enthusiasm and the drive towards finding some kind of solution to all this. Is it not the case that in Britain we find ourselves astonished that actually reflected in those opinion polls, whether it is indeed Greece about staying in the euro or the Germans and so on, there seems to be a unanimity of purpose that perhaps gathers round the idea of muddling through. There is this concept of Europe, which we talked about earlier, from which we exclude ourselves. I would like to ask all three of you how you respond to that, but also where you see the United Kingdom perhaps in a year's time, perhaps in five years' time? As I say, if you would like to introduce any concluding thoughts, I would be most grateful. Let me start with Mr Rachman.

Gideon Rachman: If the Prime Minister and the Chancellor do go over there and get infected by some collegiate spirit, that is no bad thing. That is what the EU is meant to do. It is a good thing if they understand the viewpoint of their European counterparts. For those who worry that they are going to go native, they will have a powerful corrective applied as soon as they get back to Westminster, so there will be some sort of balance.

That said, how is this going to conclude and where will Britain be in five years' time? You said we have talked a little bit about countries. One country we perhaps should have talked a little bit more about—and I will do so now—is Italy, because I think if there is going to be a crisis it will be provoked by Italian funding requirements. Italy has almost €2 trillion worth of outstanding debt, a lot of which has to be rolled over in the next few years. There are two ways in which Italy could provoke a crisis. The first is simply if there is a failure at the bond auction. If they get taken out of the markets and they cannot fund themselves from the markets, that will be an enormous dilemma. If you talk to the IMF in Washington, they will tell you that there simply is not the money for an Italian bailout. At all costs Italy has to be kept in the markets because their funding requirements are so enormous. If Italy cannot borrow from the markets, then you have a real meltdown. We talked about what the trigger point might be for Germany. It might be when the Italians come calling. Bailing Greece out or bailing Ireland out is one thing, but trying to bail Italy out is just not feasible. That could be the final crisis. Even if Italy avoids that scenario—call that the heart attack—there is the danger of slow suffocation because even if they keep rolling their debt over, more and more of its finance will be at this new higher interest rate of 5% or 6% as opposed to the 2% or 3% on which their original calculations were made. So the pressure on their budget becomes higher and higher and more austerity measures are needed. You get into a vicious cycle. We are familiar with Greece, where the whole economy goes into a sort of downward debt-driven spiral. For a huge economy like Italy, a central political economic player, that is where the crisis will come.

Looking ahead five years for Britain or anyone, given the possibility of a disorderly crisis, is really quite hard because, once things start to break down, you do not quite know how it will play out. I would say though—and Lord Kerr referred today to the piece I wrote—that as things get worse, and they will, whether through this grinding effect of austerity or through the southern crisis, relations between European states will deteriorate. It is going to be important that Britain does not allow a narrative to prevail that says, "This is all because of Anglo-Saxon capitalism", which actually is quite a powerful argument. We hear it quite a lot in Brussels. There are some people who want to blame the Germans; some want to blame the southern Europeans. There is a whole bunch of people out there who want to say, "Actually, it is Britain, it is Wall Street. They always wanted to destroy this project", and, if that becomes the dominant narrative in Europe, that is very dangerous to Britain, because at that point all sorts of measures start being wheeled forward.

One way of thinking about influence is partly in the very concrete way that Lord Kerr and Mats Persson refer to this directive or that directive. Of course that is the daily stuff of diplomacy: how do you advance our interests or block particular threats to our interests? But there is a broader question of influence that needs to be thought about, and that is: how do we shape the debate? How do we make sure that as people say, as they will, "What has gone wrong?" they do not say, "Well, actually it is this whole system of capitalism that the Brits have pushed on us and we are now going to take our revenge on it". That would be a real threat to us.

Patrick Minford: I am quite gloomy about the prospects, from the UK's point of view, pretty much on either scenario, really. If Gideon is right and the whole thing breaks up, then that would be pretty damaging to the institutions of the EU and with very unknowable consequences for them. If, which is more probable, they muddle through the next decade in a more or less ongoing monthly crisis, then I think it is also quite a problem from our point of view because of the things I said earlier. They will integrate more and more. They will bring in more regulations. There will be pressures for protectionism. Although, as Lord Kerr says, it is tempting to think in terms of influencing all this, I think we are going to have very little influence on it and we are going to become increasingly semi-detached. As is more and more the case, our trade will be diverted to the east and to other much faster growing markets. We will have to make a choice at some point of whether we become entirely detached, modestly detached or just continue muddling through into ever greater semi-detachment.

Q30 The Chairman: Mr Persson, semi-detached?

Mats Persson: Just happily and comfortably within the European Union, I think. That should be the end goal, whether you call it semi-detached, detached or a fully fledged member. The point for Britain is to find a model for itself in Europe, which makes sense for it and which can reconcile European engagement with public opinion. That is the goal of any Government and should be for Britain as well. I am a bit more optimistic. I think that the British relationship with Europe has to change. Whether the eurozone breaks up or whether the eurozone goes for further integration, it has to change. We know that. It will have to be something different. But it is possible for the UK to remain a full member of the single market and of the customs union, to trade with Europe and still allow for the eurozone to integrate further. There are a lot of pragmatic solutions between the full acquis communautaire and becoming like Turkey. I think there are options in between that should be explored. We have not looked at any little specific measures today, but we can have an institutional change that acts as a safeguard; for example, a single market protocol that allows non-eurozone countries to take a separate vote in exceptional circumstances. That will be a massive deterrent for the eurozone to start using caucusing both at a supervision level and at a regulation level. There are a number of different options that can be explored, so I do not think we should be overly gloomy about Britain's role in Europe. There is a way forward that would allow Britain to trade with Europe, to be happy in Europe and still reconcile EU membership with public opinion here at home.

The Chairman: Gideon Rachman, Mats Persson, Professor Patrick Minford, the Committee is enormously indebted to you. We will be making a transcript of this exchange. We will return it to you and hope that you can correct it. But there may be other things that you wish to update the Committee on, as it concludes its deliberations and before we write our letter. We are very grateful to you. In conclusion, I would like to say you have given us a range of smart answers to what I hope have not been questions that were too dumb. You have ranged from the Galapagos turtles, to Banquo's ghost, austerity and football, with an expertise and an intelligence that this Committee enormously values. We thank all three of you for coming here this afternoon. Thank you very much.

Mats Persson, Director, Open Europe – Oral evidence (QQ 1-30)

Transcript to be found under Patrick Minford, Professor of Applied Economics, Cardiff Business School

Gideon Rachman, Chief Foreign Affairs Columnist, Financial Times – Oral evidence (QQ1-30)

Transcript to be found under Patrick Minford, Professor of Applied Economics, Cardiff Business School