HOUSE OF LORDS

Library Note

Debate on 16 February: Recent Developments in the European Union

This Library Note considers reaction to recent developments in the EU, ahead of the debate in the House of Lords on 16 February 2012. The first section concentrates on the agreement by 25 of the 27 EU member states of a new fiscal compact on 9 December 2011, and the agreement of the text putting it into practice on 30 January 2012. The second section examines comment on the decision by the Prime Minister to refuse to agree a new EU treaty change.

For a chronology of the events prior to the signing of the Draft International Agreement and further analysis of the negotiations and their impact, see House of Commons Library Standard Note, *The Draft International Agreement on a Reinforced Economic Union* (26 January 2012, SN/06199). A list of other briefing documents is available at the end of this Note.

A further House of Lords Library Note, *The European Union Today* (9 February 2012, LLN 2012/003) provides a broad outline of the history and development of the EU.

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1. Reactions to the Agreement of the Fiscal Compact

On 8 and 9 December the 17 Eurozone countries agreed on a fiscal compact. Nine out of the ten non-Eurozone countries (all but the UK) indicated the possibility of taking part. On 30 January 2012, 25 of the 27 European Union (EU) leaders agreed a Draft International Agreement on a Reinforced Economic Union. It was also agreed that the European Stability Mechanism would come into effect from July 2012.The UK Government decided at the December summit not to participate in the fiscal compact agreement, and the Czech government withdrew at the 30 January summit. Further details of a plan to ensure the stability of the Eurozone are still to be finalised, with a European Council Summit to be convened in March 2012.

Anatole Kaletsky, writing in the *Times*, argues that the Draft International Agreement is skewed towards Germany's demands for greater austerity and that it will not save the euro from collapse:

> If [German Chancellor, Angela] Merkel succeeds in imposing her present one-sided Treaty, and if her demands are taken literally, then the euro will surely collapse. The Treaty as it stands gives Ms Merkel everything she demanded while offering nothing in return. Greece and the other debtors are condemned to endless austerity and German economic colonisation, with no reciprocal benefits, since joint debt guarantees or monetary easing have been ruled out.
>
> (*Times*, 'Crises and bailouts are what's best for the euro', 2 February 2012)

The *Economist* contends that the enforcement of fiscal discipline through the fiscal compact insisted upon by the German Government will cause popular resentment against EU institutions:

> Citizens are thus left feeling impotent. Their Governments are eviscerated at home, yet voters lack the means to throw the bums out of Brussels. This is dangerous. Bringing debt under control and, more importantly, promoting reforms to boost growth, will take years of sacrifice and suffering. It can be sustained only with a strong national mandate. Without that, both Governments and the EU will eventually be discredited.
>
> (*Economist*, 'Charlemagne—Angela the lawgiver', 4 February 2012)

Kevin O'Rourke, Chichele Professor of Economic History at the University of Oxford, also believes that pursuing austerity regardless of whether demand is strong enough to ensure adequate growth will lead to the collapse of the euro:

> Rather than creating an inter-regional insurance mechanism involving counter-cyclical transfers, the version on offer would constitutionalise pro-cyclical adjustment in recession-hit countries, with no countervailing measures to boost demand elsewhere in the Eurozone. Describing this as a "fiscal union", as some have done, constitutes a near-Orwellian abuse of language.
>
> (Project-syndicate website, 'A Summit to the Death', 9 December 2011)

A more optimistic view of Europe's handling of the crisis is offered by C Fred Bergsten, Director of the Peterson Institute for International Economics. He accepts that EU leaders have been unable to offer the markets a clear statement on how the EU will ensure growth while enforcing fiscal discipline for fear of antagonising their electorates.

However, the EU is evolving new structures which are enabling it to avert a financial crisis:

> European institutions have demonstrated that they can both mount successful crisis responses and evolve rather dramatically toward plugging the huge gaps in the economic and monetary union. The European Financial Support Facility (EFSF) is rapidly becoming a European monetary fund that, along with the European Central Bank (ECB) can attach tough conditions in return for the money provided to troubled countries and institutions. The EFSF also represents the embryo of the eventually inevitable fiscal union of the Eurozone. The European Banking Authority is en route to becoming a Eurozone-wide financial regulator and supervisor. More importantly, for a long period of time, the ECB lent without limit as needed to quell each successive round of the crisis.
>
> (*Prospect*, 'Europe's Done Well', December 2011, pp 18–20)

Jean Pisani-Ferry, Director of the European think tank Bruegel, believes that the focus on austerity can help Eurozone countries reform their economies to make them more competitive. However, this can only work as part of an effective growth programme for the Eurozone:

> Buffers from market pressures can indeed slow down reforms. This was vividly illustrated last August when Rome backtracked on tax reform commitments a few days after the European Central Bank started buying Italian bonds. However, austerity and reform are not always complementary.
>
> ... Governments under extreme intense pressure may have no choice but to do everything at once, but when political capital is scarce, prioritising fiscal consolidation is usually at the expense of reforms. Reforms may also involve budgetary costs, if those who lose from them need to be compensated.
>
> (Bruegel website, 'How to Make the Eurozone's Strategy Effective', 6 February 2012)

1.1 Balancing Fiscal Discipline with Growth

As the EU continues to develop a plan for recovery, the need for fiscal discipline and for growth and investment have pulled the negotiations in two separate directions. The *Times* reports that, prior to the agreement of 30 January 2012, Chancellor Merkel said that the emphasis of the future March 2012 summit would be ensuring recovery and growth in the Eurozone. However, she insisted that Germany could not take on an open-ended financial commitment in support of weaker states as this would endanger Germany's own fiscal standing. Chancellor Merkel also called for a strengthening of the decision making structure in the EU, calling for greater integration (*Times*, 'Germany will not Ride to Euro's Rescue, says Merkel', 26 January 2012, pp 32–3).

Christine Lagarde, Managing Director of the International Monetary Fund (IMF), states that one of the key imperatives to ensuring a recovery, alongside the development of a larger firewall and deeper integration, must be stronger growth:

> On fiscal policy, resorting to across-the-board, across-the continent, budgetary cuts will only add to recessionary pressures. Yes, several countries have no choice but to tighten public finances, sharply and quickly. But this is not true everywhere. There is a large core where fiscal adjustment can be more gradual. Automatic stabilizers, which let tax revenues fall and spending rise as the

> economy weakens, should certainly be allowed to operate. And those with fiscal space should support the common effort by reconsidering the pace of adjustment planned for this year.
>
> (IMF website, 'Global Challenges in 2012', 23 January 2012)

Martin Schulz MEP, current President of the European Parliament and Leader of the Socialists and Democrats Group, suggests that the decisive action needed to save the euro must include a new role for the ECB and the issuing of eurobonds:

> I think what we need are decisions about the role of the European Central Bank. Is the ECB for some member states in the Eurozone a kind of lender of last resort? In my eyes, yes, but then we should confirm it. Then, we should decide how far-reaching the measures taken by the ECB should go. This is important because the ECB board must know the position of the member states.
>
> Secondly, we need a decision about eurobonds and in the case there will be no eurobonds, because Germany is against it, then they should explain to us what they propose, [German Chancellor Angela] Merkel and [French President Nicolas] Sarkozy, by saying what they anticipate for the European Stability Mechanism.
>
> They could anticipate a sort of a bank licence, where the ESM could act as a bank and lend money to the states at risk with appropriate interest rates or not? This is I what I expect. It is a pity, the tendency in preparing the summit is not to deal with the problem, but rather talk about the treaty change.
>
> (EurActiv website, 'Schulz: Merkel-Sarkozy, the couple of contradictions', 8 December 2011, updated 9 December 2011)

The demand for creditor countries to do more to lower borrowing costs has also been made by the Italian Prime Minister, Mario Monti. Martin Wolf, writing in the *Financial Times*, notes that the new Italian Prime Minister is in a strong position to argue for this, given he is "a well-respected official with staunchly pro-European views and a strong sympathy for German attitudes to competition and fiscal and monetary stability". Wolf goes on to say that Italy must be able to borrow more cheaply for the euro to survive:

> In Italy's case for example, the combination of high interest rates and vulnerable banks with fiscal austerity is likely to lead to a lengthy and deep recession and so to a rise in cyclical deficits as the structural deficit falls. For a big country to deflate its way to health, in these circumstances, is a labour of Sisyphus. No modern democracy has infinite patience.
>
> (*Financial Times*, 'Why the Super-Marios Need Help', 18 January 2012, p 9)

1.2 Political Dimension

The immediate fate of the fiscal compact has been questioned in response to the commitment by the Socialist candidate for the French Presidency, François Hollande, to renegotiate the compact if he comes to power (*Irish Times*, 'European Left Targets German Compact in Move to Gather Support', 27 January 2012).

In an interview with European newspapers, including the *Guardian*, Chancellor Merkel has defended her role in the negotiations, by arguing that she has provided decisive action to preserve the EU:

> German idealism appears to be reviving in the Berlin chancellery. But Merkel underlined that this is no longer enough if Europe is to escape decline, defeatism, and increasing irrelevance in the world.
>
> "I don't want the EU to be a museum for all the things that used to be good. I want an EU which successfully strives to create new things. I know that this implies a massive change for some people, and that we will therefore need one another's support.
>
> If, however, we balk at these efforts, and just treat one another with kid gloves and water down any attempts at reform, we will definitely be doing Europe a disservice".
>
> (*Guardian*, 'Angela Merkel discovers her inner European', 25 January 2012)

The emphasis on preserving and strengthening the EU comes in the face of domestic pressure on the German Chancellor to let Greece leave the euro. In its editorial following the summit on 30 January, newspaper *Die Welt* (quoted in an article on the Spiegel International website) asserts:

> In order to rescue their state and their sovereignty, the Greeks have to leave the Eurozone. They owe it to themselves. They have to go their own way with the freedom afforded by exchange rate movements and with a strong stimulus of economic growth.
>
> (Spiegel Online International, 'The World from Berlin—Germany's Power 'Is Causing Fear' in Europe', 1 February 2012)

Honor Mahony, Brussels Editor of the EUobserver blog, argues that Chancellor Merkel is walking a tightrope, attempting to please her backbenchers while not alienating her EU allies (EUobserver blog, 'The Political Tightrope', 31 January 2012). She suggests that the need for an agreement for a fiscal compact is driven primarily by the desire to ensure German support for any future recovery package:

> Germany needs some sort of pact that makes it look like it will be almost impossible for member states to be big and careless spenders in the future. A fiscal straitjacket. The document could then be served up when Germans are feeling unenthusiastic about mutualising Eurozone debt, or greater involvement of the European Central Bank, for example. The problem is most of what is in the slim draft (now 16 articles) could simply be done using the normal EU law-making procedures. The six-pack of economic governance legislation—in place since mid-December—already represents a ground-breaking shift in Brussels' relations with member states when it comes to budget matters. New legislation, announced in November, consolidates these budgetary powers still further, giving the commission even greater discretionary powers over national spending. So what is left? Not much but still two things to which Berlin remains very attached—a constitutional debt brake and automatic sanctions for excessive deficit countries. These cannot be done via the current treaties.
>
> (EUobserver blog, 'The Emperor's New Treaty', 12 January 2012)

1.3 Ramifications for the EU

Chancellor Merkel's commitment to preserve the EU comes at the same time as a commitment to push towards further integration. Lord Mandelson, writing in *Prospect*, argues that the French and German political leadership are advancing a new decision making framework for the EU which will marginalise the European Commission:

> The governance of the Eurozone will develop its own instruments and working methods which depend less on the European Commission—France and Germany will see to that, because of their antipathy to the Commission and their desire to keep the direction of the Eurozone the purview of Paris and Berlin. Inexorably the institutional motor that has set the EU's direction since inception will be weakened in favour of the Eurozone.
>
> (*Prospect*, 'Cameron's Euro Dilemma', 16 November 2011, pp 15–16)

Economist Martin Feldstein has criticised the drive to centralise economic policy in the Eurozone area. He argues that a single currency must inevitably fail if imposed on a collection of countries as heterogeneous as the countries of the euro:

> Although the form of political union advocated by Germany and others remains vague, it would not involve centralised revenue collection, as in the US, because that would place a greater burden on German taxpayers to finance government programs in other countries. Nor would political union enhance labour mobility within the Eurozone, overcome the problems caused by imposing a common monetary policy on countries with different cyclical conditions, or improve the trade performance of countries that cannot devalue their exchange rates to regain competitiveness.
>
> (Project-syndicate website, 'Europe is Not the United States', 29 November 2011)

The view that the euro will inevitably fail because of structural tensions has been rebuked by former European Commissioner, Jacques Delors. In an interview given to the *Daily Telegraph*, Delors contends that the problems the EU faces are the result not of the architecture of the single currency but of the way in which the policy was enacted. The only viable way of creating a single currency without the apparatus of a single state would be through the creation of common economic policies "founded on the co-operation of the member states":

> There was also a problem of "surveillance". The Council of Ministers should have made it its business to police the Eurozone economies and make sure that the member states really were following the criteria of economic convergence. This did not happen.
>
> For a long time, the euro did remarkably well, M Delors argues, bringing growth, reform and price stability to the weaker members as well as the stronger. But there was a reluctance to address any of the problems. "The finance ministers did not want to see anything disagreeable which they would be forced to deal with". Then the global credit crisis struck, and all the defects were exposed.
>
> (*Daily Telegraph*, 'Euro would have been stronger if it had been built to my plan says Jacques Delors', 3 December 2011, p 4)

2. Reactions to David Cameron's Veto of a New EU Treaty

The decision by the Prime Minister, David Cameron, to veto a new EU treaty change has been debated at length in the UK press and amongst commentators.

Rafael Behr, Chief Political Commentator for the *New Statesman*, argues that the Prime Minister's decision has left the UK marginalised in Europe, preventing the UK from having an influence on the shape of the single market:

> The so-called Eurozone-plus group will surely end up fiddling in areas in which the UK would traditionally insist on having a say—financial regulation, tax co-ordination, competition policy. Except, unlike in past negotiations, Britain starts off on the wrong side of the door. Cameron has yet to get into the room to fight a battle to secure the national interest, despite having sold it in advance as a famous victory.
>
> (*New Statesman*, 'We're heading for the exit but this is no sceptic's fantasy', 30 January 2012)

Andrew Rawnsley, writing in the *Observer*, states that the use of the veto has gained nothing for the UK. He suggests that the Prime Minister's negotiating position was already weak even before the summit:

> [The] question British ministers have to ask themselves is why did Nicolas Sarkozy find it so easy to isolate David Cameron, cast him as the most unreasonable person in the room and maroon Britain in a minority of one? One reason it was pretty easy was because of earlier decisions made by Mr Cameron that had already marginalised him. He had previously chosen isolation when he took the Conservatives out of the European People's Party, the mainstream grouping of centre-right parties. If he thought then that this was a cost-free gesture to his sceptics, he ought to know better now. He was not present at either a pre-summit gathering of the EPP in Marseilles or a Brussels dinner on the eve of the negotiations when President Sarkozy, Chancellor Merkel and other key leaders fixed many of their positions. The Prime Minister might have been in a less hopeless position had he not excluded himself from these crucial gatherings.
>
> (*Guardian*, 'Now it's a Three Speed Europe. And We're Left on the Hard Shoulder', 11 December 2011)

There is also support in the press for the position taken by the Prime Minister. Simon Jenkins, writing in the *Guardian,* argues that the Prime Minister was correct to distance the UK from the fiscal compact. He thinks that it was in fact in the EU's best interest that the 25 EU states have had to pursue an international agreement rather than a treaty change:

> Cameron must have been right to stand aloof from what looks a hopeless last stand in defence of a common currency—even though, bizarrely, he wants the euro rescued. Another grandiose treaty seeking ever more intervention for Brussels would have triggered a series of probably disastrous national referendums. Cameron performed Europe a good deed in vetoing that.
>
> (*Guardian*, 'Europe's hopeless last stand in defence of the single currency', 13 December 2011)

Simon Jenkins goes on to contend that the Prime Minister "was right to plead the cause of the simpler disciplines of the single market against the baroque authoritarianism of the Franco-German treaty" (ibid).

In the *Times*, Daniel Finkelstein argues that because the Eurozone must move closer towards political union to stabilise the single currency, the UK's isolation is an inevitable consequence of the decision not to join the euro:

> [The euro] cannot possibly work without large transfers of resources between nations, as inhabitants of more competitive nations are forced to sponsor less effective ones. Naturally voters in countries doing the sponsoring demand control of the decisions made by those that they are subsidising. And the voters in subsidised nations resent the restrictions imposed upon them.
>
> The only possible way to reduce such tensions, even just a little, is to attempt to create a political union.
>
> ... just as the euro has created a logic for its members, so it has created one for us. And we were presented with its consequences last week.
>
> (*Times*, 'We've been isolated for 20 years. Get used to it', 14 December 2011, p 27)

Michael J Geary, Lecturer in the History of European Integration at Maastricht University, and Kevin A Lees, Associate with Latham and Watkins LLP, believe that the Prime Minister's decision to veto changes to the existing EU treaties was inevitable given the history of Britain's relations with the EU:

> Deeper integration, even in an effort to save the euro and forestall a financial crisis that could leave the UK in deep recession, was always going to spook Cameron's Tory backbenchers. After having avoided the straitjacket of a one-size-fits-all monetary policy, no British prime minister could reasonably accede sovereignty over fiscal policy as well.
>
> (EurActiv website, 'Britain and the European Union: Continuity or Rupture?', 13 December 2011, updated 22 December 2011)

Northern Ireland Secretary, Owen Paterson, argues in an interview with the *Spectator* that the use of the UK's veto provides an opportunity for a renegotiation of Britain's relationship with the Eurozone countries:

> There is no question, if they effectively create a new country, that is absolutely their right to do so. It does run counter, of course, to 300 years of British foreign policy in trying to avoid that happening. But if that is the way out of the conundrum on the euro, I think we have to respect that. But they have to respect the fact that it will create a brand-new relationship for us.
>
> (*Spectator*, 'A new deal for Britain', 10 December 2011)

Conservative MEP Daniel Hannan is critical of the Prime Minister's agreement to allow the use of EU institutions to police the new fiscal compact, arguing that this has critically undermined the bargaining position gained by the Prime Minister by the use of the veto:

> In theory, their accord is an intergovernmental agreement among 25 countries that just happen to be EU members. In practice, it draws fully on the EU's

> institutional structure, specifying regular meetings with the European Parliament, for instance, and laying down that penalties will be applied by the European Court of Justice. Such things have absolutely no legal basis. A sub-group of EU states can no more decree meetings with the European Parliament than with the Japanese diet; no more rely on the ECJ for arbitration than on the Supreme Court of Mauritius. Yet Britain has raised no objection to this flagrant illegality.
>
> (*Guardian*, 'David Cameron has Allowed Europe to say FU to its People', 31 January 2012)

The *Daily Telegraph* reports that the Prime Minister has stated that if these institutions are used to damage the UK's national interests then legal avenues will be pursued. This would be on the basis that any encroachment by the international agreement on the current purview of the European Union would be illegal (*Daily Telegraph*, 'Cameron will Sue if Euro Pact Nations Threaten Britain', 1 February 2012, p 4).

Another reaction to the use of the veto has been the launch of the campaign for a referendum on the UK's membership of the EU. Natascha Engel, Labour MP for North East Derbyshire, writing in the *Guardian*, calls for support for the cross party People's Pledge campaign for a referendum:

> A new European political and economic architecture is being created, which may or may not see the Eurozone survive, and if it does, in a very different form. Yet the public can only act as spectators. It is this sort of arrogance that voters recoil from; it is why people don't see the point in getting involved in politics. They are allowed a say only in matters that aren't considered too important.
>
> (*Guardian*, 'Let the British people decide whether they still want to be part of the EU', 29 January 2012)

2.1 Impact on the City of London and Other Financial Centres

One of the primary reasons given by the Prime Minister for the use of the veto was to ensure the ability of the City of London to operate as a globally competitive marketplace. David Lascelles, Senior Fellow of the Centre for the Study of Financial Innovation, characterises the impact of the veto on the City as mixed, with the one constant being uncertainty:

> In its soul, the City of London will welcome last week's events. Europe's largest financial centre has grown increasingly Eurosceptic over recent years, viewing the rest of the European Union as obsessed with regulation and hostile to financial markets. Any move that creates a greater distance between London and Brussels can only be good news.
>
> Clouding the whole picture is the uncertainty about what happens next. Although there are some in the City who would welcome a total break with the EU, the majority would support some kind of engagement and need to know where it is now heading. Here Mr Cameron's unexpectedly stubborn stance has prompted concern.
>
> (*Financial Times*, 'Square Mile Stares into a Vacuum', 15 December 2011)

The regulation of financial markets in the EU has yet to be agreed amongst European leaders with measures on regulation and taxation expected to form part of any final agreement. The French President, Nicolas Sarkozy, has announced that France will unilaterally impose its own tax on financial transactions in August 2012, regardless of whether the European Union agrees to impose such a tax (*Guardian*, 'France plans Tobin tax on financial transactions', 30 January 2012).

Secretary of State for Business, Innovation and Skills, Vince Cable, argues in the *Guardian* that the UK must fight its corner in negotiations over new reforms in the face of European opposition:

> The current pipeline of EU proposals includes some areas genuinely in need of reform—like rules for trading in derivatives or to tackle conflicts of interest in rating agencies. They also include more damaging ideas, like proposing restrictive solvency rules for institutional investors that could undermine their ability to invest in UK infrastructure. But in a calm, un-politicised environment, all of these issues could be negotiated through qualified majority voting, as they have been in the past. It is also unavoidable, since the veto hasn't changed the voting system for single-market rules.
>
> (*Guardian*, 'Put Aside the City's Whinging', 20 December 2011)

3. Further Reading

House of Commons Library Standard Note, *In Brief: Eurozone Crisis Documents*, 3 February 2012, SN/06160

House of Commons Library Standard Note, *The Draft International Agreement on a Reinforced, Economic Union*, 26 January 2012, SN/06199 (parliamentary intranet only)

House of Commons Library Standard Note, *In Brief: Leaving the European Union*, 20 October 2011, SN/06089

House of Commons Library Standard Note, *The Tobin Tax: Earlier Debates*, 16 January 2012, SN/01346

Indermit Gill and Martin Raiser, 'Golden Growth—Restoring the Lustre of the European Economic Model', World Bank website, January 2012

International Monetary Fund website, 'Regional Economic Outlook: Europe—Navigating Stormy Waters', October 2011

OECD website, 'Economic Survey of Euro Area 2010', 13 December 2010

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