



HOUSE OF LORDS

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Financial Affairs Sub-Committee

Inquiry on

COMPLETING EUROPE'S ECONOMIC AND MONETARY UNION

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Questions 195 - 204

WEDNESDAY 24 FEBRUARY 2016

10.15 am

Witnesses: David Gauke MP and Jonathan Black

Members present

Baroness Falkner of Margravine (Chairman)
 Lord Borwick
 Lord Butler of Brockwell
 Earl of Caithness
 Lord Haskins
 Lord Lawson of Blaby
 Earl of Lindsay
 Lord McFall of Alcluith
 Lord Shutt of Greetland

Examination of Witnesses

David Gauke MP, Financial Secretary to the Treasury, and **Jonathan Black**, Director, Europe, HM Treasury

Q195 The Chairman: Good morning, Financial Secretary to the Treasury Mr David Gauke and Jonathan Black, European affairs director at the Treasury. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee and a full transcript will be taken. This will be put on public record in printed form and on the parliamentary website. You will be sent a copy of the transcript and will be able to correct minor errors. The session is on the record; it is being webcast live and will be accessible subsequently via the parliamentary website.

Financial Secretary, perhaps I may say how good it is to see you again, particularly in this case early in the year. We hope to see you again later in the year. We appreciate that it is a very busy week for you, leading up to the Budget. Therefore, we welcome you even more, knowing how precious your time is. I understand that you would like to make an opening statement to the Committee.

David Gauke MP: Thank you. First, perhaps I may thank you and the Committee for inviting me to give evidence today, and also introduce Jonathan Black, who as you say is the Treasury's director in charge of EU policy. I am looking forward to this morning's discussion and I welcome the Committee's work on this important area of EU policy, which will certainly provide a very valuable contribution to the debate. I last spoke on this topic in July in a Westminster Hall debate initiated by John Redwood. Since then, we have had further details of a number of the proposals identified in the Five Presidents' Report, but others remain subject to ongoing discussions. So in this regard the five Presidents process remains a work in progress.

Of course, last week the Prime Minister secured an historic deal to reshape the UK's membership of the European Union. That deal is not the focus of today's discussion but it provides an important frame for it. The principles secured by the Prime Minister have an important bearing on how the implementation of the measures set out in the Five Presidents' Report will affect the United Kingdom.

It is also worth recalling the wider context. The fundamental economic challenges facing the euro area have been clear since its inception. Its members need to be able to prosper with a common monetary policy and to be able to manage the impact of economic shocks that may affect members differently. The political challenges are equally clear, as joining the euro requires a loss of national sovereignty over key aspects of economic policy. In light of these challenges, the UK decided not to join the euro and the Prime Minister has been clear that we will never join while he is in No. 10.

The Chancellor has also long made clear his view that there is a remorseless logic that means that the euro area needs closer economic and fiscal integration. He has been equally clear that how this is achieved is a matter for the euro area countries. The debates in the euro area over further pooling of sovereignty and the appropriate degree of risk sharing are deeply political and are rightly matters for those Governments. It is in our interest that the euro area is a successful, strong currency area, so we do not want to stand in the way of the euro area resolving its difficulties.

However, we will not let the integration of the euro area jeopardise the integrity of the single market or in any way disadvantage the UK. This is why I highlight the importance of the historic deal which the Prime Minister secured last week. We have secured agreement to a set of legally binding principles that ensure that the UK will not be discriminated against by EU rules because we have chosen to keep the pound. This is backed up by a new safeguard mechanism that means we can take our concerns to the European Council if these principles are not addressed.

The EU has formally recognised that the UK will not take part in further integration. This means that the UK and its businesses trading in the single market cannot be discriminated against because the UK is outside the euro area. Responsibility for ensuring the financial stability of the UK will remain in the hands of the Bank of England and other UK authorities. UK taxpayers will never be required to pay for euro area bailouts. All discussions on matters that affect all EU members will involve all EU member states. This gives us the certainty that we need that the UK's rights outside the euro will be respected as and when the euro area integrates further. I look forward to your questions.

The Chairman: Thank you very much indeed. You appreciate, of course, as you raised the renegotiation, that there may well be different opinions across the Committee.

David Gauke MP: I would expect that to be the case.

The Chairman: Let me take you back to your interesting remarks about the Five Presidents' Report. How do you see the long-term sustainability of the euro area working through, given the follow-up action plan of 21 October and so on, and given that you are expecting a White Paper in 2017?

David Gauke MP: I would go back to what I said about the Chancellor's comment about remorseless logic, if you like. Creating a monetary union creates a number of challenges for that area in terms of dealing with asymmetric economic shocks, for example, and how one addresses that. The Five Presidents' Report provides a very useful contribution towards the debate as to how the members of the eurozone can work together to address the challenges of being in a monetary union.

One of the arguments made, rightly, against the UK's membership of the single currency was that it was necessary for further powers to flow and for there to be further integration among members of the single currency. Those member states that took the view that they wished to join the eurozone therefore need to respond to that. How they go about doing that in terms of the detail is largely a matter for them. They will need to determine that. There are clearly different views among different member states as to exactly how they respond to that challenge.

The priority for the United Kingdom is to ensure that in that closer integration, members of the European Union who are outside the eurozone retain the rights that they should retain and retain access to the single market without discrimination. The precise nature and the speed of reform is something for eurozone countries. As I say, we do not want to stand in the way of that, but the Five Presidents' Report is an important contribution to that debate.

The Chairman: The Chancellor talked about headwinds in the global economy. We are all aware that the hard-won climb out of the great recession is not achieved, and particularly not for the euro area. The US economy, too, is looking less predictable than it was even a few months ago. How do you feel in principle about the United Kingdom sharing risks across the 28 versus saying very positive things about the eurozone needing to integrate but wanting to stand aside from it? In general terms, the Chancellor accepts—and I think most people would accept—that in a very integrated global economy we are affected by each other's actions, so could you give us a general perspective on how you see risks being shared across all 28 as opposed to across the eurozone?

David Gauke MP: I will give you one example. I do not think that it is reasonable for non-eurozone countries to have to be part of a bailout to preserve the euro. We made a very clear decision—one that I think history has certainly vindicated—that it would not be right for the United Kingdom to join the eurozone, and it does not seem right for United Kingdom taxpayers to be on the hook to bail out the eurozone. We made significant progress in the last Parliament in terms of protecting our position on that front. But last week's deal provides further clarification and certainty as to the UK's position in that respect. So I point to that as a clear example. This is a risk that should be shared not among the 28 but among the eurozone countries.

The point that is clear, however, is that the United Kingdom retains access to the single market. The single market predates the euro currency. We are as entitled to participate in that single market as any other member state. Again, that was an important part of the Government's objectives in the negotiations last week.

The Chairman: So your attitude is really “pick and choose”. You were talking about bailing out, but actually now we are moving more towards bailing in. Anyway, we bailed out Ireland. So it is not as if on principle we never want to help other countries; we choose which ones we want to help and which ones we do not.

David Gauke MP: The point I would make is that certain things flow from being in a monetary union. We are not in a monetary union and, therefore, those things do not flow for us in the way that they do for eurozone countries.

The Chairman: But Ireland is.

David Gauke MP: In Ireland there were particular circumstances. It is the only country with which we have a land border and one has to look at the Irish position on the basis of those particular circumstances: the geography, the strong economic tie and the circumstances of that tie. As a matter of principle, however, I do not think that it is right that UK taxpayers should be in a position of having to bail out other countries because they made a decision to be part of a single currency—we took a different decision.

The Chairman: Thank you. We will come back to the risk issue in more detail a little later.

Q196 Lord Butler of Brockwell: Good morning, Financial Secretary. You have said that progress towards a European monetary union is largely a matter for the members of the eurozone, but the UK clearly has an interest in it. We have had evidence about the Five Presidents' Report that it is rather a cautious document, partly because of the German and French elections, which will take place in the next year or so. What would you, as an observer—or with the UK as an observer—expect to be in the White Paper that will be

produced next year? What are the most important things that you would expect to see included?

David Gauke MP: First, I think that the Five Presidents' Report is a useful contribution to this debate, but I accept that it is, by its nature, of quite a high level and that it is not the final blueprint, as such, for the future of the eurozone—I do not think that it particularly intends to be.

In terms of what should be in the White Paper next year, I do not think that it is for the United Kingdom Government to be particularly prescriptive in this area. There are different approaches among eurozone member states that are understandable given the different circumstances that exist. It is important for us not to stand in the way and not to prevent the eurozone addressing the issues that it faces, because, for the reasons that Lady Falkner alludes to, it is in our interests for the eurozone to be a more robust and growth-driven economy than it has been of late. Our interests lie in, first, not getting in the way and, secondly, ensuring that the policies that are pursued do not put us at a disadvantage. That comes back to access to the single market. For example, I do not think that it is for me, or the Government, to be prescriptive as to precisely what should be in the 2017 White Paper. We should wish them well but not to try to dictate what they should say.

Lord Butler of Brockwell: But the UK will be part of the informal consultations in the lead-up to that White Paper. What would be the mechanics of that?

David Gauke MP: We have already made contributions to the informal consultation process that preceded the publication of the Five Presidents' Report. The process is primarily aimed at strengthening economic governance in the euro area. That is for the eurozone countries but, as I say, we clearly have an interest, as a euro out country, in ensuring that the integrity of the single market is protected. Last week's deal gives us the certainty that I think we need.

When it comes to the precise mix of policies, to come back to your previous question, it is not for us to be dictating what is in there. One point I would make is that competitiveness remains a big challenge for the European Union as a whole and in particular for the eurozone. For example, one issue that the member states are considering is national competitiveness boards. This is still a high-level policy at the moment and there is a debate about whether that would make an effective contribution or not. If there is a view that it can contribute then it is certainly something that we would like to see.

Lord Butler of Brockwell: Yes. You have said that the UK should not be prescriptive, but from the point of view of the UK's own interests, are there any aspects that you would

particularly like to see in the 2017 White Paper? Or indeed are there any that you would like not to see in the White Paper?

David Gauke MP: Perhaps I will deal with your second question first as the easier one. We would not want to see—and would not expect to see, in the light of the recent negotiations—anything that we felt would undermine the single market. I come back to the agreement that was reached on Friday, which strengthens our position and provides greater clarity. It is, of course, something that we would need to be alive to but, as I say, I would not necessarily want to be prescriptive. I referred to the national competitiveness boards; if a case can be made that they are helpful—and I think that the intentions towards such boards are worthy—then we should support them, given that more clearly needs to be done to improve the European Union's competitiveness.

Q197 Lord Shutt of Greetland: I wrote this down before you said it: we wish the euro well. I paraphrase what you said: we wish it well but we do not want too much to do with it. Is this not a dangerous position to be in? I see the European Union a little like an orange: we are part of the skin and the euro is the meat of the orange inside. I peeled an orange once and found that it was bad inside. Surely one needs to know what is going on inside. How can we be certain, by just wishing it well and not wanting to do much about it, that all is well and, indeed, that the resources are being used properly and that the people meeting together inside are not talking about things that perhaps ought to involve the UK? What if the border is not as clear as it might be or the resources are being used just for the insiders and not for the entirety? Are there not some dangers here? You say, “We wish it well but we don't want to be too involved”, but is that not a dangerous, complacent position to be in?

David Gauke MP: First, as far as the European Union is concerned, the UK plays a very active role in ensuring that it is as competitive as possible and, for example, that we pursue free trade agreements with other countries—and that we pursue that more rigorously and enthusiastically than has perhaps been the case before. The UK plays an important role within the European Union in advocating a more open, competitive—Atlanticist, if you like—policy than would otherwise be the case. That is not to say that we have no interest in the European Union being a successful economic area. The point I am making is that we are not part of the eurozone, so we need to ensure that we protect our position as a euro out and that we do not allow our access to the single market to be in any way compromised because we are a euro out.

On your point about institutions, arrangements are already in place for the euro group. If the euro area wants to integrate further within the EU, for example by setting up euro area only

institutions or a separate euro area budget within the EU, it will require treaty change. This of course would require the unanimous agreement of member states, which would give us the chance to address any concerns about the use of EU-wide resources for euro area purposes. You are right to raise the point and we have to remain vigilant.

The Chairman: You mentioned the Atlanticist bent that there is. I found that quite an extraordinary comment to make in light of our interests. I would like you to give us an overview. It sounds as though you are saying that the euro area countries are merely another group—that as we trade with the US, so, too, do we trade with them. If you look at the figures, nearly half of our trade is with the EU and something in the order of 15% is with the US. So is the Atlanticist analogy that you use appropriate? Can we distance ourselves sufficiently from the EU when we have that kind of relationship?

David Gauke MP: If I may say so, I feel that you may be overinterpreting what I am saying, so I am happy to provide some clarity. We bring, if you like, an Anglo-Saxon view of the world and how the economy should work. We advocate what in English rather than American would be described as liberal economics. We believe in free trade, we want to take down trade barriers and we believe that we should look outwards. As a country the UK has consistently not been “little European” but has believed that we are part of the European Union and that the European Union will prosper by trading more with other parts of the world. That is a role that the UK plays and will continue to play.

Part of the Prime Minister’s negotiation for greater economic competitiveness was a recognition that mature western democracies such as the UK and indeed many of the other member states face challenges in terms of maintaining our prosperity, and that the way we should respond to that is not by closing in, having very high regulatory burdens that price European businesses out of world markets or putting up trade barriers to try to close out international competition. That is the position of the UK that Governments of different colours and compositions have argued over many years. That is the point I am making. It is nothing more than that.

Lord Lawson of Blaby: May I come back to what you said earlier, Financial Secretary? I am always happy to see a Financial Secretary because I was a Financial Secretary to the Treasury once upon a time. The Chancellor of the Exchequer is clearly absolutely right to say that if you are going to have a reasonable monetary union, you have to have fiscal union, which means what the Germans—who do not like the idea—call a transfer union. That is always the rule. Indeed, the Five Presidents’ Report very logically says that there needs to be a European finance ministry. Whether it is going to happen by 2025 or not is another matter. The things

that the European Union goes for, in my experience, tend not to happen by their due dates—but they do happen. So there would be a European finance ministry, which means a political union. Indeed, the Prime Minister explicitly said in his Statement to the House of Commons on Monday that this was about political union but that the United Kingdom would not be part of it. I suspect that if we remain in the European Union, it will be an increasingly uncomfortable and unsatisfactory position for us, which concerns me a great deal. But it is clear that that is the direction of travel. In the meantime, while we are travelling—I am not a lawyer; the lawyers will have to get their hands on it when there is a proper text and so on—although we say that we are outside the eurozone and will remain outside it, with some protections against the inbuilt qualified majority that the eurozone countries have, the text also states that they reserve the right to do anything that in their opinion is necessary to preserve and strengthen the euro. Do you not see the possibility that there may be things there that are contrary to Britain's interests? I am sure that they will not be deliberately aimed in a spirit of hostility to the United Kingdom, but their right to do whatever in their opinion is necessary to consolidate, strengthen and protect the euro, which overrides everything else, might well not be in our interests.

David Gauke MP: I would look at the agreement as a whole. In there are a number of key protections for us. There is an explicit recognition that euro outs should not be discriminated against. There is also the ability for us to go to the European Council in the event that our view is that the agreement is not being abided by. It is legally binding. As I said, I would come back to the UK Government's position, which is not to stand in the way of eurozone countries doing what is necessary given that they share a common currency, but also to ensure that we maintain access to that single market and that there is clear, legally binding protection for us that the ECJ has to take into account. We have the ability to go to the heads of state and government European Council in the event of any departure from that. It is not the role of the United Kingdom to stop those countries that are part of the eurozone doing what they need to do, but not in such a way that it overrides our right to be part of the single market.

Lord Lawson of Blaby: It is not legally binding at the present time but may become legally binding at some time in the future. My point was not so much about whether it was legally binding in that sense but that there may be a conflict between what they believe is necessary to protect and strengthen the euro and what is in the interests of the United Kingdom. As I read the agreement, the former trumps the latter.

David Gauke MP: My understanding—and, as you say, no doubt the lawyers will get their hands on this—is that our rights are protected, along with our access to the single market, notwithstanding the fact that we remain and will continue to remain outside the eurozone.

Lord Butler of Brockwell: But that protection does not go as far as the Luxembourg compromise, does it?

David Gauke MP: In terms of the projection, I will just come back on the point about it being legally binding. My understanding and the advice of Professor Sir Alan Dashwood is that an international legal document of this sort is legally binding and that the ECJ does have to take its contents into account.

Lord Lawson of Blaby: “Take into account” and “legally binding” are two completely different things. The European Court of Justice would have to take it into account, as it would have to take a lot of other things into account, but that is different from it being legally binding.

David Gauke MP: “Legally binding” is the phrase that Sir Alan Dashwood uses.

Lord Lawson of Blaby: That is it exactly.

The Chairman: I feel the need to curtail these semantics; they are not really to do with our inquiry. May I suggest to both the Financial Secretary, if he has time, and Lord Lawson, that they listen to the former Attorney-General Dominic Grieve’s comments this morning about “taking into account”. They come from a former law officer of the Government speaking very eloquently.

Lord Lawson of Blaby: “Taking into account” is different from “legally binding”; that is the point.

Q198 Lord Shutt of Greetland: There is something else. We have not referred to taking into account the fact that—we are speaking in the UK, where they understand it all—there are other non-euro countries. Is there any comfort and fraternity in that and is the UK doing anything about getting comfort from other countries that are not members of the euro, in terms of our relationship with the eurozone?

David Gauke MP: That is an important point. These are protections for the euro outs. We are not the only euro out. As it currently stands, nine of the 28 member states are outside the eurozone. The concerns that we raise do not simply represent our concerns; the other euro outs also have particular concerns. There are some issues, for example with regard to financial services, that are much more acute for the UK than perhaps for other member states, but we are not in a unique position being outside the eurozone.

Q199 Lord Borwick: Financial Secretary, what democratic accountability arrangements do you foresee for the euro area as it consolidates more in the future? If this is a sort of euro parliament for the euro ins, would it not be natural—without us being part of it, of course—for that group of euro ins to start blaming the euro outs for problems that may occur for them in the future?

You said that we are completely isolated from supporting any country that is affected within the euro area by euro problems. Will that withstand the euro parliament blaming us somehow indirectly for not taking enough refugees, or for not supporting it in some other way? Will it not become rather fudgy as to whether we are isolated from the euro in future when there are more democratic structures within the euro area?

David Gauke MP: The first point I would make is that, in terms of the structures that might be created as a result of further integration among the eurozone countries, it is principally an issue for them. I come back to my answer to Lord Shutt a moment or so ago; if there is going to be use of any European institutions that would require treaty change and if there is such treaty change, we would have an important say in how that operates.

In terms of the protections for us and the concern that we will be blamed, and what have you, I would make the point that it is important for us to have the robust protections that we need to ensure that some of the burdens of being a member of the eurozone currency are not imposed upon us and that we are not discriminated against as a consequence of our status. That is really what drove a lot of the negotiation last week: to ensure that we can protect ourselves in that position, so that we are not vulnerable to people turning around and saying that actually the UK does have to do this or the UK cannot have access to that. That is why we need to protect ourselves and why the Prime Minister was right to seek an agreement and to obtain the agreement that he did last week.

Lord Borwick: But you do foresee the creation of some sort of euro parliament—with treaty change, as you so rightly say?

David Gauke MP: My point is that it is a matter for the eurozone countries to determine whether they feel the need to make constitutional or accountability changes. But, if it is part of the European Union, it would require a treaty change, which would require the support of 28 member states, including the United Kingdom.

The Chairman: Could I press you on something that we have been grappling with during this inquiry: why have most of our witnesses told us that they did not envisage a move towards a euro parliament or any such body? Has the Treasury given any thinking to what kind of voice it would have in a future eurozone treasury and how it would engage? I hear what you say

about building in protections, but given the UK's position as a predominant global financial centre, we may also need to engage in their consultations and discussions and so on. How do you foresee an institutional framework for doing that? Have you given it any thought?

David Gauke MP: It is difficult to reach conclusions on this as it is very speculative at this point. We are a long way away from even having firm proposals along those lines. That is not where we are with the Five Presidents' Report. I do not know if there is anything that Jonathan would want to add to that.

Jonathan Black: Thank you, Minister. A few things come to mind. Clearly, if there is not a proposal, at least at the minute, for a new eurozone institution of the kind that you have talked about, a few things are relevant. The agreement last week was relevant; one of the principles in the text was about transparency, where issues that affect all member states should be discussed by all member states. That is an important principle and is one that also governs how the ECOFIN council of 28 Finance Ministers interacts with the Eurogroup council of 19 Finance Ministers.

Quite a few of the things in the Five Presidents' Report that are being developed now are involving working groups that, at the officials' level, involve all 28 member states, even if the non-euro countries are not taking part in them. There is a parallel that we could look at for future institutions in some of the existing ones. For example, there are arrangements where the ECB and the Bank of England work together through the SRB—the Systemic Risk Board—on common issues to do with financial stability risk. So there are precedents for how this would work, but there are no proposals for a new institution at this point. On the extent to which some of the more modest proposals in stage 1 are being developed, it is being done in a way that involves discussion among all 28 member states.

Q200 Earl of Caithness: Good morning, Financial Secretary. Before I come on to banking union, I have two other questions for you. First, could you please write to us—there is no point going into it now—on the agreement? Under section B, on competitiveness, it is now legal for us to push the Commission into getting rid of surplus regulations. What is the Treasury's list of surplus regulations that it wants to get rid of? Following up on Lord Lawson's point, what happens if that clashes with the eurozone? How will you get around it? My second question to which I would like an answer is: does the Treasury have any reservations about the proposed merger between the Frankfurt and London stock exchanges, which has been in the papers yesterday and today—particularly if Frankfurt is going to have a major share, given that we might stay in or we might come out?

David Gauke MP: I am probably not in a position to give an answer on that, so it is probably best that I do not attempt to say anything more than that we will need to see the nature of the details. It is the case that as a country we take the view that it is not for the Government as a rule—I make a general point rather than a specific one—to overly interfere in the ownership of businesses. We are an open economy. That is probably all I can say on that at this point.

Earl of Caithness: Let us move on to banking union. We have heard evidence, from the Corporation of London among others, that in all probability some of the banks would have preferred to be in the banking union. What representations has the City made to you and what are you doing to alleviate their concerns and address their wishes?

David Gauke MP: In terms of the approach to banking union and the City's view on this, the approach that we have taken as a Government and in terms of the renegotiation deal was to ensure that UK firms and banks cannot be discriminated against because they are outside the eurozone. We have also ensured that the UK's financial institutions are supervised by institutions such as the Bank of England that are experts in the operation of our leading international financial services sector. We believe that that is the best way of protecting the position of the UK taxpayer and our financial stability.

The negotiation includes explicit recognition of the need to fully exploit the single market and to reinforce the global attractiveness of the European Union while also ensuring that the integrity of the single market can be protected during any further eurozone integration. So the objective here is to have the best of both worlds—to use the Prime Minister's phrase—in terms of access to the European market for our UK-based banks while also ensuring that they are supervised by UK institutions that understand our sector and are not discriminated against.

Earl of Caithness: I understand your position, but if it is against what the banks consider to be in their best interests, would you still hold that position?

David Gauke MP: Well, we do think that the case for banking union makes sense in the context of countries sharing a common currency and sharing particular risks. In those circumstances, it contributes to financial stability within the eurozone, which is in our interests. But we are not going to be part of the eurozone. We protect our rights in terms of managing our fiscal, economic and financial stability risks. Therefore, we do not think that there is a case for us joining banking union. We think that our situation is different from that of the eurozone member states.

Earl of Caithness: Can I turn to the original third leg of the stool on banking union? The common deposit insurance or reinsurance scheme was dropped. Is there a need for it now and how do you assess the three-stage proposals put forward by the Commission?

David Gauke MP: In terms of deposit insurance, first of all, we understand the importance of measures to support eurozone stability and of action to promote the strength of the eurozone. We do see that a common deposit insurance scheme could be an important part of that. We also recognise that for it to operate effectively, those participating would need to consider measures to address risks and to develop a more consistent risk profile across member states in the eurozone. Given how interconnected our economies are, it is entirely in our interest to see the eurozone succeed. That is a key priority for us. But in terms of common deposit insurance, ultimately that is a matter for the eurozone member states to determine for themselves. We see how it could play a role. We do not have a fundamental objection to it. But this is for the eurozone countries to look at the details. The euro area does need to manage and reduce its systemic risk. We in turn need to ensure that that does not cut across the operation of the single market—but, as I say, primarily this is a matter for eurozone member states.

Lord McFall of Alcluith: Minister, you mentioned interconnectedness. In the financial crisis of 2007 we were caught by that, particular with cross-border issues. Given that situation, is there not a case for us to will a deposit insurance scheme even though we are not in the euro because of the certain disadvantages to the UK if we are not in it?

David Gauke MP: I think I probably come back to my previous answer. This is clearly an issue that eurozone member states need to look at. We can see that it could play an important role in policies to strengthen financial stability. But that is ultimately for eurozone member states. As far as the UK is concerned, we are outside banking union. We are in a different situation because we do not share a currency. As such, it remains our position that banking union would not be right for the United Kingdom. Common deposit insurance is part of that banking union process and is a matter for members of the banking union.

Lord McFall of Alcluith: But banking and finance is global. Is there not a case for the UK to say that such a step would be welcome?

David Gauke MP: It is global, but it also comes down to national taxpayers as well. The experience of 2007-08 and so on is that it is taxpayers and the tax collected by national institutions that stand behind financial institutions. If you are part of a common currency, that changes the nature of the relationship—but we are not part of that common currency and therefore it is right that we are outside it.

The Chairman: I wonder whether I could press you on banking union and our approach to it. Several of our witnesses were at best confused about why the United Kingdom did not wish to be part of it. I hear you taking some comfort from the fact that several—I think you said

nine—outs are on your side in several of the arguments. But of course, of the eurozone outs, 26 are in the fiscal compact and several of them are part of banking union as well. Given London's role—I come back to this—as arguably the world's financial centre, and given the size of our banking sector, would you be able to tell us briefly why you rule it out?

David Gauke MP: I come back to the point that we do have a large financial sector and a great deal of expertise in terms of the regulatory capability of the Bank of England, for example.

The Chairman: But we are allowed to have higher standards. We would not be forced to reduce our standards; we would be allowed to keep them.

David Gauke MP: Indeed, but in terms of pursuing policies of financial stability and economic security, we can pursue the regulatory policies that we need outside banking union. We are not part of the common currency. I think that if we were part of the eurozone, it would be a different matter, but we are not. We have a financial services sector of a sufficient size that our regulatory institutions and our levels of expertise are such that we are perfectly capable of operating outside banking union and providing the level of regulatory expertise that we need.

Q201 The Chairman: Could I take you to developments in capital markets union, of which we are enthusiastic proponents? Could you tell us how you foresee supervisory functions being carried out as we deepen capital markets union? Again, our witnesses have told us that while they can see banking union supervision working fairly comfortably, in terms of capital markets there would be much greater difficulty, because in many of the participating member states there is simply not the expertise to rise up to the level of regulatory oversight that would be needed. How do you see that coming down the road?

David Gauke MP: The first point is that the Government are very supportive of capital markets union. There are real opportunities for UK businesses and financial institutions in capital markets union. We are supportive of that. We are also of the view that this is principally a single market rather than a single currency project. So again I make the point about wanting to ensure that we protect our interests and that this is a matter for the 28 and not for the 19.

In terms of the supervisory nature and so on, it is only fair to say that this is a long-term project and we are in the relatively early stages. The Commission is very clear about that. At the end of September last year the Commission published its action plan—you are familiar with it—which covers putting in building blocks for 2019 and onwards. It contains an indicative timetable. In terms of working out exactly how the supervisory relationships will

work, we are still in the fairly early stages and it is difficult to comment too much. Perhaps Jonathan would like to add something.

Jonathan Black: You commented yourself, Chair, that the action plan does not contain a proposal for a single supervisor. The action plan is very comprehensive in that respect. It is useful to distinguish between greater standardisation in terms of single market rules, whether that is common regulation or mutual recognition of regulation, and the question of how exactly those are implemented. But as I say, the proposal from the Commission, which is quite a full one and over a long time, does not include a proposal for a single supervisor.

The Chairman: So in the longer term you are not planning in any sense for that eventuality. Can I take you back to banking again? We know that the December ECOFIN agreed an ad hoc working group. Do you support rule-making on sovereign exposures at the European and/or international level, and what role should the EBA play in that?

Jonathan Black: As you say, this working group has been set up. It is quite a useful example of how some of these issues are being discussed by the 28, even though they are interests for the eurozone. This working group is looking at the question of how EU sovereign debt is treated in the prudential regime. The Committee will probably be aware that it is treated as riskless. Clearly the euro crisis raised some questions in that respect. This working group has been set up at official level in the EU to work through some of the questions in relation to institutions in the single market. It is still very early days but work is taking place in parallel with what I would describe as the primary work of the Basel committee, because these issues are not just European but global. The Basel committee will probably make some recommendations on that towards the end of this year, but there is some way to go. As I say, the issues stem from some of the questions in relation to what happened in certain parts of the euro area rather than, for example, in the UK.

The Chairman: What are the headline issues in terms of risk?

Jonathan Black: As I said, sovereign debt is treated as being riskless in the prudential regime. Therefore, you do not have to make capital provision for it. But, as we discovered in some of the euro countries, that judgment on risk probably needs to be looked at. That is what the purpose of this is. It goes without saying that it is a very complicated issue and not a straightforward one. The right place for this to be looked at in the first instance is the Basel committee, because this question is not just for European banking institutions but for whichever part of the world they happen to be in.

Lord Lawson of Blaby: May I come in on the question of so-called capital markets union? It seems that this is all a bit of a muddle. One of the problems with the European Union now is

that anything it addresses has to have the word “union” tacked on the end. The issue, as I understand it—and I agree with it—is that on balance the financial system is healthier. There is relatively greater reliance on capital market finance and relatively less reliance on bank finance. That is very sensible. This country has, compared with the rest of Europe, a much greater reliance on capital market finance and a relatively lower reliance, apart from small businesses that do not have easy access to the capital markets, on bank finance. So we have achieved that, about which I am glad, without any capital markets union. So why do you not just talk about the desirability of countries becoming more like the United Kingdom or the United States rather than capital markets union, which seems to me to be a complete muddle? Do you not think that there are two issues here?

David Gauke MP: I think I would say to you that I wonder whether the substance of the policies behind capital markets union is more attractive to you than the name. I take your point, but I think that the extent to which we can make progress in ensuring that across the European Union there is greater access to capital markets is something that would be of benefit to all the European Union.

Lord Lawson of Blaby: It might be desirable if people worked harder, but we do not talk about a working harder union. I do not see the point of this.

David Gauke MP: In terms of the details of capital markets union, it goes beyond mere aspiration. It is seeking to find ways in which capital markets can work more efficiently across the European Union. That seems to me to be something that is to be welcomed.

The Chairman: You wisely stayed away from Lord Lawson’s point that they should all be like us. Might I suggest that in 2008, when our too-big-to-fail banks were spectacularly crashing, there may have been many other countries in the EU that were quite relieved that they were not us.

Lord Lawson of Blaby: Ours were not the only banks that crashed, Chair.

Lord McFall of Alcluith: It was a global financial crisis.

The Chairman: I have allowed us to stray outside our remit.

Q202 Lord Haskins: I will go back to the Five Presidents’ Report. I support the Prime Minister’s position on Europe. Therefore, it is important for those of us who believe that we should stay in Europe that the eurozone works properly. If Lord Lawson has his way, this will all be of academic interest because we will have gone somewhere else and it will be somebody else’s problem. But assuming that it is our problem, and coming back to the Five Presidents’ Report, it has a very ambitious heading: “Completing economic and monetary union”. It does not begin to deal with completing economic and monetary union. It deals with

a few superficial issues. We have mentioned banking union. There are some good things about that. We mentioned capital markets union. There are some good things there. But in taking evidence for our report, we found a lot of cynicism—not always openly stated—and little understanding of or agreement about what fiscal union means. Certainly there was little appetite for fiscal union or treaty change. All of that is in this report. The conclusion came that this was a holding report, a muddle-through report—and, by the way, at the end of it throw in the Semesters, which were a good idea, in my view. The question is: is any of this going to take us any further?

David Gauke MP: I do think that it is a useful contribution to the debate. I do not think that anyone is pretending that the Five Presidents' Report is a complete blueprint for the future of the eurozone, but it is a useful contribution. There is clearly a debate within the eurozone, and to some extent outside it, as to how the eurozone moves forward. I come back to the Chancellor's comment about the remorseless logic of closer integration as a consequence of sharing a common currency and addressing the challenges of convergence and economic shocks. One thing that we have learned, if we did not already recognise it, is that when you have a common currency it is important that that area is able to respond to economic shocks. The eurozone has not been in a comfortable position to do that. It is in a less fragile position than it was and now there is an opportunity for eurozone countries to try to develop their ideas. The Five Presidents' Report is part of that process, but is that the be all and end all? It clearly is not.

Lord Haskins: I agree with the Chancellor's point but, for that to work, you need political will among the nation states. At the moment, the eurozone crisis has gone into second place because of the migration crisis—but lots of witnesses have said to us, for example, that Greece could come back to haunt us and become a big problem. Would there be the political commitment in Greece to do what is needed to keep it in the eurozone or is it conceivable that Greece would have to leave the eurozone?

David Gauke MP: When it comes down to it, the Greek Government and the Greek people have not shown an appetite for wanting to leave the eurozone. We have to respect that. It is for the eurozone member states to determine an effective and robust way to work together in a sustainable manner so that the eurozone is able to withstand economic shocks. As I said earlier, we do not wish to stand in the way of that. It is in our interests for the eurozone to work. We are where we are in terms of its member states and we wish to play a positive role. We do not wish in any way to impede the eurozone from making the decisions that it needs to

make but, ultimately, it is for those eurozone countries, and indeed their peoples, to determine the right way forward.

The Chairman: In your view, is the European Semester useful, in real, tangible terms?

David Gauke MP: We recognise that more can be done to improve the effectiveness of the Semester. The spirit of partnership that characterises it is something that we support. Sharing national practices and experiences is helpful and coming forward with recommendations for improvements is good as far as it goes, but it could go further. It is really important that there continues to be a tight focus on jobs and growth and we think that it is right to emphasise that. I think that there is a case for moving the Semester to a multiannual process. It would allow member states to introduce the structural reforms recommended in the country-specific reports and for these to become embedded.

There is also more to be done to improve the transparency of the Semester. The Commission could make greater use of pre-existing, relevant, objective, external and globally recognised indicators, in the context of the current EU-level processes and tools, including by refining the indicators already in use. That would allow more meaningful comparison of the impact of member states' economic reforms and could assist in developing good practice. It has a role but it could be improved.

The Chairman: Are all these reforms on your agenda, should we get to the other side of the referendum and take on the presidency in 2017?

David Gauke MP: I am not sure whether it is for me today to determine what would be our presidency objectives. All I am doing today is sharing with you ways in which I think that the Semester could be improved. We would obviously have to view that as and when we get there. Perhaps Jonathan has something to add.

Jonathan Black: That is right; the Minister has gone through areas in which we would further streamline the Semester. When it comes to the presidency, we will need to make a decision on whether it is something that we would prioritise over other things.

Q203 Lord Lawson of Blaby: Let me ask you a very easy question. What do you and the Chancellor of the Exchequer understand by the term "fiscal union"?

David Gauke MP: Lord Lawson, you describe that as an easy question, but I think different people—or different countries—take different views on that.

Lord Lawson of Blaby: I was asking about you and the Chancellor.

David Gauke MP: I think that it is about closer co-operation between member states to ensure that the fiscal risks of having a common currency are more closely shared. Within that, there are different ways one can do that. Some would argue that this is about the stability and

growth pact and about ensuring that there are rules in place among members of fiscal union as to how they behave. Others would argue that it is more about fiscal transfers between richer parts of a fiscal union towards poorer parts. The precise nature of a fiscal union can vary and I do not think that there is consensus on what precisely a fiscal union should look like. That is one of the big challenges that the eurozone continues to face.

Lord Lawson of Blaby: But there are, of course, plenty of fiscal unions in the world. You just need to look around. The United States, for example, is a fiscal union. Of course, population movements are also important, which are slightly more contentious within Europe than they are within the United States. But, leaving that aside, the fact that there is a significant federal tax base—although individual states have their own taxes, there is substantial federal tax—is agreed by most economists that I know to be an essential part of a fiscal union. It makes the monetary union of the United States workable. Is there any reason to believe that the laws of economics are different on the continent of Europe?

David Gauke MP: No, but the point I would make is that the concept of fiscal union is a fairly broad one. As you say, there are many fiscal unions around the world. The United States provides one very important model, but there are different views within the eurozone as to the precise nature of what that fiscal union might be. Within the eurozone it is, I think, still referred to in a broad sense, and that covers a wide variety of high-level policy proposals. I do not think that there is consensus on that.

Lord Lawson of Blaby: So when the Chancellor of the Exchequer, who is a very clever man, says that there would have to be a European, or eurozone, fiscal union, he does not really know what he means?

David Gauke MP: No—I agree with the first part of your question about the cleverness of the Chancellor of the Exchequer, but not the second part. The nature of fiscal union—or, if you like, the phrase “fiscal union”—covers a multitude of models. To take the two purest, or clearest, positions, one is the view of fiscal union as about rules and restricting what member states within a fiscal union can do and ensuring that the deficits are of a certain size and so on, and the other view is that it is about the transfer of resources. Then there is a spectrum in between. The point I was making, and that I think the Chancellor would make, is that the objective is to ensure that there are fiscal policies that prevent instability within the eurozone. As we discussed, having created a common currency, it is clear that alongside that there needs to be fiscal policies, in one form or another, that complement, support and buttress that currency union. It is not something that you and I would ever want the United Kingdom to be

part of—but, given that there are member states that have entered into a common currency zone, they need to consider, and are considering, how they address the fiscal challenges.

Q204 Lord Butler of Brockwell: Do you think that the proposed European fiscal board is going to make much difference to that? Could you also comment on the macroeconomic imbalances procedure and whether, again, you think it has an important influence on fiscal co-ordination?

David Gauke MP: It is difficult to say how much of a difference the board would make without seeing more detail of precisely how the board would undertake its duties. So that is a definitive “don’t know” at this stage. It is too early to say whether it would make much difference. It may do, but it does not have the ability to compel member states to change their fiscal policies; it has an advisory role. We would need to see a more precise proposal.

The macroeconomic imbalances procedure is still a relatively new process. We support it as a means of strengthening the understanding of macroeconomic risks, particularly in the euro area. But in terms of its effectiveness, it is fairly early days.

Lord Haskins: The US fiscal union evolved over rather a long period of time. It did not come overnight.

David Gauke MP: Indeed. I feel that this is one of those occasions where debate may be about to break out among Committee members. I do not want to impede that.

The Chairman: Financial Secretary, you have been very kind and have given generously of your time. Unless the Committee has any further questions, I think that we can conclude today’s public session. The Committee will continue its work in private. Thank you again, Mr David Gauke and Mr Jonathan Black, for coming to give evidence.