MONEY, THE COALITION AND THE EUROPEAN UNION

(Speech by Sir Brian Unwin at the Federal Trust conference, 4th November 2010)

It is a great pleasure to be here and to speak about Britain and the EU before an audience that I suspect will be a little less sceptical and better informed about these affairs than is sometimes the case in London.

There are many aspects of the present British coalition government's policy that it would be fascinating to talk about – such as welfare reform, education and health, home security, immigration, reducing the fiscal deficit, defence and so on. Defence is particularly fascinating – and baffling – since we have just had a so-called strategic defence review which seems to have concluded that we will build two giant aircraft carriers which we cannot afford, one of which will be put into cold storage as soon as it is completed and the other will have no aircraft available to be carried on it – hence a renewal of the entente cordiale with the French to share a carrier which will not be suitable for either our or their planes either! However, I will resist going further into this and confine myself, as requested, to British policy towards three issues of important European financial and economic interest – financial supervision and regulation; the EU budget; and the current discussions on economic governance of the eurozone. The last is the most immediately pressing issue, particularly given the crisis in Ireland, but I will start with European Financial Regulation.

The global banking and credit crisis, and subsequent economic recession, had many causes, ranging from imprudent macro-economic policies, including

notably the failure to control deficits during a period of sustained, though unbalanced, growth to individual and corporate greed and irresponsibility within the financial system – often implicitly, or even directly, encouraged by governments, as with sub-prime mortgage lending in the United States. Loans were made on the security of assets whose inflated value in the commercial and housing property market collapsed. Banks became bedazzled by fancy financial derivatives that not even their own executives could understand but which in the immediate term boosted bottom line profits. As capital markets ceased lending, and liquidity dried up, we were very close to a complete collapse of the western banking system. We must no forget that the eurozone crisis was, and still is, at heart a banking crisis.

There is no doubt that inadequate regulation and supervision of the financial and banking sector – known euphemistically in the United Kingdom as 'light touch' regulation – was a contributory cause of this and that rectification of this was a necessary, if not sufficient, condition of preventing it happening again. The experience of Canada, which enjoyed more stringent regulation and whose banks emerged virtually unscathed from the crisis, adds weight to this thesis. I do not accept the view held by some free marketers, such as the Institute for Economic Affairs (IEA) in the UK, that the financial industry in the UK was overregulated rather than the reverse. The extraordinary failure in 2007-8 to pick up in sufficient time the impending crash at Northern Rock – the first of the UK banks to fail – and the slowness of the Bank of England to appreciate the seriousness of the crisis demonstrated the inadequacy of the tripartite supervisory system put in place with such a triumphant fanfare by Gordon Brown in 1997. During the early days of the crisis the Governor spent more time lecturing on moral hazard than getting down to

practical steps to avert serious contagion and collapse. It was like preaching sermons as the Titanic went down rather than getting the lifeboats ready and manned.

So it is clear that an immediate overhaul of financial regulation was required, and that this needed to be carried out at a transnational level in view of the incredibly fast globalisation and expansion of financial markets in the past few years. An internationally coordinated response was required and it is greatly to the credit of the last Labour Government that they realised this and began to act on it, albeit with a slow start.

It would, of course, have been better if Europe and the United States could have gone forward in step together under the G20 umbrella. But progress in the United States was halting and inconsistent and it was quite right for the EU to press ahead with its own reforms without waiting for the White House or Congress to get its act in order. The EU is often accused in Britain of moving slowly and cumbersomely but in this case it moved with remarkable speed, first through the excellent report of the Committee under Jacques de Larosière in March 2009, and then the recommendations based on it that went from the European Commission to the ECOFIN Council and were finally approved by the European Council in June 2009. It was a truly ambitious achievement, designed to set in place a new regulatory framework and system of supervision leading to a reduction of systemic risk, enhanced prudential oversight, improved risk management, greater transparency and reinforced international cooperation.

Along with many others I greatly feared at the time that this would lead to a head-on clash with the next British Government that was due to take office in the spring of this year, which most of us thought would be a Conservative one. Although the shadow Chancellor of the Exchequer, George Osborne, had said that he was willing to 'trade' to protect Britain's financial services industry, there were powerful voices among the Conservative Party's eurosceptic backers and in the City of London urging Mr Cameron to resist any further intrusion of 'Brussels' on the City. The prospect that we saw, therefore, in a report published by the Federal Trust on this issue in March, was of a critical early trial of strength with his European partners by Mr Cameron, who was already compromised in his relationship with Mr Sarkozy and Mrs Merkel by his regrettable decision, against their advice, to withdraw the Conservative Members of the European Parliament from the centre-right European People's Party in the European Parliament. Since the new Directive before the European Council would be settled by majority voting, he would risk being outvoted on a set of proposals supported by France and Germany and a large majority of member states, thus further damaging his European credentials at the very start of his Premiership, although no doubt gaining Brownie points from eurosceptics and many in the City at home.

I am happy to say we were quite wrong. Messrs Osborne and Cameron in the event followed the sensible pragmatic course of cooperation on this issue adopted earlier by Messrs Darling and Brown. Moreover, perhaps partly due to the fiscal let-out clause obtained by Gordon Brown in the initial Council negotiations (which removed any power to force a member state to bail out a collapsing financial institution), and the later decision to locate the new banking authority in London,

there has been a relatively little hostile reaction in the City or on the Government backbenches. Indeed, Mr Osborne was even quoted as seeking reassurance that there will be no backsliding from the deal reached in the Council, which he described as ‘a very good outcome for the UK’. The agreement also received relatively little attention in most of the UK press while the Financial Times, which had not previously been outstandingly supportive of the package, hailed it as a financial reform that ‘should not be seen as a threat’; and that ‘far from being a tool for obtuse and jealous continentals (sic) to destroy the UK financial sector, the EU reforms could help save the industry from its own excesses’ (FT 7 September 2010).

This outcome on this issue, therefore, so far represents an encouraging alignment of the coalition government’s policy in the European direction for those of us who wish Britain to play a more constructive and engaged part in making the single European market work. For establishing a credible, consistent and effective framework of financial regulation is a necessary condition of completing the single market, which itself should be a major contributor to economic recovery. And let us not forget that the principal midwife of the single market was a Conservative Commissioner, Lord Cockfield, appointed by Margaret Thatcher.

Those ‘obtuse and jealous continentals’ now need to ensure that the new regulatory and supervisory system, comprising the European Systemic Risk Council (ESRC), and the three new European Supervisory Authorities (for banking, insurance and pensions, and securities markets respectively) set up under the European System of Financial Supervisors (ESFS) are up and running by next January. As Napoléon would have said ”L’exécution c’est tout”. It is also important to ensure that the new

European initiative remains in harmony with the ongoing deliberations at the G20, in the IMF, and at the Basle Committee on capital and liquidity 5requirements. A particularly crucial element is, of course, the final determination of regulatory reform in the United States, which could be further stalled under a President now much enfeebled by the recent US mid-term election results.

Many detailed issues remain to be resolved, such as remuneration - the hottest political potato which has not so far been seriously grasped - the role and regulation of rating agencies and alternative investments (on both of which there have been Commission initiatives), and the difficult question of the size of banks and the 'too big to fail' problem. I fear the Governor of the Bank of England hardly helped to clarify it in a curious speech at the Economist's Buttonwood Gathering in New York on 25 October when he is reported to have said that reform could take decades; that "of all the many ways of organising banking the worst is the one we have today"; and that the new Basle III proposals represented a 'giant leap for regulation' but only 'a small step for mankind. He appeared still to want to break up large banks, separating the retail and so called casino elements, but, *pace* Mr Cable, the British Business Minister, and Mr Osborne's earlier inclinations, it is by no means certain that the Government will favour this even if it is recommended by the Commission to review the banking sector established under Sir John Vickers. If it does not Mr King could be in an awkward position if and when he assumes responsibility for banking supervision from the FSA. But at least the coalition government, no doubt to some degree influenced by its Liberal Democrat component, seems to have accepted in this instance that UK interests are best served by the UK remaining within the mainstream of European discussion and policy.

Thus so far policy has been in the right direction, and if I were a teacher marking them I would give them 6 out of 10 on their performance on this chapter.

The European budget is another matter. It carries so much emotional baggage from previous eras – notably the Thatcher battles of the 1980s, in which I was an ardent and active foot soldier, culminating in the rebate mechanism secured at the 1984 Fontainebleau summit – that it is difficult for any British Chancellor or Prime Minister, Labour or Conservative, not to adopt a belligerent, fighting, lay-down-the-red-lines approach. The economic significance of the European budget as it exists at present – and I will not here debate the important question of whether it should be larger and give the EU a more powerful fiscal facility at the centre - is, however, much overrated. It is small both in absolute terms and as a proportion of national income in relation to those of member states, and in percentage terms has dropped substantially in recent years (from an average of 1.18% of gross EU national income between 1993 and 1999 to 1.06% between 2000 and 2006). It has remained at broadly the same level since 2006 but has, of course risen much more slowly than the UK budget and those of most other member states during this period (around 20% compared with over 40% in the UK).

So far as the 2011 budget is concerned it is not surprising that Mr Cameron represented the decision of the recent European Council to restrict the increase of payment appropriations in 2011 over the current year to 2.9%, as opposed to the increase of some 6% supported by the Commission and by the Parliament, as a victory which ensures that 'from now on the EU budget will reflect the spending cuts being made by national governments'. He did not secure the original objective

of a freeze of the budget which many of his eurosceptic supporters would dearly have liked, and thus avoid what Lord Tebbit, stoking up the emotional stakes in familiar fashion, called a 'Vichy-style' surrender. But a freeze was never on the cards and even the anti-EU Sun hailed the outcome as a victory preventing "Brussels from lining its pockets with money that would pay for 14,000 new doctors" (who would no doubt mainly have to be immigrants!).

Following the decision at the European Council the President of the Council, Mr van Rompuy, has the difficult task of reaching agreement on the budget through the conciliation process with the European Parliament by mid-November. We have heard that the negotiations this week broke down, but if there is no agreement the budget for 2011 will remain at the current year's level so that Mr Cameron will no doubt still be able to claim that at the Council, and subsequently in discussions in the margins of last week's G20 summit, he succeeded in – to use his own words –'preventing a crazy increase in the EU budget'.

Despite all the familiar rhetoric it is at least encouraging that the Prime Minister chose to accept a compromise and avoid a direct confrontation. It is, however, a pity that this is not a more rational world in which he could also have pointed out to the British public, so bombarded with misinformation about Brussels bureaucracy and profligate EU spending, that the principal priorities of the 2011 European budget are measures to boost economic recovery (such as research, innovation and technical development, transport and energy networks, youth action programmes and so on) – all of which are, or should be, priorities for the British Government itself – and also that the budget will entail a freeze on nearly all staff

recruitment in Brussels. The budget also incidentally provides for a substantial increase (some 7%) for environmental protection – as President of the European Centre for Nature Conservation (ECNC) I wish that were the case here where environmental protection is now becoming a poor relation! But that is a separate subject and it is alas unrealistic to expect that we can shed the emotive language of fighting and battles in the Brussels budget context. In the circumstances I would give the government about 3 or 4 out of 10 on this one.

Much more important than the 2011 budget issue is the critically important question of the economic governance of the eurozone. The immediate preoccupation is, of course, with Ireland, but I should like to concentrate on the underlying structural issues which were discussed at the recent European Council. Here, so far as the UK is concerned, we have a distressing paradox. The UK potentially has a huge contribution to make to this debate – not in the odiously smug and patronising way in which Gordon Brown for many years vaunted the virtues of the Anglo-Saxon free market model and lectured his EU colleagues on how to run their economies, but by virtue of our experience, administrative expertise and the predominant position of London as a financial centre. Our vital economic interests are in any case at stake – we have proportionately more bank lending in relation to our GDP than even Ireland. But while Mrs Merkel and Mr Sarkozy led the debate at the European Council, we were content to stand on the touchline in a detached manner by dint of our exclusion from the eurozone, while at the same time somewhat pathetically reassuring the British public that the decisions on these issues will not affect us because we are not members of the eurozone. Our non-Euro membership also means that the Governor of the Bank of England remains outside the

Governing Council of the ECB and is therefore unable to exercise a full role in their current deliberations.

The UK should in truth play a full role at the very centre of this debate. The governance of the eurozone, to which over half our exports go, is critically important to the United Kingdom, not least in view of the current crisis in Ireland, where British banks, particularly RBS, have a huge exposure, and which takes some 7% of our exports. We stood idly by at the Council in June, almost with an expression of schadenfreude, when the European Financial Stability Facility of Euro 440 billion was established in order to avert a Greek collapse could have had disastrous consequences not just for the eurozone but for the United Kingdom also. No doubt Germany and France were particularly motivated by the heavy exposure of their banks in Greece, but whatever the motives agreement among the great majority of euro members was reached and the issue now is how to convert the short term facility into a more permanent sovereign default mechanism which will impose stricter national fiscal rules (to replace the discredited mechanism of the original Stability and Growth Pact) and provide an agreed procedure for restructuring the debt of insolvent countries, while not at the same time unsettling the markets and driving up the borrowing costs of troubled eurozone countries. A crucial feature of the new mechanism will be the size of the loss that private creditors will be required to bear and what should trigger a decision to start insolvency proceedings. It will not be easy to strike the right balance, and so far as precedents are concerned it is a little discouraging that at the international level the IMF has so far failed to get agreement to a sovereign-debt restructuring mechanism (SDRM).

Following a surprise eve-of-Council deal between Mrs Merkel and Mr Sarkozy the European Council also agreed to consider a Treaty change. The June emergency measures, which were only for three years, were instituted under Article 122 of the Lisbon Treaty, which permits emergency aid to a member state struck by "exceptional circumstances beyond its control" but this is unlikely to be sufficient for a more permanent mechanism – certainly not enough to satisfy the German Constitutional Court, which is one of Mrs Merkel's main concerns. The German government now seem fully committed to the new mechanism but not unreasonably they are not prepared to pay an unlimited price without putting in place powerful incentives to other eurozone members to exercise greater fiscal prudence and a 'managed insolvency' process for those who fail.

So the form of the Treaty change has yet to be settled. There are suggestions that it could be a relatively simple amendment under Article 136 or perhaps even tacked on to the forthcoming Croatian EU accession treaty. From the British point of view, if suitably drafted, this could enable the Prime Minister to avoid calling a referendum in the UK. This may, however, not be easy, and will critically depend on the final terms of the unfortunate European Union Bill, which was published in the British Parliament last week and requires any changes to EU treaties that "moves a power or an area of policy from the UK to the EU" to be approved in a referendum. The devil will lie in the detail and interpretation of this proposed legislation. Eurosceptics will want it to amend it to make a referendum automatic for any Treaty change, however minor, and it could prove to be another self-inflicted albatross round Mr Cameron's neck.

Although I am relieved to hear that the British government are prepared to make loans to Ireland (though it is not yet clear whether this would be on a bilateral basis or under the special facility to which the Labour government signed up) I can only award them 2 out of 10 on this chapter. It is manifestly senseless for the British government not to be substantively involved in this debate, leaving it to the Franco/German duo to make the pace. It will be ridiculous if more domestic attention is focused here on how to avoid parliamentary trouble by side-stepping a popular vote than on the substance of what will be the most important change in the economic governance of the eurozone since it was established. The British Government ought to be a leading participant in a discussion which is vital for the future of the whole European area. But this is, of course, only another way of once more pleading for the United Kingdom to cease hovering in mid-Atlantic, satisfying neither one side nor the other, and to redirect its policy towards greater integration into the European Union and its inner policy-making processes. If this means sooner or later joining the eurozone, however politically improbable that may seem at present, so much the better. The world is an increasingly hostile, unstable and competitive place, and the option of a go-it-alone little England, with its currency fluctuating not as a result of deliberate policy management, but primarily as a function of the strength of the US dollar, the euro – which now constitutes nearly 30% of international reserves - and other rising currencies (and the investment decisions of their issuers) is not an attractive one. But that is a story for another lecture!