The UK and the Euro

Conference held 12th December 2011

Summary

Four speakers offered different analyses on the subject of the UK and the euro, although all speakers agreed in criticizing the actions of the British government at the recent European Council, where the British Prime Minister David Cameron had refused to participate in the proposed new European Treaty. Benjamin Angel from the European Commission opened the event by addressing the current economic crisis engulfing much of Europe and outlined how the Commission and other institutions were in the process of implementing measures to try to steer the EU out of its fiscal difficulties. In the latter part of his speech he explained why Prime Minister Cameron's decision to employ the use of a veto at the Brussels summit would not benefit the UK. Former Member of European Parliament John Stevens outlined the German approach to the euro crisis and argued that the British government's approach had effectively isolated the UK from other EU member states, which could be detrimental to Britain's place in Europe. The third speaker Graham Bishop, a financial analyst, suggested that Britain's tense relationship with the Eurozone was not in the interest of the City of London and could provoke an exodus of commercial and financial institutions. The final speaker, Sir Brian Unwin, concurred with the other speakers and summarised the benefits and successes of the Eurozone, highlighting the vital importance of Europe to British economic interests.

The view from the Commission

Benjamin Angel, Head of Unit, DG Economic and Financial Affairs, opened his speech by making a humorous reference to David Cameron's unexpected veto in Brussels three days earlier. He remarked that "coming from the Commission to London feels a bit like dangling into the lion's cage". In the wake of the unexpected veto of three days before , Britain had set itself adrift from the rest of the Union, giving its partners only minimal warning of its intended negotiating tactics. These aggressive tactics had been employed against a background of economic and political crisis, particularly in Greece and Italy, which made the situation 'extremely tense'. The Eurozone continued to be faced by a vicious circle of problems, whereby the need to support banks in difficulties created difficulties for public finances and these worsening public finances created new problems for the banks. These problems were particularly acute in Greece, Ireland and Portugal. Greek banks hold 'the bulk' of Greek sovereign debt and the "same goes for Portugal and the Portuguese banks."

Although the Greek crisis presents Europe with numerous financial risks, it is nevertheless manageable in Mr Angel's view. A more significant problem is to be found in the German and

French exposure to Italian and Spanish debt. Greek debt problems are 'benign' compared to those of Italy “which is of a completely different order of magnitude than Greece”. The “annual borrowing needs of Italy are the equivalent to the total stock of debt to Greece” meaning that each year Italy has to re-borrow the market equivalent of the whole outstanding stock of Greek debt. The Eurozone’s strategy for dealing with its present crisis was threefold, to address the existing Greek debt crisis, to improve the available financial instruments and to allow the European Central Bank to play a more active role in the markets.

The latest decision of the European Council to deal with the Greek debt crisis was to provide for 'haircuts' of up to 50 percent on outstanding Greek sovereign debt and bring Greek debt down to 120 percent of GDP by 2020 which is 'more or less' the Italian debt level. Mr Angel admitted that this plan of reducing Greek debt to 120 percent by 2020 is a 'challenging threshold' for Greece, but he showed a degree of optimism about its achievability. “The truth is” he said, “that the Greeks have made substantial efforts to make fiscal consolidations since last year.” Greece reduced its deficit in 2010 by five points. It should not be forgotten that Greece is currently struggling to get through the worst recession that has affected the country in recent memory. As a result Greek GDP has decreased and its public debt increased even as the government in Athens has made considerable efforts to cut expenditure.

As to the development of new financial instruments, Mr Angel highlighted the European Financial Stability Facility (EFSF) and the efforts the Eurozone has made to 'revamp' it “as a reaction to serious tension on the financial market”. The Eurozone’s heads of state and government had wanted to increase the operative volume of the EFSF, and to provide it with new legal instruments. The EFSF was launched in May 2010, with the goal of providing loans to countries suffering financial difficulties. Mr Angel argued that the Facility’s 'lending conditions (for member states) should be attractive' so as to enable the states involved to attain faster economic recovery. This in its turn would reduce trans-national financial risks. Currently the EFSF has a lending capacity of 440bn euros with the interest on its loans at the 'lowest possible rate'. Its entire funding amounts to 700bn euros, higher than that of the International Monetary Fund (IMF).

In July 2012 the European Stability Mechanism (ESM) will be launched. According to Mr Angel it will be “the world’s biggest financial institution” and will have the same capital as the EFSF (700bn euros.) It will have a lending capacity of 500bn euros, slightly larger than the EFSF. The ESM will be an improvement on present arrangements since the EFSF currently works through a system of national guarantees, implying that each time a state requires a loan, time-consuming national parliamentary procedures are necessary. In contrast the ESM operates in a similar way to the IMF, allowing the institution to seek a bilateral agreement with the country affected, without needing national parliamentary support on every occasion. The prospect of this new institution and the soon to be agreed Fiscal Pact within the Eurozone would allow the European Central Bank much more room for manoeuvre in its market operations than hitherto.

Mr Angel then moved on to discuss Britain's position in Europe. He warned against any complacency regarding the economic performance of the United Kingdom outside the Eurozone. The UK is "poorer than the Eurozone, if you count GDP per capita," Britain's levels of debt are far greater than those of Spain, and Britain's public deficit is higher than that of Greece. The main reason why the UK is not suffering political, social and economic 'turmoil' is that the "Bank of England has been active in working around the system and controls 20 percent of the UK's (public) debt, whereas the ECB holds just 1.7 percent of the euro area (public) debt". Moreover the Bank of England has resorted to 'printing money' in a way that has significantly increased the British rate of inflation. If the situation in the Eurozone deteriorated further, the exposure of British banks (150bn Euros) to Eurozone creditors, not to mention the fact that the euro area is Britain's largest trading partner, could have significant risks for the well-being of the British economy. British tactics at the European Council had certainly not helped the position.

Mr Angel expressed surprise that the United Kingdom should have tried to block a new treaty, which "would have had no impact at all on the UK". The issues discussed at the Brussels summit were intended exclusively for members of the Eurozone. "Cameron's actions were seen by Eurozone leaders as wholly inappropriate and they received an immediate blunt reaction". He concluded by observing that the results of the recent European Council would be very negative for the UK. Britain had isolated itself from the decision making process, which would erode its influence within the Union. Moreover, "the treaty will exist without the British". The risks of Mr Cameron's veto are that Britain will become a marginalised actor on the European stage and that the UK may witness a rise in anti-European political parties, who may exploit Britain's self-willed exclusion from the decision making process in Brussels. "Not having Britain on board" was and would be, concluded Mr Angel, "a significant loss for the European Union".

The Maastricht Treaty with teeth

John Stevens, former Member of the European Parliament and Federal Trust Council member, began by referring to the clear contrast in regard to the difficulties of the Eurozone between 'the mood in New York and London on the one hand and on the other in Berlin and Paris'. The conflicting approaches to the crisis have accentuated differences of philosophy between what is commonly referred to as the 'Merkozy' camp (French President Nicholas Sarkozy and German Chancellor Angela Merkel) and the 'Anglo-Saxon' camp. The Anglo-Saxon world has proven to be particularly critical of Berlin's austerity driven approach to the crisis. Mr Stevens however argued that from the German point of view, Chancellor Merkel's strategy is both "prevailing and justified." She and her colleagues could plausibly claim that the Eurozone economy is going 'through a process which hopefully has a resolution at the end of which will ensure that interest rates would come down in a sustainable way'. Two Eurozone governments had recently collapsed, in Italy and in Greece, sparking instability in the European single currency area. It was the most urgent task of the new administrations that had emerged in Italy and Greece to create 'structures which ensure that this crisis never happens again'.

Mr Stevens made it clear that he believed any suggestion of Greece exiting from the 17 member single currency was highly implausible. In the worst case scenario, if Greece were to pull out of the Eurozone and return to the drachma it would leave the still struggling economies of Ireland, Italy and Portugal exposed. This could trigger a domino-effect as the respective member states might be tempted to follow Greece in reverting back to national currencies. It was in nobody's interest to risk such a self-defeating process. Furthermore, if by any chance the single European currency did implode, this would have severe ramifications for British economic interests and future growth. It was in the pressing British national interest that structures should be implemented to prevent such a cataclysmic sequence of events.

Both the French President and German Chancellor have proposed structures and legislation, one of those being the 'golden rule'. The ambitious 'golden rule' would demand constitutional legislation from each Eurozone member state and bind their respective governments to balancing their budgets. Mr Stevens argued that this is "essentially the Maastricht Treaty with teeth". He recognised the flaws of the original Maastricht Treaty: "The last time a constitutional criterion was in place, it was ignored". Goldman Sachs had allegedly helped Greece to "fiddle the books "and when Greece "turned up with figures people knew to be untrue" they went largely "unchallenged". Was there good reason to believe that things might be different this time?

Responding to his own question, he insisted that "markets do repeat errors but they take about twenty-years to do so". The likelihood of anybody lending excessively in the foreseeable future to Greece, Italy or Portugal is limited as a result of the current experience. Mr Stevens recognized that sometimes the Eurozone's leaders gave the impression of wanting to put "long-term solutions in place before they've addressed the immediate problems" which has been a factor behind creating fears in the banking sector and giving some plausibility to Anglo-Saxon criticism. The European Central Bank however was playing an increasing role as something like a 'lender of last resort' in order to ensure that no banks would fail. He accepted the general German view that the ECB must not be weakened in its structures and it should not replicate the policies of the Bank of England and the US Federal Reserve, both of whom are "essentially just printing money". If the Eurozone is to succeed in overcoming this economic crisis it is crucial that the ECB retains its credibility. At the same time however "the scale of the ECB's operations to support banks will be sufficient to keep interest rates in tandem without Portuguese or Greek debt exploding". The Eurozone's prospects for finding a way through its current, short-term difficulties, were good. European bank shares had increased in value by a quarter in recent months, and although it is "going to be a slow ride" to achieve full economic recovery in the Eurozone, Mr Stevens believed that the balance of probabilities has shifted very much in favour of the present crisis of the Eurozone's being over by next spring. He accepted that the Eurozone needed to return to healthy economic growth as soon as possible, but in this regard "a very fundamental question-mark hanging over all western economies, not just the Eurozone. This long-term problem requires long-term solutions.

In the second half of his presentation, Mr Stevens focused on the UK and the euro. He began by asking "whether the UK is isolated only in this particular case or are we in a slow divorce from Europe and the Eurozone?" He echoed Mr Angel's concluding argument that a detachment from the EU would be detrimental for the UK's economic interest. He argued that for the British economy to grow the Eurozone will need to recover its economic health and provide a welcoming market for a stronger British exporting economy. Mr Stevens criticised the current UK policy of "standing alone and trying to enforce a notion of independence" because "the UK is in fact entirely dependent, even more dependent than it was before the deployment of this veto, on what happens in the Eurozone".

Mr Stevens observed that monetary questions have always been a particularly controversial element of British attitudes towards the European Union. This stems perhaps from Britain's expulsion from the Exchange Rate Mechanism (ERM) in 1992, under a previous Conservative administration led by former Prime Minister John Major. There were echoes of those turbulent times in the recent crisis of the Eurozone. "Neither episode improved British attitudes towards Europe and both played into the hands of eurosceptic MPs". The ERM crisis of 1992 remained in the British consciousness, acting as a formidable obstacle to promoting membership to the single currency "because it built an assumption in the British establishment that all European monetary arrangements are unsound". The Eurozone crisis has reinforced that attitude and "where the ERM crisis made it impossible for us to join the euro", the impact of the current crisis may drive Britain further into isolation, "a semi-detached status which is a very grave risk". Mr Stevens did however see two forces, one internal and one external, which might act as counter-weights to this movement towards isolationism.

The internal factor that acts as a counterweight to the UK's resting on the sidelines of Europe is the current drive by Alex Salmond's Scottish National Party (SNP) to lead Scotland out of the

United Kingdom. Mr Stevens argued that "a semi-detached Britain in Europe" is a Britain that has much less chance of holding together as an internal Union. The Conservative Party was deeply committed to the unity of the United Kingdom and might well be unwilling to risk its fracturing by excessively disruptive European policies. Even for the "Conservative party that might be a bridge too far". The external factor is that despite the current underlying tensions between Britain and the EU, both France and Germany "are desperate to work out a way in which Britain can be turned around into a pro-European power". Their thinking is that the more unified the Eurozone becomes, "the more the absence of Britain will weigh".

He concluded by considering the consequences of a rift in UK-EU relations. He noted that as a result of current tensions and of the ongoing economic uncertainties, the EU has moved from being a "purely diplomatic exercise into an overtly political one", a development he welcomed. When ten years ago Greece had produced figures "everyone knew to be untrue" no one went about challenging them. In contrast, such diplomacy has become today a thing of the past within the Union. In several recent instances, trans-national political action had helped to shape the development of the Eurozone. There had been demonstrations in Rome against Mr. Berlusconi where senior politicians fromthe French left were present, and the special relationship between Merkel and Sarkozy had led to her endorsing his Presidential candidature for the French Elections in the spring of 2012. This could well have implications for the domestic British political scene. A Socialist President in France and a possible change of government in Germany could lead the British Labour Party to believe that it would now be easier to work with like-minded colleagues in the other two largest Member States of the Union.

The view from the City of London

Graham Bishop, a financial analyst and commentator on economic and structural developments in the financial markets of Europe, began his presentation by focusing on what he saw as the unexpected attempt by David Cameron to veto the treaty on Fiscal Union. He wondered in particular "how the Foreign Office completely failed to read the rumours around Europe and did not realise that if you put a document like this out you are going to get hit on the nose". He quoted Sharon Bowles, the chair of European Parliament's Economic and Monetary Affairs Committee (ECON) who referred to the British government's document presented to the European Council as 'a carefully crafted wolf in sheep's clothing', and Chris Davies MEP, who described the text as 'a rat sandwich'.

Mr Bishop argued that British ministers should have realized their growing isolation at the latest in summer of 2011, when the "Merkozy joint venture" increasingly started acting together in their approach to the Eurozone crisis. "The signals were there absolutely clear so you could see the broad line of this in August...then you have the October 25th Euro summit statement which laid out 10 measures to be approved by the governments of the Eurozone”. It had for many months been clear that the Eurozone was moving towards much deeper mutual surveillance, a surveillance to be carried out in the Eurozone, not in the EU as a whole. For this, a new treaty would be necessary. The regulations currently under negotiation for the better governance of the Eurozone (the 'six-pack') bore testimony to the desire of the Eurozone countries for greater financial and monetary integration. The time taken however in this negotiation had meant that “market confidence dribbled away.” The 'six- pack' had gone “right up to the edge and couldn’t go beyond”. The EU had in consequence “for the last few weeks been furiously working on the idea of a treaty change”. The only question that remained unanswered was: is it to be a treaty of 17 or a treaty of 27? Finally the UK prevented a treaty of all 27 member states. For Mr Bishop this was a great mistake. Not only did Britain in effect marginalise itself from Europe but it also appeared as treacherous in a fashion that will be remembered.

Action along the lines of the proposed Fiscal Treaty was, in Mr Bishop’s view, urgently necessary. In the early 1970s, ratios of public debt to GDP were usually below 30 percent. The Maastricht Treaty of 1992 had determined that public debt ratios should be limited to 60 percent of GDP “but very few states met the criteria”. Debt ratios rose to around the 70 percent mark at the time when “France and Germany drove a coach and horse through the Growth and Stability Pact.” When the economic crisis began in 2008 the debt ratio increased dramatically from an average of 68 percent to 82 percent. Currently debt ratios in the EU stand at 90 percent and are set to continue rising. The implementation of austerity measures will suffice, in his view, “simply to stop debt ratios rising.” But perhaps these ratios need rather to be brought down. Buyers of government bonds are the managers of institutions specialising in life savings, pensions and other financial planning for individuals. These buyers are beginning to say on behalf of the public, “debt ratios have tripled in a life time and that’s enough". If he were a bond fund manager, Mr Bishop might well fear that his clients might not get paid back by the government. In these circumstances he and his colleagues would be tempted to go on a 'buyer’s strike' This would ensure a global bond crisis. If there were a new Socialist President in France, he might indeed wish to reflate the French economy by further borrowing, but it would be wholly inappropriate (and probably impossible) for him to do so, playing as he would be with the life savings of the public. For the past forty years governments have been claiming to want to reduce public indebtedness, but consistently failed to do so. In response to the challenging question, “Where is European growth going to come from?” Mr Bishop pointed back to the era of Thatcherite reforms in the United Kingdom, which restored competiveness “by removing the shackles on society, and allowing entrepreneurship”.

As a final observation on the European Council of December, 2011, Graham Bishop took issue with the claim of David Cameron that he was protecting at that meeting the UK's interests in general and those of the City of London in particular. His sense of the general consensus in the City was that Mr Cameron's strategy had done little to protect the interests of London as a financial hub. On the other hand, it would be a tragedy for all involved if Britain's neighbours attempted to retaliate by adopting financial regulations to undermine the position of the City. Europe's financial system as a whole would suffer, even if Britain's current financial difficulties made it particularly vulnerable to hostile action from outside. "Most people in this country don't realise how bad our situation is and this what makes things so remarkable".

Concluding his presentation, Mr Bishop warned that "unless things move quickly we're going to fall into a vicious circle" in which banks, their governmental guarantors and government bonds stand or fall together. The current crisis is, in his view, not so much a banking crisis but rather a government debt crisis. If the government debt crisis is solved then in turn the banks will survive and resume their crucial role of facilitating growth. If the government debt crisis is not rapidly solved, the future seems bleak indeed.

A British view, not from the City

Echoing the other three speakers' disappointment with the Cameron government's attempted veto at the euro summit, Sir Brian Unwin, former President of the European Investment Bank, began on a personal note explaining that he "can't remember a Federal Trust conference where I was as angry and depressed as I am today". Despite the setback Sir Brian was keen to start by highlighting positive aspects of the Eurozone in times of economic uncertainty.

Sir Brian recalled that Europe has 326m inhabitants, the third largest population in the world, behind China and India and ahead of the United States. The latest World Bank figures show it as the second largest economy in the world, with a GDP of 12.175trillion euros, behind the US, but more than twice as large that of China and well ahead of Japan. Europe as an entity is the biggest exporter in the world, the world's first destination for Foreign Direct Investment (FDI) and still dominates the competiveness rankings on a global scale.

Turning his attention to the current crisis and the debt of the Eurozone as a whole Sir Brian asserted that "it is not unmanageable". Currently, European sovereign debt stands at just over 85 percent of the Eurozone GDP. This debt ratio is too high and beyond the Maastricht Treaty's 60 percent criterion, but "it is not catastrophic". The comparison with the USA, which has a debt to GDP ratio of 95 percent and "has no credible plan to reduce" the deficit, and with Japan, where the debt ratio stands at a 220 percent is greatly in the Eurozone's favour. The euro has continued to be a strong currency throughout the period of economic turmoil.

Moreover, the euro remains the world's second reserve currency, with 20 percent of the world's currency reserves being held in euros, while the euro itself has "appreciated substantially against sterling over the last two or three years". The euro however lacks a developed government structure, "to harness this huge economic trading and financial strength as a credible composite entity". An optimistic forecast for the outcome of the current crisis would point towards the implementation of a political system of governance which could utilize the economic power of the euro, a "Maastricht treaty with teeth," as John Stevens had earlier put it .

Sir Brian accepted that there are many uncertainties about the future course of the Eurozone. He considered two broad outcomes, the first based on a failure of the recent summit decisions to prevent the collapse of the Eurozone, the second echoing the 'optimistic view' of Mr Stevens that the Eurozone's survival will be guaranteed by the "new treaty among the seventeen or probably the twenty six member states willing to sign it.".

In the first hypothesis, that the package agreed at the European Council was unsuccessful and the Eurozone subsequently disintegrated, the already insecure UK economy, not to mention the European economy as a whole would suffer enormous damage. One UK Treasury report has suggested that should the Eurozone collapse, the UK could lose as much as seven percent of its GDP. Sir Brian suspected that the figure could be far higher as almost 40 percent of British exports are to the Eurozone. The global financial system would be thrown into disarray by a collapse of the euro, leaving British banks in "serious trouble" with "all hope of UK growth receding into a very distant future". Sir Brian echoed Graham Bishop's criticism of David Cameron, suggesting that his attempts to 'safeguard' the City of London would actually allow the City to "suffer a very significant exodus of business". If the European single currency were disbanded and national currencies reinstated, an important reason why international financial institutions should continue doing business in London would disappear and trading in US dollars "which is controlled entirely from New York" would greatly increase. Sir Brian stressed that already "sterling is of limited interest to the world at large and successor European economies would be subject to tighter controls for some time following the collapse of the euro". This would certainly lead to an exodus from the City, which would thus lose its status as a major global financial hub, by some way the largest in Europe.

Under the second hypothesis, that the Eurozone will indeed survive, Sir Brian thought "it seems likely there would be a new Eurozone of up to 26 members consolidating round a fiscal union with a tough new regime of budgetary discipline." Sir Brian also envisaged some neutralisation or joint guarantee of debts and "certainly a broader role for the ECB". The broader role for the ECB should oblige it to act along the lines of the US Federal Reserve, guiding economic growth as well as inflation.

Sir Brian criticized the current British government's general attitude to the problems of the Eurozone. It had shown an "unwillingness to lift a finger to achieve the common solution which is overwhelmingly in Britain's interest". The danger of this approach was that Britain would marginalise itself and end up having little or no influence over the new Eurozone "compromising the great majority of the European Union's membership". Although the British government was happy to urge European governments to get their own financial houses in order, the UK had until now refused to give any "practical or financial help at all".

Sir Brian believed that the City of London was in a "lose-lose" situation. If the Eurozone succeeds in overcoming this crisis, "we could see a similar withdrawal of foreign and financial institutions leaving the City to that we envisage in the disintegration hypothesis". This could in its turn lead to what Mr Stevens had mentioned as a danger, namely a reinforcement of the position of Conservative eurosceptics in particular and in the medium term a referendum on British membership of the European Union. The overwhelmingly Eurosceptic state of British public opinion might suggest that such a referendum would lead to British withdrawal from the European Union. On the other hand Sir Brian did not rule out the possibility that a combination of further deterioration in the UK economy and renewed growth in the Eurozone might trigger a revision of British attitudes to the single European currency and to the European Union in general. Since the 2007-08 banking crisis began, the UK's main competitors, France and Germany, "have fared better than we have". Both states have suffered lesser falls in output than has the UK. The British public sector has a "fiscal deficit three times that of Germany and 50 percent above that of France. By 2013 the burden of UK government debt will for the first time in decades exceed the Eurozone average". The Bank of England almost seems to have lost interest in its two percent target for inflation and "prices in the UK are rising much faster than those in the Eurozone". Even the Chancellor George Osborne had acknowledged in a recent statement that the British economy "is in a very much worse mess than the government predicted only a few months ago."

Sir Brian rejected the argument of those who claim that outside the euro the UK has had the "great advantage of being free to devalue its currency and so maintain competiveness". The depreciation of sterling by 20-25 percent in trade weighted terms over the past three years had "done nothing for exports". He recognized that all speculation about the possible course of the British economy had it been part of the Eurozone since 1999 must be largely speculative. If Britain had joined the euro, interest rates over most of the past ten years would have been lower than they were, possibly fuelling yet further the United Kingdom's credit boom and subsequent bust. On the other hand, "it's perfectly possible to argue that within the euro we would have run a much tighter fiscal policy and even imposed offsetting credit controls." Within the euro, Britain would certainly have been able to have a direct influence of the policies on the ECB. Sir Brian hoped that this consideration at least would come to figure more largely in the British public debate on the euro resulting from the polemic and controversy generated in this country by the crisis of the Eurozone.