



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

9 July 2010

Dear Taskforce members

I am writing ahead of the EU Economic Taskforce meeting next Monday to set out some thoughts on economic governance. This debate is of great importance to the future strength and prosperity of the European Union and to all our economies.

The challenges that we now face highlight the importance of the Stability and Growth Pact as a framework for fiscal policy in Europe. The importance of co-ordinated fiscal policy is particularly strong for euroarea Member States, but it is in all our best interests that European economies are strong and well functioning. The UK is facing similar economic challenges to those confronting many other European countries – including how to put public finances back on to a sustainable footing - and we have a strong interest in the important work that this Taskforce is doing. I therefore hope that you will find the ideas in the attached paper useful and interesting.

I look forward to seeing you at the Taskforce next Monday, and continuing our discussions on these and other issues.

A handwritten signature in black ink that reads 'George Osborne'.

GEORGE OSBORNE

Paper from the UK on economic governance

The EU's first priority is to restore our public finances to a stable footing while continuing to ensure the economic recovery. The UK believes that there are five key principles that should underpin our future approach to EU economic governance:

1. Greater transparency and independence of national institutions.

The Commission Communication of 30 June highlighted the importance of robust and credible economic forecasts underpinning budgets and fiscal projections. These, together with accurate statistics, are vital to give confidence to markets and investors. The recent amendments to the EDP Statistics Regulation allow Eurostat an appropriate level of oversight of national debt and deficit statistics, which is a step in the right direction, but we now need to go further. We must act to prevent any perception of political interference in the production of statistics and fiscal judgments by reinforcing our statistical and fiscal institutions, to make them functionally independent of government.

Since the Taskforce last met, I have announced the creation of a new UK Office for Budget Responsibility (OBR). The UK Government's fiscal policy decisions will be based on independent forecasts for the economy and public finances, prepared by the OBR. The OBR will also analyse the Treasury's fiscal plans for every Budget, and provide an assessment of whether the Government has a greater than 50% chance of meeting its fiscal mandate. The creation of the OBR places the principles of transparency and independence at the core of the fiscal policy framework in the UK.

2. National budgetary and parliamentary procedures

The EU semester is a welcome development, as it will reconcile the timetables for consideration of fiscal and structural policy. While the two are separate, it is often important to consider fiscal policy in conjunction with structural policy. The EU semester will allow the Commission and Council to assess Member States in a coherent way. A single timetable for all Member States will also add a greater degree of transparency and fairness to Stability and Growth Pact assessments. However, the Commission Communication recognises that the EU semester would benefit from an "early and strong" input from national parliaments. Democratic legitimacy is vital to everything that the EU does, and Ministers need to be accountable both to other EU Member States and to their electorate. Therefore, as the June European Council conclusions make clear, any new mechanisms or processes that we introduce must take account of, and complement the work of national parliaments in setting budgets. For the UK, this will mean that the UK Budget is presented first to the UK Parliament.

3. Macroeconomic surveillance

Stronger macroeconomic surveillance, which can identify any competitiveness challenges or patterns of imbalanced growth, is crucial if the EU is to achieve stronger and more stable growth in future.

There has been a growing recognition of the link between the lack of adjustment in some euroarea Member States, the loss of competitiveness that has followed, and the

resulting pattern of unbalanced growth in the euroarea. The Commission noted, in the EMU@10 report (2008), that "... even though a comprehensive framework for fiscal surveillance has been developed and agreed in EMU, countries may comply with the provisions of the SGP and still build up internal or external imbalances... This calls for ... a deepening and broadening of surveillance".

The need for intra-euroarea surveillance of macroeconomic imbalances is strong, with a particular focus on developments in competitiveness and economic flexibility, because membership of the single currency necessarily removes some particular channels of adjustment. But this is an issue that needs to be considered across the EU27 – compliance with the Stability and Growth Pact in some Member States went hand-in-hand with significant and unsustainable economic imbalances.

The German position paper for the Taskforce said that Member States must play an "active and committed" role in macroeconomic surveillance. The UK agrees that the EU needs to take this process more seriously in future. Changes should build on existing instruments under Europe 2020 wherever possible, using the national obstacles or "bottlenecks" to growth for example as a valuable mechanism for improving national ownership, responsibility and accountability. We must be able to give clear, fair and honest policy recommendations to Member States that have been made on the basis of solid evidence, and these should be followed up by tougher recommendations if necessary, in line with Articles 121 and 136 of the Lisbon Treaty. Equally, praise should be given to Member States that have made significant progress, so that there are positive incentives for countries to improve - and more efforts should be made to highlight and share best practice. This may not always be a comfortable process, but we have to be courageous if we are serious about making macroeconomic surveillance work properly.

4. Reinforcing the Stability and Growth Pact

For the Stability and Growth Pact to be effective and credible, the EU must be clear that we are willing to take action against Member States who do not comply with its terms. The EDP plays an important part in holding national governments to account, and the Commission and Council must not shy away from putting countries into EDP when they breach, or are forecast to breach, the Treaty reference values. Equally, we must take a rigorous approach in assessing whether effective action has been taken against EDP recommendations.

The UK would advocate greater use of non-financial sanctions: "naming and shaming" can have a powerful effect. With this in mind, I would suggest that ECOFIN itself should have more substantive discussions of Stability and Growth Pact decisions and recommendations. Given the importance of these documents, it is surprising that these are normally signed off by senior officials - Finance Ministers should spend more time at ECOFIN considering the assessments of other countries, as well as answering questions on their own fiscal position and budgetary plans. In particular, Finance Ministers should be required to make a personal, public statement to ECOFIN if their fiscal plans fall short of Council recommendations.

Financial sanctions for non-compliance with the SGP already exist for euroarea Member States under the Treaty, and the UK continues to hold the view that sanctions are most appropriate for euroarea Member States, for whom non-compliance with the SGP has the greatest potential externalities. That said, the UK understands that, in the current circumstances, other Member States who are not currently members of the single currency but in line to join the euro in the next few years may decide that it is in their interests to be subject to the same sanctions as euroarea countries. We respect the economic logic behind this argument, and would be happy for those countries to make a voluntary agreement that sanctions can be applied to them. However, sanctions cannot apply to the UK, due to provisions in our Protocol to the Treaty. Unlike all other Member States, who “shall avoid excessive deficits”, the UK is only required to “endeavour to avoid” excessive deficits. Moreover, sanctions under the Pact are explicitly disappplied to the UK in our Protocol to the Treaty.

5. Debt and the Stability and Growth Pact

The June European Council Conclusions confirm that there should be a greater focus on the debt criterion of the Stability and Growth Pact. The UK strongly supports this approach – countries with rapidly increasing debt levels are particularly vulnerable to changes in market sentiment and interest rates. The structure of debt is also important and should be taken into greater account. Member States that have a large amount of short-term debt may be more vulnerable to refinancing difficulties in the face of deteriorating market sentiment than Member States with longer term maturity debts.

Moreover, the scale and impact of the economic downturn will leave many Member States with debts above 60% of GDP for a number of years, so there must be an appropriate period of adjustment. The primary focus should be on the path of debt, rather than absolute debt levels. It may be appropriate for countries with rapidly increasing debt levels to be put into the EDP or kept in EDP when their deficits fall below 3%. However, debt is a complex issue and the Council must retain some degree of discretion when looking at this.

6. Governance at EU27

The financial crisis and subsequent problems in the real economy have highlighted the importance of considering issues of economic governance at the level of EU27. The difficulties that we have faced and our ability to respond to them have clearly demonstrated the ever-increasing interdependence of our economies. Problems in one Member State can quickly impact on us all, and the actions that we have taken to respond have worked best when we have acted collectively.

All countries have important experience to share in this debate, whether they are members of the single currency or not. The work of this Taskforce provides an opportunity for us to consider these vital issues and share experience at the EU 27 level. Obviously there will always be issues of particular significance to the euro area, and we must respect specific Treaty provisions as they apply to individual Member States. However, a strong and stable European economy requires a framework that respects the views and circumstances of all its Member States.