



HOUSE OF LORDS

Revised transcript of evidence taken before

The Select Committee on the European Union

Financial Affairs Sub-Committee

Inquiry on

COMPLETING EUROPE'S ECONOMIC AND MONETARY UNION

Evidence Session No. 4

Heard in Public

Questions 45 - 55

WEDNESDAY 16 DECEMBER 2015

10.10 am

Witness: Christian Odendahl

Members present

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

Examination of Witness

Christian Odendahl, Chief Economist, Centre for European Reform

Q45 The Chairman: Good morning, Dr Odendahl, and welcome to the inquiry of the EU Financial Affairs Sub-Committee on completing Europe's economic and monetary union. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee. A full transcript will be taken. This will be put on the public record in printed form and will be on the Parliament website. You will be sent a copy of the transcript and will be able to amend any minor errors. The session is on the record. It is being webcast live and will be accessible subsequently via the Parliament website. Would you like to make any opening remarks in relation to your paper or other thoughts you have on this issue?

Christian Odendahl: No, we can start with the questions.

The Chairman: In that case, let me kick off. What is your assessment of the Five Presidents' Report and the actions introduced in the short term as well as the longer term? I recognise that the question takes us forward in terms of what is envisaged in completing the eurozone's economic and monetary union, and that of the EU, but another question that has come up in our minds as we have gone through this inquiry is whether you think that the economic and monetary union itself has a long-term sustainable future. Perhaps you could address that broader question first and then go into the Five Presidents' Report.

Christian Odendahl: That is a difficult question to answer, because we do not know the future path of policymaking. I do not think that the euro is unsustainable per se, but in its current form, both politically and economically, there are a couple of risks. One is that we are still in the aftermath of a crisis and still below potential in terms of growth and inflation. Economic policy changes are needed for the eurozone to return to potential. This would be a prerequisite for the long-term survival of the eurozone. Politically, if countries and

constituencies believe that policies are implemented on the basis not of national democracy but of necessity to keep together a project that they were not in favour of in the first place, this threatens politically not only the eurozone but maybe even the European project as a whole. It is crucial that in the eurozone we discuss what policy changes are needed—without reservation—to make sure that it is sustainable in the long term.

The Chairman: Can I just stop you there in light of what you have just said? Do you believe that the policy changes envisaged by the Presidents are inadequate?

Christian Odendahl: I do not think they are enough to address the political problems. The eurozone also depends on what is happening in the world, so there is a scenario in which, if the world economy develops well, the current set-up will also be enough economically—in combination with the ECB's monetary policy, for example—to get the eurozone back on track. But they are not adequate to address the long-term political challenges of the eurozone.

The Chairman: And the Five Presidents' Report?

Christian Odendahl: There are good and bad sides to the Five Presidents' Report. The positive side is that the Five Presidents' Report focuses on completion of the financial union. That is very important. It has two parts to it: banking and capital markets. Banks play a very strong role in financing eurozone businesses. In the crisis they were also a prime source of instability, both for the economy and for the Governments, because local economies, local banks and the Governments were in a sort of doom loop, where the weakness of one reinforced the weaknesses of the other two. Regulation needed to be improved and the banks needed to be decoupled from their sovereigns. The banking union has been a big step forward in that respect, a larger step than I think many people believed was possible at the time, but there are lots of loose ends that still need to be tied up. One of those is implementing regulations that have already been decided, such as the BRD—the bank resolution and recovery directive—and the directive on common deposit insurance. There is also the further harmonisation of regulation and supervision, and the resolution procedures, which are still complicated and probably underfunded. So there are lots of loose ends, and the Five Presidents' Report puts a lot of emphasis, in the short and long term, on completing that. That is probably the most positive step.

The other part is capital markets. Capital markets in monetary unions such as the US play a very important role in spreading regional shocks. So truly integrated capital markets and more private risk-sharing would be a big step forward. Of course, this is a much more complicated problem than banking union was. Capital markets cover a broad range of issues and they touch upon various things that are clearly under national responsibility, not European

responsibility. The fact that the Five Presidents' Report recognises the importance of the capital markets union and wants to make it a priority to develop it a bit further is very positive.

I have two main criticisms of the Five Presidents' Report. The first concerns fiscal policy. The governance framework for fiscal policy in the eurozone was set up as a defence mechanism against government bailouts. Clearly that has not worked, but its reforms still emphasise debt reduction, whereas fiscal policy in a monetary union is a much more complex issue. When countries give up monetary policy—their main stabilisation tool—they need to replace it with something else. Strongly countercyclical fiscal policies should have been the focus. That is not being emphasised nearly enough, in my view.

The second criticism concerns the ECB. One of the most important lessons from fixed exchange rate regimes in the past, going all the way back to the gold standard more than 100 years ago, is that a deflationary period, or a period of too low demand in general, is very threatening for the entire project. The ECB has failed to keep demand on track. We still see inflation at around zero. It famously hiked rates in 2008 and 2011. We need to rethink whether the mandate for the ECB is appropriate and whether the ECB's monetary policy is appropriate for the eurozone. The Five Presidents' Report, for understandable political reasons, is entirely silent on this issue.

Q46 Lord Borwick: Thank you very much for your report, which I really did find fascinating. Can we talk about the differences of policy preferences among the eurozone countries, particularly where you say that each central bank will be an important player in the future? Is it not very likely that each central bank will be a national champion for its country and therefore tend to increase divergences among the eurozone countries?

Christian Odendahl: That is a fair point. The difference is that national preferences are informed in part by the position in this crisis—whether you are a debtor or a creditor. Historically, there have been countries that have changed their positions based on whether they were a creditor or a debtor, so I do not want to make the argument that there is a general German view; it is also informed by the fact that Germany is the main creditor. When it comes to central banks—this was the idea in the report—they have been the guardians of macroeconomic stability in the past. The tool was monetary policy because it was the most important. When countries give up monetary policy, the tools for macroeconomic stabilisation change. The idea in the report was that central banks already have the implicit mandate of macroeconomic stability. They probably have a more macroeconomic mindset than, say, finance ministries. The tradition of central banks may well differ across the eurozone—that is

for sure—but in terms of the institutions most likely to have a macroeconomic mindset and to conduct policies in the macroeconomic stability interests both of the countries and of the eurozone, I think that central banks are probably the best placed of the given institutions that already have credibility in the eyes of the public and a strong political mandate that politicians might listen to.

Lord Borwick: You are saying that they are the most likely people to do this but do you think that they actually will do it. Will they be sufficient?

Christian Odendahl: The idea that I put forward in the report was to facilitate the discussion about what kind of fiscal institutions we need. For instance, can fiscal rules lead to macroeconomic stability? We are seeing that fiscal rules are difficult to implement from the outside. The idea was: is there a national institution that would be capable of that? It is hard to say. If that were implemented, would national central banks be willing to carry out that role? I would say yes.

Lord Lawson of Blaby: May I add something to Lord Borwick's question? I, too, thought that your paper was most interesting. I would like to probe one or two things arising from that, because I think it identifies most of the important issues. Specifically on this point, the idea that the independent central banks—because in addition to the European Central Bank being independent, each of the national banks is independent, so they escape the political constraints altogether—should be responsible for fiscal policy is completely unacceptable in a democracy. There has been a lot of debate in this country. In Germany, it was different. The idea of an independent central bank was accepted because of Germany's history—because of Weimar and the inflation of the 1920s and the inflation that happened in the immediate post-war era. So there was an acceptance of an independent central bank for monetary policy. It took a long time before this was accepted in this country, because it was felt that there had to be a democratic say in monetary policy. We have accepted now that there should be an independent central bank for monetary policy, but there is no way in which this country—and, I suggest, most countries—would accept removing democratic consent from fiscal policy. It is intensely political.

Christian Odendahl: Yes, absolutely. I am not proposing to put the entirety of fiscal policy in the hands of an independent institution. The idea was that in the eurozone, at least de jure, we already gave away the right to set the appropriate stance of fiscal policy for the fiscal rules that we signed up to. It is not that I am proposing—

Lord Lawson of Blaby: Which are not adhered to, of course.

Christian Odendahl: You might well argue that countries have agreed to fiscal rules because they knew that they would not adhere to them. That might be true, but my point is that it is only the part that determines the appropriate cyclical stance of fiscal policy that needs some checks and balances in a monetary union, where the cyclical stance of fiscal policy cannot easily be corrected when things go wrong by a tailored monetary policy in that country. I am fully aware of the political difficulties of that point, but it is crucial in the eurozone that we talk about how we set fiscal policy appropriately from a macroeconomic stability perspective. We have tended to go to fiscal rules, because that is how it was set up in the beginning, but as you rightly say, they are in part not implemented. I would argue that they are not capable of capturing the complexity of fiscal policymaking in a monetary union. I do not think that fiscal rules are necessarily appropriate, so the question is: what kind of different institution that constrains democracy in some respect is necessary for the eurozone to flourish macroeconomically?

Countercyclical fiscal policy has always been difficult for democracies to implement. There are various examples across the world and across history. I always find the example of Chile the most interesting, because Chile's fiscal revenue depends to a large extent on the copper price. Chile has given itself very predictable, very transparent fiscal rules that relate to the copper price. It is relatively easy to tie fiscal policy to copper, but even there it has been very difficult democratically, despite the experience of repeated crises, to stick to those rules when the copper price is booming. Democratically, it is very difficult to conduct strongly countercyclical policies. Since that is what we need in the eurozone, we need to find some kind of arrangement that ensures that.

Q47 Lord Shutt of Greetland: The question was about fiscal union. Having read your paper, I wonder whether you think there should be any fiscal union. Fiscal rules are one thing but a union is something different. Would you like to expand on where you are with fiscal union? Should there just be fiscal rules and fiscal policy is to do with member states—in the eurozone or otherwise?

Christian Odendahl: Fiscal union is a term that is understood differently by different people. To some extent, limited fiscal union is necessary. One thing is the function of lender of last resort for the ECB. That is one of the strongest lessons from the crisis: without a lender of last resort to Governments, the eurozone is inherently unstable. A central lender of last resort to Governments is a form of fiscal union, because it is a form of risk insurance—fiscal insurance, if you like. The other part is banking. As I said in the report and before, it is crucial that we decouple banks from sovereigns, which means that we put the resolution—back-up

and bailout—capacity of banks at the European level, which is also a form of fiscal union. Some pooling of risk is necessary, but given that the democratic legitimacy at the central level is much lower than that of nation states, we need to be careful which parts we want to put under common control. That is why I would argue that the lender of last resort function, plus the banking union and whatever fiscal union that entails, is probably necessary.

The other part is whether fiscal policymaking needs to be determined centrally. My argument is that nation states have all the incentives to conduct reasonable fiscal policies, because they are the ones that suffer when this goes wrong. But the problem, as I said before, is that democracies might find it hard to conduct these kinds of stabilising fiscal policies. Fiscal union in terms of risk-sharing needs to be limited to things where it is really necessary—the lender of last resort and the banking union—and fiscal union as it concerns how we want to set up fiscal institutions should probably be left to nation states.

Lord Shutt of Greetland: You are talking about countercyclical policy, and I think you are suggesting that the nation states would, as it were, be trying to rev up economies. How is it going to work when overheating happens?

Christian Odendahl: Countercyclical policies, of course, go in both directions. Countercyclical policy is difficult, in both the upturn and the downturn. In the upturn, during boom times, it is difficult for democratic Governments to contain that boom. There are plenty of examples in history of that. So we need a constraint on Governments during boom times that they conduct countercyclical policies to contain that boom. During a recession time, we saw a push for pro-cyclical consolidation across Europe because people disliked the deficit and they feared that they were running up too much debt. Even there, we saw pro-cyclical policies. During both periods, boom and bust, we saw pro-cyclical policies. Countercyclical policies are difficult for democracies in both periods but are equally important.

The Chairman: You mentioned institutions in terms of fiscal union. I take it you would be opposed to Mr Schäuble's vision of a super-commissioner, a eurozone Finance Minister, because you want to keep fiscal tools in the hands of national Governments.

Christian Odendahl: I think Wolfgang Schäuble and I are of the same opinion on this, because his suggestion is probably a political one. He says, "We can offer a central fiscal institution and some kind of risk-sharing at the central level, but then we need central control"—of course knowing that no country in Europe would give up budgetary control to a European Finance Minister. My suggestion is that for political reasons we should try to keep as much as possible with the nation states, and if we can find the right institutions to implement countercyclical policy at the national level it can be left to national Governments.

Q48 The Chairman: I want to go back to a more overarching concern for our Committee, which is the implications of the Five Presidents' Report on the eurozone outs, and whether you think that there will be implications. How do you see the nine countries outside the eurozone being impacted, particularly the United Kingdom, because it is Europe's singular financial services capital?

Christian Odendahl: The direct impact on the UK will probably be minor because the UK is not affected by most of the eurozone's processes; it is not part of the banking union, for example. A potential upside for the United Kingdom is probably the capital markets union. If there is a larger push for a swifter process on the capital markets union, one of the countries that stand to benefit is the United Kingdom, as the centre of the financial system. The indirect impact of a more stable monetary union will of course be positive but, as I said before, most of the macroeconomic stabilisation policies are not tackled in the Five Presidents' Report, so there will not be that much of a positive impact. The most positive impact would be if the eurozone started to generate self-sustaining growth and not depend on the outside world, including the United Kingdom, to drive its growth, as is currently the case. Eurozone growth depends to too large an extent on the outside world, and the result is a weak economy, low interest rates, a low currency and a strong pound—arguably too strong for rebalancing the UK economy. But I do not think that the suggestions made in the Five Presidents' Report will go a long way to addressing that.

The Chairman: Since you are talking about the eurozone's reliance on a few countries only, do you think the report will have a significant direct impact on Germany?

Christian Odendahl: Economically the direct impact will be minor. The limited amount of risk-pooling which the report suggests—in terms of the banking union, for example—is something that Germany dislikes but which Germany could actually benefit from. A more stable banking system—including Germany's, by the way—is clearly in Germany's and the eurozone's interest. But on economic policy, I do not see how the Five Presidents' Report on the eurozone will affect Germany much. The biggest issue is the German current account surplus. The policies for reducing that current account surplus are almost entirely national. The thresholds in the macroeconomic imbalance procedure were set at a relatively high 6%. Even now that Germany is above that level, the Commission is merely warning Germany that this is potentially endangering the balance. The measures that Germany has decided on to address that imbalance are so tiny that they will not make a difference, and there is no way the Commission can force Germany to address this.

Lord Skidelsky: There are no sanctions on countries that run what the Commission considers to be an excessive current account surplus?

Christian Odendahl: There are two things. First, we need the Commission to decide that it is actually excessive. Then we need a political decision on sanctions, but I do not see that happening.

The Chairman: That takes us to Lord Butler.

Q49 Lord Butler of Brockwell: Coming on to banking union, I think I heard you say that you regarded the steps towards a banking union that had resulted from the reaction to the crisis as one of the successes of the policy. Given that Germany has expressed its opposition to the further steps proposed by the Commission, do you think that is going to be carried forward?

Christian Odendahl: Germany has not expressed reservations on all the points that the European Commission proposed. If you read the Five Presidents' Report and the action plan, some of those issues are actually exactly what Germany wants: namely, that countries implement the existing regulations first. That is one of the points that Germany insists on before any steps towards further mutualisation of risk can be taken. I think in the end there will be an agreement, because Germany cannot credibly deny the eurozone some form of common deposit insurance once most policies that affect banking are at the European level. That was always Germany's point: wherever there is decision-making, there should also be the responsibility for risk-sharing. Once banking policies are to a large extent at the European level, I do not think Germany can resist, entirely at least, a common deposit insurance. There will be a compromise that takes some of the German concerns into account; for instance, the German small savings and regional banks probably will have to be excluded, because otherwise the political resistance within Germany will be too strong.

I am not entirely sure that at this juncture, in the short term, deposit insurance is the most promising policy step in the banking union. We already have changes in regulation. We have a new set of regulations called TLAC—the total loss-absorbing capacity—which means that bailing in depositors would be a last-resort measure. We have the ECB's established role as a lender of last resort to banks, which took the crisis to develop. We also have the implicit political protection of depositors. If you remember the Greek crisis over the summer, rather than hitting depositors, European policymakers, even in that political heat, decided to protect Greek depositors. That is also politically a strong signal that they have learnt from the Cyprus disaster and have agreed politically that depositors should not be hit, and the ECB is a strong defender of depositors, both internally and externally. I am not sure it is a necessary step. I

would much rather have the resolution procedure reopened and for there to be a proper backstop for the resolution fund, which the European Commission also proposes in its action plan. There are lots of loose ends in this banking union. Germany wants some of them; the other countries want others. I hope that there is some kind of compromise. At least for the deposit insurance, I expect there to be a compromise because that is such a prestigious project.

Lord Butler of Brockwell: I think you said that a prior condition was that individual countries should introduce regulations in their banking systems. Do you think that that prior condition is likely to be fulfilled?

Christian Odendahl: I think Germany will insist on it. I do not think Germany will agree to any sort of meaningful deposit insurance before that, or it will build in the requirements that only countries that have fully implemented all these regulations can take part. I think that will be made a condition, absolutely.

Lord Butler of Brockwell: We have a bit of a chicken and egg situation, do we not?

Christian Odendahl: Possibly, but I think Germany has proved again that it is quite good at this game.

Q50 Earl of Lindsay: In your opening remarks you welcomed the capital markets union as being one of the more positive parts of the Five Presidents' Report. You then went on to say that you saw complications in its delivery. Would you like to expand on what those complications are? Do you think they will be overcome? What will be the consequences for economic and monetary union if the capital markets union ambition fails?

Christian Odendahl: The first complication for implementing the capital markets union is that it came about quite differently from the banking union. The banking union was decided at an emergency summit when the crisis was almost at its peak. Countries decided to put regulation and supervision under their common control, which of course gave a central institution the power to implement quite a few policies that countries would probably not have agreed to outside the time of crisis. The capital markets union came about as a project that kind of made sense, but now we need to agree on lots of little steps towards that goal.

The second complication is that a lot of policies that would affect the capital markets union positively, or that are necessary for a full capital markets union, are under national control. So at every step of the way there will be a process of harmonising, say, insolvency regimes. I am not an expert on insolvency regimes, I am not a lawyer, but experts tell me that it is a task for a decade, not for a couple of years. A lot of the issues that need harmonisation in order for a proper capital markets union to emerge will be quite complex politically to implement.

As to the level of ambition that we need in the capital markets union, Commissioner Hill is using a very empirical approach—which is a good idea, given the constraints—looking at the most binding, insurmountable obstacles to more integration; a review of the prospects directive; a review of regulation of risk for securitisation; an investigation into obstacles to European venture capital markets, and so on. It is a step-by-step, empirical approach. I am not entirely sure whether that is a fast enough approach for the eurozone. Given the importance of the capital markets union for the resilience of the economic and monetary union, the eurozone would do well with a faster process, but I do not think that is politically possible.

Earl of Lindsay: You do not sound very optimistic that the capital markets union is going to be achieved in a desirable timescale.

Christian Odendahl: Capital markets union is a broad term for a lot of things. There is a grand capital markets union where we have full integration of all policies, including accountancy rules, taxation of investment and insolvency regimes. That will take a long, long time, if it is ever achieved at all. The slightly lower aim is to constantly move towards more integration of capital markets along the lines of what Commissioner Hill has proposed. That can be reasonably expected to be fulfilled. But that is a much lower ambition than the ambition we had for the banking union before we implemented that.

The Chairman: So in the early stages, risk-spreading is the most important thing?

Christian Odendahl: The most important thing for the resilience of the eurozone is diversified private portfolios across the entire eurozone, to spread shocks. Equity markets are most important. So far, my main criticism of the capital markets union is that it is not focusing strongly enough on the integration of equity markets across the eurozone. In terms of the additional resilience the capital markets union will deliver for the economic and monetary union, in the short term there is probably not much. Over the medium term it depends on how fast we progress on integration of equity markets, private placement, and so forth.

The Chairman: Lord Skidelsky, did you want to pick up on the ECB?

Q51 Lord Skidelsky: I was interested in your paper. You favour the idea of the ECB's mandate being revised to secure a higher inflation target of 3%. I am not against that. You say, "The European Central Bank ... has failed to maintain the necessary level of demand and inflation during the course of the eurozone crisis, and needs a stronger mandate to prevent this from happening in the future". That presupposes that monetary policy is quite potent and that setting a 3% inflation target will ensure that nominal income grows by a required amount. What is the empirical evidence that that is the case? What is the relationship between monetary and fiscal policy in the countercyclical measures?

Christian Odendahl: The empirical evidence on the effectiveness of monetary policy, particularly in a crisis, is reasonably strong that overly restrictive monetary policies are not helping. That is something we can agree on. Whether monetary policy alone will be enough is a more open question, both theoretically and empirically. There are two ways in which central banks can impact overall demand. One is the more direct channel, via asset prices, interest rates and currencies. The other is via the expectation channel: shaping the expectations of investors and consumers. The ECB has mostly focused on the first, trying to lower interest rates, buy assets and support banks with liquidity. I do not think it has been aggressive enough from the start. There was no necessity, for instance, to hike interest rates in 2011, and that was a strong signal to markets that the ECB is a comparatively hawkish central bank. The ECB has not made as much use of forward guidance, commitments and expectation management as other central banks have. The ECB might want to implement a regime change away from being a hawkish central bank that hikes when inflation is slightly above target, on the basis of international commodity prices, towards a central bank that looks through these and wants inflation not only to reach its target again—as it is currently communicating—but actually is willing to let inflation overshoot, because it knows that inflation is undershooting. The ECB could implement this kind of expectation management much more strongly. If fiscal policy pulls in the other direction, every central bank in the midst of such a crisis will have a difficult time stimulating the economy sufficiently. In a deep crisis, as we have experienced, fiscal policy needs to play its part as well. But I do not think that the ECB's monetary policy was optimal, let us say, from 2008 onwards.

Lord Skidelsky: But your position is that the announcement of a 3% target and the creation of the required expectations will enable it to hit that target.

Christian Odendahl: Not by itself. If the ECB had had a 3% inflation target throughout the crisis, that would have given it more room to cut interest rates conventionally and it could have let inflation run higher post-crisis. It would have given it political cover to start buying government bonds earlier or to extend this programme for longer. Higher inflation targets, strong expectation management and a more explicit backing for the central bank to buy both public and private assets would give the ECB a stronger role in managing demand. I am not entirely sure whether any of those points alone will be enough, particularly in such a deep crisis as we have experienced.

Lord Skidelsky: So you are not a complete follower of Milton Friedman.

Christian Odendahl: Not a complete follower, no—of no one.

The Chairman: On that happy note, let us move on to governance reform and the macroeconomic imbalance procedure. Did you want to come in on that, Lord Skidelsky?

Q52 Lord Skidelsky: Yes. I mentioned this earlier, but I find very little explicit attention to the role of current account imbalances in perpetuating the weak performance of the eurozone as a whole. In Draghi's speech in Helsinki, he said that we know from economic theory that it is crucial in a monetary union to ensure adjustment through prices. Well, economic theory also tells us that however flexible wages and prices are, they are not going to restore full employment if you have these big imbalances between trading partners. There is almost nothing in the Five Presidents' Report to address that question, which is actually to require Germany, through some sanction, to reduce its current account surplus.

Christian Odendahl: I think you are absolutely right. The Five Presidents' Report, in my view, is in part aiming at intellectual convergence on what is needed and the analysis of the problems, but it is also aiming for balance, which is not the same thing. I think that is a nod to Germany not to make too big a fuss of the current account surpluses, even though I fully agree with you that it is macroeconomically crucial that we have symmetric adjustment. I disagree with Mario Draghi on the importance of flexible wages and prices. In the early stages of optimal currency union research, starting with Mundell, flexible prices and flexible labour markets were seen as crucial. But over time economists have become a bit more sceptical about how much that really helps. Surely it helps those people migrating, for instance, but flexible wages in an economy also take away demand at a time when there is no other mechanism to address the weakness of demand. Migration takes away purchasing power as well. So the flexibility of labour markets, wages and prices is not necessarily a crucial ingredient for the stability of a monetary union, but I do think that a symmetric adjustment is necessary. That basically means that those regions that are doing well economically need to overheat a little. Policies to reduce the German current account surplus would almost necessarily overheat Germany a bit. I do not think that Germany is willing to implement that, and that is a deep political problem in the eurozone.

Coming back to the ECB, if I may, this is one of the issues where stronger monetary policy would be a welcome development. A stronger monetary policy stimulus would almost certainly have helped Germany to grow faster and overheat a little. Monetary policy, fiscal policy and all the other policies that Germany would need to implement all come together. There is not just one policy that Germany can implement for reducing—

Lord Skidelsky: And it resists them all.

Christian Odendahl: I have to say yes.

The Chairman: Does that not tell us something about the sustainability of the eurozone, when you have one dominant player concerned with its own interests?

Christian Odendahl: Germany is not unique in Europe in following its own interests. Of course, the problem is that the changes that would need to be made to make the eurozone economically more sustainable in part come from Germany. There are a couple of factors not under Germany's control that I hope will address its imbalance in the future. The first is demographic change: older generations start dissaving. The second is that the German budget revenues seem to be above target year after year, which gives the Government more wiggle room to invest. The third is that Germany has not invested all that much in its public sector over the past decade. Now, with low financing costs and a declining debt burden, the realisation that Germany needs to invest more in its future is growing in the internal discussion in Germany. Maybe I am being too optimistic, but there are a couple of developments that will reduce the current account surplus over time, although Germany should support that.

Q53 Lord Lawson of Blaby: May I go back to the fundamentals, and then move on from there? What, in your understanding, is the point of monetary union?

Christian Odendahl: That is a good question. At a time when there was no common currency, a paper called *One Market, One Money* implied that a single market needs a common currency to function properly. The experience of the eurozone's first decades and now the eurozone crisis is empirical proof that that was not the case, and whether the risks at least of having a common currency—

Lord Lawson of Blaby: Sorry to interrupt you, but I did not say what you might think or what some economists might think—as you say, they have been proved wrong if they did think that—but it was European politicians who decided that there should be economic union; it was not a group of economists. I repeat my question: what, in your understanding, was the purpose of it?

Christian Odendahl: The purpose was mostly political. European countries wanted to find further steps of integration after the common exchange rate mechanism broke down in the early 1990s, to foster integration among the core countries of Europe that wanted to participate in this. Even at the time, economists warned that that was a very risky path. As we see now, there is more divergence, both economically and politically, in the eurozone rather than convergence and closer ties between countries. The economic fundamentals were against a common currency, and the politics of managing a common currency were also speaking against it, but at the time politicians did not see it that way. So the attempt was to bind

European countries closer together, both economically and politically, and I think that has failed.

Lord Lawson of Blaby: I accept what you say: that it was designed entirely to bring about a move towards a political union. You could say that politicians at the time were not altogether stupid. Incidentally, although I do not agree with the idea of a European political union, I accept that there is nothing discreditable or disreputable about it; it is a perfectly legitimate objective. The cleverer ones, such as Jacques Delors, realised that it was bound to be inadequate without a fiscal union. You cannot have a fiscal union in a democratic construct without a political union. These all hang together. In a sense, that was meant to be the first step along the road. I cannot think—maybe you can tell me—of a functioning monetary union of any size at all which is not accompanied by fiscal and political union. If there is one, let me know.

Furthermore, if I may say so, it is rather curious that you seem to define fiscal union in terms of countercyclical policy. That is not how fiscal policy is interpreted in the two major countries of the European Union—not in Germany, never has been; and not now in the United Kingdom, although it once was. We pursue fiscal policy in terms of the right size of the deficit, if any, over the medium term and, to a lesser extent, the correct balance between public expenditure and taxation. It is not a question of countercyclical policy. Furthermore, it is really what I believe is known in Germany as a transfer union. That is what is important. Of course, Germans do not like that. It is necessary that in a fiscal union, in a true sense, you have to a very large extent—of course, there will be local taxes and local spending decisions as well, particularly in a federal country such as Germany—national levels of taxation and expenditure. Inevitably, the more successful parts of the union raise more money, which goes automatically, without any discretionary decisions, to the less successful part. That is true of the United Kingdom, the United States, Germany—everywhere. That is necessary to make it work. What is your take on all that?

Q54 The Chairman: There are quite a lot of questions there. Perhaps you could start with the question Lord Lawson asked about whether you could think of any other monetary unions that were not fiscal and political unions.

Christian Odendahl: It is of course right that those fiscal—

Lord Skidelsky: The Latin Monetary Union worked.

Lord Lawson of Blaby: That did not work. It conspicuously failed.

Lord Skidelsky: It worked for some time.

The Chairman: Let us hear what Dr Odendahl thinks.

Christian Odendahl: There are monetary unions that were successful over at least a period of time.

Lord Lawson of Blaby: Which?

Christian Odendahl: The gold standard, for instance, is one of those. There is Latin America. There is one in west Africa. In east Africa they have just agreed to one.

Lord Lawson of Blaby: The gold standard is quite different, if I may say so.

Christian Odendahl: Of course, but it was a fixed exchange rate regime. There are not that many monetary unions as such, as we see now in the eurozone.

Lord Lawson of Blaby: I am sorry, I cannot let you get away with that. With the gold standard, every single country maintained its own currency. It was not a currency union.

Christian Odendahl: The mechanisms, though, of a fixed exchange regime and a currency union—

Lord Lawson of Blaby: That is different. They are quite different.

The Chairman: Lord Lawson, let us allow Dr Odendahl to complete his thoughts.

Christian Odendahl: They are at least similar enough for economists to draw economic lessons from the parallels between them. Of course there are differences; for example, breaking up a gold standard is much easier than breaking up an entire common currency such as the eurozone.

On the fiscal policy point, I appreciate the opportunity to clarify this, because I see fiscal union as some form of risk-pooling or transfer. The lender of last resort and the banking union are two cases where I think that is necessary. Countercyclical fiscal policies are part of fiscal policymaking in every country, including this one. I disagree that this is not part of fiscal policymaking. You are right that countercyclical fiscal policy is most important for countries that do not have any other adjustment mechanisms, such as countries of a monetary union, whereas the United Kingdom has its own monetary policy and its own currency. There is a bit of a difference.

When it comes to a transfer union, you are right that politically that is what Germany finds unacceptable, even though it is doing the same thing inside its borders. But I do not think that a transfer union is necessary for making a monetary union work—there I disagree with you. To some extent, a transfer union is a way of conducting countercyclical policies, because the more well-off parts will subsidise or transfer so that there is more fiscal spending in weaker regions over the business cycle. Permanent transfers are a political decision within countries to have common living standards, but not a necessity for making a monetary union work.

The Chairman: Do any other Members—before I come to you, Lord Lawson—have any follow-up questions they would like to pursue with Dr Odendahl?

Lord Skidelsky: That is an interesting argument.

The Chairman: Lord Lawson, you had a further point to make?

Q55 Lord Lawson of Blaby: I would like to press Dr Odendahl a bit more. You say that there is not much difference between a fixed exchange rate system and a monetary union. I would say that there is all the difference in the world. This is why, although the European Union had a fixed exchange rate policy for many years, it decided to move away from that into a monetary union. If those two things were the same, it would not have done that. Germany, as you have conceded, is a transfer union because it is a political, monetary and fiscal union. The United Kingdom is a transfer union. The United States is a transfer union. We have established that a single currency and a fixed exchange rate system are quite different. Can you tell me where there is a single currency without a transfer union?

Christian Odendahl: That is a good question. You are absolutely right that there are differences between a fixed exchange rate regime and a monetary union. But as I said before, the economic dynamics underlying the instabilities of fixed exchange rate regimes, including the European ones, are the same drivers of instabilities in a monetary union. The difference is that they have different mechanisms to deal with those. A fixed exchange rate regime will more likely break up because it is possible to break it up, whereas the instabilities in a monetary union will show up in bank failures, debt build-up, Governments running up debt and so forth. The manifestation of those imbalances will be different between the two, but the drivers are the same. But on the transfer union question, I would have to think about that.

Lord Skidelsky: It is a new form of life, the monetary union.

The Chairman: Sui generis.

Lord Skidelsky: It is not a political union; it is not a state. The question is: can you run a monetary union without all the functions that a state—

Lord Lawson of Blaby: That is right. It is incoherent without—

Lord Skidelsky: That is the question.

Christian Odendahl: It may not have existed in the past, but it is a question that we need to answer with regard to whether the eurozone will be sustainable in the long term.

The Chairman: Thank you very much. That is a very good thought to focus our minds on as we go through this inquiry. Dr Odendahl, it has been really useful to have you here today. Thank you so much for giving your time to come and give us evidence.

Christian Odendahl: Thank you very much.

The Chairman: That concludes today's public evidence session. The Committee will now continue its meeting in private. Thank you again. If you think of anything to add to what has been said, feel free to write in. This is a very interesting debate.

Christian Odendahl: I look forward to seeing the transcript.