



HOUSE OF LORDS

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Financial Affairs Sub-Committee

Inquiry on

COMPLETING EUROPE'S ECONOMIC AND MONETARY UNION

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Questions 56 - 67

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10.10 am

Witnesses: Professor Lorenzo Codogno and Reza Moghadam

Members present

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

Examination of Witnesses

Professor Lorenzo Codogno, Visiting Professor in Practice, LSE, and **Reza Moghadam**, Vice-Chairman in Global Capital Markets, Morgan Stanley

Q56 The Chairman: Good morning, Professor Codogno and Mr Moghadam. Thank you for coming to the EU Financial Affairs Sub-Committee's inquiry into 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 and a full transcript will be taken. This will be put on the public record in printed form and on the parliamentary website. You will be sent a copy of the transcript and you will be able to revise any minor errors. The session is on the record. It is being webcast live and will subsequently be accessible via the parliamentary website.

I gather that you are not keen to make introductory remarks. Therefore, we will go straight into the session, if we may. You are both experts in your areas, and are familiar with the Five Presidents' Report and the actions proposed by the European Commission. Perhaps you could give us a brief overview of your assessment of the report and the actions proposed, particularly in the shorter-term but of course later we will go into the longer term. I am particularly interested in whether you think that economic and monetary union is sustainable in the longer term, whether the proposals in the report to strengthen the euro and its sustainability go far enough, and what other things you believe we should do in terms of the sustainability issue. Professor Codogno, would you like to kick off?

Professor Lorenzo Codogno: The report claims to be pragmatic and ambitious. Indeed, given that the five Presidents are very experienced people with a very deep knowledge of European politics, and that the language is carefully drafted not to upset anybody, you can certainly say that that is the case. However, if we look at the history of European integration and take stock

of what the crisis has suggested to us, it is fair to say that it is notable for a lack of ambition. It should be much more ambitious than it is, particularly on some aspects. It gives the misleading perception that there is plenty of time for the eurozone to fix its problem, which I do not think is the case. Basically, the eurozone needs to speed up the process of integration. It makes sense, particularly for the countries that share a common currency, to make sure that Europe proceeds with the speed that is necessary.

There are also issues related to a number of topics that were taken out of the report or were not touched on in an appropriate way. I refer to countercyclical policies, for instance, or policies that are aimed at achieving risk sharing among member states. There is a lack of attention to how to achieve structural reforms in Europe; rather, there is a lot of attention on that but only from the angle of monitoring and of deepening the existing tools and instruments without introducing any additional things. For instance, in the previous report, the Four Presidents' Report, there was the idea of contractual arrangements, which has totally disappeared—for many good reasons, maybe, but that is missing. Finally, the focus is still very much on monitoring and compliance, particularly with the fiscal rules, which, again, is quite important but is not enough.

Reza Moghadam: My assessment is a little more positive. I think the Five Presidents' Report goes in the right direction. One has to recognise that the process of integration in Europe requires political support; it cannot simply be forced from the centre. The report recognises that there is a balance to be struck between moving towards greater integration, which is necessary, and garnering political support. Therefore, its approach, which is step by step, is a pragmatic one, but I think it is a practical one. Does it touch on all the right issues? There I agree with Lorenzo. Let me tell you from my perspective what I see as the key areas where the eurozone needs to make progress.

The first area is completing the banking union. When I was at the IMF in 2012, we put the idea on the table and, frankly, I was pleasantly surprised by the speed at which the eurozone moved to put some of the key elements in place. It was a time of stress and crisis and therefore the motivation was higher, but enormous progress was made within a year and a half. Is that progress complete? Far from it. You still see fragmentation of the banking system across the eurozone. You still see that credit growth. Although it has started to grow by very small amounts, it is not uniformly so. Credit is contracting in a number of countries, particularly in the periphery. So banking union is very far from complete. There has been enormous progress with the single supervisory mechanism, but you need a single resolution mechanism to back that up, and that single resolution mechanism is incomplete because it

requires something that is politically very sensitive and difficult: that is, risk sharing. There are some minor elements in place but there is no mechanism for central funding for potential resolution across the countries. The numbers are very small. You certainly do not have a deposit guarantee system across the eurozone. Those things, in my view, impede the effective operation of the banking system.

What are the other important issues? For example, in the build-up to the eurozone crisis we saw the build-up of imbalances. You see it clearly in current account imbalances and, to some extent, in debt and fiscal imbalances. There are really no mechanisms to prevent those. Those imbalances have improved over time. The imbalance procedure is under discussion by the eurozone Ministers, but it is just a discussion; there is no actual preventive action.

Another area in which I would say that progress is being made—it is recognised in the report—is the capital markets union, generating proper lending not just through banks but through the capital markets, where I work now. Progress is being made on that. It is far too slow, but at least it is recognised in the report and things are moving forward. Fiscal risk sharing is a very sensitive area across nations. There has been very limited progress on that front in terms of completing the monetary union.

Finally, I very much agree with what Lorenzo said about structural reforms. This is not an issue for the periphery of Europe. It is an important issue for the core of Europe. There are many initiatives on the table that have not come to fruition. The services directive has been there for a long time. There are a number of areas where it is possible to make progress on structural reform and enhance growth in the eurozone, but progress on those is too slow.

Q57 The Chairman: Thank you. We are going to cover some of the things that you have mentioned as we go along, Mr Moghadam. Professor Codogno, you talked about a lack of ambition and so on. Several witnesses have suggested to us that the end of stage one being 2017 was driven by political imperatives, particularly elections in two of the significant countries—France and Germany—in 2017 before the White Paper comes out. Do you think that the fact that we are not going to see the White Paper, with more concrete proposals, until after these politically sensitive events in France and Germany will be a real impediment to proceeding with economic and monetary union?

Professor Lorenzo Codogno: To some extent yes, because the first stage is called “deepening by doing”, which effectively means taking care of the leftovers, in my view. All the political capital has been put on completing the banking union. That is the key project, which in itself would be a major achievement but is certainly not enough. Clearly, there is now a lot of opposition to any kind of risk sharing or mutualisation on the part of Germany and of other

countries. The idea is that first you need to achieve convergence—the reduction of risk—in order to share, which effectively means postponing integration to a later date. The Five Presidents' Report reflects this attitude, and it is probably fair to say that by waiting a couple of years, which happens to be during a time of elections in Germany and France, there might be a chance—certainly, it is not a guarantee—to move the process in the direction of integration. My guess is that even after 2017 there will be a kind of step-by-step approach. There will not be a big bang.

Q58 Lord Lawson of Blaby: I thought the professor made a very important point about the neglect of structural reform and microeconomic reform. What lies at the heart of this is the question of what this is all about: how can we strengthen the European economy, which has been underperforming? That is partly because the single currency is actually a negative, but I think that is a minor factor. The major factor is the lack of structural reform. The Government of which I was a member, who inherited a very badly performing economy, put structural reform first. We had a huge range of structural reforms and on the whole they were pretty successful. This has not happened in the rest of Europe. In a sense, this is a diversion, because it is not designed to make the European economies work better; it is designed as a path towards political union. There is nothing disreputable about that, but that is what it is designed for. All the measures here are designed to deal with the problems of a malfunctioning monetary union. Therefore, to me it is a cause of sadness that while our European partners have found structural reform difficult—as you know, politically it is extremely difficult and controversial—they are now not even trying to do it, although they are paying lip service to it, because of this huge diversion of effort to try to make the single currency work and to preserve the steps towards a single European finance ministry, which of course makes sense only in the context of political union. Is it the case that not only is there not enough emphasis on structural reform but that structural reform actually runs counter to the idea of putting together a better-performing economy?

Professor Lorenzo Codogno: I partly agree with that. Probably it is too strong to say that it runs counter to it. I do not think there is enough effort going in the direction of structural reforms. In the near term, all the effort is going in the direction of strengthening the macroeconomic imbalance procedure, which is a very strange animal, actually, because it is not clear what it is aimed at. On the one hand it should aim to prevent dangerous imbalances in the economy. On the other hand, it is really a way to put pressure on the reform process through the back door, because it is a formal procedure and puts real pressure on countries to deliver. Having said that, the macroeconomic imbalance procedure is probably not enough to

achieve major structural reforms in Europe. We saw that even during the crisis not many Governments were able to deliver deep enough structural reforms to solve the structural issues. So, again, more needs to be done.

In the Four Presidents' Report, there was an emphasis on the possibility of introducing contractual arrangements: that is, some kind of formal contract between the country and the rest of Europe, by which if you introduce major structural reforms, you get some benefits, such as risk sharing or more flexibility. That has disappeared, for very specific reasons. It was not very much supported, not only by the core countries, which perceived it as a way to push for some form of mutualisation, but also by the periphery because it was perceived to be forced into a programme. It was perceived like a memorandum: you have to do this. So it was not very much liked by anybody.

Now, the Five Presidents' Report introduces the idea that in the second stage there are some benchmarks. A country should try to achieve convergence of its economy, like when there was convergence for the entry into monetary union before 1999. There is little detail in the report so we will have to wait for the White Paper but there is a serious issue here in terms of general equilibrium. You cannot achieve goals in all different aspects of the economy at the same time, and that will be very challenging. I am puzzled by the approach that has been decided. I would guess that from a political point of view there was no chance to get anything better.

The Chairman: Mr Moghadam, do you agree with that?

Reza Moghadam: Very briefly, it would be unfair to say that there is not much emphasis on this issue. I have attended many meetings of the eurozone Finance Ministers. There is focus on it. It is a difficult issue. Why? Because there is a short-term cost, against a long-term benefit. That is a big challenge for the Governments. Bodies such as the IMF and the OECD have tried to calibrate the positive impacts that come over time, but of course it is difficult for the Governments to accept the short-term costs that it entails. We have to acknowledge that there has been progress. Some of it has been achieved under duress. The countries on the periphery—Portugal, Spain, Italy, Ireland—have made progress, not as much as independent observers would have liked but there has been progress, and the markets have responded to that progress. The funding of these countries has transformed itself over the past three years. The more difficult issue in the core countries such as France and Germany is: is there enough progress being made and is there enough peer pressure, because this is not enforced at the European level, to make that progress? That is where it is much more difficult and where

there has not been as much progress, despite the fact that everyone acknowledges the long-term gains; the short-term costs are preventing the Governments from taking action.

Q59 Lord Butler of Brockwell: My question follows on from this. Is it a fair criticism of the Five Presidents' Report that, perhaps because of the German and French electoral cycle, it concentrates too much on what might be described as a German approach—or perhaps even a Frankfurt-Brussels approach—to these issues? What I mean by that is a lot of concentration on countercyclical policies rather than on policies to promote growth; a failure to produce practical or acceptable measures to deal with banking union; and talk about structural reforms but not much in the way of how to achieve them. Is that a fair criticism: that it is too German-Franco centred?

Professor Lorenzo Codogno: As I said before, the perception in Germany and in a number of other countries is that you have to achieve convergence before any sharing or mutualisation. I think the Five Presidents' Report makes the right noises not to upset these countries. At the same time, it leaves open the possibility of steps in the direction of integration in the future, which is positive. But, again, it has to be discussed in a couple of years, not now.

The dimension of structural reforms is certainly missing. I agree that effort has been made over the past few years, but probably not enough. I chaired the committee that was in charge of the macroeconomic imbalance procedure in 2010-11, so really we developed the procedure. We were in charge of analysing member countries' progress on reforms, and I can tell you that it has been very difficult to achieve consensus on a number of issues. The competitiveness councils, which were launched by the Five Presidents' Report, might achieve a bit more, because the issue is also about attaining ownership of the reform process at the national level of the reform process. You might have a more independent, non-politicised view of reforms by having these kinds of councils. That is one possibility.

The other thing that is missing, in my view, is positive incentives. Now, we have only negative incentives in that you penalise a country for not doing something, but I think we should give positive incentives: if you do something, you achieve something better, such as more risk sharing. There is a suggestion in the report that we might go in this direction, but it is postponed for the future.

Reza Moghadam: Very briefly, I am very conscious that we are sitting in a political body with many eminent politicians. The political reality in Europe also requires some form of consensus and consensus building in order to make the reforms last. That makes it complicated. It requires not only France and Germany but everybody to come to a common view. Therefore, there are compromises. That is the reality of bringing sovereign countries to

a common purpose. As independent observers, or as people looking at it from a UK point of view, we might not see as much progress as we would like, but one has to recognise the setting. Good or bad, progress requires everybody to be on board, so it is not constructive or helpful to point at individual countries. Each country has its constraints, and those constraints are put on the table. When you are moving, and Europe has moved, towards forms of risk sharing—for example, the setting up of the European stability mechanism and the setting up of a small form of risk sharing in terms of the single resolution mechanism—these require broad political support. Therefore, they are imperfect because they take all the constraints on board.

Structural reform is particularly difficult, because it has to be implemented at the country level, and each country has different shortcomings in what they need to do. Also, as some have said, it is not an explicit part of monetary union. One has to recognise these shortcomings. It does not mean that Europe does not need to move on these fronts; it needs to move. But we have to understand that unless you have domestic political support for this, progress will be slow.

Lord Butler of Brockwell: I have one final question, if I may. My question was really about German-French influence. Do you think that these proposals take too little account of the sensitivities of what I call the poorer countries, the weaker economies, in the EU? Italy, for example—I address this question to Professor Codogno—has been particularly critical of the approach in the Five Presidents' Report. Does that indicate that it is not really balanced when it comes to the concerns of the EU members?

Professor Lorenzo Codogno: It is difficult to say. There are a number of issues, and the attitude might be different depending on the issue. Italy has always pushed for more pro-European, pro-integration policies. In that regard, the report may be a bit disappointing. Again, it does not push the issue forward in a way that might be desirable. At the same time, even in Italy there are growing movements that are increasingly Eurosceptic or openly against European integration, which is a bit risky, in my view. Over the past few years we have seen a very deep economic and financial crisis throughout Europe. Now, there might be a lagged effect on politics and social matters as a result of the economic crisis, so it might become even more difficult to achieve integration in a number of areas. The lack of appetite in different countries is also, to some extent, a result of the crisis and the way the crisis has been addressed and resolved. So we need relaunch of the idea of Europe, with positive messages that might convince not only the national parliaments but the electorate that it is a convincing,

credible story that can achieve benefits for all countries, otherwise it might be very difficult to take decisive steps in the direction of integration in the future.

One example, which is very close to the interests of the UK, is the single market, which is one of the big missing pieces of integration, because despite all the efforts in the past, particularly in the service sector and energy, not much progress has been achieved. That probably has the most important potential for enhancing growth in Europe, which would be achievable without major upheaval in the institutional framework. It is just a matter of doing it.

The Chairman: Mr Moghadam, you wanted to come in on that briefly.

Reza Moghadam: The single market point is very important, and the capital markets union could have the same impetus for reform. But in terms of countries' interests, I recall when the Five Presidents' Report came out that one of the strongest criticisms of it came from Germany. It is in the nature of these reports that they try to take different constituents' view into account, which means that you please nobody and you have criticisms. The criticism was not simply from the periphery or Italy; it was also from Germany about risk sharing.

Q60 Lord Skidelsky: I would like to take up the point about the asymmetry of the adjustment process of the macroeconomic imbalances. You have the fiscal imbalances and the current account imbalances, and they are connected, but I will take up the issue of the current account imbalances. Keynes remarked in 1941 that adjustment is compulsory for the debtor and voluntary for the creditor. That is quite a good summary of what is going on, because if you approach the thing from the microeconomic point of view, as indeed Lord Lawson does, then of course you are driven to structural adjustment as being the thing that needs to happen, and structural adjustment is a debtor problem, a debtor country problem. Surplus countries do not have to have any structural adjustment; they are doing fine. So to what extent is a monetary union sustainable in which the onus of adjustment always falls on the weaker members?

Reza Moghadam: That is an excellent point. This goes to the heart of one of the key issues of crisis management. If I have one major criticism of the crisis management, it is this asymmetric adjustment burden in terms of macroeconomics. The problem is that fiscal policy to a large extent is country-specific, despite the stability and growth pact, because the stability and growth pact leaves a lot of flexibility for individual countries, but we did not have during the crisis, and still do not have, a more aggregate macroeconomic view in order to translate that into what it means for each country. It has been bottom-up and it has been driven by individual targets and by adjustment at country level, precisely because of what you say—it is being driven by concerns about debt and market access rather than a macroeconomic point of

view. The debt level of the eurozone is lower than the United States' but the dispersion is very high. Some countries have extremely high debt, some have very low debt. You could have leveraged these differences during the crisis to have a more appropriate and measured response, but the way the monetary union was put together, especially before the recent changes that were made to the mechanism, made the adjustment process somewhat more painful for the debtor countries than it needed to be.

Professor Lorenzo Codogno: I certainly agree. The current account issue is a tricky one. You can easily argue that a surplus is not as dangerous for financial and economic stability as a deficit, but at the same time if you look at the area overall and you feel that there is a need for policy co-ordination in order to achieve the goals, you need to recognise that there should be symmetry. Otherwise you end up in a situation like the one we have experienced over the past two or three years. The adjustment has come only on one side, as you mentioned, and this has introduced some kind of deflationary bias for the whole area, and we have to recognise that. So, indeed, the adjustment should come from all countries. In the Five Presidents' Report, there is enough emphasis on policy co-ordination, although it does not say much about how to achieve it. Again, that is postponed to the second stage. Some kind of policy co-ordination is absolutely necessary.

Lord Skidelsky: But no recognition of symmetry.

Professor Lorenzo Codogno: No, no recognition of symmetry, although I have to say that if you look at the excessive imbalance procedure, the Commission is now much keener than in the past to push even countries such as Germany to do something about the surplus. To be fair, the Commission has always pushed for that in the past, but a number of countries strongly opposed it, not just Germany. Now we are getting closer to the point at which some adjustment is required also from countries in surplus, so I think it is coming.

The Chairman: Thank you. We need to move along. Lord Haskins.

Q61 Lord Haskins: These issues look a little different in this country in terms of the referendum coming up. One of the four issues that the Prime Minister has on the table is the relationship between eurozone and non-eurozone countries. It seems to me that in the original concept of the euro, the assumption was made that eventually the euro would apply right across the Union. It is clear now that that is not going to be the case. Do you think that the report in any way addresses the permanent situation developing between eurozone and non-eurozone countries to enable the single market, particularly in this country, to develop as it should do? I agree with your comments about the disappointing failure to widen the single

market. Do you think that the Presidents are addressing this issue in a way that would satisfy our Prime Minister?

Professor Lorenzo Codogno: I think the whole issue is delayed, because, as you know, in the first stage it is not taken fully into account. The key moment will be when there is a treaty change. My personal view is that the UK would be much better off being at the table at that time to discuss how to rearrange everything rather than being outside, but for now the discussion has not yet addressed this. It will be addressed at some point, not before 2017 but, I hope, soon after that. But my guess is that it will not happen soon; it will take a while.

Reza Moghadam: At the European meetings that I have attended it is probably the case that the emphasis is often on issues faced by the eurozone rather than the EU. To change that you need a strong voice for non-eurozone members. The way the European system works, the discussions are usually first among the eurozone members and are then widened to non-eurozone members. Therefore, the interests of the eurozone members are addressed first. Strong voices are needed at the table to widen the discussion. That has not happened over the past few years, in my experience at least. It is an issue. But, again, from what I have seen in Europe, there is a very strong interest in and recognition of the benefits of the EU as a whole, rather than the eurozone, but given that the crisis was a crisis of the eurozone and many of the issues to do with integration affect the eurozone first, it has been natural for that discussion to take place among those members, but the voices of those outside have not been heard strongly.

The Chairman: What institutional safeguards might be required, from your perspective?

Reza Moghadam: For example, the discussion on banking union was instructive here. The discussion was initiated first among the eurozone members, but some of the eastern European countries, such as Bulgaria and Romania, which have banking systems that are very much integrated with the eurozone, and countries such as the UK, which are financial centres, played a very constructive role in changing the initial proposals in order to make sure that everybody's interests were taken into account. Frankly, during that discussion the eurozone members were quite understanding about the concerns and the benefits for the wider Union, and many of the proposals that were made by non-eurozone members were accepted. It is an issue of dialogue and bringing the issues to the table in a constructive way, and bringing constructive proposals to the table.

The Chairman: Broadly, do you accept that there is a genuine concern within the United Kingdom that caucusing by the eurozone is bound to damage the United Kingdom's interests?

Reza Moghadam: I absolutely understand the concern. I tried to explain why that process has come about. But I also believe that the United Kingdom can and should bring its concerns to the table. I have seen that when that is done in a constructive dialogue, the UK is a very effective force.

Lord Haskins: Are you suggesting that the Government have not been sufficiently keen to put their position on the table?

Reza Moghadam: I am not saying that. I am suggesting that a positive approach, when the views are expressed in a constructive way, does have an impact. The UK has a strong weight in Europe when it uses that weight.

Lord Lawson of Blaby: May I put a particular example? It is not party political. The present Government have expressed the strongest possible objection to the financial transactions tax. They could not have put it more strongly. They are trying to use legal means as well as political pressure. Yet the European Union continues to propose the financial transactions tax. This is a matter of deep interest to the United Kingdom because of the importance of London as a global financial centre. I do not think you could say that the United Kingdom has not tried to influence matters. It has tried and failed.

Reza Moghadam: Let me give you examples of where they have succeeded. For example, on the voting structure, the UK proposed, and succeeded, in getting double majority voting.

Lord Lawson of Blaby: For a short time.

Reza Moghadam: But they succeeded. You are right about the financial transaction tax, but fortunately it has not been implemented yet. In the financial sector, which I work in now, obviously there can be arbitrage if one country does not implement it. It will probably fail as a proposal, so you are correct that there is concern about this, and rightly so, but that proposal has not really got off the ground. There have been others where the UK has made proposals that have succeeded.

Professor Lorenzo Codogno: From what I can tell, the UK usually punches above its weight in European committees, so it is doing a good job. But you also have to acknowledge that throughout the crisis it became a matter for the eurozone. The countries that put the money on the table were the eurozone countries, so inevitably the UK was on the fence, so to speak. That is inevitable; you have to face it. It is certainly correct to say that there have been some failures. You mentioned the financial transaction tax. I fully agree with you. By the way this, for me, is in contradiction with the capital markets union. It needs to be addressed in the future. Again, you also have to consider the other side of the coin, which is that the eurozone crisis was addressed by eurozone countries.

Q62 Earl of Lindsay: Could you expand briefly on the importance of the capital markets union and the role that it is intended to play? I noticed, Mr Moghadam, that you mentioned your disappointment at the slow progress that has been achieved so far on capital markets union. What are the difficulties in achieving capital markets union, and how optimistic are you that they will be resolved, and resolved within a sensible timeframe?

Reza Moghadam: In very simple terms, companies raising finance in the United States use both the capital markets and the banking system, and in some ways the capital markets probably dominate. In Europe, financing is predominantly done by the banking system. Post-crisis, the banking systems are weak, as is their ability to extend credit both because of the regulatory concerns and because of the strength of the balance sheet. Also, looking ahead at their ability to have return on capital, they are constrained. The European companies will find it difficult to obtain credit if there are no other sources of credit available, particularly when you move down the sizes and you talk about small and medium-sized enterprises. I work in capital markets now, and there has been a shift in companies trying to access capital markets, so it is happening. But it is very difficult because, unlike the United States, if you are raising capital across jurisdictions you have the rules and regulations of many countries to deal with. That makes it very complicated. One issue is therefore simplifying, for example, the bankruptcy rules across nations. The standards vary a lot across Europe. That is a complicated process that goes beyond the competence of, for example, the European Commission. It can recommend but not enforce. It is very much a matter for individual countries.

There are also other regulatory issues. As a result of the crisis, the regulatory charges on securitisation, for instance, are very high, so if you are going to the market and you are a number of small companies, if a bank like ours wants to take them to the market you have to securitise it somehow. That is extremely difficult because of the costs and the legal processes across Europe. There are many impediments. The good thing is that across the EU right now—this is an EU-wide issue, not a eurozone issue—there is recognition of the benefits of this, but given the political environment, steps are being taken in a gradual way to improve capital markets access. I wish it could be faster. Some of the regulatory things could be changed quite quickly; some steps have been taken towards that. If you want to issue equity in the US, the procedure is very simple; there is one regulator. In some countries in Europe it is extremely complicated; the prospectus process, for example, is very complicated in a number of countries. There are practical things that can be done to improve this that are not so controversial to do. It takes time to bring the consensus of different nations together. The availability of credit is a key issue.

Professor Lorenzo Codogno: If I might add to that, I do not suggest that the capital markets are less risky than bank financing. They are not. However, we know that the situation in Europe is the exact opposite of that of the States. Most of the financing to the economy comes from the banks—more than 80%, if I understand correctly. So it makes sense purely from a diversification point of view to shift. There is now wide consensus in Europe on moving in that direction. That does not mean necessarily that we are going to achieve the same balance that the US has. There might be good structural and cultural reasons for maintaining a different model, but starting with the capital market financing that we have at the moment in Europe, it makes sense to move in that direction.

Having said that, I think the capital market union is also somewhat unambitious, because it has started very slowly. It is a massive and very difficult job, because you have to harmonise different systems and so on, but it has started slowly. Let me give you an example. One of the probably easy things that can be achieved over the near term is the so-called prospectus. Achieving a single prospectus is very important, but would you recognise that as a major reform if it was done in a single country like the UK? It would be perceived as a technical issue, not a major reform. You have to move to a second stage. By a second stage I mean the philosophy of the Five Presidents' Report, which is about moving from rules to institutions. In the case of the capital markets union, we are still missing an institution to take care of the project. The Commission cannot do it, because it is not in charge of all the aspects of this process.

Lord Skidelsky: Perhaps I could ask a supplementary question. Whether it is a capital union or a banking union—let us take the idea of a banking union—how do you weight the benefits of a more efficient allocation of capital, which is what banking union can achieve, against the risk of banking collapse, which is what we experienced in 2008-09? Obviously, you have to make the banking system more secure before you can have a banking union. Do you think that enough has been done in the way of improved regulation to make a banking union feasible in the terms in which people are talking about, or is it just rhetoric?

Q63 Lord McFall of Alcluith: Perhaps I might add to that because it goes to my question. It is the main question. I have listened to the points you have made about the banking union. In my mind is the concept of a hugely complex jigsaw puzzle. You have said that there is no deposit scheme across Europe. There is no agreement on risk sharing and mutualisation. There is no central treasury for fiscal transfer, which is essential. There is no single resolution mechanism—that is far from complete. Fragmentation exists across countries—that is a reality. Credit contraction is a feature, especially in the periphery. Yet all political capital, as

you have said, has been focused on the banking union. We have bet the house on it as a result of that. So is it not wildly optimistic to consider that we could have an efficient and comprehensive banking union that makes the financial architecture safer and works in the interests of all countries? It is a bit of a fantasy at the moment.

Reza Moghadam: I will answer both questions. All those constraints that you mentioned are correct, but you also have to weigh against that the progress that has been made on supervision. This is an area I have been closely involved with. The single supervisory mechanism that has been put in place is necessary and the work that has been done is impressive. It is extremely difficult, but I have been impressed both by the speed with which this was put in place and, more importantly, by the thoroughness of the SSM's new supervisory responsibilities. For me, the issue is about making that effective by putting in place the shortcomings that are there.

Now, a number of these shortcomings are addressed in the Five Presidents' Report, but they come into effect slowly so one hopes there is no major problem going across borders in the next few years. If there is, there are some mechanisms in place. The question is: are they adequate? They are certainly a lot better than what was there. Something that we did not witness, fortunately, during the financial crisis was a major banking crisis going across countries—a big bank with problems that needed to be resolved across borders. There were a number of small banks, and the process of the resolution of those was very complicated and some of it is still going on, but we did not face a major bank problem across borders. The SSM needs to ask whether the European nations are able to resolve a major bank across borders. We are moving towards that direction, but some of the building blocks are not yet there.

On the question of capital market union versus banking union, they are related, but what is important here is that you have European corporates that are creditworthy and could access the capital markets. There will be appetite from investors from invest in them, but the infrastructure to support them is not there. It is an alternative to the banking sector, which, although strengthened, is not going to be strong enough to generate the kind of credit that you need to support a growing European economy.

Professor Lorenzo Codogno: We have to acknowledge that there has been progress over the past few years in achieving integration in Europe, particularly in some areas. Banking union is probably the area where the achievements are tangible. Indeed, the ECB has been very effective and has done a very good job of improving surveillance. But we also have to acknowledge that it is incomplete. You mentioned the deposit insurance mechanism, which is

still missing. Although I am pessimistic about risk sharing and mutualisation going forward, deposit insurance is one area where I think it is feasible to achieve some kind of agreement within a decent timeframe. The rationale is overwhelming. There is a very strong case for that. The proposal that was put on the table by the Commission in November is very reasonable and pragmatic; starting with some kind of reinsurance is the way to go. I am quite optimistic that, given the political capital that has been put on banking union, this can be completed.

Then there is capital market union. Together, they are absolutely essential to achieve a better allocation of capital within the area. By the way, this is linked also to current account balances. Some countries might have imbalances that are reasonable because they need capital. It is better for the whole Union to allocate capital towards these countries. For example, Poland used to have a current account deficit. It still has a current account deficit, but for a good reason because they are rebuilding the infrastructure and the productive capacity of the country, and it is through foreign direct investment. That is a positive allocation. It is a positive imbalance within the EU.

Lord McFall of Alcluith: Deposit insurance is just one leg of a complex architecture—I think you would admit that. From the UK point of view, although the capital market union project involves all EU member states, the banking union is limited to the EMU members and those non-euro area member states that opt to join it. Would you consider that such a division between the ins and outs may in the longer term lead to the creation of market barriers between members and non-members, which could be to the disadvantage of the UK?

Reza Moghadam: I do not think that will necessarily be the case. In a way, the building blocks have been in place for the past year or so. I do not see extra fragmentation between eurozone members and non-eurozone members of the EU. If anything, there is quite a strong understanding in mainstream Europe that places such as the UK, but also a number of other countries that are not members of the eurozone, such as Sweden or some of the eastern European members, have strong financial systems that need to operate within a broader system. There is an understanding from that perspective. Of course, it is an evolving situation and the regulations will evolve over time. One needs to make sure that the non-eurozone EU members' interests are clearly stated and observed.

Q64 Lord Borwick: In the scrutiny of the respective roles of the ECB and the national authorities in the governance of the banking union, do you think that the ECB is being held to account properly by the European Parliament? Is the lack of connection between some of the decisions that you have talked about that need to be made in future and the people of various

eurozone countries developing into a growth of minority parties in those eurozone countries, implying a problem for the future?

Professor Lorenzo Codogno: I think there is a growing anti-Europe sentiment in many countries in Europe, which is indeed a trap, in my view. In terms of democratic accountability, it is probably fair to say that the ECB has done quite a good job of trying to communicate and report to the European Parliament whenever possible, and I think this situation has improved over time. I do not think that is a real issue at the moment. But the issue of democratic accountability will come back when there are treaty changes. That will be a big issue.

Lord Borwick: You are implying that there are lots of things that need to be done but the people have not been brought along with those arguments. Indeed, the Five Presidents' Report talks about a whole list of things that must be achieved but not about how the people will be persuaded. All the indications are that people are diverging from this list of changes that must be made, which you have described as being too slow and that must be accelerated. This is highly likely to lead to rejection of these treaty changes in the future.

Professor Lorenzo Codogno: I would say that it needs to be properly addressed in order to pass the test. You are right that there is an issue. Even the Five Presidents' Report reflects the concerns that there is not enough democratic accountability, representation and so forth. I will give you an example. As things stand, the so-called Treasury Minister for the eurozone in the future would be the head of the Euro group. That is not an elected position and it does not go to the European Parliament for confirmation, which is pretty odd, so it needs to be changed. That is just one example of the kinds of problems that are still open. I am sure that they have to be addressed in future, because otherwise that dimension would be missing.

Q65 Lord Lawson of Blaby: What is your understanding of the term "fiscal union"?

Reza Moghadam: Probably some form of risk sharing across the members of the eurozone, which is probably the most controversial issue. Risk sharing is at the heart of some of the political opposition. Union necessitates risk sharing, essentially.

Lord Lawson of Blaby: I am glad to hear you say that, because it gets close to the heart of the issue. There has been a great deal of muddle, as we have discovered in previous witness sessions of this Committee. Many people talk about fiscal union as if it means every country in the Union pursuing the same expansionary, or contractionary, fiscal policy. Clearly, that makes no sense whatever, as you indicated—quite correctly—in earlier answers. If fiscal union means anything at all, it must mean that you have to a considerable extent—not totally, because there will be local taxation—a single taxation system and a single benefit system so

that the transfers that are necessary do not have to be argued about and voted on; they are automatic, in the sense that the more successful countries in the eurozone will generate a greater amount of tax revenue and the less successful ones will receive a greater amount of benefits. That is what happens in every monetary/fiscal union—the United Kingdom, the United States or wherever. This is clearly what is meant. I think that Germany likes to call it a transfer union and it is opposed to it. Would you agree that we will never get the monetary union to work satisfactorily unless there is a corresponding fiscal union of this nature?

Reza Moghadam: In the long run, I agree with that. In a way, it was recognised at the outset, when the EU was put in place, but instead of the issue being addressed head on, safeguards were put in place, such as the SGP and the limits on debt and fiscal deficit, which many countries did not observe—in fact, it is difficult to see who did observe those norms. Those were a political compromise in order to keep fiscal policy independence in each country. Of course, a successful monetary union ultimately requires some form of fiscal risk sharing. It is moving towards that, but in a gradual way. Politically it is extremely sensitive to go there. We are likely to see halfway houses, as we have seen, or in the time of crisis you will have risk sharing. Initiatives such as lending through the European stability mechanism are a form of risk sharing put in place during emergency times, so you could patch it like that at the time of crisis, but ideally you need to move towards more explicit forms of risk sharing. That would actually reduce the risks of crisis.

The Chairman: I recall John Maynard Keynes's saying that "In the long run we are all dead". How would you define the long run in terms of eventually getting there, if you think that it is going to be incremental?

Reza Moghadam: Going back to some of the questions that you raised regarding the Five Presidents' Report and the implementation timetable, I would not take that report as a blueprint for where Europe will go. There have been many of these reports. Ultimately, there will be political compromises among countries. The Five Presidents' Report is a proposal by the Commission, so it is a basis for discussion, but ultimately there will be political compromises among countries. The nature of the eurozone and the EU in general is that there will be incremental progress. I do not think that you will see a transfer union in place in the next five years, but you will see steps towards it, such as the deposit insurance scheme that Lorenzo mentioned being built up over time. I think that one has to accept in Europe that progress will be incremental.

Professor Lorenzo Codogno: Achieving fiscal union and possibly political union at the end of the process is absolutely essential, in my view. It is a key ingredient for making economic and

monetary union sustainable in the long run. Having said that, I am not suggesting what you suggested, that there should be some kind of transfer union. Transfers should be seen in the context of risk sharing and in the context of providing facilities to compensate for asymmetric shocks that might happen in the area. They should not be perceived as permanent transfers from one area to another. I do not think that that should happen. Again, achieving risk sharing and some kind of mutualisation is inherently part of monetary union.

Lord Lawson of Blaby: I am sure that you are right. It is the clear purpose of the exercise: for monetary union to be successful, fiscal union is required and fiscal union requires political union. The notion, which we will come back to, if we have time, that the European Finance Minister should be an unelected official is clearly problematic, to say the least. I do not see what your objection is to a transfer union, however, because a transfer union does not need to be explicit; it is implicit. In any political union, transfers happen all the time. In fact, most of them are not recorded. They are implicit in the system.

Professor Lorenzo Codogno: But if there are permanent transfers, that means that there is a problem that needs to be addressed—there are structural issues at stake and these have to be addressed first. I am not saying that there will not be transfers, as any union has transfers, as you say. Sometimes they are implicit and sometimes they are automatic, but if they are permanent transfers from one area to another, it means that you have a problem.

Lord Lawson of Blaby: Let us take your own country. On the whole, in economic terms, northern Italy is much more successful than southern Italy. I would be surprised if therefore there are not permanent transfers going on from northern Italy to southern Italy. That is the nature of a single country. Is this problematic?

Professor Lorenzo Codogno: You picked the right example. In Italy we have permanent transfers from one area to another. Has it been a successful story? No, it has not. It basically means that you have structural problems in one area of the country, which need to be addressed through structural policies; otherwise, you end up in a situation where you have permanent transfers. But permanent transfers should not be the rule; they should be the exception or should compensate for shocks. But if there are permanent transfers, it means you have a problem. You have to address the problem from the point of view of structural policies.

The Chairman: Perhaps I could press you for clarification. What you are foreseeing as fiscal union is that it is underpinned by a stabilisation rationale rather than a distribution rationale. There is a desire to move towards it in order to bring about convergence in the longer term and so on, not because of the transfer union envisaged by Lord Lawson.

Professor Lorenzo Codogno: Yes. I agree 100%.

Q66 Lord Shutt of Greetland: Returning to the eurozone, what is your view of what might now be needed for the effective governance of institutional development? Indeed, where does democratic accountability come in?

Professor Lorenzo Codogno: It is a very tricky issue. I am an economist so I might not be perfectly qualified to answer that question from a political point of view. But I think pieces are still missing. In order to have full democratic accountability and address the democratic gap that is perceived to be in place in Europe, probably you need some kind of fiscal capacity in the centre and the European Parliament has to be in charge of deciding on a number of issues. The European Parliament is elected and therefore you probably address some of the issues. It is the intergovernmental approach in Europe that sometimes contradicts democratic mandate.

Lord Shutt of Greetland: Would that be a two-tier European Parliament?

Professor Lorenzo Codogno: There might be ways to address that. I would not be surprised to see a European Parliament that deals with eurozone matters and a European Parliament that deals with EU matters, in different formats. Why not?

Reza Moghadam: You have put your finger on a very important issue. What happens in a monetary union is that essentially you cede power to the centre. You do that through a democratic process. You decide to give certain powers from your Government to the centre. That is one democratic process. The question is the sustainability of that over time—whether the sovereign nations find that acceptable in practice. The second issue, as you correctly point out, is that through the crisis the European Parliament has been the body that has provided democratic scrutiny. The question one needs to ask is whether that is the appropriate body. Given that you have a two-tier system, can you have a section of the European Parliament or does this concept of European accountability need to be rethought? Unfortunately, among the nation states the European Parliament is not viewed as a strongly democratically accountable body, as national parliaments are. It is a legitimate issue that needs to be sorted out over time. It is a very good question.

Q67 The Chairman: Before concluding, Mr Moghadam, perhaps I could press you briefly on the role of the IMF in any future eurozone crisis management framework. As you know, that has been much debated recently.

Reza Moghadam: In what respect?

The Chairman: In the respect that the IMF has come out with a clearly divergent policy from that of the ECB and eurozone Governments and institutions in terms of Greece, but also

externally in the rest of the world the criticism of the IMF and its involvement in the Greece situation as having been dictated by the fact that the head of the IMF is a representative of a eurozone member country.

Reza Moghadam: Fortunately, I no longer have to defend the IMF but I can give you my own views.

The Chairman: Given your background, it would be interesting to hear your thoughts.

Reza Moghadam: The IMF is, and I am sure will remain, an international body. Its involvement in the European crisis has been helpful in two respects. First, it has brought a more international perspective to the table. I have seen that in practice. Whether it is the Brazilian chair, the UK chair or the US chair, they have been able to express views about the operations in the eurozone through the IMF bringing that to the table. The IMF has also benefited from the fact that it has a tradition of independent staff and analysis. That has been helpful in bringing another point of view, correct or not, to the table. It is correct that the management of the IMF is politically appointed and has been European. To be frank, that is an issue of governance. I worked with the last three heads of the IMF very closely. I was chief of staff to two of them and was appointed by the last one to deal with the European crisis. From what I have seen, they have been very attentive to the views of the IMF staff and the wider IMF membership. The governance issues are separate. For me, the fund has provided a constructive force in the European crisis and a reasonably independent point of view. I am sure, like with other crises—I have been involved in the Asian crisis and the emerging market crisis—there are lessons to be learned from the European crisis. But the fund has also been good at self-analysis—for example, through the Greek crisis—and looking at lessons. These lessons have not always been welcome in Europe but it has been necessary for the IMF to look at them because of its global perspective.

For the future, the IMF came to the table at a time when the European Governments and system did not have sufficient crisis bodies to deal with the situation. Many of those are in place. The financing and advisory voice that the fund has provided may not be as necessary going forward but the fund needs to provide an independent point of view, both through surveillance and crisis management. I think it will remain valuable whether it is in Europe or elsewhere.

The Chairman: Thank you very much indeed. That concludes today's public evidence session. The Committee will now continue its meeting in private.