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. 6 *Heard in Public* *Questions 68 - 81*

WEDNESDAY 20 JANUARY 2016

10.15 am

Witnesses: Professor Erik Jones, Megan Greene and John Peet

Members present

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

Examination of Witnesses

Professor Erik Jones, Professor of European Studies and International Political Economy, Johns Hopkins University, **Megan Greene**, Chief Global Economist at Manulife Asset Management, and **John Peet**, Political Editor, the *Economist*

Q68 The Chairman: Good morning. I welcome Professor Erik Jones, Megan Greene and John Peet to the EU Sub-Committee's inquiry on completing Europe's economic and monetary union. We are delighted that you were able to come. You have a list of interests which have been declared by 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 will be able to revise any minor errors. The session is on the record and being webcast live, and will be subsequently accessible via the parliamentary website. I take it that you have no introductory opening remarks to make and that we can go directly into questions.

I will kick off. You are all familiar with the Five Presidents' Report and the actions subsequent to that, proposed by the Commission. In general, do you think the report does enough to strengthen the euro and its long-term sustainability? I wonder whether you might also tell us if there are significant omissions that you think need to be in there. Also, what are the really important things that we need to look at when the White Paper comes out in early 2017? In all of that, would you remember that our particular interest is the sustainability of the euro but also its impact on the United Kingdom. Perhaps, Mr Peet, I might ask you to kick off, since you will have the political overview as well as the economic overview.

John Peet: Thank you very much, Lord Chairman. I make two comments in response to your question. The first is that my experience is that the European Union moves in response to crises. The perception around Europe is that the euro crisis is dormant at the moment and that there are other issues—migration, terrorism and, indeed, the British debate about Europe—that concern European leaders more. So I do not expect things to go fast in this area. I think it will be more a case of muddling through with what we have got and taking only small steps. I do not think the Five Presidents' Report will lead to early action. Also, there are things in it that some countries, most notably Germany, will continue to resist. Germany is continuing to resist common deposit insurance and the completion of the banking union.

On the substance of what is there, I think the euro can probably muddle through without substantial change. But it is an unsatisfactory situation because the banking union is not complete, there are not sufficient arrangements for the co-ordination of fiscal policy and there are not strong enough incentives for the members of the eurozone to make structural reforms, the absence of which led to the crisis much more than fiscal profligacy. So I do not think it is in a satisfactory situation but I expect it still to muddle through.

Megan Greene: There are a few things missing from the report. The ECB is a central bank that has had one hand tied behind its back. That is not really addressed in the report in terms of the ECB stepping in to boost demand. I also think there is a focus on having collective decision-making on the fiscal side. I do not think that is necessary or worth burning political capital over, because it will never happen, in my view. Finally, there is no mention of countercyclical fiscal policies, which I think are absolutely necessary. I would rejig the priorities of the report and make the financial union piece the most important. Part of that is for cross-border exposure and flows, which is embedded in the capital markets union. The one thing really missing from the report is an asset pool deep and liquid enough to withstand investors pulling capital, or mutualised debt. Eurobonds need to be in there. I know that Eurobills were in the previous version. There is no political appetite for them but I think they are absolutely necessary.

Professor Erik Jones: I second everything that Megan has just said. The underlying idea to the report—that there is something missing—is probably right. We need a financial union and we need something to stabilise Europe’s financial sector. I think that the proposals in the report to do that go a long way, and these are the same types of things that we have seen developed inside countries as capital markets have integrated inside countries. This is an important step forward. There are a lot of whistles and bells in the report that are not very helpful. The fiscal advisory directive is not very helpful and the competitiveness councils are probably not very helpful.

The Chairman: When you say the fiscal advisory directive, do you mean the fiscal boards?

Professor Erik Jones: Yes, the five-person fiscal board that is supposed to supervise the adherence to the rules and explain this to everyone. I think if they simplified the rules, that would be more effective than creating this kind of institution.

Lord Davies of Stamford: Why would that board not be effective and why would the individual competitiveness boards not be effective?

Professor Erik Jones: The fiscal board is not going to be effective because the reason why the rules have not been abided by is the political determination at the national level, and that is not going to change. We are seeing that right now in Italian Prime Minister Matteo Renzi's insistence on greater flexibility being given to his Government. That kind of political problem will be there whether there is a five-person supervisory board or not. The idea that we will get more abidance because of that board is a political fiction. Unfortunately, it is not going to influence facts on the ground.

As for the competitiveness boards, the issue of structural reform is an important one. This was not a crisis of competitiveness for these countries. If we look at the movement and the real effect of exchange rates and decompose that into its component parts, we would find that most of the countries we accuse of having lost competitiveness, such as Greece, actually did not. They suffered from a very different dynamic, and that is the dynamic that Megan was trying to address. It has to do with the rapid financial disintegration when you move capital across borders, which is great, but it builds up a lot of net foreign exposure, and if you liquidate all those assets at once and pull the money out, you end up with countries like Italy, Spain, Portugal and Greece that have no liquidity in their economies. That is what brought them down, not the loss of competitiveness per se.

Q69 Lord Lawson of Blaby: Before we get into too much detail, although the detail is highly relevant, I do not dispute that, may I ask each of you a prior question? What, in your view, is the purpose of economic and monetary union, in a nutshell?

John Peet: I think that Lord Lawson was involved in the early discussions about economic and monetary union. I think it was primarily a political project. It was there in the Werner report in 1972 as a political project to accompany the European Union. There was a view that if you moved towards European economic and monetary union that would be a big step towards political union. Indeed, Mario Draghi has called the euro a large step towards political union. I think it was also connected with the unification of Germany, the desire to underpin the single market and a desire on the part of France in particular not to be beholden to the deutschmark. They thought that EMU would be a way of getting French as well as German hands on the single currency. Politics is probably the most important answer.

Lord Lawson of Blaby: I agree. I am sorry, I must not interrupt because I am inclined to hear what Ms Greene and Professor Jones have to say.

Megan Greene: I agree that it was a political project. That is partly why the eurozone exists intact today. If it had not been a political project and there were not political commitment to it, countries would have been allowed to drop out—which we have not seen happen. I would also highlight that it is an economic project, too. It is why Europe can compete globally and has any weight on the global stage whatsoever. If you do not have the European project and European countries tried to compete individually, they could not corner for themselves as much of the very elusive aggregate demand that we find globally.

Professor Erik Jones: I have to disagree. Many people thought that it was a political project but deep down inside it is an economic one. It is an economic project with a very specific purpose introduced in the Padoa-Schioppa report of 1987: to stabilise cross-border capital flows and prevent them from inducing unnecessary exchange rate volatility. Political things may have been put on to this—I have written a lot about this—but I had the good fortune to work with Daniel Gros and Niels Thygesen in the late 1980s and early 1990s. They informed the Delors committee and were completely oblivious in their work to the politics of this project. The economists I knew that worked on the single currency in the late 1980s and early 1990s never thought about the political implications. In fact, we were asked by the German Bundesbank precisely to study what the political preconditions would be for a stable monetary union. Since that question was exposed, I would argue that this was an economic project that had political implications which were very poorly understood.

Lord Lawson of Blaby: May I follow this up? I think it is obvious that if economists are asked their views they will talk about the economics, but you mentioned the Delors committee. I knew Jacques Delors very well and he was absolutely clear in his line that it was a political project. I was rather surprised to hear what you said.

Q70 Lord Butler of Brockwell: You said that the 2008 crisis was not a competitive one. None the less, there are great competitive problems and very high unemployment in the weaker economies of the EU, and there are likely to be further incidents of capital volatility. Do you agree? Do you believe that it is tolerable for these to go on indefinitely and is it likely that the euro will survive all of them?

Professor Erik Jones: I do not think this is tolerable. I just came from a meeting of bankers attached to the City. They speculated that we might see the re-introduction of capital controls not just in Europe—we have seen that in Iceland and in Cyprus—but in other parts of the globe as well. These cross-border capital flows are having a tremendously disruptive effect.

That is all the more reason why you would want to do the type of things that Megan alluded to in the context of financial union. I was struck by Henning Christophersen's testimony before this Committee, where he indicated his desire as a banker in Denmark to see Danish banks engaged in a European banking union because that is necessary to stabilise the single market—not the single currency, because Denmark will retain its own currency.

John Peet: I was going to respond to the point about competitiveness that Lord Butler raised because I do not quite agree with Erik Jones. The loss of competitiveness was a significant issue in the euro crisis for several countries, particularly the southern Mediterranean ones. What happened to their unit labour costs compared with Germany was more important than fiscal profligacy as a source of the tensions that led to the euro crisis. We are seeing quite a lot of improvements in competitiveness, including in southern Europe, but the issue for the eurozone as a whole is not really competitiveness as such but imbalances within the system. That is demonstrated particularly by the continuing very large current account surplus in Germany compared with other countries. That seems to generate a situation where we have very low growth and not enough employment in many countries.

Lord Butler of Brockwell: None the less, your view is that the euro will muddle on.

John Peet: I think it will probably muddle on because one lesson of the last five years is that it is generally agreed that the costs of going back and breaking it up could be very large and therefore that is something everybody wants to avoid. Every time the issue of whether Greece should leave the euro came up, all sides—the Greeks and the creditor countries—decided that it was too risky and preferred to find some way of muddling through.

Lord Butler of Brockwell: One final question: what about the political and social consequences of those symptoms, particularly the high unemployment?

John Peet: That is an issue. Obviously, both the European Union and the euro require political assent to continue. If it becomes generally thought in countries such as France and Italy in particular that the single currency is leading to a situation of low growth and high unemployment for a long time, then we can expect the politics in those countries to change towards a situation where people say, "Maybe this project is not worth supporting". If the euro does not find some way of generating more growth and employment than it has done in the past, the political consent for the project to continue may be withdrawn.

Q71 The Chairman: Professor Jones and Ms Greene, both of you mentioned the importance of financial union. Can we be confident that that will mitigate the financial instability and disruptive capital flows that we experience at the moment?

Professor Erik Jones: If we had risk-sharing such as a pooled deposit insurance mechanism, that would inspire confidence. I remember being in Belgium the day that Deutsche Bank changed its status from subsidiary to branch and published a full-page ad in the Flemish newspaper saying, "Move your money to Deutsche Bank and it will be covered by German deposit insurance". We have to level the playing field in that context and I would apply that to resolution funding as well. The point that Megan made about a single risk-free asset is equally important and that is obviously missing from the report.

Megan Greene: Yes, if this is done half way so you make it easier to have cross-border flows then it could increase volatility. You see that in good times there are lots of cross-border flows and in bad times everybody withdraws their capital back to their home country banks, and you have a balkanisation of the banking system. That is exactly what we saw during the crisis and that is what caused the sudden stops in the periphery. If you do this without an asset class that is big and deep enough to withstand those challenges, it will increase volatility. Volatility is not just an issue for Europe. I highlight that Mario Draghi said, "Hey, get used to volatility; it is here to stay". It will be a key feature in the global economy over the next five to 10 years.

Q72 Lord Borwick: Would you talk for a moment about the direct and indirect effects on the UK of the EMU? Whether it is a political or economic project, it does not appear that Britain has bought into it. What effect do you think these future steps will have on non-euro states?

John Peet: The issue of the relationship between euro ins and outs is the most important part of the current negotiation that David Cameron is conducting, even if it is the most difficult one to get across to voters and the public. If it becomes clear that the real project here is not the European Union but economic and monetary union, that raises the question of what precisely "out" countries such as the UK should do. Having put it on the table, the British Government are likely to get worthwhile assurances that Britain's interests will be taken into account by the "in" countries. There will be "out" countries for quite a long time to come. Something can be done to reassure the "out" countries that they will not be discriminated against in any way, but that issue is worth a lot of attention by the Government. That is what I would say.

Lord Borwick: Sorry, you are saying that it will be taken into account, but what happens in the event that it is not taken into account and they regard the political necessity of whatever action they are going to take in the future to be more important than taking it into account?

John Peet: We have the double majority system inside the European Banking Authority, which was a way of protecting the interests of "out" countries. We had what happened when the eurozone tried to make use of the European Financial Stability Facility and the Chancellor of the Exchequer objected and that was put right, in a sense. There will be some kind of formal declaration, which I think will take a legal form, about the importance of not undermining the single market and of the eurozone countries not acting against the interests of non-eurozone countries. How much you can rely on this will, I suppose, be a political issue.

Lord Lawson of Blaby: There are two aspects to this, are there not? First, what precisely are the guarantees or assurances? Secondly, will they be embodied in a treaty, because unless they are embodied in a treaty they can always be changed?

John Peet: You can get it in a legal form. You can get declarations and commitments that take some legal form, short of a treaty. But I assume that the Government hope to achieve some form of agreement that will, when and if there is a subsequent treaty, be incorporated into that treaty.

Megan Greene: One of the shortcomings of this report might be its naïve view, in my view, that all EU members will become eurozone members. That is realistically not the case and so has raised the hair on the back of the UK's neck. Clearly, as I mentioned at the beginning, financial union is the key piece of this report. On that front, the UK stands only to benefit. In fact, Lord Hill has been banging the drum on capital markets union for ages. It is the same for banking union. The UK could really benefit from that, along with TARGET2-Securities. It is in the UK's best interests to sign up to it.

Professor Erik Jones: I would like to pivot off this allusion to TARGET2-Securities. If there is one great contribution that the euro made during the recent crisis, it was not through the existence of the single currency but through the existence of the underlying payment mechanism between central banks, called TARGET or TARGET2, which provided instant and infinite balance of payments financing for those countries that got in trouble. The recent comment by Yves Mersch was that there is no reason why the next evolution of that mechanism could not be made a multicurrency mechanism for sharing resources between central banks. That would complement very nicely the recent European Court of Justice ruling that allows for euro clearing to take place as part of the single market within the City of London. If, instead of a swap agreement, you had access to the standing facility for sharing liquidity between central banks, that would improve the stability of the City of London. There are real possibilities for improving the situation using the architecture that has been put in place.

Q73 Lord Skidelsky: What do you understand by fiscal union? I want to concentrate particularly on the role of stabilisation or countercyclical policy. Is it your view that the incomplete character of the eurozone, its lack of a sovereign state, imposes tougher restrictions on fiscal policy than would be enjoyed by a sovereign state, especially one that has its own central bank? If so, is there, in your view, a macroeconomic justification for the rules of the growth and stability pact as it is now understood?

Professor Erik Jones: That is an excellent question. The fiscal framework that is applied within the euro area is completely optional. It is not necessary. They adopted this fiscal framework for political reasons: to reassure the German Government at the time and, increasingly, to abide by German Constitutional Court decisions about the validity of the single currency as a commitment to be made. But it is optional. You could have a monetary union without that fiscal framework, and within that monetary union without that fiscal framework the situation might be improved. Depending on what rules you write for how markets treat sovereign debt instruments, the situation might be improved for countries. As a matter of fact, during the 2000s, by being part of the single currency, countries such as Italy were able to borrow at incredibly low rates, maintaining very high levels of debt. That would be possible, but that was more about the way the debt was treated in terms of financial market regulation and the elimination of currency risk. Monetary union could allow for very lax fiscal policy—decide as you will what kind of fiscal framework you want to introduce.

Lord Skidelsky: But is that a lax fiscal policy on the part of all states, or just some?

Professor Erik Jones: That is an interesting question. My argument is that they should have different rules for different countries. Small countries should not be trying to use aggregate-demand management techniques based on fiscal policy because there is too much leakage into other countries. They should have very tight rules for small countries. But, as we saw in the early 2000s, a big country like Germany wants to use fiscal policy and so it should be able to.

Megan Greene: For countries that have no control over their monetary policy or currency, countercyclical fiscal policies are all you have got. One shortcoming of this report is that there is this idea that you need to centralise fiscal policy and make it more rules-based. I do not think it should be rules based; I think fiscal policy should be determined on a case-by-case basis. And that is not to mention that it will never happen politically, so I am not sure what the point of burning all your political capital on this is.

John Peet: If I may say so, the politics of this question is extremely difficult. I call this the MacDougall question. In the original MacDougall report, it was suggested that monetary union would not work unless there was a central fiscal capacity. I think he mentioned possibly a budget of the size of 7% of GDP, which is seven times as big as the current European Union budget. It has been clear from the very beginning that Germany will not accept that. The

Germans believe that if you did that, it would become a transfer union that would involve permanent transfers from Germany to other members of the eurozone.

What has gone wrong with fiscal policy in the eurozone is that it has too much of a deflationary bias, because the pressure has always been on countries that have large deficits to reduce their deficits and there has been no pressure on surplus countries to offset that. I am not sure whether I think that countercyclical fiscal policy ever works terribly well but, in the eurozone, there has been pro-cyclical fiscal policy, which I think has been very damaging.

Lord Skidelsky: Just one follow-up question. In contrast to the United States, one of the questions is that there is a reference to the US fiscal constitution, notably the balanced budget rules governing states and the scale of transfers from the federal budget to lower-tier government. Are their rules similar to those imposed through the growth and stability pact on the federal government in the United States?

Professor Erik Jones: This point about the United States is really important, because there is such misunderstanding about how American fiscal policy works, particularly on the transfer side. Federal transfers go to state governments that match the money that they receive. So states that invest more in receiving transfers will get more transfers per capita. Massachusetts has a much higher income per capita than Texas, but it also has a higher transfers per capita than Texas. We could do the same in the comparison between New York and California. There is this idea that the US federal fiscal system stabilises income through the tax and transfer system, but that is not what happens. In many respects, it exacerbates the differences, which explains also why those parts of the country that reputedly benefit from the transfers—the south and south-west—absolutely hate the federal Government, because they do not see the benefits that they are reputedly getting.

Lord Skidelsky: That is the transfer system.

Professor Erik Jones: That is the transfer system.

Lord Lawson of Blaby: They would be worse off without the transfers, would they not?

Professor Erik Jones: Yes, but the amount they pay in relative to the transfers is significantly more than for richer states such as Massachusetts and New York, which are even better off with the transfers that they receive. If we had that kind of political dynamic in Europe, you could only imagine the secessionism that that would breed. We see that already in countries such as Spain, Belgium, Italy and all the rest, but it would be on a continental scale.

Lord Skidelsky: What about the other side of it, which is the fiscal rules of the federal Government? Are they comparable? Are there equivalent fiscal rules binding the federal Government on their budget balance and things of that kind? I am trying to probe the rationale. You said that it was optional but of course it represents the fiscal philosophy of Germany, and also the need to keep some control when there is no central treasury.

Professor Erik Jones: The only binding rule that we have is the debt ceiling. All the other rules are written in normal legislation. But we have a very curious congressional structure where they vote revenues and expenditures, and then they also vote a separate rule for how much debt the Government are allowed to borrow. That is the binding rule and unfortunately that led us very close to the brink of default in August 2011.

Lord Skidelsky: So that is the binding rule, not limits on deficits and things of that kind? Okay.

Q74 Lord Davies of Stamford: I would like to go further, as we have two American economists here, on the contrasts between the European Union and the fiscal and monetary union in the United States. I am very glad that Professor Jones corrected what I believe to be a common error in this country, which is to suppose that the United States has a very effective fiscal union with a larger degree of automatic stabilisation through public expenditure. I do not think that is the case, because—I think I am right—welfare programmes, for example, which are an obvious source of automatic stabilisation within member states of the European Union, are a state responsibility and not a federal one in the United States. Similarly, though Medicare was originally a federal programme it has now been devolved to the states, as has Medicaid. A lot of these programmes that are regarded as automatic fiscal stabilisers in the EU and individual member states—which they are—do not operate in that way in the United States. Then you have some flexibility even within the existing fiscal union rules for individual member states to run deficits up to a certain amount—1% of structural, 3% of cyclical and so forth—whereas in the United States I think I am right that at least 48 or 49 states have balanced budget rules so there is no opportunity there for flexibility.

My instinct—can you tell me whether I am wrong on this?—is that the United States is an example of very effective automatic stabilisation not through the public spending system but through the capital markets so that savers in Texas will hold claims on California or Massachusetts, and vice versa. If the oil or cattle price goes down very badly, Texas will not do so well on that but it benefits because it invested in high technology stocks in Massachusetts. That is a very simplified version of how this works but that mechanism seems to work very well in the United States. We have drawn the conclusion from that that we need a capital markets union in the European Union. Is that a fair summary of the situation? What chance do you think we have of achieving that degree of automatic stabilisation through the capital markets, such as you achieved after 200 or 300 years, in the European Union?

Megan Greene: I agree entirely that a huge shock absorber in the US is the capital markets union. That is why when the price of agricultural land in Kansas tanks, nobody else is really affected. That is something that I have argued for in Europe for ages. On the fiscal union piece, Erik mentioned that states are better off with fiscal transfers than they would be without them. If we were to try to construct an optimal currency area from scratch, would transfers to a fiscal union be on the list? Yes, absolutely, but that will not be agreed in the Eurozone. There is no way Germany will ever accept transfers, particularly off the back of its own experience with reunification. In thinking about what is politically possible, we absolutely do not need that in order to get close enough to an optimal currency area to have the eurozone be sustainable.

Lord Davies of Stamford: My point is that—I think I am right on this—the receipt of federal funds by states in the United States is about the same, as a proportion of the gross domestic product in the state concerned, as receipts of structural funds in the European Union. It is a very small amount of money in relation to GDP. My general point is that the state is not important here; the private sector and capital markets are. If we all agree on that interpretation of replicating your great success, what chance do we have in achieving the cross-holdings of diversified portfolios throughout the European Union that would give the same degree of stabilisation?

Megan Greene: I will take a quick stab at this and then pass it over. One key difference between the US and the eurozone is that the US mutualised sovereign debt and Europe did not. You do not have such a big asset class. US Treasury bonds are the biggest, most liquid asset class in the entire world. We do not have anything close to that in Europe. As long as you do not have mutualised debt, a capital markets union and making it easier to transfer money and pull it back will increase volatility and instability. That is the lynchpin: if you do not have that it does not work. But is there political support for eurobonds? Not really.

Professor Erik Jones: I think Megan has put her finger on it. Let us not forget that we had in the United States a project of making it possible to share financial resources between New York, California, Massachusetts and Texas. When we did that, we gave birth to the savings and loan disaster because the banks that shared these resources were all underwritten by deposit insurance schemes run at the state level. They were chartered at the state level as well. What we had to learn in the United States is that chartering banks at the state level that do business across the integrated US financial economy is a bad idea because the states could not bail them out ultimately, and had to appeal to the federal Government for assistance. That was us learning what Europe is going through right now with banking union.

For this to work, you would have to make it more challenging for people to speculate across borders. This is the point that Megan made. Banks need risk-free assets for their routine treasury operations but in the context of a crisis even these so-called risk-free assets are not the same from one banking jurisdiction to the next. In Europe, they are all Italian debt, German debt or Spanish debt so people start selling these instruments and buying others. That is why you have negative-yielding bonds in Germany. We do not do that in the United States. If we could short North California and buy New York, in the context of the Bank of America scandal the US would have blown apart. We would never have been able to maintain the integrity of the financial system. Because we have this common, risk-free asset that everybody can use we are able to contain the kind of pressures that financial markets and a capital markets union engender.

Lord Lawson of Blaby: May I go back to the main point, following on from what Lord Davies said? That surprised me. Mr Peet referred to the analysis in two of the reports all those years ago. That seemed to me to be perfectly valid analysis. He said that, in short, you cannot sustain happily a common currency—it might be sustained, but unhappily and in an underperforming way—without a much greater European tax system and spending system so that you get these transfers. He pointed out that that is the case in the United States, unlike what Lord Davies said, that these transfers are substantially more than in the European Union at present, and certainly more than in this country—which is, if you like, a monetary union between England, Scotland, Wales and Northern Ireland. The transfers there are very substantially greater. I understand that Germany does not want a transfer union. That does not mean it will not happen but it may not. If it does not happen, I would have thought that the eurozone is likely to continually underperform. I would be grateful for your views on that.

John Peet: On this interesting contrast with the United States, I do not quite go along with Lord Davies's analysis that fiscal transfers play no role in the United States. I think they do.

Lord Davies of Stamford: I did not say they play no role, but their role is often exaggerated.

John Peet: That may be true but they do play a role, and that can be quite a significant one inside the monetary union. In a sense, this goes back to how Hamilton set up the US Treasury in the first place, assuming the debts of the states in exchange for creating a federal budget and risk-free asset. That is a weakness in the eurozone. But there are, of course, other things that matter in the United States. We all talked about the capital markets being very important. The capital markets are insufficiently developed inside the eurozone. Capital markets seem to function as a risk-sharing mechanism inside the United States and it would be desirable to have that in the eurozone. America also tends to have more liberal and deregulated labour markets. People move more freely inside the United States. Those adjustment mechanisms are also a help in the United States, and they tend to have been missing in the eurozone—although some progress has been made on structural reform, as I said. But I think the political objection to fiscal—

Lord Davies of Stamford: Migration flows within the European Union are pretty considerable. We have been arguing about Poles and Romanians for the last 15 months in this place.

John Peet: I believe the flows are much bigger in the United States. People genuinely move from Texas to New York far more freely, partly because of the common language and so on. I go back to the point that I think we all made: the politics at the moment seem to be such that setting up a system that would entail fiscal transfers within the eurozone is not likely to happen—although I believe it would be desirable.

The Chairman: Professor Jones, would you like to send us anything that you have written on the differences between the United States and the EU in this regard? That would be really helpful. Let us move on to economic policy.

Q75 Lord Shutt of Greetland: We learnt from you this morning that the economic and monetary union may be a political or economic project. Is there a need to achieve a resilient and sustainable union in this? What co-ordination is required among EU and eurozone member states?

Megan Greene: On economic union, the approach so far has been that there needs to be co-ordination and everyone needs to look a bit more like one another, but actually everybody needs to look more like the northern states. Unfortunately, that is partly why Germany has such a huge current account surplus. You have razed off any kind of domestic demand in the weaker states as a result of that. Going back to the conversation earlier, competitiveness features pretty heavily in the economic union piece. There has been a maniacal concentration on price competitiveness that has been pretty misplaced. We need to see a much more symmetrical adjustment. In any case, if within a monetary union we all try to make ourselves more competitive relative to everybody else, that beggar-thy-neighbour strategy ends up being a race to the bottom.

Lord Lawson of Blaby: What people really mean by competitiveness is productivity, efficiency and all that kind of thing. That is not a stupid objective, is it?

Megan Greene: No, it is not a stupid objective. Yes, there are many different ways to achieve price competitiveness gains. One is to open up labour and product markets. That is a slow-burner. A much faster way is to go ahead and cut wages and pensions. That is the route that the weaker countries have pursued because it was the fastest, most efficient way to hit strict, difficult fiscal targets. I think that has been an unfortunate approach to this crisis, and one that needs to change. Continuing to focus on price competitiveness is sort of baking an internal devaluation into the adjustment. I would argue against that.

The Chairman: Would you include structural reforms in that analysis?

Megan Greene: I think structural reforms are probably over-emphasised. They are important, of course, but they take a long time to bite and to start supporting growth. Nobody knows how long they take but you might say on average five years. Spain's labour market reforms have taken about that amount of time to start supporting export growth. I am not sure how much time we have given the political and social dislocation in Europe, particularly now in the light of the refugee crisis.

Lord Shutt of Greetland: So what would you advise?

Megan Greene: I think you should forget about the entire competitiveness piece, and setting out competitiveness tsars in every country. That is not the most important bit. Some kind of co-ordination is absolutely necessary but it needs to symmetrical. It cannot just be the weaker countries trying to look like the stronger countries. They need to meet in the middle.

John Peet: I agree with that last point, certainly. There is a problem that adjustment is imposed on deficit countries and not on surplus countries. The eurozone is suffering from insufficient demand. That is a problem generated particularly by Germany, which is not doing enough to increase demand. But I do not quite agree with Megan about structural reforms because they are important. If you lose the ability to devalue your currency and you lose your monetary independence then you need structural reforms to make your economy more flexible. I am not sure "competitiveness" is the correct word to use here but flexibility is very important. I also believe that although labour market reforms, which are very important to get down unemployment, may not produce quick results, product market reforms can produce quite quick results—services liberalisation can, in particular. Those are things that are very desirable in their own right and they could help to increase demand and consumption inside the eurozone. I would advocate pursuing structural reforms more rapidly than is happening at the moment, including in Germany.

Q76 Lord Skidelsky: Germany's surpluses are mainly with non-European countries. In fact, to get a balance within the eurozone the deficit countries would need to run surpluses with Germany. How do Germany's surpluses outside the European Union affect the balance of supply and demand within the European Union?

John Peet: I think the total size of the German surplus, which now runs at 8% of GDP, has the effect of, if you like, a deflationary bias on the whole world, and that affects the eurozone. The consequence of the adjustments that have taken place in the eurozone in the last seven or eight years is that the whole of the eurozone is now moving into substantial current account surplus. I think I am right in saying that the eurozone now has a bigger current account surplus than China. I am not sure that that is necessarily a bad thing because for an ageing continent that might be desirable, but I think the way that happened also had the effect of reducing demand and, possibly, growth inside the eurozone.

The Chairman: We have not heard from Professor Jones on this yet. Then I will take other members of the Committee who caught my eye.

Professor Erik Jones: I just want to emphasise that productivity growth is far more important than market flexibility or any of that other stuff. Productivity growth is achieved by redeploying capital from places where it is in surplus to places where there are surplus opportunities for investment. That is what we did in the 1990s and early 2000s. To throw some data into this, if you look at the way the European periphery worked at the start of the 1990s, there were 10 million manufacturing workers in Germany and 10 million manufacturing workers in Portugal, Italy, Ireland, Greece and Spain. By the end of the 1990s, Germany shed 1.7 million workers as a consequence of unification but the peripheral countries of Europe kept all their manufacturing employees. By 2007, Germany shed another 800,000 manufacturing workers but the peripheral countries of Europe kept all 10 million of theirs. Over that 17-year period, 40% of the manufacturing workforce retired and was replaced in peripheral Europe—why? It was because the cost of capital had gone down so low that they were able to enhance the productivity of those workers, make them more productive and therefore contribute more to the economy. This is what the development model was supposed to do.

We put that in reverse in 2007. We pulled all the capital out and threw all these people into unemployment. That is the thing that we have to fix. We have to get the capital back into these countries. You do not do that by exporting capital from the euro area to the rest of the world. On the contrary, you put the euro area at risk of losing the principal of those capital flows in emerging markets such as China, Brazil or South Africa; or, even worse, in asset classes in the United States such as student loans and other things that Europeans should not invest in. But they are investing in those because they cannot get any reasonable rate of return in Europe.

The Chairman: So how do you do this?

Professor Erik Jones: We need to restart capital market integration in Europe as it is the capital market disintegration that caused this problem. You do that by doing all the things that Megan alluded to at the beginning: you need to restore confidence in intra-European finance so that instead of Germans investing their money in Brazil they invest in Greece, Spain, Ireland and Portugal again.

The Chairman: But is not the logic of the allure of the emerging markets or places that are perceived to have a better return on investment that investors will choose those options rather than intra-Europe investment? Do you have any legal, institutional or architectural suggestions for how to do this?

Professor Erik Jones: But the institutional suggestion is banking union; it is the creation of a single risk-free asset so that when people become afraid they do not have to pull their money across countries. They can leave it in the country but somewhere safe.

John Peet: May I add one point to this discussion? At the moment, I believe that German political and economic leaders are proud of their very large current account surplus. They think it is a sign of strength. Actually, over the years a lot of Germany's current account surplus—which has then led to large exports of capital—has been wasted. It has been foolishly invested, some of it in America and some in Greece and other places. Their current account surplus has not done Germans any good at all. It would be desirable for Germans' own standard of living to reduce the current account surplus.

Lord Shutt of Greetland: We have been addressing throughout our inquiry matters to do with the EU and the eurozone. You are almost suggesting that we are wasting our time and that we should be talking about Germany.

Megan Greene: No, I do not think that is the inference at all. Germany is at the helm of a lot of the policy because it is the biggest economy and therefore gets a big say. But things such as the banking union, the capital markets union, are pan-European solutions. Germany may or may not like bits of them but they are pan-European. On "Won't investors try to find yield in the emerging markets where it is higher, rather than invest in Europe where yields are negative?", I would not underestimate home bias. Right now, the home bias is within national boundaries but if you had eurobonds it would be in Europe. That would be pretty powerful.

Q77 Earl of Lindsay: I just want to come in on capital markets because it has been mentioned a number of times, not least in terms of the benefits of shock absorption and responding to the way crises currently cause unhelpful flows of funds. Do you think that there is any realistic prospect of seeing capital market integration, the capital markets union, within a timescale that would support what the Five Presidents' Report is trying to achieve? If not, what are the obstacles to prevent a proper integration of capital markets?

Megan Greene: This is why I said at the beginning that I think the priority should be re-jigged to make this number one. It will take a bit longer than the timescale in the Five Presidents' Report but a number of things are impeding the development of capital markets union. A lot of it is down to legislation.

The Chairman: When you say it will take a lot longer, the end timeframe is of course 2025. You see it taking it longer than that, do you?

Megan Greene: Yes, I think so, unfortunately. You have things like property rights and the legal enforceability of cross-border property rights that need to be addressed first. That will take some time.

Lord Lawson of Blaby: Would Mr Peet like to comment on this?

John Peet: I think Lord Hill quite correctly made building a capital markets union his top priority and he appears to have the support of all his fellow Commissioners, so I think there will be progress in this area. People see it as a desirable thing. But, as Megan Greene said, quite a lot of regulatory changes need to go with it. It is possible that some countries will start to say we need to have regulation of capital markets at European not national level. That will be resisted by many countries, including probably this one. It will take time.

Lord Lawson of Blaby: And what about the Chairman's question about whether the 2025 deadline or objective of the Five Presidents' Report proposals is likely to be attained? What is your view on that?

John Peet: It is nine years off. You can do quite a lot in nine years. As I said at the beginning, I do not expect much to happen in the immediate future and certainly not this side of the French and German elections. Then there is an Italian election. But after those are through, and particularly if the eurozone continues to suffer from low growth and high unemployment, I think the pressure to improve the situation will intensify. It could be possible to have a much more functioning capital markets union by 2025, yes.

Lord Lawson of Blaby: But their objectives go far beyond capital markets union. If I recall, they include a European Union or eurozone treasury.

John Peet: Yes, and I would not expect that to happen by 2025—if ever.

Lord Davies of Stamford: I want to come back to the comment of Professor Jones and Ms Greene that one reason why you cannot replicate the very effective capital markets transfers of the United States in the European Union is the absence of a market in the liabilities of the federal system. I think that is wrong; it is not a problem. It seems to me that currency risk is a problem and a big obstacle to holding diversified portfolios. But currency risk has been eliminated by the existence of the euro in most of the EU, so that was an important way forward. I agree that it is necessary to have so-called risk-free assets for both the banking system—indeed, to have open market operations between the banking system and the Central Bank—and savers, who need something which they consider to be the absolute bottom of the risk profile. But there are in the European Union so-called risk-free assets: they are called bunds. You could say that they extend also to liabilities of other member states with AAA ratings. I think those are the problems but they have been resolved in the euro area. I do not think the existence of a market in liabilities of the federal Government is itself a factor here; at least, I am not persuaded of that yet.

To come back to the issue that in the United States you cannot short Massachusetts or South California, of course you can: you can short the municipal bonds in that particular state. You can short that state not merely by going short of the equities or liabilities issued by the private sector in that state. You can also go directly to the public sector through the municipal bond market, which is very liquid. So I do not agree with that either. I just throw those two points out as a provocation to you to come back on if you would like to.

The Chairman: If we could just take Professor Jones and then I want to move on.

Professor Erik Jones: The point I was trying to make is probably best made through an illustration of what happened to Italy in the summer of 2011. Italy's position in the TARGET2 system for exchanging liquidity between central banks was a surplus or credit position of about €8 billion in June 2011. Between June and September, it went from an €8 billion surplus to about a €100 billion deficit. That should have been a balance of payments crisis in any story but it was not: it was automatically accommodated by TARGET2. The reason that took place is that about 8% of the stock of Italian sovereign debt was liquidated by foreign investors over those three months, and 8% of a stock of a debt that is more than 100% of GDP is a lot of money to pull out of a country at one time. That is the problem.

When it did that, it not only pulled that debt out of the country but also damaged all those Italian banks which had their portfolios stuffed with Italian sovereign debt. You can short Texas government bonds but the Texas banks will not be holding those bonds, so it is not the same effect as it was in Italy when all the money was sucked out of the country. When all the money got sucked out of the country, those banks literally stopped lending to the private sector. Our SME sector in my part of Italy, which is very profitable and productive, found itself denuded of capital. It could not even get working capital except by deferring wages to its own employees.

Lord Davies of Stamford: I will not repeat myself; I will think about your point very carefully.

The Chairman: Lord Davies, we are going to move on.

Lord Davies of Stamford: But Chairman, have we commissioned a report by Ms Greene and Professor Jones into the contrast between American capital markets and the European capital markets, and the aspirations we have for the European capital markets? That would be a very useful document because that goes right to the heart of this whole issue.

The Chairman: We would be very grateful to have any more evidence that you may wish to draw up. I am not sure I am in a position to commission a document from you. I suspect that would be rather too expensive for the House of Lords. If we could move to banking union, Lord Butler wanted to pick up a couple of points.

Q78 Lord Butler of Brockwell: Yes, Mr Peet said at the outset that he did not expect much progress to be made on banking union. In view of the German opposition to the proposals for the European deposit insurance scheme, that seems to be right. Do the other witnesses agree that this is an area of the Five Presidents' report where we are likely to see very little progress?

Megan Greene: Unfortunately, that is probably right, particularly in terms of the common deposit insurance scheme, which is absolutely essential to a banking union. I have no doubt about that but I also have no doubt that Germany will do everything it can to oppose that. Unfortunately, although there are great proposals on banking union in this report, politically it is difficult to see how they would see the light of day.

Professor Erik Jones: Just as a little factoid, they tried to write progress on deposit insurance into the draft. It appeared in the first draft of the European Council presidency conclusions, circulated in December. Deposit insurance was pulled out of that draft. By the second draft that got circulated it was already gone. So even before the meeting—a week before it—they had decided that they were not going to make progress on this issue. The other thing, just as a little factoid, is that they do not even have a common deposit insurance system in Germany. The different types of German banks have different deposit insurance. That is the biggest part of the problem. Sparkassen and Landesbanken do not want to get implicated in a European system because they have their own preferential arrangements.

Lord Butler of Brockwell: Is this just a problem of what happens before the German elections or does the objection lie more deeply than that? Your answer implies that it lies more deeply.

Professor Erik Jones: Yes.

Megan Greene: Yes, it is not a question of an upcoming election and pandering to the electorate. This is deeply embedded in the German psyche. German voters do not ever want to bail out Greek banks.

Lord Butler of Brockwell: Thank you. I do not think there is any more to be said on banking union for the moment.

Q79 The Chairman: I just have a little question. We are now presented with plans for these very incremental steps on re-insurance, co-insurance and so on. Do you see that taking off, working and solving the problems we are trying to address?

John Peet: I go back to the point I made right at the beginning: I do not expect much to change so long as the markets seem reasonably calm and people, including those in Germany, can believe that there is not to be a fresh outbreak of what is called a eurocrisis. The political resistance inside Germany and some other countries such as Austria to anything that looks like German taxpayers having to bail out other countries will continue.

Professor Erik Jones: I think what John said about other countries is quite important. The Netherlands are dead set against deposit insurance. When I ask people in the Netherlands why that is, they say, "We don't want to bail out any Italian banks". I always say, "Okay, name one major Italian bank that went under during the crisis and one major Dutch bank that didn't—because all the Dutch banks failed. So wouldn't it be the Italians bailing out the Dutch?" Their answer is always, "No, we just don't have any political support for this. Even if you could make a rational argument for how this would help us, it is just not going to work".

The Chairman: Are they even opposed to just re-insurance, whereby the national bank steps in first?

Professor Erik Jones: They are opposed to anything that smacks of a risk transfer that goes down on to depositors.

Lord Davies of Stamford: Has this re-insurance system been agreed? I would be interested to hear what you think about it. Over time, it would solve the problem.

The Chairman: I asked about what had been proposed but is not yet agreed.

Professor Erik Jones: I think it would be instructive to look at the collapse of Fortis. Fortis had a giant plan for how it would be resolved since it was a tri-national bank. The first thing that happened when Fortis got into trouble was that it took that giant plan and threw it right out the window, and then ripped Fortis apart into national units. We can design these institutions and we might achieve some incremental progress in them but there has to be real political will to make them work, particularly in the context of crisis. I just do not see that at the moment.

Q80 Lord Haskins: To come back to the issue of governance, Professor Jones, you said you thought that this project in total was led for economic rather than political purposes. Yet in the innocent days pre-entry there were some very sound political criteria laid down, which were ignored by the politicians in the case of Italy, Spain and Greece. Once the union got going and the stability pact was there, sound economic reasons why that stability pact should be applied were ignored. Had they not been ignored, the world might be a different place from what it is now. We are now, however, in a situation where we say something must be done and governance must be strengthened. We hear proposals that the European Parliament should in some ways be given greater powers to ensure that rules which are laid down are applied. Maybe there is another option but it does not come to mind. It seems a pretty worrying situation if we are to rely on the European Parliament to make sure that all this happens properly.

Megan Greene: I highlight that the first two countries to not comply with the stability and growth pact were Germany and France. It was not a weaker country issue necessarily. I also highlight that the only country that ticked all the boxes for eurozone membership was Luxembourg. Germany certainly did not. One problem with trying to set up rules such as these, and having a rules-based approach, is what stick you will use. Right now, if you were to punish a country for fiscal profligacy you would fine them but that is pretty counterproductive. That is the biggest issue. There is no stick that is really effective and that is why countries do not comply with these rules. This measure apparently has more teeth but I think that when there is trouble they will be pretty relaxed about it as well, particularly now that we see big countries such as Italy and Spain pushing back on their fiscal targets.

Lord Skidelsky: Presumably, countries pay attention to fiscal rules. In a way, it is a sort of name and shaming if not done through a fine. A code of behaviour comes to be accepted. The real issue is whether the fiscal rules are appropriate.

Megan Greene: Yes, and I am not saying it is necessarily a bad thing that these rules are not considered to be written in stone. Spain’s budget deficit was 5% of GDP last year. That is a big reason why Spain is growing. Nobody seems to really notice this—and will not until the European Commission throws a big stink about it. Actually I think it is quite a good thing that often, these fiscal rules are bent—but then I do not argue that we should have a rules-based approach.

Lord Davies of Stamford: The real sanction is the collapse of the government bond market in cases of excess deficit. Then you have to pay much higher rates on your new debt. That is a real pressure on Governments.

Megan Greene: It should be but now you have the ECB stepping in and essentially saying that it will be the lender of last resort. You have the "Draghi put", which means that markets are not putting pressure on these countries.

Professor Erik Jones: Just to clarify, the fiscal issue may have been relevant in the Greek case but it was not relevant in the Irish case. For most of 2009, Irish bonds traded at higher yields than Greek bonds. In that sense, we have to be careful in assuming that failure to abide by fiscal rules generated this crisis. What generated this crisis was financial market disintegration in the context of a very profound economic shock from the United States.

Lord Davies of Stamford: It was excessive lending in the case of Ireland, on the part of the private sector.

Professor Erik Jones: In Ireland, the issue is in the private sector but in Portugal it is both private and public. In Spain it is in the public sector. It is in different sectors in every country.

Lord Haskins: But in Ireland's case, the Irish Government could have taken steps to deal with the problems in front of them but they did not.

Lord Lawson of Blaby: They made it worse.

Q81 The Chairman: Can I press you, in concluding, on what other democratic accountability arrangements need to be in place? We have been pretty good at identifying what went wrong and in looking through the Five Presidents' Report at what they want to do. But they are rather weak on democratic accountability. How might we improve on that?

John Peet: That might be an insoluble conundrum. I do not think that the European Parliament provides sufficient democratic input into the European Union as a whole, and certainly not into the arrangements of the eurozone. The European Central Bank has a relationship with the European Parliament and Draghi testifies in front of the European Parliament but I do not think that that generates the democratic consent process that you see inside a single country, such as this one. But I do not think that anybody has come up with an alternative. I do not think Europe is ready for the election of the European Commission, the European Commission President or the European Council President because there is not a common demos inside the European Union. So we have a system that has now created a single currency and elements of a political union without the democratic underpinning that is, in the long run, desirable. It may arrive in due course but I do not think it is there yet. I am not sure that anybody has come up with a good solution for that.

The Chairman: I should ask members of the Committee if they have any concluding thoughts. Well, thank you all very much for coming. That concludes today's public evidence session. The Committee will now continue its meeting in private. Thank you very much indeed.