



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. 15

Heard in Public

Questions 167 - 178

WEDNESDAY 3 FEBRUARY 2016

10.15 am

Witnesses: Professor Lucia Quaglia, Dr Andrew Lilico and David Marsh

Members present

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

Examination of Witnesses

Professor Lucia Quaglia, Department of Politics, University of York, **Dr Andrew Lilico**, Executive Director and Principal, Europe Economics, and **David Marsh, Managing Director**, Official Monetary and Financial Institutions Forum

Q167 The Chairman: Good morning, Mr David Marsh, Professor Lucia Quaglia and Dr Andrew Lilico. Welcome to the European Union Financial Affairs Sub-Committee's inquiry on completing Europe's economic and monetary union. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee, 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: it is being webcast live and will be subsequently accessible via the parliamentary website.

I will kick off the questions by pressing you on your overview of the Five Presidents' Report and the actions pertained in it. Do you think that it does enough to strength the euro's long-term stability? Would you also comment in your opening remarks on the overall implications that you think it will have for the United Kingdom? Mr Marsh, would you like to start?

David Marsh: The Juncker report is a valid attempt to paper over some of the cracks in economic and monetary union, but it is very evident that the real decisions under the Juncker report, the Five Presidents' Report, will not be made until after the French and German elections in 2017. That tells us something a little more. If I may say so, many of us have known for many years that you need more political union to make a monetary union work; Chancellor Kohl said it nearly 30 years ago. The trouble is that, as time has gone on, something that becomes more desirable becomes less feasible, because there is not much political will, particularly in France and Germany—the two most important members of

monetary union—to make this thing work. This is exposed in the Five Presidents’ Report. They do not, as you said in your remarkably perspicacious questions, to which of course there is normally no answer, mention debt mutualisation. They have dropped that, above all because of German hostility, but also because France does not really know what it wants.

Professor Lucia Quaglia: The report seeks to strike the right balance between what is economically desirable for the completion and good functioning of a monetary union and what is politically feasible, taking into account the different preferences of the member states and the different domestic constraints that they face. To that extent, the report is successful. Whether all the right points have been covered I am not so sure. On fiscal union, for example, much emphasis is still placed on monetary and fiscal union and less on mechanisms for macroeconomic stabilisation.

Dr Andrew Lilico: It recognises the importance of increased political integrity to make the euro work and the need for democratic accountability that is associated with that. It is an advance that it abandons debt mutualisation, which was one of the greatest threats to the euro as a whole. It is a mistake that it focuses its thinking about fiscal union upon temporary measures to the exclusion of ongoing fiscal transfers, which will be absolutely required for the euro to function over the medium term. I emphasise, though, that there is quite a lot in here that will have direct implications for the UK via the institutional implications for the European Union. It will mean that the European Union institutions, as distinct from euro-area institutions, become increasingly irrelevant. It reinforces that there is unlikely to be, over the medium to longer term, any place for any non-euro member of the European Union.

Q168 The Chairman: Thank you. I will first pick up one or two things that you have said, Mr Marsh. If I understood you correctly, you said that it is an advance that they have abandoned the Four Presidents’ Report’s emphasis on debt mutualisation.

Dr Andrew Lilico: I said that.

David Marsh: I said that it is notable that they left it out.

The Chairman: Is that a good or a bad thing?

David Marsh: I think it is a good thing to recognise political reality. Mrs Merkel has said, “Over my dead body”, which might be metaphorical, of course, or she might actually die. That was a fairly strong hint from Germany that they do not find debt mutualisation acceptable, so they have exerted a veto there. One of the problems with monetary union is that everybody thinks that they are victimised by the others. There is a culture of victimisation, so the Germans think they are being hoodwinked by the French, and the French think they are being hoodwinked by the Germans. You can go on and on.

The Chairman: Dr Lilico, we have seen your paper, which was very interesting. Will you elaborate a little on what you have just said?

Dr Andrew Lilico: Sure. In my view, the only real way to make the euro work over the medium term will be associated with deeper political integration, which will also require mechanisms for democratic accountability. It is clear that the document mentions specifically the idea of an increased role for the European Parliament, with its focus on the euro area, and the development of democratic accountability mechanisms associated with the management of a treasury function. As the number of non-euro members of the EU declines—and it continues to decline; the euro continues to be an expanding project, and quite a successful one in the political sense at least—you should anticipate that the European Parliament will increasingly sit as a sort of grand committee for euro-area matters that is equivalent, perhaps, to some of the ways in which people in the UK think of English votes for English measures being dealt with by a Grand Committee of the House of Commons. I would expect that, in much the same way in which people fear that that would lead to the marginalisation of Scottish Members of Parliament, they fear that it would lead to the marginalisation of UK MEPs within the European Parliament. Similarly, I would expect that more and more Commission business to be devoted to euro-area matters to the exclusion of wider EU matters, which in due course would mean that the interests of non-euro members of the EU become increasingly marginal. So I do not see how, as things stand, there is any long-term future for any members of the European Union who are not members of the euro.

Lord Lawson of Blaby: May we ask Mr Marsh whether he agrees with that?

David Marsh: First, I disagree with the idea that the non-euro membership is becoming smaller. I could easily see it becoming larger, frankly—and you all know who I mean. Secondly, I feel that there will be some safeguards under—

Lord Davies of Stamford: Presumably we are talking about Greece.

David Marsh: Greece, and there is a strong danger that other countries might follow. It is like Chancellor Kohl's cardigan starting to unravel. So I do not agree with Andrew on that point. Secondly, I do feel that there are very strong reasons why the rather well-performing European Union members that are not members of the euro, and are not likely to be members of the euro for some considerable time—I cite Sweden and Poland here above all—may be given some safeguards to guard against the kind of caucusing that Andrew has been speaking about. So I disagree with both of those propositions.

The Chairman: Thank you. That is really interesting. I want to come back a little on what Dr Lilico said. Do you accept, nevertheless, that the presence of our MEPs in different groupings is there to provide the democratic accountability?

Dr Andrew Lilico: They are there, absolutely, to provide one element of democratic accountability within the European Union framework as it stands—there is the Council of Ministers as well, of course. The issue is not whether the MEPs provide any mechanisms of democratic accountability as it stands. I do not think the intention of the European Union via the MEPs is that much to provide individual member state-level accountability; it is via the MEP. But my issue is not there; my issue is that as you move towards a greater political union, which you have to make the euro area work, the role of those that are not in the euro will become increasingly irrelevant.

Lord Haskins: Following Mr Marsh's comment that, on the one hand, Chancellor Kohl said this had to end up in political union and, on the other hand, that there was not a cat in hell's chance of anybody agreeing to the measures that are required to make that happen, what will be the outcome?

David Marsh: It is a rather messy halfway house, with elements of political union. You could mention the European Parliament, which you might say gives a fig-leaf of democratic accountability. There will clearly be greater oversight of different countries' budgets under all the different European mechanisms that have been included in the last few years. There will also be some degree of debt mutualisation of the sort you might have in a proper federal state, simply because there are many mechanisms now by which, either through the front door or the back door, the creditor countries are mutualising some of their overall foreign claims against their liabilities: the debtor countries. What we will not have, though, is a genuine sharing of fiscal mechanisms and the kind of long-term, permanent transfers that Andrew is talking about. That will not happen, and that is a major lacuna. When monetary union was being talked about in the early 1990s, there was a thought that at least 3% of the budgets of the European Union should be there to spread around in transfer payments for the less fortuitous states. In fact, as we all know, the EU budget is 1% of GDP; in America, it is between 10% and 20%. That is the essential gap, and until you can close it there will be no properly functioning monetary union worthy of its name.

The Chairman: That may be the case, but do you think the Five Presidents' Report has created the framework for the likelihood of strengthening the financial stability, given where we were in 2011 and so on?

David Marsh: The banking union has been a major step forward, and they have surprised me by going further forward, particularly on the supervisory mechanism, and even on the resolution mechanism. So there is an element of building in some additional financial stability on the strictly banking side. The problem with financial crises is that it takes 10 years to put into effect the mechanisms needed to forestall another one, and another financial crisis normally happens five years after the one before. So Europe is always a little out of kilter, I am afraid, with the realities. I am afraid to say that what might be brewing now could wash away the rather slender edifice of banking union that has been constructed so far.

Professor Lucia Quaglia: If I could add to that, it seems to me that there are two elements missing from the banking union project. The first is a common European deposit guarantee scheme, which has now been proposed by the European Council. The second, which is also under discussion, is the setting up of a fiscal back-stop.

The Chairman: Dr Lilico, any comments on strengthening the financial stability?

Dr Andrew Lilico: As people here may know, I think that deposit insurance is a mistake all up, and that the common deposit insurance scheme is a mistake on stilts. I agree that the development of an improved resolution framework is positive, although I might add that we should not neglect the significance, both for financial and financial stability, of developments such as a common European pension and common European unemployment insurance, which are both being explored quite actively. Those kinds of things could also be significant for this.

Q169 Lord Borwick: We have got into the second section of the question without leaving the first, which is wonderful. Your description of it, Mr Marsh, as a lacuna sounds more like a fatal flaw. You are really talking about the collapse of the euro system, are you not? The effects on the non-euro countries could be economically really rather bad news.

David Marsh: It depends what you mean by “fatal”. The more literal English view of “fatal” is that you are going to die of it, whereas the more metaphorical continental view is that it is simply something that is very difficult to get out of. It may well turn out to be terminal. It is certainly a flaw. Other people might think that it is something that you can work your way out of. As I said, everybody knew that this was a flaw right from the very beginning. Kohl’s views was that there would be so much monetary union they would push political union along. That has not worked. Therefore that could be the end of it all. On the other hand, Europe has a remarkable facility for continuing to survive when all around think it is dead. It is limping on in a way that could well be thought of as terminal.

Lord Borwick: So would you predict the recreation of the deutschmark and the French franc at some stage?

David Marsh: If it came to a really seminal bust-up, there would be the recreation of the ERM, such as we had it up until 1999, with a strong d-mark/Netherlands guilder link. It would probably still be called the euro, there would be six or seven countries inside it, and they would probably include countries such as Sweden, Denmark, and possibly Poland, which are not actually in the euro at the moment, so no, I do not think we will go back to the deutschmark.

Lord Borwick: But you are implying the creation of a lira and a Greek currency.

David Marsh: That is always a possibility. I would not like to judge that. Nor would I like to judge where the French will fit in; they are, as always, unpredictable.

Dr Andrew Lilico: The Greeks and Cypriots might still leave the euro at some point, although that is now increasingly unlikely, given that they did not leave last year. I do not expect the collapse of the euro. People have predicted the collapse of the euro many times, yet it keeps on going. The members of it boast of it as a success. New people keep joining the euro area, so I do not see why you should expect it to collapse. To my mind, the threat to the euro would come only from the core countries—France and Germany—deciding that it was no longer in their interests. We should not think of it as the euro unless it has France, Germany and Italy in it, so the thought that Italy might leave and the euro might carry on is not very realistic. The threat I see would be that the countries that provide the money might decide at some point, “If the only point of the euro is that we pay for everyone else, then we’re off”. This is why I say that things like debt mutualisation are the real threat to the euro project. It is not the small countries that are the threat to it. The euro can carry without them. What it cannot carry on without is the big ones.

There is already a system of fiscal transfers within the European Union: the structural and cohesion funds. It is just that they are very small and at the kind of regional policy level in the EU; only 0.8% or something of that order. I agree absolutely that they need to get to something like 3%. I think they will get there in the end; I just think that there is a bit of political difficulty in getting there. The key political difficulty is that while those who will fund these things suspect that any other scheme is a way of making them responsible for €2 trillion of Italian debt which the Italians took on before the euro even existed, they are going to be resistant. Once you reassure the Germans enough that the Italian debts, the existing debts, are not your problem, they will be much more open to moving forward in other ways.

Q170 Lord Butler of Brockwell: Do you think that either the election or the threat of election of populist parties might lead to the break-up of the euro, or at least to certain countries leaving it?

Dr Andrew Lilico: The most obvious candidate for that is the FN in France, I guess, although there is also some possibility of AfD, and the CSU is calling for a German referendum on euro membership at some point. You could imagine such a scenario. I am not saying it is imminent, but if I were to think of two kinds of scenarios that might constitute a threat, I suppose the one other might be Five Star in Italy, which is an outside possibility.

Lord Butler of Brockwell: Or Podemos.

Dr Andrew Lilico: Again, I think the euro could continue without the Spaniards, although I do not think it is very likely to. On Podemos, it turns out that one of the lessons of Syriza is that you would have to be doing things pretty badly to end up getting chucked out. It really has to be catastrophic. If Syriza did not get chucked out, basically nobody is going to. It also turns out that your freedom to act in ways that are a risk to the euro ends up limited, even for these very populist parties.

The one thing I would add is that I would have thought that the great likelihood is that a party such as FN, which has already tried to rehabilitate itself a long way in the public mind, would achieve power only if it rehabilitated itself to the point at which it was no longer a threat to the European project. You could imagine it getting in and having quite extreme views on lots of other things, but the movement of populist parties to reach for power would be associated at the same time with the movement of them towards being a less of a threat to the euro project.

Professor Lucia Quaglia: Perhaps I could add to this. It is interesting not only that there are increasingly Eurosceptic parties—in particular, on the periphery of Europe—but that Euroscepticism at the level of public opinion has increased to a remarkable extent in those countries which used to be very pro-European. So it is a problem at the level of political parties and at the level of public opinion. To some extent, political parties respond to public opinion, but that also happens the other way round in that public opinion is somehow carried away by the political parties which are increasingly Eurosceptic. That is an interesting trend to detect.

Q171 Lord Butler of Brockwell: Shall we go on to the external representation of the euro? One of the recommendations of the Five Presidents' Report is for co-ordinated external representation of the euro, and I would like to ask you one or two questions about that. First, going back to the handling of the euro crisis, what effect has that had on the perception of the euro countries by the outside world? Does it regard them as more unified or less unified as a result of their handling of the euro crisis?

David Marsh: If I could have a stab at that, it is all to do with the politics. We have spoken about the lack of political union. Ideally, after 17 years of monetary union there would be one euro bloc with a certain percentage of voting at the IMF, with one member of the Executive Board, rather like in the United States, for example. That clearly has not happened. The French and the Germans, to say nothing of the British, want their own representation because they are still all individual countries.

On the second question, about how the euro is viewed, you can see that in the way the central banks hold their reserves. There was some talk, mostly among the French, who always got a little carried away by this, that the euro could become a real challenger to the dollar on the international monetary scene. You can see that most strongly in the reserve holdings. After a bit of a fillip in the early 2000s, that has not happened, and the percentage of reserves held in euros has been falling gradually over the last three or four years to the favour of the dollar but also to the favour of other currencies, such as sterling, the yen or even the renminbi. So the euro seen from abroad still looks a bit more stable and permanent than many people in this country might see it as being, but it is not anything like as attractive a currency as many thought it would be. You can see that particularly if you go to Asia. The Chinese were big buyers of euros right from the very beginning. They wanted to have the euro in the same way as an airliner might want to have an Airbus as well as a Boeing. They saw it as an alternative reserve currency. They have been deeply disappointed; they bought the currency and expected a state to come along sooner or later. They are not really interested in talking to the provincial governor of Luxembourg or Belgium; they want to see the people in charge. The problem with the euro is that nobody is in charge.

Q172 The Chairman: We are getting slightly ahead of ourselves, but perhaps I might just press those of you who have the expertise in this area. Do you think there has been a problem with the eurozone's representation at the IMF? At the moment, as you know of course, apart from the members of the board, others are divided into constituencies. Do you think that there has been a problem with them taking a common position on issues that are relevant to them? It is certainly flagged up in the Five Presidents' Report and was reiterated in the 21 October statement from the Commission, but our own feedback from the Minister is that the United Kingdom, sitting at the table, does not seem to think that there is an issue. Certainly a European Union pre-meeting takes place the week earlier and there is a sub-committee of the European Union members at the IMF. So there is some lack of appreciation in the United Kingdom that there is an issue. What is your assessment of that, please?

Professor Lucia Quaglia: My impression concerning, for example, the handling of the euro area crisis and the IMF discussion is that even among the euro area member states there were different preferences. It was not a case of the UK against the others, so to speak; the European Union and the euro area itself was internally divided. I am not sure whether unified representation would have made a huge difference.

Dr Andrew Lilico: This is not an area in which I have strong expertise, so I will probably defer to the others on it, although I am happy to put in my twopenny-worth. I guess my inclination is to think that the key issue for external people with regard to the European Union more generally—I will perhaps come to the IMF question—is that they could regard euro area states largely interchangeably. You could see this with the debt premium associated with the yields on government debt over the period of the euro up to 2007. Then it turned out that they were mistaken in that. They then tried to look around for somebody they could deal with, and I think that they have alighted upon Draghi, whom people now think of as the representative rather than anyone else. I would have said that over the medium term that kind of issue would be more resolvable. If you started issuing euro area debt, a euro area treasury representative would deal with them in respect of euro area consolidated debt, and that would resolve the debt question. Once you started issuing debt, that might make a difference to the European Union's representation of bodies such as the IMF, because then there might need to be a distinction between the sovereign euro area dealing with the IMF and the individual sovereign area dealing with the IMF. I think that they would probably continue to issue at least some debt.

David Marsh: Perhaps I could add two sentences. I think the real crunch will come over Greece. Do not forget that the IMF programme for Greece runs out in March and there will be a decision by the Executive Board, on which France and Germany sit, on whether to renew it and under what terms. Do not forget that the German Finance Minister has put forward a proposition which is still on the table for Greece to leave the euro area “temporarily”—a proposition with which France definitely does not agree.

Professor Lucia Quaglia: Perhaps I may add to this. It is important to consider also the implication of unified external representation of the banking euro area in other international financial regulatory fora. I have in mind in particular the Basel Committee. I did some work for the European Parliament on that. It is very interesting that now the SSM and ECB are full members of the Basel Committee. The Commission and the European Banking Authority are there as observers. Then there are representatives from the central banks and national banking supervisory authorities of certain member states. Assuming that the member states of the

banking euro area have similar preferences, I guess that that will have an implication in the future in the sense that they may be more able to exert some sort of influence, or at least to project their preferences in the Basel Committee, which is a very important body.

Lord Butler of Brockwell: So what do you think are the practical prospects of the formalisation of integrated representation of the euro? If I understood Mr Marsh correctly, he said that that would follow the emergence of a unified treasury function. That seems to be a long way off. If we look at this proposal in the Five Presidents' Report, do any of you think it is likely to be achieved in the near future—that is, in stage one?

David Marsh: I do not think it will be in the next five to seven years. Also, more generally, when I was in Berlin recently I saw a number of senior officials and they all distanced themselves very much—surprisingly, actually—from the recommendations, such as they were, of the Five Presidents' Report. I was not expecting such a lukewarm response.

Lord Borwick: To the whole report.

David Marsh: To the whole report.

The Chairman: Dr Lilico, you mentioned a eurozone treasury or head of finance Minister or something. Do you believe that that is imminent?

Dr Andrew Lilico: It depends what you mean by imminent. Even at the last EU President election, Juncker tried to claim that he had been elected. People did not really buy it, so he is the only person who claims that. But I do not think it will be long before you get an EU President of some sort. Exactly whether that is a euro area President or an EU President is slightly up for grabs, but I think that the finance person would follow on from the political election of the head of the European institution as a whole, and that cannot be far away. Once people start claiming that they are elected and at least some people start buying it, you will get momentum behind that two or three elections down the line.

Lord Butler of Brockwell: Would you like to define “far away”?

Dr Andrew Lilico: As I said, two or three elections down the line.

Professor Lucia Quaglia: I also consider that to be a sort of long-term project. More likely in the short to medium term is a formalisation of the Eurogroup. That has an implication for outsiders in that the Eurogroup is generally seen as a smaller body in which member states are better able to reach a consensus. Therefore, if there is a formalisation of this body, it will have implications for the outsiders. My impression is that increasingly important, or at least politically controversial, decisions are taken in the Eurogroup first and are then discussed in the ECOFIN council.

The Chairman: Just before we leave this, would treaty change not be required? Dr Lilico, you see this as happening two or three elections down the line but you are assuming that, in this interim period, in order to create that role there will have to be treaty change.

Dr Andrew Lilico: Yes, clearly.

Q173 Lord Skidelsky: I would like to turn to economic policy co-ordination and ask for your views on what seem to me to be two omissions from the Five Presidents' Report. The first is any proposal for dealing with current account imbalances—in particular, permanent German surpluses, which tend to force deflation on deficit countries. The second is the absence in the fiscal rules of any proposal for stabilisation or countercyclical policy; there is very little scope for that. In so far as those two omissions affect the economic performance of the eurozone and the European Union as a whole, they will affect Britain, whatever the view of the present British Government might be on those questions. So not only will it affect the economic viability of the eurozone, that will have an impact on the United Kingdom as well. I would like your views on that, please.

David Marsh: If I could start, you have put your finger on two really important issues, and it is not surprising that they are not dealt with in any great detail. First, on the imbalances, it has been glaringly obvious that the current account deficits and surpluses of the euro states since the start have been among the largest in the world in terms of percentages of GDP. Some of the most egregious problems with the deficits have obviously been healed but the countries that have surpluses are still piling up enormous surpluses. Germany, which you mentioned, has surpluses amounting to 8% of GDP, and that is probably growing slightly because of the weak euro. The Dutch surplus, which does not get talked about very much, is 12% of GDP. This is clearly, as you say, the cause of some kind of deflation, or at least it lowers the propensity for economic growth, because the other countries that had deficits are now being forced to have surpluses. So everybody has a surplus. That means that there is not enough domestic demand, which, in my view, is the principal problem of the euro area. When people try to put their finger on Germany and say, "You should do something about this", or they say that there should be some fines or some sort of finger-pointing, the Germans say that it is not their fault and that they have a very competitive Europe-wide industry these days. And of course Germany is being helped very much by the weaker euro.

There is absolutely no way, it seems, of dealing with this very large problem. It also creates problems for Germany. It is registering enormous increases in its foreign claims as a result of these very big build-ups of surpluses but it will never get the money back. The situation is

even worse for the Netherlands. It has net foreign claims of well over 15% of GDP and that money will never be redeemed. So it is really a zero-sum game.

When it comes to countercyclical policies, again, people in Europe tend to look at the budget deficits in nominal terms. They should have gone over to structural terms some time ago. In fact, the Germans insist on running a surplus even though that means that their structural surplus is very large, because they have more or less full employment these days. There is no willingness to think of the deficit in terms of what it would be if you adjusted for the cycle. Greece has had a monumental adjustment of something like 15 percentage points in its budgetary position. No credit is given for that. In fact, the Greeks are rather the whipping boys still. On the other hand, there is no criticism of Germany for running a policy that is certainly inimical to growth. So there is an enormous difference between the creditors and the debtors. It goes back to the Keynes position about asymmetrical adjustment, and it is the same thing that people were complaining about in the 1940s. You see it writ large.

As you said, all this would have big implications for Britain. Whether we are in or out, Europe is still our biggest trading area. Indeed, Britain is the biggest and most important trading area of the euro bloc, both in imports and exports. We are bigger than China and the United States. So if there is a progressive dismantling of the euro area, which I think could easily be accelerated if Britain were to leave the European Union, we will be hit one way or the other by the fallout. We cannot really escape the problem of what I consider a gradual European disintegration.

Lord Lawson of Blaby: I think Dr Lilico wants to add something to that.

Dr Andrew Lilico: Perhaps I could briefly respond on one or two things. One element of the imbalances is that they are the counterpart to the budgetary imbalances. If the Greeks borrow a lot of money from the Germans to fund their budget deficit, there will be a balance of payments consequence of that. To the extent that you address the fiscal question, you will automatically address some of the imbalances issues as well.

Secondly, on the report, I think you should understand some of the discussion about competitiveness in terms of seeking to partially address the problem of imbalances. It sees some of the imbalances as arising from differentials and differential trends in unit labour costs. If you could get everybody to improve their competitiveness, that should partially address those things as well. There are some things to say about capital spending but I do not think I need add any more.

Q174 Lord Lawson of Blaby: I would like to stick with this area, because we are now talking about the big issues. It is easy to get seduced by talking about all these technicalities,

which are not totally unimportant but they are not the main thing. The main thing is that there is undoubtedly a huge problem with the eurozone. Indeed, David Marsh has addressed this in a book which he has just updated. It is well worth reading. Dr Lilico has also addressed it in his excellent written evidence to us. Tell me if I am wrong but the position seems to be that if the euro area is to be a success, and if the euro as a single currency is to be a success, there has to be an automatic transfer union. You cannot have to have a vote of the members each time there is a transfer; you have to do what the United States does, with most taxes being raised in the more successful parts of the Union and public expenditure disproportionately being in the less successful parts. So the transfers have to be automatic—they should not have to be voted on—and therefore you need a transfer union which requires a political union. There seems to be a consensus that that is so, and I believe that is right.

There also seems to be a consensus that that is not going to happen any time soon. Indeed, it may not happen at all. The question then is: what are the economic consequences? There is also the question of what the political consequences will be. It seems to me to suggest two things. One is frequently spoken about and the other less frequently. The one that is frequently spoken about is that the eurozone will be a continually underperforming economic area, although the euro will not necessarily collapse. The second thing is that for the European economy to really prosper—this is generally agreed—there need to be major structural reforms of one kind or another. Structural reforms—I have some experience of this—are politically extremely difficult and need huge, single-minded determination. It seems to me that in the European area—whether the eurozone or continental Europe as a whole—even if there were this determination to implement structural reforms rather than just talking about them, which varies from place to place, they are so preoccupied with the problems of the eurozone and the euro, and devote so much of their firefighting and energies to it, that the chance of their being able to implement these needed structural reforms is approximately zero, or certainly very small. Therefore, underperformance will continue. I do not welcome this. What is your view of the economic consequences of this eurozone dilemma?

Dr Andrew Lilico: On the economic consequences and their thinking about the kind of thing that implies, suppose I have a bath and I want some water in it. It turns out that the plug is not in, so water drains out continuously. I might try a couple of times, if I have not worked out that the problem is that the water is draining out continuously, to chuck in a new bucket of water to keep it going. That will not solve the problem because the water will continue to go out through the plughole. I will get equilibrium only if I can switch the tap on fast enough. If I cannot put a plug in, I have to have water going in continuously at the same rate as the water

is coming out. At the end of the day, unless you address the point that for many parts of the euro area to function you must have a continuous fiscal transfer equivalent to that tap going on, you will have a series of crises which people will try to resolve by chucking in a new bucket of water. Eventually they will work out that this will not solve it, so they will then have to accept that they have to provide a tap or give up and leave. I think Mr Marsh thinks that they will eventually leave—that they will collapse. I think that series of crises will eventually be embraced as meaning that you have to have a tap, but I agree that it could go either way.

Lord McFall of Alcluith: But the volume of water matters.

Dr Andrew Lilico: It does.

Lord McFall of Alcluith: So tell us about that. Will it be ever-increasing?

Dr Andrew Lilico: My estimate is that you would want something in the order of 3% of transfers. There are already structural and cohesion funds of something like €60 billion, so for, say, Italy and Portugal, you could have transfers of around 1% of GDP. Although that is not a trivial amount of money—I calculated that that was €37 billion or something¹; I cannot remember the exact number now, but it was one and a bit per cent of GDP, which is more than the growth that they have had in the period of the euro. So you would be able to provide, with a relatively modest contribution, more growth for these countries. I have the figures for this, but not in front of me, I am afraid. I can send them along in due course. Compare that kind of feature—a modest contribution, a few tens of billions each year, across the euro area, exposing yourself to €2 trillion-plus of debt via a mutualisation or debt risk, taking on the responsibility for other people's debts. That should be considered a no-brainer in terms of the type of thing that people are willing to do. There are many people who say that at the end of the day they will be forced to accept debt mutualisation. That was a claim many people made in 2011-12. My point is that if you think that they might be forced to do that, how can you think it is incredible that they might accept giving much smaller sums on an ongoing basis? I do not believe that you should consider that incredible. If that is a natural extension of kind of programmes that are already in place, you could transform the situation—not provide a final solution, because you need to be getting up to 3%-plus of GDP—merely by providing

¹Dr Lilico subsequently provided the correct numbers as €20-€40bn, referenced from: Institute of Economic Affairs, *The Euro – the Beginning, the Middle ... and the End?* (2013) p 119:
<http://www.iea.org.uk/sites/default/files/publications/files/IEA%20The%20Euro.pdf>
 [accessed 1 March 2016]

something of the same order of magnitude again as the structural and cohesion funds that are already in place.

Professor Lucia Quaglia: Fiscal transfer is a common feature of all the federal states and nation states, but the European Union and the euro area are not federal states, and politically it would be very, very difficult for certain countries to accept a transfer union and a permanent set of fiscal transfers; I am thinking of Germany but also the Netherlands, Finland and the other Nordic states. What might be politically a bit more feasible but still very difficult is the construction of a stabilisation mechanism in a countercyclical way, which is different from permanent fiscal transfers taking place within the euro area. Even that would be quite difficult to achieve, because there is concern in particular member states about moral hazards and about being permanent net contributors, if you want, to this sort of euro-area mechanism for stabilisation and distribution.

The Chairman: How would you suggest that is done?

Professor Lucia Quaglia: At the moment, certain proposals have been put forward in the Juncker report, but they have not been fleshed out. I guess that we might see more details in the White Paper after the German and French general elections.

David Marsh: I would like to address a couple of points that Lord Lawson made: one on structural reforms and the other on the transfer union, which these days translates into a question not just of utilising new debt but of restructuring existing debt. First, on the structural reforms, the problem is that they always get done, as Lord Lawson says, at the wrong time, and there will be winners and losers. Germany got its retaliation in early by doing structural reforms when it actually had some very strong advantages because the rest of the euro area was growing very fast—too fast. The lack of demand in its own country, which these structural reforms caused in the early 2000s under Gerhard Schröder, was made up for by booming exports. That was extremely fortunate from a German point of view. You are now asking countries to carry out extremely difficult and laborious reforms at a time of low world demand and low euro-area demand, for all the reasons that have been spoken about. They will not be able to do it against a backdrop of the very high levels of unemployment and big social and political opposition that we have seen in places such as Portugal, Italy, Spain and Greece, and you should not take that lightly. It takes a long time for these people to become angry about the European Union, but it is now happening. It is clearly offset by all sorts of social cohesion and young people living with families and so on, but it is building up and we ignore it at our peril. It is very difficult to do these structural reforms, even though we

all know that they are needed, and there will always be some countries that seem to have done it better and earlier than others.

On the debt, just to continue the bath-time metaphor, we need the people who are controlling the taps to be in favour of running more water. We probably need another set of taps. Actually, we need to combine a few bathtubs here; it is more than just a single-tap issue. I do not see that there is the political will here. As I said right at the beginning, something that we all knew was desirable right from the beginning has now become progressively infeasible, because crises, I am afraid to say, do not breed greater solidarity—at least in Europe they do not; they breed greater egotism. Also, because Germany now has these huge net foreign claims on other countries, this makes the Germans avaricious—something that was foreseen by Wolfgang Schäuble about 30 years ago: the Germans do not want to part company with these very large foreign claims. We are now talking about massive debt restructuring, which is needed. It is not just existing money that is needed for transfers to pay the present problems: the bills of Greece, Spain and Italy. We are talking about massive losses from the past that will need to be covered one way or the other by the creditor countries, and the creditor countries, not surprisingly, are digging in their heels. So I do not see that there is really an answer to that. Europe will limp on. I agree with Andrew Lilico that the big problems are likely to come more from the large creditor countries, which simply refuse to turn on the taps and may indeed decide to move house and not share that particular bath any longer. The problem is that the Germans will never want to be seen as the people who, to use another metaphor, are sticking in the dagger. They do not mind if somebody else commits suicide, and they might even supply the dagger to do the deed, but they will not be seen, in a theatrical sense, plunging in the bloody sword at the end of Act 5 of this particular tragedy.

The Chairman: Those remarks will provoke quite a response. We are going to hear from Lord Skidelsky, then Lord Davies and Lord Shutt.

Q175 Lord Skidelsky: I just want to take up the point made by Andrew Lilico. As I understand it, you think that a fiscal transfer union is inevitable and might come about quite soon. However, there is an alternative, which is that countries resume control over their own currencies—in other words, they leave the single currency. Why do you think that the development of a fiscal transfer system is more likely than the break-up of the single currency area, which would lead to a smaller eurozone?

Dr Andrew Lilico: It is not completely implausible that one loses a couple of euro members, but that should not be considered a significant break-up of the eurozone. I think that the euro can carry on happily without the Greeks and the Cypriots. In fact, it would probably be better

without them. If the logic of the system demands fiscal transfers or break-up, it is more likely that you will end up with fiscal transfers because the commitment to the political project is extremely high. They have been building this political union for 64-plus years and they are not going to stop any time soon. They would consider it a catastrophe of monumental proportions to abandon a project that they have been working at for such a long time, and going back to national currencies would be regarded as that. There is every prospect of that leading to the collapse of the EU as well at the same time.

Lord Davies of Stamford: If I may say so, I thought that Mr Marsh's reading of history was a bit quirky. He said that Helmut Kohl's prediction that monetary union would lead to political union was wrong, which is a rather extraordinary reading. I cannot think what the Lisbon treaty was unless it was a step in the direction of political union or indeed the two-pack, six-pack, the European Semester, the banking union and all the measures that have been taken over the past few years. I think there has been a lot of confusion about the transfer union in this discussion. There has been talk about transfer union in terms of long-term structural, which means permanent, transfers from one member state to another being a necessary part of monetary union, but I do not think the case has been made at all. Such transfers are obviously irrelevant where the same cyclical pressures are faced by all the member states or all the states of the euro area—in other words, where shocks are essentially symmetric. By definition, they are irrelevant where shocks are asymmetric if they are permanent, because the whole point about transfers is that if they are to be effective in stabilising against asymmetric shocks, they need to be specific to those asymmetric shocks and not long term or so-called structural. The experience that we have had in Europe of long-term structural transfers has not been a happy one. Italy has had these long-term structural transfers since the 1950s, which has just created this climate of dependency in Calabria, Puglia and Sicily and so forth. We have had the same problem in Northern Ireland and Cornwall to some extent. The Germans have been playing the same game in subsidising Mecklenburg-Vorpommern and so forth, and I do not think that has done any good either. So that is irrelevant.

We need mechanisms that deal with asymmetric shocks. There I agree with Professor Quaglia that we need to take further some of the suggestions that are already on the table about having some element of a common unemployment insurance system. You cannot possibly have a merging of national unemployment insurance funds, because that would create the most appalling perverse incentive as the more efficient, higher-employment countries would be subsidising on a structural basis the structurally higher-unemployment countries. You could have something that insures against the cyclical element of unemployment, such as a

reinsurance scheme of some sort. It has been talked about. I think the Bruegel institute has developed a model of that kind, which is quite interesting. There is also a suggestion on the table that we might have an IMF within the euro area or the European Union that would be in a position of dealing with people who ran short-term gain—if we are talking about asymmetric shocks—or short-term liquidity balance of trade problems. That is also an interesting suggestion, so I think that is the way forward.

As for the debt element, of course it is a worry that debt is so high in Italy and so forth. Frankly, any kind of mutualisation creates the most appalling moral hazard. The only solution is to get back to what I call a normal rate of inflation, which might be about 2%, which is what the ECB is supposed to be aiming for. I think we will get back to that. At that point, we must maintain fiscal discipline as a result of the two-pack, six-pack, European Semester and other measures in the pipeline, which I thoroughly approve of, so that people maintain relatively balanced budgets throughout the cycle so that the fiscal position tends to be neutral through the cycle. I say “through the cycle”, because there must be an element of stabilisation there. Then, if there is a reasonable rate of inflation, the real value of this debt will be seen to be falling over time in a cyclical trend, which will reassure people and be sufficient to enable us to live with these levels of debt. At current interest rates, they are not frankly a burden on the fiscal position of the countries that they might otherwise be.

The Chairman: Lord Davies, did you have a question? I am not encouraging you to go any further.

Lord Davies of Stamford: I made a statement that was probably provocative. If anyone wants to disagree with me, I would be very happy.

David Marsh: Could I make a point about the quirkiness of my historical interpretation? Lord Davies, you made a point that would have been perfectly valid about 25 years ago, but because of the way that monetary union has developed, we have now moved on. It has become a monumental series of resentments between creditors and debtors. It is not me saying that; it is said by people who are utterly in favour of the monetary union—people such as Mr Draghi or Mr Issing, who was at the ECB when it started. They are telling me—I am not telling them—that it has become a debtor/creditor quagmire. We have to take account of that. What do you mean by political union? I think we would say political union tends to have a sovereign body that is allowed to take tax and spending decisions for the body of the people represented by that state. It has to be a body that decides on questions of peace and war, armies and navies. It needs to have a flag and a football team and all the other apparatus that goes with it. Things like the six-pack might excite people like you and me and Professor

Begg, but I do not think they add up to much more than a very thin gruel on the path towards political union. Chancellor Kohl once said to one of his speechwriters, “Political union. Very good question, Mr X, and an impossible question to answer”. That was Kohl about 20 years ago. They have not actually defined what they mean, and what we have now is in no way, shape or form political union, so we will go back to fulfilling the Maastricht criteria, which were all nominal and not structural. The Germans have the phrase, “He who has the money has to have the control, and he who pays the piper plays the tune”. The Germans want to have control over these countries, and the other countries will say, “This is not why we went into monetary union—to be bossed around by the Germans”. Above all, it is France saying that. There you have the dichotomy between France and Germany. I am sorry to say it, but that is reality.

The Chairman: I know that we spent quite a lot of time with central bankers both in and out of the eurozone. Are you saying that there is no common collective vision of what is needed to make the eurozone sustainable?

David Marsh: I am very much saying that

Q176 Lord Shutt of Greetland: Let us go to back to the bath. It seems to me that there is no point getting into the bath unless you want to be cleansed. Of course, you have been out in the internal market getting filthy and then you get into the bath. What I cannot understand about what I am hearing is the extent to which this tub is a eurozone tub or an EU tub. The discussion has all been about it being a eurozone. To what extent is it a communal tub as far as the EU as a whole is concerned? Is it debtor or creditor?

The Chairman: Professor Quaglia has been very silent. Would you like to come in with your views?

Professor Lucia Quaglia: It is a very difficult question. I would reframe the question about the implication of, for example, the euro area initiative for the wider European Union, and the one I have been looking at is mainly banking union. There are very clear spillovers there, some of them not very positive, for the entire European Union and potentially for the single market. In that sense, there is a connection between the two baths, so to speak.

Dr Andrew Lilico: I think that most of these are euro area issues. The ways in which they mainly spill over into the non-euro area are threefold. Obviously it is in the interests of the countries that are major trading partners of the euro area that the euro area does well, so there are implications from that for the trading and capital flows of our financial partners. There is also the issue of the measures taken, which may include measures at a European Union level. They, too, may have spillover impacts on the non-euro members. A classic example of that

would be the attempt by the ECB—which it will manage in the end—to move euro area clearing and settlement to within the euro area instead of it being based in London.

Lord Davies of Stamford: But they have withdrawn from that.

Dr Andrew Lilico: No. They have withdrawn from the explicit measure but I would expect that in due course they would look in a more friendly way on those doing their clearing and settlement within the EU. I expect soft influence to deliver that in the end, even if explicit measures are forbidden. The third way is the impact that deeper political integration, which I think will occur, will have on the functioning of the European Union institutions in the way that I described in the paper that I sent to you.

David Marsh: May I comment on what Lord Shutt said? This is a crucial question. The key to all this is Poland. Until a few years ago, we would easily have thought that Poland, along with a lot of other central and eastern European states, as well as Sweden and Denmark, would be members of the euro area. That is certainly what people were predicting in, say, 2010, but that has not happened. Therefore, there is a big body of fairly well-run and populous countries—quite large players—that are outside the euro area. Therefore, the point that you have put your finger on is extremely important.

I was very pleased to see in the Donald Tusk paper from yesterday that the other Europeans acknowledge, as is clearly the case, that there are other countries in the euro area and not part of the euro. I think that should be enshrined in some sort of force of law, whether it is treaty change or a watertight document which says that, if Britain remains in the European Union, we will have nothing to do with euro area bailout measures. That needs to be made absolutely watertight, either through a treaty or in a sort of Freshfields-signed document. I think all your allusions to tubs and whether we are all in it together are very important in that regard. The clearing issue is very important. London remains an important financial centre and therefore, if we are to stay in the European Union, we must have safeguards so that we can carry on doing euro trading here. If we leave, of course things may change, but that is extremely important.

The problem is that you do not know whether individual members of the euro tub will remain. It is all very well for Andrew Lilico to say, “Oh well, some may go but if they are small it doesn’t really matter”. I think it would be incredibly important if a small country, particularly one such as Greece with so much history and so much willingness and ability to get its way, were to leave. We cannot simply say, “They’ve left. They’ve gone off to another tub. They’re going to take another bath towel from somewhere else. Let them get on in their own little tub”. That would have an enormous impact on Italy and France.

Lord Davies of Stamford: I want to challenge what Mr Marsh has just been saying. I think there is a fundamental contradiction in what you have just said. If we are to be the financial capital of the EU area, banks and other institutions in the City of London will have massive amounts of assets in the eurozone. It follows that if there were a systemic threat to the stability of the eurozone, we would be exposed to that, and it might be very much in our national interests, and necessarily in the national interests, to be part of a bailout. The alternative might be worse and cost British taxpayers even more money in refinancing or recapitalising our banks because liquidity had been destroyed. So if we are to have a key role in the European Union, it makes no sense at all to say that we need some legal safeguard that makes it impossible for us ever to be a part of a bailout.

David Marsh: Perhaps I may make one point on that. I did not say that we would never be part of it. We decide as a sovereign body. Britain took part in action to help Ireland. We were not part of the euro area; we did that of our own accord because it made sense for British interests.

Q177 The Chairman: Thank you. I just want to pick up on the bath analogy, and I promise that this will be the last reference to it. You talked about a bath and the water draining out. What about the plug in the bath? That takes me neatly on to the banking union. Do you see that as the backstop? Do you think that risk-sharing over the medium to long term is going to happen? What are your views on banking union taking off under the Dutch presidency in the slightly longer term in terms of its missing elements at the moment?

Dr Andrew Lilico: I would say that by far the most important and positive element of the banking union is the resolution framework. The introduction of a bailing tool and things of that sort are excellent advances, although they are not complete. I think that having such a high level of insurance in the form of depositors is a mistake. I do not believe in depositor insurance. We have got on perfectly well in the UK without any depositor insurance since 1979. We seem to be happy enough with having only 2,000—

The Chairman: But if we had not had it, the banking crisis would have had a rather catastrophic effect.

Lord Davies of Stamford: Are you suggesting, Dr Lilico, that little old ladies with £5,000 to deposit should spend several days looking at the balance sheets of all possible banks to decide what credit rating she might to give each one and where she can safely place her deposit? Do you seriously think that? Is that reasonable from a human point of view or would it be systemically dangerous for the stability of the system?

Dr Andrew Lilico: I have written about this at some length. Until the 1970s we had a set of institutions called savings banks in the UK. The Trustee Savings Bank was the last of them until its nature was changed in the mid-1970s. You put money in the bank and it was 100% backed by government bonds, gilts and things of that sort. I am saying that you should have two kinds of deposits in every bank licensed to accept retail deposits. If all you want to do is store your money in the bank, you should be able to put it into storage deposits, but if you put your money into a fractional reserve bank, there should be no deposit insurance whatever associated with that.

The Chairman: I want to come back and focus on the eurozone.

Dr Andrew Lilico: That is the system in New Zealand, for example. There is no deposit insurance. The idea of moving towards increased collective risk-sharing is a mistake. The sense that the right objective here is to spread risk over a larger area is a mistake. The central useful thing here is achieving a common resolution framework and some greater cross-border collaboration. We have already had some of these things. There were measures in 2008 and there were ones before that with various kinds of colleges of supervisors and so on agreeing resolutions. Those are possible developments but I would say that the risk-sharing elements are a mistake.

The Chairman: Thank you. Professor Quaglia, I take it that you have a slightly different perspective.

Professor Lucia Quaglia: Banking union has been quite successful in preventing the worst outcome from the euro area sovereign debt crisis. It has also been successful in breaking the vicious cycle of states supporting the banks. The single supervisory mechanism has been set up and works quite well, and there is also a single resolution fund and a single resolution mechanism. It seems to me that the missing parts in the completion of banking union are a European deposit insurance scheme and then the setting up of a common fiscal backstop.

David Marsh: Very briefly, I think that the setting up of the Single Resolution Board, which has really become effective only in the last month, is a major milestone. It remains to be seen whether it will be tested in the heat of battle. The problem with the non-performing loans that we are becoming aware of around Europe is that all that will become significantly worse if Europe fails to do even as relatively badly as we thought it would. If we have a major world problem as a result of the United States not growing as much as we hoped it would, that will hit NPLs in, say, Italy. I wonder whether this international mechanism for the Single Resolution Board will work or whether we will go back to elements of banking nationalism, which we had before. I would not be prepared to swear that the sovereign banking nexus has

now been ended. That has to be tested but I am not confident that that can prove to be resilient enough to face the storms that we might see in the next two or three years.

Professor Lucia Quaglia: Perhaps I may add to that. The decision-making process of the single resolution mechanism seems to be quite convoluted as it involves several authorities at a national level—the Commission, the European Central Bank and the Single Resolution Board. The big question is whether it will be effective enough in taking decisions in the heat of the crisis of, say, a major bank failing. The proof of the pudding will be in the eating.

The Chairman: Thank you. Shall we move on to capital markets union? Lord Davies, did you want to come in on that?

Q178 Lord Davies of Stamford: I was going to ask about the United States and that sort of thing. It would be interesting to hear your views on the extent to which the capital markets bring about stabilisation in the United States. In the case of asymmetric shocks, an awful lot of the stabilisation will inevitably be accomplished by capital markets, quite apart from what the public sector needs to do. We all know that in the United States if the price of oil goes down, it is bad for Texas but very good for New York, Massachusetts and California. That sort of system is quite healthy. To what extent could that, or should that, work, or is it working, in the euro area? World capital markets, you can help.

David Marsh: It is very helpful to look at America as another role model and try to get away from undue dependence on the banks in Europe and move towards a more capital market-focused structure. I think that this capital market union idea, which has been dreamed up by the European Commission and the EIB—Lord Hill played a role in that—is very worthy. It also provides something for British banks and British asset managers, so you could say that it is quite clever politically but it also throws an olive branch to us in the UK as well.

There are structural reasons why capital markets have always been much less important than the banking markets in continental Europe, and you will not be able to overcome that in just a few years. The lending for covered bonds, which in Europe go back over a couple of centuries, is an extremely important part of what you might call a banking/capital market structure. That will not change. Asset-backed securities were at the root of some of the problems that we had in 2007 and 2008. The Commission and the ECB have been trying to revitalise those but they have come up against huge regulatory and structural problems. So that it is very laudable and there are some steps forward there, but I think it will take a very long time for us to really emulate the United States in that regard.

Lord Davies of Stamford: Would it provide significant protection against asymmetric shocks?

David Marsh: I am not sure it would because these asymmetric shocks will be more significant than we think in certain areas—for example, Germany being affected by China or Spain or Portugal. Portugal has been immensely affected by the downturn in oil prices with regard to Angola, one of its former colonies. That is an asymmetric shock and I do not see how you can legislate for it.

Lord Davies of Stamford: If there is a stabilisation mechanism, presumably it depends on the diversification of portfolios. If people hold widely diversified portfolios so that they have claims on businesses in other EU member states, whether in the form of bonds or equities or what have you, there will be a stabilisation effect. That is clearly significant in the United States, although I do not think it is very significant at the moment in the EU generally or in the euro area.

David Marsh: We saw a lot of cross-border claims being built up before 2010. That was, if you like, a successful part of monetary union. Then, when problems started to occur, the creditors of the deficit countries withdrew their liquidity, leading to all this official assistance that we have seen. So we have been through that phase.

Lord Davies of Stamford: But that was the banks rather than the capital markets.

David Marsh: It was partly the banks. A lot of bonds were owned. A lot of German and Swiss insurance companies had subscribed to bonds issued by, say, the Greek Government, and I know for a fact that the Chinese Central Bank, too, had lots of those bonds. So it was certainly down to much more than simply the financial markets; it was down to the holding of bonds. They were all withdrawn and converted, and the IMF, the ECB and the European Commission had to step in to make up for those bondholders.

Lord Davies of Stamford: Are there any studies that quantify the effects? I have not seen any.

David Marsh: Yes, there are, and they are immensely interesting. I am very happy to share a few footnotes with you.

The Chairman: Dr Lilico, I think you want to come in on this point and then I will go to Professor Quaglia.

Dr Andrew Lilico: I have three things to say. First, one should bear in mind that in the US a significant portion of shocks are dealt with by labour mobility, much more so than in Europe. That is an important factor if one would like to have more labour mobility in the EU.

Lord Davies of Stamford: Some Cabinet Ministers think there is too much labour mobility in the EU.

Dr Andrew Lilico: I do not, although things like the problems in the Schengen area are probably damaging.

Lord Lawson of Blaby: This is an important point. Population mobility is a crucial part of life in the United States. It is accepted there; it is not controversial. Within Europe, very much the reverse is the case: it is highly controversial and not accepted. This is a major problem that you have put your finger on.

Dr Andrew Lilico: The second thing I would say is that the prevalence of corporate bonds in the US relative to Europe is not mainly the result of regulatory barriers and flaws in the European framework; it is the result of traditional regulatory barriers and flaws in the US framework which limited the ability of banks to do certain kinds of corporate lending and it drove the development of the corporate bond market.

The third and last thing I would say is that we did quite a lot of analysis of convergence in the capital markets associated with the single financial services market programme from the late 1990s into the mid-2000s. By 2007 there was considerable convergence in transaction costs, in equity risk premia and in debt premia across the euro area. Now, that has been reversed, partly as a consequence of the eurozone crisis, but I would view a lot of the capital market union discussion as overblowing the problems. There are not that many things to solve in that dimension. The issues, in so far as they arise, are the same in relation to the capital markets union—by and large, they are just a version of the issues that have been associated with the eurozone crisis.

The Chairman: Professor Quaglia, you have the last word.

Professor Lucia Quaglia: Many financial economies would argue that liquid financial markets are one of the best ways to deal with asymmetric shocks. That said, there are still very important structural differences between the European Union and the US. In the European Union, banks intermediate about 80% of the credit of the real economy; only 20% is intermediated through capital markets. In the US, it is the other way round. These are structural features that are not very easy to change, despite the capital markets union project. So it might work but it will take time.

Lord Davies of Stamford: It is going in the right direction, is it not?

Professor Lucia Quaglia: Yes. Politically, as David mentioned, I think it is also an incentive for the UK and the City to adopt a positive attitude towards the European Union.

The Chairman: Thank you. Do any of you have a final, concluding thought?

David Marsh: There is one thing that I would say. I wonder whether you have had any eminent French or German luminaries come to speak to you. Whether they are ex-Finance

Ministers or “experts from the street”, I wonder whether that might be helpful. I know that you have Lucia here, who speaks for the euro in this body, but there are one or two eminently politically issues. For instance, all sorts of German people would be very helpful to your Committee’s deliberations.

The Chairman: Thank you. We had a very interesting trip to Brussels, where we got a panoply of opinions, but it is an interesting thought. Thank you very much. I take it that the Members have no other questions. This concludes today’s public evidence session. The Committee will now continue its session in private.