



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

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Questions 205 - 214

THURSDAY 3 MARCH 2016

10.30 am

Witness: Professor Otmar Issing

Members present

Baroness Falkner of Margravine (Chairman)
 Lord Boswell
 Lord Butler of Brockwell
 Earl of Caithness
 Lord Davies of Stamford
 Lord Lawson of Blaby
 Lord McFall of Alcluith
 Lord Shutt of Greetland

Examination of Witness

Professor Otmar Issing, President, Center for Financial Studies

Q205 The Chairman: Good morning, Professor Issing, and welcome to the European Union sub-committee's inquiry into Europe's economic and monetary union. You have a list of interests that have been declared by Committee members. This is a formal evidence-taking session of the Committee and a full transcript will be taken. This will be put on the record in printed form and on the parliamentary website. You will be sent a copy of the transcript and you will be able to revise any minor errors. That is the technical information that I am obliged to give you. I should also say, Professor Issing, that it is a busy day today, and Lord Lawson of Blaby will have to leave at 11 o'clock. Other members will most probably be able to stay for the full session, but we hope to conclude at some time around 11.30 am. Thank you so much for coming here. We have been lucky to have German LSE week this week, so that many of you can come into town. We understand that you also have a full day.

Let me commence by explaining to you that we are coming to the concluding stages of our inquiry into Europe's economic and monetary union. It was predicated on the Five Presidents' Report, with which you are very familiar, and I see that you have written journalistic articles about it extensively. What is your assessment of it and the actions introduced in the short term as well as the longer term? First, do you believe that the proposed actions will come about? If they do come about, do you believe that they will result in the euro's long-term stability?

Professor Otmar Issing: Thank you for the invitation to come before the Committee. We had this hearing in Frankfurt some years ago, and the topic has not changed much. As I published a rather critical article on the Five Presidents' Report, I must not withhold my remarks here, so I will say nothing different. I will probably be more open in a presentation like this one.

Let me start by saying that this report has a number of good ideas, especially on economic union and competitiveness, et cetera, but unfortunately we also have a long history of wishful

thinking about what countries and Governments should do. One cannot repeat that often enough, so I do not criticise that. The only thing I am critical about in relation to this part of completing economic union is the idea of creating competitive authorities in all countries. To my mind this just adds red tape, because since the Lisbon agenda back in 2000 it has been obvious what should be done. The Lisbon summit in 2000 decided to make Europe the most dynamic region in the world. If it were only to take decisions, we would be in a better situation now. It was during my term at the ECB, and I was criticised by some colleagues for interfering in politics when I said that I thought this was a very dangerous path to follow, because Europe—and your country was included in this decision; it was a European Union decision, a declaration—took responsibility for communicating to the public on things on which it has no competences, because structural reforms et cetera must be done on a national level; it is a national responsibility. We have been dealing with this problem since the start of monetary union and even since the start of the European Union, and in this respect the Five Presidents' Report does not add anything special. It repeats what has been repeated every time. Suggesting another bureaucratic level of competitive authorities, to my mind, is not helpful.

My positive assessment of the report ends here. I am most critical of the idea of creating fiscal union and moving towards political union.

Q206 The Chairman: We will come to that later in the questioning. You have identified very clearly that national competitiveness boards should already have been in place in any event, but what would you identify as the most important priorities for the next phase, which hopefully will be enunciated in the White Paper in 2017? As an economist, what would you suggest they should be doing?

Professor Otmar Issing: I did not expect much from that anyway, and my scepticism, if I may say so, was confirmed by recent developments. One idea in the Five Presidents' Report is the creation of what is called a European fiscal board, and my assessment is that this deserves a trial to create an independent authority, committee or whatever you might call it to survey the public finance of national Governments. If this is to work, the precondition is that it is an independent board with independent experts, but, as I almost expected, the Commission has already taken it over. The Commission obviously has no interest in having an independent surveillance board. To personalise this, although it is not just Juncker, when Juncker came into office he said, "I will be a political President", and in the field of fiscal policy that means that decisions on fiscal policies in the context of the Stability and Growth Pact and of two-packs and six-packs et cetera may be political decisions. Rules are pushed aside and lip

service is paid to them, and this move by Juncker to bring this authority under the surveillance of the Commission totally destroys the idea in the Five Presidents' Report of an independent authority.

The Chairman: We also know from your published views that you have been critical of the proposals for debt mutualisation. Do you think it is the wrong thing to do in the current context—both political and financial—because of moral hazard, or would you rule it out for ever?

Professor Otmar Issing: Will you allow me to make a personal remark?

The Chairman: Indeed. That is why you are here.

Professor Otmar Issing: When I went through the potential issues that you would like to discuss, in every second sentence there was the feeling that “this guy is against everything”. It was not explicit, but that was the thrust. Forgive me, but your question goes in the same direction: that I am for ever against everything involving debt mutualisation. Whether I will be for ever I do not know. I am old enough already.

The Chairman: As an economist, you will know John Maynard Keynes' comment that in the long run, we are all dead. I will not press you on that. I am just confirming that, at the moment, you do not think that this would be appropriate in terms of sovereignty.

Professor Otmar Issing: The key point is that if parliaments—in my case, the German parliament—decide, with a majority vote, to participate in debt mutualisation, this is a democratic decision and members of parliament have to justify that before their voters. But nobody had this in mind, because it would fail, so talking about debt mutualisation is a back-door move that, as it has no democratic legitimacy, I am strongly against. I am not against debt mutualisation in principle, but it involves the transfer of taxpayers' money, and I need not explain to this House that for that you need democratic legitimation. If that is the intention, okay; I can vote against the party that is in favour of it, but that is all.

Q207 Lord Butler of Brockwell: Good morning, Professor Issing. Here is a chance for you to talk about something that you are in favour of. You said that not much has changed since you met the Committee in Frankfurt, but the role of the ECB in banking governance has developed since then. Do you think those developments have been helpful?

Professor Otmar Issing: I was a member of the de Larosière committee, a high-level committee that was installed by President Barroso. Jacques de Larosière was the chairman. We presented a paper containing two proposals, one of which was to establish a European macroeconomic surveillance board. That has happened, and the ECB is more or less in control of its administration, but it is a European board. We were strongly against transferring

competence in banking supervision to the European Central Bank. We pointed to a conflict of interest for monetary policy, and politicising decisions at the Central Bank, because, in the end, it is taxpayers' money that is at stake if it comes to the resolution of a bank, which puts the independence of the bank in a very awkward position. These were our arguments, and we proposed an independent European banking supervisory authority. For that, one would of course need a treaty change, and there is no way to achieve that in the present circumstances.

By the way, at that time the Commission and the European Council accepted our proposal more or less unchanged; only minor changes were made. So they welcomed and supported that, but things worked out differently because treaty change is not on the cards. The Council referred to an article in the treaty that says that some, but certainly not all, banking responsibilities can be transferred to the European Central Bank without changing the treaty.

I am not a lawyer, but let me demonstrate the point. The Commission's legal service said that this was enough of a legal basis to transfer the whole competence of banking supervision to the ECB. Other law committees, such as that of the Bundesbank, said that it was obvious that this was not a sound basis. There is a case before the German constitutional court on exactly this point, but it is useless to discuss this issue, because if it came before the European Court of Justice the court would say, "That's okay". So let us set the legal issue aside.

I must confess that I would not have thought it possible for the ECB to hire more than 1,000 people and at the same time start this very complex supervision of the 123 biggest banks in the euro area. In this respect, it deserves high applause. It was easy to foresee the position which the ECB would take in respect of Greece and Italy. At the same time, the quality of collateral has been reduced, helping weak banks to get central bank liquidity. This is a monetary policy measure, but at the same time it is a banking-supporting measure, and the supervisory authority is in a very awkward position in this regard. We have to live with that now; the decision has been taken to conduct banking supervision in this way, but I expect more problems. I am very concerned about reputational problems for the European Central Bank if a bank fails, et cetera. This will be a big problem, to put it mildly, for the reputation of the ECB.

Lord Butler of Brockwell: I think a British audience finds this difficult to understand, because for many years the Bank of England was both the banking supervisor and the lender of last resort. We never saw any conflict in that position.

Professor Otmar Issing: I remember a past crisis during which the Bank of England did not gain by this authority. Would you agree with that?

Lord Butler of Brockwell: I am not sure I would. Anyway, given that the ECB has effectively become the lender of last resort, should it extend its role to buying sovereign bonds, in the manner of the Fed or the Bank of England?

Professor Otmar Issing: To me, the idea of a central bank being a lender of last resort—which came from this country, from Walter Bagehot, back in the 19th century—is a very strange one. The idea is that a central bank is a lender of last resort for banks, with punitive interest rates, on the basis of good collateral. Somehow, in the context of the crisis in the euro area, the idea of lender of last resort was transferred to lender of last resort for governments. That is totally different. This is the monetary financing of governments who are in fiscal trouble. The idea is that this is the source of the transfer of the term to governments. In the US, for example, investors would never be afraid of the US dollar collapsing, because in the end the Fed, as the central bank, could print money without limits. No such institution exists in a monetary union in which you have different governments and nations. To transfer this authority of lender of last resort to the European Central Bank is, for me, totally misguided, because this is not being the lender of last resort e.g. for California. In this sense, it is being the lender of last resort for the US. No such thing exists in the euro area.

The Chairman: Lord Butler, I wonder whether we might allow Lord Lawson to come in now, because he has to leave.

Lord Butler of Brockwell: Not at all. Thank you. I had finished my question anyway.

Q208 Lord Lawson of Blaby: I would like to move away from the detailed matters that you have just been discussing—not that they are not important, but they are matters of detail. In your recent articles and pronouncements, you have raised the most fundamental concerns about this whole process as it is now. I must say that I find myself entirely in agreement with you, but it would be helpful if you could summarise for the benefit of the Committee your most fundamental and major concerns.

Professor Otmar Issing: Summarising is difficult with such a complex issue and might create misunderstandings, but I will try. I should start from my position back in the 1990s, which was the position of most politicians and economists, at least in Germany, that political union and monetary union should at least come together. It is better to have political union first and then monetary union. By the way, this was Chancellor Kohl's thinking.

Lord Lawson of Blaby: It is also the history of Germany, where political union preceded monetary union.

Professor Otmar Issing: But, as we know, when monetary union started, no steps were taken in the direction of political union. Countries did not even try. When the euro started, the

question was: can monetary union survive without political union? Let me make clear what my position is now. I will try to be as pragmatic as the British are thought to be. For the time being, the nations of the Union are probably further away from the idea of a political union than at any time in the past, so the idea of political union is at best a vision for the distant future. This is my major critique of the Five Presidents' Report, because if you take this point—and it is hard to deny—if any country in the euro area dares to have a referendum on entering political union, just do this test of thinking. If you take this as a given, whether you like it or not is not my point—I am not saying that I am against political union; I am just stating the fact that the major part of the Five Presidents' Report loses its anchor when the whole text in design goes in a direction that ends in a political union. This is the fundamental philosophy behind the whole process, and if you take that away for a relevant time, this whole proposal loses its anchor.

My major concern—and here I come back to your initial question—is that those who have written this report know that. So any suggested steps in the direction of a fiscal union are steps towards a fiscal union without democratic legitimacy, because without political union all transfers et cetera will lack European democratic legitimacy. This is my major concern: that they know it—nobody can be so stupid as to assume that political union is around the corner.

By the way, the scepticism of the authors is demonstrated in a way. When I read the report I was sitting in my study and I laughed, because they said, “We should start this process only after 2017”. Why 2017? Because just by chance there will be elections in France and Germany. They do not want to confront voters in these major countries with such ideas before a general election, only after it, and I think this demonstrates their fundamental lack of confidence in this idea. I am afraid that we might have a transfer of taxpayers' money in a process without democratic legitimacy. Again, to make it clear, if this were a democratically legitimate decision of national parliaments I would not criticise it, but the thrust of all these ideas is fiscal union by the back door.

The Chairman: Just on that point, one could of course argue, without I hope appearing unnecessarily naive, that there had to be some point when they produced a White Paper. The European elections will be in 2020, so a midway point was some point in 2017, and if there were going to be two significant elections there was no point in doing it until after they were over. Am I being incredibly naive?

Professor Otmar Issing: If I had written this report, I would have left it open and not set the date of 2017.

The Chairman: That is really helpful. Thank you.

Lord Lawson of Blaby: To conclude this, I share your analysis 100%. I will, if I may, read briefly from something that you wrote only a few months ago, which is very much in the area that you have been discussing: “without true political unification”—and here I put in parenthesis that that is, of course, the object of the whole exercise, as you have pointed out—“efforts to pursue the rest of the Presidents’ plan, including the transfer of fiscal competencies to the European level, would carry serious risks”. Is the serious risk that you refer to the affront to democracy, or is there some other serious risk? What did you have in mind when you referred to “serious risks”?

Professor Otmar Issing: To clarify what I mean by that—by the way, when I wrote that paragraph I wrote more sentences in this direction, but I deleted them and left this rather weak remark about serious risk—in the end I am afraid that people, voters, will in the end understand what is going on, and they will not accept being exploited in a way in which they have no say. This will foster extremist parties on the left or the right, because the major parties will be unable to resist such developments. Let me give an example. Mario Draghi and the ECB were substantially criticised by German Members of Parliament. When he attended the Bundestag for the first time—I did not attend, but I read the newspapers—it was a very friendly meeting. Just by chance, some days later I met two of his strongest critics, and I said, “I am very surprised. I read that this was a very friendly meeting. I expected some critique. Why did you not present your reservations?” Some days later, one of them finally opened up to me, and the answer was not surprising. He said, “There was a danger that a rescue package of €30 billion would come to the Bundestag to be decided by the Parliament, and in this case I thought it was better that the ECB did this”.

I do not want to put too much weight on this particular event, and I am not saying that I know what all 80 million Germans are thinking, but you can imagine the unwillingness of people to accept that without having any say. That is the major risk that I see if this approach continues.

Q209 Lord Davies of Stamford: Professor Issing, listening to you today, and I have heard you before, I have the strong impression that you are a perfectionist—perhaps what you might describe as a platonic idealist: you believe that there is one solution to problems and that it should be implemented thoroughly and in every possible detail, you do not like partial solutions, you do not like indirect progress, you do not like political compromises, you do not like loose ends. You do not like what we in England sometimes call the crooked timber of humanity. You have a sort of mathematical vision of how things should work. I do not know whether that is a fair description; it is not meant as a criticism.

We are in a particular, concrete situation now, at a particular conjuncture. Moves have been made—in my view, very successfully—towards fiscal union and towards improving productivity and competitiveness in the less competitive countries of Europe. In my view, there has been very considerable progress. Four countries that were bailed out only four years ago are now doing rather well—indeed, at least three of them are doing outstandingly well—so I think a lot of progress has been made. What would you do? Is your solution just to do nothing at all and to say from the side-lines, “It is all hopeless. Everybody got it wrong. I was right all along”? Do you have a practical agenda of your own? If you were in a position to impose your own programmes and policies at present—taking account of the actual situation we are now in, not starting from 20 or 30 years ago—what would you actually do?

Professor Otmar Issing: I was just thinking at what age that description of my thinking was appropriate—probably 30 or 40 years ago. I am no longer that person. When I write, I try to start from sound economic thinking, and if it comes to making decisions I try to separate that from the conditions under which people such as Mario Draghi and Juncker have to act. I am not a politician and I am fully aware that I sometimes still come across as a naive professor. Modesty is required. I am reminded of a hearing at the European Parliament. Some members of this country’s Labour Party attacked me, as a former Bundesbanker, describing me as very dogmatic. I tried to explain my position, and then somebody said, “Intellectual arrogance is a very dangerous thing”. My reply, which is documented, was that, “Intellectual arrogance has no place in the central bank. Humility in respect of what we can do is key”. That was a principle during my time at the Bundesbank and the European Central Bank, so I am fully aware of all the constraints.

One of the reasons why we are in the mess we are in in the euro area is that at almost no point in time were politicians confronted with what would happen if they continued on this slippery road. For that, you need a clear framework.

Lord Davies of Stamford: You are not answering my question, Professor Issing. My question is: what would you like to see done? In my view, Mario Draghi has been in the best tradition of pragmatic central bankers. To some extent, you have to make up your own solutions as you go along—which is in the fine tradition that was recognised by Bagehot, by the way, and which we have always recognised at the Bank of England. You cannot always predict all the instruments that you will require to deal with a particular kind of crisis. I think he has done brilliantly, but his approach has been pragmatic. Your approach is the exact opposite. It is theoretical; indeed, some people might call it dogmatic.

If you were forced to take responsibility now for European economic and monetary policy, what would you do, starting from today?

The Chairman: Professor, before we go further, we are of course well aware of the fact that you have been right at the coalface of public policy in your role at the European Central Bank. I wonder whether you might answer the question very briefly, because I would like to move on after that.

Professor Otmar Issing: First, I should say that I have no fantasy of being a dictator, so I find it difficult to put myself in the shoes of one. Secondly, there is no way in which anybody can totally change the direction we are moving in. I am afraid that I am much closer to your thinking than you imagine. My major concern is not theory or fundamental positions but that pressing developments are taking us deeper and deeper into this mess. I am driven by concern for this European project. The same is true for Mario Draghi. The question is: how do we deal with that? I am not here to criticise the ECB and its policy, but in Europe—forgive me when I say Europe; I mean the euro area.

The Chairman: We say Europe now.

Professor Otmar Issing: I am not so sure what it means in this country, but that is what I mean when I talk about Europe. The ECB's monetary policy is seen as the only game in town, and politicians rely on that. If they cannot deliver, the ECB will deliver. This is a very dangerous position for the central bank, for politics and for the euro-area project as a whole. That is my concern. Let us take the example of OMT. It was during a visit to this country that Mario Draghi said that we will do "whatever it takes". He added, "within our mandate", but he must have been sure that this would immediately be forgotten. What does this announcement—"whatever it takes"—imply? Yesterday, Mervyn King referred to that remark when addressing the panel at the LSE. He was Governor when Draghi, a central banker, made that remark.

To clarify my position, as a central banker I always insisted on our independence. No politician of any calibre would ever have put me in danger of forgetting my principles. At the same time, I was always convinced that this is a limited responsibility. An independent central bank's mandate must be limited, and that limit has to be observed. A central bank, which consists of appointed technocrats or whatever you choose to call them, cannot play politics with distributional consequences. This is up to parliaments—democratically elected members—not central banks. This is my basic reservation: that a central bank, with the best intentions, has no mandate for going beyond a rather limited remit. There are emergency situations, no doubt—in Germany, the republic collapsed after the First World War—but,

since 2008, have we really been living in a permanent emergency situation in which the European Central Bank is the only game in town? This is the core of your question. I think we fully agree that this is the key problem.

Lord Davies of Stamford: Professor, I do not agree at all. I want a central bank that will always do what it takes to maintain stability and that will use unconventional methods when necessary.

The Chairman: I think the key point was “within its mandate”, as you said, which is forgotten. On the point about democratic accountability, I want to bring in Lord Shutt.

Lord Shutt of Greetland: Just before we get to that, can you clarify one thing? Do you believe that the euro, as a currency, ought to succeed?

Professor Otmar Issing: It depends on what you mean by “succeed”. It will stay; I am sure about that. There is too much political investment in this project to allow the idea that the euro will one day collapse. Of course, nobody knows what the future is about, but as far as one can argue I think the euro will stay as a currency. What is forgotten in all these discussions is that the euro is a stable currency. It is the second most important currency in the world, so the situation of the currency as such is not so bad.

Q210 Lord Shutt of Greetland: That is fine. That is interesting. Lord Lawson has left us, but clearly, although he agrees with you in many ways, he does not agree with you on that, so at least we have that.

Coming to the points that I wanted to raise, you have been clear that political union might remain possible “in the distant future”. Now, while we are here, what democratic accountability arrangements do you favour at present if steps towards political integration are taken? Should something be done at this stage? Is there a distinctive German view on this? Should there be further movement on democratic accountability?

Professor Otmar Issing: Let me start with the question of whether arguments are just arguments. I am a German, and as a representative of the Bundesbank I was also a representative of a German institution. When I was at the ECB, you would never hear any remark from me that you could identify as defending German interests. I continued to be a German, but I served a European institution and a European project. What is German about the idea that a central bank should take care of the stability of the currency and should not finance public deficits? Is this German? It is, rather, also the mandate of the Bank of England here. I am too old to change, and sometimes I think, “It’s too late for that”, but if I phrased my words differently and removed the German flavour from my interventions, they might have more impact. On the other hand, it is not my character, so I have to leave it at that.

To clarify, I am not arguing here that it is in the interests of Germany. I think it is in the interests of all people who are interested in a stable currency and solid public finance, and for that we need a solution. For me, putting aside the question of whether political union is desirable or not, it could happen in the not so distant future if you took this position. We have to concentrate on what the euro area is. It is a group of countries, or whatever you might call it, that have transferred their sovereignty in monetary policy to the European Central Bank; one common central bank, one single currency. Of course, we have a lot of common policies. I do not need to explain that here, but this is one of the issues that I can discuss now. To a large extent, nations in the euro area have given up their independence in trade and competition policy, the European Court of Justice et cetera. These are all elements of a political union and a central bank by itself. For all the colonies that became independent in the past, the first thing to do was to establish a central bank, introduce a national currency, establish a national airline.

Let us go back to the currency. These are elements of a political union, and so far the arguments that you hear almost every day are that the lessons of the past, of history, are that all monetary unions that were not combined with political union collapsed over time. This is true, but the comparison is misguided for two reasons. First, the Latin Monetary Union, for example, was a currency union at the time of the gold and silver standard. It was totally different, and it lacked all the elements, which I just mentioned, that are there. What remains is the final responsibility for taxes and public expenditure. This is key for democracy, as I said a few minutes ago. If we think about the present situation, we have to stabilise this arrangement, and in the end it must lead back to the no-bailout clause, because in such an environment Governments are in the end responsible for their own actions. This is congruent with the no-bailout clause. This clause is violated almost every day, and we would have to go back a long way to get back to that, but, as I said before, one needs a principle. Forgive me, this has just come to my mind, but it is another argument in a nutshell. There was once a Minister of Cultural Affairs in Bavaria. He was a professor of law and a very erudite person. He once said, "You need principles, but you have to hang them so high that in case of need you can go under them". Most people see only the move below, which might seem more pragmatic than you would expect, but the message is twofold, because he was aware that principles still exist, and that if you deviate from them in an emergency you have to explain why. The principle of no bailout should in the end lead fiscal policies into the future in a more stable environment.

Lord Shutt of Greetland: Okay. I had better leave it there.

The Chairman: Thank you, Professor Issing. I should have introduced Lord Boswell of Aynho, who is Chairman of the EU Select Committee, who has joined us today. Lord Boswell, you have some questions.

Q211 Lord Boswell of Aynho: Thank you very much, Lord Chairman. It is a great privilege to be able to come to your Committee and to hear Professor Issing. I should perhaps make it clear that I have not participated in this inquiry and have not heard all the evidence. I should also declare an interest in that I have personal shareholdings in both UK and euro-area securities.

I have two points to make. First, I want to be clear in my understanding. The argument I have heard from you is that although the ECB is capable of creating an economic and monetary union, or managing one, the issue is not so much the feasibility of that process as the democratic acceptability. Is that a proper understanding of your position?

Professor Otmar Issing: The ECB was forced into politics by events, but it has not resisted that too much, to put it mildly, although I fully agree that we could not immediately stop the process for the time being. As the Five Presidents' Report demonstrates, our concerns are the same, as I have said before. Mario Draghi is a friend of mine, so I am not criticising him personally. I met him just recently, and he was not particularly friendly about my remarks. I was not surprised about that, but we agree that we share the same concerns.

Let me give you a telling example. In May 2010, there was a Eurogroup meeting in Brussels on a Friday, at which Trichet presented a dire picture of what might happen in the financial markets on the Monday—you must have been aware of that as a shareholder—if Governments did not intervene to help Greece. It was very clear that this was a matter of fiscal policy and was the responsibility of Governments. At the same time, it was clear that politicians, Finance Ministers, even if they wished to, could not intervene on Monday with billions of euros. So the ECB was in a lose-lose situation. If it had not intervened, nobody knows what would have happened on the Monday. I did not agree with this dire description, but there was uncertainty about that. If the markets had totally collapsed on Monday, the ECB would have been blamed for refusing to intervene. Intervening means that the ECB lost its innocence. A former president of the Bundesbank said that it had crossed the Rubicon, like Julius Caesar.

Some journalists called me at home, and I refused to comment. I asked myself, coming back to a question I was asked earlier, "What would I have done?" From my professional, theoretical position, putting myself in the shoes of a central banker, with the associated responsibilities, I was not sure what the right move was, because it was a lose-lose situation.

The ECB should have made it clear to politicians, Finance Ministers, Heads of State and Government that in such an emergency we did what we are normally not allowed to do, but that this was the first and last time. Do not expect us to continue along that line.

I would not criticise the intervention on that Monday, for the reasons I have just explained, although missing was the clear signal that next time you should be prepared. If you are to make it credible, such an announcement is a hugely complicated task. To some extent, since the ESM was created, it worked.

Lord Boswell of Aynho: Thank you. That is very helpful. My second question might further muddy the waters, and I would just like a brief comment on it. You will be aware—and this is of wider interest than simply economic and monetary union—that there is some interest across Europe in a greater role for national parliaments, perhaps as opposed to the European Parliament; indeed, reference was made to this in the British deal in the European Council conclusions in February. Although this House is not democratically elected, we are representative of the interests of our member states and are relatively close to our electorates—the people who pay taxes and who may, for example, become unemployed—do you see scope for national parliaments having an input into the democratic process, or do you think it would be very difficult to produce a sensible accountability structure?

Professor Otmar Issing: On that, I must confess that I have no clear view. The Presidents' report has some ideas about mixed committees involving Members of national parliaments and Members of the European Parliament. These are very complex constructions, and I have limited confidence in creating democratic legitimacy in that way.

Q212 Lord McFall of Alcluith: Professor, I am a Labour Party member. You mentioned earlier Labour Party members criticising you. When I was Chairman of the Treasury Committee during the early 2000s, we went to Frankfurt regularly and spoke to you. We always left with more intellectual curiosity than when we started, so I thank you for that. We were left with the impression that people were feeling their way in the dark as to how to go about European monetary union. You mentioned ex-Governor King. In his new book, *The End of Alchemy*, he states very clearly that, presently, central banks and economists do not know how the world economy works. I think that fits with what we have heard in the evidence so far, particularly on the issue of banking union. First, if we are going to get a banking union, we need to clear up Europe's legacy issues, which in many ways have so far been ignored. I would therefore like you to comment on the legacy issues.

Secondly, what does banking union really mean? Does it need to include debt mutualisation? Does it need to include the European deposit insurance scheme? In the vein of your informing us of your opinion on a practical level, I would value it on those two points.

Professor Otmar Issing: May I just come back to the issue of the hearing before I was appointed? Notwithstanding the initial attacks, in the end there was not a single no vote against me.

Lord McFall of Alcluith: I was confident of that.

Professor Otmar Issing: Your party colleagues finally gave up, or supported me—for what reasons I do not know.

Lord McFall of Alcluith: We did.

Professor Otmar Issing: On the one hand, banking union is a technical concept. On the other, it goes deep into the structures—I am thinking of the capital markets union and so on. One question, for example, is: would we be safer with the American system of market-based financing of industry, or a more bank-financed system? I am in favour of removing the barriers that still exist to medium-sized companies accessing the capital market. Doing so would be beneficial. Independent of the capital markets union, it should be fostered in all countries, and we are probably on the way to that.

I would combine your second question with the first one on debt mutualisation or debt forgiveness. For me, it is rather obvious that we will get out of the present situation only if we clarify the legacy problem. You might be surprised to hear this from me, and I will say it only here. Take, for example, the debt of Greece. This money is lost anyway, so it would be much better to start by cancelling the debt in a process that probably accords with the German Council of Economic Experts' proposal, which you mentioned, of a solvency rule for states. I would be immediately in favour of that if it was not an incentive to start the same bad behaviour as in the past. This is not about Greece, but I take Greece as an example. This is key for the future of a world economy with such high indebtedness. I have no answer to the moral hazard problem, but I fully agree with you that the legacy problem has to be solved.

Here we come to another aspect of banking union: deposit insurance. At present, deposit insurance, to European eyes, at a time when banks in different countries are in a very different situation, is just the expropriation of taxpayers' money in some countries. The idea of a common European deposit insurance is fine, but before we have that we have to clarify balance sheets et cetera and then have a new start on a European basis. This refers back to your question and is also tricky and complex. Even a dictator coming in tomorrow would immediately be caught in this complex situation, so there is no simple way out, just a

muddling through. I am a great admirer of Karl Popper, who said that politics is piecemeal engineering, but to do that and not be misguided you need principles and concepts.

Q213 Earl of Caithness: Good morning, Professor. May I probe you a little further on fiscal union? You commented on it in answer to our Chairman and to Lord Lawson. We got evidence from an MEP that is rather telling. He said, “A lot of people are sure they know what fiscal union is until they are asked what it is, and a lot of people want it until they get it”. What is your interpretation of fiscal union, and what is politically achievable in Germany with regard to the facets of that?

Professor Otmar Issing: Some years ago, I wanted to write an article on the concept of fiscal union. I looked into the literature and deleted one page after the other. I came to the conclusion that the notion of fiscal union in substance is to a large extent transferring competence for taxation and public expenditure to the European level. It also refers to bank resolution. This all implies taxpayers’ money, and if it is about taxpayers’ money, fiscal union means Europeanised competence on taxation and public expenditure, not fully but to a large extent. This, for me, is the key notion of fiscal union. There are many, many concepts and details, but in the end it all boils down to that. In this context, for me, the next logical consequence is that, in order to transfer such competences, you need democratic legitimacy. That is the connecting link with democracy. This is my basic interpretation of what fiscal union might mean.

Earl of Caithness: But that is not going to happen, because that political step will not happen. What do you think is achievable for further fiscal union at the moment, given the political situation, or do you think there will be a hiatus for some time to come?

Professor Otmar Issing: As I said before, and this is a key point for me, it is obvious that Greece, for instance, needs financial support; we see the refugee problem. National parliaments should decide on that and deliver the money. I would not call that fiscal union; this is just solidarity with a country that has problems that it has not created itself. Many aspects of fiscal union imply a transfer mechanism for mistakes of national policies. Take, for example, the idea of European unemployment insurance. This would create moral hazard. The worse the labour market policy is, the more you get subsidies from the European fund.

Lord Davies of Stamford: No one is proposing that. They are proposing a reinsurance system that would be triggered only by changes in the rate of unemployment. So there is no moral hazard in the proposals that have been put forward. No one is producing a proposal as naive as the one you are suggesting. Of course, you are perfectly right that if we just had a pooling of unemployment insurance, the countries with lower unemployment would subsidise

systematically those with higher unemployment. That would be very perverse. What has been suggested in the European Union is not that at all; it would capture not the structural but the cyclical changes in unemployment, so that when unemployment rose above a certain margin in a particular country there would be a reinsurance and money would be available from other funds. It is a reinsurance scheme.

Professor Otmar Issing: I am not surprised that you are very familiar with quite a number of very intelligent designs for such an insurance system. I know a number of these proposals, and I have great respect for the intellectual capacity of the authors of them, but if you think about implementation, what will be left? All the complex provisions and structural aspects are excluded. In the context of the Stability and Growth Pact, to define and measure the structural deficit is a highly complex issue that, in the end, is solved politically. One can design a system that does not create moral hazard, I agree, but I am afraid that once this idea enters the political arena, a very different animal will come out of this process.

Lord Davies of Stamford: Those objections have been met, of course.

The Chairman: Lord Davies, did you want to pick up the theme of economic governance?

Lord Davies of Stamford: We touched on fiscal union, Chairman. I do not know how long we have to discuss that.

The Chairman: Professor Issing, can you stay on a little longer? You are available to do so.

Lord Davies of Stamford: Professor, do you not recognise that in relation to the crisis—you have talked about 2009 and 2010—considerable progress has been made? When one reads your articles it looks as though everything is very grim indeed and that the European Union is heading over a cliff, but are you not struck by the fact that over the past five years there has not been the crisis that was expected in the euro area? There has been considerable progress towards fiscal union with the two-pack, the six-pack. After all, what is destabilising is the deficits rather than the total level of public expenditure or the structure of taxation, and there are now real constraints on the deficits that are preventing irresponsible fiscal policies by member states. Do you not feel that some progress has been made and that we are in a much better position than we were a few years ago as a result of the measures that have been taken?

Professor Otmar Issing: My answer to your question is on two levels. One is that there has been substantial progress on structural reforms in Spain and Portugal, and even Greece, on the budget side, has made tremendous efforts. For me, it was a mainly misguided concept. The troika played a doubtful role, because it concentrated too much on fiscal constraint and too little on structural reforms. In this respect, not much has happened in Greece so far, which is very bad for employment. What we see now in Portugal and Spain raises extreme concerns

for me. Spain and Portugal came out of a deep recession, made progress, growth was coming back, unemployment was falling—too slowly, true, but substantially—and then we had the national elections. The parties in government—whether Conservative or not I do not care; for me, it is not a party problem—in taking responsibility for reforms that hurt, were only partly supported by the development of the economy. This progress was visible, but it was not enough to convince the majority of voters to support the continuation of those reforms. Take, for example, what Prime Minister Tsipras said—and here we are again at the core of the political issues. We had elections and people decided on a policy that is different from the one that is needed for monetary union. This goes to the core of democracy.

Lord Davies of Stamford: I agree that they decided that, but then unfortunately they changed their mind and are now implementing the programme.

Professor Otmar Issing: Yes, but reluctantly so, and so it remains. You were not among them, so I will risk saying that probably no politician understood what he signed when he signed the Maastricht treaty. Signing that treaty meant for them removing DM and transferring monetary policy to the European Central Bank, and that is it. In the treaty, there is no line on unemployment or labour markets, although there is on the fiscal side to some extent. Having a single currency, a single monetary policy, that has to fit all—there is only one—has deep consequences in many fields of politics in which, de facto, national Governments have lost competence, without transferring it legally. That is what makes this situation so complex.

Q214 The Chairman: You have mentioned Greece, Spain and Portugal. Can I take you to the asymmetries in current account surpluses and deficits among the eurozone member states? Can we hear, in concluding, whether you believe that there should be greater pressures for symmetry among the eurozone states—the surplus and deficit states? This, of course, is the big question, given the popular—in other words, democratic—deficit that it touches upon.

Professor Otmar Issing: But the present situation has to do with the policy of the ECB. The spreads on government bonds, as bond holders know, have shrunk. They are not invisible, but—

The Chairman: Yes, they are very low.

Professor Otmar Issing: They do not represent the different risks of different national policies. This creates an illusion in countries. This includes Germany, by the way, as our balanced budget would disappear immediately if we had “normal” interest rates. Germany can borrow money over 10 years at zero interest rates—for five years in negative territory. This gives an illusion of fiscal solidity, and this is true for Germany and even more so for other

countries. This is politics—if you are not under pressure from fiscal constraints, you think that you can afford many things, but the fundament is very shaky.

Lord Davies of Stamford: You are implying that we are going back to inflation, but if we do not go back to inflation there will not be problem.

The Chairman: Then you would have Japan.

Professor Otmar Issing: When I arrived at the Bundesbank and at the ECB, it was to contain the threat of inflation. Now they struggle to have higher inflation.

The Chairman: And to encourage demand. Nobody wants a Japanese-style, low-inflation economy. Thank you so much, Professor, it has been a most interesting session. We are very grateful to you for coming here and we wish you well for the rest of your busy day. We now conclude today's public evidence session and the Committee will continue in private.

Professor Otmar Issing: Thank you for your kind remarks. Please forgive my German style. I cannot promise to change.

The Chairman: This Committee likes candid interlocutors.