HOUSE OF LORDS

EU ECONOMIC AND FINANCIAL AFFAIRS SUB-COMMITTEE

Euro area crisis (February 2014)

Evidence

Contents

Roger Bootle, Managing Director, Capital Economics; Gerard Lyons, Chief Economic Adviser to the Mayor of London; and Simon Tilford, Deputy Director, Centre for European Reform—Oral evidence (QQ 26-49)

Evidence Session No. 3. *Heard in Public.* *Questions 26 - 49*

TUESDAY 25 FEBRUARY 2014

Members present

Lord Harrison (Chairman)
Earl of Caithness
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford

Examination of Witnesses

Witnesses: **Roger Bootle**, Managing Director, Capital Economics; **Simon Tilford**, Deputy Director, Centre for European Reform; and **Gerard Lyons**, Economist and Chief Economic Advisor to the Mayor of London.

Q26 The Chairman: Roger Bootle, Gerard Lyons, Simon Tilford, welcome to this penultimate session of the Committee's latest review of the euro area crisis. We are most grateful to all three of you for coming this morning to engage with us at this important time. As Roger Bootle well knows, we shall send you a transcript of this morning's exchange, which you will be asked to correct and examine. If you have any further ideas that you think would enrich the reply that this Committee sends to the Government on our concerns about these developing matters, we would be most grateful if you would add those, too.

Let me begin the questioning with a bit of a tour d'horizon. There have been various comments from President Barroso that 2014 will see the end of the problem; on the other hand, Mario Draghi has said, "Not so quick". What is your assessment of the current state of the euro area crisis, and how would you judge when it finally comes to an end? Is it the case that some recovery has taken place in this interim period but all that is required to restore health to the euro has not been put in place, or would you say that, rather, the reverse has happened and that the euro area and the wider EU 28, having got together, have finally started to put in place the architecture, although it is yet to be built, that will stabilise the euro over the coming months?

Roger Bootle: I very much think that Mario Draghi has pronounced the fairer and more accurate judgment on this question. There are aspects of the crisis that seem much better. Clearly, the markets are much calmer, but I would not place much store by that, quite frankly. I would not judge these matters by what people in the markets think, because they are notoriously bad at assessing political issues. One need only remind oneself that, not that many years before the crisis began, the markets were lending to the Greek Government at not much more than they were lending to the German Government, so they did not have a clue then about what was going on and we should not imagine that they necessarily have much more of a clue now about what is going on.

There are a number of things that strike me as still very worrying. One is the very high level of unemployment in a number of countries, in Spain and Greece in particular, without much indication—despite the signs of Spanish recovery—that the problem will be significantly ameliorated. Combined with possible political developments, that is a very worrying trend. Another issue is deflation, which we may come on to talk about later, in the context of these phenomenally high debt-to-GDP ratios. Although the deficit-to-GDP ratios have come down in a number of countries, if GDP is more or less flat, any deficit at all means that the debt-to-GDP ratio is still rising—it has been rising and has reached some pretty alarming levels. In addition, the political developments across the zone are really rather worrying. The situation in Italy is desperate and the debt-to-GDP ratio there has risen very substantially. All along I have thought that Italy is a much more serious vulnerability than Greece, because Greece is comparatively small and can somehow be fixed or fiddled, whereas Italy is not—it is big—and the political scene there remains very difficult. And then you have the forthcoming European elections, which look as though they will produce a hefty vote in favour of Eurosceptic parties in a number of European countries, including France.

Q27 The Chairman: We will come on to deflation and disinflation. First, though, does Gerard Lyons share Roger Bootle's analysis that not everything has been put right at the moment, or are the Europeans on the path to finding the architecture for the way out?

Gerard Lyons: Good morning. Let me just say that it is an honour and a pleasure to be here. Thank you for the invitation.

I agree with much of what Roger Bootle has just said. I would characterise the situation by saying that I think that we are past the worst but, given that the European economies are still so fragile—they have not yet, to coin the phrase that is used here in the UK, reached escape velocity—that leaves them very vulnerable to any further shocks, either domestic, within Europe, or external. Given that weakness and potential vulnerability, I would suggest that it is premature to say that the crisis is over yet. I would like to think that the crisis is over and that may well be the case, but we should not take anything for granted. In that environment, I think that the head of the European Central Bank is probably right in what he said and on the policy environment.

I tend to say that, whichever economy one looks at, the outcome depends on the interaction among the fundamentals, policy and confidence. On the policy-making side, there is certainly a desire to boost confidence, but the confidence factors across Europe vary considerably and there is a lot of divergence among them. If we look at the policy side, it is not that there are few policy tools left to use, but monetary policy—both in Europe and in other western countries—has very much become the shock absorber. Clearly, the European Central Bank will need to remain accommodating for some time until it is confident that the European economy as a whole is resilient to further shocks and has enough momentum of its own.

Moving from confidence to policy, we come to the fundamentals. The clearest message there is how divergent the fundamentals still are across Europe. Roger Bootle has touched on Italy and one or two other economies, but I think that the real divergence is highlighted by the two economies that we used to think of as being at the centre of Europe, which are France and Germany. As Roger Bootle correctly touched on, unemployment generally—and youth unemployment in particular—is a big issue, and that is very much highlighted by the divergence between France and Germany. However, we are seeing some European economies on the periphery improving, with Ireland, Latvia, Portugal and Spain often cited in that context.

Putting all that together, I agree that we are past the worst, as is reflected in the forecasts. However, when one looks at the divergent nature of Europe, it is still premature to stay that we are completely out of the woods and could not be hit by a further shock.

Q28 The Chairman: Mr Lyons, would it be an unanswerable question to ask how we will recognise the beast when the crisis is over? Is that too difficult to spot?

Gerard Lyons: Yes, that is perhaps the right thing to say. Sometimes you know it when you see it in some respects. Coming back to the fundamentals, policy and confidence, I think that even though confidence by itself cannot pull up an economy, it is sufficient to hold it back. If we start to see more confidence, not just in the markets but among people and among businesses, that would help, but ultimately—the IMF touched on this last week when it talked about deflation—the problem across Europe has been a lack of demand. Some economies see higher demand than others. We need to see stronger activity. To go back to your question, once we start seeing not just confidence but more evidence, in the economic figures themselves, of growth picking up—hopefully, across all countries, but the reality is that that will not happen—that should give us more confidence.

Q29 The Chairman: Simon Tilford, I would like your snapshot, but Mr Lyons has already drawn us on to territory that is of great interest to you, given the interesting essay that you wrote on whether the right tools were adopted and adapted at the beginning of the crisis. Can you first give us just a snapshot in response to those first questions?

Simon Tilford: Thank you very much for inviting me here today.

I, too, think that Mario Draghi has offered the more clear-eyed assessment of where we are. It is resoundingly good news that the eurozone exited recession. At the beginning of the year, it was not apparent that that would happen, so that has to be seen as good news. However, I think that we are a long way from being out of the woods. It is worth bearing in mind quite how far short of pre-crisis levels of activity the eurozone as a whole and various members of its periphery are and how huge the gap is between where we are and where we would have been had the eurozone countries continued to grow in line with trend growth. We are at the very early stages of recovery. Typically, after a loss of activity of that magnitude, the recovery would be pretty robust. It is not. The recovery is very weak and vulnerable. It is very export dependent—domestic demand in the eurozone remains very weak—and deflationary pressures are strong. The issue is not just that there is outright deflation in the periphery and relatively robust inflation in the core; there is not a single member of the eurozone whose inflation rate is over the target of 2%, so deflation pressures are broad based—they do not affect just the likes of Greece and whatever but they are across the board. We also continue to have large and highly leveraged banks.

So, in terms of the recession ending, I think that some cautious optimism is justified, as there are some signs that we are seeing a return to growth in the periphery. However, the output gaps are huge and the recovery is unlikely to be strong enough to counter deflation pressures. That brings us on to the point that, as Roger Bootle mentioned, the crucial thing for fiscal positions is not really the deficit as such but what is happening to the debt stock. If eurozone growth struggles to exceed 1% per annum in the medium term, which I think is a fair assumption, and inflation remains very low—we do not even need to see outright deflation—it is very hard to see how the debt burdens of a number of member states can be made sustainable. To be optimistic or confident that we are out of the recession, the economy in the eurozone would need to be growing above trend—whatever that is now, but certainly 1.5% or 2%—and it would need to be driven largely by domestic demand, particularly German domestic demand. We would also need to see Governments agreeing to a degree of risk pooling.

Q30 The Chairman: Let us return to Roger Bootle. Can you draw a distinction between disinflation and deflation? Given what Christine Lagarde has called the "ogre of deflation" that still needs to be slain, what would you add to what Simon Tilford has just said?

Roger Bootle: On disinflation versus deflation, I think that those terms can be clearly distinguished. Disinflation refers simply to a reduction in the inflation rate, where there is still a process of rising prices; deflation is a process in which general prices fall. Deflation is an ogre in this context—it is very much about the context. There are circumstances in which I think it is perfectly okay to have a rate of deflation of prices. For example, in the 19th century Britain periodically experienced quite substantial rates of deflation, as did the United States, where price levels fluctuated. Indeed, I can imagine monetary regimes in which it would not be a bad thing at all occasionally to have a bit of a fall in prices. However, that is not the context in which the eurozone finds itself. The big difference is debt and the absence of sustained economic growth.

In addition, this is occurring against the backdrop of the Japanese experience. Before Japan entered its deflationary decade—or two decades—I think that I am right in saying that economists paid virtually no attention at all to deflation, which was a curiosity of economic history books. The Japanese experience showed us that a modern economy such as Japan can land itself in this position and it clearly illustrated the terrible interactions among deflation, debt, the banking system and confidence. Japan has struggled to get out of that mess, and in many ways it is still not fully out of it. So I agree with Christine Lagarde that, in these contexts, deflation is an ogre that must be fought decisively.

It is rather like inflation, by the way. In the 1970s when inflation first took hold, lots of monetary economists said, "Well, the cure is dead simple—you just cut growth in the money supply and all will be tickety-boo". That was a complete nonsense, of course, because inflation got into the most dangerous place of all, which is the mind. That is, inflation affected what people, businesses and investors expected. Deflation is just the same. If deflation gets really ingrained so that people come to expect deflation, it is devilishly difficult to shift. The Bank of Japan may try desperately to inject more money, and yes eventually, presumably, that will work but, just as it was very difficult to reduce inflation because it was so ingrained, so it will be difficult to get rid of deflation once it is ingrained in the system. So I think that it is very important to stop it getting ingrained in the system in the first place.

Q31 The Chairman: Gerard Lyons, can you give us your views on deflation and disinflation?

Gerard Lyons: I agree with what has been said. This is perhaps a challenge for economics itself because, if you said to the general public that falling prices are a bad thing, they would probably be quite confused. When the IMF's chief economist Mr Blanchard was advocating higher inflation targets for a number of countries a few years ago, I thought that it was dangerous to argue that inflation is the way out of the problem. We really need to put the context around the issue and explain what it means. I think that Roger Bootle is right about the deflationary mentality in Japan—if people expect prices to continue to fall, that deters people and firms from making purchases or investments, so the expectation can be self-feeding. In the context of Europe, I think that the problem is demand and the consequence is deflation.

Also, I think that the issue needs to be seen alongside what is happening globally. If we look just at Europe, there is a danger that we could come out with a down-beat, pessimistic view about the world economy. The reality, in my view, is that the world economy is in pretty good shape and there is a lot of growth and a lot of activity. The challenge for Europe—and, for that matter, for the UK—is to reposition itself in this changing global economy because, as the world economy grows and changes, there will naturally be winners and losers. The report that the World Bank released in December, which looked at what happened to disposable incomes or real incomes between the fall of the Berlin wall and the financial crisis, is perhaps relevant here because it said that, taking the poorest person in the world in 1989 as being at zero on the income spectrum and the richest person being at 100, over the next 20 years the biggest gainers were those centred on around 40 in 1989. In other words, the middle to high income earners in the emerging world saw the biggest gains. The reason that I mention that here is that the biggest losers were those centred on around the 80 to 90 mark in 1989. By global standards, their incomes then were really high—they were middle to lower income earners in the western world, particularly in western Europe but also in the States—and they looked pretty well off, but over the next 20 years, because of globalisation and competition, their wages did not really grow or increase. That is the real challenge. When we talk about deflation and inflation, we need to see that challenge alongside the pressure that has been seen on wages in many countries. On top of that, there is the whole issue about employment and unemployment.

Coming back to your question, I think that, if we had a deflationary spiral, that would be a worry, but we need to be clear that the reason why there could be a deflationary spiral would be that there was a lack of demand within Europe itself. Is that possible? I think that it is more likely that we will have a deflationary risk in some countries, such as France, but in Germany and the countries at the core of Europe I think that it is unlikely that we will see deflation. Briefly, that is because the nature of the euro is that, in good times, it encourages the money to go to the periphery because Spain, Ireland and so on become high-yielding Germanys without risk, so the money floods in and feeds asset booms, but I would argue that, in the bad times, the money floods back to the centre, which might start to feed more confidence in the centre—Germany is doing relatively well—but could start to feed inflationary pressures. That adds to the pressure on the European Central Bank, given its one-size-fits-all monetary policy for all these different economies. So it is a complex picture.

The Chairman: Simon Tilford, I guess that you are champing at the bit to respond to the point on demand, but I wonder whether you can hold your horses there. I shall turn to Lord Marlesford, who has not only a supplementary question but his own question.

Q32 Lord Marlesford: I want to ask a supplementary on deflation, because, in a sense, it is a bit of a paradox that you can have a major deflationary force which shifts the structure between countries, helping some countries and being very damaging to others. I am of course talking about energy prices and the effect of fracking in America, which has had a major impact already on American manufacturing, with jobs going back to America that had disappeared, and which will probably have a significant deflationary effect on Europe as well as on certain countries in the third world.

The Chairman: Does anyone want to respond to that before we go to Lord Marlesford's main question?

Gerard Lyons: This is interesting, because you could argue if you follow through and believe that analysis—and some people will suggest that it might not necessarily end up like that—you could argue that it is a double-whammy problem for Europe. In normal recessions in Europe and the States, commodity prices—food and energy prices—will be pretty low, so that people in work or on low wages would not feel that squeeze, but because of China and emerging economies and strong demand from those, we have not had that escape route in the recession of the past five years. Commodity prices, both food and energy, have been relatively high. That has compounded the squeeze on people who have either been made unemployed or have not seen wages go up. So you have that commodity price inflation from one side, but the other whammy is the fact that, as you say, America has responded better and is in probably the more competitive position to cope. Europe needs to respond to this.

Lord Marlesford: And Europe, of course, has rather turned its back on fracking, particularly France.

Gerard Lyons: Yes, there is a whole host of issues there.

The Chairman: Before we move on to the next subject, Simon Tilford, did you want to come back on deflation?

Simon Tilford: Briefly, yes. I think that Gerard Lyons is absolutely right that the core of the problem is demand. There is no doubt that, across Europe, we are seeing chronically weak domestic demand. In terms of the deflation risks, I am not sure that I quite agree that Germany will escape. In a way, Germany is a curious case, because it is in many respects a source of much of the deflationary pressure in Europe, because this is an economy with a huge glut of savings. It is running a very large external surplus, which is basically a result of the fact that it generates far more savings than can usefully be employed within its economy. The main reason why the euro is so strong now is Germany's external surplus. Most of the eurozone's external surplus is accounted for by Germany and the Netherlands. That is pushing up the value of the euro and compounding deflationary pressures across the eurozone economy. The underlying problem here is that Germany is hugely competitive at this euro/dollar exchange rate, but Italy, France and Spain are not, so the rise in the euro is very bad news for their chances of engineering export-led growth. Also, the lack of demand in the German economy means that they find it difficult to export to elsewhere in the eurozone, so I think that Germany is part of this deflationary problem that we have in Europe. Although I acknowledge that the underlying problem is one of demand, I think that monetary policy could have been used more aggressively in the eurozone to counter some of this.

What is striking about eurozone policymakers is that they have rejected not only Keynesian responses to this crisis but monetarist ones as well. It is curious that money growth has been allowed to decline to about 1% in the eurozone. Given that the ECB is modelled on the Bundesbank, which was steeped in monetarist thinking and would never have allowed that to happen, it is quite curious that, even now, with inflation in every member state at under 2% and money growth at 1%, we are still seeing discussions over whether the eurozone should adopt more aggressive strategies to counter deflationary pressure rather than actual action.

There is no doubt that it is a different animal from the US and the UK; quantitative easing would presumably have to be directed more at the banking sector—because these are bank-based financial systems, unlike the more capital market-based ones here—but there are ways of doing that and other ways of engaging in credit easing. It needs to do that; this is not a problem that is going to go away, given the economic outlook.

The Chairman: Lord Marlesford, would you like to ask the question to which Simon Tilford has already replied?

Q33 Lord Marlesford: I want to raise the whole question of the competence and performance of the ECB and get your views on this. Having sailed along quite happily in the smooth waters pre-2008, it was pretty well taken off guard. Certainly, we do not want to go into detail, but one example of incredible lapse was that, as part of the troika, it signed up to that incredibly bad initial proposal for the solution of the Cyprus problem. I think that everybody finds it wholly inexplicable that all three could get it wrong—I can understand the Commission getting it wrong, but it is incredible that the IMF and the ECB should have done. The big thing now is their role in the banking union. In November, the ECB will take on responsibility for the supervision of the banks in the euro area. In order to get ready for that, it is quite rightly trying to discover where the banks are. It has started the stress tests and has boldly stated that it will announce the results in July. I wonder whether you feel that the stress tests can be carried out within the timescale, what you think they may reveal and whether you agree that, in one sense, there is a conflict between Draghi's first mandate, which is to keep the show on the road—which he has done very well with his "do what it takes" policy—and the possibility that the stress tests show up deficiencies and shortfalls greater than any support mechanism envisaged at the moment can meet.

Gerard Lyons: There are two aspects to the question. One is the ECB monetary or macroprudential policy; the second is the ECB in terms of the banking sector aspect. Perhaps because Lord Marlesford finished on it, let us do the banking sector bit first.

There is probably more confidence about these stress tests because they have an additional aspect to them: they have the asset quality review component. So there is not just the stress test about how the banks will do in a certain scenario; there is also another component which is aimed at improving transparency and making people more comfortable about the current positions of the banks. You are clearly right in one respect: you can have stress tests where you can pick scenarios that expose problems in banks—indeed, the whole aim of these tests is to expose where the potential problems might be ahead of those coming into reality. So on the stress tests, maybe we should be more confident because their added component would make them more comprehensive than previously.

In terms of the single supervisory mechanism, it is all part of the banking union aspect. We have to step back and look at Europe in the global context. There is a desire to have a global approach, but the reality is that different areas and countries will respond at different times and the ECB clearly has a vital role within that. We could talk further about this, but coming back to the ECB component on the banking and supervision side, I think that that is a necessary part of making banking union work.

Coming to the monetary policy side, I think that it is always difficult here because hindsight is a great thing. Since Mr Draghi made his comments in London—gosh, was it July 2012?—there has been a transformational process. Since then, the ECB has done a very good job, adding liquidity and cutting interest rates. Clearly, given what Mr Draghi said, it is prepared to remain accommodating. However, just as one size does not fit all in monetary policy, one has to see monetary policy alongside reform and fiscal policy as well. Roger Bootle touched on Japan. Japan had the demand and supply-side problem and never addressed its supply-side problem. Europe has supply-side issues as well as demand issues. Some countries are trying to address supply issues, but demand issues are not just monetary policy and the whole issue of fiscal policy needs to be put on the table as well here.

The Chairman: Simon Tilford, what is your assessment of the ECB?

Simon Tilford: It is a product of the political context. Mario Draghi has done enormously well. Strategically and politically, he has done far more than most people thought possible, but clearly there are huge divisions on the ECB board and he has had to plot a course between those two camps. Given the differences and the political sensitivities in particular member states over some of these issues, I do not think that he could have done a better job during the past 18 months or two years. I do not think that anyone could have done a better job than he has.

The Chairman: Roger Bootle, is that your assessment?

Roger Bootle: Yes, I would largely agree with that. Obviously, the ECB has not been perfect, and I think that a lot of people would characterise it as being rather sluggish and overly complacent about the seriousness of the problem. It was slow to recognise how serious the deflation danger was—as were a number of other people. However, I think the right thing to emphasise, as Simon Tilford mentioned, is the political constraints under which Draghi has been operating. He really has got to walk a narrow tightrope. In the background of course is the German constitutional court and we do not yet know how all that is going to play out, with the suggestion that OMTs are in some sense illegal. If the ECB were to want to embrace outright, proper quantitative easing, there would be an almighty row with the Bundesbank and other parts of the German establishment. None of this is Mr Draghi's fault or in any way comments on his competence. I think that he has done a brilliant job.

The Chairman: I shall just bring in Lord Kerr, who is particularly interested in that.

Q34 Lord Kerr of Kinlochard: I declare my interest as Chairman of the Centre for European Reform. Does the German constitutional court reference to the ECB take it out of German politics? Does it make it more or less likely that the ECB would in a renewed crisis take dramatic measures to do whatever it takes?

Roger Bootle: I am not an expert on either German or European law so I have to, as it were, rely on my market experience. All I know is that when the judgment came out, the German Eurosceptics were celebrating. They thought that the judgment was very much in their favour in the sense that the court made it pretty clear what the limits were. The court seemed to indicate that to go any further would require a new German constitution. Okay, they have sent it across to the European Court of Justice. I do not know how Draghi is going to react to that. I suspect that he will be pretty worried that the constitutional court may yet cause problems for him.

The Chairman: Could you explain that, Simon Tilford? It has been sent across to the ECJ, which perhaps surprised a number of us.

Simon Tilford: Those who argue that this is a good thing, in that it takes the decision out of German hands and leaves the responsibility with a European supranational institute, the ECJ, are probably misreading the situation. I do not think that this does take it out of the German political arena. As far as I understand, and I am not a constitutional lawyer, they have referred it to the ECJ for guidance. The ECJ cannot rule whether it is consistent with the

German constitution; it can rule only that it has to be consistent with constitutional requirements of the various member states. Irrespective of what the ECJ rules, the German Government still face a constraint because the German constitutional court has primacy there. I think that this is a big ruling. Coming back to the discussion earlier about the markets, I find it a little surprising that the markets are so relaxed about this, because I think it puts up a potentially significant obstacle. However, as I say, I am not a constitutional lawyer.

The Chairman: Gerard Lyons, can you help us with this one?

Gerard Lyons: I cannot really add to that, no.

The Chairman: So the cry goes up: "Help!"

Lord Dear: I may be wrong and please correct me if I am, but the ECJ can give a view but it cannot give a ruling unless there is a case before it, which would be the circumstance here in this country. You used the word "ruling". Have I missed something? Has a case gone to it?

Simon Tilford: Sorry, that was a poor choice of words by me; it is guidance that I think it can give.

Q35 Lord Dear: Yes, guidance. So it may very well be the outcome, but one cannot rely on it absolutely. If you go to the Supreme Court here, you will not get advice. The diktat comes down when you put a case before it and it decides on the external facts.

Can I move away from the ECB and look at the troika of the Commission, the Council and the Parliament? Can you give us just a general view on whether individually they are performing in the way that one would hope and whether, as a troika or triumvirate, they are cutting the ice as one would hope? From my experience of organisations and indeed of driving carriage horses years ago, I know that driving one horse is difficult, driving two is more difficult and driving three is an impossibility. But that may be unfair to the troika.

The Chairman: So the question is about those three institutions plus the troika, which of course involves the IMF.

Simon Tilford: The Commission started off well. If we go back to 2009, we see that the research that it did in response to the crisis was very balanced, very empirical. It argued that, within the eurozone, adjustment needed to be symmetrical; that is, if we were going to see internal devaluations and very weak demand in the south, there would need to be offsetting increases and demand in the north, which was an implicit criticism of Germany and the other surplus countries that they needed to look at their own imbalances. It called for an appropriate balance between the interests of the creditors and the debtors—at root, this is a debt crisis and no debt crisis has been solved by the creditors demanding that the debtors make them whole. Unfortunately, the Commission was not able to retain control over the direction of thinking here and the European Council pushed back quite hard, particularly the German, Dutch and Nordic Governments, and it quickly changed track. The emphasis on symmetric rebalancing was lost and Germany quickly became the benchmark for all other countries to emulate rather than part of the problem. That is not to say that the Germans are responsible for the eurozone crisis, but they are certainly part of the problem. To a significant extent, the Commission has become an advocate for the creditor countries, which is a problem because it is supposed to be an independent arbiter of the European interest and it has had negative implications for the handling of the crisis and for the creditor countries themselves.

The ECB has done extremely well in the past two years. Up to that point, the evidence is rather more mixed. I think that there was a lot of complacency about demand in the eurozone. The mantra was that this was all a supply-side problem and that fiscal austerity of this magnitude against a backdrop of very weak demand would not be contractionary and would pose no deflationary threat. It was quite dismissive of problems in the banking sector. So initially there was some complacency in the ECB, but, increasingly, the performance of that institution has been very good and it has been keeping the show on the road.

The Chairman: And the Council and the Parliament?

Simon Tilford: The Parliament's role in all this has been pretty limited.

The other relevant institution is the IMF. What has been curious from the start on this is that the IMF has got involved in a situation that typically it would have stayed well clear of. The eurozone does not have an external financing problem. It is now running a big external surplus, but even at the height of the crisis it was broadly in balance with the rest of the world. It is also enormously wealthy. For the IMF to provide financing to a country that has no external financing requirement was unprecedented and reflected the power of European countries on the IMF board. Aside from doing quite a lot of damage to reputation of the IMF across the world and particularly in emerging markets, that gave intellectual backing to a strategy that many people from the start argued probably would not work. To that extent, the IMF has done Europe a disservice by providing money and intellectual ballast, or backing, to a strategy that was unlikely ever to work.

The Chairman: Roger Bootle, can you take the Commission, the Council and the Parliament and assess their role?

Roger Bootle: I do not have a great deal to add to what Simon has said except to emphasise the point about the asymmetry of response within the eurozone. The key role and requirement for these institutions—and I think that all of them have effectively shirked this—is somehow to cajole principally Germany, and to a lesser extent the Netherlands, into accepting their role in relation to the crisis. Unless they do that, I do not see that they have been in a position to achieve very much in terms of a fundamental contribution to solving the problem. What happens is that the German view wins out, which means that the solution to this is to carry on clobbering the periphery, so you end up with a lack of demand in the system, which leads you on to deflation and so on and so forth. I do not think that any of these institutions has sufficiently stood up to Germany and challenged that German view.

Q36 The Chairman: Gerard Lyons, do you share that view? In other evidence that we have heard, Erkki Liikanen, and to some extent Mario Monti, pointed to the European Parliament as having played an interesting and involved role.

Gerard Lyons: I agree with what has been said. Perhaps I would look at it from another perspective. If we think back to the crisis starting five or six years ago, and it was a global crisis but centred in the west, it highlighted two areas: the systemic failure within the financial system and the imbalanced global economy. If we take both of those as separate, one can argue that the Commission, the Council and the Parliament have worked in their own ways to address the first issue, about the systemic failure in the financial system—and coming back to the earlier question about the stress tests, it is clearly work in motion. In that respect, it is difficult to criticise. But then if you move to the imbalanced economy argument, that is a slightly different approach, and Roger Bootle touched on the issues there. In some respects it again comes back to hindsight; it is about the fact that it was a moving target. I think that on the continent and in other parts of the world people did not really envisage the problems that were evolving or emerging, so that maybe led to the inertia. Effectively, the way it resolved itself on the continent was for the European Central Bank again basically to become the shock absorber and step in. I was in Brussels a couple of weeks ago to talk to different people in the Commission, the Parliament and the Council about the London or UK relationship. Just as people talk about the Westminster bubble, there is a sort of Brussels bubble. I came away feeling really positive about the place and about the people whom I met, the way in which they were engaged and the way in which they were working together. The two issues are: the communication with the outside world and the sense of urgency. So it is not what they are doing that can be criticised; it is the way in which they communicate that or maybe the speed at which things happen.

The Chairman: We call that Brussels bubble and squeak.

Simon Tilford: I think that the European Parliament has done a terrific job on the financial sector. I do not think that it has had much of a role when it comes to addressing the big macro issues, but on the financial sector questions its work has been hugely positive.

Q37 Baroness Maddock: You have touched on some of these issues, but I want to ask what we can to do to stimulate more growth in the eurozone and deal with the lack of competitiveness, particularly in some of the peripheral countries. Also, what can we do to tackle unemployment, particularly youth unemployment, which we touched on earlier? Mr Lyons, you talked about the importance of confidence in the eurozone. Could we do more on that? Otherwise, what other things can we do to tackle these issues?

Gerard Lyons: Confidence is important, but it cannot be looked at in isolation. Personally, I would look at the issue as being about fundamentals, policy and confidence all acting together. You can have the fundamentals right and you can have the policy right, but if confidence is low the economy will not reach its maximum potential. Confidence alone will not drive an economy, but confidence is an important factor.

What needs to be done? The crisis of the past five years has highlighted the difference between the core of Europe and the periphery, but even in the core some would say that the Netherlands has problems that other core members do not face. People who look at these individual economies in greater detail than I do come up with different answers, but when one steps back one sees that the core of the eurozone is in much better shape than the periphery and the structural adjustment has very much been put on the periphery.

That comes back to an issue that Roger Bootle mentioned, which I touched on in my previous answer. Leaving aside the systemic failure in the financial system, one arguably sees within Europe a microcosm of the imbalanced global economy. The question is where the adjustment needs to be made. A perennial problem since the Second World War has been that, whenever there is a problem or crisis, the adjustment is always required from the debtors or deficit countries; the perennial argument is whether more of the heavy weight lifting should be taken on by the surplus countries. Indeed, the US Treasury Secretary was in Europe a few weeks ago to try to put pressure on Germany, as a surplus country, to do more. However, the reality is that, when you speak to people in Germany, they will point out that their economy is picking up and unemployment is falling, so they might naturally ask, “Why should the good become like the bad?” There is no easy answer to that.

Coming back to your question, I would also look at the issue from the policy perspective. There is fiscal policy, there is monetary policy and there is the whole supply-side reform. Supply-side reform is necessary across Europe to make Europe competitive. We have already touched on monetary policy, but a question that we have not really talked about is whether more should be done through fiscal policy as well.

Roger Bootle: At the risk of being unduly provocative, if you ask me what can be done to stimulate growth across the eurozone, I will give you a very bald answer: break up the euro. That is the way to do it. We have heard very eloquently from Gerard Lyons that there is a strong case for Germany taking a looser policy stance, but Germany will not do so. It will not do so because its economy is doing pretty well, so why should the good be infected by the bad? All these dangers have come about as a result of fusing together falsely—on false premises—economies that are very different. What an exchange rate does is allow you to isolate one set of practices, habits and problems from another set. If Germany had its own independent currency, its currency would rise on the exchanges and those of the other countries would fall, and Germany would then be in a position to expand fiscal policy, which it would need to do to make up for the blow to exports. I would not quite say that everything would then be tickety-boo, but the part of the problem that is about competitiveness would be solved in a trice.

The Chairman: Some of us might remember echoes of a former Chancellor of the Exchequer of this country saying, at the time of an interest rate rise, that a little unemployment in Newcastle is the price that you pay for having a single market and single economy.

Roger Bootle: I do not quite see the relevance of that. I did not say it. Was it Lord King or Lord George who said it?

The Chairman: No, Lord Lamont said it when he was Chancellor of the Exchequer.

Roger Bootle: Did he? Oh.

The Chairman: Anyway, let us hear from Simon Tilford.

Lord Flight: Perhaps I could answer that.

The Chairman: Lord Flight, you are not a witness.

Simon Tilford: I think that real exchange rates are a problem. One argument for the euro was that it would put an end to competitive devaluations and that was a key reason why the Germans signed up to it, but that does not mean that the euro has abolished the issue of exchange rate misalignments. Obviously, one can have nominal and real exchange rates; one has to look at the real value of exchange rates, not the nominal value. There is no getting around the fact that Germany now has a hugely undervalued real exchange rate, both relative to the rest of the eurozone and relative to the rest of the world, and that is not something that we can all have. However, the strategy in the eurozone is really all about emulating what Germany has achieved. So what we need is for the Germans to lose competitiveness.

The problem is that in Europe competitiveness has become synonymous with productivity, whereas they are two very different things. When people talk about competitiveness, they seem to be talking about the price competitiveness of traded manufactured goods. Of course, if competitiveness means anything sensible, it has to mean productivity growth. I agree with Roger Bootle that we certainly need a stronger German currency, but if we are to avoid huge economic and political dislocation, it will need to come within the eurozone and that means that, one way or another, the German economy will need to grow under its own steam and generate some inflationary pressure. Without it generating some inflationary pressure, it will be all but impossible for the others to generate a decline in their real exchange rates relative to Germany without pushing them into deflation and debt traps.

The Chairman: Lord Flight, you are not a witness but you are an inquisitor.

Q38 Lord Flight: Can we move on to the eurozone and the UK? Although the full integration package is miles from being achieved and, as our briefing paper has pointed out, the current banking union is incomplete, we are headed in the direction almost certainly of greater eurozone integration. How should the UK address that? In a sense, we are in the also-ran camp, as we are in the semi-detached market bit. Does that matter? Are Government to Government relations the most important, as seems to be the case, or does the current situation point to saying that we might not need to withdraw as we can become a semi-detached member automatically because it will be the eurozone that matters? How do you see all that developing in the future?

Relevant to that, what about the City of London and the EU? Most of my honest EU friends admit that the EU will do its best to damage the City, which has obviously been happening. On the other hand, the City is useful to the rest of Europe and the attempts to do elsewhere, such as in Frankfurt, things that the City does have failed. In many ways, so what? The City makes the best of providing its international services. How do you see the City in the light of the development of a more integrated eurozone?

Gerard Lyons: There is a danger that this answer could go on for hours—

The Chairman: No, there is no danger of that.

Gerard Lyons: There are a whole host of issues here. One thing that I always find interesting is that, here in the UK, we always look at this issue primarily from an economic perspective, whereas when I speak to people on the continent, I find that it is viewed primarily from a political perspective, which leads to a very different dynamic. I was heavily involved in the no campaign, as indeed was Roger Bootle, that Britain should not join the euro, and I think that that was the right thing to do. At the same time, I remember writing in the *Financial Times* back in—gosh—1997 that, for the euro to survive, it needed to become a political union. Now, you could argue about different templates for that, but you need to back up the currency in some way. So the first point is that we look at this issue really economically, whereas on the continent it is viewed very politically. Therefore, there is often a different mindset.

I am very positive about the prospects for London. I think that the challenges in London are more home grown, such as the cost of living and the ability to have the right infrastructure in place. Earlier this year, an interesting report from Deloitte's on high-skilled jobs globally said that London is the number one city for such jobs, with 1.5 million—New York was second, with 1.2 million, and then came Los Angeles, with about 800,000, and Hong Kong with 650,000. Those jobs are not just in banking but in the professions, in business, in commerce and in the creative industries. Looking at the financial component of that, I would say that, as was pointed out to me when I was in Brussels a few weeks ago, the wholesale market part of the single market for the financial sector works well. There seems to be little doubt that the wholesale market for Europe's financial sector remains in London. The single market in retail services is very different, as that is spread across the different countries. As we have seen, the Chancellor has, like the previous Government before him, very much positioned London in the global sphere, in new markets such as the renminbi et cetera. I think that London is very well positioned.

A final point that might give some insight—it is relevant for this answer—is that the Mayor of London, Boris Johnson, asked me to produce a report on the pros and cons for London of the whole EU debate. In my own mind, the way that I characterise the issue is like a four-sector diagram, if you can picture that. Although many people look at the debate as being about "in" versus "out" or a spectrum between those positions, when you speak to businesses here or to policymakers on the continent you find that another real issue is about a "reform" versus a "non-reform" agenda. You might view those as the other two sectors in that four-sector diagram, if you are with me. In the analysis that we are doing, the best scenario would be where Britain remains in and the European Union reforms, although there are also questions about what or how you reform, which is a debate in itself. An interesting point is that, if we left the EU but the EU reformed and we also had good relations with it—there is no reason to think that our relation to it would be identical to that of Switzerland or Norway, because we are a very big economy—that is still a good scenario, although it is not as good as remaining in a reformed EU. A third scenario is that we remain in an EU where there is a lack of reform. The worst case is where we detach, the EU does not reform and we have a bad relationship with it. In some respects, as in other debates, the issue is not just about what happens but about the subsequent institutional framework and what you do with that.

At the end of the day, you can only control what you can control yourself and you try to influence the other side. In my view, the best scenario would be for Britain to remain within a reformed European Union. The question then is what you reform. Speaking to people here in the UK, you come across what I tend to call the regulatory paradox: people do not disagree with individual regulations, but they do not like the mass of regulations. In some respects, you could argue that Europe becomes the sort of fall guy. People feel it easy to blame Europe, whereas many of the issues about our economy are really home-grown issues.

Q39 The Chairman: Before I ask Simon Tilford to respond to Lord Flight's question, can I just ask Gerard Lyons whether the work that he did for Mayor Johnson is in the public domain?

Gerard Lyons: It is not in the public domain yet, as I am writing it up now. Because of the purdah period around the European elections, it might be more sensible for the report to be released in June.

The Chairman: Could you kindly pass it on then?

Gerard Lyons: Certainly.

Simon Tilford: I think that it is fair to say that central bankers, business leaders and regulators across Europe fully understand the importance of the City of London. The UK is the regulatory leader in financial services, and what the UK argues for tends to go. However, there is a very different story when it comes to politicians across much of the eurozone, in particular in some member states.

On the implications for the City of withdrawal from the EU, I agree with Gerard Lyons that most of the things that hold back the UK have next to nothing to do with the EU, with EU regulation or with EU membership in any shape or form. The things that hold us back are supply-side constraints within the UK, which are to do with skills, the land market, corporate governance and one or two other things—they do not really have anything to do with the EU. If we were to leave, however, I think that over time the City would suffer. There is no doubt that it would take time because the City is based on a huge concentration of highly skilled human capital, which is very difficult to move; it is much easier to move a factory to another country than it is to persuade huge numbers of highly skilled professionals to do so. So I do not think that that would happen quickly, but there is no doubt that a Britain on the outside of the EU would elicit a lot of resentment within the eurozone. If London continued to be the financial centre of the eurozone, that would be seen as a big problem. Britain within the EU but not in the euro is not a problem—if we stay in the EU but resist getting involved in further integration with the eurozone, that is fine—but I think that, if we were to leave, the City would over time be vulnerable to regulatory attacks et cetera.

Q40 The Chairman: Roger Bootle, as well as replying to Lord Flight's question, do you think that the City itself—by all means Gerard Lyons can also come back on this—ought to market itself as an EU institution, or as an EU asset, rather more than it does currently?

Roger Bootle: On Lord Flight's first question about greater economic integration, this is an awfully interesting question, because you could see a scenario in which the eurozone goes ahead and integrates more closely and fully and those EU countries that are outside the eurozone negotiate some different arrangements so that you end up with a situation in which Britain and other like-minded countries have the sort of relationship with the core that we have wanted all along without actually breaking up the EU. I think that that is possible. I myself do not think that it is likely, not least because of the concept of what Europe is. Often, there is a view on the continent that those countries that have not joined something have just not joined it yet—they are the "pre-ins" or whatever rather than the "outs". In that situation, the danger for Britain would be that all the power and the influence would reside in the eurozone core of the EU. Unless there were cast-iron legal guarantees and, above and beyond that, a real willingness on the part of the Euro-elite to conceive of the EU as consisting of these two rings, the danger has to be that Britain would be marginalised and all sorts of things would be decided in the eurozone core and in effect imposed on Britain. I think that that is a big risk, which we would have to view very closely indeed. In those circumstances, I might feel that it would be better to have, as it were, the real thing—that is, a real separation—and negotiate for the arrangements that we actually want. There is a danger of being put upon in that second-tier status, unless that is accepted willingly by the Euro-elite.

On the point about the City, I have little to add to what has been said, but I will add something. In my experience, there is a tendency on the continent to see the issue as being about how much European business is done in London versus Paris or Frankfurt. There is a feeling that, for a variety of reasons, London has unfairly stolen a march and it is destabilising, and in some sense humiliating, that the majority of euro business is done in London and "Wouldn't it be so much better if, somehow or other, that was redirected towards Paris and Frankfurt?" However, in fact the real issue is not about London versus Paris or Frankfurt but about London versus New York, Singapore, Shanghai, Dubai, Zürich and so on. That is the real issue.

Q41 The Chairman: So London is representing the EU. Can you also answer my question on whether the City of London should present itself as an EU asset?

Roger Bootle: I do not know quite what that means. Should it put on a great PR campaign? I do not think that it is the case that people do not know this. They know it.

To put my last remarks about that global rivalry into context, I would take a different view from Simon Tilford about the essential nature of Britain's role and the City as being in the

EU. I am not sure that that is true at all. It depends on how intrusive the EU is. We have to ask ourselves how the City came to occupy the position that it occupies in the world. Why did the Eurodollar market—that is to say, trading and lending in dollars—arise in London? It arose in London because of overregulation and bad regulation in New York. The business was driven away from the United States and into London. There is precisely the same risk in relation to financial business in Europe.

Moreover, although I am sure that Simon Tilford is right about the understanding on the part of central bankers, there is not the same understanding on the part of politicians. The politicians tend to think that all financial things are, somehow or other, the work of the devil—just look at their reaction to the recent financial crisis. The danger for Britain has to be that, inside the EU, this great national asset is squeezed to death and clobbered. One has to view this in a global context. In the long run, where is most of the City's business going to come from? It will come from the world outside Europe. That is for one very simple reason: the EU is a failing economic area. I see nothing in prospect that is going to change that. The rest of the world is going to grow faster. The City's prospects are all to do with supplying financial services to the fast-growing parts of the rest of the world.

The Chairman: So you see the origins of the universities of Oxford and Cambridge as being when all the best students were booted out from Paris. That was perhaps an early example of what I think you are talking about.

Q42 Earl of Caithness: Mr Tilford suggested that, when it comes to discussions in Europe, what the UK says goes. Do Mr Lyons and Mr Bootle agree with that? Evidence that we have got points quite the other way.

Roger Bootle: There are some matters on which I am sure Simon Tilford is right. There is terrific expertise in London and we are able to use our powers of persuasion, so we get some things through. However, you need only look at the bonus cap—a policy that I happen to think is absolutely lunatic, even though I have been a great critic of excessive remuneration in the City—to realise that whatever we say does not go. We have seen the results, and you can see it in today's papers. What happens is that, when you are not able to raise bonuses above a certain level, you get rises in basic pay, which is just crazy. That policy was against the UK's interests and against the UK's advice, but we have had to put up with it.

Gerard Lyons: I agree with what has been said. Whatever happens to the EU, one important thing that we need to ensure that we safeguard, from a UK perspective, is the idea of double-majority voting. Apart from Denmark and Britain, which have opt-outs, all EU countries are obliged or expected to join the euro, although the reality is that others will probably not join. At the moment, one of the worries has been about the caucus between the eurozone members and the non-eurozone authorities. The UK authorities have been good at making sure that there is double-majority voting, but I think that we need to ensure that that is safeguarded. One issue that has been raised in Brussels is whether Britain will be able to safeguard its financial sector in the same way that other countries always safeguard their core interests. I think that that is very much about ensuring that we continue to engage in the process as much as possible.

It seems to me that the UK has put in place a good post-crisis framework, at the Bank of England and elsewhere in the City. It also seems to me that, at monetary policy level, the Bank of England has a very good relationship with the European Central Bank, so there are lots of things that, in my opinion, seem to work very well between the UK and the continent. For future crisis resolution, there is also the Financial Stability Board and the global approach. Lots of those aspects should reassure us, but in getting down to the nitty-gritty details of some of the points that were raised earlier we need to ensure that we continue to engage properly.

Q43 Earl of Caithness: You have answered the question that I was going to ask about the relationship between the Bank of England and the ECB, but I would like to put that question to our other two witnesses. Do you think that that relationship has improved over time and do you think that it is capable of handling the next and shortly-to-come banking crisis better than they handled the previous one?

Simon Tilford: I think that, behind the scenes, the relationship between the Bank of England and the ECB is very good. I am not quite convinced that I would buy into the dominant narrative in the Bank of England on the nature of this relationship, which is that this is a relationship of equals. Many within the Bank of England argue that, because we are home to such a large share of the markets in question, the Bank of England will remain an equal partner in this relationship with the ECB. I would not go that far. I think that that is possible, as Gerard Lyons has outlined, if Britain engages intensively and constructively to defend the country's interests and the perceived interests of the City, but the Bank of England will not be an equal partner in this, and it would be naive to believe that.

Roger Bootle: I am not sure about that actually. Given that London is the European financial centre, it is in no one's interest for the European financial centre to be destabilised or—coming back to your question about the crisis—unable to respond. It seems to me that, at central bank level globally, and certainly in the west, things really work well. Out of the crisis, the Financial Stability Board, which the Governor of the Bank of England now heads up, has done a very good job. You could be right, but I would not take that as a given and I would disagree. There is no reason to think that the future relationship will not work well.

Simon Tilford: I am not saying that it will not work well. I am just saying that I do not think that it is going to be a relationship of equals.

The Chairman: Let us move on to our final questions, the first of which is from Lord Hamilton.

Q44 Lord Hamilton of Epsom: Can I ask just one quick question? Gerard Lyons made it quite clear that he and Roger Bootle were in the no campaign for joining the euro. Simon Tilford, were you in the yes campaign?

Simon Tilford: With regard to the euro, my heart has always said yes; it is my head that has always had doubts. I favoured Britain joining the euro and I was aware of the risks, but I allowed my heart to rule my head. It did not take many years of the euro for me to come round to being rather more sceptical. I am still in favour of the euro, but I think that the eurozone countries continue to deny the implications of what they have done, which are that they will have to become considerably more integrated politically than they are ready to acknowledge. That means that they have a big selling job on their hands.

The Chairman: Lord Hamilton, let us go on, please.

Q45 Lord Hamilton of Epsom: My main question gets on to the politics of where this is all going at the moment, particularly in France and Italy. We are supposed to have seen a U-turn by President Hollande on economic policy. Is that going to happen and what will be the ramifications? We now have a new Prime Minister in the form of Matteo Renzi in Italy, who is castigated for having no experience of government. Well, he was Mayor of Florence, which is more than one can say for either Tony Blair or David Cameron. What impact do you think he will have on Italian politics?

The Chairman: Is that directed at Gerard Lyons's line about what mayors might do in future?

Gerard Lyons: Actually, the Mayor of Florence met the Mayor of London a few months ago just by chance when Mayor Bloomberg of New York—I am not sure what the campaign was but it was about global cities, which actually do a lot together—got together with the mayors of Warsaw, Florence and London.

The Chairman: I should just tell you that Lord Dear and I had breakfast this morning with the former Mayor of Tirana, who has now become the Prime Minister of Albania.

Lord Dear: There is no stopping them.

Gerard Lyons: Indeed. Sorry, I am not sure what the question was now.

Lord Hamilton of Epsom: It was on the change of direction in France and the new Prime Minister in Italy.

Gerard Lyons: Gosh. Coming back to an earlier point, I said that on the continent it seems that the approach to the whole issue is seen to start from a political perspective; here, it is from an economic perspective. Even on the continent, I would say that good economics at the end of the day are good politics, so they need to turn their economies around. I think that we have touched on the issues about demand. Demand is an important part of the recovery story on the continent full stop, but there needs to be supply-side reform. President Hollande has talked about the reform process, but, clearly, there is a long way to go for France. I have jotted down some of the figures: unemployment in France is at a 16-year high; in Germany, it is at a 20-year low. Those two economies used to be pretty similar in many respects some time ago. Ten years ago, you could argue that Germany was seen as the "sick man of Europe"—a phrase that was widely used—but I would say that it is in pretty good shape now. It is always possible for France to turn things around, but you should not underestimate the challenges there—and in Italy likewise. But it comes back to the question from the noble Baroness that I answered earlier: it is about demand and supply-side changes. It is fiscal and monetary policy and supply side. Supply-side reforms can do some of the work, but they cannot provide all the answers.

Simon Tilford: Clearly, structural reforms are important in the long term and should boost productivity growth across much of the European economy, but there is a risk of placing excessive emphasis on them. Reforms are not the answer to all economic problems. One could be mistaken for thinking that many policymakers across the eurozone believe that they are. As Gerard Lyons has already alluded to, there is a big demand problem. To my mind, that requires very different macroeconomic policies first and foremost.

In terms of France and Italy, France has come to be seen as kind of the sick man of Europe over the past couple years. If it is the sick man of Europe, I dread to think what Italy, Spain or even the UK are, to be honest. France has its share of structural problems, particularly in the labour market—there is no doubt about that—but on many other levels it stacks up quite well in a European context. We are all looking terrible, but France does not look particularly terrible in this context. In terms of growth, it is the only country other than Germany that has recouped pre-crisis levels of activity. Its debt position is one of the more sustainable in Europe, not least because of very good demographics. It attracts more foreign investment than any other member state bar Britain and, in terms of greenfield investment, as much as Britain—much of ours is just M&A. It has good skills and great infrastructure. So, to my mind, France is not the sick man of Europe. Italy, I think, is in very serious trouble. I do not think that structural reforms, however aggressive, in Italy at this point are going to lead to some miraculous recovery. Italy needs a very different macroeconomic approach, combined with these reforms clearly, but I do not think that reforms alone will make much difference. I am not an optimist on Renzi, who I do not think will have that much more success than anyone else.

Roger Bootle: I am not optimistic about either France or Italy. The key point about structural reforms is that you have got to do them, but do not expect to get much of a pay-off in the short term. You have got to think very long term indeed. I happen to think that the main pay-off for the Thatcher reforms of the 1980s came in Tony Blair's Government. You have to have very long time horizons and the thing about the euro crisis is you cannot have long time horizons—it is there in the here and now.

With regard to President Hollande, it is a very easy thing to say, "You're reforming this; you're going to do that; you've got to cut this and consolidate public finances", but when you actually come to do it, it is devilishly difficult. He is not a man with a high stock of political capital at the moment. One thing that is particularly interesting about France, which is in so many ways different from almost any other country, is that, increasingly, Hollande's opposition is coming from what you might want to call "the right"—that is, Marine Le Pen—but in so many ways that opposition is actually from the left. If you ask what Marine Le Pen thinks about Europe and the euro, she will say that they are the problem because they stop the French state controlling France in the way that it always has done, and that is what she wants the return of. So he is not going to be pressurised by a party wanting to get government out of the hair of the private sector—quite the opposite; it is all about retaking control.

On Italy, I do not know anything about the new Prime Minister, but I do know something about Italy. You have only to look at the number of Governments there have been and how little has been achieved over the past 10 or 15 years to be very sceptical about what Renzi can push through. As Simon Tilford rightly says, the debt numbers and the macroeconomics are pretty grim. What you would need to see for Italy is a radical reform programme lasting a number of years combined with a demand stimulus from central Europe led by Germany which would give some macroeconomic relief to Italy. I do not think that that is likely.

The Chairman: Our last questions are from Lord Dear.

Lord Dear: I think that what you are saying on the last point is that the problem in Italy is attitudinal rather than structural within government.

Roger Bootle: I think that it is both. It is a whole series of things.

Q46 Lord Dear: I was putting attitudinal slightly ahead, as the major contributor to structural reform.

I had a big question about Germany, but we have kept touching on Germany and most of it has gone. I wonder whether I could ask all three of you, really in a nutshell, to give a quick thumbnail on where Germany is and whether you think that, overall, Germany in the current debate has been a positive or a negative.

The Chairman: We have actually spoken about it, but if there is anything extra—

Roger Bootle: I will start on that, if I may. I think that there is a serious problem about the German attitude to macroeconomic issues. I do not understand quite where it comes from, but so often when I hear German policymakers or bankers talk about these questions, I feel that awful American phrase "They just don't get it" coming into my mind. They just do not get macroeconomics, it seems to me. Their approach is always, "You do the right thing, and the right thing is to do with structural reform and being very tight with your money, and not spending and saving but working hard" and so on and so forth. "If only the rest of the world could be more like us, everything would be fine". They do not understand that the rest of the world cannot be like them, because these things add up to zero in terms of surpluses. They could work harder and raise their productivity—they could do all those things—but in terms of surpluses, it simply cannot be done. This is almost the biggest obstacle in the whole eurozone. If somehow or other the Germans could get that thing right, get over that—

Lord Dear: That is attitudinal.

Roger Bootle: It is, yes.

Q47 The Chairman: In your reply, gentlemen, could you take on board Baroness Maddock's point about the pivotal importance of the Anglo-German relationship?

Simon Tilford: German attitudes to these questions are not monolithic. One of the worst things to come out of this crisis is that those in Germany—and there were plenty of them—arguing that the country's export dependence was a source of vulnerability have been sidelined and replaced by a certain hubris and a rejection of criticism from countries that the Germans largely blame for the financial crisis; that is, the US and the UK. But there are plenty within the country who are perfectly conscious that Germany is part of the problem. It was interesting yesterday to hear the German foreign ministry, now back under SPD control, saying that Germany enjoys an unfair advantage within the eurozone because of years and years of wage restraint and that it owes it to the rest of the eurozone to take aggressive steps to address this imbalance.

On the outlook for Germany, is Germany going to recover strongly? Is German demand going to pick up robustly and help alleviate many of the things that we have been talking about? Now, there is cautious optimism about this on the part of many forecasters. It needs to be borne in mind, however, that we have seen an awful lot of false dawns. Last year, the German economy managed 0.4% growth, despite the fact that many people at the beginning of the year thought that it would be closer to 1.5%. This year, it is clearly going to be rather stronger than that; it should be considerably over 1%. But there are reasons to believe that it is not going to see a period of really rapid or sustained growth, because that will require structural changes in the German economy. All we hear about in terms of the eurozone debate is the need for the peripheral countries to address their structural problems, but Germany has considerable structural problems of its own; hence, it has a massive surplus of savings over investment and domestic demand has been largely stagnant for 10, 12 or 15 years. It has very weak productivity growth and not particularly impressive overall levels of productivity. It has a service sector which is largely protected, and the service sector accounts for 60% to 65% of overall activity. If the Germans are going to get serious about stimulating more domestic demand in their economy, they will have to open up the service sector to more competition among other things. I do not think that a Government which includes the SPD are going to embrace those kinds of structural reforms. The SPD is making some quite sensible noises on fiscal policy and the need for Germany to impart some stimulus, but that is offset or negated by its opposition to reforms of the country's service sector, which would have a much bigger long-term impact on domestic demand in Germany than tweaks to fiscal policy.

Gerard Lyons: I am positive about the German economy. I am also, for that matter, very positive about the UK economy. In terms of the debate, if we accept that there was an imbalanced global economy five or six years ago before the crisis, then people talked about global imbalances being addressed by the deficit countries saving more, the surplus countries spending more and currencies adjusting. You could actually argue that Europe is a microcosm of that debate—

Lord Flight: With Germany being the China?

Gerard Lyons: Possibly, but it requires the same sort of thing: the boosting of domestic demand in Germany; deficit countries getting their house in order; and, although you cannot have currencies adjusting, you have internal currency changes through wages and competitiveness. So there is a case to argue that Germany could do more, but it is difficult to criticise Germany completely because the German economy has made a lot of painful adjustments over the past 10 years. The German economy, you could argue, is in pretty good shape.

My last point is similar to the point that Roger Bootle made earlier, which I completely agreed with, about the City of London's ability to be global. There is a global infrastructure boom the likes of which has never been seen before. Ahead of the G20 in Sydney at the weekend, there was talk of a £37 trillion infrastructure spend globally over the next 20 years or so—it was approximately that figure. Germany is incredibly well placed as a global manufacturer and exporter of capital goods to benefit from what is happening globally. The big challenge for Germany, which is why I think policy will evolve and change on the continent, is that one of its big markets is closer to home: the rest of Europe. In some respects, it is a repeat of what we saw with the Marshall Plan after the Second World War.

Lord Dear: When industrial production went up 64%.

Gerard Lyons: Yes, you need to see other countries importing for Germany to export. I say again that demand is the big issue in Europe, but Germany is still relatively well placed. We should not write it off at all.

The Chairman: We are getting close to closing the exchange. I am just going to ask Lord Marlesford to ask a supplementary.

Q48 Lord Marlesford: It is really to follow up on this question of exchange rates. Presumably, the euro is where it is because it includes Germany. If you had the eurozone without Germany, how much lower do you think the euro would be? If it would be much lower, are we actually saying that the presence of Germany in the eurozone is holding back the competitiveness of the other countries?

Gerard Lyons: I would argue two points on this. One is that you could always argue that there should be a hard euro and a soft euro, a northern euro and a southern euro, because the northern economies are very different from the southern economies, but that comes back to the whole entry criteria for the euro in the first place—the Maastricht convergence criteria—and the fact that it was not an optimal currency area. That comes back to the whole politics that we talked about earlier.

If you step back, you see that countries in Europe can compete on cost or on quality—clearly, you have to be competitive—but if we just argue that we should be producing something cheaper, we will not solve our problems. Someone somewhere will always do something cheaper than you. Devaluations help you out in near-term challenges, but they are not a longer-term economic solution. If you look at price and quality, you see that you need to be competing on quality as well as on price. I would therefore disagree with the suggestion that removing Germany would solve Europe's problems—absolutely not; I think that Germany is part of the solution to Europe's problems. In my personal economic opinion, a strong Germany is part of the solution to Europe's challenge but, for a strong Germany, Germany needs to be spending more and demand needs to be higher—which helps everyone else as well.

Simon Tilford: Even in the case of Germany, there is a strong correlation between the country's real exchange rate and demand for its goods. Even for a country that produces what we would call goods for which demand is price inelastic, there is still a strong correlation. Much of Germany's export prowess in recent years is down to the fact that its real appreciation has fallen steadily. It has competitors for what it produces in most sectors. Germany is not going to leave the euro, so the only way of making this fly is to ensure that German inflation rises, which would then bring about those adjustments. However, clearly, without Germany—this is a counterfactual—the euro would be much weaker of course because it accounts for much of it.

Q49 Lord Marlesford: Is that not a problem in the euro area as a whole?

Simon Tilford: I think that it is a big problem; this is why the German surplus is such a big problem for members of the eurozone. Quite a few German policymakers now argue that most of their surpluses with the rest of the world are not with the eurozone and, hence, it is no longer a problem. The problem with that argument is that the surplus still pushes up the real value of the euro and still prices other euro countries' firms out of non-European markets and third markets and it still increases deflationary pressures. But as Gerard Lyons says, Germany is there and it is not going to leave the euro. So the question is how to bring about adjustment in Germany.

Roger Bootle: That goes right to the point that I made earlier about the key to growth being to break up the euro. This is a very ill-assorted group of economies that have been shoved together. You have not necessarily to return to national currencies. I agree with Simon Tilford that, to keep the thing together, you need a combination of fiscal and political union and a change of macro policy in the German core. If you did that, you could envisage this thing sailing on.

If you do not get that, there is a need for some sort of radical shift. One possibility would be to split the euro into effectively north and south, with Germany being a leading member of the north. I do not think that there is much chance of Germany leaving unilaterally in current circumstances and I do not even think that there is much chance of a north-south split, but that would make pure economic sense. That goes right to this issue of politics that we have been debating from the start: that is not what this is all supposed to be about; it is supposed to be about a way of bringing deeper and profound European unity for the EU as a whole. The people who forged the Union in the first place were not thinking purely about economic matters and they still are not.

The Chairman: Colleagues, let us finish it there. We have not reached the question on banking union and banking structure—Erkki Liikanen was one of our witnesses earlier. If you have anything that you wish to tell us about that, could you be kind enough to write?

I say to Gerard Lyons that, when that piece of work is published in June, we would be very grateful for sight of it. In the mean time, we will send you a transcript of what has been exchanged today; we would ask you to correct it, improve it and add to it to help the Committee. In the mean time, it is my great pleasure to thank the three of you for coming in this morning and for affording us not just your time but your thoughts and expertise on a tricky but important subject, on which I hope we have all been illumined at least a little bit more than when we came in the room this morning. Many thanks indeed.

Sir Jon Cunliffe, Deputy Governor for Financial Stability, Bank of England—Oral evidence (QQ 50-71)

Evidence Session No. 4 *Heard in Public* *Questions 50 - 71*

TUESDAY 4 MARCH 2014

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Earl of Caithness
Lord Carter of Coles
Lord Dear
Lord Flight
Lord Kerr of Kinlochard
Baroness Maddock
Lord Vallance of Tummel

Examination of Witness

Sir Jon Cunliffe, Deputy Governor, Financial Stability, Bank of England

Q50 The Chairman: Good morning, Sir Jon, and a very warm welcome to you to this, our final examination of the euro area crisis. You have come today and you are going to talk about many other things which Sub-Committee A is interested in. We note that you are speaking during the MPC purdah and, given that the MPC's policy meeting is due to start tomorrow, I understand that you will not be able to discuss matters relating to the UK economic outlook, which will restrict the answers that you can provide to us on the economic environment and outlook in Europe, the UK's largest trading partner. I am sure that we will have the same interesting engagement that we have had in the past in this Committee. I just remind you that we are being webcast and, as you know, we make a note of these exchanges, which we will send to you. We will ask you to mark it out of 10 and improve it, if you can, if you have any further thoughts about how we might eventually write our letter to the Government about the issues developing, which we hope to talk about today. Many thanks indeed for coming. Unless you want to make any comment or opening statement, could I ask you when we will recognise that the euro area crisis has finished and faded, or are we always going to be given that there will be mini-crises and changes on the way and that adaptability will be the name of the game henceforth?

Sir Jon Cunliffe: I think historians will argue for many years, as with the Great Depression, when the crisis started and when it finished. It depends a little on how you want to define the crisis. I would characterise the crisis as having two phases. There is a crisis around individual countries where a number of members of the eurozone got themselves into a weak and vulnerable position before the financial crisis, which was partly exacerbated by the single currency. Then when the stress hit them in 2010-11, they did not have complete freedom of action because they were members of the eurozone, although they perhaps had more support because they were members of the eurozone. That is still playing through. It has changed from a financial crisis to an economic crisis. That is one stream.

The other element I would distinguish is a crisis of the single currency as a whole. That emerged with the fear of break-up risk, which came a bit later and was not unconnected to the reaction to the crisis around the individual countries, probably around 2011-12. It had not surfaced in the markets and was pretty much unthinkable beforehand, but it started to become something that people talked about openly as a response: that countries might leave the euro. That risk I call the redenomination risk: that some countries might leave the single currency and redenominate into a national currency. The fear of that gained currency through 2011-12. That is a rather different aspect of the crisis.

Mario Draghi's statement in July 2012 that the central bank would do what it takes and it would be enough made a huge difference to that aspect. If we characterise the crisis as a crisis of confidence in whether the single currency will hold together, which I think it was by that point, I would say that that has diminished materially. You cannot completely put that genie back into the bottle. People had not really thought about break-up beforehand, except as a theoretical possibility. I think the markets have learnt that it is a possibility. People still ask whether Germany should leave the euro and whether we should have a north/south divide. But as far as market behaviour and perception are concerned, I think we are well past the point of that existential fear around break-up, due in most part to the ECB and Draghi's statement. So if I think about whether the crisis has receded and whether I would still call it a crisis, I would say that that part of it has receded, and it does not feel to me as though we are still in financial crisis-type mode.

Have the problems of the individual countries that underlay this gone away? No. Their economic performance has improved materially, more for some than for others. There are still very high levels of unemployment in a number of periphery countries. There are high stocks of debt, and a lot of the adjustment process has not happened. Does that leave us vulnerable to going back to where we were? In theory, yes. How vulnerable are we? If you had asked me in October, I would have said that one can always see political events that might take us back into crisis. To me, the position looks much better than it did in October.

If I put all that together and ask whether we are out of it, I would say that we are still going through a very serious hard and grinding economic adjustment in a number of euro countries. That can throw up all sorts of other risks. Some of the material imbalances in those countries have not been dealt with. You could argue that in the UK we are some years after the financial crisis and we are still dealing with some of the imbalances in our public finances. This takes a long time, but we are not in the edge-of-the-cliff world that we were in up to, say, 2012.

The Chairman: Lord Kerr identifies a potential hiccup.

Q51 Lord Kerr of Kinlochard: I was going to ask about hiatus risk this summer, Sir Jon. I know that you as a central banker will play down any future risks, but this is the summer of no European Parliament for two or three months and then a European Parliament obsessed with its appointments, a Council already obsessed with its appointments, and no new Commission until November. Is there a risk that if there were a return to drama and the need for instant action we would be a bit disarmed this summer?

Sir Jon Cunliffe: If we went back into the sort of crisis and need for crisis action that we saw in the middle of 2011-12, at the moment the Commission is pretty distracted. We are in the end period, and at that point if it happened in the summer we would have no Commission. So yes, it would be more difficult to deal with it in those circumstances. To my mind the question is how likely we are to go back into that world. It does not look very likely to me. Anyone could identify potential risks, mainly political but political driving through to economic, that could put us back there. I do not see it at the moment as a risk on the horizon, but we could go back there, yes.

Q52 Baroness Maddock: Sir Jon, good morning. You mentioned in your opening comments that many countries were in a weak and vulnerable position. Can you tell us in fairly general terms, given the problems that we had with where you are at this moment in your career, what is needed to ensure that there are healthy economies and healthy growth and prosperity for citizens?

Sir Jon Cunliffe: In the eurozone?

Baroness Maddock: In general if you want. We are talking about the eurozone.

Sir Jon Cunliffe: It may be best if I relate back to the past in the eurozone. First, I would say that it was not only eurozone countries that got into trouble in the economic crisis. The UK, the US and a number of other countries such as Switzerland were stressed by financial crises but also had economic imbalances that built up and corrected very painfully. In general, healthy, long-term sustainable growth comes from the supply side of the economy, so you need ultimately to be using your labour force productively and investing in capital, and you need to make capital and labour technological advances come together to increase growth. In the short term you can do things on the demand side by stimulating demand through fiscal or monetary policy, but in the long term growth in the economy comes from the productive use of that economy's resources. That requires macroeconomic stability as far as possible, so that the economy is not going from one extreme to another. It also requires financial stability. We have just had a fairly graphic example of how much financial stability can derail the productive use of resources in the economy—just look at the UK.

In the longer term, though, it is about how productively and how well the economy uses the resources that it has and the amount of innovation in that economy. If I take that high-level view and put it back to the euro crisis in the euro countries, I think a number of countries in the euro allowed imbalances to build up through either public sector debt or private sector debt. They allowed their economies to take advantage of the low interest rates and the ability to borrow that they got from being a member of the euro, but rather than investing that in productive capacity and structural reform to make their economies flexible and best able to use the resources, the money went into housing booms, consumer booms and the like, and the public sector was able to borrow more easily than it would otherwise have been able and fiscal deficits were therefore cheaper to run. But the underlying problems were similar to the ones that you saw in non-euro countries. To put that right requires structural reform in a number of eurozone countries. The periphery countries have made quite strong adjustments to varying degrees, but they need to go further. A single currency can be a hard task master, because you do not have the exchange rate to help you cushion your readjustment and competitiveness. You have to do it through real prices, which is a fancy economist's way of saying that wages have to come down, and very often that means that unemployment has to go up. The adjustment that is going through is a hard adjustment mechanism in a single currency, but that structural reform has to continue and to be carried through. Then they need macroeconomic stability to grow.

I would make one other point about the eurozone. Inside a single currency, it is easier for those imbalances to build up because the natural adjustments of exchange rates do not happen. It is much easier for financial flows to go from one part of the eurozone to another because they are in the same currency and the exchange rate does not adjust. Normally, all other things being equal, a lack of competitiveness leads to a weakening exchange rate et cetera, but in this situation that does not happen. In the long term, it is not very good for a country to be continually catching up on competitiveness by a weakening exchange rate. We had experience of repeated depreciations in the UK in the 1960s and 1970s, and the Italians and the Spanish wanted to get away from that. I am not suggesting a system in which one part of the eurozone is always less competitive than another or that just adjusting by devaluing is a good way of dealing with it. None the less, the exchange rate provides an adjustment mechanism that was not there before. These countries were able to attract capital and misallocate it within the economies to a greater extent than they would otherwise have been able to, and of course when the correction came it was more difficult because they did not have the ability to deal with that. The eurozone has to think about how it balances demand and avoids imbalances building up in the future if we are not to see a repetition, because within a single currency you need to have adjustment mechanisms that counteract some of the pressures that brought the crisis.

The Chairman: Sir Jon, we are not at all deaf to what you say, but some of us forgot our ear trumpets this morning.

Sir Jon Cunliffe: Okay, I will speak up.

The Chairman: Lord Dear, you wanted to come in.

Q53 Lord Dear: Only to take up the Lord Chairman's point. I did not quite pick up everything you said about the exchange rate. Correct me if I am wrong, but I am getting the picture that you are arguing that there is some sort of case for a variable exchange rate rather than a fixed exchange rate. I know there is an argument both ways, of course, and we are where we are.

Sir Jon Cunliffe: It is not an argument for or against. First, exchange rates do not disappear because you have a single currency. Real exchange rates continue. It is only the nominal exchange rate adjustment that goes. I am saying that with flexible exchange rates you are able to adjust to changes in competitiveness through the exchange rate before a crisis and afterwards, and there would have been higher costs to the borrowing and the capital flows that some euro countries were able to have. You could put the argument the other way and say that the periphery countries got the benefit of a much lower interest rate and access to capital they would not have had and to trade flows that are not subject to currency restrictions, but did not use that period well. When the crisis comes, flexible exchange rates make the adjustment less painful. I am not saying that one is good or one is bad. I am saying that the single currency comes with some pluses, but it can be a hard task master if you are not a flexible economy and have to adjust. And that is what we have seen.

Q54 Lord Flight: Just very quickly, in terms of the crisis being over, the issue of access to capital is surely not repaired in that intra-eurozone lending is still extremely cautious and limited and the Bundesbank via the targets system is still majorly financing other central banks to support their banking systems.

Sir Jon Cunliffe: I think that it is better now than it was. There is more evidence of lending between banks in different eurozone member states than there was six months ago. It is still not back to where it was. Cross-border lending within the eurozone to the real economy is still very low, so I would say that we have not gone back and the financial system is to some extent still fragmented. My guess is that some of that will change with time, but some of it may not come back, simply because banks learnt a lesson about risk and the mispricing of risk, and they will be more careful in the future.

Q55 Lord Vallance of Tummel: Sir Jon, can we invite you to rate the performance of various eurozone players over the crisis period, perhaps starting with the ECB? You implied that Mario Draghi had had a good crisis so far, but does he have the tools to do the job and what should his priorities be for the next year?

Sir Jon Cunliffe: First, I would say that the crisis tested all the central banks, both in economic and financial support terms—I was not a central banker during that period, but I observed it happening—and made them think off piste about new policies and things that had not been done before, both on financial and monetary sides. The test was pretty great for all the central banks. The second preliminary point I would make is that it is more difficult for the ECB. The ECB has to balance the component parts within it. The constituent members of the ECB have in some areas very different views about what central banks should do. While the Bank of England, like the Fed in the United States, has different views within it—you want a diversity of views for the policy debate—none the less it is still a unitary institution, reflecting the needs of the United Kingdom. The ECB has a more complicated job to do, and it does not really sit under any political authority or any Parliament. We could discuss whether it sits under the European Parliament, but the job is much more complex.

If we go back to the point that I was making earlier on about redenomination risk, which to me was the biggest danger, I think that the ECB under Mario Draghi has done a very good job. Prior to that point, a number of people were calling for something to underpin the euro, something to say to the markets, "This currency is a currency and will continue to be a currency". It could only really have been two things: either the countries, the member states, saying, "We accept unlimited liability for each other", which in political terms would have been quite difficult, or the central bank saying—the eurozone has only one formal institution of its own, which is the central bank—"We will do what it takes". I think that the first attempt with the LTROs was in December 2011, and then the "do what it takes" speech in July 2012—Draghi arrived in the autumn of 2011—both of which were an excellent response and have had a major impact.

In terms of the monetary policy which the central bank has been following, I think that it has tried as far as possible to meet the demands of the crisis. It has been more difficult for it because there are different views within the ECB about what the crisis requires. Even though in the UK when the Bank of England takes decisions they have distributional consequence and have different consequences in different parts of the country—we may have to take a decision to loosen or tighten monetary policy that will suit some parts of the country more than others—you do not get to the same extent a debate happening about how one side of the country is being sacrificed for another, whereas within the eurozone member states you do get that, so I think that it has been more difficult for them. They have kept interest rates very low; they have undertaken some bond purchases; Draghi has instituted forward guidance to try to guide them through the system to where they are going. I would say that on the economics side it has been a good job in the circumstances and given the constraints that it is under.

The last question is whether it has provided liquidity and support to the financial sectors through the crisis. Yes, it has: it has made huge amounts of liquidity available, often to severe criticism in some of its constituent member states. The one point I would make is that, prior to that "do what it takes" speech, one wonders whether it would have been possible to prevent the kind of redenomination genie getting out of the bottle had there been an earlier, firmer statement before 2012 about the ECB underpinning the crisis, which might have reduced some of the costs in the long run.

The Chairman: Sir Jon, your voice is getting a bit low again.

Sir Jon Cunliffe: I will speak up.

Q56 Lord Vallance of Tummel: Coming to the second leg of the responsibilities of the ECB, the supervisory side, in our recent report on genuine economic and monetary union we thought that it might find it quite a difficult balancing act in the forthcoming comprehensive assessment of the banks to do a really rigorous review of assets and so forth without scaring the horses in the financial markets. Do you think that it is well poised to do that properly?

Sir Jon Cunliffe: It has a huge incentive to do it properly, because it is taking these banks on. One of the risks for central banks in taking on supervision is that if it goes wrong afterwards it damages reputation, and reputation is part of the central bank's set of instruments for monetary policy and general management. One of the reasons why the Bundesbank opposed taking on supervisory responsibility back in the late 1980s and 1990s was precisely that it thought that it should not have this reputational risk. It is better that the ECB has that now in the circumstances, but it is taking on a reputational risk. It is therefore in its interest to make sure that it inherits these banks in the cleanest, most robust state. To me, the incentives for a rigorous stress test and quality review are much stronger than they were in the previous iterations of this, when it was the responsibility of the national supervisors. That said, the history of stress testing within the eurozone/European Union has not been particularly strong. It is important that this exercise is credible. It is an exercise for all of us because we are doing it under the European Banking Authority, but it is particularly important as the entry gate to the banking union and the single supervisor. It is very important that, around the scenario, the methodology and the metrics that have been used, there is transparency, so that people in the market can see how it is being done and can run their own models with the numbers and there is credibility.

Q57 Lord Vallance of Tummel: Can we just touch on the other key players in the crisis: the Commission, the Council and the Parliament? And, perhaps, how has the troika done?

Sir Jon Cunliffe: Let me start with the Council and maybe the Eurogroup, because a lot of this was done by the Eurogroup Ministers and the Eurogroup leaders—and rightly so, because they were paying the cost of the crisis; it was theirs to manage. The euro did not put in place any political machinery for integration. The blueprint for the euro was that you could have monetary union, with monetary integration and an institution called the ECB. You did not require a counterpart political authority. So when the crisis hit there was no machinery on the political side for reaching a consensus about what needed to be done. When the US had a crisis, the Bush Administration had to decide what to do and then had to get it through Congress on separation of powers. That machinery worked quite slowly and with great difficulty, but there was an institutional framework there. That institutional framework just did not exist for the euro. If I look at the leadership at Council level, I think that it was very difficult for it to manage a crisis. The Eurogroup of leaders did not exist formally; it has no voting rules or rules of procedure, yet you have to make distributional decisions about who adjusts and who pays. The European Union is used to a long and complicated process of compromise and finding consensus which is pretty effective, but not when you only have a weekend. If I look at the political institutions around the euro, I do not think that they did very well because they were not there. One of the challenges for the euro members going forward is how they provide for a necessary level of political integration without creating a federal state, because I do not think that they want to create a federal state. I mark the political side of this as having been pretty difficult, simply because the institutions were not there.

The European Parliament did not play a role in the crisis really. It goes back to my point about where the political accountability and the political machinery are. As there is no political machinery at euro level, there is no parliamentary level of accountability either. A lot of this was done at national level and therefore the accountability was to national Parliaments. The European Parliament played a role in the financial regulatory reform programme, but that was more generally to do with financial crisis rather than the eurozone crisis. The Commission, I think, found it very difficult to play a role in crisis management for the euro as a whole—I go back to this break-up risk et cetera. It did not have the tools or the instruments to do that.

As far as the individual countries are concerned and the troika and the like, the early programmes were quite patchy. The IMF normally finds that its adjustment programmes do not work first time. The history of adjustment programmes for countries in crisis is often one of a programme, there is slippage and there is negotiation, so we should not assume that adjustment programmes for countries in crises are science and the IMF gets it right and the eurozone gets it wrong. It is a messy process, and you have to make assumptions about future economic performance. It normally disappoints—rarely do countries do a lot better than the IMF thinks they are going to do—and then the programme has to be adjusted. As I say, it can go on for a number of years.

That is complicated greatly in the euro crisis by the fact that in the euro crisis you did not have the normal sets of actors. Some of the actors were groups of actors that then had to co-ordinate their position. The early programmes and the early workings of the troika were quite difficult. Mistakes were made. The IMF's review of Greece makes it clear that it materially underestimated Greece's ability to grow and to service its debt. The haircut was delayed until much of the debt was in the hands of officialdom—holders which made it much more difficult. Cyprus is an example of just how difficult that machinery finds it to take decisions in crisis. The troika programmes in Ireland and Spain have been a lot more successful—Portugal is somewhere in between—but the fact that one is dealing with a single currency adds a level of complexity which we do not normally see, so the challenge is greater.

I will give you an example. If the IMF were doing a programme with a country, normally the Government, the finance ministry and the central bank would be on one side of the table and the IMF would be on the other. There would be a negotiation about what adjustment a country could make et cetera. In the eurozone crisis, the central bank was on the same side of the table as the IMF, negotiating with a country that was its own member but also negotiating on behalf of the other members of the eurozone. The Commission was negotiating as representative to some extent of the other members of the eurozone or the EU as a whole. Much of the support was coming from the eurozone members, and that had to go through its own governance procedures. It may have looked a bit clunky compared to how you would normally see one of these adjustment programmes happen, but the complexity of the challenge was very different.

Q58 Lord Vallance of Tummel: What you said begs the question whether the IMF should have been there in the first place, but, looking to the future, if there were another crisis, would there be a role for the IMF or should the eurozone not be able to do its own thing now?

Sir Jon Cunliffe: I think the IMF was there primarily because Berlin insisted that it wanted the IMF there, and it wanted the IMF there for two reasons. One was because it did not think the Commission had the crisis management expertise—the expertise in adjustment programmes. My guess is that if you ask the Commission, it would agree that it did not. The management of a crisis in that sense is not a role that the Commission had taken on before. The other reason why Berlin wanted the IMF there was that it wanted an independent check, if you like, on the Commission and the other players in the system, because there was not full trust, particularly after the first Greek programme, that the numbers were as robust as they might have been. I actually think that the IMF introduced tension to bring it in, and I know that many in Brussels would have preferred not to. Some said they saw it as a sign of weakness that the IMF had had to come in. I do not see it that way. I think that when it comes to this sort of adjustment programme for countries that have experienced crisis, much of the expertise and technology is in the IMF because that is where the international community has put it, and that is where the experience lies. Bringing in the IMF probably made the programmes better and more robust. That would be my guess, but I was not inside the troika and clearly there was strength between the various players. It is quite difficult to manage that sort of thing by committee.

Q59 Earl of Caithness: Sir Jon, given your recent work in Brussels, could you enlighten us a little more about the Eurogroup? There is huge demand from some quarters that the Eurogroup should become the Eurocommunity and a much more political animal. Do you think there is any support for these ideas, which have been floated by such groups as Eiffel Europe?

Sir Jon Cunliffe: I saw that, yes.

The Chairman: Could I just add to Lord Caithness's question? What should the UK do vis-à-vis the Eurogroup? When we asked the Economic Secretary, she said, "We have regular meetings with Mr Dijsselbloem", not individually but at various European meetings. Should the UK develop a separate dialogue with the Eurogroup?

Sir Jon Cunliffe: I will take the questions in order. I have read some reports of the Eiffel group plan and I know some of the characters on it—Sylvie Goulard and some of the others. It seems to me to be a plan for a federal euro area. I think that is highly logical. Some of the things you need to run single currencies are best done at federal level, and I can see why some people want it. Do I think there is an appetite for it? No. I do not see it flying. What I see through the euro crisis is countries finding it difficult to persuade their populations that we have to accept collective discipline or we have to accept collective support. Politically they find that very difficult. On the collective discipline side, many in France do not like the idea of the Commission having the ability to comment on the French budget, or some of the rule changes that have given the Commission much more authority and power in the system. On the collective support side, the Netherlands and Finland do not like the idea of transfer union et cetera.

Do I think it is a possible direction of travel for the euro? Yes. Do I think it is likely? No. I could be wrong, and maybe people will think about it and say that it is the only way to go, but the way I look at the politics in Europe and the way people have responded to the crisis, I do not think that is going to happen. That said, I do think it is necessary for the countries of the euro to advance further along the dimensions of economic, financial and political integration.

Lord Chairman, you asked me whether the crisis is over or whether we will see future mini-crises. To be sustainable, the euro has to go further than the original blueprint went. The real issue now is how much further it is possible to go politically, given the systems and how much further it is necessary to go. As for what the Eiffel group proposes, I do not think so. I cannot see the support for that.

As to what the UK's role should be, if you start from the position that the euro area needs to integrate further on these axes to become more sustainable, we do not know how far it will go. It is a judgment, not a scientific fact, as to how far it needs to go. I think there are judgments in there. From the UK's point of view, we should not stand in the way of it. Indeed, given the cost of the euro crisis and the risks to us, which have been pretty amply demonstrated, we should try to help to facilitate. That is my starting point in this: that we should not be a barrier, and to the extent that we can help we should help to put the currency on a strong footing, recognising that the choices are for the eurozone countries. It is quite difficult when you are outside the club to make helpful suggestions about what the club might do. We should also recognise that there are real political difficulties for those countries and we should not assume them away because in economic theory they should act in a certain way. What they do has to be practicable in those circumstances.

There is one other thing that we need to do. We need to ensure that while that integration happens it does not damage or jeopardise the community of 28 and the single market and that we do not suddenly discover that the EU has collapsed into the eurozone to all intents and purposes. That is to do with maintaining the machinery of the EU of 28 in changing circumstances. We have had some examples of that. It is also to do with being engaged in the single market and in the other parts of the EU.

How should we do that? What role should we have? Some member states think that the best way to do this is to ensure that everything is done at 28 but that there is a subset for 18, or whatever, and therefore that the meetings of the Eurogroup should involve everybody. I just do not think that is practical. When you go through some of the searing decisions that the Eurogroup countries had to make, you really have to have the people in the room who are bearing the cost. I do not think that allowing those institutions to form is the right way.

I think we can do a number of things. We have contacts with them. We can try to make sure that when the Eurogroup meets it meets in the context of other meetings of the EU, so that it meets either before a ministerial meeting or immediately afterwards so that you can bring the two things together. I think we can offer technical advice. We did that in the case of the banking union. We put in two major pieces of technical advice at the early stage in June 2012, just as it surfaced, and we were able to do that because we had just had a huge overhaul of financial regulation in the UK, so we have probably thought more about how you do supervision than have most of the other countries. Somebody in the eurozone told me that the best technical papers they read were there, and as we have no skin in the game to some extent people actually rang up and asked, "How do you do this in the UK, because at least we know that what we get from you is not directional in the way it might be from some of the other players?" But you have to be careful that you do not lecture.

The Chairman: But it can come under the rubric, surely, of it being in the UK's own interest, as well as the European Union's interest, that we offer our expertise in financial matters on such a question.

Sir Jon Cunliffe: But you have to offer it quite carefully, and if it is not wanted you have to stand back and say, "That's fine. It is for you to do with as you want". One cannot expect, and should not expect, to be part of the decision-making machinery and processes to build this integration. One can expect to be part of the processes that decide how it is nested within the European Union of 28. We have a right to expect that, we are members, but one should not expect to be part of the internal decision-making processes in the same way as a euro member is because we are not a member of the euro.

Q60 The Chairman: Just before I go to Viscount Brookeborough, I will elaborate on a couple of points that you made in response to Lord Vallance. Other witnesses that we have had—Erkki Liikanen, your colleague in Finland, and Mario Monti—thought that the European Parliament had played a responsible role. Of course, they are developing an accountability role with Mario Draghi, and we ourselves interviewed Dr Constâncio when we were doing our EU banking union report. There has also been a feeling on the part of some of our witnesses that the Commission has to some degree lost out to the Council in influence.

Sir Jon Cunliffe: I might have missed it, but I do not recall the Parliament really being involved in the crisis management decisions. Many of the key crisis management decisions were about money. Money is controlled by national parliaments, and the EFSF and the ESM are outside the EU machinery because in order to get authority for that money the member states of the euro had to go to their national parliaments to get it, and the national parliaments were not prepared to put it into Europe. When we think about the crisis, there has been a lot on the common support side, such as no bailout under Article 125 of the treaty. They have come a long way in creating a mutual lending facility called the ESM—they started with one called the EFSF and it has now mutated. They have come much further than you would have expected. If you had asked anyone in 2005, they would have said that no bailout was impossible. It has been done outside the treaty, and it has been done outside the treaty for that reason: because it is national parliaments that provide the money. Once it is national parliaments that provide the money, you come to the conditionality and what I call the security behind your lending: if you lend large amounts of money to a eurozone country, it is national parliaments you have to satisfy, which is why Berlin had to keep going back to the Bundestag for agreement. That, to my mind, is just a product of the system. There is no eurozone fiscal authority, and when you get into this sort of crisis you cannot go to the European Parliament and ask for money for an adjustment programme et cetera. That is why, in the end, the Parliament did not have much of a role in the crisis decisions.

The Chairman: It may be that part of its exercise of responsibility was that it did not show umbrage.

Sir Jon Cunliffe: That is possible, although a number of them were pretty dismayed that the financing vehicles that have been provided, which were a key part of the response, were outside the EU. There was a lot of criticism. The idea that the Commission had given up power to the Council by allowing these things to happen outside the treaty came from the European Parliament and quite loudly, as I recall. It is to my mind a misreading. I do not think it is a question of the Commission losing power to the Council as an EU institution. The Council as an EU institution did not decide money. I think the Commission lost power and was not able to have the influence that national Governments and national parliaments in the eurozone were able to have because this was about hundreds of billions of euros, and that sort of thing is controlled by national parliaments in the EU. You could argue, as the Eiffel group might, that you need a fiscal capacity of hundreds of billions of euros at the Euro level, but then you would have to say, "Do we provide it through tax, and where does that take us in fiscal federalism?"

Q61 Viscount Brookeborough: Sir Jon, you have already talked about Germany's role in bringing the IMF into the crisis. How significant do you think the German position is, and continues to be, in determining the course of the response? Would you also like to comment on positive and any negative influences, and where we go from here or where you expect Germany to go?

Sir Jon Cunliffe: Germany is the largest of what I call the creditor countries. There are other countries which share the same position as Germany, but, in that sense, it had a hugely important role to play in the crisis. If Berlin had not stood behind the euro, I think that the euro would have been over. There came a point, again in 2011-12, where a number of people in Germany were saying, "Can we let Greece go?" If you remember, there were some people who said, "We can't, because of dominoes. If we let Greece go, the whole euro area falls apart". I heard in Berlin the balloon theory: that the balloon can get over the mountain only if we throw somebody out. That discussion went on for about a year, but, in the end, the German Government and Mrs Merkel were very clear that they were not going to have anybody leave the euro unless that country wanted to. That was enormously important in the crisis. So my first point would be that I think that Germany stood behind the euro. It may not have stood behind it to the extent of being prepared to guarantee the debts of other countries, which would have been politically difficult, but in the end it did stand behind it and that was instrumental in getting to where we got to. Does that give the creditor countries a lot of power and influence in this? Yes. But the nature of crises where countries need external help is that the people providing the external help have a lot of authority and influence in the system. The markets looked to the ECB and Germany to, if you like, reassure them, which is just the nature of this sort of thing, and that has given the Germans an awful lot of authority. Have they used it wisely? You can think of instances where a quicker, cleaner response would have been better, where we have had uncertainty about what could happen because of the Bundestag having to vote. You can think how the Constitutional Court has got involved. You could also say that maybe the economic prescription in some countries was too tilted towards austerity initially because that was necessary for some of the creditor countries. I think that there is some of that, but I put it within the context that what Berlin had to do it had to do within its own politics and it had to get support from its own parliament and people to do it, which was not easy.

Viscount Brookeborough: What about the north/south divide and could Germany do more in the future?

Sir Jon Cunliffe: I think that the eurozone needs better adjustment mechanisms than it has. In single currency areas, you get crises, but you need either refined ways of using fiscal support or ways of using other forms of support to get through them. I would not call it north/south, because theoretically you could envisage it being a different group of countries, and Ireland is not in the south. In a single currency, you do not have the same ability to use your currency, to use your interest rate and, if necessary, to write down debt, because the debt is in a currency that everybody owns. You need internal mechanisms to allow adjustment and I think that the eurozone needs to develop those. If that means Germany helping or being able to help the adjustment, then that is part of it.

Viscount Brookeborough: Is that your definition of crisis? Do you believe that that is a crisis, or a crisis that may come about with some of these countries and that it is something that will simply go on and we will bumble through it?

Sir Jon Cunliffe: Crises will come. Unfortunately, it is a fact that you cannot avoid economic crises. You do not know when, and the eurozone was hit fairly early in its life with the biggest crisis for 70 years. Arguably, it could have gone another 70 years before being hit by something like this. You have to make sure that you are resilient and can deal with them when they do come along. To be sure of that, the eurozone needs to manage some of what I call its internal support mechanisms better than it does at the moment.

The Chairman: Before I bring in Lord Carter, Lord Kerr.

Q62 Lord Kerr of Kinlochard: Just a footnote on the Karlsruhe court OMT decision. I must admit that I did not expect at all what it did, referring it to the ECJ. Mark our card. Is that the end of that as an issue? The ECJ will take some time and will presumably find all this in order, or should we look at the other bits of the judgment where some pretty negative things are said by the court. How should we read it?

Sir Jon Cunliffe: The answer to that is that I am not expert in German constitutional law and the Karlsruhe court. I shall say two things, one specific and one general. The specific thing is how I read that judgment, which is that the court has given its majority opinion, but has said, "But this is an issue for the ECJ to give us a view and when the ECJ has given us a view we will take a final view". So it has not said, "ECJ, take a view and we accept it"; it has said, "ECJ, take a view and come back to us". It has also hinted at some of the areas that it finds most difficult, so I do not know how the ECJ will pick up those hints or whether it will. But the whole thing is now in a one-year to two-year timeframe. The ECJ will come back, but there will need to be another stage, as I read the judgment, where the Karlsruhe court says, "This is what we think". I do not think that the Karlsruhe court has said, "We give up our right to comment after the ECJ". So the story is not over, but the next chapter may take a couple of years to write. The general point that I would make is that there is quite a long history of the Karlsruhe court and the ECJ being at a tension and not quite challenging each other but getting close. This is not just on the euro; this has happened on a number of issues. The Karlsruhe court is very jealous, in the true sense of that word, of its role on the German constitution. So there is a longer history of these things and this sort of challenge. But how this one will play out, I do not know.

Q63 Lord Vallance of Tummel: You mentioned the need to develop further internal support mechanisms, but it is not going to be a transfer union. Could you tell us a little bit more about what the nature of those mechanisms might be?

Sir Jon Cunliffe: Well, a lot of different things could be done on the fiscal side, through a central eurozone budget. There has been talk of that; it has not been defined. Some see it as a large enough facility to allow fiscal policy to be used to smooth the adjustment; others see it as much more limited. There is mutualisation of the debt— Eurobonds, Eurobills et cetera. There has been talk about unemployment and eurozone unemployment schemes. There is using the ESM for direct recap of the banking system et cetera. There are a number of areas there. There is one other mechanism, which is trying to stop some of these imbalances occurring in the first place.

Lord Vallance of Tummel: Demand management.

Sir Jon Cunliffe: Well, I think that it is structural reform actually. It is ensuring that you do not have within the eurozone countries that are completely focused on the external sector. It is demand; it is rotation of demand rather than demand management. That is more structural than anything else. If you had a more balanced pattern of demand within the eurozone, you would not see some of these imbalances grow up. The alternative, which other people say, is that everybody should be as competitive externally as Germany, but then the rest of the world watch out. That would stop some of these problems. That is what I meant before when I said that one thing they will have to think about is having a conversation about demand management to avoid these problems coming up in future. I do not know how far they will able to go politically, but I think that that is the next chapter. I do not think that it will happen until after the European elections.

Q64 Lord Carter of Coles: Sir Jon, perhaps I could take us to the eurozone and the UK. How does the Bank of England view regulatory developments in the eurozone? Given your comments about the outside-the-club position that you are in, how much influence can we have and could we improve that influence in any way?

Sir Jon Cunliffe: It depends on what you mean by "regulatory developments". Our view is that an awful lot of financial regulation and rules for the system are set for the single market. It is a necessary adjunct of a single market that you have common rules, which is true not just in the financial sector. For the single market to continue at 28, those rules need to be set by all the members of the EU. Some of the members might want to do the setting through the ECB as their representative because they are in a single supervisory mechanism; others not. But the rules, the regulatory developments if we are talking about rule-setting, have to remain for all 28 to do together in one form or other. It has got to be a process. If 18 of the 28 are voting with one voice, that has to be recognised in the processes, which is why the voting changes in the EBA were quite important. I was involved in the negotiation of that in a former life. I do not think that anybody objected or queried the principle that, if 18 members with an automatic qualified majority come and speak as one and co-ordinate their position beforehand, somehow the voting rules have to reflect that. There was a long argument about the best way to do it and where the balance should be struck, but the principle was not questioned. I see regulatory developments in the EU as remaining in that way.

If by regulatory developments you mean the establishment of the banking union, the single supervisory mechanism, the single resolution mechanism, the single resolution fund—this area is acronym-rich, I am afraid—I think that it is a good thing. I think that countries that share a currency are tied together in sharing risk in a way that countries that share a market are not. We can see in the eurozone crisis the role of the central bank in supporting the banking system. The central bank is owned by all the euro members and it has to be able to operate freely, which means that it is risk sharing to an extent. You could say that the ECB has lent a huge amount of money to banks in the periphery countries. If that were to go wrong, the whole of the eurozone would be on the hook for that money. They share a currency, so if you let break-up risk out of the bottle—the genie out of the bottle—that affects all the members of the eurozone. They share contagion because it is the same currency. One of the great fears on default is that if you had had default on Eurobonds and government bonds in Greece then people would have expected the same thing to happen in Portugal and elsewhere. So the single currency ties those countries together more closely. A single supervisory mechanism that can have common standards and give members assurance that it is being managed properly, and that country A is not being asked to pick up the burden or the risk of a badly managed system in country B, is very important. The same goes for a single resolution mechanism, because one of the hardest things that you have to do is to resolve a cross-border bank, and within the eurozone, again, the risk is shared.

A single resolution fund will be a good idea. It will be 10 years before it is built, and it has to be built from industry money, but those strike me as developments that go in the right direction to put the currency on a more sustainable footing. From a UK point of view, we should support that and we have supported that—the Bank of England supports all those three. We should encourage it to be as practical and effective as possible, bearing in mind that there are political difficulties—we are going to have to recognise that. Then I come back to the earlier point about making sure that that development does not swallow the single market.

Lord Carter of Coles: That is the question. It is the tension between the 18 and the 28. What would the rub points be in that?

Sir Jon Cunliffe: I do not think that there necessarily has to be a tension, any more than there has to be a tension between the different policies on supervision and regulation between France and Germany or between Germany and the UK. I think it will become more complicated, partly because they will have to resolve differences within the single supervisory mechanism. Just building that is quite a complex task. We have to make sure that it does not happen that these things are built but it has been so painful to build consensus inside the single supervisory mechanism that the last thing you can do is open it up again for others. That was one of the reasons for the changes. One has to work to avoid tensions. Occasionally there will be things that rub, but it is not axiomatic to me that those are problems that cannot be solved if everybody wants to solve them.

Q65 Lord Kerr of Kinlochard: How does the relationship between the Bank and the ECB work? It seemed to me in the early days that there was a fair amount of disdain from the Old Lady towards the Duisenberg bank. I think that has completely gone. The last Governor but one rather reduced the staffing of the Bank in that EU area. I hope that has been changed. You, of course, are personally extremely well placed for this. How does it work, and do you have sufficient of a team working with you on all this? When you were doing EU stuff in the Treasury and I was doing UKREP, there was a very fine team in the Bank, which provided me with all the ideas I ever had, except the ones I got from you in the Treasury.

Sir Jon Cunliffe: I will not ask you which you preferred.

Lord Kerr of Kinlochard: That team got massacred, really, in the late 1990s. Is it rebuilt? Do you have sufficient of a team? The Treasury has thinned out your old patch a bit, and I would hope that quite a lot of the ideas and the actual liaison are handled by the Bank.

Sir Jon Cunliffe: I will start with a forward-looking piece, if I might, rather than a backward-looking one. There have been two really significant developments that have changed the nature of the Bank of England's relationship with the ECB and vice versa: one is the bringing of supervision into the Bank; the other is the bringing of supervision into the ECB. Prior to last year, neither of those things had happened. The Bank of England's relationship historically with the ECB was around monetary policy and macromanagement. My impression, watching it from the outside in those days but also afterwards, was that that was quite a good relationship. As we went through the crisis, the central banks, as I said earlier, had to do things that they thought happened only in history books. There was a lot of contact between experts in different central banks on how to manage things. So I think there are good contacts on the macroeconomic, monetary policy side. This is not something that either under the EU treaty or internationally you do communally: witness what is being said about US monetary policy now. It is normally set nationally but in an international context. The central banks worked pretty well together during the crisis through swap lines and the like, and that was certainly true for the ECB.

The Bank of England also had a financial stability role, but that was quite attenuated after the 1997 changes, and it had no policy levers. It was more a role of commenting. I was involved in that system. The ECB had a financial stability role, but, again, financial stability before the crisis was not really done with much energy anywhere in the systems. That might be one of the reasons why the crisis developed the way it did. So I do not think that the past relationship really tells you that much about the future challenge. For the future, there are two areas where the Bank and the ECB need to work very closely together. One is financial stability and macroprudential, and the establishment of the ESRB—the European Systemic Risk Board—and the banks' role as governors and vice-chairmen, with Draghi as chairman. The banks put a lot of effort into that and it is very important for us and the ECB, particularly when it takes on this new role and has macroprudential instruments for the SSM, that we stay very close on risks and the like. To some extent we have to build that relationship, not because we had it and lost it but because it has never existed before.

The second, which may be even more important, is that as the single supervisor develops it will be very important that the banks supervising the PRA and the single supervisor work closely together and understand each other. This is not a question, as somebody put to me, of their together determining what happens to the European Union as a whole, but if different views and approaches then come out with the intention to set the rules, that will be quite difficult. We will have to recognise that that SSM will sit above 18, or maybe more, national supervisory regulators. The national supervisors are not being abolished; they still exist for the smaller institutions, and they will sit on the board of the SSM. To some extent when you are trying to run a supervisor over 18-plus countries with very different banking systems and the like, some of which are very rudimentary and some of which are pretty complex, you probably have to require quite a rules-based approach to what you do, simply because you do not have the ability to do it on a more discretionary basis. If you are the supervisor of a very large, complex financial centre, as in the UK, you are probably going to want a more judgment-based, intensive approach, because you have a smaller but more complex population to manage.

We have to ensure that those different supervisory approaches understand each other and fit together. It is going to be a big job for the Bank to form that relationship, and a big job for the ECB SSM to do. We were quite keen that the legislation that founds the SSM requires the SSM to have memoranda of understanding, which it does, with regulators in other member states outside the SSM precisely for that reason. My sense, talking to the ECB, is that it understands that and wants that relationship. Remember that the firms that it regulates are in many cases closely tied to London through the wholesale and other markets, so it wants a good supervisory relationship. It will take time to build, if only because we are going through our own integration at the moment, and it is going through a much more complicated thing that is not integration but construction. I do not think it will happen immediately. It will certainly take time to build.

On this question of people, resources and the like, again, looking forward, I think that we at the Bank understand this challenge, and we understand that it requires perhaps working in a different way and resources, and it requires co-ordination because the ECB and the Bank of England will touch each other on a much broader front and on many more issues than before. At the moment we are engaging in a strategic plan for the Bank, which I think is public knowledge. The results will be announced shortly and this is one of the issues that we have to address in that.

Q66 Lord Kerr of Kinlochard: That is absolutely fascinating. Can you touch lightly on the Commission? Again, I was lucky: six UK directors-general, plus the secretary-general of the Commission and the deputy secretary-general of the Council secretariat who supervised the single market councils. Of these six directors-general, three or four had come out of Whitehall or the City. I do not see the same network of people who have a financial background, a Whitehall background or a City background in the middle and upper ranks of the Commission. Is there a ready-made replacement for Jonathan Faull who is likely to come from Britain, or is that a silly question? Are we no longer in a position to provide such people because we are not in the eurozone? Do you feel that it is as easy as it was in the 1990s to be upstream in the legislative process and to be aware of the ideas that the Commission is likely to produce and possibly to provide the ideas that the Commission will produce?

Sir Jon Cunliffe: I think there are a number of different strands here, to be honest. To put it facetiously, Édith Cresson's dentist and the Kinnock reforms reduced the ability for all member states to ventilate the Commission with people coming in from the City, industry or civil services, so many of the directors-general did not start in the Commission; they had come in at various stages of their career—parachutists, et cetera. Basically, one of the problems of the Kinnock reforms, looking back, was that the Commission has become much more monoculture. The only way in is at the bottom, and you travel up, so ventilating the Commission with outside experience for new tasks and the like is very difficult. It is finding that now: it needs many more economists than it has had in the past in DG ECFIN and DG MARKT. That partly goes back to the point about it not having the experience and the people that the IMF has. It is going through recruitment and is finding it much more difficult to bring people in at mid-stages in career, because the staff regulations and the unions all make it very difficult. The days in which people like Jon Faull, to pick up one of your examples, could move from the DTI into the Commission at senior level have gone for everybody. One of the reforms that I think is necessary in the EU institutions is to allow the Commission to ventilate itself by being much more open. You could argue that Whitehall has been down much of that journey, but it is difficult.

On the question of whether we still have the influence, given that, again that is a problem. Do we still have the influence? Jonathan Faull, of course, did not start in the City or wherever. He started at the bottom, had never been in Whitehall and had never worked in the UK, I think. He worked his way up. Will we still have the influence when the golden generation of the Brits who joined the Commission just after we joined the European Union go? The demographics are not good, and you know that this is an issue which the Government have been trying to address. We discussed it for some time when you were in Brussels. We have talented people below director-general level, but not as many as we would like, and replacing that demographic deficit is going to be quite difficult because you cannot bring in except at the very bottom, so even if we improve the feeder streams it could be some time before it happens. We are not the only member state that has that problem. The Irish also have the problem, and it tends to some extent to be a function of when you joined. Your officials go in. Then, of course, there have been subsequent waves of enlargement, and at the moment it is all middle ranks.

Lord Kerr of Kinlochard: Yes, but to be honest I am not worrying about the Irish. I am worried about the EU if it does not have experience of the City of London. That seems to me to be the crucial thing.

Sir Jon Cunliffe: We have to find ways to get it in.

Lord Kerr of Kinlochard: One way, although I personally think this is now closed to us, would be to make sure that the Commissioner, M. Barnier's successor, is somebody with considerable experience of the City. Do you believe that that job is open to a Brit now?

Sir Jon Cunliffe: The head of DG MARKT?

Lord Kerr of Kinlochard: No, the Commissioner.

Sir Jon Cunliffe: The Commissioner post? Yes, I do not see why not.

Lord Kerr of Kinlochard: I doubt it. So much of his time is spent writing the rules of banking union and on business that is primarily for the eurozone, or euro plus, where, as you have rightly explained, we play a very good role, but it is a defensive role. It seems to me unlikely that eurozone member states will give that kind of Commissioner portfolio to a Briton.

Sir Jon Cunliffe: I think that point would perhaps have more relevance in DG ECFIN, because it is DG ECFIN that does the economic management et cetera and now has a much bigger role in the economic management of the eurozone. You might say, "Well, this is not something that the UK is very engaged in, so why have a Brit?" The alternative might be, "Let's have a Brit because you get an impartial person there". I have seen that happen with the chairmanship of the monetary committee, for example. I would not except DG MARKT, because those are the rules of the single market, and that is for all 28 of them.

The Chairman: Colleagues, I am anxious to let Sir Jon go, but we still have some very pressing questions, and we are so grateful for your time, so I am going to ask colleagues to be a little more telescoped in what they ask. Lord Caithness, you wanted to ask a quick supplementary.

Q67 Earl of Caithness: A quick supplementary, Sir Jon, to which I think the answer would be yes or no. I noticed that Britain, sadly, did not produce a Minister for the recent ECOFIN meeting. Is this an increasing trend, and does this diminish our influence with the other member states?

Sir Jon Cunliffe: I have not been in Brussels since November, so to be honest I could not comment. I am not tracking it.

Earl of Caithness: But in your time in Brussels did you notice that Ministers were attending fewer meetings than they were in the 1990s, when I was a Minister?

Sir Jon Cunliffe: No, I did not notice that. Nor did I notice that we were sending Ministers less often than other member states were.

Q68 Lord Dear: Sir Jon, you have mentioned integration. In fact, you have almost covered the question that I was going to ask in an earlier exchange. It seems that there are two sets of integration going on. There is the possibility of integration within the EU as a whole, and the whole burning question that is even all over the redtops about whether we should be in or out and integrate in that sense as well. The two are in many ways interlinked, as you will appreciate more than most people. I wondered whether you could give us a very quick canter across what you think the moves for greater eurozone integration are all about, how we fit into that and how, if you were in such a position, you would advise the Government to progress, burning issue though that is.

Sir Jon Cunliffe: I am not sure that I can add much to what I have said. I think that it is important that the eurozone does integrate. It is a paradox perhaps.

Lord Dear: It is how it does it and what the end product is.

Sir Jon Cunliffe: Yes. From the point of view of the EU and the single market, it would be more convenient if they did not have to and we could go back to the status quo ante. But the single currency is a fact. The break-up of the single currency would be enormously disruptive and impose costs on us. I do not sense that the countries of the euro want it to break up. We are in a single market and a European Union with these countries; we live next door to it; it is our biggest export partner, with large channels through the financial sector. We want it to be sustainable and function well. That pushes in the integration direction. The question then comes: how do we help them make the integration as effective as possible? There, there may be a role for low-key technical advice where we have some expertise, but one has to be careful not to try to design the system for them. However, how that is developed and whether it works with the grain of the European Union at 28 or against the grain is very much for us. We should be very engaged in those negotiations to say, "Well, okay. We understand you need to do this thing. We think it's the right thing given the choices you have made on the euro to do it". But then within the European Union 28, we have to arrange things to ensure that the single market is not jeopardised for some of the reasons that I talked about earlier. The role for the UK authorities is to find that place.

Q69 Lord Flight: Perhaps I could you ask you about EU perceptions of the City of London and how effective the City's engagement is. It seems to me that the ECB has a very good perception and you make the point that, when the banking run started in summer 2007, it was the ECB that provided the liquidity to the banks of London, and the Bank of England had not really woken up to the severity of the oncoming banking run. So a big tick for the ECB at that time. But at a political level, and a lot of one's colleagues openly admit it, there is jealousy and, I am afraid, a desire to spike the City of London if possible. The AIFMD is widely and publicly accepted by politicians here and regulators as extremely bad news, adding costs and burden to no point. We are now threatened with the financial transaction tax, an even more ill-considered measure which, although we would not be a part of it, could still do London great harm because of legally questionable obligations to collect it. How do you see those two bits? What do you think the City should be doing? I finally add that I am also told by friends in Brussels that they are rather fed up with City Corporation over-engagement and that its impact is the opposite of what they might wish.

Sir Jon Cunliffe: I do not think that you can look at Europe in isolation. The financial sector globally and in the UK has a huge amount of work to do to restore its reputation and to restore public trust. That is true for the UK. You have only to read the UK newspapers to see just how the financial sector is viewed. Many of the current generation of leaders in the financial sector accept that, but there is quite a long way to go before public trust is restored. I do not think that the UK is any different. It is dangerous to read some of the negative sentiment about the financial sector which is picked up in the EU as being anti-City of London rather than just negative sentiment about the financial sector. I have to say, with conduct cases coming to light globally, it makes it even more difficult. That is not to say that there are not some people who either believe that the City of London poses a threat to EU financial stability because it is not properly regulated or, on your point, would like to see some of that economic activity transfer. There are certainly people who take the view that there is something unfair about the financial centre for the euro being offshore in London rather than in the euro area. National positions are made up of many different views, but I do not think that it is the national position of many of the Governments or of the European Commission that the financial centre for the euro should be in the euro area or that the business of the City of London should be elsewhere. I think that a sizeable proportion of people within the European Union realise that it is not a question of London or Paris or Frankfurt but of London or Singapore or New York, and that this huge financial centre brings benefits to the eurozone and the EU because of liquidity, innovation and international reach. It is not just a question of "Can we move that somewhere that we would find it more amenable?" If you want to have that within the EU, where there is EU regulation—albeit on exchange of information; you know what is happening—you need to make sure that it stays in London rather than goes elsewhere. That said, there are particular segments of the financial sector that different countries have different views about. Hedge funds are a good example. I think that a lot of the animus against hedge funds and private equity in some European member states led to the AIFMD. For the Bank, the question is: can we get the regulation and the macroprudential surveillance that we need for UK financial stability out of the EU legislative machine, bearing in mind that it gives us the chance to influence the rules that are set for many other countries that have an impact on UK financial stability? In the main, I think that we have done that.

Q70 Earl of Caithness: I want to pick your brains a little bit more on banking union and bank structure. I have a mass of questions to ask you, but let me condense them into two. You have mentioned the single resolution mechanism. Do you think that it is too cumbersome a resolution procedure to be really effective and has it done enough to break the vicious circle linking bank and sovereign debt? That is on the banking union. A second question is on bank structural reform. We have had the Liikanen group; we have had the high-level working group; we have got Volcker; we have got Vickers. Is structural reform still necessary and, if it is, should it not be on a global basis rather than a continent-by-continent basis?

Sir Jon Cunliffe: I shall try to deal with those quickly. The SRM is still under negotiation, so I do not know where it will come out. The decision-making is a very fine balance between different interests across a number of countries. I go back to my earlier point that, over a crisis weekend, you need a bit more simplicity, so I would like to see it made simpler. I am not alone in that; I think that Mario Draghi said the same thing, as have others. We would have to work with it conceivably if we had a cross-border failure of a bank that had branches or subsidiaries in the UK and within the single supervisory area. It is important to us that it works well. Particularly when it comes to the use of public funds, that mechanism gets quite complex and unwieldy, so I hope that it is streamlined. Sometimes the EU does not streamline things initially; it finds a way of doing it over time. That may be how it happens. Has enough been done to break the vicious circle between banks and sovereigns? In a way, it was mainly the "do what it takes" speech and the cooling of pressure on sovereigns. You see the reduction in the sovereign bond spreads in the eurozone that have done that. Of course, many of these eurozone banks are sitting on large amounts of sovereign bonds, which is how the link came about. That vicious circle has been diminished by a lot of other action. The single supervisory mechanism, particularly the ability to bail in sub-debt and other creditors, helps also in that respect, but there is still a connection. As long as banks in the eurozone periphery are sitting on very large amounts of debt of Governments who are going through a difficult adjustment process, we are going to be living that.

On Volcker, Vickers and Liikanen, I think that the extent to which you need structural separation depends a little bit on the size of your financial sector. With a financial sector of 500% of GDP, we have to be much more careful than if the financial sector was 10% of GDP. One reason for the Vickers proposals in the first place was to ensure that we did not get in the position in the future that we could not let banks fail because their riskier activities were entangled with critical economic functions for the UK economy—retail payments, business and the like. The US came to it in the same way. The Commission proposals and Liikanen-Vickers start from the same principle of separation. Vickers looked at what should be inside the ring-fence; Liikanen looked at what should be outside and separated from retail. So they did it in different ways. There is a lot of uncertainty and a lot of definition involved in that Commission proposal, so it is difficult to see how the two line up. Very importantly, it recognises that for countries that have brought in an equivalent system there should be a derogation. I do not expect that really to move until the end of this year or the first half of next year with the new Commission, so how those things fit together we cannot yet say, but they seem to me to go in the same direction. I do not think that I would want to impose the same structural separation globally; I do think that I would want to have globally consistent standards and rules for how you resolve failed cross-border banks. There is a huge workstream going on internationally under too-big-to-fail, which is not about structural separation in life but is about ensuring that, in death, you can separate and recapitalise without the taxpayer having to keep these things alive. That is hugely important for the UK given our role in the international financial sector. When we get there, and I hope that the FSB will get a long way towards that by the end of the year, the European Union will have to bring that into being.

Q71 The Chairman: Sir Jon, my Committee allows me my one whimsical question on an annual basis, and today is the day. It is not entirely whimsical. I made the suggestion on the "Today" programme recently when asked about the role of Scotland that it might not be a bad idea for the 1694 Bank of England to rename itself as the Bank of England of the United Kingdom. I wonder whether you had had a chance to think about that and whether it would better reflect the four nations of the United Kingdom and go some way perhaps to assuaging feelings that might have been hurt by so palpably highlighting the one nation within the four.

Sir Jon Cunliffe: I had not thought about it. The simple answer is that that is for Parliament and Government to decide. If that is what is decided, fine. I remember that we looked at this during the 1997 changes and decided not. My recollection is that the reason why we decided not is that the Bank of England has a name and a reputation that go back 300 years. It is known internationally and stands for something. Even though it is not really apt, given the way the United Kingdom developed after the establishment of the Bank of England, that sort of thing has value and if you change it you lose something. I guess that my question would be: if you have something that has a reputation and is well known et cetera, do you change it? I have not heard that it is a huge thing in the Scottish debate. Clearly, that is not for the Bank; it is for the legislators to decide.

The Chairman: Sir Jon, you have moved from the acronym-rich world of Brussels to the acronym-rich world of financial oversight. We are most grateful for you coming in this morning and for not only showing that knowledge and expertise and helping the Committee with the questions of the eurozone crisis but also reaching out for more. I am very conscious that there may be other things that you wanted to say in response to some of those final questions. If you did, please write to us and supplement the very considerable help that you have given us this morning. Please check the transcript that we send you. We hope to engage with you in the future and look forward to it. I think that this has been a very productive session. On behalf of the Committee, I say many thanks indeed for coming in this morning.

Erkki Liikanen, Governor of the Bank of Finland and former Chairman of the High-level Expert Group on European Bank Structural Reform—Oral evidence (QQ 12-25)

Evidence Session No. 2 *Heard in Public* *Questions 12 - 25*

TUESDAY 11 FEBRUARY 2014

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Earl of Caithness
Lord Davies of Stamford
Lord Dear
Lord Hamilton of Epsom
Baroness Maddock
Lord Marlesford

Examination of Witness

Erkki Liikanen, Governor of the Bank of Finland, and Chair of the High Level Expert Group on reforming the structure of the EU Banking Sector

Q12 The Chairman: Good morning, Governor Liikanen.

Erkki Liikanen: Good morning, Chairman.

The Chairman: It was a great pleasure to meet you in Vilnius last year, and to ask you to come and spend time with us, albeit in the video-conference format, to discuss the euro area crisis and other matters, including the Liikanen report, of which you of course are the distinguished author. I believe you would like to make an opening statement on the euro and the Liikanen report. I would be most grateful if you would begin by giving us that statement.

Erkki Liikanen: Of course. I can be quite brief, because I am sure that your Lordships have many questions. On the big picture of the euro area, the recovery of the world economy is ongoing. The US monetary policy, the tapering asset purchase, is under way. It has had an impact on the global scene. There has been the new issue of emerging economies, and capital movements may continue for some time. Countries that have external vulnerabilities may be affected. There are some downside risks.

Still, I would say that the euro area has been quite resilient to these turbulences. We are working to make Economic and Monetary Union even stronger. We will come back to that when we come to banking union, the single supervisory mechanism, the recovery and resolution schemes and so forth, so I am very happy to reply to questions later.

Secondly, on banking reform, the Commission recently came out with a proposal that caused quite a diverse reaction in the media. My preliminary assessment, even after I went through the detail, is that the Commission proposal serves the same objectives of our report, as well as the recommendations, but of course there are also areas where it differs. It proposes to ban proprietary trading, which we did not. That proposal was closer to the Volcker rule. As to market-making, it proposes to empower the supervisor. The competent authority can require separation, where specific conditions are fulfilled. The Commission proposal is different, but anyhow these two solutions make it possible, if the supervisor so acts, to come closer to the proposal we made earlier.

I will perhaps leave this here, because I know you have many questions, and I will leave time for discussion.

Q13 The Chairman: I would be very grateful. Before I turn to Lord Davies on the report and banking union, could I ask you about the continuing euro area crisis, which President Barroso thinks will be brought to a close in 2014 but President Mario Draghi is less sure? Who do you think is right, and how will we know when, indeed, we can say the crisis of the euro area has finished and completed?

Erkki Liikanen: You will well understand if I tend to agree with President Draghi, with whom I work closely. He is chairing the ECB Governing Council. I would also say that central bank governors tend to be cautious. There are absolutely good sides. Look at the market developments during the past 12 to 18 months. Let us take a few examples. One is spreads between Euribor and Eurepo, without collateral and with collateral lending between the banks. The spreads have been narrowed to a level they have not been at since autumn 2007. The spreads of sovereign bonds, 10-year bonds, were a real cause for concern in summer 2012. As Senator Monti said earlier, there was a real problem then. These spreads have been narrowing consistently since OMT was launched.

The third issue is bank funding. There was a big difference in the treatment of the banks between the northern and southern European banks. The spreads of banks' CDS prices have also been narrowing. I would say that the market picture is positive.

On the real economy side, there has been consolidation. The current account developments of the southern European countries were a real problem when the crisis was in its most intensive phase. Now, the current account is in surplus, if you take Greece, Italy, Ireland, Spain and Portugal together. If you look at their primary surplus, the public finances, they are also narrowing the gap there. Also, competitiveness is improving. There are many good points, but there is still uncertainty.

Unemployment is still very high. The capacity utilisation in the economy is low. The monetary dynamics, especially in credit, are still weak. I would still say that as a whole the risks are on the downside, but we must note the major changes during the past 12 to 18 months.

Q14 Lord Davies of Stamford: Governor, good morning. As you just said, the proposals brought forward by Michel Barnier on behalf of the Commission very much reflect your recommendations, except in the two significant points you mentioned about proprietary trading and the role of national regulators. Do you feel that those differences are marginal, not important, and are you generally happy, therefore, to back the proposed new regulation, or do you still feel strongly about those two points of difference?

Erkki Liikanen: First of all, I welcome the fact that the Commission came out with a proposal. It took time, which is understandable, because it had to do a broad consultation with all the interested parties. My first reply is positive: that there was a proposal. Secondly, as to the structure of the proposal, it really is different, because we wanted to keep proprietary trading and market-making together. We found it very difficult to find a line between those two. The Commission has taken a different view; it wants to ban proprietary trading in a narrow sense. It comes closer to the American solution. It is a possible solution that can make international convergence easier.

As to the other activities, such as market-making, risk securitisation and complex derivatives, we proposed to separate them from the outset. As to the European Commission, they oblige the supervisor to do the review, and then they empower them to ask for separation. In the end, this can lead to the same type of solution as we proposed.

The third point, then, is that they say that if some country has adopted legislation that fulfils the basic criteria, they can be exempted from the implementation.

All in all, you can come to the same conclusion, but it very much depends on how the supervisor acts, and how the Commission itself assesses the convergence. I am positive, but we are in a bit of a wait-and-see position at the moment.

Lord Davies of Stamford: Thank you, Governor. Is there not a strange irony behind all these proposals? Every first-year economics student knows that underwriting losses or trading losses in a universal bank can, theoretically at least, lead to the collapse of that bank and the endangering of the depositors' interest. In practice, that is not the cause of the terrible banking crisis we have just come through. That crisis was caused by mistakes made in commercial banking operations: the collateralised debt obligation scandal, and excessive and incautious lending to real estate and so forth—classic mistakes made in commercial banking.

Equally, of course, it is true that the collapse in 1931 was not due to underwriting or trading losses, but that was the solution which the Glass-Steagall Act proposed. Once again, we have come up with a proposal that is not really relevant to the causes of the crisis that we are trying to address. If in fact banks are too large, is the answer not just to break them up to divide up the deposit base, if they are too large to fail? That is the problem. If they are insufficiently capitalised, they obviously have to be recapitalised. Is this focus on this structure, trying to separate the trading and investment banking activities from the commercial banking activities, actually not a very relevant or pertinent response to the experience we have actually had?

Erkki Liikanen: Thank you very much for this question. Of course, we must remember that we have taken many reforms already, which have been quite important. Many banks went under because they were badly capitalised. Many banks went into difficulties because they had no liquidity buffers. Many banks got into difficulty because they overleveraged. Many banks got into trouble because they were, as you said, excessively focused on real estate lending. That is true. These issues are being handled by some other parts of the major regulatory reform, such as reforms on having more capital, or reforms on having better liquidity buffers handled by, for instance, leverage ratio. These are important.

The question of course is: have these reforms taken us all the way or do we still need to take a step further? Our conclusion was that, yes, they have been important; they have taken us a long way, but not all the way. To complete this, we still need to have structural reforms that give a fundamental reply to the question of whether banks are too big to fail. In the way that we can make it possible for universal banks to continue to act as one company if they are able to separate these two activities from each other, the key message from my side is that there should be no implicit government guarantee for high-risk activities. We all know that the deposit banks that have an important depositor base, with deposit insurance and often implicit government guarantees, can lead sometimes to situations where the funding costs for high-risk activities are just not reflecting their risks. The separation in such cases to our mind is definitely advised. The other solution could be to break them up. Our proposal is softer compared with that.

Lord Davies of Stamford: Logically, if you had actually wanted to address the issue of implicit government guarantee, the only solution would have been to make them small enough to be allowed to fail without a government guarantee—in other words, to break them up. You agree with me that what we have been doing is focusing a lot of attention on producing a remedy to a problem that has not actually occurred, and we have resisted the most obvious and logical response to the problem that has occurred.

Erkki Liikanen: I do not want to give you the names, but I would still say that, during the last crisis, there were financial institutions that were able to borrow cheaply, because they had implicit government guarantees. For one reason or another, that led them to take excessive risks in the markets, which led to the crisis and led to taxpayer costs. I do not say that this problem is non-existent. There were cases in the last crisis, and our report goes through some of those.

Q15 Lord Marlesford: I wonder whether, Governor, I could ask you about this threat that Madame Lagarde has talked about of deflation—whether you think it is a real threat and, if so, what the ECB should do about it. Secondly, and, in a sense, almost more urgently, the ECB as part of the banking union is to take over supervision of all euro-area banks in November. Before that, they have to look at the health of the banks, and they are carrying out the stress tests into the balance between assets and liabilities. Do you think these stress tests are likely to reveal a fragility, which to put right will require resources that are greater than the resources that may be available? If so, how will the markets take these stress tests?

Erkki Liikanen: Can I start first on the banking union? When we are proceeding towards a banking union, there is one clear principle: a banking union is not a hospital. We do not take patients to give them treatment there. We must guarantee that any bank or division that will be taken over by the ECB is sound and properly capitalised. For that reason, this comprehensive assessment has three parts. The first is a risk assessment that is done according to the same rules, practices and criteria throughout the euro area. The second is the asset quality review, which will be done top-down and bottom-up. We will use independent external expertise. It is a very demanding, very heavy exercise that is necessary. After that will be stress tests. I would say that all these three parts are important for us to know the state of the banks before they are taken over.

If banks fail to show that they have enough capital, the first rescue must be their own shareholders. When the banks are more transparent and it is easier for investors to see their proper stage, perhaps there is more possibility also of having investors. If that is not the case, then the home country authorities must be prepared to capitalise. That would be of course the extreme case. It can help them. If even that is not the case, it is totally possible that some of these banks will not go through the test and may be wound down. It is possible. I saw that in the *Financial Times* the chairwoman of the Supervisory Board raised this issue too.

As to deflation, it normally means a broad-based fall of prices over a prolonged period and a broad front. We do not have signs of deflation in the euro area.

Lord Marlesford: Could I just follow up for a moment on the stress test, which you obviously regard as very important? The markets may not look very happily at the prospect of banks being wound down. You have not mentioned the ultimate back-up of the euro area as a whole to prevent banks failing, in the sense that those to whom they owe money will be left without the money; it is not the shareholders. The shareholders may have very little assets. The bank may be worth very little, but surely what we are talking about is the liabilities that the banks have to other outsiders.

Erkki Liikanen: I would come back to my comment only by saying that the key principle is the following: only banks that are sound and well capitalised will be taken to be a part of the European single supervisory mechanism. We must know the state of the banks after the comprehensive assessment. Shareholders need to put in more money, if needed. If that is not the case, it is the home country at this phase. Once the supervisory mechanism and bank unit is in place, of course more European dimensions will be there, but in this phase it will be the home country. There can be some cases, as I said, where there is no viable bank left and unwinding can be an option. We will see.

Can I just perhaps add one point here? When you have followed the market reactions recently on the banking sector in Europe, as I said earlier, you will have seen that actually it has been quite calm. I am also very pleased to see that while the SSM is being constructed and when recruitments have been made for the SSM during the past few weeks, they have been very strongly merit-based competent people, known on a European and global scale. That has also given a lot of confidence to the effort the European supervisory mechanism is making, which works closely to the ECB, but in an independent way.

The Chairman: Thanks very much. Returning to your reply to Lord Marlesford on deflation, where you were clear that that was unlikely, what about disinflation?

Erkki Liikanen: Of course our inflation figures are subdued, due to different issues. Economic activities are relatively fragile. Credit flows are low. If you try to separate different details on inflation development, you see that part of that is due to falling energy prices and to falling food prices—high-processed food prices. Those are normally changes to relative prices. The rest is obviously related to weaker demand. We need to do this kind of analysis carefully. When we go to the next Governing Council meeting, which will be in early March, we will have more information again. First of all, we will get the full data for the year 2013 and then, in that context, we will also publish the forecast for 2016. We analyse carefully all the data to understand what is happening.

Q16 Lord Hamilton of Epsom: President Draghi said that he would do what it takes to stabilise the sovereign debt markets. That seems to have worked its magic on those markets. You have been a member of the ECB Governing Council. Were you worried that there might actually be a call on the ECB to do what it takes, because it would not have been legal, as I understand it, for the ECB to have been involved in outright monetary transfers, transactions or whatever OMT stands for?

Erkki Liikanen: Thank you very much for this question. I am happy to hear it from London. Of course, President Draghi gave his famous statement or interview in London in July 2012, and that was very important, but equally important was the decision then taken by the ECB Governing Council, which defined the forms and procedures for how this programme will be implemented. I will just give you a few essential characteristics.

The first is that this programme clarified the division of labour between European institutions, which has not always been clear. Every member state is responsible for its own public finances. They must be able to have primary surplus. They must be able to do their own structural reforms. Secondly, if there is a need for bridge financing, that can be done by the EU and/or IMF, but it must be heavily conditional. Thirdly, the ECB can only undertake the purchase of sovereign bonds if the programme is fully on track. The division of labour between the three is clear.

Secondly, on the practicalities of the programme, to limit the risk that the ECB takes here, we would focus on the shorter end. That means from one to three-year bonds. Thirdly, to make this effective, we have said that we will not give an ex-ante limit to our bond purchases. Fourthly it is also very important is that these purchases will only be done when the programme is on track. This means that when the review process starts, we do not do purchases. We can start them again after the programme is considered to be on track.

I think it is very important to understand both sides—President Draghi's statement in July 2012 and then this structure of the programme. As to legality, this programme, in our opinion, is totally compatible with the treaty and with our mandate.

Lord Hamilton of Epsom: Do you think that the ECB has the tools for future interventions? What do you feel about negative interest rates, for instance? Would the ECB consider using them?

Erkki Liikanen: Of course, when we work on the monetary policy, we take decisions every month, but then we must think and consider different contingencies. One risk normally is that short-term volatility of interest rates would propagate to the longer term. If these kinds of issues happen, then we will take proper monetary policy decisions.

The other risk of course is that if our inflation outlook worsens, we must be ready for that. Of the tools that we can consider and have discussed, negative deposit rates is one of those. Of course, when we take policy decisions in our monetary policy meeting, they are based on the most recent data and careful preparation, which we do in the Governing Council and also among our experts outside the Governing Council, before the meetings.

Lord Hamilton of Epsom: My second question, Governor, is: what is your assessment of the performance of other EU institutions—the European Parliament, the Commission and the Council?

Erkki Liikanen: I spent about 14 years of my life close to the European Parliament, as an ambassador first and 10 years as a commissioner. I have a diversity of experiences, let us say, with the European Parliament, not all of which I remember with great delight. I must say that, in this financial crisis, perhaps due to the depth of the crisis and the seriousness of the crisis, Parliament has delivered on time. They have had their opinions; they have had their views. However, in first assessing the seriousness with which the rapporteurs approached the issue, I must give a lot of credit to that. Secondly, when the institutions have then had to negotiate on the solutions and find compromises, there have not been—at least not so far—undue delays through the European Parliament.

As to ECOFIN, of course they are under pressure from home and from the European direction. When any Government must give taxpayers' money to any cause, it is always a difficult decision. For that reason, for instance, compromises are sometimes being done that may look complicated, as is the case for instance with the resolution mechanism. The outcome is: this is a process in evolution, through different phases, but it will not hinder the proper functioning of the resolution fund. The Commission is doing its work of course. We are working very much together with Olli Rehn, who is the Commissioner for Economic and Monetary Affairs. I happened to work with him; he was my head of Cabinet for a long time, and we even have the same language, so it is a very particular relationship. They have been doing proper work, especially with reference to the European governance rules, so we now have better governance, both for public deficits and debts and for macroeconomic performance. We have a better framework there.

As to the financial markets, which are the other area that we follow closely, of course the Commission has been under a very heavy and intense workload but, to a great extent, the Basel reforms have been or are being implemented throughout Europe. I find this positive. Also, they were able to come out with a proposal on the structural reform 10 days ago. Fine. The overall assessment is satisfactory.

Q17 The Chairman: What, Governor, do you think about the troika? Do you think the troika has been effective as a part-EU institution?

Erkki Liikanen: You have different views when you travel to the countries concerned. Sometimes you hear that they understand nothing of what is happening in our country. In private, people say that finally somebody has come and tried to give some clarity. Anyhow, from our viewpoint, it is extremely important that when these kinds of programmes that include bridge financing are being done and when the conditions are being fixed, neutral parties with high expertise are there to follow it up. I was always in favour of participation with the International Monetary Fund, due to their expertise from the past. My experience is that they have been working well together with the European Commission in the territory, which has been difficult. They are in liaison with the ECB. They have been necessary. History will tell if they all have been sufficient.

The Chairman: That is a very diplomatic answer, if I may say so.

Lord Hamilton of Epsom: Can I just come back on that? It strikes me that there is a serious risk that we will see over the next five years, say, stagflation in the eurozone—very low growth and very high levels of unemployment. How do you think this is going to play out politically? Do you think this is going to change the political landscape of Europe and how will democracy come to play a role in this?

The Chairman: In fact, I am going to ask Baroness Maddock to ask her question, because this follows.

Q18 Baroness Maddock: Good morning, Governor Liikanen. My question is indeed connected to my colleague’s. We see in Europe various problems. We see low growth, we see a lack of competitiveness, and we particularly see problems of unemployment, particularly youth unemployment. You touched on a couple of those issues in your earlier comments. I wonder if you think enough is being done within the eurozone and the European Union to tackle these issues. If not, what ideas do you have to try to deal with these rather serious matters?

Erkki Liikanen: I could not agree more with your questions. Unemployment, and especially youth unemployment, is the biggest problem in Europe and, actually, very much also elsewhere in the world today. These technological changes, productivity changes, have led to high unemployment among young people in very many parts of the world.

Let us focus on Europe and the euro area. You see that these unemployment figures vary from country to country very much. When you start to find the differences in the countries, there are also differences in labour market institutions. In the countries where labour markets are dualistic, which means that there is very strong protection of permanent employees and a lot of short-term employees without any protection at the same time, normally youth unemployment is high, because it is easy to get rid of young, temporarily employed persons and the threshold to employ new people is high. There have been some reforms in Europe that are worth looking at. One is the German labour market reform after 2000. This reform led to the situation where the—

The Chairman: Governor Liikanen, I am so sorry; we lost the last two minutes of what you said.

Erkki Liikanen: What was the last part you heard?

The Chairman: You were talking about Germany and then we lost you.

Erkki Liikanen: I will come back to Germany. If you look at the figures in Germany, they have been able to keep youth unemployment to a very low level. We have, in my bank, done research on that issue. Are there some practices that can be replicated? One issue clearly—

The Chairman: Oh dear, we were just getting the answer. I am so sorry again, Governor Liikanen, you were just about to give us the answer.

Erkki Liikanen: There are good examples, such as labour market reforms in Germany. Part of that is worth studying and learning from, because they were able to cut down youth unemployment rates dramatically. You cannot copy it, because institutions are different, but there is a lot to learn. The same is true in some other countries, but I would just say that structural reforms are very critical. Structural reforms do not let labour markets become fragmented. Work must always be more beneficial than not working. We must try to find combinations to study and to work that are more practical and simpler. That has been the case in those countries that have done it better.

Secondly, on the general question about stagflation, I do not see stagflation risks in Europe now, but of course we must be careful in two senses. Policymakers must be able to take the structural reforms that increase competition in productive labour markets and can release growth potential. Of course, we all need to do an assessment. Especially for us, our primary mandate is price stability, so always carefully analyse inflation data, both from the real economy, and the money and credit side.

Q19 Lord Dear: I wonder whether I can continue pursuing the issue of Germany a little further. Clearly from what you said and from what we all believe, I think, the German position is critical in the EU. I wondered whether, overall, you thought that Germany has had a positive or a negative influence. That is putting it rather starkly, I know, and probably the answer is somewhere in the middle, but your views on the German position would be a great help to us.

Erkki Liikanen: Every policymaker must get their mandate from his or her own people. They need to be elected and they are accountable for their actions before their own people. That is a fact in every single country—in the UK, in Germany, in Finland. When we have had to take decisions where taxpayers have had to take certain responsibility for problems that are European, it is more so in European areas. Still, all in all I would say that Germany, like many other countries, has at the end of the day tried to find elements for common solutions that could give direction to the European solutions.

I must say, for instance, that discussion about the banking union single supervisory mechanism, which we are now creating, has been pragmatic, which was very helpful, even though it was difficult for some countries. The single resolution mechanism part of that, at the end of the day, is satisfactory. The structures are a little heavy, because we talk about the transition from the intergovernmental area to the Community area. Germany has had difficulties, Finland has had difficulties in those areas, but at the end of the day they have been able to work for common solutions. In these difficulties, I must say that, compared with where we were in 2012, when the euro area was in major crisis, we had to win back confidence, which required actions from the ECB.

Secondly, we had to build up a banking union that could create a basis for separating sovereigns and banks. In the banking union area, progress has been faster than most people expected. I have been working with European issues for the last 25 years, and I must say that for me this is the most consistent reform process in such a short time that I remember. It would not have been possible without certain flexibility for member states, such as Germany, to find a compromise between their national aspirations and European interest.

Q20 Lord Dear: I am grateful to you for that. I wonder if I could move the conversation across the map of Europe, if I may, and look at two other very large countries, France and Italy, two of the largest eurozone economies, of course, and both of them in a certain amount of difficulty, although there have been some suggestions over the last few weeks, or perhaps the last few months, to try to address their problems. Your views on whether you think those suggestions and policies, vis-à-vis France and Italy, would bear fruit or not would be a great help to us.

Erkki Liikanen: Before we go there, on my table I always have one *Economist* from June 1999, when the cover story described Germany as, "The sick man of the euro". That always keeps in my mind the fact the countries may change. Most countries are proud to be able to change, to be able to be competitive and to create jobs. Germany of course is in its own class.

Italy is an interesting case, because it has been a country with low growth for a pretty long time, but it has, at the same time, been able to create primary surplus, so it has had relatively high fiscal debt, but its revenue has been higher than its expenditure without interest. It has been able to roll on this debt well. I would say that for that reason its public finances are structurally healthier than one could imagine, which has made its position better. It has been doing well in sovereign bond markets.

As to France, Commissioner Louis Gallois made proposals about a year and a half ago. He also happened to be, by the way, a member of my group on banking structures. He made proposals to improve the competitiveness of the French economy and French industry, which were quite strong and important but only partly met with political response at that time. If I have read correctly the recent proposals by the French President and the Government earlier this year, they now go further to improve the competitiveness of French businesses and corporations to be able to compete globally. It is a step in the right direction and I welcome it, but of course we need to see implementation. There are certain terms that can be historically important.

Lord Dear: Overall, do I get the picture that you are moderately confident that both will come out of the current difficulties or not?

Erkki Liikanen: No gain without pain. They will come out of it, but there is no gain without pain. There is no structural reform without pain. My reading only is that the reform proposals put out by the French authorities earlier this year are serious. Normally authorities must take the pain to implement them, and that process will be seen. The jury is still out.

Q21 Viscount Brookeborough: You have mentioned the single supervisory mechanism, and therefore the resolution mechanism, on which there was an agreement recently. Do you share concerns that this may be too cumbersome and therefore too slow a mechanism to put into place? Secondly, ultimately it may not have sufficient resources for a future crisis, and therefore it may not be enough to break the vicious circle between banking and sovereign debt.

Erkki Liikanen: On the complexity first of decision-making, if you look at the ECOFIN opinion it is relatively simple for smaller cases, but it is complex for bigger ones. My reading and understanding anyhow is that if, and I am sure when, the ECB supervisory mechanism is strong, competent and credible, and it comes to the European resolution mechanism and says, "This bank must be put into resolution," the resolution mechanism would say, "Sorry, it is too complicated to take decisions here". I do not believe that. The fact that we have a clear division of power between the supervisory mechanism and resolution mechanism is the key. I know and I am confident that the supervisory mechanism will do its work and that in the end the resolution mechanism will follow.

As to the resources, of course we must remember that the key issue in recovery and resolution is the hierarchy and how you proceed. The first is shareholders. They must take the first losses. Then come debt holders; there must be bail-in according to the agreed rules. These rules have now been agreed upon. After that, there will be a resolution fund, where the banks have been paying a fee, like insurers. That is the third. There will be very rare cases where you do need to go beyond that, to taxpayers. This structure will essentially help us to alleviate the taxpayers' costs. That is the big lesson of this crisis: where the profits are private, the losses should also be private.

There can be extreme cases when we need public authorities and public money. I have no reason to doubt that the authorities would not be able to do their part. They would, anyhow, be in a much better position than they were before this crisis, when we did not have these bail-in rules. We did not have a supervisory mechanism in Europe, which was able to supervise big banks. We did not have a resolution mechanism in place and so forth. We have learnt our lessons. We have improved the strength of our banking union.

Viscount Brookeborough: Governor, the last crisis, or the beginning of the current crisis, happened very quickly indeed. Do you honestly believe that this mechanism can react quickly enough to save banks under those circumstances, especially with initial problems?

Erkki Liikanen: I want to come back to my previous reply that the key role is in the supervisory mechanism. European supervisors decide if and when a bank should be put into resolution. I am sure that the supervisory mechanism is able to do it. Then imagine that the resolution mechanism would not be able to take decisions on that case. It will happen, but of course we are on a learning curve, because when we build up an institution from intergovernmental to a Community institution, when money will partly be collected as fees from the banks and will partly be public money, this process is complicated. In the end, I hope we will be through that in 10 years. The structure is simpler and clear.

Q22 Lord Davies of Stamford: Governor, just two more questions, if I may. On banking union, we have dealt at some length with the single supervisory mechanism and now with the banking resolution mechanism, but we have not mentioned at all this morning the third leg, which is a common retail and deposit insurance scheme. How important for the success of banking stability in the eurozone is the existence of a common deposit insurance scheme? How serious, therefore, is the fact that no progress appears to have been made or is being made on that subject at all at the present time?

Erkki Liikanen: It is important that we have harmonised rules for deposit insurance in Europe so that all countries have deposit insurance according to the same European rules. We need to get that done now, but we can build up the banking union in this phase, based on the single supervisory mechanism, which is European, the resolution mechanism, which is European, and harmonised schemes but national deposit insurance systems.

Lord Davies of Stamford: Is the problem with that, if you just have harmonised rules but the responsibility is with local member states, that the credibility of the banking insurance system will depend upon the credibility—the fiscal solidity and the creditworthiness—of the local member state? Deposits up to €100,000 will tend to be placed in countries that have the fiscally strongest Governments. That might mean a flight of deposits from the more problematic member states, the poorer member states or those with perceived fiscal problems. That would be the opposite of what we want, surely, in order to restore growth in those countries.

Erkki Liikanen: It is a good question. It is very clear that we must be careful that every sovereign nation is responsible for its own activities, is able to take care of the banking system and that its deposit insurance is properly implemented and applied. It is clear that at this phase we need to base our deposit insurance systems on national schemes that are European and harmonised but based on national funding schemes. In any case we must remember that banks are stronger after comprehensive assessment.

Lord Davies of Stamford: I take it from that response that you are trying to put a good face on what is really a rather disappointing lack of progress in that area. Governor, you said earlier on that the Bank of Finland had undertaken some studies into the German success with reducing youth unemployment to see whether there might be lessons that could be replicated elsewhere. I just wonder if you could tell us whether or not the Bank of Finland had come to the conclusion that there were such lessons that could be replicated elsewhere in the Union and, if so, what they were and what policies could be usefully adopted, profitably adopted, in other EU member states.

Erkki Liikanen: There are lessons that we could learn. One is that the labour market authorities have been very effective in mobilising young people to the labour market. They have been especially active. The second is that the businesses and the labour market authorities have also been working very closely together. They have a quite important apprenticeship scheme, which functions quite well there, which does not exist in many other countries. The third scheme, which has been controversial, is that there has always broadly been a preference for work, even with low pay, which has led, as we have understood it, to the obligation to receive work being strong.

It is difficult to say whether it can be replicated or not, and the question remains as to how we can guarantee one or two issues. One is the preference to work always. The second is to live on what you earn from your work. That is the challenge. The third issue, which we cannot replicate, is that we have individual taxation schemes. The husband and wife have individual taxation schemes. In Germany, it is joint, which makes the incentives a little higher to receive part-time work or work that is less well paid than the other partner's. I am happy to pass to you this report, which has been quite interesting.

I would say broadly that it is an impressive reform that began on the labour markets in Germany. On the other hand, of course, the issue is really how to guarantee that it is always better to work than receive only social support. How do you guarantee that when you work you can also live on your salary? That is the issue that has remained at the centre of German policy discussions for a long time.

Lord Davies of Stamford: I have a high regard for the Bank of Finland's economics department and some of the research work that you have done, which I have seen over the years, so we would be grateful to see this study, which could be useful for us all. Thank you.

Q23 The Chairman: Governor Liikanen, I would like to pass that on to Baroness O'Cathain, who chairs our single market Committee, because it is doing an inquiry into youth unemployment. My final question before I turn to the Earl of Caithness is: given that the European Parliament will go into recess shortly, do you expect there to be a conclusion of the trilogue on the single resolution mechanism before it so does? Do you have high hopes that that can be concluded?

Erkki Liikanen: I sincerely hope that the European Parliament will conclude this trilogue on the single resolution mechanism. It is an essential or necessary part in the early phase of building up the banking union. We will get the single supervisory mechanism by the end of 2014. ECOFIN was ready to agree that we get the single resolution mechanism in early 2016. I hope the Council of the European Union, the European Parliament and Commission find a deal. The earlier it is given, the better. The area where we hope that the trilogue will still make progress is to shorten the transition period of 10 years for this build-up at Community level. That would be more consistent and efficient, but I have a lot of trust in the European Parliament and ECOFIN that they want to conclude this big package that was launched in the summer of 2012.

Q24 The Earl of Caithness: Governor, I would like to ask you about the relationship between the eurozone countries and the UK. Could you lift the lid a little on the relationship between the ECB and the Bank of England? How you have seen that working in the past and how you see it working in the future, whether Britain is within or outside the EU?

Erkki Liikanen: I hope you are not asking me to speculate about the possible non-membership of the UK.

The Earl of Caithness: You certainly can if you want to.

Erkki Liikanen: I will not take part in that discussion. I can say that within the EU there are many platforms on which we work together very closely. One of the very important ones is the European Systemic Risk Board, which was created a couple of years ago on the basis of the so-called de Larosière report. The European Systemic Risk Board focuses especially on the systemic risks that have been a conclusion or a lesson from this crisis. We focused too much on single trees and not on the whole forest. We focused on single institutions, but not on issues that were common to the whole financial system. The European Systemic Risk Board has members from all EU member states—but no non-EU member states—from the European Central Bank and from supervisory authorities. Today, the chairman of the systemic risk board is Mario Draghi, and the vice-chairman is Mark Carney. Before Mark Carney, it was Mervyn King. In this body, we have been able to draw on the experience, knowledge and research of the Bank of England in the financial crisis and systemic risks.

As to the other bodies on which we have worked together, one is of course the informal ECOFIN. The informal ECOFIN is the context where Finance Ministers and central bank governors meet. Unfortunately, they have been meetings that you never forget. I remember my own meeting in Porto, which was during the weekend when Northern Rock went into difficulty. That was 2007. In September 2008, when we were in Nice and Madame Lagarde was hosting the meeting as Finance Minister of France, Lehman Brothers went under. In those contexts, we meet often and our relationships are very good and open, professionally between institutions and personally between people. Then of course beyond that there are the Basel institutions; the Bank for International Settlements is where all bankers meet. It is good; formal and informal co-operation work well.

The Earl of Caithness: You mentioned ECOFIN. I want to come back to that in a minute, but could you just tell us how you and the rest of Europe look at the City of London? Do you think the City of London is given due weight as the financial centre of Europe and not just the financial centre of the UK?

Erkki Liikanen: The City of London is an important financial centre, of course. I often go there myself. Many of us visit there often. We often see bankers from the City of London too. It is one global financial centre that is located in Europe; I have a lot of respect for that. Respect is always mutual and reciprocal, and I hope that is also the case in this area.

The Earl of Caithness: Going back to ECOFIN, Governor, is it frustrating for those in the Eurogroup to agree something the night before ECOFIN, and then have to discuss the whole thing again with members who are not part of the eurozone the following day and to reach agreement in a broader and wider group of people? With the greater integration that is happening and likely to continue in Europe, where is this going to place the UK and our relationships with the eurozone and the Eurogroup? What would your advice be as to how we should conduct our relationship given that divergence between the two groups?

Erkki Liikanen: I always hesitate to give advice to a foreign country, because it normally only creates difficulties, but still I would say that, because the UK has such a strong financial centre with the City—this financial centre plays a big role in global financial markets—when we reform our regulation of the financial markets, it is very important to get proper competent input and expertise from the UK authorities. These issues are often on the agenda of ECOFIN and other ministers.

Of course, in the long term, in the ECB the situation is simpler, because we have a Governing Council that decides our monetary policy; then we have a European Systemic Risk Board, which has a clear mandate, where we work together with the Bank of England, Riksbank—the Bank of Sweden, and so forth. Then we have the General Council, where we have some separate tasks. This ECOFIN context is different, because they meet through the same days, but my expertise and competence is not sufficient, because I am not sitting in those where they are separate; I only sit in those meetings when we are all together, which means informal ECOFIN, where both euro-area and non euro-area Finance Ministers and governors participate.

Q25 The Chairman: Governor Liikanen, my last question to you. When we were in Vilnius last year, I asked you a question in the plenary about Herr Schäuble's comment about requiring for the single resolution mechanism a steel-framed house and not a wooden-framed house. You replied to me in true Finnish manner, saying that in Finland you rather liked the wooden-framed houses. This is my last question. How is all this seen from Finland? What do the Finnish people believe and think about the development of the banking union, the United Kingdom and the development of the single market? Is there a view that you can convey to us that, sometimes, we big countries tend to neglect?

Erkki Liikanen: I still insist that wood is a safe and strong building material, and we have plenty of that available. The role of Finland in European politics has been a constructive role, in the sense that we want to contribute to the solutions; we do not want to waste other people's time. We do not want to lecture, but if we have something original and genuine, we are happy to contribute. I hope it remains that way. We have also had difficulties during this crisis. It is very clear that domestic opinion has not been favourable. The Government have had to commit resources to the problems and losses of certain countries or certain financial systems. We have had this uneasy discussion during the last few years of how to construct a European line and still have legitimacy and acceptance by the Finnish people. This genuine open debate has taken place.

Still I think today that the solutions that were found in the banking union, which relate to the single supervisory mechanism on the one hand and the single resolution mechanism on the other, are such that our parliament is ready to accept them, perhaps not unanimously. European? Yes. Be constructive? Yes. But if you ask people, "Would you like to spend more taxpayers' money there?", they would not say "yes" happily; they would say, "Be careful".

The Chairman: Governor Liikanen, we will send you a transcript of this exchange. We would be very grateful if you could correct it and send it back to us, adding any further thoughts that have occurred to you in the meanwhile. Given the character of your last answer, we are most grateful for the frank way in which you have spoken to us this morning, the wit and the wisdom that we have experienced from you, and we are always open to receive you here in person, at the Committee, whenever you pass through London. In the meantime, my grateful thanks to you for providing time to talk to us this morning. Many thanks indeed.

Erkki Liikanen: Thank you very much.

Gerard Lyons, Chief Economic Adviser to the Mayor of London; Roger Bootle, Managing Director, Capital Economics; and Simon Tilford, Deputy Director, Centre for European Reform—Oral evidence (QQ 26-49)

Transcript to be found under Roger Bootle, Gerard Lyons and Simon Tilford

Senator Mario Monti, former Prime Minister of Italy—Oral evidence (QQ 1-11)

Evidence Session No. 1 *Heard in Public* *Questions 1 - 11*

TUESDAY 11 FEBRUARY 2014

Members present

Lord Harrison (Chairman)
Viscount Brookeborough
Earl of Caithness
Lord Davies of Stamford
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Baroness Maddock
Lord Marlesford

Examination of Witness

Senator Mario Monti, former Prime Minister of Italy

Q1 The Chairman: Buongiorno, Onorevole Monti. Mi chiamo Lyndon Harrison. Siamo molto contenti di discutere con lei occhi tutti—

Senator Mario Monti: Mi chiamo Mario Monti. Spero che possiate vedere mi e udire mi bene.

The Chairman: Grazie. Welcome, Onorevole Monti, to our discussions. I hope you can hear and see me.

Senator Mario Monti: Yes, indeed.

The Chairman: Thank you for coming before the Committee. We are examining the euro area crisis once again, so we are most grateful for your finding time to speak to us. Unless you want to make an opening statement, perhaps I could ask a first question.

Mr Barroso seems to think that 2014 will see the end of the euro area crisis, but Mario Draghi is much more reluctant. I wondered, from your point of view, what you felt the prospects were for the euro area in the shorter and longer term, whether we can be judged to be in recovery by now, and, indeed, when we would know that we had fully recovered from the euro area crisis.

Senator Mario Monti: My Lord Chairman, first of all, I wish to thank you and the sub-committee very much for inviting me. It is a privilege that I have had from time to time and am delighted to renew this on the occasion of this very important inquiry into the euro area crisis. I only apologise that I was unable to be with you physically today at the House of Lords, but I hope this appearance at a distance will nevertheless be of some use for the sub-committee's work.

If I can take your first question, there are many facets in the eurozone crisis. First of all, even though this is entirely clear to the honourable members of your Committee, it is always good to be reminded that we did not have a euro crisis, in the sense that there was not at all a crisis of the euro as a currency but a remarkable and very serious banking and fiscal crisis within many member states of the eurozone. I think it is important to make the first point I made: namely, that the euro as a novel monetary construction was never in crisis during these years, whether we measure its strength through purchasing power domestically in goods and services, or externally in the exchange rate. Many would even note, or complain, that the euro has perhaps been too strong rather than too weak. This is the first point I would like to make.

Turning to the unquestionably severe eurozone banking and fiscal crisis, one observation that we should set as a background is that that was largely due to, or made more serious by, the fiscal imbalances with the budget deficits and budgetary debts. Nevertheless, we should note that this is one of the prices we have to pay for an integration that is still vastly incomplete. We know that the US, at times the UK, and certainly Japan have been having both budget deficits and debts higher than that of the eurozone in aggregate, but, of course, those are states, either federal or non-federal, whereas the eurozone is a collection of member states in the process of acquiring closer integration, but certainly much apart from each other.

That is why some concerns that need not be there, for example in the US concerning the geographic distribution of deficit and debt in the country, emerge as great difficulties within the European Union. Now, with that in the back of our minds, if I may say so, when President Barroso declares 2014 as the year when the eurozone will finally put the worst behind it, I strongly believe that he is right. Certainly, I hope he is right. He says not that the eurozone has come out of all problematic aspects but that we have put the worst behind us.

I believe that the dramatic circumstances that were originated by the Greek crisis and all the consequent events are indeed behind us. Also, there has been a sometimes slow but altogether very considerable response by the public authorities, both in terms of measures taken by different member states and in terms of improvements in the governance system of the eurozone as a whole. If we take, on the other hand, the position of President Mario Draghi that you mentioned, when he said that it is too early to declare the crisis over, the interpretation I would give is that it is too early to disarm the weaponry for confronting a crisis. For example, there are aspects of the putting together of a banking union that, as we know, are not quite there.

Coming to the three specific questions that you outlined to me, first, what is my assessment of the prospects for the euro area in the short and longer term? In terms of financial solidity and financial soundness, the prospects are rather good, because much of the remedial action has been taken, both as regards banking and as regards fiscal discipline. However, if we refer, as you might implicitly have done, to the prospects for the real economy in the euro area, then there is much more to be done and to be expected, which links to the second point: can the eurozone now be judged to be in recovery, or are the recent bright spots in Ireland, Spain, Portugal and even Greece another false dawn?

Well, they are bright spots. They should be built upon. Certainly, and we will perhaps come to this later on, we need more focused growth policies, in my view. Much of that is to be achieved in individual member states through much more intensive action on structural reforms, but much of it is to be achieved at the level of the European Union through more focused EU-wide policy measures favouring growth, of course not at the cost of higher inflation or higher fiscal imbalances.

The Chairman: Perhaps we will come on to the growth question later. Would you like to address the third question?

Senator Mario Monti: When do we judge the crisis to be over? I believe that we will be able to say that the crisis is over by reference to the fault lines exposed in a eurozone that had not really been fully built institutionally. Now, I think we are almost at the point of being able to say that the eurozone is now a fairly complete construction, in terms of its having the necessary equipment of policy tools. I refer, for example, to the European semester, the ex-ante co-ordination of budgets of the different member states of the eurozone, the enhanced powers of oversight at the EU level concerning the conduct of eurozone member states, the country-specific recommendations, and then, eventually, the so-called contractual arrangements. I believe that once the banking union is in place—we are definitely not there yet—we will be able to say that the eurozone is no longer just a semi-finished construction site but has been built.

This will never prevent the eurozone from having fluctuations in the future, either in its real economic growth—there will be cycles, even once the eurozone is a better construction—or in financial terms. There will always be financial fluctuations. However, I hope I am able to convey my point, because we talk about something that was not at all there just 15 years ago and is now there. It has suffered a lot from its incompleteness, which has exacerbated the crisis. This incompleteness is almost over. From this point of view, I would say that the building crisis, or the infant eurozone phase, is almost over. Then the task will be the much simpler, yet still very demanding, one of ensuring proper economic policies within this eurozone.

The Chairman: The Earl of Caithness will ask about a present challenge to the euro area.

Q2 The Earl of Caithness: Christine Lagarde has said that deflation is an "ogre that must be fought decisively" and, recently, an ex-governor of the ECB said that it "boggles the mind" that the ECB has done nothing to counteract the threat of deflation. It has been summarised in the British press as a crisis equivalent to 2007, but in a different place. Do you think that the ECB has been hijacked by the German politicians, and how should it react?

Senator Mario Monti: It is correct and wise that we should ask ourselves this question. Nevertheless, I am not that concerned by the risk of deflation in the eurozone. Why? Well, first of all, we, in the eurozone and outside the eurozone, have been learning a number of lessons from past deflations and depressions, and the policy authorities have those lessons in their minds.

Secondly, I believe that should there be an early materialisation of the actual risk of deflation, it would not take much time for the policy instruments to be released, i.e. to be managed in a more expansionary way. Certainly, there is no lack of recourse in the member states of the eurozone, for example, to an exceptional temporary period, should deflation be declared, of more expansionary fiscal policies. Equally, the ECB has given proof of a much greater flexibility, not in the sense of passively complying with political requests, but in the sense of being able to adjust its own fully autonomous and independent decisions to the actual needs of the economy that they have to manage from a monetary point of view.

Obviously, it is and will always remain a very difficult proposition to conduct a single monetary policy in a eurozone of 18 different member states, with their different structural features and even, to some extent, different economic cycles. I would say from this point of view, if I may, that there are two key requirements for the playing ground of the single monetary policy to become more like the playground that we consider ideal in an optimum currency area.

One is that there should be more openness or mobility in goods, services and the factors of production in the whole of the euro area. From this point of view, as I had an opportunity to say in a previous hearing at the House of Lords in 2010, we need to deepen, and to make more functional, the single market for goods, services, capital and not least people, particularly in the euro area. It is a paradox that I always denounced that many of the countries in the eurozone have not really learnt the lesson of optimum currency areas. They entertain amongst themselves a degree of actual implementation and compliance with the single market rules that is on average smaller than the degree of effective absorption of the single market by the UK, the Nordic countries and many of those countries in central and eastern Europe that joined the EU 10 years ago. It is also from the point of view of facilitating a more effective monetary policy that member states become both more flexible through structural reforms and more open through full implementation of the single market, as the UK would like us all to do.

The second requirement for a single monetary policy to be able to be conducted is something on which President Draghi and the ECB have, rightly in my view, concentrated very much in the last couple of years: namely, there has to be an effective transmission mechanism of monetary policy. When for a number of reasons the spreads between interest rates, say, on government bonds of the various member states in the eurozone differ widely—and I would say widely—there is a sort of fragmentation in the financial markets and this undermines the possibility of conducting an effective single monetary policy. This has made the ECB and others more and more aware of the fact that looking at the spreads, and having some policy action there, is not outside the realm of monetary policy, because it can precisely affect the degree of abilities through which the single monetary policy can be performed through the transmission mechanism.

The Chairman: Perhaps we could pursue that point about the ECB's role with Lord Davies.

Q3 Lord Davies of Stamford: Good morning, Senator. You may have implied an answer to this question already, but it is an important question that I think we should ask you. How do you assess the overall performance of Mario Draghi as president of the European Central Bank?

Senator Mario Monti: My assessment of the performance of the ECB since its inception is, indeed, a very positive assessment under the three presidents: President Duisenberg, President Trichet, and now President Draghi. The three of them together enable us to credit the bank with something that was not obvious at all, initially. It is very difficult to establish a high credibility for a new institution. We all know this. The fact that they created and then managed a currency that since the beginning and throughout has been able to command interest rates as low as those enjoyed prior to the inception of the euro by the country considered to be most stable, i.e. Germany, is a very remarkable achievement.

Does this mean stubbornness across the board, and an inability to maturely take into account the needs of the economy of the eurozone? No. In my understanding, that would be an inappropriate inference. The best illustration, if I may devote a couple of minutes to this, of this flexibility within independence is the performance of the ECB under President Mario Draghi, in the course of 2012.

Lord Davies of Stamford: Are you referring to the OMT instrument?

Senator Mario Monti: I am referring to the OMT, but I would like to put it in a broader context. What is the path that was followed leading up to the OMT? The ECB only one year before had done many purchases of Spanish, and in particular Italian government bonds during the summer of 2011, and in spite of this, there was an increase, not a decrease as one might have expected, of the spreads between Italian government securities and the Deutsche Bunds. That way of conducting business has been discontinued. The TRO has been used. However, the most interesting policy debate in the eurozone was the one in the spring of 2012, when a few countries—may I mention my own country, Italy?—under a very drastic cure of budgetary discipline, and also the beginning of structural reforms, had rather quickly come into a situation where the European Commission and other bodies were able to say, "Okay, that country is complying now with all the country-specific recommendations and all the guidelines". Yet we were experiencing moments in the financial markets—I remember them vividly because I was Prime Minister at the time—when in spite of these good marks given by the European authorities, the interest rates would come down very slowly, if at all.

Initially, there was the view, particularly in the northern member states, that if a country does not get the rewards of declining interest rates that it might have expected, well, that is simply the proof that it has not been doing enough. We argued in a number of meetings that that was not necessarily the explanation. A complementary explanation could be, and in my view was, that there was still an element of systemic risk embedded in the euro. Markets did not believe in the integrity of the euro for ever, and were fearful that one day one country or another might leave the company, so there was a risk premium on the euro that of course had a disproportionate weight on those member states, such as Italy, which in spite of implementing the good policies, as judged by the EU, nevertheless had a high legacy of debt from the past.

This intellectual and quite vigorous policy debate led us, in the eurozone summit of 28 and 29 June 2012 in Brussels, to the adoption of a long-negotiated—until four o'clock in the morning—statement of the Heads of State and Government, which was pretty innocent and one might even say dull at face value. After all, it said, "We affirm our strong commitment to do what is necessary to ensure the financial stability of the euro area, in particular by using the existing EFSF/ESM instruments in a flexible and efficient manner in order to stabilise"—which is the key word—"markets for member states respecting their country specific recommendations" et cetera. Then we said, "We welcome that the ECB has agreed to serve as an agent to EFSF/ESM".

In this very non-spectacular language, we have for the first time a college, a body, including the Heads of Government of Germany, the Netherlands, Finland—traditionally hard currency countries not prone to monetary policies of stabilisation, that nevertheless do concur with the statement that I just briefly quoted. It was only a matter of a few weeks before President Draghi, in London, felt comfortable in saying, "We will do whatever is necessary".

Q4 Lord Davies of Stamford: If I can interrupt for a moment, that statement you just quoted, where Mario Draghi said he would do whatever was necessary, was clearly a key moment. There is a considerable consensus, both in the academic world and in the markets, and increasingly in the political world, that your assessment of Mario Draghi's and the ECB's performance is right. I wonder if I can move on to the future, because people are naturally concerned about where we go from here. You have already been asked a question by my colleague Lord Caithness about the danger of deflation, and you said, in answer to that, if I can quote what you said a few moments ago, that, "it would not take much time for the policy instruments to be released" that would be required if deflation became a reasonable threat.

Can I ask you to go a bit further into the tools available to the ECB? There are obvious disadvantages about the tools available. Negative interest rates would effectively be a tax on reserved assets. They would reduce the profitability of banks. That would affect their stock market rating, counter to what we are trying to do now to shore up the stability of banks. Any threat of passing on negative interest rates to consumers would lead people to go straight into holding large amounts of currency, in notes presumably. There could be a run on the banks, if there was a danger of the note issue being somehow suspended.

Equally, if you went for targeting a QE process in which the ECB was supposed to buy the liabilities of member state Governments, the question arises as to what basis they would make those purchases on. If they did it selectively, would the German constitutional court accept that? If they did it on a weighted basis, would excessive liquidity be created—excessive reductions in yields in Finland, Germany, the Netherlands and so forth? There are a lot of risks attached to the process of developing these new tools. I would be grateful for your assessment as to whether you think the ECB has the right instruments to use in a crisis of that kind.

The Chairman: I do apologise, Signor Monti; we are beginning to run short of time. I wonder whether you could reply to Lord Davies about the instruments available to the ECB, but I know he is very interested to learn of your view of other EU institutions, namely the Commission, the Council and the European Parliament, and how successful they have been.

Senator Mario Monti: Yes. I will try to accelerate my answers. On the instruments of the ECB, I have spent some time in the past coming to the conclusion that, within the scope of its full independence, the ECB is able to adapt. That conclusion in June 2012 of the eurozone summit gave the ECB, in my interpretation, the perception that that had become an utmost imperative at the level of the Heads of State and Government. The ECB, within its independence, then felt comfortable with the statements by Mr Draghi in London, and that the OMT would not be perceived by any of the Heads of Government as being in violation of the mandate of the ECB. This is why I personally believe, unlike many in Europe, that it would not be worthwhile changing the mandate of the ECB, because there is no need for that. I would be reluctant to see the mandate changed by the introduction, for example, of a reference to growth, because I am afraid that the political leaders of the member states and of the EU might take some comfort in being able to point a finger at the ECB in their public opinions if growth is lacking in spite of it being included in the ECB's mandate.

I prefer the policies for growth, which are policies in the real sphere of the economy, to be conducted by those who must find the political will to do that. As to the tools available, I admired the presentation of the difficulties of each of the possible tools, and I tend to concur with that. In the eurozone, again, because it is not yet—and may never be—a single state entity, there is always an inevitable problem of distribution among member states depending on which bonds are purchased.

Nevertheless, I would remain hopeful, because we have the capacity of the ECB under more than one President to—I am almost tempted to say—invent operational tools that they see fit within the limits of their mandate.

Q5 Lord Davies of Stamford: I suppose you could say that all successful central banks in history have shown flexibility in inventing policy instruments that are appropriate to new circumstances. You have been very flattering about the ECB's conduct of its role—not excessively so, in my personal opinion—but I wonder whether you feel the same about the conduct of the other elements of the troika—the Commission, the Council of Ministers and the European Parliament—in this crisis. Have they equally well acquitted themselves of their responsibilities?

Senator Mario Monti: No. When you mentioned the troika, you referred to the three European institutions. We know that "troika", in some European countries, has become synonymous—

Lord Davies of Stamford: With the IMF.

Senator Mario Monti: Exactly. I am very sensitive to this point, because there were many authoritative suggestions to my Government when we started: that we should file for a programme and accept the troika. I strongly resisted that and said that Italy would be able to come out with its own force and determination, and I think this has happened. Turning to the troika of the three proper EU institutions, I would say that the Commission, for one, initially, was not in my view aware enough, and then not responsive quickly enough, to the need to update, to modernise and to integrate the financial regulation and supervision. The crisis made this obvious, but it took some time for the Commission, through the use of the excellent advice of the de Larosière Group, to produce the proper rules.

As to the European Parliament, well, I know it does not always enjoy the highest possible consideration in Westminster. Without pronouncing an overall judgment about the European Parliament, I can say that in the handling of the eurozone, the European Parliament has surprised many—it has certainly surprised me—in being totally different from what one would suspect a parliament to be: a somewhat irresponsible body in fiscal matters. No. We now have in the governance rules of the eurozone pretty tough rules that the recommendations of the Commission concerning the enforcement of the stability pact cannot be easily overturned by even large member states. That is due to a very helpful coalition that was established between the moral authority of the ECB and the political authority of the European Parliament.

The Council, which of the three institutions is the one to which I have belonged more recently, has really seen a momentous change. In the misfortune of the eurozone financial crisis, we have all been very lucky in having had the innovation brought about by the treaty of Lisbon—that is, the permanent President of the European Council—come into effect at the end of 2009. At least a permanent President of the European Council, President Herman van Rompuy, was there, and he has been able, not really under much limelight, to be a very effective element of continuity and broker the necessary unitary positions in the Council, even though there are some inherent weaknesses in a body of 28 that has to work by consensus. I am ready to go into more detail, if you so wish.

Q6 Lord Marlesford: Senator Monti, you have pointed out that the euro crisis was essentially a banking crisis, and as part of the banking union the ECB is due to take on supervision of the banks in November this year. Before that, they are busy carrying out, or organising, stress tests of the asset and liability situations of the banks in the eurozone. Do you think that if any fragilities are revealed by these stress tests—any shortfall in assets of the banks—there is, or will be, sufficient financial back-up to make them good, or do you think there could be some form of crisis in July when stress tests are revealed?

Senator Mario Monti: I must say that I do not have certainties in this respect. I wish I had, but I do not. These stress tests are an operation of necessary—I am tempted to say purification—before entering a new phase of European banking life. As we all know, they have to be tough enough so as to be credible, but one hopes that their toughness does not reveal a landscape that is so full of holes as to make it impossible to have sufficient financial means.

I come to the Governments here. The Governments of the eurozone have learnt a number of lessons, and they have seen that the lack of financial resources for banks, if not remedied promptly, may drag on and make many other victims throughout their economies. Although it is politically sensitive in all our countries to give the impression that banks are priority number one in terms of the use of public resources, at least I feel confident that member states will not underestimate this issue. I realise that I have not provided you with much light on your question. On this one, I am not able to throw much light.

As a final footnote, it will be very important that no segment of the eurozone banking system of any importance is left out, for any reason, from the analysis, from the testing, and from the possible remedial actions. I have long admired Germany as the place where the model of the market economy has been tested in Europe much earlier than elsewhere.

By the way, I have always criticised the French in the last few years when they considered the market economy, or neoliberalism, as an Anglo-Saxon phenomenon, because after all I remember that one of the key points in the campaign in the mid-1970s to find out whether or not citizens wanted to keep the UK in the common market, as it was then called, was the sentence, "Without tying our hands to the market discipline system of Germany, we will never transform this rather messy UK domestic economy", a bit like Italy and others, which years later, after all, welcomed the discipline coming from the Maastricht treaty.

Sorry, I have diverged a bit. I was going to conclude this slightly tortuous reasoning by saying that the Germans have been obviously the inspirers of much of European integration, but if there is one point where I admire them less it is the transparency and the quality of segments of their banking system, in particular the Landesbanken, a component with which I had a lot to do when I was European Commissioner for Competition.

Q7 Baroness Maddock: Good morning, Senator Monti. I want to ask about something you already touched on. You were talking about stimulating growth. Within the eurozone, we see low growth, a lack of competitiveness and very high levels of unemployment in some areas. I would be interested to hear more about your ideas for stimulating growth, but do you think enough is being done to promote competitiveness, to help reduce unemployment, and if not, perhaps you could enlarge on that for us too?

Senator Mario Monti: On stimulating growth, competitiveness and employment creation in Europe, I could not agree more that youth unemployment is plague number one in many of our countries. To achieve more growth in Europe, we really have to do more in terms of structural reforms. "Structural reforms" risks being, by now, an almost empty term, but we know that in reality this means reforms in the labour market and, in the case of some countries such as Italy, with a hub of decentralisation of the wage-setting mechanisms—less protection for the insiders, more openness and favour to the outsiders, and other things that would lead us towards the flexicurity that is typical of countries like Denmark, and has been much celebrated.

So, there is the labour market, but also the introduction of more doses of competition in the markets for products and services. Here, the UK has done more than many others over the years, and I think this is key to giving more impetus to competitiveness and growth. I could mention other structural reforms. In some of our countries, certainly in Italy, we attached a lot of importance to producing, for the first time, a comprehensive package against corruption, because that is, of course, a very serious cause not only of unethical behaviour in economic life but of the malfunctioning of a market economy.

We also have to do more to stimulate growth at the European Union level. What does that mean? Does that mean that we need more aggressive monetary policies? No, I do not believe that would be the answer. Does it mean that we need a more visionary investment policy at the level of the EU? In many cases, I believe, yes. This does not necessarily require public money or national public money. The European Investment Bank is doing a lot. It can do more. However, there are still very visible bottlenecks, for example, and our energy, transport, information and communication technology systems lack interconnection. If we really want a real single market in Europe, as the UK has always advocated and as I, much more modestly, have always advocated, we need to have the legal single market in place but also the physical single market. There is still a lot to invest there.

Finally, I do not believe that major transformations in the policy framework should be introduced, but one is gradually gaining ground and that is greater recognition, in the European rules concerning the fiscal discipline of the member states, of the role of public investment. I have always been convinced that in the way the stability and growth pact is enforced—I am not suggesting changes in the pact at this stage—it may be worth being even more rigorous, even more stringent, as regards the deficit due to current public expenditure, but perhaps to leave more flexibility to the part of the deficit that is due to genuine, according to certain definitions to be agreed, public investment. This is a component of demand, yes, but it is also a component of public demand that generates more growth capacity for the future. I think I have given you a very intricate set of actions at the level of member states, at the European Union level.

Finally, I know this is a very touchy point. Each of us during this historical phase is busy with economies in our national budgets, so it is perfectly understandable psychologically that we want at least those same economies at EU budget level. However, we all know that that contains aspects of irrationality. I would be totally in favour of even more stringent budgetary and administrative controls. At the same time, we cannot *a priori* renounce for ever the potential of economies of scale that we could benefit from by having some provision of public goods done at EU level. One aspect is, of course, defence, although it is very sensitive, and there are other aspects where all of our countries would save money if they agreed to do a bit more at the community level.

The Chairman: Signor Monti, before we go on to the banking union, and a final set of questions about the United Kingdom, I am going to ask Lord Marlesford to come in briefly.

Q8 Lord Marlesford: Senator Monti, your stewardship of your country as Prime Minister was very widely admired in Britain. I wonder if you can give us an assessment of the economy at the present time, and perhaps comment on two points that worry us. The first is to ask you whether you feel that the north and the south of Italy are moving closer together or further apart. The second point is that you mentioned corruption. Is the power of the mafia and its affiliates now growing, or is it diminishing?

Senator Mario Monti: Thank you for the very simple questions you asked me. Thank you also for conveying appreciation for my work as Prime Minister. You know, there was not really much choice. Italy was at a difficult stage, and if it had gone down, the whole of the eurozone might be at very, very serious risk. So, with a very tough transition, we have managed now to be the only country in southern Europe that has done without a programme, and therefore without the troika. We are the only country in southern Europe that has come out of the excessive deficit procedure with the European Union. In this respect, I must say that we can broaden the notion of southern Europe a bit, because France, Belgium and the Netherlands are still under the excessive deficit procedure, but not Italy.

In terms of structural reforms, we have started work, particularly with pension reform, which was very structured, very determined. The other day I was reading a study by the Stiftung Marktwirtschaft in Germany. It calculates the sustainability ranking for each European country by making the addition of the explicit public debt and the implicit public debt due to the liabilities of the pension system, and they calculate the so-called sustainability gap. I was heartened to see that the most sustainable situation—that is, the smallest sustainability gap—is that of Latvia. Second is Italy. Third is Estonia. Fourth is Germany. I hope that this perception of Italy as a financially unstable country could gradually give room to a more realistic and deeper assessment.

The north-south problem is really still there. You rightly point to it. Some progress has been achieved, notably through a fight, which has been much more vigorous in the last several years, against forms of organised crime. In my view, my Government had more urgent priorities in the 18 months they had at their disposal, and time was also very short, so we have not yet reflected enough on and adapted enough something that would find a more appropriate place for Italy in the international specialisation of labour. A country that is lucky enough to have a cultural heritage, nature and quality of life—not necessarily the dolce vita but works of art of the country to enjoy—sometimes the beauty of the weather, although not today in Rome, because it is raining hard, is a country that could extract more from these comparative advantages. I mentioned this in the context of the north and south, because the south has more than proportionally to provide to this enhancement of Italy.

The Chairman: Signor Monti, we have only 10 minutes left and I wanted to know what advice you can give to the United Kingdom. I wonder whether I can ask Lord Brookeborough and Lord Hamilton to pose some questions about banking union and the Liikanen report. I should tell you that in 15 minutes' time we interview Erkki Liikanen, by video conference, just after you.

Q9 Viscount Brookeborough: Senator, good morning. I wonder if you could tell us your views on the agreement over the single resolution mechanism. Do you not think that it will be too cumbersome or too difficult a process to be effective? Will its size be enough to guarantee the future of the banking sector, accepting that we do not know what crises may be down the road?

Q10 Lord Hamilton of Epsom: On the Liikanen proposals, it strikes me that it is now becoming quite apparent that, both in the United Kingdom and in the eurozone, we have banks that are still too big to fail. Do you think that perhaps Liikanen and Vickers did not go far enough in breaking up banks so that they would cease in the future to be a liability on taxpayers? Is the evidence that the Liikanen proposals have been diluted to some extent to make that situation even worse?

Senator Mario Monti: If I may very quickly respond to both questions, now that Europe has decided to endow itself with a banking union, as it was right to do, a gradualistic approach would not be very appropriate. I favour gradualistic policies in some areas, but here the cumbersome nature of the decision-making process is such that it would be much better, although politically more difficult, to err by excess of boldness, in terms of size, than by defect. I would say that the single resolution mechanism and the size of what is available to support that are probably not enough. The Liikanen proposals are, in my view, good, and I hope the dilution is as little as possible. I would hesitate in going into these aspects any further, since you will have the benefit of having President Liikanen very shortly. If there is time, I would be delighted to try to answer any question about the eurozone and the UK.

Q11 Earl of Caithness: Senator, with the increasing integration of the eurozone, where do you think that is going to leave the UK? Moving on from the UK, to the City of London specifically, how well recognised is the City of London as being important for the EU as a whole, not just the UK?

Senator Mario Monti: I believe that the importance of the City of London as an asset for the EU as a whole, not just the UK, is recognised many more times in the EU than the UK believes. On what happens to the UK with greater integration in the eurozone and how I would advise the UK Government to engage with the integration agenda, let me be quick and somewhat bold here. The UK is a very important presence in the European Union, and at all its decision-making tables. It is an important presence for itself, but also for the messages, the genes, which in policy-making the UK brings with it, maybe because I happen to like them very much: openness, competition, market, et cetera. These are inputs that the UK, since Lord Cockfield, has brought abundantly into the EU, and that sometimes do not resonate strongly enough in our large continental eurozone countries such as Germany, France and Italy. There would still be an unexploited potential for the political influence of the UK on us all if the UK were to take the centre of the scene in the European Union, advocating very strongly the pursuit of more economic integration. To give you an example, it was a pity that the UK Government did not come on board with the fiscal compact treaty, not so much because they are not on board with the fiscal compact treaty, but because in my view—and I had discussions with Prime Minister Cameron at the time—the UK might have used that moment in a very proactive way, namely by saying, “Okay, dear other member states, you will understand that I have to pay a price politically, because any ratification of a treaty is difficult in my country, so I need to be compensated somewhat”. It would have been of great advantage to us all if the compensation asked for by the UK Government had been the following: “Okay, let us all be much, much more serious in completing the single market and enforcing it rigorously”.

For example, it is inconceivable to me that the tools for the effective enforcement of the stability pact in Europe are now much stronger and faster than the tools to get rid of an obstacle erected by one member state in the face of the single market. If the UK had positioned itself centrally by saying, “Okay, I will agree to the fiscal compact, but only if you do so and so”, it would have not been isolated; it would have been as great an ally as the Nordic countries, but also the new member states of central and eastern Europe. It would have taken the high ground morally and politically. It would have been very difficult for Germany, France and Italy to say, “No, we will not subscribe to this”.

This means that when it comes to deciding what to achieve from Europe in the next few years that might be spendable in a British referendum, I hope the UK will not go for carve-outs, exemptions, little or large backward moving steps in integration but will be bold and call all of us to genuine action in achieving more integration. I believe it would be of great interest for the UK, because, of course, the City of London is there. It is of great value for us all and for the UK, but the single market for energy, the single market for the digital agenda and the single market for the professions are all aspects the UK could ideologically, economically and financially gain from. I apologise for this to some extent unsolicited advice.

The Chairman: Senator Monti, I would like to thank you on behalf of the Committee. I would like to add my own personal thanks to those of Lord Marlesford, not only for your period of being Prime Minister but for when I knew you in the European Parliament, when you were one of our very excellent commissioners. I am also very pleased that we have finished on a note bearing in mind the contribution of Lord Arthur Cockfield, who was a Member of the House of Lords and was the architect of the single market. I am as fanatical as you are for promoting the single market as the way that we can exit some of the problems that Europe now experiences.

In finishing, I note that Lord Arthur Cockfield and I shared the same birthday, 28 September, but so, too, did Confucius. If I may say, the wisdom and the wit that we have heard from you this morning certainly adds to the passing of a very swift hour and a half. We thank you from the United Kingdom. You will always be welcome before our Committee in future times. Thank you very much indeed.

Senator Mario Monti: Thank you very much, my Lord Chairman, and my Lords and Ladies.

Simon Tilford, Deputy Director, Centre for European Reform; Roger Bootle, Managing Director, Capital Economics; and Gerard Lyons, Chief Economic Adviser to the Mayor of London—Oral evidence (QQ 26-49)

Transcript to be found under Roger Bootle, Gerard Lyons and Simon Tilford