HOUSE OF LORDS

Revised transcript of evidence taken before

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Economic and Financial Affairs and International Trade (Sub-Committee A)

Inquiry on

THE FUTURE OF ECONOMIC GOVERNANCE IN THE EUROPEAN UNION

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TUESDAY 23 AND WEDNESDAY 24 NOVEMBER 2010

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Lord Monks and Mr Ronald Janssen

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Memorandum by the European Trade Union Confederation (EGE 2)

European Monetary Union

1. With monetary union, one single monetary policy for the whole of the region needs to be combined with the different – and often diverging- fiscal, tax, wage policies as well as with the diverging structural features of a multitude of member states. While monetary union also makes it impossible for global financial markets to undertake harmful speculation against individual currencies, it also means individual member states face one single exchange rate and one single policy interest rate. Once member of monetary union, member states have to cope with that, irrespective of the particular business cycle position they find themselves in and irrespective of the structural challenges or needs of their national economy. And as the Euro area have been reminded during this crisis, member states are rated individually – and with wide variation – on the international band markets.

2. The makers of monetary union did recognize this basic fact. However, the solution provided by them was a <u>static</u> solution: Countries were (are) only allowed to become a member of the Euro Area after respecting a number of convergence criteria. The idea was to get the different members in a similar starting position on issues such as inflation, public deficits, exchange rate stability and public debt, hoping that countries would continue to converge afterwards.

3. However, in doing so, the <u>dynamics</u> that could and would develop after countries entered monetary union were ignored. One exception to this was the Stability Pact which pushed members of monetary union from a 3% deficit when entering the single currency to a zero public deficit or even a surplus. This focus on the elimination of public deficits (however welcome it may be for the sustainability of public finances) diverted attention from the forces of disequilibrium and divergence that developed and gained strength <u>after</u> the single currency was joined.

Dynamics of disequilibrium intensify after entering monetary union

4. From the moment the single currency was launched, some members saw this as an opportunity to increase intra- euro area competitiveness. This was especially the case for those countries which, because of their powerful industrial base and their specialization in sector such as machinery, telecom and transport equipment and chemicals, were already in a good competitive position. Whereas in the past, the gains resulting from a strategy of competitive disinflation, were simply neutralized by an appreciation of the national currency (the DM in particular), this was no longer the case under monetary union. This proved to be in reality a powerful incentive for a country like Germany to embark on a decade long strategy of real wage stagnation, thereby helping the conquest of substantial export markets shares inside the rest of the Euro Area; and this without having to fear that these gains would be offset by a devaluation of the lire or peseta in future. In this way, Germany, the Netherlands, and Austria avoided the Japanese experience – an over strong currency which hobbles growth.

5. Whereas monetary union installed the incentive on the part of traditional 'surplus' economies to continue pursuing and even intensifying their 'export-led growth strategy'

to the maximum extent possible, monetary union at the same time provided the traditional 'deficit' countries with the opportunity to experience a 'golden' decade of growth, thereby in turn also saving the 'surplus' countries from the effects of their deflationary policy of depressing domestic demand. One single monetary policy with one single exchange rate and one single interest rate basically causes this. Whereas the interest rate was held extremely low to prevent the 'surplus' countries (representing 30% of the economic weight of the entire monetary union) from collapsing under its strategy of wage stagnation, this same limited interest rate was stoking growth and demand in the 'deficit' countries by creating asset price bubbles and/or heavy debt dynamics. Observe that these debt dynamics were <u>not</u> public but private sector dynamics (with the exception of Greece), implying that the discipline of the Stability Pact was beside the point.

6. The peculiar dynamic resulting from the combination of one single monetary policy and diverging economic strategies was that external deficits and external surpluses were feeding each other throughout the entire first decade of monetary union. It is only now that this has come to an end, with financial markets having become risk averse in the aftermath of the subprime crisis.

One key question: Can deflation and wage cuts save the economy?

7. This brings us to the core of the problem. After ten years of growing divergence, can countries who no longer have the instrument of a currency devaluation at their disposal correct for these economic imbalances by undertaking an 'internal devaluation' in the form of extreme wage flexibility? The idea, which is openly promoted by the ECB and which is already a reality in several countries (Ireland, Greece, Spain), is to cut both real as well as nominal wages in order to install a process of 'competitive <u>deflation</u>' in what is now called the Euro Area periphery.

8. However, deflation, even when limited to a sub region of the Euro Area, is counterproductive and extremely risky. Wage cuts will directly kill domestic demand. Moreover, wage cuts will trigger a process of debt deflation, a process which given the enormous (public and private!) debt levels in several countries will drive their economies into ruin. Meanwhile, the single monetary policy will not be helpful, given the fact that regional deflation in combination with a positive nominal interest rate will make these economies face high real interest rates on their already high debt loads.

9. The strategic response of 'surplus' countries to the wage cuts and deflation in 'deficit' countries is not so straightforward either. These countries (Germany in particular) may respond by attempting to hold on to their hard won cost competitiveness advantage, in which case wage cuts in the periphery will be met by wage cuts in the core, tipping the whole of the Euro area into a deflationary trap which the ECB will find difficult or even impossible to fight. And even in the case 'surplus' countries do decide to reflate their economy with the aim of trying to rebalance the whole of the Euro Area, it still remains to be seen whether and how the additional demand generated by them will reach the rest of the Euro Area or will disappear into external deficits with the rest of the world. Re balancing the Euro Area then means that 'surplus countries' need to make an effort to the extent that demand decelerates in the 'deficit' euro area members <u>plus</u> to the extent that demand disappears into the rest of the world. In practice, this implies that former 'surplus' countries should not only reduce their surpluses but should be turning

their external surpluses into deficits, most probably by staging some kind of debt or asset price boom from their side. This is not a prospect that is very likely (or even desirable for that matter), given the tradition of 'stability' that is inherent in the economic culture of these countries.

10. Finally, what complicates things even more is the fact the usual adjustment mechanism which is available in other currency unions is weak in the Euro Area: When wages start to fall, workers in the US (or Germany for that matter) tend to move towards the regions where jobs are available. Labour mobility is a safety valve preventing wage dynamics from diving into deflationary territory. Europe however, with its cultural and language difficulties does not have the same type of labor mobility the US for example has.

From European governance to European government?

11. The concept of economic governance, as it is being proposed right now by the European Commission, the ECB, European finance ministers and the Van Rompuy task force, basically boils down to semi automatic sanctions, to be decided by finance ministers, against countries that fail to cut wages, social benefits and public services. The single focus is on internal devaluation and cost competitiveness, coming at the expense of labour in Europe. Not only will this policy not work (see above), it also risks turning 'Europe' into being perceived as the international 'penalty police', cracking down on the interests of labor throughout the entire Euro Area and Europe.

12. The discussion on 'economic governance' therefore needs to take up a different dimension.

13. On the one hand, governance should refocus away from excessive cost competitiveness and instead on a European coordination of social economic policies to stop the social race to the bottom that is now risking to materialize. This is not to deny the need for adjustment but adjustment needs to be <u>symmetrical</u> (restrictive demand policy by some, reflationary policy in other economies) and is to remain <u>within reasonable limits</u> (no systematical deflation, no generation of new debt bubbles to turn 'surplus' into 'deficit' countries).

14. On the other hand, the discussion on economic governance needs to evolve into a discussion on European economic <u>government</u>. The Euro Area needs an alternative to deflationary wage cuts and 'beggar-thy-neighbour' strategies to ensure a minimum of economic and social cohesion inside monetary union. Other currency areas (US, Germany) do this by using the federal budget as a way to help stabilizing the different regional parts of their economies. Whereas politically, it is premature to expect a European/Euro Area supra national budget that would function in the same way and on a similar scale as the US, what Europe can do is to provide 'investment transfers' to those economies of monetary union now suffering from the brutal unwinding of ten years of built up 'surplus/deficit' dynamics. A gradual and limited build up of debt at the Euro Area level would allow the 'deficit' countries to drive down their debt levels without completely choking off domestic demand. This can be seen as a 'positive conditionality' allowing member states to grow out of debt, as opposed to the 'negative conditionality' approach now being applied by the joint IMF/European Commission adjustment plans.
    21 September 2010

Members present

Lord Harrison (Chairman)
Lord Hamilton of Epsom
Lord Jordan
Baroness Maddock
Lord Marlesford

Examination of Witness

Witness: **Dr Daniel Gros**, [Centre for European Policy Studies].

Q170 The Chairman: We had the pleasure of meeting your colleague Dr Thomas Mayer. He came before our Committee a couple of weeks ago. I must say he was fascinating and dealt with some of the same area that you might be able to cover. Thanks for coming. You know that we're having a good look at economic governance within the euro. A transcript of this interview is being taken. We will send it to you, if there are any errors or something you'd like to clarify if it was not quite clear what you wanted to say we'd be most grateful if you could supply that, or any additional information that you have. As you fully realise with the news today, as fast as we try and nail it down, the situation is moving.

Dr Gros: What is new today?

Lord Marlesford: North Korea is attacking South Korea.

The Chairman: Well, there's that as well. We are keen to talk about your ideas about the European monetary fund, but first of all, going back to the inception of the euro and the EMU, there was always a thought that it was going to be a difficulty having a central bank controlling monetary policy, against the fact that fiscal policy was left to the member states that joined the euro. I wonder whether you feel that's a fault line that has never been resolved and whether it should be attended to, or whether it's something you can live with.

Dr Gros: It is something we thought we could live with—and I must say to some extent I'm guilty as well—because we underestimated the fragility of financial markets. They don't always have to be fragile, but at times they are, which makes the makes no-bailout clause not credible. Many people, including to some extent myself, did not put enough emphasis on strengthening the banking system in the face of this dichotomy between monetary and fiscal authorities. You can maintain that only if you have a very strong banking system, strong enough to withstand a sovereign insolvency.

Q171 The Chairman: So is that one of the areas where you would begin to strengthen the system if you were trying to maintain the model of strong monetary policy, but a fiscal policy that is devolved?

Dr Gros: I would trade the entire Van Rompuy package on economic governance against a couple of things on the banking side. Right now, if banks hold euro area Government debt in their portfolios, the risk is zero-rated, which is strange, because the Basel rules said zero until a rating of AA, and then 20%, and then 50% ratings. So not even that was transposed in the CRD directive, which deals with capital adequacy. If I could get reasonable risk rating, I would link it to the excessive deficit procedure. If your country goes into the excessive deficit procedure, you increase the risk rating a little bit. If it doesn't follow recommendations, you increase it a bit more. Each step of the excessive deficit procedure you could ratchet up a little bit the capital that banks have to hold against that debt. You would do the same for insurance companies and other regulated entities. Then you would have very strong incentives for the banks to get out of that stuff and the banking sector would not be so exposed.

Q172 The Chairman: Could you give us a pen portrait of the European monetary fund? You have written extensively about it, but it would be very helpful for the record to have that, and whether it would apply to all 27 countries, or just to the 16 of the eurozone. That would be helpful.

Dr Gros: The idea is to have a body that has enough funding to save financial markets from collapsing even if a sovereign goes insolvent. It's basically a fund that can't say no to a sovereign. One can discuss the amounts and how much you would need. In essence, that's it. To make that work, you need an independent institution behind it that has to take the difficult decisions on whether the sovereign is liquid or insolvent. Should we let the banks of that sovereign go insolvent, like in Ireland? That is why one needed an independent institution. The Commission itself is not the proper place, because as a college it is becoming more and more political. It covers many things. Just making ECFIN partially independent is not enough. That's why I thought that we needed an independent institution to do that.

The final thing was how to finance that. You need funding from member states or from somebody else, but I would link the excessive deficit procedure to the funding of the fund. Thomas Mayer proposed that any deficit above 3% should attract a certain charge, which would be refundable later. That's not a fine. I always say this is like the bonus-malus system of car insurance. The policeman says you will pay a fine because you have been speeding and the fine is so much. With a bonus-malus system, if you have a high debt level you pay into the fund because you are effectively a bigger risk. The key is that it is very gradual. It doesn't require decisions, whether by unanimity or automatically. These are the three most important elements for me.

Q173 The Chairman: Would it apply to the 16 or to the 27?

Dr Gros: I would say rather to the euro area, for the simple fact outside that area the financial market integration is not as large. Why? Within the euro area the risk rating of Government debt is zero for all sovereign issuers. For issuers from outside the euro area the risk rating is 20, 50 or 100, so there is already something in there that makes it very likely that systemic issues are unlikely to arise within the euro area from a non-euro area member country.

Q174 The Chairman: You said you might have thought of the Commission or ECFIN or whatever. What about the IMF? There are those who say that that is the natural repository of attempting to do what you want to do.

Dr Gros: I don't have a strong view on that. The European department of the IMF would de facto be the EMF. But at the IMF, other political considerations might enter into the decision of the board. Do we trust China to always make an impartial judgment? The US as well? It is not that I mistrust the professional qualifications and expertise of the staff of the IMF, which are unrivalled, but the board might take—and has taken—decisions on political grounds.

Q175 The Chairman: Before I bring Lord Hamilton in, how would we make up the composition of the EMF? Who would we draw upon to be the personnel?

Dr Gros: It would have its own personnel. You would have lots of people, for example, in the European Systemic Risk Board. They should be looking at the same things. It shouldn't be so difficult to find an institutional setup.

Q176 Lord Hamilton of Epsom: Surely the accusation is that the IMF is dominated by the United States, because they produce most of the money, and the EMF would be dominated by Germans because they produce most of the money.

Dr Gros: Yes, but that's okay. The creditors always call the shots. By the way, the IMF is not dominated by the Americans because their quota is lower than the total of the EU area, which is 10 percentage points higher. The IMF is dominated because the Europeans can't get their act together.

Q177 Lord Hamilton of Epsom: Can we move on to the politics of this? One of the reasons why Angela Merkel wanted the IMF involved in the Greek bailout was that she didn't want the Greeks blaming the Germans for the austerity that the Greeks had to suffer, because this would then put the Europeans—and probably the Germans—in the front line by imposing austerity on recalcitrant nations in Europe.

Dr Gros: These political things are always difficult to judge and I try to stick with economics. In Greece, it's known as the troika. We should be grownups and stand by our choices and not try to hide behind somebody. It usually doesn't work in the long run.

Q178 Lord Hamilton of Epsom: Do you think it would be unavoidable to include private investors in any permanent crisis resolution mechanism? To what extent can the burden be placed on bond holders?

Dr Gros: It can't as long as the financial markets are in such a state. I find this discussion not very useful. You can write what you want in the official mechanisms, but if the financial markets react the way they did in April and May, you feel you can't. This entire thing is theoretical. You cannot say at the beginning that all you can have is cuts and then say, "But, if this and this happens then I might ask you". Okay, let me know when you know. It can already happen now. The key thing is whether you can say no. You can say no if (a) the financial markets are stronger from the beginning, and (b) you have some funding to save the good banks, but let the bad banks go down. As long as you cannot do that, the threat of bond holder involvement is empty. That's why I find all this stuff not very useful. Sorry.

Q179 Lord Hamilton of Epsom: The Germans were entertaining the idea of managed default of sovereign nations. Do you think the eurozone could live with the idea of that?

Dr Gros: Again, that is just a vague idea somewhere. What happens de facto? If you look at the proposals around, we have CACs—collective action clauses. So what does it change? Nothing. Academic literature on CACs is that they don't have any effect and then you can just do a mopping-up law to have the same effect. The day before default, you pass a mopping-up law and you get a minority of creditors on board. You anyway have a majority in official hands via the ECB. So you get the majority you want.

Q180 The Chairman: Are you saying it is really down to sensible people taking sensible decisions?

Dr Gros: Allowing them. Putting them in circumstances where they can have a choice.

Q181 The Chairman: Right, so there still has to be an architecture, then?

Dr Gros: In terms of financial markets, yes, and an EFSF or whatever that can be used to save markets. That's the key thing. It's a small thing, but it's very important. The EFSF right now can be used only to save Ireland. The alternative would have been to tell Ireland that the banks go bust. If you, as a Government, have funding difficulties, we will help you. If there are banks left and right throughout Europe they get money from us, and if there is a systemic thing we go in the big way. That would have been the alternative for me.

Q182 Lord Hamilton of Epsom: They say that Iceland is now recovering, having allowed all its banks to go completely bust.

Dr Gros: Exactly. That's what Ireland should have done.

Q183 Lord Marlesford: Let's go back for a moment to Greece. First of all, let me say straight away that your colleague Dr Mayer agreed with Professor Goodhart at our evidence session that Greece had not been bailed out, because the money supplied had been a loan, not a gift, and it had been at commercial rates of interest. I don't know if you agree—it may be a semantic matter—that Greece has or has not been bailed out and secondly, on that point, whether you feel that what is going to happen for Ireland is or is not a bailout. It's quite important, because the moral hazard issue flows directly from whether it is a bailout. If it is, that introduces moral hazard and has broken the Maastricht criteria. Do you regard it as a bailout?

Dr Gros: The Maastricht Treaty, Article 125, just states the obvious. The holder of a Greek bond doesn't have a direct claim on the German taxpayer. That's obvious. We know that. If the German Government nevertheless decides to help the Greek Government, that is no contradiction with the Maastricht Treaty. That is clear. There is no prohibition on helping other countries. You are native English speakers. I don't know the deeper meanings of bailout. In German insolvency law, the definition is that a company is insolvent if it cannot finance itself through normal market mechanisms. Maybe it has assets that are worth €1 billion, but it cannot liquefy them. That's not the question. The question is whether it can finance its normal current operations through normal market mechanisms. Greece could not do that at that point in time. I leave it to you whether you want to call that a bailout. I'm not much interested.

Q184 Lord Marlesford: Is there a German word for bailout?

Dr Gros: In that sense, it was technically insolvent. The word is insolvent. You're not solvent. You cannot pay your bill tomorrow. It doesn't mean that your liabilities are larger than your assets. The value of the assets always depends on market conditions, and so on. It just means, as in the case of a bank, that the bank is not solvent.

Q185 Lord Marlesford: From what you're saying, the constant use of the word bailout is rather unhelpful.

Dr Gros: Correct.

Q186 Lord Marlesford: Right. That's a good point. In the case of Greece, it has been generally said that Germany did have a choice. It could either help the German banks that were loaded up with Greek bonds, or it could help Greece. Was that a choice, and if so why was it taken in the way that it was?

Dr Gros: Of course, you know the close relationship between certain parts of the German banking system and almost the entire political system. At the Landesbanken they have boards of 30 people with all the parties on them. Lafontaine was on the board of ECB. Even he was asked on TV why such and such had happened and he said, "At the critical board meeting I couldn't be there because I had to speak to my party people, and anyway I was one among 30 and what could I do?".

That's the first reason why it wasn't done. The second is that Greece was saved, and then in May we had an almost systemic breakdown. Greece had already been saved. Was it just a nervous breakdown of the markets? That's the question. These are the things that forced the hands of the politicians. Why was that? May is very interesting to study. Greece had been saved.

Q187 The Chairman: So what was it then?

Dr Gros: I don't know. I don't have a very good explanation. There was just a general feeling that maybe everybody could be next and then we won't have anything. That is why they had what they thought at the time was a big fund. The method was to say that we can save everybody, and therefore the attacks will stop. It did stop for a while, but now we are going back to it, one by one.

Q188 The Chairman: But then we are forever vulnerable to this uncertain sentiment of the markets.

Dr Gros: Yes, if you have a very highly leveraged banking. That is something else that people don't realise. The key problem is that the fragility stems not so much from the amount of Greek spending, but from the leverage. That is something that I have been running around saying for years. The degree of leverage in the euro area has increased more than in the US, and the level is higher here than in the US. And over the last few quarters it has been falling in the US, but continued to increase in euroland.

Q189 Lord Jordan: You started off by saying that we underestimated the fragility of the banking system. Some people might call it the greed of the banking system. Do you think the Commission's proposals are adequate to address the unsustainable development of private and public debt? I ask that against the background that you probably could get Governments on board in self-interest, but it seems that whenever you start to try to lay down

Dr Gros: The Commission's proposals on the excessive imbalance procedure were a nice try. The systemic risk board should do the same thing. I'm not against it, but I'm very doubtful that it would work. If you get exactly the same thing, then it will work, but the next bubble will be different. I don't know in what way, but it will be different, and we won't have one for the next 10 years. That's quite clear.

Q190 The Chairman: Because?

Dr Gros: Real estate bubbles last at least 10 years on their way down, also. The bubbles were obvious and they will take 10 years or more to deflate. It will take some time before a German bubble develops. That's why it might be useful for the next generation, but not for the next 10 years.

Q191 Lord Hamilton of Epsom: The Germans have been quite good at not creating bubbles.

Dr Gros: They had their bubble in 1995.

Q192 Lord Hamilton of Epsom: Exactly, it scarred the psyche.

Dr Gros: That is why I say you have the next 10 years as the last 10 years in reverse.

Lord Marlesford: When was your bubble?

Lord Hamilton of Epsom: The Weimar Republic.

Dr Gros: No, it was not a bubble in prices, but a bubble in construction. Between 1990 and 1995, the German economy grew by 4% or 5%. A lot of this was construction. Construction in Germany went up from 1990 to 1995, and then it went down again, and then up again.

Q193 Lord Marlesford: Portugal never had that, of course.

Dr Gros: Portugal had that earlier, but Portugal is a separate category. Portugal is pretty much lost for me, but Spain and Ireland are exactly the mirror image of Germany there, with the real estate bubble and now 10 years bust.

Q194 Lord Marlesford: A real estate bubble means a bank bubble, doesn't it? It means a bank crisis.

Dr Gros: This is important. I am talking about a real estate bubble; I am not talking about a crisis. The real damage was done by excess construction.

Q195 Lord Jordan: It is a curious coincidence. I was in a conference in Germany at the time and the police came in to arrest the chairman in connection with some construction. The rest of the conference stopped them doing it. You have said we're not going to have a problem with the banks for a while now.

Dr Gros: The banks? No, the banks will continue to have a problem.

Q196 Lord Jordan: That was my original question and I don't think you answered it.

Dr Gros: I was going to come to that.

Q197 Lord Jordan: How do you control them when they can just stick their fingers up to you and walk away?

Dr Gros: Do it. Why not do it? What's the problem? Less potential liability for us. The Irish would be quite glad now if Anglo-Irish was a 100% subsidiary of Deutsche Bank. Then they could wash their hands. I don't understand why not. The Swiss are quite reasonable. They have understood that now. If you want to go away, please be our guests. A large banking sector means large contingent liabilities for the Government.

Q198 Lord Jordan: But they won't tackle them, will they? We can't even get the Government to crack down on bonuses, let alone more serious things.

Dr Gros: I don't care about bonuses. If banks want to run away because you have put in capital requirements and cap requirements for holding Government debt and cap requirements high up for mortgages that were presumed to be ultra-safe, which they are in a non-bubble environment, please be our guests. What was the biggest failure of the Irish? Remember in 2008 they said they were guaranteeing their banks. Then everybody wanted to do the same, otherwise everybody would go to Ireland. So we said okay, let's see how many German savers will go to Ireland. Finance Ministers need to understand that a large banking sector means large potential liabilities. What you want is just a functioning bank environment on the ground, which can be run from somewhere else if somebody wants to make the legal seat somewhere else.

Q199 Lord Jordan: So we've got to insist on the proposals about making the banks more responsible?

Dr Gros: I'm not in the business of morals.

Q200 Lord Jordan: No, I meant the proposals that talk about making them hold more capital.

Dr Gros: Yes.

Q201 Lord Jordan: Can I go on to the second part? There are very serious structural imbalances in the eurozone between countries—the strength of Germany and the weakness of Greece—which seem endemic. Do the Commission's proposals really start to get at that in any real sense?

Dr Gros: They are irrelevant. We don't have a planned economy. These things will go away over the next 10 years. Ten years ago we had serious imbalances in Europe. Germany's currency was overvalued. Now we have the opposite. If you let the markets work, they will come back. We already have close to full employment in Germany. You will see wages increase in Germany and a real estate boom—or boomlet, at least—will start in Germany. In 10 years, the German competitive advantage will be gone. The market works, slowly. These things have 10-year cycles, but if you give countries enough time to make the adjustment, it works. We cannot steal it from Brussels.

Q202 Lord Jordan: But there are proposals that are going to try to minimise the imbalances—even the question of fines.

Dr Gros: For the next 10 years, we all know that the PIIGS have to do the adjustment, not because somebody in Brussels tells them, but because the markets tell them.

Q203 Lord Hamilton of Epsom: Do you think real wages are going to come down in Spain and Greece?

Dr Gros: Yes.

Q204 Lord Hamilton of Epsom: By 30%?

Dr Gros: Over 10 years, yes.

Q205 Baroness Maddock: I wanted to ask about the economic governance of Europe and the British position. What are the implications for the United Kingdom if there are separate economic government mechanisms developing in the eurozone, which we are not in, of course? What role can we play if there is a more comprehensive economic governance regime?

Dr Gros: All this entire economic governance is lots of talk, lots of paper shuffling and complicated procedures. In the end, it comes down to whether any important economic policy decision in Germany or France will be affected by all this. I doubt it. The PIIGS don't have a choice. They are being told what to do and otherwise the markets react, and all the rest. Will you tell the Finns to do this or that? Okay, the Finns are very serious. The Dutch are more obstinate. I can't see what the implications are. Yes, there will be talking shops with people huddling in a room and talking earnestly. You think I would like to listen in.

Q206 Lord Marlesford: The problem has been in the past that the market has not worked because it has been assumed that all these countries are under the complete control of the ECB and all have an equal risk; therefore, there has been no differential in their rates for borrowing.

Dr Gros: I didn't talk about financial markets. I talked about real product and labour markets. Financial markets exaggerate and have moods. We are talking about product and labour markets. They work very slowly, but I think they work.

Q207 Lord Jordan: But surely the great German example only worked in the times when you could devalue. In the past Greece could devalue and thereby make its products more competitive. It can't do that now.

Dr Gros: Yes, but the Germans did it as well in 1995 and 2005 at more or less fixed exchange rates. It wasn't the German Government pushing a button. Look at the German Phillips curve—the relationship between unemployment and wages.

Q208 The Chairman: If I understand you right, you are saying that the product and labour markets in a way should be self-righting, but the financial markets are open and vulnerable to swings of sentiment, which is where the EMF plays its vital role. It is a kind of 12th man or backstop. Is the EMF a necessary but not a sufficient condition? Are there other things that should be done beyond the EMF?

Dr Gros: The markets should be allowed to work—labour and product. You might make them more flexible; it doesn't hurt. I have my doubts that it will have a big impact. In Germany there were basically no reforms until 2003 or 2004, and still the adjustment took place. It wasn't because the Government said it; it was because people were unemployed and accepted lower wages. The enterprises were desperate. There was not a massive demand and they had to export.

Q209 The Chairman: I'm very concerned about asking you this question, because I think I know the answer you are going to give, but there is a lot of interest in trying to work out competitiveness. Do you think it has any relevance at all? You say in one of your very good papers that in competitiveness, in one sense, one gains against somebody else's loss within the eurozone area.

Dr Gros: If you have a real estate boom and a strong domestic demand, your wages go up and you become "less competitive".

Q210 Lord Marlesford: So this concept of divergence and competitiveness is nonsense, because you always get divergence at different times?

Dr Gros: It is endogenous to the real estate boom. Ireland has just had one. Spain, Portugal and Greece had a credit-financed consumption boom, which is the difference. Ireland and Spain can adjust by just eliminating wasteful housing construction. Portugal and Greece need to adjust consumption. That's always more painful.

Q211 Lord Hamilton of Epsom: How about movement of labour? Are we going to see more of that in the eurozone?

Dr Gros: Marginal.

Q212 The Chairman: It was always thought to be very difficult, wasn't it?

Dr Gros: I never understood why that should be the magical cure. When labour moves, it also moves demand. If the young Irish leave, there will be less unemployment in Ireland, but also less demand. That impact is not so strong. I'm not saying it doesn't help at all.

The Chairman: I'm looking round at my colleagues because I think we are drawing to a close on this.

Q213 Lord Marlesford: The whole emphasis has been on the problem for the eurozone from the defaults. I can see that is a problem for the eurozone. Am I right in thinking it's not necessarily any problem for the euro as a currency?

Dr Gros: Correct.

Q214 Lord Marlesford: Therefore, if there are countries that cannot manage to operate within the eurozone, what is there to stop them continuing to use the euro, but being out of the eurozone and reintroducing their own central banks to see how they could manage?

Dr Gros: What did you have in mind?

Lord Marlesford: If they find it very difficult to comply with all these regulations that the Commission and everybody is trying to dream up, they can decide to leave the eurozone, but continue to use the euro, because it is there and you can use any currency you like. If someone using the dollar goes bust, it doesn't affect the dollar. They can go on using it or not. If they were outside the eurozone, they would have to have a central bank, because they could no longer be under the ECB. What is there to stop that happening? It may not be the optimum solution, but would it be a fallback solution?

Dr Gros: If the going is too tough for Greece, let's say, the Government falls and they want to leave the eurozone, presumably they do it because they want to have their own currency, which they want to devalue.

Q215 Lord Marlesford: Yes, but they can't improve their position by inventing another currency.

The Chairman: It would be like the United Kingdom

Dr Gros: The perception might be at that point that they might as well introduce a new drachma, because that way they can lower their wages and become "more competitive". Then, of course, their debt expressed in euros will be more difficult to service, but since they won't pay it anyway, it doesn't matter.

Q216 Lord Hamilton of Epsom: How do they then raise new debt with drachma?

Dr Gros: You do that when you have a primary balance.

Q217 Lord Jordan: Several of the countries in the eurozone are in trouble. The labour movement in all those countries and across Europe says that when countries are in that sort of trouble, it's not austerity measures that they need but additional help. Are they right, or must it be austerity measures? I am saying that financially helping to create jobs is more important than just letting the market take its effect through austerity measures—and we know how that works.

Dr Gros: First of all, take Ireland. In Ireland you need austerity measures because the Government is supposed to save the banks. You would need much less austerity if the Government didn't save the banks. That's the first point. Secondly, what these countries need is more jobs in the tradeable sector and exports. More Government spending doesn't give you that.

Q218 Lord Jordan: More efficient industry?

Dr Gros: In Spain, you need more exports and more jobs in the exporting industries, but if the Government spends more on social security and what have you, that doesn't give you more jobs in these sectors.

Q219 The Chairman: I think many people would say that the solution you offer is in many ways very simple, but is it simplistic? Are we missing something here?

Dr Gros: Yes, what you are missing is that there might be contagion in the markets. It's simplistic, but it is simple also in the approach. The wager is that if Ireland had done what I recommend, would it have been a second Lehman, or not? Nobody can really prove it either way.

Q220 The Chairman: In a way, you are saying that the mature approach is to accept that there may be contagion and there may be these 10-yearly financial market problems.

Dr Gros: That is why I am saying you should strengthen and have a big pot of money.

Q221 Lord Jordan: In the case of Portugal, you said they are spending on social security or pensions or whatever it is. How do the Government stop that and now invest in jobs? In what way do they do that? Do they say that they are going to construct new factories?

Dr Gros: In some cases Governments can invest in jobs. I don't think Portugal is one of these cases. The main problem that holds down Portuguese growth prospects is the dismal state of the education system. The numbers are worse than Morocco sometimes, and certainly below Turkey. But Portugal spends more on education, officially at least, as a share of GDP than other countries.

The Chairman: Dr Gros, if I may use an awful pun, this has been an engrossing three-quarters of an hour. I can say on behalf of my members that it has been absolutely exhilarating. We will be sending the transcript and we would be most grateful if you could respond to that, or give other ideas that you have. As an economist, you'll know that there's no such thing as a free lunch, but we have some sandwiches—a poor thing, but our own—and if you have time to stay with us, we would be delighted. Many thanks indeed. I formally close the session.

Examination of Witness

Witness: **Mr Jose Leandro**, [Economic Adviser, Task Force, Van Rompuy].

Q222 The Chairman: As you know, we're doing this investigation into economic governance. We are looking at the longer term, but it seems that actions happen day by day so anything you might like to say would be very interesting on that score.

We hope to report in January or February next year. We hope it will be of help to the Government but we hope to have a wider audience in the European Commission, among our colleagues in Parliament and elsewhere. This session is being recorded so we will make a transcript of what you say. I'd be very grateful if you could cast your eye over the transcript just to see that it is correct. In addition to that, if you have further thoughts that you think would be of use to the Committee in making up its mind and trying to get a direction, we'd be very grateful.

Other than that, if you are happy, we can make a start. I suppose one of the things that I am particularly interested in is the difference between the task force view of what might be done and the Commission's view. It would be extremely helpful to the Committee if we could get some feeling from you about where the differences lie. I know that there is lots in common, but it would be interesting to get your thoughts.

Mr Leandro: Thank you first for this opportunity to present the recommendations of the task force on common governance. As you know, the task force was set up by the European Council in March. An objective was to come up with a set of recommendations on how to improve economic governance in the EU and how to locate the issues related to crisis management in Europe. At the same time, the Commission started working on its own legislative proposals. These were two parallel tracks, progressing at the same time, each one building on the work of the other. In the end, you see a lot of convergence between the recommendations of the task force and the legislative proposals put forward by the Commission on 30 September. Actually, the Commission's recommendations built on the work of the task force, and vice versa.

There are few issues where the task force goes a bit further and other issues where the Commission goes further. For example, one area that is not covered in the Commission's proposals but is covered in the task force recommendations is related to the improvement of statistics and the statistical system in the EU, which is a key issue. So I see a lot of convergence between these parallel tracks that, at some point, converged to the final report.

What are the next steps? The task force has put forward its recommendations and its report was endorsed by the European Council on 28 October. Now the work should start on the detailed discussion on the legislative proposals put forward by the Commission one month earlier, but taking into account the recommendation of the task force, of which the Commission, with all the member states plus the ECB, was a member. This is the stage where we are now, where the work on the legislative texts has started. The objective is to finalise this work by mid-2011 so that we have the new set-up in place for 2012.

Q223 The Chairman: I'd like to alight on that difference that you've highlighted. One of our colleagues on the Committee is Lord Claus Moser, who is an expert in statistics in the United Kingdom but is also very influential in Europe, and I know he would be very interested. How was it that the task force arrived at what we regard as a very important collection of sound and robust statistics and the Commission perhaps is omitting it? Was this an act of omission, of commission or what on its part? Do you know?

Mr Leandro: Prior to the conclusions of the task force, there was agreement in the Council on an EU regulation to regulate the statistical system in the EU and reinforcing the powers of Eurostat, which is the European agency for statistics. But it was thought in the task force that maybe this regulation did not go far enough and that there were additional steps that maybe needed to be taken to go further, notably in the light of events in Greece that you are all aware of where there was a specific problem with fiscal statistics. There was a consensus around the table that this was a key issue and that further steps needed to be taken to reinforce the reliability, competence and independence of national statistics systems, and that Eurostat may have additional powers in terms of collecting data and auditing the reliability of the national statistics, which remains a national prerogative.

Q224 The Chairman: But in a way the task force would like to see more done, and is perhaps sorry that that has not found its way into the legislative proposals from the Commission.

Mr Leandro: The regulation on statistics was not part of the package. That was a separate process that was concluded before the other package on economic governance that the Commission put forward had been finalised.

Q225 The Chairman: On the other hand, exploring the differences between the two reports—I think you have your own final report coming up in the not too distant future—was there anything that the Commission tackled that perhaps the task force thought was of less importance? I'm trying to find what other differences there were between the two parallel groups in any way.

Mr Leandro: I don't think there were other areas of fundamental differences. There was an area where there is a slightly different emphasis between the Commission and the task force, which does not concern the UK, on sanctions in the context of the stability and growth pact. But beyond that, I don't think there is any other area where there is a fundamental difference, except maybe on the crisis mechanism, where the Commission has not put forward any legislative proposals, but on the other hand the task force has put forward a set of principles that should guide the design of the future permanent crisis mechanism.

Q226 The Chairman: That is very helpful. Could I take you on to another potential divide, between the 16 countries of the eurozone and the 27 countries of the European Union itself? What have you in mind in terms of economic governance in terms of applicability to the eurozone—the wider interest that all the 27 countries have? The United Kingdom Government sees a clear demarcation, with itself as a country outside with an opt-out on the euro. Do you see that as quite as final as the United Kingdom Government believes it to be, or is the United Kingdom drawn in more than might otherwise be supposed?

Mr Leandro: No, I think the dividing lines are pretty clear and are set out in the treaty. Protocol 15 sets out clearly what applies and what does not apply to the UK. These dividing lines are perfectly respected in the task force recommendations. There is an area where it is explicitly stated that it does not apply to the UK, and that is the area of sanctions in the stability and growth pact. The task force report explicitly refers to Protocol 15. On the other hand, there are a lot of the task force's other recommendations that apply to all member states, including the UK.

Q227 The Chairman: The broad economic guidelines, which were already in Maastricht.

Mr Leandro: Exactly. This is because there is a need to reinforce economic governance across the EU, because our economies are intertwined and interlinked. Decisions in one country may affect others. The spillover effect needs to be better taken into account through reinforced co-ordination. This crisis is a clear example of how intertwined we all are.

Q228 Lord Marlesford: The task force report concludes, "The global crisis has demonstrated that compliance with the Stability and Growth Pact is not sufficient to ensure balanced growth in the EU". If growth is more balanced as a result of adoption of the task force proposals, what effect do you think that will have on overall growth?

Mr Leandro: As you rightly pointed out, the crisis has shown that compliance with the stability and growth pact is not enough. We now have the example of a country that is hitting the headlines, Ireland, which was complying with the stability and growth pact in terms of the deficit ratio. The same applied to Spain. But at the same time you had imbalances building up outside the budgetary area—in Ireland a credit bubble and a housing sector bubble, and in Spain a housing bubble—that were off the radar screen of the surveillance framework that we had in the EU. So there is clearly a need to enlarge the surveillance beyond the budgets to take in other areas as well. If we do so, we will be able to better spot and monitor these potentially harmful developments and tackle them before they have a negative impact on the economy. By doing so, we will reduce the volatility of growth in the EU and make growth less fragile and more sustainable over time. It is, in essence, one of the rationales for the enlargement of economic surveillance within the EU. The objective is that we have balanced, sustainable and less volatile—if we can add adjectives to all this—growth, with the ultimate objective of creating more jobs.

Q229 Lord Marlesford: Yes, but basically, in the case of Ireland very obviously and, from what you say, probably in the case of Spain, the problem really is the spillover of unwise lending by the banks into the sovereign Governments, which have accepted, in one way or another, a responsibility for the banks. We've been through this whole thing with the world banking crisis. To what extent do you bail out, and why do you bail out? Are you really saying that the task force now is seeking to take over not only the monitoring of the performance of sovereign Governments within the eurozone but also the performance of the banks within the countries concerned? Or, rather, are you saying that before the sovereign Governments take any responsibility for the banks, they must clear it with the central authority of the eurozone?

Mr Leandro: The regulation and supervision of the banking sector in Europe is well defined, and it's not for the Commission to ensure the supervision and regulation of the financial sector. A new framework has recently been approved for banking supervision within the EU. The task force recommends that we look at the economy not through the "keyhole" of the budget deficit, but through the "bay window" of the whole economy—fiscal sector, banking sector, macroeconomic imbalances and structural reforms—so that we have an overview of how these things come together, how consistent they are and how they contribute to sustainable growth over time, without of course impinging on the responsibilities that are well established in terms of banking supervision.

Q230 Lord Marlesford: But then we come back to the crucial point. You may be doing this as a great survey, and what you have outlined means that there is virtually nothing outside that survey—nothing left for the sovereign Governments—but then you say that they're not actually going to interfere. The only purpose of surveying it and keeping an eye on the situation is, presumably, to do something about it, if this is to solve the problems that have emerged until now.

Mr Leandro: Yes. That's precisely the objective, to make sure that when countries take decisions on economic policy, and that remains their exclusive responsibility, they take into account the spillovers or possible harmful effects on other countries of their own decisions. As you see every day, we are so intertwined that a decision by a country somewhere may have an effect on the other side of Europe.

Q231 Lord Marlesford: So is it a central system that you envisage?

Mr Leandro: It is not.

Q232 Lord Hamilton of Epsom: Surely the problem with bubbles is that Governments enjoy them until they burst. Bubbles employ people, they lead to greater incomes being enjoyed by the people and they win elections. They're a wonderful thing until they go pop and everybody's bust. In a democratic society, how are you going to get a Government to prick its own bubble, which may not lead to its re-election?

Mr Leandro: Again, it is up to each country to take its own responsibility in the conduct of its economic policy. We are saying that in the broader co-ordination and surveillance framework that the task force has recommended, these issues need to be discussed among the EU member states. Above all, in Spain or in Ireland, they may have a huge effect on the stability of the euro area or of the EU as a whole—it could go beyond the euro area. So, while these decisions remain the responsibility of democratically elected countries, it is our duty to have discussions among the 27 member states about the coherence and how these decisions may affect others.

Q233 The Chairman: I think Lord Hamilton's point is that peer review and pressure doesn't always work, does it? That's the nub of the problem. It's a real difficulty.

Mr Leandro: It is. If we look back at the track record over the past 10 years or so of the stability and growth pact, we know that the principles were all there but the enforcement was maybe not sufficiently consistent.

Q234 Lord Hamilton of Epsom: It didn't happen at all, let's be honest. The French and the Germans were the first to break the stability and growth pact, and no one brought any sanctions against them at all.

Mr Leandro: Correct. When it suited the big countries, they changed the rules in 2003.

Q235 The Chairman: Just to push the analogy of Lord Hamilton's bubbles a bit further, if a country took it upon itself, because an election was coming along, to continue down a path that others thought was injudicious, despite the peer review and peer pressure, would there be anything that we could do from the European governance level to stop that?

Mr Leandro: The fiscal area is very well regulated under the stability and growth pact. But all the other areas were not covered anywhere, apart from soft co-ordination. That will now come under this macro surveillance framework. For euro area member states, we will have a mechanism that will enforce the recommendations of the Council, and which could ultimately lead to sanctions if the countries do not comply with the Council's recommendations. That could cover issues such as developments in the housing sector or credit.

The Chairman: Let me go to Baroness Maddock and then return to Lord Marlesford.

Q236 Baroness Maddock: Keeping on that subject, Lord Hamilton has a point. Despite what you say, if a country has an election coming up—there are always problems in our country with not enough houses—it is hardly going to take action along those lines just before an election, even if there may be a little more force behind it than there was. This is the problem; the politics interferes with what might be the sensible thing to do. I'm not sure whether you think that the proposals you're coming forward with will actually advance it any farther, or whether in the short term people might behave better because of what has just happened.

Mr Leandro: Again, as I said, the ultimate decision resides with the legitimate Government, but my sense is that the markets will play a much more active role in enforcing discipline than they have in the past. So, a Government that insists on taking a specific decision, even knowing that it may have a harmful effect, simply because of an election, may have to take account of the reaction in the markets.

Q237 Baroness Maddock: So it is the markets that will decide? The other question I was going to ask is a bit connected. There has been a suggestion that sovereign national legislators have their own fiscal rules set in stone. Obviously, there are rules for the EU and there are certain things that everybody thinks are a good idea, but there has been a suggestion, which I think has come forward because, in all our countries at the moment, people don't like the big hand of Europe. They are therefore suggesting that if you put these things into national legislation, you might do better and get people following you. In the light of what you've said, do you think this is a good idea? It doesn't quite tie in with what you've been saying.

Mr Leandro: The task force does not say that the requirements in terms of fiscal frameworks needs to be set in the legislation.

Q238 Baroness Maddock: But the suggestion has been around, and we have had it from people giving evidence. I just wondered what your view was.

Mr Leandro: It does not necessarily have to be set in stone in a legislative text. It can be done through government regulation. The task force has recommended, and everyone has agreed, that there has to be a minimum set of standards that need to be met, at the latest by 2013. Beyond this minimum set of standards, there would be desirable features that could go beyond them that countries may want to comply with, but they would not be binding.

Q239 Baroness Maddock: So you would say that if individual countries had their own fiscal policy, it would go beyond what everybody else is doing?

Mr Leandro: Maybe we need to clarify what we are talking about here. When we talk about national fiscal frameworks, we do not mean fiscal or budgetary policy. We are talking about issues relating to, for example, accounting standards; issues related to the budgetary process, such as transparency and accountability in budget accounts; and fiscal rules that were agreed and set in the treaty, such as the 3% and the 60% limits. We are not talking about government decisions on fiscal policy objectives. The task force agreed that a minimum set of requirements would need to be met, and beyond that some countries could take additional measures.

Q240 The Chairman: Surely the point is that the benefit is that the country takes ownership of things. Is it not a problem that even if you say that there is a minimum set of standards—the 3% and 60% accounting rules and so on—countries will differentiate and take

Mr Leandro: The details of these requirements are still to be set out.

Q241 The Chairman: There is a benefit if they take ownership, is there not?

Mr Leandro: Of course there is a benefit if they take ownership. However, some countries are more sensitive than others about transposing common requirements into national legislation. That is why the task force did not go into that field, but left enforcement decisions to be taken by each member state.

The Chairman: Lord Marlesford, perhaps you could follow that up and also ask another question.

Q242 Lord Marlesford: Yes, I want to follow that up. I absolutely understand and personally support your desire that things such as proper standards of accounting, visibility and transparency should follow. However, you also indicated that you would hope to spot things that could potentially go wrong and point these out to the countries concerned. I question how practical that suggestion is. Let me take the obvious example of the sub-prime mortgage crisis in the United States. Alan Greenspan wrote a book called The Age of Turbulence, which I think was published in April 2007—unfortunately a bit early from the point of view of his reputation. In the book, he says that he was warned of the dangers of the sub-prime mortgage market, but that he thought then—and still thinks—that the risks were justified to expand home ownership. Apart from the fact that arguably it is not the job of a central banker to go in for social engineering, here was a man who was praised as the greatest central banker of the moment making a major mistake, so how the hell do you think—sorry, how do you think—your body is going to be able to do what Greenspan failed to do?

Mr Leandro: Hopefully, these issues will be simpler than monetary policy and the sub-prime loans crisis, which turned out to be extremely complex issues. We are talking about simpler things such as accounting standards and budget classifications.

Q243 Lord Marlesford: We all accept that, but the big things that can go seriously wrong on a global basis are the more complicated things, like sub-prime loans. As you rightly say, they were hugely complicated and heavily disguised by the financial communities around the world—disguised from each other as well as from everybody else. Your recipe for what you are going to do in the survey is much broader and more ambitious. It would be lovely if you could do it, but I cannot see that you have a hope.

Mr Leandro: Well, as you know, the task force report says that the Commission would assess the fiscal frameworks, and these issues, and issue a report. If a report says that in country X the accounting standards are below what is expected of a member state of the EU and do not comply with transparency and accountability standards, hopefully something will happen.

Q244 Lord Marlesford: I see. Okay. Right, well, good luck. You have got this very interesting phrase, "competitiveness imbalances" between member states. What measures could be used against these imbalances? First, perhaps you would explain what you mean by "competitiveness imbalances", and what the Europe of 2020 can do about them.

Mr Leandro: Again, I think this crisis is revealing that in an internal market, and even more in a monetary union, problems of divergence in competitiveness may have very harmful effects and could destabilise the whole. Competitiveness imbalance means, for example, big divergences in current account balances. For example, Portugal, Greece and to some extent Spain until 2008 had widening current account imbalances. That means that they were importing more than they were exporting, and were losing competitiveness. The gap was being covered by inflows of capital, in particular of private credit which financed housing bubbles, credit bubbles et cetera. This is what is meant by competitiveness imbalances. If this imbalance becomes very large, it can have harmful effects on the stability of the internal market—even more so in a single currency area.

Q245 Lord Marlesford: So you are saying "when it is irresponsible". You would not say, therefore, that in the case of Germany, which has been very cautious and is operating the other way round, that there are competitiveness imbalances there that need to be corrected?

Mr Leandro: The task force report is very clear on that. Reforms are needed in all countries, both in those that have accumulated large deficits because of competitiveness deficiencies and also in those that have accumulated large surpluses. Of course, it is more urgent in the current context to take corrective action in the countries with deficits than in those with surpluses. However, there is also a need in the countries with surpluses—here, we are talking mainly of Germany, as you mentioned, which is a big economy, and of the Netherlands and Luxembourg, which are small economies—for a better-balanced growth model, less reliant on exports and more reliant on domestic demand.

Q246 Lord Marlesford: That is a huge interference with sovereignty. I quite understand that you might get away with saying that countries that are in difficulties should correct them, but the psychology of a country like Germany is cautious—it wants never to go back to the problems that it had before the Second World War. If it chooses an almost puritanical approach to how it runs its economy—as our former Chancellor, Gordon Brown, used to say: "Prudence, prudence, prudence"—it is quite bold for the Commission or any part of the European Union to tell it to change its policies.

Mr Leandro: The Commission is not telling Germany that it should do this or that. The German Government itself recognises that an over-reliance on exports to emerging markets, for example, is risky, and that perhaps there is a need for a more balanced approach that is more reliant on domestic investment and consumption and less on exports, because if there is a problem, say, in China—

Lord Marlesford: I was thinking of China.

Mr Leandro: They will have a problem at home. That is where the idea of more balanced growth comes in.

Q247 Lord Jordan: I have several questions and would like to kick off with a couple, one on surveillance and one on supervision. The task force recommends the introduction of new mechanisms for macroeconomic surveillance, underpinned by a new legal framework. To what extent would this mechanism apply to the UK? That is one question. The other one is, what role should the European Systemic Risk Board play in macroprudential supervision, and how effective could it be?

Mr Leandro: On the issue of macroeconomic surveillance, the framework that is proposed applies to all member states, including the UK, but is likely to be more demanding on euro area member states. This is important to ensure the proper functioning of the internal market. Again—I keep saying this—we are so intertwined that these spillovers need to be taken into account. Therefore, these recommendations apply to all member states. In cases of repeated non-compliance, sanctions could apply; but this does not apply to the UK. What was the other question?

Q248 Lord Jordan: It was about the European Systemic Risk Board. What role should it play in macroprudential supervision and how effective do you think it could be?

Mr Leandro: I think it could be very effective. We have had a very good system of banking supervision that was looking at the trees, but nobody was looking at the forest. The systemic risk board would look at the forest and will try to ensure that compliance with each country's regulatory framework is consistent with the stability of the whole. Under the system we had, we were supervising individual banks and making sure that these complied with the regulatory framework, but we were missing the systemic risks. The idea is that in this broadened surveillance framework, the opinions or inputs of the systemic risk board would be taken into account when assessing these macro imbalances, so that we would integrate the fiscal, financial and structural sides of things.

Q249 Lord Jordan: You referred a little earlier to sanctions. A previous witness said that it appeared that the Commission was a little bit more enthusiastic about sanctions than the Van Rompuy report. Can you comment on this, particularly in regard to the imbalances? Do you accept the point?

Mr Leandro: I do not think that there were fundamental differences between what the Commission put forward and what the task force recommended.

Q250 Lord Jordan: I used the word "enthusiastic". Were they more enthusiastic than you?

Mr Leandro: This is not a question of enthusiasm or lack of enthusiasm; it is a question of whether or not it makes sense, and of how you make sure that what has been recommended has a chance to be implemented. I think that both Commission and task force members recognised that ultimately, in the case of these imbalances, you need sanctions and an enforcement mechanism: otherwise there is a risk that somebody will say, "Okay, fine, thank you very much" but will not implement it. Therefore, I do not think that there is a fundamental difference between the two.

Q251 Lord Jordan: We have heard a lot of views about the possibility of sanctions not really working. Would it be counterproductive to punish Governments for outcomes such as excessive deficits that are not fully controlled by national Executives?

Mr Leandro: We discussed this issue. There are factors that affect deficits, and debt dynamics, that may be beyond the control of any Government—for example, growth dynamics and interest rate developments that directly affect debt sustainability and that a country does not completely control. Therefore, the idea is that, when assessing the situation of each specific country in terms of deficit and debt, all these factors will be taken into account and there will be an intelligent assessment of whether the country is on the right or wrong path. The task force report says explicitly that all factors need to be taken into account.

Q252 Lord Jordan: We have also heard a lot of differing views about the sanctions themselves. Somebody said that it was absurd to talk about fining a country that was already in severe financial difficulty. What about the sanction of withdrawing voting rights? Could that be a more effective sanction on some Governments?

Mr Leandro: This was rejected by the task force. It was not considered politically feasible to suspend voting rights for member states.

Q253 Lord Jordan: Does the Commission share that view?

Mr Leandro: Yes.

Q254 Lord Jordan: We have talked about sanctions, but what about incentives? Have they, too, got no real power? I refer to the carrot and the stick; if the stick does not work, will the carrot?

Mr Leandro: I think that the real incentive for countries to abide by the rules is the fact that, going forward, the markets will be applying a much more differentiated approach: they will differentiate much more than in the past between those that they consider to be on the right path and those that they consider to be on the wrong one. This will be a strong incentive for countries to follow appropriate and sound policies.

The Chairman: Not very sexy, is it?

Lord Jordan: No, but I am about to introduce a very sexy subject: the European semester.

Q255 Baroness Maddock: The point about this relates to a question that I asked earlier. Everybody's minds are concentrated at the moment because of various things that have happened but are the markets still going to behave in exactly the same way when this is all a little bit behind people?

Mr Leandro: I think only time will tell but--

Q256 Baroness Maddock: Will they still be tougher, or will they get complacent again?

Mr Leandro: We'll see. My sense is that we are going into a period where the differentiation will become more accentuated and markets will differentiate more.

Q257 Lord Marlesford: Ah, markets?

Mr Leandro: Yes, that's what we're talking about.

Baroness Maddock: Yes, that's what we're talking about, but again, that is all right for now, but my experience of all these things in politics and everything else is that people have very short memories.

Q258 Lord Jordan: I mentioned the European semester. To what extent would the UK be expected to comply with a semester proposal and thus be subject to EU oversight when setting its budget? It just does not seem to me as though it is likely to happen.

Mr Leandro: I think we need to be crystal clear on this. The discussion on budgets in the context of the European semester was never about asking countries to submit their draft budgets to Brussels for inspection before they are submitted to Parliament; that is a fallacy. The point is that countries would be required to submit their broad budgetary plans—not the detailed budgets, but the broad budgetary objective—plus the assumptions in terms of growth and inflation and that kind of thing that affect the budgets in order for a peer review to take place. Again, because we are so intertwined, a fiscal policy decision in one country may have implications for another, so the prerogatives of the national Parliaments have not been, and are not, in question at all.

Q259 Lord Jordan: If, as I suspect, the UK doesn't warm to this proposal, do you think that their resistance to closer co-operation on fiscal matters might in itself have any risks or detrimental effects, either for the UK or others?

Mr Leandro: The UK has already agreed to comply with, or follow, the European semester recommendation. The European semester has already been decided and agreed and will start applying at the beginning of 2011.

Q260 Lord Jordan: From what you're saying, it sounds as though the proposal itself was well received.

Mr Leandro: Yes, absolutely.

Q261 Lord Hamilton of Epsom: Can we talk a bit about haircuts? Frau Merkel thought that it was very necessary for bondholders to take a haircut of countries that have gone wrong. How do you think that happens and what would the repercussions of that be?

Mr Leandro: I think there is ample evidence that the euro area needs a crisis mechanism that is capable of addressing financial distress, avoiding contagion and preventing financial instability. We have seen the Greek crisis where we did not have an instrument in place. It took us several months until we came up with the mechanism that is now in place comprising the European financial stability facility and the European financial stability mechanism—the €750 billion package. The task force recognised that we need a permanent crisis mechanism. As you know, the two mechanisms that are in place are temporary and will be phased out after mid-2013, so we need a permanent crisis mechanism. The European Council, on 28 and 29 October, endorsed and confirmed this position and has launched work with the Commission and the President of the European Council, Van Rompuy, to work on this and come up with ideas to be discussed at the European Council in December. That is what we are doing. The task force also spells out a set of guiding principles for the crises mechanism: minimise moral hazard; prevent instability; and ensure private sector involvement. On private sector involvement, we need to take a step back and go deeper. There have been a lot of misunderstandings about this and this is very unfortunate. Some say this is one of the reasons we are seeing the current turmoil in the markets. Since the end of October, there has been talk about haircuts because people equate private sector involvement with debt restructuring and haircuts. That is wrong, and we need to say it. During the G20 in Seoul, a statement was made by five Finance Ministers, including the UK Finance Minister, which clarified this point. We need to repeat yet again what it means. Let me just highlight what the statement says. I have made copies for you in case you don't have it. Basically, it says that private sector involvement does not apply to outstanding debt or to any programmes or existing instruments. First, it will apply only under the new mechanism after 2013. Secondly, the European financial stability facility is in place and does not provide for private sector involvement. This has to be made crystal clear. Thirdly, by private sector involvement we mean a range of possibilities that can go from voluntary exposure of institutional investors to a country when it is facing liquidity problems, to rolling over of debt by private lenders, and finally to the introduction of collective action clauses in future bond contracts issued after 2013. This is what private sector involvement means. It does not mean debt restructuring or haircuts.

Q262 Lord Hamilton of Epsom: Can I be absolutely clear on that? If there is a British or a German bank holding Irish euro bonds, and the Irish debt is restructured, they will be paid out at par?

Mr Leandro: This means that under the existing mechanisms there is no provision for restructuring of sovereign debt.

Q263 Lord Hamilton of Epsom: So what is going to happen to the banks that are holding Irish euro bonds today?

Mr Leandro: The statement says that the existing stock of debt is not concerned by these issues. That's all I can say.

Lord Jordan: I think we want to know whose hair Angela is going to cut.

Q264 Lord Hamilton of Epsom: It sounds to me as though you are saying that nobody's hair is going to be cut if they are holders of existing sovereign debt. Is that what you are saying? This is quite important.

Mr Leandro: This is what the statement from the Finance Ministers, including the German Finance Minister, said on 12 November 2010 in Seoul: "We are clear that this does not apply to any outstanding debt and any programme under current instruments".

The Chairman: I think we need to go back to our own Finance Minister on that. I am conscious of the time. There was one other point that you wanted to make.

Q265 Lord Hamilton of Epsom: When Herman Van Rompuy started out on the process of looking at all this, he was absolutely adamant that there should be no question of treaty change in any of the proposals that came forward. From what I am reading at the moment, we are now talking about treaty change. Am I right in that?

Mr Leandro: The President was never adamant against treaty change. The conclusions of the task force say: "The setting-up of a crisis resolution framework requires further work. As it may imply a need for Treaty changes, depending on its specific features, it is an issue for the European Council".

Q266 Lord Hamilton of Epsom: The Prime Minister of the United Kingdom has said that if there are any further transfers of power to the Commission, they will have to be put to a referendum in the United Kingdom. I can tell you now that that will not get passed, so how are you going to handle that?

Mr Leandro: What has been agreed at the European Council is that there should be a very small amendment to the treaty that would not imply a transfer of responsibilities to Brussels.

If you look at the conclusions of the European Council on 28-29 October, they say that the member states would establish a permanent crisis mechanism, not the EU. That takes into account precisely, among other things, the concern that there is no transfer of responsibilities to the EU regarding the crisis mechanism. It is a key issue, because treaty change needs to be as small and limited as possible and be limited to a kind of enabling clause, simply enabling member states of the euro area to set up a permanent crisis mechanism.

Q267 Lord Hamilton of Epsom: But the Germans are also worried about their Constitutional Court. Can you comment on that?

Mr Leandro: This is the primary concern for them to push for the treaty change. Legally speaking, we needed a rock-solid legal basis in the treaty for such a crisis mechanism, because otherwise the Constitutional Court could challenge it. That's why the European Council decided to explore the issue of a treaty amendment.

Q268 Baroness Maddock: Somewhere in what I have been reading is a proposal that this small amendment could come in as part of the accession of another member state.

The Chairman: Yes, Croatia.

Baroness Maddock: If that happened, would this be a good enough mechanism for the German system to accept?

Mr Leandro: Indeed, this issue was discussed, but I think that, as we stand now, this option of using the Croatian accession is being excluded. It will be done separately so that we do not mix things.

Q269 The Chairman: Let me just return to one point where the Committee would value clarification. I know it is very difficult, but there were previous sanctions in the original treaties, which were ignored, against countries that broke commitments. It is still difficult to understand how we can have any certainty that these new sanctions such as peer pressure, followed by fines of various descriptions, would operate. What gives you a belief now that matters could change and that we will learn from our past mistakes in this area?

Mr Leandro: I think that is a very good question and one that was discussed in depth by the task force. The task force came up with something credible. Sanctions will be more progressive and we will not start with a nuclear bomb, as in the previous SGP, although it was, of course, a nuclear bomb which could never be used. We will start with small sanctions at an earlier stage of the surveillance process which will be decided on a more automatic basis. Let me try to clarify. This means that we would start sanctioning the country in the preventive phase of the Stability and Growth Pact before we even get to the corrective phase, with an interest-bearing deposit if the country seriously deviates from what has been agreed. Then, if it continues misbehaving and falls into the corrective phase of the pact, this interest-bearing deposit will be transformed into a non-interest-bearing deposit. Then, if it continues misbehaving, a fine will be imposed. Then the fine can be increased, as stated in the treaty, so it's a more progressive system and starts earlier. The decision-making process is also more automatic and provides for less political interference.

The Chairman: Diplomatically put.

Mr Leandro: Exactly. For example, it was decided to apply reverse majority decision-making, which means that a Commission recommendation for a sanction is automatically approved unless opposed by a qualified majority of member states.

Q270 Lord Jordan: Didn't the Council alter that proposal?

Mr Leandro: No, it is in there.

Lord Jordan: I thought I'd heard something about it being altered.

The Chairman: We must draw to a conclusion. Mr Leandro, can I first thank you for speaking in a foreign language? Secondly, I congratulate you on the clarity of your comments made in a foreign language. You have answered the committee's questions with great thoughtfulness. I must say that the view from the bay window has immeasurably improved since you have come into this room and given us your thoughts. I am most grateful to you. We will send you the transcript. If there are any errors, please correct them. Equally, if you have further thoughts that you would like the committee to receive, we would be extremely grateful for them. Many thanks, indeed. I formally close this meeting.

Mr Leandro: Thank you to you.

Examination of Witness

Witness: **Professor Jean Pisani-Ferry**, [Bruguel].

Q271 The Chairman: Mr Pisani-Ferry, I open this session. First of all, thank you very much for coming in this afternoon and offering us your thoughts on economic governance. We are all ears. As you can hear, a transcript is being made of this conversation. I'd be very grateful if, when you receive that transcript, you could look at it and correct any errors and, if you think that there is a misunderstanding, correct that in some way as well. We would be most grateful if you could do that and indeed provide any supplementary thoughts or evidence that you have to help the Committee.

While we are adjusting ourselves, could you say a little bit about Bruegel—how it started life, how it is funded and what its purpose is?

Professor Pisani-Ferry: Thank you very much, Lord Chairman. I am very pleased and honoured to have this opportunity to express views in front of the Committee. I regret that I was not able to respond to your request for a written statement but you were generous enough to offer me the opportunity to come and speak.

Let me answer about Bruegel. It is a think-tank that was created six years ago at the initiative of a number of EU countries. It was originally a Franco-German initiative but there was a clear commitment that it would start only if joined by other eurozone member countries. We started with the support of 11 Governments, including the UK, with the condition that we would soon be able to attract private resources from corporations. We were given an initial two-year period to prove that we had some instruments. The aim of Bruegel is to contribute to the key policy discussion in Europe. We claim that we are here to contribute to improving the quality of economic policy-making in Europe. That does not necessarily exclusively mean the EU; it may also mean European national and global policy discussions, of which Europe is a part. But clearly what has been going on in Europe recently has not given us many opportunities to think about other dimensions. The focus these days is very much on the crisis in Europe and what that implies.

So, we do macroeconomics but we also have research areas which we are not going to talk about today relating to firms' competitiveness and more structural issues—innovation and matters of that sort.

Q272 The Chairman: Thank you very much for that description of Bruegel, and I suppose I am going to ask you to paint a picture of what you think were the major problems that afflicted the eurozone—why we had the crisis and what faults within economic and monetary union were thrown up and demonstrated by that recent period, which continues today.

Professor Pisani-Ferry: I guess I would say that part of what is happening is unsurprising in any system where you fix the exchange rate—and monetary union is just a way of having irrevocably fixed exchange rates, as we have said in the past. We know from experience that the early years are easier but at some point there comes a moment where difficulties build up because of a loss of competitiveness, with relative price changes, the need to adjust and the lack of an exchange rate mechanism. We certainly saw this with Germany, which started in a relatively weak competitive position, with an overvalued exchange rate at the start. The weaker countries had a very easy period in which domestic demand was boosted by lower nominal and real interest rates, so domestic demand expanded. There was not much of a competitiveness concern because of the relatively weak position in Germany, but it developed and developed into the real estate situation that we have seen in Spain and Ireland, with credit booms and so on.

So that is the part that I would say is relatively unsurprising. The problem was that in the first 10 years too much attention was devoted exclusively to the fiscal dimension and not enough to this real exchange rate dimension.

I remember very well that by 2005, when we were created, there was a discussion going on about asymmetry and divergence within the euro area. We organised a workshop with the European Commission on that in 2005, and soon we published a paper entitled *The Euro: Only for the Agile*, which was very much along those lines. There were discussions at the ECB, so this was part of the policy discussion when there was simply no action. Whatever was said was frequently considered irrelevant by Governments, who considered that the situation was too good and that only deeply pessimistic people could challenge the policy course.

That is one part. The fiscal dimension was very much the focus of all the attention. Certainly, there were problems with the implementation of the stability and growth pact. That is beyond doubt. What happened with Greece should not have happened. It was purely a problem of implementation. There was a perception that there were problems with the Greek accounts. When Eurostat asked for additional powers to investigate, they didn't get them, and therefore the situation went on without being checked. I would say that Greece is an outlier in this respect, because we don't have evidence of this sort of situation in other countries.

What was perhaps a surprise was that the problems in the competitiveness field did not also show up in the fiscal field. There was an implicit assumption that, by controlling the fiscal side, you would control the wider area of policy development and policy advances. In fact, that was not the case because Ireland and Spain were two countries with an apparently very sound fiscal situation. So there was no problem with implementation of the pact; it was a problem with the design, because vulnerabilities were overlooked. The fact is that the vulnerabilities were ignored and the fiscal situation was based on exceptionally good and unsustainable developments on the resources side. At the same time, implicit liabilities were building up that could, in the end, represent vulnerabilities.

So the approach to fiscal discipline had a design flaw. It is not enough to look on a year-by-year basis at developments in the deficit—especially developments in the headline deficit—to assess whether they are fiscally secure.

Just to finish, there is a dimension that is now very much in the discussion which is to do with crisis prevention and crisis management, and I am sure you will want to return to this. Certainly a wrong assumption was that you needed only to have a crisis prevention regime and that putting in place some sort of crisis management and crisis resolution regime would have created a moral hazard and therefore would have done more harm than good. I think that lately it has been realised that the absence of a crisis management and resolution regime is a shortcoming that has to be corrected. However, it has to be corrected in the midst of a crisis, which is not the best type of situation. That is my short summary of what was wrong.

Q273 The Chairman: We will come to address that more deeply. Was it always a central flaw that you had monetary policy that was centralised and fiscal policy that was permitted to the member states but that, between whiles, the greater interdependence of the states—especially those within the eurozone—has grown so that economic sovereignty has been lost? Perhaps the logic of that is that what should be done more centrally is not just monetary policy but fiscal policy and even economic and sovereignty policy. Is that where we are going?

Professor Pisani-Ferry: I think I would not agree with that. You can well argue that it was a mistake to centralise monetary policy. It was a choice. Some EU member states chose to participate and some chose not to; that was a fundamental choice. Now, if it were known that you would form a monetary union, would you form it differently? That is where I would rephrase your question.

Certainly, EMU would be stronger with a larger federal budget—or with a federal budget, because there is no federal budget. This should not be overestimated; if you look at the contribution of the federal budget in the US to resolving problems of adjustment across states, it plays a certain role but it is not necessarily the main broker. Labour mobility is a strong channel of adjustment and cross-border private financing—by the fact that holdings are diversified and by the fact that you can get access to credit from another state—is also an important channel of adjustment.

Being fair, the federal budget plays a role, but I don't think you create a federal budget because it will improve the macroeconomic functioning of the monetary union or of the union. Historically, the federal budgets were created either with the power from the centre or because, in federations, the states belonging to them wanted to created some new budgetary functions at the federal level.

If you look at the US, it is very clear that at the beginning of the last century the federal budget was very small and that it was developed because of defence spending and welfare spending—because a number of new spending items were added at the federal level. In the EU, we already have very high levels of public spending, so there is no question of adding anything new at the EU level. It could only be a question of transferring existing spending items from the national to the EU level. I am not saying this should not be done, but it should be done only on the basis of a rationale for spending on these items at the EU rather than the national level. That is a pure public finance issue, not a macroeconomic issue, so I don't think we can draw this parallel between fiscal and monetary policy.

In addition, the fact that there is a common monetary policy but no large-scale federal budget—because even assuming that the EU federal budget would double or triple, it would not change anything meaningfully from a macroeconomic standpoint, as it would have to grow to 15 or 20% of GDP to change things significantly—and knowing that we are in that particular set-up, means that the fiscal policy has to remain national because it is an instrument that you can use to correct or take care of imbalances or asymmetries between participating countries. You need to keep this autonomy.

I would like to say a word on something that I did not address when answering your first question, which is more structural and should be mentioned. One additional problem is that monetary union would have required much more integration of product markets than we have. There is an inconsistency between integrating monetary policy and keeping a degree of market integration that is too low and can therefore let asymmetries develop for a long period without being corrected. The fact that the goods markets and the product and services markets are not strongly integrated means that this asymmetry can develop for a long time. Then, when the time comes when they have to be corrected, the problems that have built up are serious.

Q274 The Chairman: If that's true, is the shadow on the single market or the internal market the failure to get nearer to completion of it? How would you remedy the lack of integration in the product market?

Professor Pisani-Ferry: It is essentially a single-market issue. My former chairman, Mario Monti, always observes that if you look at the ranking of countries coming to the single-market scoreboard, you find that the members of the euro area are at the bottom of the league, which is highly paradoxical.

Q275 The Chairman: I used to be an avid reader of the scoreboard and I always thought that the euro was an adjunct to the single market, not the other way round. One final question, if I may: there is a divergence, is there not, but is it a worrying divergence between the 16 countries of the eurozone—soon to be joined by Estonia—and the 27 countries of the EU? Is that something that should concern us, or can we just live with it and tolerate it?

Professor Pisani-Ferry: I wouldn't draw this line. There are questions about divergences within the EU. There is the question of the asymmetry between the UK and the euro area, which in some dimensions is very significant and in some dimensions is less. I recently looked at a comparison between the US, the UK and the euro area in their response to the crisis. It is interesting to see that in some aspects, the UK is very close to the euro area. If you look, at productivity and labour market developments, it is very close to the euro area, in spite of the different labour market institutions, but in some other aspects—the depth of the crisis, the magnitude of the shock, the public finance challenge—it will be closer to the US.

At the same time, you have the entirely separate question about the consequence of the crisis on new member states. Here also, there is a model of integration that had been successful—very successful, even—for 10 years or so that is being challenged by the crisis. In the case of the new member states, the model relied on integration and the financing of large current account deficits by savings coming from the advanced countries of the EU—especially but not only the euro area. This is a model that has also shown weaknesses. So here is some degree of divergence, although the situation is not uniform in the new member states. Poland is in a very different situation from Hungary and Romania. So there is no uniformity, but there is a broader question about the model of integration of the new member states six years, say, after enlargement and 10 years after, since they started to develop in this way.

Q276 Baroness Maddock: You have argued that a realistic reform agenda must "ditch long-held federalist dreams" and that decentralisation to member states under an "umbrella framework for national rules and institutions" is the way forward. Could you tell us a little about how you see that happening? Is that to some extent at odds with the approach that the Van Rompuy task force has adopted?

Professor Pisani-Ferry: I wrote that in a paper in which I was discussing the way forward for fiscal discipline. A question we have in front of us is whether the strengthening of fiscal discipline is going to come more from additional sanctions, stronger rules, tighter surveillance from the EU level or whether in the end it will come from the realisation at national level that countries need to strengthen their own domestic fiscal institutions. In that, they will probably be helped by pressure from the market and the fact that now, each and every Government— in the euro area is looking at ways to reduce the spread in the bond markets vis-à-vis Germany. I think that's an open question. The two scenarios can be discussed and are envisaged in the Van Rompuy report. The Van Rompuy report goes very much in the direction of centralisation, but at the same time it opens possibilities for more decentralisation, for recognising and encouraging the development of fiscal rules and institutions at national level.

My own view is that it's very difficult to exercise discipline from Brussels—because, first of all, we work with broad concepts that do not correspond closely to the way decisions are made at national level. At national level, you decide on a budget for the central Government—and, in some countries, separately for social security and healthcare spending, if you have a local, subnational budget. You have specific rules that are part of your budgeting procedure and they are very diverse. Some scholars have observed that the stability pact works much better in countries where there is a tradition of coalition Governments that are generally based on a system of proportional representation. That is logical: no party dominates; you have to enter a coalition agreement. In the coalition agreement, naturally, you introduce budgetary targets. Therefore, the parties that are more on the side of fiscal discipline, that consider that it is better to have targets, are part of the contract and make sure that the budgetary targets are respected. That works very well with the stability and growth pact.

If you have a country where the tradition and practice is one-party Government, this does not exist. There is no coalition agreement; there is much more discretion. Therefore the notion that you have a pact and preset targets that you have to abide by, whatever the economic developments, is completely in contradiction with the way those Governments tend to behave.

This question of the appropriate expression of fiscal discipline in a given institutional context is a major one. The notion that it comes from Brussels frequently doesn't work. In some countries, the 3% has been taken not as an absolute ceiling but as a target or a threshold you had to be close to. Each time you were too far below 3%, it was an indication that there was room for cutting taxes or increasing spending. The public finance problems will be daunting everywhere for decades. If you want to improve, you need to decentralise and find definitions of fiscal discipline on which there is ownership at national level and that correspond in their technicalities to the way that decisions are made at national level.

That does not imply any inconsistency with the overall aim of fiscal discipline at the EU level, but it is a very different model from the model in which you have a uniform national account-based definition and everybody implements it in the same way.

Q277 Baroness Maddock: You also suggested there should be incentives for better governance institutions in member states. Could you tell us a bit more about that?

Professor Pisani-Ferry: To put it simply, I would not treat in the same way a 3.2%-of-GDP deficit in a country with good fiscal institutions and a good track record as in a country with weak fiscal institutions and a weak track record. Better institutions could go hand in hand with more flexibility in the implementation of the common rules.

Q278 The Chairman: That's an interesting thought about treating the 3% or 60% more loosely. It is certainly not sticking to the stability and growth pact, is it?

Professor Pisani-Ferry: We knew from the beginning that what matters in monetary union is the level of public debt, including implicit liabilities. That has been discussed for a long time in economic research communities because there is no way they can inflate away from that instability problem. The fact that we have seen countries such as Greece with a 160% debt to GDP ratio projected for two or three years from now is very much an indication that that is the real threat. The 3% threshold was adopted because, starting with very different levels of debt, it was impossible to set a threshold or a target for debt that could be implemented in view of the initial conditions. So, to give flexibility to countries such as Italy and Belgium, the simple 3% definition was adopted, although clearly it doesn't have much economic rationale. What is desirable is that you are significantly below the threshold at which sustainability becomes a concern. That is what matters for the stability of the euro area as a whole. I think we have learnt in this crisis that Germany was in fact right to say that fiscal discipline is a major issue. Fiscal crises are not a fantasy; they can be a reality, and we are in that reality today. So we have to take it extremely seriously but, at the same time, we have to accept that the simple threshold and rules that were put in place about 20 years ago are not the best possible rules to ensure fiscal stability.

Q279 Lord Marlesford: But sustainability of deficits, whether it be the total public deficit or the budget deficit is, in a sense, a function of interest rates, isn't it?

Professor Pisani-Ferry: Yes, it is in a sense a function of interest rates because it all depends on the interest rate relative to the growth rate. It depends on whether you want to put limits on the primary deficit or set an objective for the primary surplus or work with the overall budget deficit and the overall level of debt. The choice has been not to make the distinction and to set limits for the overall deficit and overall debt. It could have been done differently because clearly the interest rate is not under the control of the Government. As you know, when the IMF has a programme in a country, it sets a target for the primary balance because it thinks that that is what the Government can control, whereas the spread is beyond the control of the Government.

Q280 Lord Jordan: Some people seem to think that the serious imbalances in the eurozone are its fatal flaw and that, until we find a way around that problem, we're going to be in permanent trouble. It has been said that the Commission's proposals to deal with the imbalances are a bit one-sided. They focus on trying to constrain the position of the deficit countries, which the markets do in any case, rather than look at the more symmetric adjustment mechanism in which the surplus countries have to play a role as well. What is your view on that?

Professor Pisani-Ferry: This is an important and interesting discussion. We can't pretend that deficits and surpluses are the same thing with a different sign. A surplus is a problem for the macroeconomic balance in the euro area—or more widely, because we are discussing surpluses at a global level. The deficit represents a potential risk of a financial crisis, so it is not the same. Both matter, but it's not the same threat, and we cannot say that they have to be treated exactly symmetrically. So in principle the idea that the Commission has to have a set of indicators, some of which are symmetric and some of which are asymmetric, is a good one. It is all a matter of implementation—what sort of wedge you are going to give to the symmetric and asymmetric indicators, and what this is going to trigger in terms of policy discussion. In principle, you would wish to foster a discussion on the macroeconomic balance that has to take into account surpluses as well as deficits. At the same time, you want to make sure that you don't risk being in a situation like the one we are seeing now, where some countries simply cannot finance themselves because the lenders do not want to lend to a solvent company in a country that they perceive as having an excessive external deficit. That means that the external imbalance of the country matters again, whereas it was supposed not to matter under monetary union. This is a danger for the integrity of the euro area, so it cannot be treated symmetrically. Whatever the level of the surplus, a solvent company in a surplus country will always have access to money, whereas an insolvent company will not have that access, whatever the situation of the country. So there is an asymmetry here that we have to recognise.

Q281 Lord Jordan: We've seen suggestions about measures that might be used for competitive imbalances to solve the problem. What do you think of those? Are there better ones? What role might Europe 2020 play? Finally, on the question of the measures that are used, with regard to the original concept of this whole eurozone thing I noticed that you said the ideas were good but that implementation was weak. That could well apply to this very serious subject of imbalances.

Professor Pisani-Ferry: This is a very difficult discussion. It is interesting that it takes place at the same time at a global level. There was a proposal by US Treasury Secretary Tim Geithner to have current account indicators. Once you start looking at imbalances, you are immediately driven into a discussion on what is behind them—the reason for those imbalances. You cannot stop at a numerical threshold. For a country in central or eastern Europe, a large current account deficit, whose domestic counterpart is a high level of productive investment is the best that you can wish for—it's almost a text-book situation of integration—but if it's bank credit financing consumption or excessive real estate investment, that is a different situation. So you are driven into analysing the underlying capital flaws and asking what the counterpart is to this deficit in terms of the internal savings investment balance. This is a much more difficult discussion because it requires an assessment that is necessarily disputable and open to discussion, instead of the relatively mechanical approach that we have for fiscal or budgetary deficits. It implies that the countries in deficit accept that partners will start asking them why they have this development in consumption and real estate investment, and what policy instruments they may want to use.

Try a rerun of Spain. Spain should have used regulatory policies or tax policies to limit this real estate boom. Can you imagine the partners telling Spain, "You should increase the tax on mortgages", although that is basically what it should have done? Let's say that there's a red line here called tax policy, which is not supposed to be a topic for discussion with euro-area partners because it is traditionally the domain of national sovereignty. But if you don't want to discuss tax policy, the regulation of mortgages or the auctioning of building permits, which are different instruments, then the discussion is empty.

That brings us to implementation. This discussion needs to go deep into an analysis of the reasons for the imbalances and the policy failures and how they can be corrected, and this discussion needs to be accepted, otherwise it will be an empty exercise. If we end up just having numerical limits for current accounts, it will be close to absurd, because the very purpose of creating a monetary union was also to facilitate the saving flows from one country to another.

Q282 Lord Jordan: Can the systemic risk board be a useful instrument in helping to get the bigger message across, in that it has looked at the bigger picture? If it does and it comes up with good suggestions, we are back again to implementation.

Professor Pisani-Ferry: I would wish to know how to answer that question, because I agree that it comes very naturally yet we don't know exactly what the systemic risk board is going to do. There is not much available, to my knowledge, on exactly how it is going to work. In principle, the same imbalances can be addressed through either the systemic risk board, where you look at the financial stability side, or through the excessive imbalance procedure, where you look at the saving investment banks—or even, if you are sufficiently forward-looking, through the fiscal stability and growth pact because, in the end, if you have a problem arising from an excessive extended deficit or credit boom, it is at some point going to end up giving you fiscal problems. Essentially, we are now discussing three different fields as if they were three silos, whereas in fact they have much in common. How the policy framework is going to clarify better the distinction of what exactly the role is of this three-part procedure is a major issue for the clarity of the policy framework.

My short answer is that I don't know, because I see the issue but don't see clearly the solution or in what direction the discussion is moving. As far as I perceive it, the discussion moves very much in silos.

The Chairman: I think you have been alluding a little to your own arresting statement that top-down government by statistics does not work, which is very interesting.

Q283 Lord Hamilton of Epsom: On the question of sanctions for people who are running up enormous deficits—or by implication, I think, surpluses as well—can you really see the Germans accepting a fine for running an enormous surplus? Of course, the Germans are very keen on removing people's voting rights. Can you see those voting rights being removed if they are running a great surplus?

Professor Pisani-Ferry: I really don't see this happening.

Q284 Lord Hamilton of Epsom: No, I don't think I do either, so we can deal with that quite quickly. Do you think there is a strong case for establishing rules and the modus operandi for a statutory European debt resolution mechanism? There is the question of whether that would destabilise the eurozone if that was—

Professor Pisani-Ferry: Can I go back to your previous question for a second? I think the sanction is not a route to take, but it would be desirable to be able to foster a discussion that takes into account the interdependence. The problem is—let me put it in a very simple way—that a number of countries in the euro area have lost competitiveness in a major way. The estimates vary, but we are speaking not of 5 to 10% but of 10 to 20%. These countries will have to regain competitiveness. That is an imperative for everyone. If they do not, they will be permanently in a situation of high unemployment and struggling with growth. That is a dangerous situation for everyone.

For these countries to regain competitiveness, they need to have below-average inflation; that is quite obvious. If the average inflation is 2%—or 1.95%, which is the objective of the ECB—it means that other countries have to be above that section. So for Germany, the country with a better starting point, although this applies also to some other northern European countries, we need to have inflation closer to 3% than to 2% for seven years.

This is arithmetic, not a judgment. I am using prices instead of quantities because there is an objective of 2% on average. Something has to give. Either it is the objective of the ECB, in the fact that these weaker countries regain competitiveness, or it is the fact that Germany does not want inflation. There is a logical element here. With the discussion on surpluses and relative competitiveness, we would wish simply to achieve a discussion that takes into account the interdependence. That would be a step forward.

Q285 Lord Hamilton of Epsom: You can have the discussion, but Germany is scarred by the Weimar Republic, as I don't have to tell you. Germany is also extremely conscious of its position as a major exporting country, so it is not going to live with a higher than average rate of inflation very happily, is it?

Professor Pisani-Ferry: No, I'm not saying it's an easy discussion. It is a very difficult one, for all the reasons that you gave. But, at the same time, do you want to keep the weaker countries in a permanent state of high unemployment and low competitiveness, which will make their own adjustment—the solutions to their fiscal or financial problems—more difficult?

Q286 Lord Hamilton of Epsom: I think we are asking Germany to take a rather sacrificial view, aren't we?

Professor Pisani-Ferry: You could put it in a different way. There has been no growth in domestic demand in Germany for a decade and that, after a period in which it has contained wage growth significantly and is in a situation where the export industries are booming and a number of its companies cannot meet foreign demand, higher wage growth would not be—

Q287 Lord Hamilton of Epsom: No, that may happen naturally.

Professor Pisani-Ferry: It may happen naturally, thank you.

Q288 Lord Hamilton of Epsom: On the European debt resolution mechanism, what is your view about that destabilising the eurozone?

Professor Pisani-Ferry: The principle of having a response to this question of what to do if a Government finds itself unable to meet its commitment, because the underlying situation is one of unsustainability, is very legitimate. That is not a question that we should avoid because if we do, it implies that there would be a real bail-out in the sense of taking responsibility for another country's debt.

The old discussion on the no bail-out clause was very confusing, because there are two issues that need to be separated. One is the provision of liquidity; there is nothing in the treaty that forbids that provision to a country that is solvent but faces a problem of funding in the markets. However, the only thing is that there is no explicit provision for providing liquidity to a country in the euro area, whereas for countries outside it that exists through this mechanism. I checked why the treaty says that this is for countries outside the euro area only. The answer is that it came from a discussion on an existing provision for assistance with balance of payments. I have asked the negotiators of the treaty and they have said that the reasoning was, "But we don't have balance of payments any more in the monetary union, so we don't need balance of payments assistance. Let's scrap this provision".

At the time, there was no discussion linked to the no bail-out clause, which is something different. In the no bail-out clause, which I think should remain untouched and unchallenged, you are not allowed to take responsibility for a country's debt. Each country remains solely responsible for its own abilities, which I think is a very sound principle and has to remain. It should lead you to the conclusion that if you don't want a liquidity provision, it has to be part of the system. To become a permanent bail-out would contradict this principle of no co-responsibility over public debt. There needs to be a procedure or a mechanism for reducing the debt level of countries that find themselves in the situation of not being solvent and not being able to meet their commitments.

Q289 Lord Hamilton of Epsom: Don't you think it's inevitable that there is going to be a restructuring of some of these countries' debt, and then there is a sharing of responsibility for them?

Professor Pisani-Ferry: But the restructuring means that private creditors will take a loss. That does not mean that there will be co-responsibility.

Q290 Lord Hamilton of Epsom: But we were told earlier—we were given a piece of paper—which said that there is some deal by which any restructuring would honour all existing debt and will only refer to debt after 2013.

The Chairman: This was the terms of reference by the Finance Ministers of France, Germany, Italy, Spain and the UK.

Professor Pisani-Ferry: We have discovered that the permanent regime is incomplete. It is incomplete because it does not provide liquidity—there is no provision for liquidity assistance—and it is incomplete because there is no provision for insolvency. It should be corrected on both counts: there should be provision for liquidity assistance and for insolvency. You are not going to tell a country that wants to repay its debt that it is not authorised to repay its debt; that is crazy. The solution that if you cannot get access to liquidity you have immediately to go for a haircut is simply nonsense. It is a matter of sovereignty that if you want to repay your debt, you are allowed to. If you are not able to, you need an insolvency process. That is a permanent regime.

There is then a question: if you introduce this new system, how do you organise a transition? Any discussion has to start from what new system is desirable. I think that this new system has to combine those two aims.

Q291 Lord Marlesford: I want first to go back, if I may, to the discussion on competitiveness. I don't quite understand why one is talking about wage rates and inflation rates. It seems to me that the differential in competitiveness between countries is often largely a product of what they are doing. You say that there has been no great increasing domestic demand, but Germany's competitiveness has largely been because they have harnessed technology to innovation, had high-capital investment and produced products that people wanted to buy. That is a different situation from Greece, so I don't see how you can equate in any way, let alone equalise, competitiveness between countries. The answer is that Greece has to do something else or, as you say, if it goes on doing the same thing, have big wage cuts.

The same argument applies to China. China greatly objects to the attitude of the United States to the level of its currency, because China would say that it is producing efficiently and effectively large quantities of goods that people want and that it will in due course create a larger domestic market.

Professor Pisani-Ferry: I have nothing against differences in performance. That's part of the rules of the game. You do not want to equate performance. If Germany performs better, it is normal that the consequence of higher productivity and higher quality of German products is that you sell the German product at a higher price and that benefits the citizens or the producers of the country by higher income. That is perfectly normal.

What's wrong is if citizens or producers in a country have higher income than is warranted by their relative productivity. That is the situation that we are in. That is what we mean by differences in competitiveness. It is not that some countries are better, it is the fact that relative wages do not correspond to relative productivity.

Q292 Lord Marlesford: Sure, but I thought you suggested that Germany should therefore have a higher inflation rate than the average, because the average has to take into account both the high and the low.

Professor Pisani-Ferry: If you want to correct this—let us forget the inflation rate; look just at wages, if you prefer, but in the end, wage developments will result in price developments—there needs to be a change in the relative wages of Greece and Germany. Clearly, the relative wages in Greece have to go down compared to Germany. If that happens, you have to look at what are the overall consequences for the inflation rate. I am saying that the natural way for it to happen would be that the inflation rate would remain where it is, close to 2%, that the expectation would remain close to 2%, but that the relative wages would evolve with Germany's wages growing faster and Greece's wages growing slower.

Lord Marlesford: I am still mystified because the wage rates are a function of what they are producing.

The Chairman: Perhaps we will come back to that.

Q293 Lord Marlesford: Do we need a common eurozone bond; and what form would it take?

Professor Pisani-Ferry: Two colleagues of mine, Jakob von Weizsäcker and Jacques Delpla, wrote a proposal on that, starting from the idea that with a single financial market, there would be reasons for having a security that would have the same properties in terms of debt of the market and liquidity as the US Government bond market. The question is how to do it. The proposal that they have put forward is that there can only be issuance from a common agency or of common bonds below a certain threshold in terms of debt to GDP, so that that debt will be senior to the remaining national debt above a certain threshold—that will be junior to the commonly issued debt. That would split the public debt into two parts, the idea being, first, that the quality of the common debt would be guaranteed because it would always be senior; and, secondly, that the fact that the national debt above the threshold would be issued separately would mean that the risk premium on that debt would be higher. That also would serve as an incentive element to limit excessive deficits.

It's a sensible proposal. I can see all the objections, the main one I've heard being that Germany is not very keen on "subsidising" the issuance of debt by other countries, but I think that there would be benefits in doing so, overall.

The Chairman: Professor Pisani-Ferry, many thanks indeed for your substantial contribution this afternoon. We are very grateful to you for speaking to us—and in a foreign language. Thank you very much indeed. As I said earlier, we will send a transcript—please correct it—but you may have some thoughts further to our discussions. I know that Lord Marlesford, in particular, wanted to pursue a point or two. If you have further thoughts, we would be extremely grateful to hear them. We recognise that this is an ongoing exercise and we would be grateful to pick up the latest thoughts and views that we can cull from our witnesses. In the mean time, I close this session, but our very strong thanks to you.

Examination of Witnesses

Witnesses: **Mr Benoit de la Chapelle Bizot**, [Finance Ministry Adviser, French Permanent Representation to the European Union].

Q294 The Chairman: I am Lyndon Harrison and you'll be aware that we're doing this report and taking evidence on economic governance, especially in the light of what has been happening, and what is happening right now. We are also eager to try to contribute to the debate about how we can correct matters and find a proper and right path. You'll be aware that even our Prime Minister and Chancellor of the Exchequer both said, when they came in with the new coalition Government, that they were keen for United Kingdom support for moves that can be made to secure the viability and the future of the eurozone. We will be making a transcript of this session. We'd be extremely grateful if you could look at the transcript with a view to correcting it if there are any elementary errors, but also to go beyond that, because if there is anything that you feel you have not expressed well, for whatever reason, please change and correct it. In the end, we want the evidence as it should come from you. In addition, because these events are so fast-moving, if you believe that there are additional things to say, we would greatly benefit. We are hoping to complete our report by January or February. It is very difficult to know when all these decisions are going to be made, but I think it's going to be with us for quite a while yet, so we are hoping we will make a contribution, and we are very grateful to you for coming to help us today.

I shall turn to the first question. Do discussions on economic governance need to evolve into discussions on European economic government? In asking that, I am very conscious that the French Government, over many years, has expressed that view or felt that that was the direction in which we might go. I wondered how relevant and important that still was.

Mr de la Chapelle Bizot: On economic governance, we think we should avoid misunderstanding. You have economic governance and economic government. You should distinguish between them. Economic governance is the way we are going forward with the proposal of the Commission. Economic government is not consensual any more among the eurozone, because some member states perhaps fear that there could be a challenge to the independence of the ECB, which of course is not at stake. Everybody now prefers to speak about economic governance, and that helps to calm down the debate on that question.

On economic governance, the necessity is to allow the Council to tackle what is necessary when you have a common currency and to reach a better level of co-ordination. This greater level of co-ordination is also needed for other countries that have no common currency, for many reasons, the first of which is that in a single market you need to have common policies to make it click, to put it simply.

Q295 The Chairman: In fact, you're saying that the purpose of the single currency is to reinforce the single market.

Mr de la Chapelle Bizot: I think there is a close link between the single currency and the single market for many reasons. It is of course better for capital and for the freedom of movement of capital to have a single currency. It is better for trade, because you avoid volatility in exchange rates for import and export. Nevertheless, there are some differences, because you can have a single market without a single currency, of course, but it needs some other engines of co-ordination, which is not the currency. You should have some regulations on technical standards for goods, to ensure the freedom of import and export and trade, harmonisation of financial services and so on. Of course, if you do not have the force of integration of a single currency, you have to find another way to build a single market.

Q296 Lord Hamilton of Epsom: On the question of sanctions and punishments for countries running into deficit, we have heard evidence that proposals are being put forward.

One of the problems is that if you are in deficit, you get fined, so your deficit will get worse if the fine is significant. Experience doesn't suggest that the sanctions actually work. The first two countries to break the stability and growth pact were France and Germany. Why is anything going to be any different in the future when national interests conflict with what the Commission or some EU central organisation thinks should be happening?

Mr de la Chapelle Bizot: Your question has many aspects. First, this is the point of view of the President of the ECB, who has said publicly that the enforcement of economic governance is too soft and we need real enforcement of sanctions to create real financial discipline among member states. In the past, in reality there were no sanctions for breaching the stability and growth pact. No sanctions were applied to any country. Of course there is the example of France and Germany, but if you remember they created a breach in the stability and growth pact; they stopped the procedure and afterwards the pact was changed. But for other member states that were breaching the stability and growth pact, there were no more sanctions—Greece, Hungary and so on—because for some member states that were not members of the eurozone, it was impossible to apply any kind of sanctions. For members in the eurozone, there was no sanction, because that step of procedure was never reached, because the procedure was too long. So the first thing to agree in the Council is to create a real and reasonable timeframe to allow sanctions to be fully applied.

The second one is to find real sanctions that prevent member states in future from breaching the pact. In that case, you may have financial and non-financial sanctions. According to the German view, non-financial sanctions could be more dissuasive. It is a question of removing voting rights for outliers. France has decided to support Germany in that view and that is one of the questions that should be raised at European Council level.

The other point is, do the procedures respect the subsidiarity principle? It was especially a matter of concern for France, but we think we have reached a kind of compromise and totally avoided automatic sanctions. The reality and complexity of the procedure is as follows. First, in almost every case the final say is in the hands of the Council. In reality, the automaticity of the sanction applies after the recommendation of the Council. There are some exceptions for outliers that repeat their breaches of the pact again and again. The first stage of the procedure is that the Commission proposes something and there is an assessment from the Commission on which the Council gives its recommendation. The second step, depending on that, is automatic—or, to be more precise, semi-automatic—sanctions, because you have a reverse qualified majority that can block the sanctions. Because we are still in a semi-automatic procedure with a real say for the Council, we think we have preserved the principle of subsidiarity and, moreover, brought into balance the role of the Commission.

Q297 Lord Hamilton of Epsom: Is that not going to make the EU very unpopular with the countries that get these sanctions imposed on their Government? It's not exactly fantastically popular now.

Mr de la Chapelle Bizot: To be clear, in that situation we think that all the systems can work only if there is a real endorsement by the different Governments of the whole system. If the Government repeat past behaviour and say that they have to do it because Brussels, the Commission or the European Union impose it, but say, "I am obliged to do it but it's not my fault", there will be a real political problem and real unpopularity. Take the example of France. A former Prime Minister said once that the French financial policy cannot be decided by a head of bureau in Brussels. That was exactly his words. Of course everybody knows that it was not the case. We think that the role of the Council allows us to avoid such unpopularity for the Commission.

Q298 Lord Hamilton of Epsom: Have you ever met a democratically elected politician who hasn't blamed somebody else for any unpopular decision he has to take?

Mr de la Chapelle Bizot: I think my answer will be very cautious.

Q299 The Chairman: Perhaps just to elaborate Lord Hamilton's point, on the other hand are there incentives? We talk about the sanctions, which you have listed, but we have asked other witnesses and puzzled over incentives. It would be very useful to find opportunities where there might be incentives to encourage countries. Have you got any bright ideas?

Mr de la Chapelle Bizot: To be clear, on that case there are many reflections. In the Commission proposals there are kind of incentives. The amount of the fines could be distributed to countries that are not under the excessive deficit procedure. That is written somewhere in the text. That is one of the Commission's proposals. That could be a real incentive, if you consider the level of the fines, which could be 0.2% of GDP. That is an example of fines. Some member states have made reflections on other kinds of incentives. We may think about some better access to EIB financing. The modalities and practicalities of it are not really clear at that stage. One may think about the capacity for member states to have part of their debt guaranteed by the European Union because they are under 3% of deficit. To be clear, there is a clear limit to those kinds of incentives in the following question: which country will contribute to the financing of these incentives? If they are the same as the ones under the procedure, you will have a difficulty somewhere. So it evidently limits the capacity to create real incentives. So we are cautious on this. We are sure that we have to create incentives, but at that stage it is difficult to design them in an orderly manner.

Q300 The Chairman: You talked a little bit about the reverse majority voting, which is an innovation. Another innovation that is being suggested is the withdrawal of voting rights within Council. How do you view that?

Mr de la Chapelle Bizot: On an institutional point of view, it is a second-rank question, according to the European Council conclusion. The first stage is to modify the treaty regarding the permanent mechanism. The second paragraph after that says that the Council will have to find a solution on the withdrawal of voting rights. But it is not at the same level. It is written a bit differently. That is the consensus at the level of the European Council. It is really difficult to find a way to reach that aim, because you need to change the treaty. It is why some member states thought about a kind of political agreement, with each member state recognising the fact that if it is under the excessive deficit procedure, it will decide not to vote in some cases, without any constraint on its own basis. But some countries are very reluctant to do that and it would be only a political commitment without any legal force. We think that negotiation would be really difficult, but we need to put that subject on the table and find a solution to the following problem. If some countries break the stability and growth pact on a permanent basis, we have to tackle that kind of behaviour on a permanent basis without creating fines—which could not be paid. We need to find a permanent answer. If you contribute to the instability of the European Union in one way or another, you have to be stopped somewhere. Should you still have a say with the other member states? That is the question.

Q301 Lord Marlesford: My question is really the other side of this argument. We have had a lot of talk about excessive deficits. In order to get the balances right, it has also been suggested that there should be pressure, if not penalties and fines, for excessive surpluses. Do you think that is a practical suggestion? Can you envisage any country being subjected to sanctions or penalties because it is being too cautious and has too much surplus in its accounts?

Mr de la Chapelle Bizot: That is a really difficult question, because you need to have a lot of pedagogy to say that in economics, surpluses may have negative consequences, just like deficits. It is not common sense. You have to make it well understood by everyone. That is the first difficulty. The second is that inside the European Union or the eurozone, you have to draw two kinds of lessons at the same moment. First, member state by member state, is each country in surplus or in deficit? But, you need to have a whole picture at the level of the European Union and the eurozone. Perhaps it is a good thing for the eurozone on the whole to have no deficit and no surplus, so it has no responsibility for global imbalances. That is a matter of fact. But inside the eurozone you have great imbalances between Germany and Spain, for instance. So the question is how you tackle these imbalances inside an economic zone. The answer is macroeconomic surveillance. There is a Commission proposal on that. At the latest stage, there are some provisions about sanctions in these proposals. There is a difficulty in imposing sanctions on global imbalances, because if you consider the example of Portugal, the Government has been tackling global imbalances for more than 10 years without any real progress. The will is there, but the results are not really there, because it is much more difficult to tackle imbalances than to reduce excessive deficit. That does not mean that you don't need sanctions. You have to put some pressure into the system. The macro surveillance is, to my mind, absolutely necessary. The President of the ECB said that it is all the more important, and perhaps more than the excessive deficit procedure. If we had had such a procedure before, there would have been no problem in Ireland and Spain, because the real estate bubbles in both countries would have been detected before and at that stage the responsibilities of the Governments would have been erased. It is not a question of losing legitimacy or independence. It is saying that you are conducting an unsustainable economic policy. Are you really aware of what you are doing? Yes or no? Are your citizens and your Parliament aware of what you are doing? If that is the case, okay, but at the end of the process, if there is some difficulty, don't say there was no warning about it. In the case of Spain and Ireland, especially in Ireland, it creates real difficulties, because citizens think they have been betrayed and there are some lies, and so on. If the problem had been put transparently on the table, the thing would have been totally different. That is the first aim of macro surveillance.

The second aim, of course, is to prevent any crisis, such as in Ireland, because the first step of course is to make people aware of the situation and of imbalances and the second is to solve the difficulty. For that, you need many years, so the sooner you detect the difficulty, the better it is, of course.

Q302 Lord Marlesford: I can absolutely understand that you use surveillance to detect unsustainable situations such as property booms and bubbles. That is totally understood. It is more difficult to understand how you could say that surpluses generated by highly successful export policies, such as Germany has, could be subject to the same sort of warning.

Mr de la Chapelle Bizot: On macro surveillance, the question is to have an in-depth analysis of surpluses and deficits. To be clear, you have different ways of achieving surpluses. Some are sustainable and some are not. Some are on a co-operative basis and some are not. If we take non-European states, there is a real question about the level of the currencies. Is it sustainable? Is it really an appropriate way to lead economic policy, when you are a great and powerful economy?

At the European level, one of the aims of macro surveillance is to avoid non-cooperative policies. For instance, if some countries devaluate their currency, is it in the interests of the whole European Union or not? Does that help the member state itself or not? All these questions need to be raised and they will be raised at the level of macro surveillance. After debate at ECOFIN level, there will or will not be consensus on it. We think that national Parliaments will be aware of all the results of these debates and will be in a more comfortable situation to vote on any kind of measures or budgets, because they will be aware of the position of other member states. It is exactly the same question for the European semester.

Q303 Lord Jordan: What do you see as the advantages of a European semester and what role the European Central Bank might have against that background? And should efforts to co-ordinate fiscal policies further apply just to the eurozone or to the wider European Union?

Mr de la Chapelle Bizot: The European semester will be implemented for 2011, so it is on track. Every member state has not much time to fulfil all the commitments for the European semester. The second point is what could be the role of the ECB. It will be exactly the same as its current role. It will provide a technical assessment on every member state's budgetary orientation, exactly as it does now under the excessive deficit procedure. That is a technical assessment, which is not public. It is for the 27 member states, even if some are not in the eurozone. It is to feed the debate. To be clear, they stick to the Commission assessment. It is rare that they have different views on one particular member state. They are close together.

The consequence of the European semester is that it will reinforce national Parliaments. It is important to say that this is the opinion of our national Parliaments. Before the summer there will be a debate on the main budgetary orientation at European level. The question is not to present the debate before Brussels rather than in front of the national Parliaments. It is to say that when we are preparing our budget on the main orientations or reforms, the underlying hypotheses, on inflation rate, rate of growth, and so on, are submitted at European level before 30 April.

After, there will be an assessment by the Commission. If the hypotheses are unrealistic or the intended reforms are not sufficient, there is a debate at Council level. At that stage there will be peer pressure from other member states. The Council will come to a member state to lower its forecast on growth, for example, because it appears a bit too optimistic.

There is a specific case for the UK. In the second part of the year, there will be the national budget debate. At that stage, the Members of Parliament will have in front of them the recommendation of the Council. They will say to the Government, "Okay, the basis of the budget is, for instance, 2.5% growth of GDP, but we had a recommendation of the Council that said it is too optimistic, so could you explain why you are more optimistic than the other member states, the Commission, the ECB and so on?" So it will feed the debate and will provide Members of Parliament with another point of view, which could be different from the Government's. I think it will help the national Parliament to vote with more information.

Q304 The Chairman: Before I bring in Baroness Maddock for a final set of questions, you mentioned the role of the United Kingdom in the semester. What other ways could the United Kingdom be helpful in achieving the ambitions of all our colleagues—now 27, of which 16 are within the eurozone—and those expressed by the Prime Minister and the Chancellor of the Exchequer to ensure that the eurozone comes through this period of rockiness to success? From your perspective, what else could the United Kingdom do? What resources do we have that could contribute to that end?

Mr de la Chapelle Bizot: The Prime Minister of the United Kingdom said that the stability of the eurozone is a matter of interest for the United Kingdom. That message could be conveyed everywhere, because we need to say that. It is in the interests of the whole world to say it clearly. The concern expressed by the American authorities showed that very clearly. There will be a difficult debate at European Council level in the summer. It will be really important to show the rest of the world unity at the level of the European Union. If the markets or some financial intermediaries or other countries could consider that there is no unity, no impetus, no consensus to go forward and tackle the financial difficulty inside the European Union or the eurozone, we will, together, face real difficulties. As you know, to change things inside the eurozone, we need to modify the treaty for all 27. So the role of the United Kingdom in that difficult stance will be very important.

Q305 Baroness Maddock: In talking about the European semester, you were indicating that there should be more central oversight of member states' budgets. Do you think there should be a new institution to do this, supporting the EU Finance Minister? From what you have said and from what has been said generally, I was wondering what you think about how much this should be just within the eurozone and how much it should be wider. I am aware, of course, that the United Kingdom has signed up to the European semester.

Mr de la Chapelle Bizot: At that stage of the Commission proposal, there is no provision on a new institution. It was an idea supported at the early beginning by Germany and some member states to have a council of wise men to create a kind of oversight of the role of the Commission, the ECB and member states. At that stage, there was no consensus on that kind of council of wise men. In the last version of President Van Rompuy's report there is no mention of it. So that will not be created.

Going forward, to have an EU Finance Minister appears much more difficult. First, you need to modify the treaty. That is the proposal of the former chairman of the ECON commission, to have one person who combines the role of Commissioner of Economic Affairs—Mr Olli Rehn—president of ECOFIN and president of the euro group. For that, you need to modify the treaty. You need to convince member states to change the balance between institutions. You need to convince the Commission that there will be a person in charge of economic matters who may not be part of the Commission. Or, on the contrary, you have to convince member states that the president of ECOFIN should be a member of the Commission, which is a real challenge. You have to consider modifying the balance between institutions. It is the reason why you have to change the treaty and I am not totally sure that member states are ready to do so.

Q306 Baroness Maddock: The last question is what is your view on proposals for a permanent crisis resolution mechanism and what might be the effect if the United Kingdom didn't partake in it?

Mr de la Chapelle Bizot: On that tricky issue, I have to read something I have prepared before. Considering the situation of markets, I don't want to make any kind of mistake. On that kind of permanent mechanism, first we have to tackle the issue. Some people have said that perhaps we had better not do anything because we are in a financial crisis and that creates some kind of tension, but we do not have time. As you know, we have to modify the treaty. We have to decide among 27 member states. After that, each member state has to ratify the modification of the treaty. You need time for that. So we have to tackle this issue by now.

What do we want? First, of course, that permanent mechanism should be permanent. It is impossible to say there will be a new mechanism but there is a cut-off date in 2020, for instance. Second, we need to clarify some practicalities, such as the role of the IMF, to ensure rigorous conditionalities, to ensure that you are not creating a moral hazard and you need to think about the involvement of the private sector. That is probably the trickiest issue, because you have to consider the consequences of that private sector involvement. If, at the end, you prevent the private sector financing the weakest member state of the European Union, that is not a result that we want. We have to define the right balance between avoiding moral hazards while preserving private financing. That is really difficult.

Q307 The Chairman: Is there anything else you'd like to say as a witness before us today? Is there something that you feel ought to be brought out, but you haven't had the opportunity because of the nature of the questions we've asked?

Mr de la Chapelle Bizot: No, my Lord Chairman. Thank you so much for inviting me. I hope I haven't made too many mistakes and that I was clear enough on that complex matter.

The Chairman: Mr Benoit de la Chapelle Bizot, you have been the model of clarity. We are most grateful to you. We know that these are tricky subjects, and to deal with them in another tongue is very difficult indeed, but we are grateful to you and your colleague for coming today and helping us with our inquiries. We will send you a transcript. Please do correct it, but please also add anything else. I am sure you will go out of the door now and think of something you wish you had said. Please do commit it to paper. In the mean time, many thanks indeed, et je voudrais vous remercier tres, tres genereusement pour votre assistance aujourd'hui. Merci et je vous souhaite une bonne nuit.

Mr de la Chapelle Bizot: My Lord Chairman, thank you so much. I hope I was not so clear.

Examination of Witnesses

Witnesses: **Lord Monks**, and **Mr Ronald Janssen**, [Economic Adviser, European Trade Union Confederation].

Q308 The Chairman: If I can say to Mr Janssen, but especially to Lord Monks, you are now among friends. He may not know his French but he will in time. We are very grateful to you both for coming and for producing the ETUC paper, which will help us to form our questions. You will be aware that we are taking a transcript of this evidence session, so I would be grateful if you could check it. When you check it, if you think there is a lack of clarity either in our questions or in the answers that you want to develop, please do so. If you have further thoughts beyond this evidence session that you want to express, we are very conscious that this is a moving target. We are trying to help in the economic governance, especially of the euro, I believe, in the coming weeks, months and years. Thank you both for coming this afternoon.

I shall begin this session by saying that the ETUC's written evidence states that to correct competitive imbalances, surplus countries should not only reduce their surpluses but should be turning their external surpluses into deficits. I wonder whether you could explain that and answer the question: do you really think that a surplus country, like Germany, the Netherlands, or Austria for that matter, could be induced either to reduce their surplus or in some way tackle it?

Lord Monks: Thank you, Chairman, and thank you to colleagues for this invitation to come along. We appreciate it. Some sharp questions have been drafted by the committee. Clearly, these are two questions. One is the theoretical desirability and the other is the practicality. The point that has been picked up in other questions is that, at the moment the EU is relying on deficit countries to repair their sins. This is the sinners being asked to repent. It's much harder to ask saints to sin, if I can put it the other way round. The German halo is burning brightly above Europe at the present time. I bumped into Bill Jordan the other day in the House of Lords and he said it was a bit like asking Manchester United to stop winning a bit to give Manchester City a chance, which is not likely to happen. On the practicalities of it, you know the reasons for it as well as I do—cultural and so on. Some countries are like they are and others are like us—sinners and deficit countries which have lived on borrowed money for quite a long time. Having said that, the economics of it are that not everybody can repair their deficits if the surplus countries continue to run strong surpluses. At the same time, I do not expect them to do less on the export front, but we do expect them to do more on the domestic demand front than they are doing at the moment.

The reality for a country like Ireland, which is the rabbit in the headlights this week, is that they need growth rates not just of 1 or 2% if they are going to get anywhere near where they need to be. The same goes for Greece. They need growth rates of 3, 4% and they have to sell their stuff somewhere. Ireland has probably got a bit of a better chance, as a reasonably good exporter, than some of the other deficit countries, possibly, proportionally, than the UK. We have to repair our deficits as well. As David Cameron and George Osborne have acknowledged, we have been running debts in just about every corner—household, business as well as public.

So, at the moment, as you well know in this city, we cannot budge the Germans on these points—or the Dutch, the Austrians or the Finns. Basically, the message is give up sin. But we fear that this imbalance is likely to persist and however hard the Greeks, the Irish and others try, they are not going to close that gap unless there is a big boost to demand in the stronger economies which are running surpluses. The rather surprising statement that they should be turning surpluses into deficits would be a big sin in Germany—we were just checking, and they only ran a deficit in the period immediately after unification. They have always run a surplus since the immediate post-war period, Marshall aid, and so on. They have only run a deficit in the most extreme circumstances for them. But it is extreme circumstances for others now. They have to start buying some imports and doing more than they are doing at present. We know the reasons for it, from the Weimar inflation onwards; it would take a remarkable German leader to persuade them that spending is the right way to go. Spend, spend, spend is not a slogan that wins many votes in Germany.

Q309 The Chairman: Mr Janssen, do you want to add to that?

Mr Janssen: Yes, I think, as John has explained, the situation is now that deficit countries need growth. If they simply reduce their deficits to zero, that would eliminate the drag on growth that is represented by net imports. They need much more than simply 1 or 2% of growth, given their levels of indebtedness. So they need to transform their net imports not to zero, but to net exports. If we then take into account the fact that in the end Europe and the euro-area economy is a rather closed economy, it means that periphery countries need to become net exporters and logically the core of the euro-area—Germany—needs to become net importers. That is basically the logic of things. It is not sufficient to cut the external deficits of the periphery countries. They need to turn it into an export external surplus. By logic, that means that Germany should in theory become a deficit country for a while.

Of course, as John also said, there is also the dimension of practicality and desirability, because this would to imply that Germany would need to stage its own asset price bubble to become a net importer. We wouldn't recommend it to Germans either. It is a very tricky thing to do, because you are counting on the fact that, in five or 10 years, when the bubble bursts in Germany, we need to reverse it and someone else needs to save you. Will there then be the solidarity of Spain again, so it is a tricky business?

Q310 Lord Marlesford: I'd like to follow up those very interesting answers. Lord Monks, we had an interesting aspect on this question of an excessive surpluses regime given to us, which is that one of the purposes of the surveillance is not so much to identify excessive surpluses per se, but to identify excessive surpluses which are themselves unsustainable; for example, the product of property booms. That is one where you can identify an excessive surplus and perhaps at least draw attention to it, or maybe even have sanctions to reduce it in order to avoid perhaps the problems, like Ireland. But it is a little difficult to see if there is any real read-across – I do not know if you feel there is, or not, from what the group said– to Germany, for example, being able in any sense to rescue the deficits of countries such as Ireland and Greece by merely importing.

Probably the biggest single trade with those particular countries may well be tourism and they probably could expand that. But the scope for drinking more Guinness or eating more feta cheese is probably rather limited. So it seems to me that it is pretty unrealistic to be asking Germany even to contemplate the sins of being a highly successful exporting country, which is itself based on harnessing technology to innovation of products and having considerable capital investment.

Lord Monks: That is absolutely right, and you can't see them turning on and off export performance to maintain an economic balance around Europe. You do not invent a company like Mercedes in five minutes. It takes years and it has been built up over the generations. If you are running a single currency, as we are in the European Union—at least a number of countries are—these things matter. The sadness of the British position is that we had a strong export record and we lost it, or we lost a lot of it, and we have now got the difficulty of re-building an export performance if we're to run a balanced economy. But we can't be the only ones, in a way, trying to do the balancing. Those who are in strong surplus after all are the ones who funded the bubbles to a large extent. I mean, what does Germany do with its surplus if it's not spending it in Germany? It puts it in banks which go and lose it in California, American banks and some German banks as well. Some British banks lost some of their money. The Chinese and the surplus countries have all got this particular characteristic; that they have been somewhere near the source of funds which has prodded the property bubbles in a number of countries, most of all in the United States.

So it's not a perfect system from anybody's point of view, but I agree.But you cannot say, "Oh, make a few less BMWs or whatever or make them in Ireland" looks pretty remote. But in terms of generating domestic demand in Germany and more spending power, it would help Europe as a whole. Migration is of course the Irish major export.

Q311 The Chairman: And starting again?

Lord Monks: And starting again. There were plenty of Irish workers in Germany in the early 1990s at the unification time. But these are the kind of things that can help in crisis, as Britain helped the Polish economy very markedly in 2004.

Q312 Lord Hamilton of Epsom: If we don't see these surpluses being worked down, we are going to see a prolonged period of austerity in Ireland and Greece, and possibly Portugal and places as well. There is no evidence one way or the other, but what is your guess as to how this is going to work out? It is going to go on for a long time. Are they going to be able to get through all this, do you think?

Lord Monks: There is an optimistic view. Ronald came with me to see President Van Rompuy the other day, and I was accusing him of being like the captain of the Titanic, reassuring everyone as the band's instruments were filling with salt water. I think, when he was Finance Minister in Belgium, he cut the deficit very substantially and we got through it, but we got through it in a period of growth, with strong German expansion and other European expansion.

I don't want to be too pessimistic either. All economists are pessimistic, aren't they, always? I have a kind of rough guide. If you look at cycles of boom and bust, they have been about the same length, quite often. So I recall my Old Testament and the Children of Israel in Egypt, and the seven years' feast and seven years' famine. They used to always be symmetrical. It was symmetrical timing in those days. I don't know, there has been some link between the long waves of economic growth. If you had a boom for, whatever it was, 10 to 15 years, we could be talking something similar. That presupposes that everything goes well for the next 15 years but there could be another bank collapse. These fellows are doing what they did before, by the way, in the derivatives markets and all the other hedge funds and so on. They're back to their bonuses as usual, as far as I can see. What more might they inflict on us? I do not know.

Q313 Lord Hamilton of Epsom: Do you think the attractions of default are going to grow in some of these countries?

Lord Monks: A default isn't really much of an answer. Ireland is getting a bailout. Some British commentators are suggesting that, if it wasn't in the euro, okay, it would get an IMF bailout probably in the present circumstances. Because the root of the problem was not the Government, except with a government guarantee of incontinent banks who can't stabilise their position. They've had some time to do it and they haven't done it. I hope that we have done it in the UK. But it's fingers crossed, isn't it?

Q314 Lord Hamilton of Epsom: Iceland is interesting because they allowed their banks to go bust and they're now looking at growth next year.

Lord Monks: Yes, but the costs of that were enormous as well. Whether Ireland is in a better spot than Iceland, I am not sure. That is interesting. We might have a look at that.

Q315 Lord Jordan: The evidence that you sent us states that, "governance should focus away from excessive cost competitiveness and instead focus on a European co-ordination of social and economic policies". Could you expand on that statement?

Lord Monks: From our point of view, as trade unions representing workers, there is no doubt who is going to bear the cost of this. A lot of it is going on wages and on related matters like pensions, welfare benefits and so on. That is the truth of it. The first thing, I guess, when the EU are negotiating is the level of the Irish minimum wage at the present time when they arrive in Dublin.

We are very conscious of the fact that the downward pressure on living standards, if this is a prolonged, decade-long problem, is going to reverse what we have become used to since World War 2. We have been used to periods of stagnation. We have been used to periods of unemployment, but this time the unemployment and reduced living standards are on quite a big scale. That can become competitive, particularly if the pressure is on you to start exporting.

Going back to the German question, they didn't have a real pay increase from 2004 to 2009. They held wages right down with a kind of national consensus, including the unions, to do that. Part of the reason others are in trouble is because of that. It made sense for them, to sustain their export champion status, but it was a beggar-thy-neighbour policy and other countries cannot do it or they have not got the culture, mechanisms, political strength or whatever it is, to do it.

Those problems lead us to ask whether we can get some co-ordination of a more positive kind. Are there ways of tapping new sources of finance to help countries in distress? Could the European Union, for example, issue—this is of course politically lethal in British politics at the moment—some bonds itself? In effect, the European Central Bank has been buying a lot of people's bonds at the moment to try to keep stability. But Europe itself could step up in a more positive way and play its part in the markets. The Germans don't like it and the UK Government don't like it. But there are some mechanisms there.

Secondly, on tax revenues, we are strong supporters, as you all know, of the financial transaction tax. Anything that can slow down some of the traffic a bit among the speculators, whatever practical difficulties that are raised, does not seem insurmountable to us.

Maybe differentiating a little between legitimate deals and speculative deals is very difficult. But this is a rather small slither of the deals and it could make a difference, both psychologically and in other ways. We're not getting very far with that argument at the moment.

More generally, we are looking at where the good news is in this. The European Union is not that popular that it can afford to be the person who takes all the sweets away from Europe's economy, which is what it is doing in Ireland—I mean, all this Irish "we're a colony once again". As to the psychological feeling, I have encountered that in Greece—you'd almost think the Turks are back, in their wilder moments after a couple of ouzos, not Guinness. I remember what it was like under the IMF in the UK. You feel you've lost something, don't you? And they feel that they have lost a lot.

Lord Hamilton of Epsom: They have.

Lord Monks: They have. I don't think it was the euro; it was made in Ireland and to some extent made in the Anglo-Saxon world.

Q316 Lord Jordan: John, you and I in particular are aware that the British press have long campaigned to make the words "social dialogue" sound like an empty or discredited concept. Yet, it is frequently mentioned in proposals on governance. Could you explain what it is and how it can contribute to better economic governance, so that at least we can have that definition in our record?

Lord Monks: Yes, social dialogue is part of the EU treaties. It's a way of doing things that goes back to the old Coal and Steel Community and that era. But the processes of social dialogue take a large part of our time. One of our things at the moment is, for the EU and the IMF, are they going to practise a bit of that in Ireland when they get there, or is it just going to be with the Central Bank and the Finance Minister?

The social dialogue is a process in which things that affect the labour market are discussed with employers, the trade unions and to some extent with other organisations—I have to say to a lesser extent. Union membership densities are around about 35 per cent in the European Union. They are a bit lower than that in the UK and Germany where there is about 28 per cent. But the idea that you need to take people with you on a process of change and that people should be engaged and should have a chance to negotiate has been carried for quite a long time in the EU. Most of all, under the Maastricht treaty in 1991-92 the social partners were given the right to negotiate laws and the European Parliament could not change it if they were agreed by the social partners under that process.

The Council of Ministers could have a view. I wouldn't say that they have been used much, but they have been used quite a lot. But there is a lot of traffic in a way that would seem a bit 1960-1970s. I remember Bill, you were on the National Economic Development Council—NEDC. But it could sound a bit passé to a modern-day new Labour or a Conservative coalition politician.

It is a process which makes a contribution towards maintaining social peace and order. It makes a contribution towards getting some things right, like the detail. Ronald does quite a lot of work with employers on analysis of the European labour market and so on, and we have reached limited agreements. In the present context it is very difficult. But it has done some useful work. We've reached a measure of agreement with agency workers, which the UK Labour Government didn't like, by the way, but eventually came to accept.

So it's not a ritual; it's a living thing. But as the social tensions widen, there are gaps between employers and unions, because of this downward pressure on wages and conditions at the moment. I mean, I am a realist. It is very quiet at this moment and it will be quiet until we see some growth. The mood is more protests.

I was in Portugal yesterday. They are planning a general strike tomorrow. That's much more the mood around southern Europe. Well, we will see if it spreads.

Q317 The Chairman: Mr Janssen, did you want to jump in?

Mr Janssen: Yes please. One particular, but important, dimension of social dialogue is collective bargaining and, in particular, the co-ordination of collective bargaining. There is also your question on the link of social dialogue and collective bargaining with economic governance. There are these things that are happening in different countries. For example, take a deficit country like Spain, which is in need of some competitiveness to be restored. The thing that you have there is that the trade unions sit together with employers at a national level. At the beginning of this year, they struck a deal to co-ordinate the collective bargaining rounds for the next three years, in which they were saying, "We will have a maximum outcome of 1 per cent of wage increase this year; 1.5 per cent wage increase maximum next year; and 2 per cent in the third year". That is a kind of voluntary slowing down of wage dynamics to help the country get out of its trouble. You co-ordinate collective bargaining so you are giving the signal to everyone in the country—to all companies, all sectors in Spain—and saying "For the next three years, let's slow down with wage dynamics because we are facing economic difficulties".

You can do the same thing from the side of surplus countries. You could say in Germany, "Let's have co-ordination of collective bargaining", in different sectors and regions of Germany. They have this pattern-setting of wages to beef up wage dynamics in Germany a little bit so that you correct for the imbalances inside the euro area. That would in theory be a way to use the different exercises of co-ordination of collective bargaining in the different countries to improve economic governance and the functioning of the euro area.

Of course, it works inside countries, but the challenge is, of course, to tilt this to a European level. There it is more difficult. You can have the pressure on Spain, but the upward pressure on Germany is more difficult.

Q318 Lord Jordan: Do you think that the interests of workers are in any way taken into account in the Van Rompuy report? If not, is there any way in which they perhaps ought to find their way into some of those proposals?

Lord Monks: I'll have the first crack at this. The realpolitik is that Governments are a lot more afraid of the bond markets than they are afraid of anyone else at the moment, and their credit ratings in those markets. That may change if social unrest gets bad and this is going to be 10 years of grinding down standards, particularly of pay, with high unemployment. You can't take these things for granted just because we've had a period of relative social peace for a long time.

President Van Rompuy would be the first to say, "Look, we have got to try to bring the social partners with us" and so on. He is of that school. He has given two or three weeks to come up with something that might stabilise the relationships on the markets.

In so far as they've thought about it, it's about how we are going to cut living standards to pay these debts back—that have been run up by the banks, by the way.

Q319 Lord Hamilton of Epsom: Can I just pick up on Mr Janssen's remark. If you have got very high unemployment in Spain, is that not going to force wages down effectively anyway? If you're moving to full employment in Germany, will that not force wages up? Doesn't the market work on that?

Mr Janssen: Of course, the market works on that, but the question is whether the market works quickly and rapidly enough. Even in a country where you have high unemployment, you will have sectors, companies and workers or parts of workers who are trying to get more out of the cake. That creates a kind of competition in which workers and employers are asking why they should pay attention to the country's benefits, to the country's competitive position, if their fellow workers or fellow companies are hiking wages anyway. This co-ordination of collective bargaining kind of mimics the market, but also allows producing a faster process of adjustment. That is the reason behind it.

Lord Monks: Just a little addendum to that. Pay at the top of the financial services sector is unchecked by what is going on. I cannot understand it, but every argument from city bankers is, "We can't do it because our competitors won't do it". If there is ever a case for collective bargaining by about five or six people agreeing on what they are going to do about bonuses and giving a firm lead, and agreeing it with New York, among other places, as well, they could do it. But they won't. They keep the churn going and keep privileged groups of workers.

Q320 Baroness Maddock: Your organisation has argued that the eurozone needs a mechanism to stabilise the different regions within the eurozone, possibly providing investment transfers to some of the economies that are not doing so well at the moment. I have got three questions. How do you see such a mechanism working? Is there a role for the EU budget in such a process? Should such a mechanism simply be for states that are inside the eurozone or would the wider European Union have a role?

Lord Monks: Another good question. Obviously, people quote the success of the United States in that you have got a huge single market, but you have got some provision for transfer payments—not to bail out California—but at least to a degree. In Europe, they are very limited. There is a lot of agricultural money flying around and transfer payments. And there are much smaller funds like the social fund.

A major change in the agricultural fund is made more difficult by enlargement because it's a major transfer mechanism to the new member states with big agricultural sectors which are not as well developed as western ones have become. There has been a big transfer to France, of course, as well. The issue is, are we going to find any resources to transfer, which is one of the arguments about the EU budget? I think Europe needs some good news and some programmes, for example, on areas hard hit with youth unemployment. I think that it needs some money to encourage sustainable development and technological developments. That crisis is being forgotten in the economic crisis. It should make its case for some co-ordinated work in these areas.

The line from the previous and the present Government has been to fight the budget as though they have got to keep it as small as they can. Labour gave back some of the rebate, that's for sure. I think that a bigger budget is the key and some fiscal transfers are important. If an area has high youth unemployment, the EU should be able to make a difference, as it does in agriculture.

Q321 Baroness Maddock: Do you think there will be more opportunity when we start the new budget era, as it were? The big problem at the moment is trying to argue in Britain that the EU budget is going up and we are having great cuts. It is very difficult. As we go into the new budget, if things don't get much worse, do you think we will be in a better position to do that?

Lord Monks: It's not difficult in some ways, is it? Apart from a few, people accepted what George Osborne said about helping Ireland. We are borrowing money to lend to Ireland. We don't have it; we have to borrow it. People are accepting that, more or less. If there is a clearly identified popular need, people would accept it. If there was something specific that was convincing about sustainable engineering projects, people would accept it. What they won't accept is the EU having more money to spend on junkets and expensive lunches in

Michelin restaurants, and so on—the kind of daily fare of the *Daily Mail*. If it was imaginatively presented that we need some money for this, people are quite generous and get the point, especially if there is a payback some time. I do not think that the politics is as impossible as some people suggest.

Baroness Maddock: It will be interesting to see.

Lord Hamilton of Epsom: Can I just come back on that? You might have some money to play around with if the EU had actually honoured its commitment to completely revise the common agricultural policy in return for us reducing our rebate. I say that as somebody who owns land who for some reason gets money from the European taxpayer just for the fact that I own land. This is at a time when food prices are going up markedly. It has all become complete nonsense. The effect of China and India is that people want to eat protein and this is forcing food prices up remorselessly. We should stop treating farmers as if they were some poverty-stricken group of people grinding along but don't ask me to give up mine.

Lord Jordan: John'll take it

Lord Monks: I think the Queen is the biggest beneficiary of the common agricultural policy, followed by the Duke of Westminster.

The Chairman: It is getting towards the end of the day.

Lord Monks: I'm grateful to you for declaring an interest.

Q322 Lord Hamilton of Epsom: Your evidence went on to say that the discipline of the stability pact was beside the point. Many of the countries that have found themselves in trouble have problems with private rather than public debt. To what degree should private debt problems be something that we have procedures to look after, and can we do anything about it? I have a slight worry that we are always fighting the last war and the next financial crisis will inevitably come in 10 years' time, which will be totally different from the one we have now.

Lord Monks: But we learn, don't we?

Baroness Maddock: Do we?

Lord Monks: Well, I hope we did. I often confess that I was General Secretary of the TUC for 10 years and it was not until 2004 that I knew what a hedge fund was, and it was 2005 before I knew what credit derivatives were. The only consolation is that I am not alone. Outside that world, nobody knew.

Lord Hamilton of Epsom: Including the people running the banks.

Lord Monks: Including the chairmen and chief executives of some of the banks about the risks involved. We do learn something. The stability and growth pact dealt with public debt where Governments were. The PFI and all these things were designed to satisfy these kind of rules—not particularly in the British case, the stability and growth pact—but the fiscal rules that the Government adopted, which were very similar. We have learnt—and the Irish situation confirms it—that their Government was pretty good before the crisis. They were an exemplar country—small public sector, low taxation, low degree of regulation, and so on. Alan Johnson quoted George Osborne's words at him on that not so long ago. Everybody can have their words of a couple of years ago quoted at them. Gordon Brown in 2007 congratulated the City on having eliminated risk. That must have been one of the great ones of all time. The reality is that if you've got a housing boom with people borrowing like crazy and you do nothing about it—well, the Governor of the Bank of Ireland was trying to get them to do something about it, but nobody wanted to be the one to turn the lights off when the party was in full swing. They let it go too far, and others did the same.

Q323 Lord Hamilton of Epsom: Gordon Brown was deeply influenced by the fact that 26% of his tax revenues were coming from the City of London.

Lord Monks: He was indeed, and you could turn that off as well, of course.

Q324 The Chairman: We are going to have to draw to a close, but if I can just ask a final question, and please jump in Mr Janssen. The ETUC states that the peculiar dynamic result in the combination of one single monetary policy and the diverging economic strategy has led to an unsustainable situation where surplus and deficit countries were supporting each other. To what extent is closer fiscal union necessary for the eurozones to succeed?

Lord Monks: We believe it is. I'm going to pass this to Ronald to explain.

Mr Janssen: The basic fact is that in a currency union you have one single monetary policy, one single interest rate and one single exchange rate. It is a very rigid setting, especially if you have 16 or 17 divergent economies with diverging structures, completely different industries, specialisation, and so on. We know from theory that in that case you need two other instruments to compensate for it. One instrument is labour mobility, so that people can migrate from regions inside the currency area in recession to regions where there is economic growth. Strauss-Kahn in an article yesterday referred to this as one of the big issues of the euro area, so developing a single labour market with a lot of migration. At the same time, we also know that this is Europe. We have many different languages and cultures. You can promote labour mobility to a certain extent, but in Europe it can't be the solution. What is the other alternative to correct the imbalance between one single currency and 17 different economies? It is fiscal policy, and saying, if there are regions in recession, let's organise fiscal transfers from the regions in growth to the regions in recession so that you can balance things out in that way. That's the way the United States is doing it. They have a 20% of GDP federal budget and if California goes down with its business cycle, you immediately get automatic transfers stabilising the currency union of the United States to a certain extent. Of course, it does not solve all things, as John mentioned. We all know that despite that, California is having to be bailed out and is having bankruptcy problems. But the difference is simply too big. The challenge of one single currency in Europe with 16 or 17 different economies and only 1% of European budget cannot work. In that sense you need a bigger European budget or a European fiscal policy, or as you call it closer fiscal union, to get the single currency to survive.

Lord Monks: There is the Irish dimension, which is quite interesting, because of their charging 50% of the corporation tax rates of the UK. We've got this major emigration of significant companies, Northern Foods being the last one. There is an article in the *Guardian* today about that. When you get WPP going over there—Martin Sorrell—and so on, you have to take notice. Has everybody got to go down to 13%? The Irish owe a lot of money. They will have to put taxes up. Will they put that tax up? I don't think they are, but at some stage, somebody over here will say that that is not fair. You may be on your back now and it is the wrong time to interfere.

Q325 Lord Hamilton of Epsom: The French are saying it now.

Lord Monks: Yes, but they've backed off. They've not made it a term of the rescue package. Somebody in Ireland might be grateful for that. They are not feeling very grateful at the moment but they should be grateful for that.

The Chairman: I must move towards closing the session. Incidentally, Lord Monks mentioned that there are two teams in Manchester in the world of football. It is interesting that in the free movement of workers—the case of Bosman—if we look at the European Union scene, the British are hamstrung by having a lack of other languages and, some might say, a lack of other skills. But it is the home of the supreme league of football in the continent of Europe. Some economist ought to write a good summary of that.

We are extremely grateful to you, Lord Monks and Mr Janssen, for coming today and being so confessional. You induced others round the table to be equally confessional. You have given us a different side to aspects of the problem that we have heard from other witnesses. We will mull it over, and please will you mull it over? Will you look at the transcript and correct it? If there are additional items that you think would be beneficial to the committee we will be most grateful. In the mean time, thanks ever so much for coming.

Lord Monks: Thank you very much, too, to all members of the Committee and all members of staff.

Examination of Witnesses

Witnesses: **Mr Hans Martens** and **Mr Fabian Zuleeg**, [European Policy Centre].

Q326 The Chairman: Welcome. Thanks very much indeed for coming. As you know, we are doing this study on economic governance. This is our visit to Brussels. We have eight witnesses altogether. We have had a series of interviews. We hope to produce our report in January/February. This inquiry will be useful, because I think that we will continue to have problems. Every day that passes, there seems to be a new country that is in trouble. If you want to make any preliminary comments about the current situation, we will be all ears, but we are looking perhaps to the longer term. A transcript of what we are saying is being taken. When we send it to you, would you be kind enough to check that it properly reflects your views? If it does not, please correct it. If you have additional comments, please make those as well, because our purpose is to gather as much evidence as we can to make our final assessment. I'd like to ask you about the European Policy Centre, its history and how it is financed and so on, but, first, I have to congratulate you and your colleagues because you have provided as fine a set of papers as I have ever read. They are a model of clarity. Some very interesting points arise there which we would like to learn about. Perhaps you would just introduce yourselves and tell us a bit about the EPC.

Mr Hans Martens: I was also tempted to comment on the current situation, but I don't want to go into it because I do not want to delay the committee. At the moment, I am reading a book about the crisis by Henry Paulson, *On the Brink*. I am shaking my head at the way that the markets behaved and the risks that the financial sector was willing to take in the lead-up to the crisis. We have had different waves over the last couple of years, with the attack on the non-euro countries to begin with. I think that some people have forgotten that. In the UK, we had the pound very close to parity with the euro at one point, because we had the yield possibility. The same went for Sweden; Denmark wanted to be a member of the euro without voting rights, so the interest rates shot up. Then we had the attacks on the eastern European countries. Then they moved to within the euro area. It seems that what is going on now is completely unrelated. The public sentiment is that you can just compare Greece with Portugal and Ireland and so on. If we had two hours, we would try to tell you a little bit about why their cases are completely different. It is also a little bit beyond normal economic logic because this is about vultures circling around to find a place they can attack and make some money out of it. I am not sure that Fabian shares my opinion, but, to me, being from a bank, it is rather disgusting. You never know where the next attack will come from. I don't think that it will be confined solely to the euro area; it could go to many places.

Let me move away from these emotional sentiments. I have been in charge of the EPC since 2002. One reason why the papers are clear is that we are proud to say that we are a policy think tank. We are not a research institution. We rarely produce difficult-to-understand publications, because we try to cover policy which is topical. We try to link our membership with decision-makers in Europe and beyond. We are based on what we call a multi-stakeholder approach, because that is the way in which Brussels operates. Not only are we non-partisan but we also have members from companies, regions, Governments and NGOs. We have about 400 member organisations and they contribute to our finances. I think that I can safely say that we have been leading in the area of transparency and openness. If you go to our website, you can find a very detailed description not only of who decides what in the organisation, but also of where the finance comes from. We disclose down to €5,000 the income that we get, because there are a lot of accusations about think tanks being used for whatever. If you make such an accusation, you can at least see where the money comes from and what it is used for. That has been a leading principle, and we did that even before the Commission's register came up. We are the only major think tank to have joined that. That is not to register as a lobbyist, but to increase transparency. Our work is divided into three main programmes. We deal with global issues—we have a Europe in the world programme; we of course deal with European institutions; then we have the economic programme that Fabian leads.

Q327 The Chairman: That's very helpful indeed. In your paper you say that, "we are a long way from working together effectively on our fiscal and structural policies, which is needed if we are to make the Economic and Monetary Union work". Is closer co-ordination essential, or just desirable? What does this closer co-ordination mean? Does it mean more central co-ordination from Brussels, or some sort of bargaining process about respective national positions? Should closer economic co-ordination take place beyond the eurozone or in the wider EU as well?

Mr Fabian Zuleeg: From our perspective, it does not really matter what we call it. There has been a big debate about the terms. What matters for economic and monetary union is that we can take decisions jointly and that these decisions are then implemented and enforced. Whether we call that effective co-ordination, economic governance or even economic government does not really matter in that context. It is the implementation of joint decisions where we have had problems in the past. That is an area which needs to be improved. Our reference here was really about the co-ordination of the austerity programmes. We have observed that there has been very little co-ordination between the different member states.

Q328 The Chairman: You say in particular in your briefing, which caught my eye, that this is a potential distortion of the single market. I was going to ask you to elaborate that point when you came to it.

Mr Fabian Zuleeg: That was going to be in my comments. In certain areas where we already have a very high degree of economic integration, particularly the single market, it is much more about central co-ordination or whatever we want to call it. We have a legal framework in which this takes place. We have rules which need to be kept in the different countries. When we saw the European economic recovery programme, it was recognised that there was interdependence between policies of different countries, that one country's fiscal expansion would have an impact on another's. Effectiveness would be reduced if there was a lack of co-ordination. Exactly the same economic logic applies to the austerity programmes. If we cut money in a particular area, it has an effect. For example, subsidies might distort the competition between companies in the single market. If we have different approaches to tax rates, that could lead to people going across borders to purchase products. These are all potential distortions of the single market which have not really been taken into account in the austerity programmes. That is a missed opportunity.

Q329 The Chairman: Was an example the automotive industry a year back? That is highly integrated within the European Union. There were fears of special pleading by countries. Was that an example of what you had in mind?

Mr Fabian Zuleeg: That was an example where, at least at the time, the debate was very much about continuing some form of subsidy regime for a particular car maker in a particular location. There was very clear potential for single market distortions in that. We have seen throughout the economic crisis that there is a potentially significant impact on the single market. In those areas, it is not just economically sensible; there is a duty for the Commission to safeguard the single market, because it is based on our common treaties, which the Commission has to uphold.

The Chairman: I think that that is a really interesting point. Potential distortion of the market has not been highlighted.

Q330 Lord Marlesford: I would like to take up your comment that tax is a distortion of the single market. Would you like to expand on that and say, first, which forms of tax; and, secondly, what you think should be done about it?

Mr Fabian Zuleeg: Potentially, all taxes can distort the single market. It is not necessarily a legal distortion; not necessarily something which is covered by the rules. We have had a long debate around VAT, not in the sense of having the same VAT rate but of having the same systems and regimes to make it easier for companies to work across borders, especially on the internet, where it is very difficult to deal with the current situation. We have also had a debate not about the rate itself but about a harmonised corporation tax base, so that the basis of taxation is the same. That would make it easier for companies which are based in multiple locations within the European Union.

Q331 Lord Marlesford: Before we leave corporation tax, can you confirm that, at the moment, the dispute is over the rate? The Irish rate is seen as a peculiarity which is valued by Ireland. In our parlance, taxation has always been a real red line as far as further development of the EU is concerned. That goes for British Governments of both parties, both the coalition and the previous Government. Are you suggesting that it was a mistake not to have a more harmonised system or rate? I understand your system point on VAT, of course, and you rather excluded the need for the rates to be the same. In the case of corporation tax, one can understand the desirability of the harmonisation of accounting principles and that sort of thing, but the rate is the really sensitive point.

Mr Fabian Zuleeg: First, I mentioned where we are in the discussion at the moment. From my personal point of view, there should be harmonisation of VAT rates as well. It is a distortion of the single market in the long term. I do not think, politically, that it is very likely to happen in the near future but, as a long-term goal, it is something that we should be aiming for. When it comes to corporation tax, and particularly the Irish case, the debate at the moment is somewhat missing the point. If we look at the fiscal position in Ireland, Ireland would have had to put this rate up in any case whatever happened outside. There are only so many different sources of revenue for the state. Some of them have completely collapsed in Ireland. It is very difficult to see where the money would come from if not from some form of increase in corporation tax. In general, it is to be expected that, if we have a system whereby countries will receive support, those countries that are giving the support will also make certain rules about it. That conditionality has been put in all the proposals so far. There are rules which have to be followed. It was to be expected that some countries which have been unhappy about the level of the Irish corporation tax for a long time would put pressure on it. The key here is that Ireland ultimately did not have a choice. It had to access the support. That means that it also has to accept the rules which come with that.

Mr Hans Martens: This is not a new story. In all the time that I have been following EU affairs, there has been this issue with Ireland. You will remember that, a certain point, they were discriminating against their own people because they had lower corporate taxation for inward investment. They had in the end to align it because that was as far as we could go under EU law. I just wanted to comment on the red line as well. I am Danish by origin. I have not lived there for many years, but I follow what is going on. They were saying the same thing: “We independently fix our excise duties and VAT”. No. They have fixed the VAT and excise duties in relation to Sweden and Germany, because it is a small country with access to those countries. It cannot diverge too much. I am trying to underline the argument of interdependency. We are all interdependent, because we are living in an open world. Some of the things that we do on health and education can have an effect as well, because people can move freely. If, for example, you make a lot of savings in the education system and the quality goes down, it is perfectly possible for young people to go elsewhere to receive their education; the same goes for health. I am trying to make the interdependence argument in terms of real life and not just in theory.

Q332 The Chairman: It's very interesting, because in the United Kingdom, the four nations are following different paths in, for example, the National Health Service. You are getting that differentiation. But I return to economic governance—Mr Zuleeg, you said that it did not matter what you called it so much. What role does the European Central Bank have in that mix, if any? What kind of role should it have?

Mr Fabian Zuleeg: The European Central Bank has been set up in a very specific way. This is intentional. It is responsible only for monetary policy. It has focus, in essence, only on price stability. Yes, it needs to take other things into account, but its overriding aim is price stability. Changing that is a problem both politically and technically.

Q333 The Chairman: Are you implying a criticism that price stability was the single-most ambition of the bank?

Mr Fabian Zuleeg: I would not apply a criticism to the bank. It is important that, at the European level, we also look at the other elements, but that is not necessarily a job for the ECB. The ECB has a specific job to do, as given in the treaties. There are some areas where there is spill-over between fiscal policy and monetary policy. If unsustainable levels of revenue are being raised by certain countries, the ECB has at least a responsibility to raise the warning sign. In general, its role is very much focused on monetary policy and should remain so, but we need to think about other parts of the equation in the economic governance system. With Ireland, it is the growth part of the stability and growth pact that needs to be discussed. The big worry that we have at the moment is that there is very little debate around that growth part. How are we going to make sure that countries such as Greece, Ireland, Portugal, Spain or Italy grow in the future? If we do not manage to do that, I am afraid that all the sanctions and enforcement that we are putting in place are not going to work. Debt has to be eroded through GDP growth. Inflation is a much more difficult and economically detrimental method of eroding it. If we do not solve that growth problem now, we will certainly be back in trouble in the medium term, if not in the short term as we are seeing already.

Q334 Lord Jordan: We would welcome your observations on what you see as the role and potential of Europe 2020 in three particular areas: first, in any moves to co-ordinate further economic policies in the EU; secondly, in its relationship with and in the link between it and the stability and growth pact; and thirdly, on the streamlining of the timetables for the SGP and the annual Europe 2020 cycles and on whether they will make any difference to the commitment of member states to achieving structural reform.

Mr Hans Martens: We very much see 2020 in the light of experience with the Lisbon agenda. We were very supportive of that, exactly for the argument that was just made about this being about competitiveness and future growth. This has been accentuated because we have seen global competition being a threat to Europe and, in particular, because we have a demographic time bomb lying under us which will mean a lot in future. We would like to see us getting away from discussing monetary and fiscal policy because they have limits.

It is perhaps difficult to see it in the present situation, but the real issue in integrating Europe in the longer term is aligning structural reform polices. We all know that the reason why the southern countries are in difficulty—it is a bit different in Ireland—is their lack of competitiveness, which is why they have deficits. We are strong supporters not only of the present 2020 but of focusing even more on that. We constantly criticise the fact that nobody really deals with public sector reform. Public sectors are large in Europe, and there is very little talk about how we can improve their competitiveness or productivity, primarily because we measure their value for the economy through their inputs, not their output. That is a huge problem.

One of the reasons why public sector reforms are not there is because they are politically inconvenient. In certain countries, any talk about improving productivity will immediately be misunderstood and there will be strikes all over the place, so it is politically difficult. They matter more because we have a low birth rate and a rapidly ageing population so future pressures on European welfare states will be huge, so we are talking about this from a long-term perspective.

The engagement of member states in discussing and meeting targets on structural policies is regrettably low, which has something to do with the lack of urgency. It is a bit like discussing climate. We would all like to do it, but can it please wait until next year. There is not the same urgency as when the vultures are flying over your financial markets and you have to do something on fiscal policy. We have been pushing very hard for structural reforms and have argued for integration in the growth and stability pact. As Fabian is rightly saying, it is not just a question of cutting public budgets—well, it is right now—but in the longer term it is about meeting the targets for the modernisation of our economies for the reasons that I just gave.

I am not saying that all the structural reforms should be integrated in the stability and growth pact, but they should be built in to a certain extent and there should be integration to refocus our views and to allow peer reviews and mutual responsibility about countries meeting certain standards. I do not know whether that is clear enough, because it was quite a big way around it, but I am basically saying that structural policies should be an integral part of future discussions about euro governance because they are so essential for the future and should probably be integrated in a revised growth and stability pact.

Q335 The Chairman: The Lisbon agenda was not very successful, was it? Everyone said yes to it and signed up to it, but then failed to implement it.

Lord Jordan: It seemed like a wish list in the end.

Mr Hans Martens: I do not think that the climate summit was very successful. Everybody wanted to save the planet, but they said, "But can you please do it in 10 years?" There was never the urgency. It is also politically inconvenient, in particular when people like us bring up the public sector. We say, "You don't want us to make a speech about more efficiency in the health system, do you?" I think that it has something to do with that. There is also—I am glad that you asked the question—some lack of understanding in political circles about the importance of modernising Europe in the face of globalisation. The backlash when we get into trouble and become less competitive could be our becoming economic nationalists, which I think is the term for protectionism these days. The Lisbon agenda was perhaps a little too complicated, but it was a success in the sense that, for the first time, it officially put structural policies on the table for possible co-operation. However, the achievements were not great.

Q336 Lord Jordan: I would like to talk now about something that some people see as a bit more controversial: the central oversight of member state budgets by Brussels. Should it be strengthened? Is there a case for a new institution, perhaps supporting an EU Finance Minister? Should there be an enhanced role for the euro group? Should this be applied to just the eurozone or the wider EU? What might be the role of a European semester?

Mr Fabian Zuleeg: First, "central oversight" is not really what is being discussed at European level. Certainly, we are talking about more surveillance and examination of national budgets, but central oversight implies some form of control. That is very different and is not really on the table. In that sense, new institutional posts—for example, a Finance Minister in some form who has enhanced powers—are not on the table; nor is anyone really asking for them at the European level. The euro group has had a different role since the Lisbon treaty came into force; it has an official role now; it is in the treaties. It has responsibility for co-ordinating eurozone members. In that sense, some of the economic governance proposals that we are discussing apply only to the eurozone. Article 136 clearly refers to the ability that we now have at the eurozone level to co-ordinate and scrutinise each other's economies more. That is very deliberately set up only for the eurozone and not for the rest of the EU. If you ask me what should be the case, that is a different question. Coming back to the Irish example, we can see that interdependence does not stop with different currencies. If we look at what is happening in Ireland, or if we go back to what happened in Iceland, we are talking about economic developments and crises which very easily spill across currency borders. The UK, for example, is forced to extend a loan to the Irish Government even though it is not part of the stabilisation mechanism which forms the umbrella. That is because the UK banking system ultimately depends on the continued health of the Irish banking system. In that sense, we should have much more co-ordination and surveillance across the whole EU. Of course, budgets are very difficult. They are at the heart of what Governments and Parliaments do. That is part of the big issue. But I do not see what the big problem is with having a discussion of a draft budget at European level and having it pointed out if there are contradictions with the overall direction of economic policy at the European level. The final decision—that is why I say that "central oversight" is not the right term—rests with national Parliaments. In the end, it is not about a transfer of power. It is about getting more information about budgets and taking into account this interdependence at an earlier stage. That is the whole function of the European semester. It is simply to have a discussion about what impact a budget in one country has on other countries before it actually happens.

Q337 Lord Jordan: We know, because we have already discussed it ourselves, that the word "oversight" conveys completely the wrong impression. What we are perhaps more interested in is the extent to which the surveillance of draft budgets and the role of the European semester itself, if they were up and running well, would have stopped anything that is going wrong at the moment. I can see there might be a case for saying that it could have spotted what was potentially going to happen in Ireland, but what would it do for Greece? Everybody knows what the problem was in Greece. You can show all the figures you like. What will it reveal if it is up and working properly? What pitfalls can it help countries avoid?

Mr Fabian Zuleeg: I think there are two elements: first, what it will reveal; and, secondly, what impact that will have on policy. I think the situation has changed. Nobody wants to be in the position of Greece and Ireland. That is the worst possible outcome both politically and economically. Ultimately there is more of an incentive for countries to take the discussions at European level seriously, so that if there is, for example, a particular flaw within a budget and it is highlighted six months before the budget is passed, that would at least trigger quite a heated debate in the national Parliament about whether it is a sensible route to go down if it clearly contradicts what we are trying to do at European level. However, in the end, the decision will still be down to national Parliaments. No one is taking that away. National Parliaments can, if you like, take the wrong decision at any point in this. I think the chances are that it will help national Parliaments to be more aware of what the wrong decisions might be, but it will not completely eliminate the possibility.

Q338 Baroness Maddock: I was very interested in your comments about restructuring the public sector. One of the things that the new coalition Government are attempting to do is to do that, and of course it is easier if you are coming in new. It will be interesting to see whether they succeed. I think we will have more demonstrations, particularly about the price of higher education to students rather than to the state, and we have demonstrations today, but that is by the by. I want to ask about the stability and growth pact. When we are looking at this, should we consider private sector debt more closely and should we look at incentives as well as at sanctions?

Mr Hans Martens: On the reform of the stability and growth pact, as I said before, the major thing we could do is to consider our public sectors. We are frantically trying to push forward a debate about real measurement of the value of the public sector so that we can compare it over time and with best practices. Measuring only the money that we put into it is not a satisfactory situation, but we can always discuss that another time. I am not sure that private sector debt should be included in the growth and stability pact. It is clearly designed to deal with the public deficit and its inflationary effect, which relates to the role of the European Central Bank. Nobody is unaware of the level of private debt. You will remember that before the crisis the big discussion in the US was the triple deficit with private debt and household debt. What was not clear at the time was the extent of the financial sector debt and the off balance-sheet debt and their effect because of leverage. An enormous amount of debt was flying around and being financed around the world. However, I am not sure that we can integrate them, and it is not the immediate responsibility. You need a qualification as well because, if we are talking about private sector debt, is it internal—in your own currency—or is it in foreign currency, because that changes the picture a bit, and is it long-term or short-term? The measurement becomes too complicated, but it appears and is taken into account by the financial markets. You were talking about incentives as well. I cannot really see the Christmas presents that we can give out of the EU. I do not think that fining a country in difficulty, such as Greece, helps, because the problem is the money.

We also have to look at this in an informal way because it is clear that whatever sanctions come out of this system, they are nothing compared with the sanctions that the market imposes. I am not always convinced that the markets react completely logically, but when these difficulties are exposed, the interest rate on government debt, and perhaps on private debt, goes up so substantially, which is the worst sanction. That has always been my thinking. A crisis inside the monetary union where you cannot devalue will show up in interest rates. As Fabian said, it is the worst possible situation to get into. It is not very pleasant in a crisis to finance your public debt with a 9 per cent interest rate. The market mechanisms are working here and punish more than any EU sanction could ever do.

Q339 The Chairman: We were scratching our heads about an incentive.

Lord Jordan: We had heard the somewhat novel idea that if you impose big fines on the ones that are failing, you can give those fines to the ones that are succeeding as a bonus.

Mr Hans Martens: I can see some lines for the reform of our judicial system there. I would like all the criminals to pay me.

Q340 Baroness Maddock: There has been talk about taking away voting rights.

Mr Fabian Zuleeg: The difficulty here is what the underlying problem is. If it is divergence in economic fundamentals between different parts of the eurozone, transferring money from those who are performing badly to those that are performing well is not going to help us address the underlying divergence.

Q341 Lord Marlesford: Taking up Mr Martens's point about the difficulty of including private debt, the linkage is that private debt tends to go straight into the banks. In an extreme case, that means a country, for example Ireland, underwriting its banks. It is quite difficult to separate them out. For example, I believe that in Britain we have a major problem with credit card debt, which is worth some £60 billion, and nobody quite knows the value at which the banks have it on their books because they sold some off at between 10 and 20 pence in the pound. These are potentially huge systemic risks to the economic system.

Mr Hans Martens: They are, and that is what the whole thing was about in 2007-08 in the US. However, there are other questions—for example, is it healthy to have a bank like Northern Rock that finances both long term and funds on very short term? If you put it that way, it is an insane idea, but there was a lot of insanity in the financial system at the time. However, I do not think it would help to put a gross debt figure in the growth and stability pact because Governments are not responsible in that sense. I recommend that we have better statistics, but then we need to take into account the risk profile of these issues. So far, we have not been able to measure them because we do not have the capacity to understand the levels we are talking about, but the risk is obviously there.

Ireland is a special case, like Iceland, but one rule you can learn from them is not to have banks that are so big in relation to your GDP. It is nice when it goes well, but it goes bad when it does not go well. The Government are directly responsible for government debt and should be able to respond, whereas the underwriting of the private sector should, in normal cases—and here I exclude Iceland and Ireland—not really be a big issue. You could take that underwriting into public sector commitments, but credit card debt—

Q342 Lord Marlesford: They are liabilities, aren't they?

Mr Hans Martens: They are potential liabilities.

Lord Marlesford: In the case of Ireland, they are direct liabilities on the current account.

Mr Hans Martens: You can say that in that case, but you cannot say that the Government are directly responsible for the Irish credit card debt. We need to highlight the private sector risks here. The market is trying to estimate them, but it does not always get it right, as we know, because within half a year its evaluation of the risk of subprime loans, for example, changed considerably. I would also like to say that perhaps the rating agencies should do a better job because they are particularly opaque. To this day, I cannot understand why they were AAA-rating Lehman Brothers until the night before, or why they were supporting subprime lending so heavily by the high gradings.

The Chairman: I'd like to ask you a question about that later on, but I am going to bring in Lord Hamilton.

Q343 Lord Hamilton of Epsom: When the eurozone was established, the stability and growth pact was drawn up with quite sensible measures, but the measures were completely ignored by France and Germany when they turned out to be inconvenient. Are we not in danger of going through the same motions all over again, so that we have a new stability and growth pact, everyone says that it is a very good idea as it is dealing with the existing crisis, but then, as time passes and it becomes inconvenient, everybody ignores it? This is a serious worry. There is a desire to be seen to be doing something, as Governments do when there is a crisis and then, when it has gone, they ignore the whole thing anyway.

Mr Fabian Zuleeg: What is being discussed at the moment is not a new stability and growth pact; it is the enforcement of the existing pact. It is about trying to give the stability and growth pact teeth. There is a difficulty here because we should have taken the opportunity to look at the stability and growth pact again, but that is very difficult because it is tied up with the treaty, and that would mean renegotiation of treaties, which is not easy.

On the enforcement issue, I think there is more appetite for it now. Returning to who wants to be Greece, if you are continuously breaking the rules in the stability and growth pact, the spectre of ending up like Greece—not only economically but also politically, because Greece now has to accept that large parts of its economic policies are made in other countries—is a major issue. Will it also apply as effectively to the big countries? That is a difficult question to answer. Some things being put in place make it easier to apply it to big countries, even if they are unwilling to accept them. For example, if we have this new majority voting rule so that, ultimately, you have to find a majority to vote against a country being reprimanded, it could well work.

Of course, we also have to accept political realities. France and Germany, particularly Germany, are the economic heavyweights in the eurozone. Germany is by far the most economically and politically powerful country in these questions, so it has to be willing to accept that the rules that are now being drawn up will apply to it. There has to be the rule of law in that sense. We are agreeing a legal basis at international level, and Germany has to stick to it. At the moment, at least, Germany is emphasising that it is creating a framework that will apply to everyone equally, so we will see, but we also have to recognise that the situation is unlikely to arise in exactly the same circumstances. It may for France, but for the moment, it looks as if Germany will be one of the stronger players for at least the foreseeable future, especially when it comes to fiscal sustainability.

Q344 Lord Hamilton of Epsom: You said earlier that when we look at the stability and growth pact, we are, at the moment, concentrating very much on the stability elements and how we address deficits. However, as we are finding in the United Kingdom, the other half of the equation is equally important and if we do not get economic growth, we will not close our deficit gaps. This brings us to my harshest criticism of the EU, which is the economic model that it has been following for some time. It strikes me that the problem with the EU is that it is extremely introverted and has a very antiquated economic model that basically says that there is almost no limit to the burdens that business can bear vis-à-vis what it pays towards its employees and so forth. That has not been unsuccessful, but it is become progressively less successful. EU growth rates were pretty low prior to this financial crisis and the world is changing, as I do not have to tell you as an international consultancy business. We are now trying to compete with China and India, and we do not get much reference to this in any discussions about Europe. We are always talking about how we are

Mr Hans Martens: For the record, I want to say that we are not an international consultancy; we are an independent think tank. It makes a big difference because we are not paid to have an opinion; we have an opinion and then we hope that somebody will pay us. What I said before about structural and modernisation policies was because of that. The imbalances within Europe are primarily because of differences in competitiveness rather than anything else, and financial imbalances are a symbol of the difference in competitiveness. We are trying to push for that. Going back to the public sector, I will not burden you further with this, but we often raise proven controversial issues, such as inefficiency, because we do not have the statistics about corruption. Issues play a big role here.

As I said before, the difficulties ahead for Europe are, first, our internal problem of changing demographics—low birth rates and rapid ageing; and, secondly, global competition. China and India are always mentioned, but they will become more expensive for themselves. China's currency policy is another thing to get into. However, it also works the other way around because one of the successes of Germany at the moment is that it has not been protectionist but has kept the market open. Germany has taken the more realistic euro rate that we now have and the very low funding rates in Europe as an opportunity to expand its markets in, for example, the growth economies in China, India and so on.

Also, please note that just over our border is a very large nation that we do not really want to talk about: Turkey. It has Chinese growth rates and a young population. It is a growing country, whereas Germany's population is declining. So we are in a global competition and it matters a lot here.

On the models, I am not prepared just to say that your Lordship is absolutely right because I have some question marks about the Anglo-Saxon economic model as well. I agree with Mr Paulson, whose book I am reading at the moment. He says that we should stop talking about the Chinese currency issue as the major factor in all this and that the real factor was that our economy was too consumption-driven and that the savings rate in the US went to zero in the current account. That was more of a reason for what happened than Chinese currency policy. I think we need to look inside ourselves again and discuss whether we want more stability at a lower level or boom and bust.

Mr Fabian Zuleeg: Can I just add something to that? It is interesting that at the moment if we had a discussion with the French Senate, for example, we would get exactly the opposite accusation. It would say that the European model is based on Anglo-Saxon ideas of free competition, free trade and all those areas and does not take enough into account the social and other elements that we are talking about. There is, if you like, an image of the European Union, which changes from country to country, that has very little to do with the realities of the policies that are being pursued. If you are looking at, for example, Europe 2020, we are talking about structural and supply-side policies that are very much in line with the ideas of growing businesses, generating a bigger market and integrating with the external world.

It is not quite as simple as saying that Europe is a mechanism that creates problems for businesses. In my view, it is equally concerned with trying to create an environment where European businesses can compete with the rest of the world while, at the same time, preserving our economic and social model, which includes social and environmental protection. It is, because of its nature, always somewhere in the middle, and there will always be something that can be attacked, but I do not think that the caricatures of Europe as an anti-business place or as an anti-social place are correct. It is somewhere in the middle because it bundles together a lot of different models and ideas.

The Chairman: We are very short of time, so I am going to ask Lord Marlesford to contribute, and then we must move to wrapping it up.

Q345 Lord Marlesford: On this very important point, my worry is that you give me the impression that you often regard differences in economic policy, taxation or other policies, such as social policies, as distortions. Do you not think that harmonisation of economic policies risks limiting economic innovation, which in certain cases can be as important to economic growth as technological innovation, and that you are more likely to get economic innovation at a national level rather than at an EU level?

Mr Hans Martens: I want to respond very briefly because I agree to a very large extent, but there are some criticisms that you would apply to other models. As a Scandinavian, I think I am allowed to say that I think that a major problem in Anglo-Saxon economies is the deep tax aversion because you cannot really use your public sector in the sensible way that we Scandinavians do—let me come back to that. There is a truth behind it because when you approach an election, it is difficult. It is not possible in the US to get a decent policy because you cannot tax cars or petrol—you know what I am talking about—and you have a bit of that in the UK.

One of the things that the continental model in Europe has created has been a sound and more long-term savings rate in the private sector because there is a tendency to emphasise growth to consumption which leads us into these booms and busts. There was a certain interest in the Scandinavian model before the crisis. I have to clarify, if there is any misunderstanding here, that having a big public sector and high tax pressure, as the Scandinavians have, has not been a problem for competitiveness. All the competitive countries have been in trouble, but the public sector in Scandinavia has never been intrusive or intervened in business, and there is an extreme free market. Social policy in Denmark and France takes about the same proportion of GDP, but in France it is used to keep people, broadly speaking, in their jobs—it is a labour-market policy—but in Scandinavia it is used to retrain people who get fired to get back into jobs. So there is a difference in how you use the public sector. People are patently not having trouble paying taxes and so on.

Q346 Lord Marlesford: That is very helpful. How do you feel a permanent crisis resolution mechanism should function?

Mr Fabian Zuleeg: Unfortunately, in the current situation, we have to discuss how the temporary crisis mechanism can function. We have an absolute need to have an effective crisis mechanism. We are unfortunately running out of time to put that into place in an orderly, long-term fashion with treaty changes and everything. First and foremost, the permanent crisis resolution mechanism needs to create certainty and be a step ahead of the markets. Our biggest problem has been that there has been too much uncertainty around, which has aggravated speculation. We have always been on the back foot and have reacted to the markets rather than being in front of them. My wish would be that we can use the temporary crisis mechanism more effectively now, because we need it, and that, for example, we do something pre-emptively on Portugal before we are in the same situation that we were in in Ireland in two weeks' time or whenever it might happen. There is still a lot of debate around the exact form of the crisis mechanism. To some extent, the most important thing is having it there and working effectively. Some of the details are not that important.

However, because you have mentioned debt restructuring and default mechanisms, I think we have to start thinking about these issues at a European level. It is dangerous to equate them immediately with exit from the euro. They are two separate issues. We may well need to have debt restructuring within the euro, and there may be countries that will have to address their long-term debt burden but will be able to remain in the euro after that is done. I think it is very unlikely that countries such as Greece, Portugal or Ireland will, in the foreseeable future, manage to repay the debt that has been accumulated over a number of decades, so we need to talk about restructuring because the cost burden of financing this debt is already very high and is likely to be even higher. At the moment, even though the spreads are very high, we have very low base interest rates. If the interest rate goes up and we have a big spread, it becomes unaffordable.

Mr Hans Martens: I just want to say that if you want an area where we disagree, it is in the role of using euro bonds. Because this man is of German origin, he is, of course, against it. A more liberal-minded Scandinavian thinks that it could have some effect in cases of a possible bail-out.

The Chairman: We must end it there. You have left so many interesting trails for my colleagues to think about. Mr Martens, I would have loved to pursue your point about credit rating agencies. It has been a fascinating hour and, gentlemen, your clarity in the flesh has matched your clarity in writing. You have been what we hoped and expected. We are most grateful for what you have contributed this morning. We will go away and think hard about it. I hope you will go away and think hard about it. If there are any supplementary ideas or thoughts you would like the committee to know about, because this is a fast-moving situation, we would be most grateful, and we would be most grateful if you would check the transcript. In the mean time, many thanks indeed. Thank you very much.

Mr Hans Martens: Thank you for having us.

Mr Fabian Zuleeg: Thank you.

Examination of Witnesses

Witness: **Professor Jean-Victor Louis**, [Université Libre de Bruxelles].

Q347 The Chairman: Professor Louis, we are doing this report into economic governance. We are particularly grateful to you for coming this morning, because there are legal aspects to what we are doing that we particularly want some advice on from you. We will be making a transcript of the witness session and will send it to you. Will you be kind enough not just to correct it if it has been falsely written down in any way, but also if there is anything you wish to add, or you have any afterthoughts. We would be most grateful. The problem that we are dealing with at the moment continues to change shape every moment of the day, so your most recent thoughts will always be valuable to us. So thanks very much for coming.

Let us make a start. One of our previous witnesses indicated that, "the eurozone is a difficult and fragile halfway house because it combines monetary centralisation while leaving fiscal and indeed wider political issues to individual nation states". I wonder whether you could comment on this view. How could the arrangements for fiscal and monetary policy in the eurozone be improved? Are we talking about economic governance—I know there is a difference in French, which I do not think has this distinction—or economic government? It is a distinction that we have in English. Certainly from the British viewpoint, it has quite a different meaning. Please explore those difficult issues.

Professor Louis: My Lord Chairman, first thank you very much for inviting me. It is a great honour for me. On the first question, I think that the previous witness was right in saying that there was a kind of halfway construction. How fragile is it? We have to remember that the European monetary union is very young. It has existed for 12 years, so the euro does not have the prestige, and the general use of another international currency, the US dollar.

At the same time, it is the second international currency, which gives enormous responsibility. You have seen this morning that the markets went down in Tokyo because of Ireland. That did not happen just by chance.

It has been conceived as a central monetary pillar with a very low degree of economic union. Why? We were at a time of supply-side economics. The doctrine of Ronald Reagan was always in the picture. Among those who conceived the economic union was the memory of the Werner plan, which was much more imaginative about economic union. They did not want that, for a lot of reasons that are too long to detail. They made a rules-based economic union. Monetary financing and indirect monetary financing through privileged access to the private sector were prohibited; there was a prohibition of bailouts and there was a ruling about excessive deficits. That offered, so it was believed, a solid material for building monetary union.

History has revealed that it did not work that way, because excessive deficit prohibition and the stability and growth pact have not worked as it was believed they would work. Also, when the problem of assistance to member states became a reality, the rule of no bailouts was not considered credible. It was impossible not to do something. There was a little-known provision, Article 122.2, which is a crisis provision allowing financial assistance in exceptional circumstances where the state is in a situation that it cannot control. I have the text and I can read it if you like. In very strict circumstances, with very strict conditionality, there was this facility for the Council. That was a kind of counterweight to the no-bailout rule. It was used after the Greek case. The assistance to the Greece was arranged on the basis of an intergovernmental agreement but in the general rescue package adopted in May-June last, there was a Union part under Article 122.2.

On the idea that we need more economic governance, you know that for the Germans it has long been European "economic governance", and for the French it has been "gouvernement économique". At the beginning, "gouvernement économique", as proposed by the French and by Oskar Lafontaine when he was Finance Minister of Germany, was a counterweight to the Central Bank—in opposition to it in some terms. But this movement did not succeed and Lafontaine had another destiny. Bérégovoy died and the majority changed in France, so the strong revendication of an economic government was no longer there. But Sarkozy has come back once again with the idea of the need for an economic government. The justification for him too was for it to be a kind of counterweight to the Central Bank, but not in the aggressive way of Lafontaine because he realised that there was no majority—and no unanimity either, of course—for such a move.

It is interesting, if you look at the vocabulary for the preparation of the European Council of 29-30 October, you will see in the Deauville bilateral agreement that both the Germans and the French use the same expression; "gouvernement économique"—"economic government". Why? Because they have decided that the European Council will be the economic government, and for both Sarkozy and Merkel, that is good enough because they believe that, with their common agreement, the European Council will follow. Merkel has theorised that that there is a Community method and a Union method. The Community method involves a proposal by the Commission, and that this is a majority decision of the Council and of the Parliament. That is the ordinary legislative procedure.

Apart from that there are many areas where the Union is not competent in that way. There is only co-ordination, co-operation and the responsibility of governments. If, for certain fields, you add the Community method to this co-ordination, you have what Chancellor Merkel, in her Bruges speech, called the Union method. It is very interesting to see that Mr Van Rompuy, the President of the European Council, has found that very interesting. They believe—for me it is an error—that a meeting of 27 Member States is a reasonable way to exercise government. In the French legal tradition, "gouvernement" is an entity able to take binding decisions in cases of urgency and having all the responsibility of the Executive. That is not what the European Council is, evidently. For that reason, if we speak about "economic government", it should be in terms of the Finance Ministers of the whole area, a euro-group with decision-making power, and enhanced co-operation in some fields, such as taxation, employment and perhaps social affairs. All those things are taboo for many member states, but are a necessary complement to monetary union. That is my answer.

Q348 The Chairman: What is your view of the potential institutionalisation of the euro group? Do you think that would be beneficial?

Professor Louis: I have been in favour of it from the beginning. In the convention, I regret, the French Government and the Commission, which supported the idea, abandoned it. As for why it has not been done, the position of Britain is well known. Against that, we remember what Blair thought of the euro group itself. To have a group meeting without the presence of the United Kingdom was a farce – at least for Mr Blair at the time – a fortiori if you give it decision-making power. Also, in the ranks of the member states of the eurozone, there was no unanimity on that. They believed that as an objective it was too divisive. We were in a moment when there was a question of having Denmark entering the euro area and perhaps Sweden could consider it. Some people thought that perhaps Britain could join. That was an illusion but at the time there was that idea. So it was thought, "Let us not divide the member states at a moment when we possibly will have everybody in the euro".

Q349 The Chairman: Could you advise us, as British parliamentarians, what are the dangers for the United Kingdom of this activity, which may develop over time, of greater governance, if not government, in the economy of the euro?

Professor Louis: I am not a monetary specialist, so I cannot give you a view on the future of the pound in the circumstance of a strengthening of the euro area. If I may speak openly, you have to observe that the UK has been qualified as a semi-detached member of the

European Union, because of its attitude to Schengen, to the freedom, security and justice area, and to the European Charter of Fundamental Rights. There are many important parts of European integration-as I still call it-from which the UK is absent at the moment. That is a fact.

It is normal to have a currency defended by organs that are proper to that currency. In that the realisation of this objective, one of the obstacles to enhanced co-operation has been that the Parliament can only decide in plenary. So, hypothetically speaking, you would have acts under enhanced co-operation between members of the euro area which would have to be approved by the full Parliament. The Parliament has always resisted any attempt to create divisions among its members. That was at the point of evolving more recently, but now I must say there is no question of that. On the other hand, we must recognise that there are topics such as taxation where actions at the level of the whole euro area would be difficult. We are speaking a lot about Ireland these days, but Ireland is not in favour of tax harmonisation and it is a member of the euro area. So there is no unanimity on this subject in the euro area. The euro area is becoming more and more diverse. We have Estonia and Slovakia, which later retracted the preceding Government's decision to help Greece. They said, "We will not help Greece; it is richer than us". By contrast, we have Slovenia, which is more conciliatory and surely more European-minded. We will be 17 of the 27 in the euro area. It is a bloc that is more heterogeneous than when the euro was created.

Q350 Lord Marlesford: This follows on very much from that. Could a country depart from the eurozone, either voluntarily or by expulsion? Could a former eurozone country continue as a member of the EU? In particular, is there any reason why a former member of the eurozone – assuming a country can become a former member of the eurozone – should not continue to use the euro as its currency with its own central bank, rather than invent a currency of its own?

Professor Louis: That is a lot of questions. For the jurist, this is a very interesting and delicate question. On the possibility of exiting from the euro, I always say—and I must say that this is also in official documents—it is called the euro area, not the eurozone. We do not like “zone”. The possibility of exiting the euro is not there because participation in the single currency is a policy of the Union and there is no possibility of retreat from one policy unilaterally. As you will see, there is no possibility of expulsion either. That is not self-evident because participation in the euro area is conditional. You could say that if there are conditions to enter, there should be conditions to remain in, but that is not the case. We cannot presume that the possibility of getting out exists because the monetary union has been conceived as irreversible, as it is one of the two pillars of the EU, the other being the single market. I personally consider that for this international currency—I have mentioned this before—it would be a question of lack of international credibility to see some parties going out. If you transpose this to another country with a world currency such as Japan, the United States or the UK, - I mention these countries because their currency is in the SDR basket - you could not imagine one part of one of these countries deciding to have its own currency. The exit is not provided for, and for me that is good.

If a state secedes from the Union, because that possibility exists under Article 550 of theTEU under the Lisbon treaty, it will not be in the euro area any more. To be in the euro area means, in particular, that you have a representative at the Governing Council of the European Central Bank and you benefit from refinancing by the Central Bank. You are in the position of being an institutional, and I would say “economic”, member of the area. Normally under Article 50, an agreement would be negotiated with the states that is going out, and it could be stipulated in that agreement that the state would keep the euro.[1] There are examples of countries using the euro, such as Montenegro, or Kosovo. That is a question of

[1] A very remote possibility.

history, because they all used the deutschmark, so when it disappeared they cahnged over to the euro to avoid being in a vacuum. The European Central Bank does what the US did in the past for Ecuador and other countries of Latin America; it gave them dollars. Frankfurt gives euros. We can imagine a secession being made on good terms and negotiations closing with an agreement that could also bear on the "euroisation" of the seceding country. The negotiation of an agreement can last as a rule for a maximum of two years. If there is no agreement between the parties, the possible unilateral maintaining of the uero as the currency of the exiting state could cause an argument with the EU.[2] The euro system, the Central Bank, and the collectivity of national central banks, along with political institutions, are all in principle against the phenomenon of "euro-isation": a word built on an analogy with "dollarization". They consider that it might be perhaps no problem for a micro-state, but that if the euro is being used in a medium-sized or big country outside the Union, it could be a challenge for monetary policy. Secession from the euro area is thus not allowed under Union law. It is only possible as an accessory to the secession from the EU under article 50 TEU.

Can we expel a country as a member state of the European Union? The answer in European law is no, but if a member state starts a war of aggression, or a Nazi regime, I am afraid that it will not remain a member of the European Union. In these extreme and hopefully hypothetical cases, the general principles of international law would apply in substitution to the normal rule of Union law. There is only inEuropean law, as you know, the possibility of a suspension of voting rights in the Council in very specific circumstances. Article 7 of the treaty on the European Union is applicable in case of violations of human rights and the basic principles of European Union law. It has never been used. There was the case of Austria, when an extreme-right party entered the government, but there was no suspension. Eleven

[2] But the EU cannot impose its will on a country that has become a "third" country, after the secession.

states protested and recalled their ambassadors, but Article 7 was not activated. The spirit of Article 7 was applied.

Q351 Baroness Maddock: I wanted to ask about treaty changes, which are a rather difficult thing at the moment. Article 48 of the treaty of the European Union sets out the procedure for amending the treaties. It distinguishes between ordinary revision procedure, which applies generally, and a simplified revision procedure, which applies only to the provisions of Part 3 of the treaty. It has been suggested that the simplified procedure would be appropriate to effect some of the changes that have been proposed by the European Council. First, do you agree with this view? Would the decision not to convene a convention within the ordinary revision procedure be easy to obtain? It requires the European Parliament's consent as well. If were not possible to introduce a suitable amendment under this simplified procedure, what would the alternative be? What are the implications for alternatives?

Professor Louis: The answers to these questions are difficult, because we do not know yet the nature of the amendments that they have in mind. They do not have precise amendments in mind. I saw that Mr Schreubel of the *Frankfurter Allgemeine Zeitung* the day before yesterday said that we are in a process of consultation with partners. He could not prejudge the result. He was much more cautious than the Bundeskanzellerin in that respect.[3] In answer to your question, there is a simplified procedure under article 48 para. 6 TFEU, which is not that simplified because you need unanimity and ratification by all the Member States.[4] There are many things to consider. It was one of the big failures of the convention not to have the possibility of a majority for revision. This simplified procdure is applicable for the provisions of Part 3 of the TFEU on policies of the Union, and there is a sentence in

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[3] The European Council has since adopted a decision on the revision of the TFEU at its meeting of 16/17 December.

[4] It is called 'simplified' because there is no need for an intergovernmental conference and of a "convention" as foreseen in the ordinary procedure under article 48, para 3 and 4 TEU.

article 48, para 2, sub-para 3, that says that "the decision referred to in the second paragraph shall not increase the competences conferred on the Union in the Treaties".

If you have a fully-fledged system of resolution in the case of the insolvency of a member state for its debt, this can imply, as has been proposed by a group of economists and jurists,[5] a sophisticated mechanism of restructuring which needs an economic and legal process. There is also the possibility of an appeal before a court of justice. I will come back to that. It is their idea to have in the treaty the principles of restructuration, because they want to avoid what has happened in the past, with some creditors saying that they were unwilling to accept the restructuring that it could not be imposed, and that they would go to the Court of Human Rights and argue that it infringed their property rights. The Bruegel report wanted to preferably have the principles of restructuring in the treaty in order to avoid such contests. Is it a new competence for the institutions? For the court, no, because there is the possibility, by a decision of the European Parliament and the Council under Article 257 TFEU, to create a specialised court attached to the General Court. I believe that a specialised court for this case would be all right.

I have not studied the restructuring of sovereign debts in all its details, but my first reaction would be that it is very difficult to build it under secondary law: via regulation, under Article 352—the flexible clause of the treaty. If Member States want something that could fully satisfy the Bundesverfassungsgericht, the constitutional court of Germany, they have to put a legal basis that in primary law.[6] Of course, everything I say is theoretical, because there is no evidence of unanimity among member states in favour of restructuring. I believe that restructuring could make the situation of the debtor more difficult, contrary to the

[5] See F. Gianviti, A.O. Krueger, J. Pisani-Ferry, A. Sapir and J. Von Hagen, "A European Mechanism for Sovereign Debt Crisis Resolution. A Proposal, "Bruegel, Brussels, 9 November 2010. This (private) report was the most developed proposal that has been drawn up concerning restructuring sovereign debt. The European Council endorsed at its session of 16-17 December 2010general features of a mechanism which were adopted in an Eurogroup.

[6] Although every provision going in the direction of more stability for the monetary union would be, in principle, viewed with favour by the Constitutional Court.

appearances. We have seen recently in the case of Ireland that the simple announcement of this possibility drastically aggravated the case of the debtor. It increased the risk of the creditor, which led to an increase of the interest rate requested from the debtor for additional debts. In Ireland, Greece, and other peripheral states, we have seen the spread between the Deutsche Bund and their securities increasing and the price of CDS—credit default swaps—rising. So insurance in case of default, is more costly because the situation is less favourable. I always come back to the idea that a default of part of the territory of the monetary union, with the euro has the second international currency would not be very favourable for the status of the euro but we will see what is decided.[7]

On the other point—the attitude of the Parliament—the Parliament can propose other points for the revision (as it has the right to do under Article 48, para 2 TEU) and say that a convention is needed[8] rejecting the idea of revising the treaty only on The point proposed by the European Council. The European Council would only need a simple majority to adopt a decision favourable to the examination of the modifications proposed by, in our hypothesis, the EP. The European Parliament would have to give its assent to the non-convening of a convention as provided by the ordinary procedure. But that is an improbable scenario.

The Union needs a permanent fund. What was set up, remarkably, in May and June, was part Union law, based on Article 122.2, part intergovernmental, plus the IMF—everything joined—without knowing the rank of one in relation to the other. What is the precise role of the IMF, et cetera? There are a lot of things that, for the permanent fund, should be settled. There is also the question of legal remedies against the fund. We have a facility in under Luxembourg law that is a company limited by share. I do not criticise it. It has done an

[7] See footnote 5.

[8] Under the simplified procedure of article 48, para 6, TEU, the EP has only to be consulted, like the Commission and for such a case, the ECB.

excellent job as a matter of urgency in two or three days and has saved a lot, but it is not as solid as stone. We have to have something more constructive, something that is inserted into the legal order and that conforms to the characteristics of European Union law.[9]

Q352 Baroness Maddock: So, if I have understood this, if we are really going to sort this out, it requires a rather more serious treaty change than people are talking about.

Professor Louis: It would not be the first time. You will remember that Sarkozy announced a small treaty of five articles, and we had the Lisbon treaty. I am not suggesting that this would be the same, but if we do something, we have to do it seriously. If there is unanimity for more reform, we will have to find the courage to put it in a treaty. That is my point.

Q353 Lord Marlesford: So you are really saying that the way the Greek bailout was done was technically and strictly of doubtful legality.

Professor Louis: I supported the legality of the Greek "bailout" because it was not a bailout but assistance given to Greece in a situation where the stability of the euro area was at stake, but I recognise, first, that the provision on bailout is not just what is written in the text; it is also the idea that in principle a member state is on its own in fiscal affairs. The main gendarmes are the markets, but that did not work and the principle was not credible. Why? It was because the European Union is founded and grounded on solidarity. That is set out in the clause covering solidarity in Article 3 of the treaty on the European Union and the stability of the whole area was at risk.

Before the European monetary union, an old Court judgment stated that this matter of the economic chapter was impregnated by solidarity because member states have to consider their economic policy as a "matter of common concern". The lawyers might say that such words does not matter very much, but sometimes you have to take the words for what they

[9] The European Council has opted for an intergovernmental mechanism, governed by the unanimity of member states, which gives a veto to, for example Germany and France. The insertion in the legal hierarchy of the EU would have been impossible under the simplified procedure.

are because people will not understand what they mean if you do not. Before Maastricht, there was a big debate between those in favour of having the present Article 122 (100 ECT) and the strict believers in no bailout. So we have two articles, Articles 122 and 125, precisely to provide a kind of security valve, although not an escape clause. I wrote about that in the *Common Market Law Review*, by the way, in the August issue.[10] It was a kind of counterweight to the strict general rule of no bailouts, which lacks credibility if pushed to its ultimate conclusion In a monetary union you cannot just let a member state fall in that way. That was an important consideration.

The Chairman: Baroness Maddock, shall we move on to another tricky legal point?

Q354 Baroness Maddock: Yes, I turn to a point that was mentioned earlier: the suggestion that voting rights in the Council might be withdrawn from countries that breach the stability and growth pact. I think you mentioned that this was possible under Article 7. Is that what you said earlier?

Professor Louis: It was, yes, in the case of a breach of the values behind the Union and human rights. Do you have the text of Article 7 in English?

Q355 The Chairman: I think the point we are trying to get at is that while it is legal, it would also be a political matter, would it not?

Professor Louis: No, you need a revision of the treaty to do that in such circumstances. The conditions under which the voting rights can be suspended are covered in Article 7, paragraph 2 of the TEU—"The existence of a grave and persistent violation by a member state of the values"—which are set out in Article 2. That article does not talk about money, but "respect for human dignity, freedom, democracy, equality" and so on.

Q356 The Chairman: The general rubric of the values.

[10] See guest Editorial: The No-bailout clause and rescue Packages, CML Rev 47: 971-986, 2010

Professor Louis: I do not believe that Article 7 is applicable, so we would need a revision of the treaty.

Q357 Lord Hamilton of Epsom: Article 121 mentions "the proper functioning of economic and monetary union". How could that article be used to strengthen economic governance within the EU? Why was the article never made operational through secondary legislation? How important is Article 136, which appears to replicate Article 121, for the euro area members? Does Article 136 provide wider scope to introduce new measures for euro area members, as some commentators have suggested?

The Chairman: Indeed, the Commission has suggested that.

Professor Louis: This is another complex question. On the "proper functioning of the economic and monetary union" provided for in Article 121 TFEU, paragraph 4 of that article begins: "Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardising the proper functioning of economic and monetary union". That provision, which is a sort of guarantee of the proper functioning of EMU, was accepted with no problem by the UK. That was interesting at the time. Why was it accepted? Because it is the continuation of paragraph 1 of Article 121—formerly Article 99—which states: "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council". That "common concern" which extends to EMU applies also to the UK, which was not excluded because it was thought that at some time the UK would come into EMU and because it was considered in the UK's national interest for EMU to work correctly.

The important point by way of starting to answer your question is that, when the stability and growth pact was discussed from 1995 to 1997—before monetary union but after the entry into force of Maastricht—the idea was that Article 121 on the co-ordination of economic policy and Article 126 on excessive deficits would be linked by the stability and growth pact. The stability and growth pact was considered the central piece of economic and monetary union, so there was no contradiction between the two. The stability and growth pact was part of the co-ordination, although that was not evident to everybody at the time. The preventive arm of the stability pact would be implemented under Article 121—it was Article 99 ECT—and the repressive arm would be pursued under Article 126 TFEU (Art. 104 ECT). Two regulations were adopted in 1997, one of which was under Article 121 and one of which was under Article 126. When the stability and growth pact was revised in 2005, the European Council by endorsing an ECOFIN report confirmed that the stability and growth pact is an essential part of the macroeconomic framework of EMU. A fundamental idea was that the EU was working for economic co-ordination and economic union in strengthening and modifying the pact.

At the same time, additions were made in connection with the 2000 Lisbon strategy and in connection with the medium-term objective of having a small budgetary position close to balance or in surplus, which is provided in the first regulation of 1997 that I mentioned. The guidelines for the implementation of the reform of 2005, stateed: "When defining the adjustment path to the medium-term budgetary objective … the Council shall take into account the implementation of major structural reforms". That means that the objective of the Lisbon strategy of 2000 with its structural reforms was to be incorporated in the adjustment paths under the stability and growth pact. This was based partially on Article 121. On 9 October 2007, ECOFIN adopted interesting conclusions that invited the Commission to develop its regular assessments of national fiscal policies by a more comprehensive analysis of the overall macroeconomic imbalances. That was after Northern Rock but before

September 2008 and the fall of Lehman Brothers. That was also done on the basis of Article 121.[11]

As for the usefulness of Article 136 TFEU—this will be my last point, but I will answer any other questions as this is a very big subject—those who drafted the text, which was not preceded by public discussions as it came unchanged from the Ministers of Finance in 2003 rather than from the convention, intended that only member states of the euro area would vote on specific measures for the euro area. Before that, the measures like Broad Economic Polices Guidelines could be adopted specifically for the Euro area, but they were adopted by the whole ECOFIN Council. On the other hand, the idea was to go further for the euro area than what was realised at the level of the EU, on the basis of Articles 121 and 126, which still provides the legal basis, as is recalled in Article 136. For example, it is interesting that the economic discipline measure for Greece that the Council adopted after providing help in May and June quote Article 136 as well as Article 126. The Council considered that Article 136 provides a supplementary comfort for the legal basis. That is interesting, because you could have a more literal reading of Article 136 based on all the restrictions in paragraph 1.[12] However, the Commission gave substance to that in its proposals presented to the Council and the European Parliament on the surveillance and the correction of economic imbalances as well as fiscal discipline and its views were for a great part approved by the task force on economic governance chaired by President Van Rompuy and by the European Council. The interpretation given to the article is based on effectiveness and on

[11] But it is true that the implementation of the Stability and Growth Pact remained in practice, concentrated on fiscal matters.

[12] The text of Article 136 para.1 reads as follows: 1. In order to ensure the proper functioning of economic and monetary union, and in accordance with the relevant provisions of the Treaties, the Council shall, in accordance with the relevant procedure from among those referred to in Articles 121 and 126, with the exception of the procedure set out in Article 126 (4), adopt measures specific to those Member States whose currency is the euro:
(a) to strengthen the coordination and surveillance of their budgetary discipline;
(b) to set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance.

"ut res magis valeat quam pereat"—that provision should be given an interpretation that gives to it a meaning—which is a reasoning that has been adopted in the past by the Court.[13] In the proposals, we have something substantial for dealing with economic imbalances. First, we have the preventive phase, where criteria and scoreboards based on these criteria are elaborated, a report, opening an alarm procedure, presented to the member state, to which it has to react. If that reaction is not satisfactory, the member state receives a recommendation of the Council with a framework for action. If a member state who is a member of the euro area repeatedly does not confirm to the recommendation , the member state could be fined by the Council. That is a substantial complement to what is possible under Article 121, alone, in my view.[14]

The Chairman: Lord Hamilton will move us on one step further, but we can then come back to this issue.

Q358 Lord Hamilton of Epsom: A previous witness argued that the excessive imbalance procedure is not going to amount to very much more than we already see at present because there are already surveillance and macroeconomic imbalances through the broad economic policy guidelines under Article 121 of the treaty. Could you comment on that view?

Professor Louis: It has been interpreted in the way that it gives some flavour to Article 136, as I said. We can do nothing—not with the sanction. Fines are impossible under Article 121. We are in the field of soft law. All that I have mentioned—the indicators, the scoreboard, the report of the Commission, the in-depth review, et cetera—could have been done under Article 121 for everybody, or for part of the Union but with the vote of all the member states within the ECOFIN Council. The sanctions are very new, and I am not sure that

[13] It will be for the Court, in case of an appeal, to judge on the legality of the content of the economic governance package, as it will be definitely adopted, in the present context of crisis, it will decide if the limits of Article 136 were exceded.

[14] This is only a rough summary of a complex procedure as proposed by the Commission in two regulations which are respectively submitted to the ordinary or to a special legislative procedure.

politically it would have been possible for the Member States to admit it without the circumstances of this spring.

Q359 Lord Hamilton of Epsom: Do you think we will see policy warnings and recommendations being used more extensively? Do you think fines will ever be brought in? Will they ever be used or enforced?

Professor Louis: You cannot receive a definitive view on that.

Q360 The Chairman: No chance?

Professor Louis: You obviously cannot abuse of warnings and recommendations. On the one hand institutions have to exercise the power they have. On the other, they have to avoid banalisation of these instruments, Peer support, peer control and, in a way, peer sanctions are useful stages to respect. A dialogue cannot be abruptly interrupted by a unilateral act except if the absence of action deprives the institutions of their power.

Q361 Lord Jordan: You have covered the no-bailout clause and explained its relationship to others. What do you see as the legal foundation for the European Financial Stabilisation Mechanism and the Permanent Crisis Resolution Mechanism?

Professor Louis: The stabilisation mechanism is the €60 billion one and is grounded on Article 122.2. That's no problem.[15] With the permanent mechanism, it depends on what you want to put in it. But I believe that we have no choice, for the moment, but to work to a permanent fund. You can imagine having a permanent fund through secondary law because what is important is that the assistance be temporary. The fund can be there if it is for temporary assistance under strict circumstances with strict conditions. But it is very clear that this is not satisfactory for some Governments, and it seems to be what has motivated Germany to consider the possible attitude of the constitutional court. The German

[15] It has been said that this article only permits an action on the budget and does not extend to allowing the Commission to issue loans and that such loans would have required a decision under article 352 TFEU. I am not convinced that this view is justified and I think that such a procedure was compatible with the extreme crisis situation.

constitutional court has been in a way the supplementary shadow negotiator in all this. The evolution of the examination of the Greek case has been in parallel with what could be imagined or asked, I do not know, of the German constitutional court. A better arrangement, as I mentioned before, means for me an insertion into the European Community legal order for the total. We have €60 billion in and the €440 billion facility out under Luxembourg law plus €80 billion for Greece in bilateral loans. That is somewhat messy. Doing that is understandable in a time of crisis, and hopefully they have done very well, but for a permanent fund we should have a better arrangement that gives a stronger guarantee at the primary level.[16]

Q362 Lord Marlesford: What is the French and the German for bailout?

Professor Louis: Bailout? La clause de non support, or something like that. The word "Bailout" was not in the Delors report, and the idea was not there either. The first time I saw it was in a document covering the preparatory work of the Commission where it was referred to as "principal of no-bailout".

Q363 Lord Marlesford: It's a Franglais?

Q364 ***Professor Louis***: Yes, it is. It was in English anyway, and all the documents are in English. In DG ECFIN, everything is in English.

Q365 The Chairman: Just for my own interest, do you think that the European Central Bank overstepped its remit when it issued bonds in the way it did? It was not foreseen, was it?

Professor Louis: May I ask you to repeat the question?

Q366 The Chairman: The European Central Bank has strict criteria governing it, but at the time of the crisis with Greece it issued bonds. I thought those were not permissible

[16] I have already observed that this was not possible under the simplified revision procedure.

under its statutes, which is why I ask you the question. To put it the other way, do you think that the European Central Bank recently did anything that is beyond its accepted remit?

Professor Louis: The Central Bank did not issue bonds.[17] The Central Bank offered liquidities against collaterals. The requirement for collaterals was less for Greece since beginning May last. That was the first measure. Then the ECB decided to buy public and private securities on the markets through banks.

Q367 The Chairman: But, as I understand it, that really was not their business.

Professor Louis: Formally, it is legal, because what the ECB cannot do, like other national central banks in the Eurosystem and like the Bank of England—except for the line of ways and means, which continue to be valid—is to buy sovereign bonds directly from the issuer, from the state. But indirectly, they can do that, so they bought securities for an amount of €130 billion through the Irish banks from September last.

It is a policy that has necessarily to be temporary, because of the balance sheet of the Central Bank and if there is a bounce or a link in value. I think that the Central Bank, the ECB and the Eurosystem in general—because the national central banks make most of these operations as ordered by the ECB—did what the Bank of England and the Federal Reserve did. They were able to act as the other main central banks in the world, as it is not contrary to its statute. The ECB has always insisted on the temporary nature of the buying of public securities and on the monetary nature of this operation justified by the necessity to restore the channels for the diffusion of monetary policy. The ECB sterilises the product of these operations in order to avoid an increase of the monetary mass, and hence inflation

The Chairman: Professor Louis, you have helped us with some very difficult and testing legal issues, and I know the committee is enormously grateful for your time this morning and

[17] Under article 18.1 of the statutes of the ECB and the ESCB, the ECB and the central banks of the Eurosystem can issue debt certificates for absorbing liquiditiy. The present situation was more characterised by a lack than by an excess of liquidity

for the explanations that you have given. We will certainly mull over what you have had to say to us. Would you do the same, because we will send the transcript? If you would be kind enough just to look at it and to see whether you feel that there is anything is inaccurate—

Professor Louis: I have to apologise for my English. I know that the work of the typist was very difficult.

The Chairman: I was about to thank you for speaking not in your foreign tongue. The fact that Lord Marlesford tested you on your Franglais made life even more difficult. Many thanks indeed and thank you for contributing. It has been very helpful to us. We hope to publish in January or February next year. Many thanks.

Examination of Witnesses

Witnesses: **Mr Declan Costello**, [Acting Director for Structural Reforms and Competitiveness, European Commission], **Mr Martin Larch** and **Mr Jonas Fischer**.

Q368 The Chairman: I'm Lyndon Harrison. We are most grateful to the two of you for coming today from the Commission. You know that we're doing this report on economic governance in the euro area—something which we hope to complete in January or February next year. You're the last of the exhaustive series of witnesses that we've had in our visit here. In some of the questions we put to you, you may find references to some of the other witnesses whom we have met. You'll also know from talking to Anthony that we'll prepare a transcript of this session. We'd be most grateful if you could look at it and correct it. Indeed, in the aftermath, if there are other things that you think you have not expressed which are important, we would be most grateful if you'd do so – because of the fast-moving nature of this inquiry, we are also grateful for later thoughts that you may have. Thanks for coming. Would you like to introduce the two of you and we shall then start?

Mr Costello: I'm Declan Costello. I'm acting director in DG ECFIN, which is the part of the Commission which deals most with the Treasury. I am responsible for the directorate that deals mostly with the real side of the economy . Until recently I was mostly dealing with structural reforms for growth—the Lisbon strategy—but with the onset of the economic crisis, we have taken over responsibility for the work on surveillance of macroeconomic imbalances, which is one arm of the proposals on economic governance. This is my colleague Jonas Fischer, who is working with me on the legal proposals. We are actually expecting another colleague, Martin Larch, who is an adviser dealing directly with the fiscal proposals for reinforcing the stability and growth pact.

Q369 The Chairman: Good. Thank you for bringing an extra team as well. That's very helpful. Perhaps I may start. One of the interesting suggestions made to us is that to increase ownership of what is being done by member states, we could enshrine the fiscal rules—set them in stone, as it were—in national legislation, preferably at the level of the constitution. What did you think about that and what difficulties or advantages did you see?

Mr Costello: I was wondering whether it might be more efficient for the fiscal policy questions to wait until my colleague comes—he is the expert. If he doesn't arrive soon, I shall try to answer.

The Chairman: In that case, we shall come back to that. Let us move on to Lord Hamilton.

Lord Hamilton of Epsom: The candidates who are joining the EU—Poland and countries like that—are booked to be joining the eurozone. Don't ask me when, but it is all a matter of course, isn't it? Has there been any rethink about whether we want all these new countries coming in to be automatically put into the eurozone?

The Chairman: Your colleague is here. Shall we start again, once your colleague has settled?

Martin Larch: My name is Martin Larch, and I am adviser in the DG ECFIN and I work in the Directorate for Fiscal Policy.

Q370 The Chairman: Thank you for coming. I am going to throw you in at the deep end, if I may. How do you see the suggestion that fiscal rules should be set in stone in national legislation—preferably at the level of the constitution? I can see advantages in terms of ownership that nation states might feel, but there is a problem of divergent applications, is there not?

Martin Larch: I think I should first clarify something. You say in the question, "should be set in stone". The draft directive actually does not require the implementation of these requirements by law. There can be any kind of provision. So the expression used in the draft directive is “provision”. This can be a law. If you want to be very ambitious in can be a constitution. But it can also be done by administrative procedures or any other kind of provision. This term was used deliberately to make sure that member states are not required to implement them in national law.

Q371 The Chairman: No, but the thinking is that by enshrining it in national law, there would be ownership. There’d be something that would be thought to be good, useful and proper to a member state. In that sense, it would not be Brussels doing it, but your own member state.

Martin Larch: Of course. So the background to the rational to this draft directive was to say that EU rules are necessary to co-ordinate fiscal policymaking in the EU and in the euro area, but they are not sufficient to make fiscal policy co-ordination work. The idea was that there would need to be national fiscal frameworks that are conducive to the kind of fiscal policymaking that is consistent with the provisions of the treaty.

Q372 The Chairman: You’ve got the current examples of Germany, Estonia and Poland. But if you have minimal and optimal elements that such fiscal rules should include, is there a danger there? Is there a vulnerability? It doesn’t prevent you saying more and doing more than the main elements. Is there a vulnerability to the application being made more various? I have in mind the applications of directives, which typically worry some in the single market development, because they are applied differently in different countries. There are different interpretations.

Martin Larch: The understanding or the idea behind the directive is that the dimensions set out in the directive are sort of minimum requirements. Then there are provisions or arrangements that each member state is free to implement on top these minimum requirements. This idea of minimum requirements, plus some optional arrangement, was, I understand, also taken up in the final report of the Van Rompuy task force, where a distinction is made between minimum requirements and the things that go on top of those. To return to what I said at the beginning, the provisions in that respect are to be understood as minimum requirements.

Q373 Lord Hamilton of Epsom: Can I come back on this question about candidate countries coming in? There is a requirement that they join the EU. What I want to know is whether, in the light of the crisis, there had been any rethinking of whether it was wise to say to all these countries, "You should automatically, after a period, become members of the eurozone"?

Mr Costello: The treaty provides that countries should work towards membership of the euro area unless, like the United Kingdom, they have an opt-out. The treaty then contains provisions, entry conditions, which must be respected—the so-called convergence criteria, which have to be respected. These have not been touched or changed in the context of the current ongoing debate on economic governance.

Q374 Lord Hamilton of Epsom: They didn't work very well with Greece, did they?

Mr Costello: Let me finish, and then we can come to specific cases. Clearly, the experience of Greece has resulted in a very important shift in thinking about economic governance in Europe, reflected in the Commission's proposals and the agreement of the task force, which recognised that there were, indeed, shortcomings, in that the type of surveillance that we were carrying out was not widely enough focused. We did not pay enough attention to macrofinancial issues. We did not pay enough attention to competitiveness elements; macroeconomic imbalances, as reflected in current accounts; and indebtedness. There is now consensus that we absolutely have to widen the surveillance, make it more integrated and strengthen the enforcement mechanism, so that we have real bite and sanctions which can apply at an early stage in the fiscal and macroeconomic imbalances. The other element, of course, is the European Systemic Risk Board, which would take care of some revision of macrofinancial stability. So I think that there has been a paradigm shift on surveillance. The requirements that are now expected of countries in terms of the economic policies and behaviour of the euro-area countries are very different. There is a much higher degree of candour and explicitness in the policy recommendations which is being addressed. This does not, strictly speaking in a legal sense, affect the entry conditions, but clearly the monetary union which countries would have joined, say, 18 months ago, in terms of the expectations on them, will be very different from the monetary union of today. So formally the entry conditions have not changed, but the type of monetary union which they are joining is changing. As a legal condition for entry the conditions have not changed, but in terms of the degree of rigour and surveillance, then indeed this would be the case. That is why the proposals on economic governance apply to all EU countries, with the exception of the sanction elements which apply only to the euro area. That was not just a wish of the European Commission, but was really something which was strongly called for by those member states concerned. They do not want a gulf to emerge between the surveillance elements and for there to be a wider gap between what we do for euro area countries and non-euro area countries. So that bridge would be harder to cross. Okay—we have Estonia, which will join the euro area on 1 January.

Q375 Lord Hamilton of Epsom: Are the delays coming in because of the more stringent surveillance that the countries have been subjected to, or are they keeping to the timescale originally set down?

Mr Costello: Accession to the euro area is assessed country by country. We do not have a horizontal policy that applies to all. Each country is assessed on its own individual merits and on whether that country respects the eligible convergence criteria. You have to look at those countries individually. A number of the non-euro area countries clearly find themselves in extremely difficult macroeconomic positions. The European Union is providing balance of payment support to three countries—Latvia, Hungary, and Romania—and clearly those countries, by definition, are a long way from where one would want them to be to consider euro area membership. I mentioned Estonia joining; Poland has performed remarkably well through the economic crisis, although it does not necessarily comply with all the convergence criteria. This will be looked at country by country and, when the economic conditions permit and the country itself feels that the time is right for it to join, it will do so. However, going back, legally the entry conditions are the same but, as I said, there is no question but that the bar has been raised in terms of economic policies and performance for all member states within the monetary union—and, yes, that will clearly play a role in future accessions.

Q376 Lord Hamilton of Epsom: You said that you were responsible for the imbalances and that we have the excessive imbalance procedure. A previous witness said that this was not going to amount to very much more than what we see at present. There is already a surveillance of macroeconomic imbalances through economic policy guidelines under Article 121 of the treaty. Can you comment on that?

Mr Costello: I think the intention is that it certainly will amount to something significantly more than we have had under the surveillance to date. It is true, in a legal sense, that the Community until now has had the legal authority and the legal base to undertake surveillance on any economic policy which it considered could be very damaging to the country concerned or which would have negative spillovers on the functioning of the euro area. In practice, however, the type of surveillance was limited. Leaving aside the fiscal, which is one area where we did a lot of surveillance, I would say that the type of surveillance on structural policies was very much oriented towards a focus on long-term growth and jobs. This is beneficial in its own right, but it is not the same thing as looking at imbalances.

Housing market bubbles, bubbles in asset markets and looking at whether the current account and net foreign asset positions are sustainable is not the same thing as looking at long-term challenges to economic growth. It is a different focus on surveillance. Legally, we probably did have the capacity to do that; in practice, the surveillance was not oriented towards and not really focused on this. What is proposed now is to embed the surveillance in a structured framework based on secondary legislation, and not just to rely on a general treaty article. This is, in a sense, much more rigorous. It formalises the reporting requirements and the obligations on the Commission in terms of what it has to do, and it requires the Council to take these decisions. It will be much more codified. You have probably seen the references to the indicators and the scoreboard, so it is not left open and rather nebulous. Then, of course, we come to the enforcement mechanisms. Okay, ultimately there would be scope for financial sanctions which would apply to euro area countries, but prior to that there will be a series of, let us say, political pressure points when the Commission and the Council have to give their verdicts on how they read the economic policies of the country—whether they think an imbalance exists and whether they think it is a serious imbalance. These become political reference points for potential non-financial sanctions. If you put this together, this is a very different animal. As a final remark, I have made reference to the European Systemic Risk Board, which will have responsibility for surveillance on macro-financial risks, both in an aggregate macro sense and then for individual financial institutions. Again this is completely new. It will be operational and take effect as of 1 January.

Q377 Lord Hamilton of Epsom: You have identified what harmful imbalances are but the problem is that of surplus—countries that are in surplus. It is quite difficult to say that it is as harmful to be in surplus as it is to be in deficit. Do you really see countries, particularly

Germany, being prepared to reduce surpluses to balance up the countries that are being leant on about their deficits?

Mr Costello: The Commission's view on this is reflected in an agreement that was reached at the euro group of March this year, which is also embodied in the final report of President Van Rompuy. I have not got the exact wording in front of me but, in essence, it says that, as with large imbalances—we are talking current accounts at this stage—the issue of surpluses is also relevant; it is not only a debate about deficits. However, a differentiation is drawn as regards the urgency in tackling this and in terms of the type of policy responses that would be expected of member states. I think it is saying that this part of a debate that will have to take place at European level. We will not approach debt with surplus countries in the same way as we approach deficit countries. What one is talking about with surplus countries is working with them to explore the options where they could raise factors that may be holding back domestic demand in that country. These are the types of policies that one would have to explore the reasons for. Why is saving so high in the corporate sector in Germany? Are there reasons that are inhibiting profitable investment opportunities in this country? Is there an underdeveloped service sector which is a potential factor at play here? We have seen housing prices falling in Germany, which may, of course, have been related to an oversupply linked to the boom that followed unification. But maybe it is not. If you look at housing rental prices, they are rather high in Germany. So what factors are holding back investment in residential property in Germany? These are the types of issues which we think would be in the general interest and would contribute to the welfare of Germany and German citizens per se. They could, let us say, contribute to the overall reduction of imbalances in a number of deficit countries, but we do not see this as a one-for-one exchange. We would certainly not advocate policies which call for Germany to undermine its own external competitiveness in a global marketplace with a view to giving a little boost to export demand in Greece. The trade spillovers between Greece and Germany are very low indeed, so the level of contribution would be minor. Germany has to compete and we will look at competitors in a global context.

Q378 Lord Hamilton of Epsom: We were addressed by an economist, who I think would describe himself as a free market man, and he said that we should not worry about this at all because, if Germany runs into surplus, it will then reach a point where it has full employment. That will mean that wages will go up, demand will increase in Germany and the thing will rectify itself automatically. Would you subscribe to that theory?

Martin Larch: As a general remark on this, before the crisis there was this prevailing paradigm in macroeconomic analysis that, if you keep your fiscal house in order and if you keep inflation low and stable, you ensure overall macroeconomic stability; you do not have to worry about anything else. The crisis taught us that this paradigm no longer holds. It taught us that there are some other imbalances—it might the current account—that are a threat to overall macroeconomic stability. That is why the Commission has tabled this broader macroeconomic surveillance.

Mr Costello: What was your question on?

Q379 Lord Hamilton of Epsom: I was saying that the market would address the problem and that Germany would not be in surplus in perpetuity because, if you are in surplus, it means that you are reaching full employment and, at that stage, wages start going up and domestic demand automatically increases. So we should not be sitting here worrying about how we redistribute Germany's surpluses.

The Chairman: Just to make the point, domestic demand in Germany, according to the *Financial Times* this morning, is on the move; it is on the increase.

Mr Costello: Certainly, the recent indications in Germany are that there may be factors that are contributing to a reduction in imbalances linked to strong domestic demand and employment growth, but there are other structural factors which may be in play in terms of its export composition.

Q380 Lord Hamilton of Epsom: Maybe you will not have to worry about falling house prices in Germany either, because people will start buying houses.

Mr Costello: First of all, under the surveillance procedure, we will investigate whether these large and sustained surpluses are due to the economic cycle or to structural factors; as I have said, the export composition of Germany is oriented towards investment products, which are in high demand in Asia. It could also be explained by demographic factors, given the ageing population in Germany, which would justify higher aggregate savings at a national level doing okay. There may be other structural factors which are contributing to that. Maybe for some reasons that I do not know, households in Germany feel excessively concerned about their future pension or social security and are therefore engaged in excessive precautionary saving. Structural public policies are driving private savings. I mentioned other factors in the economy which are inhibiting profitable private investment in Germany. We think those kinds of policies should be investigated anyway, irrespective of the size of surpluses, because they could raise the welfare of German citizens.

Q381 The Chairman: But you are looking deeper at the sources, are you not? You are not just saying that the symptoms are bad but are trying to dig down to the sources of why there may be an imbalance.

Mr Costello: We are focusing a lot on surpluses. It is certainly a valid question in the debate. The consensus that I referred to clearly emphasises that the higher degree of urgency and policy responses will be on deficit countries. We will have to look at the reason why surpluses exist in certain countries and what can be done about it, but when it comes to large deficit countries where we perceive that there are severe risks to macroeconomic imbalances, this will trigger a more intrusive surveillance exercise than has been the case.

This will lead to precise policy recommendations in very difficult areas. We will be talking about things such as the reform of labour market institutions and employment protection legislation, as well as the opening of products and services markets. There will be a higher degree of urgency. Yes, surplus is part of the debate, but clearly the urgency and rigour will fall much more immediately and severely on the deficit countries.

Q382 The Chairman: Just on the European Systemic Risk Board, is it more muted because it is unable to issue binding warnings?

Mr Costello: This is not really my area.

The Chairman: Perhaps one of your colleagues could say something. If not, could you take that one away and come back to us?

Mr Costello: There is a very precise procedure for the governance of the European Systemic Risk Board in terms of the policy recommendations and advice that it can give. It differs between whether we are talking about surveillance of the macro prudential risks or the micro-surveillance of individual financial institutions. It has a graduated series of instruments that it can use in terms of analysis, guidance and recommendations. There are provisions which allow the European Systemic Risk Board to decide when to make these recommendations and when to go public. I am giving you a very imprecise answer, I think.

Martin Larch: In the draft regulation on the broader surveillance, there is a provision that whenever the Commission steps up surveillance on a member state and believes, on the basis of its analysis, that there are imbalances, when formulating recommendations to the member state it will take into account the deliberations of the European Systemic Risk Board. So there is an interlinkage between them.

The Chairman: I am anxious to move on to Lady Maddock. Lord Hamilton and Lord Marlseford, do you want to contribute?

Q383 Lord Hamilton of Epsom: Just a very quick one. It seems that Germany is standing behind these packages that are bailing out the Irish, for instance. Is this not a form of redistributing German surpluses?

The Chairman: Would you ask yours as well, Lord Marlesford?

Q384 Lord Marlesford: Mine is merely that the surveillance now needed is clearly easier in terms of structural deficits of Governments than it is in the potential liability of Governments in respect of their financial institutions. So how on earth are you going to deal with the latter, for example, perhaps to prevent, say, Ireland from taking responsibility for the banks?

Mr Costello: There is no easy answer to that. The procedures are aimed at preventing these imbalances from occurring in the first place or, if they do occur, at tackling them early on. So if the procedure had existed and was being implemented properly, you would have picked up in Ireland, first, the very fast credit growth that existed and linked it to the growing level of stock and private indebtedness. You would have captured, one would hope, the housing bubble—both the price bubble and the excessive share of economic resources that was being devoted to this activity—and you would have, perhaps in the later years, also picked up on the loss of external competitiveness that Ireland was suffering as its wages and prices started significantly to outpace those of its competitors. Then, of course, hopefully, the European Systemic Risk Board would have picked up on what was happening in individual institutions—this was lamentably not the case through the Irish supervisory structures—and at the aggregate level. It would have identified the overall vulnerabilities that existed within the Irish financial system. The ethos and intention here is to have available the instruments to identify and act pre-emptively. If I understood correctly, the latter part of your question was how you deal with these situations with the resolution mechanisms.

Q385 Lord Marlesford: Yes. Accidents are waiting to happen, and then suddenly a country takes on responsibility for its banks which it previously did not have. How do you prevent it from taking on that responsibility, which has a huge knock-on effect on its sustainability?

Mr Costello: I think there are two elements. First, the banking landscape in Europe now is dramatically changed. In countries such as Ireland, it now largely falls within the government sector or is de facto under the control of the Government's sphere. How do you prevent it in the future? I do not have the answer. This is work in progress but, at the European level, we will have in the coming years to work on creating a competitive banking system, one which avoids a recurrence of where, in countries such as Ireland, their share of the banking system goes beyond their capacity to support it. This difficult issue will have to be resolved and is work in progress. Secondly, and this is not my area of expertise, we are working on the whole financial package—the supervisory regimes and Basel III—to establish these norms and requirements at European level. One would hope that the supervisory structures that the ESRB has established will ensure that these are complied with. Then, of course, there is the final issue—the crisis resolution mechanism—which will hopefully clarify the conditions and circumstances if a country finds itself in difficulty.

Q386 Baroness Maddock: To use your words earlier, when you were talking about the surveillance of macroeconomic imbalances, you described it as a very different animal. Do you think that the Commission has the analytical capacity to undertake this enhanced surveillance? Do member states accept your analysis, the informal advice that they get and the informal recommendations—or, as some of us think sometimes, do they do everything in their power to water down what Brussels actually says?

Mr Costello: On the analytical capacity, I am going to have to answer yes, of course—but let me try to back up that answer. First, it is not new in all dimensions. Prior to the crisis, we started to put in place a framework for surveillance and competitiveness and imbalances in euro area countries. We had been working and developing the analytical framework and the tools that would be used. So the Commission had been making recommendations under Article 121, pointing to these types of problems and developing analytical tools. But the analysis probably came a little bit too late and was probably was not specific enough in being addressed to individual countries, and then the enforcement mechanisms were simply not there.

Q387 Baroness Maddock: Can I just say something else here? The Van Rompuy report was rather concerned at the quality of the statistics that you would be using, and that doesn't seem to have to have come through in the Commission's proposals, which is quite relevant to the Commission now.

Mr Costello: I'll deal with the statistics, but what you need is the staff, the analytical tools and the statistics. We have started to work on the basis of the analysis. We have certainly gained an awful lot of experience in recent months and years, working with the IMF in Latvia and Romania. We are learning a lot and catching up very quickly. As for staff, Commission overall staff numbers have been frozen since 2007, but there was a very large reallocation of 54 persons to our directorate-general, which is a +/- 15% increase in the total staff. These were all professional staff—economists, not support staff—so I am hopeful that we have the capacity. Can we do everything today? No, but we are not starting from zero. We have some resources to do it. On statistical quality, there was a proposal on fiscal statistics.

Martin Larch: Following the Greek case, at the end of last year the Commission adopted a draft regulation to improve government finance statistics and the capacity of Eurostat to verify the data. I believe that the regulation has been adopted this year, in the summer. It gives Eurostat the possibility to carry out more frequently and under less restrictive conditions methodological missions to member states to check government finance statistics. That does not amount to a full auditing power; the staff of Eurostat cannot go to a Government and just say, “Show us the books”. But they have to provide the information that Eurostat thinks is necessary to assess the quality of statistics, which is new compared to the previous regulation. The previous regulation relied on the assumption that member states would provide high-quality statistics.

Q388 Baroness Maddock: I think some people thought that this was part of the problem in Greece—the statistics that were coming out. On the compliance of member states, how do they view you and what do they do in response?

Mr Costello: It is very important, of course, that there is some sort of ownership of the analysis. In the past, I think that the analysis has not always been accepted, partly because there was no pressure and no enforcement mechanism to do that. We need to work with member states in developing these indicators and statistics, which should be forward-looking indicators. Interpreting those indicators requires you to take account of country-specific situations and institutions in a country. The indicators on how one interprets pension spending, for example, cannot be isolated from the fact that in some countries it is purely a public system, which will show up in government accounts, whereas in other countries you will have to take account of private pensions and the extent to which there may or may not be an explicit or implicit guarantee of some kind. So you need to take into account country-specific knowledge. It is not as simple as if the Commission is all-knowing and all-seeing; we have to work with member states in developing this. At the same time, at the end of the day, you need an independent arbitrator or referee. One thing with the Van Rompuy task force is that it gives the Commission the role of producing the independent analysis. It is clear that it wants us to separate the independent analysis from the more political policy work that the Commission does. That is different from what was done in the past under the Lisbon process, whereby the Commission’s role was more consensus-building. The analogy that we use is that we are no longer the coach but the referee. Will it be accepted? We have a legal or surveillance framework that makes it easier, and the roles of the respective institutions are more clearly defined. Obviously, there is a risk, or a responsibility on the Commission; it will be accepted if we produce high-quality material, but if we produce poor analysis we will be held to account for that. We feel the heat, you know. It is very different issuing a general recommendation under the Lisbon strategy to a country, compared to going to Greece on a support programme and imposing conditionality requirements on it for the disbursement of EU funds. Yes, the Commission will have to raise its game.

Q389 Baroness Maddock: How can we ensure compliance with your recommendations? Is it going to be easy?

The Chairman: There was a thought about sanctions, wasn't there, being applied for repeated statistical problems?

Martin Larch: For repeated statistical problems, I'm not sure. In the context of surveillance, there is a draft regulation that foresees that, if a member state has been given a recommendation according to which there are imbalances that should be corrected, and that a member state does not produce a corrective action plan after two solicitations, there will be a possibility to impose sanctions.

The Chairman: Shall we move on?

Q390 Baroness Maddock: There was just one question that I wanted to ask. Do you see economic policy developing more along the lines of competition policy, where sanctions have been more successful?

Mr Costello: I think the answer is that we cannot make the full analogy with competition policy, where one is talking about individual entities, whether in the private sector or public companies, and the entire general government or public sector. On the other hand, we have been inspired by some of the approaches followed in competition policy. First, there is the very fact that sanctions are now available. Secondly, we have the formalised reporting requirements and surveillance—so to some extent there is a bit of a parallel there. Another lesson that can be drawn from competition policy is in separating the analysis from policy decisions to proceed with state aid. The competition services in the Commission prepare their own analysis on whether they think the rules have been complied with, and they are independent in that sense. The decision on whether to impose a fine on a country for a breach of a competition rule is taken by the college of commissioners, but those two roles are clearly delineated. That is one thing that features here. Attached to the Commission's regulation—this is a public document—was a declaration by President Barroso indicating how the Commission would achieve the separation internally, in the Commission, between doing independent analysis and deciding whether to proceed with the procedure. We as economists will be expected to do that, and there will be an independent person attached in our DG to provide a fresh pair of eyes, as they call it. I am not sure whether the strict analogy is the chief economist in the Competition Authority. We have been looking at those types of working method to see whether we can make that distinction.

Q391 Baroness Maddock: Perhaps you could tell us what you think is the value of establishing the European semester and to what extent you would expect the United Kingdom to comply with that. Are other states generally receptive of the semester proposal?

Mr Costello: The European semester was agreed by the ECOFIN council in September, I believe. My understanding is that that is acquis, as we call it. There are two critical features of the European semester which we need to be aware of. The first is alignment of surveillance. In the past, we used to conduct surveillance on fiscal policy at a particular moment in the year and issue recommendations on what member states should do with their budgets. At a separate time in the year, we used to have surveillance under the Lisbon process on growth and jobs, and we would issue recommendations to member states on those. We took care to ensure that those recommendations were not inconsistent, but that is not to say that they were as integrated as they should have been taking account of interlinkages. The idea now is that recommendations on economic policies which we would address to member states would be issued in one go at the same time. We will continue to use the pact for fiscal policy recommendations, but at the same time we will issue recommendations on what we think countries should be doing if there are imbalances in their country, if there are problems in their financial sector that we have picked up and if there are some critical reforms that they can make to support growth and jobs in their economies. So you are issuing to member states one coherent set of economic policy advice, not partial recommendations spread over the year. Clearly, these things are interlinked. Whether countries would be successful in returning to fiscal sustainability is clearly dependent on the policies that they introduce to support growth. Without growth in the economy, it is clear that it would be a much harder if not impossible job in a number of cases. The recommendations that I mentioned in the area of liberalising services could be important for jobs and growth in the economy, but they could also be important for tackling macroeconomic issues and the sources of non-price competitiveness. That is the first thing—to align the recommendations and have one set of recommendations, not bits and pieces spread over the year. The second thing is linked to the timing of when we issue those recommendations. In the area of fiscal policy, previously they came out towards the end of the year or early in the new year, which is usually a month or two after most member states—although not the UK—have adopted their budget. So it was consistent with an ex post explanation of what they have done, and we found it difficult to provide a policy steer as to what they should be doing with the direction of their fiscal policy. Here the idea is to organise the debate around two moments in the year. At the beginning of the year, you would have the European moment, when you provide these horizontal orientations, not suggestions but indications on the direction that we would expect member states to follow in their economic policies. Member states would then present those or take them on board in their programmes—the stability convergence programme for fiscal policy and the national reform programmes for the other dimensions, the macro-balances and the growth policies.

Q392 The Chairman: Is the UK being helpful in that policy?

Mr Costello: Certainly. The idea is that this European horizontal device would normally come early in the year—in February, say. The programmes would be submitted in April, and the policy advice comes in June. To be honest, it is probably a nicer fit for the UK budget calendar than any other. That was not the original validation for this.

The Chairman: The Commission confesses.

Mr Costello: As I say, it actually fits in rather well with the fiscal calendar anyway. So there is no particularly awkward feature. Secondly, I think the UK understands the merits of policy guidance at European level having to steer or shape the choice at national level.

Q393 Lord Jordan: We are hearing a lot more talk now about sanctions and fines. One previous witness commented that he was surprised that the Commission had put forward the idea of semi-automatic sanctions, because, in its words, it is essentially getting the commitment to take ownership of the sanction, and this is going to lead to a strategy in which Brussels might be blamed. Do you have a view on these observations?

Mr Costello: I think you should look at the proposals on sanctions in their entirety. One feature of the proposals is, indeed, this reverse voting; but perhaps a more important feature is, let's say, the graduation in sanctions and when in fact they would kick in. Martin, you are more expert on this than me.

Martin Larch: I find the expression "semi-automatic" a bit misleading for the following reasons. Although it is true that the draft proposals foresee this reversed qualified majority voting against a sanction, the decision would always be preceded by a decision of the Council. There would never be a semi-automatic sanction without a preceding decision involving the Council. For example, in the preventive arm of the stability and growth pact, the draft proposal or amendment to the respective regulation foresees that if there is a significant deviation from the appropriate adjustment path towards the medium-term objective, the Commission would first issue a warning. This is foreseen by the treaty in Article 121.4. Then, if there is no follow-up, the Council would issue a recommendation, based on a proposal by the Commission, to the member state concerned. Only after this recommendation by the Council would there be reversed qualified majority voting. The same principle—namely, first, a decision of the Council and then a vote with reversed qualified majority voting—is applied in relation to all other proposed sanctions. So a sanction would be imposed only after a decision of the Council; therefore the expressions "semi-automatic" and "Commission taking ownership" are a bit misleading. Brussels will take the blame anyway. That may be the case, but it is certainly not the case that the Commission takes ownership of the sanctions.

Q394 Lord Jordan: There's a degree of cynicism about the idea of sanctions and fines. Do you think it's plausible to impose a sanction on a sovereign country that is determined not to accept it? Realistically, will fines ever be levied, let alone paid, because, after all, sanctions have never been levied in the past, even when the rules of the SGP have been breached.

Mr Costello: It is important to bear in mind that the Community has mechanisms to impose sanctions today on member states, and does so in the context of failure to comply with certain single-market rules. It is not unique that sanctions are imposed by the Union on other countries. The Community also has mechanisms to recover funding under the structural funds which may have been inappropriately allocated—it is not a fine; it is a recovery, but it comes across as a fine. I think the answer is: yes, if those mechanisms are seen to be fair and proportional. I'd like to come back to my remark about this graduation in sanctions, because under the old stability pact, or the existing stability pact, rules, the sanction element came right at the very end, and it was quite big. So it was kind of nuclear at the end, and you did not have lighter and perhaps more effective options. The idea here is that you start, already under the preventive arm of the pact, with the possibility of imposing interest-bearing deposits on countries which are not in compliance with the recommendations which have been issued to them by the Council, not by the Commission. It is an interest-bearing deposit, so the country itself accrues the interest revenue. The sanction is that the country is required, in a sense, to put this money aside—it is kept in Brussels. It is more of a political sanction, in a sense—the ignominy of having to do this. At a later stage, under the excessive deficit procedure, but earlier than what had come before, interest-bearing deposits could become non-interest-bearing deposits, so you lose the interest income on this. We hope that this more graduated and phased approached to sanctions makes it more palatable, but also reduces what are currently very high political costs for Ministers to impose it.

Lord Jordan: The new sanctions are going to be like tactical nuclear bombs, as opposed to the real thing. We have heard that it may be counterproductive to punish Governments for outcomes such as excessive deficits that are not fully controlled by national Executives. What is your view on this, and why did the Commission's proposals not also include incentives for member states to abide by the rules—you know, the carrot and the stick?

Q395 The Chairman: Give us an example of an incentive.

Lord Jordan: Is it Green Shield stamps or something like that?

The Chairman: You're still filling your books, are you?

Martin Larch: Already under the current provisions of the stability and growth pact, there is a certain margin when assessing the breach of the 3% of GDP threshold. That is precisely because of the fact that some elements of the budget cannot be controlled fully by government. In practice, that means that when a country has a deficit above 3% but close to 3%, it will be assessed on whether that breach is temporary or not. It would be temporary if it was due to cyclical factors. We want to capture the cyclical factors that are not controlled by government. In that case, if the excessive deficit was close and temporary, already under current provisions the treaty gives the possibility not to open an excessive deficit. That would remain the case. On the issue of sanctions and incentives, the proposals that the Commission adopted on 29 September are the major part of the plan, but not the whole plan. The Commission communication of 30 June states towards the end that the Commission would like to have a two-stage approach for sanctions versus incentives. The first stage are the proposals that the Commission has adopted on 29 September—the sanctions. Those instruments allow only for sanctions. In the second stage, which should come later, there is the idea of making EU expenditure conditional on fiscal performance, but this can be done only later because it can be introduced only when discussing multi-annual financial framework. Negotiations on that will start next year. The incentives or conditionality can be introduced only by changing the regulations underlying the expenditure programmes, which means regional or agricultural expenditure.

The Chairman: As we haven't got an awful lot of time, let us move on to Lord Marlesford.

Q396 Lord Marlesford: Could you clarify the linkage between the Van Rompuy task force and the Commission? To what extent does the Commission feel an obligation to include in its proposals the recommendations of the task force? For example, there does not appear to be a proposal for a permanent crisis resolution mechanism at the moment.

Secondly, would the euro-area be able to survive a default by a sovereign member of the eurozone?

Mr Costello: On the relationship between the two, it's important to recognise that the governance proposals are being developed against the background of an ongoing crisis. We are trying to put out the fire and, at the same time, construct something that would prevent a new one. So it is a very unique set of circumstances. The other unique feature is the Lisbon treaty, which entered into force at the beginning of the year. We have a new permanent president of the European Council, President Van Rompuy. We also have co-decision for the European Parliament, which will affect the legislative process; for the very first time, we have the European Parliament involved in economic governance issues. So those events came together. The Van Rompuy task force was established in the March European Council; we then had Greece two months later and suddenly everything started telescoping together. Strictly speaking, to take a very legalistic approach, the Community method applies. We follow the treaty; the Commission proposes and the Council and in this case the Parliament will decide. Of course, in reality, as Commission staff, we will have to stand by the Commission's proposals. That is our role. The Van Rompuy task force represents the highest level political view and consensus that exists on this. In not all but very many—nearly all—areas, there is a very high degree of consensus and overlap between what the Commission proposed on 29 September and what the task force concluded on 21. What we need to do now is to fine tune the proposals of the Commission just to embed the consensus with the Van Rompuy. A number of issues were not settled by the task force, including the permanent crisis resolution mechanism. You asked why the Commission did not propose this at this moment in time—I saw that in your written questions. Essentially, the Commission's thinking was that this was already an ambitious package, but we also have ongoing programmes with countries such as Greece and Ireland right now, and we have the mechanisms to deal with this at least until 2013. Therefore, we should take care of those issues first rather than at the same time try to put in place a permanent mechanism whereby markets are interplaying and making the connection between the two. That was our preference—to have that distinction in time, though not to postpone it forever. It was clear that the temporary mechanism and support facilities go up only to 2013, but we decided to deal with that during 2011, say. Okay, events have moved on since then and the European Council decided that it was necessary to bring forward that debate. We will just have to cope with that. It is a complicating factor, but one that we will just have to find solutions to.

The Chairman: Let's move on to the EFSM.

Q397 Lord Marlesford: Yes, and the question of defaults. Let me ask about that, because it is linked. Does the European financial stability mechanism have sufficient resources to deal with everything up to 2012? Will it have to be replaced by a permanent fund and a mechanism for that purpose? That links to my earlier point about defaults.

Mr Costello: It will have to be replaced because it is time-limited, and the European Council has agreed that it will be replaced. So it is a question not of if but of when— and how. We hope that we do have enough resources do deal with that. Ideally, we want no more countries to find themselves in need of financial support, but we certainly think that it is adequately resourced at the moment. Of course, that would depend on circumstances and how they evolved. On your final question of whether the euro-zone could survive the default, to be honest that depends on which country is involved. If a small country were to default, then probably it could; with a major country, that would be a different issue. The link in a sense is the urgent need to conclude the discussion on a permanent crisis resolution mechanism, because the uncertainty surrounding that and the conditions under which the permanent crisis resolution would take place, in and of itself, is a source of uncertainty. A failure to resolve that in an appropriate way could push you towards a default—although I hope we don't get there. That is precisely why it is so urgent to sort this.

Q398 The Chairman: I'm going to wrap up with two final questions. If you feel that you don't have sufficient time to answer, please write in. The stability and growth pact is usually written that way round, but most people think that it should be the growth and stability pact and that it is the growth side that is being neglected. I wonder what you thought about Europe 2020 as the successor for the Lisbon agenda in adding and promoting that side of the balance—the growth. What about the role of the United Kingdom? Could you say something from your perch about how the United Kingdom could be helpful in all this difficult process? If you would be kind enough to be relatively short, there will be the opportunity to add to what you say.

Mr Costello: The Europe 2020 strategy is the follow-up to the Lisbon strategy, but in essence it should be the growth component of the entire recovery strategy that countries need. The proposals on EMU governance will take care of fiscal policy as well as macroeconomic imbalances and competitiveness, but you also need something to drive growth in our economies. A critical feature of this is the important role afforded to the ECOFIN Council overall in economic policy including related to economic growth. I talked about the integrated surveillance earlier on, when the ECOFIN Council is supposed to issue recommendations to countries at one moment in time. Those should also include recommendations on key reforms to remove bottlenecks to growth. The ECOFIN Council will not deal with the microeconomic design details of say labour market policies. We will not deal with how you organise training in an active labour market policy, or policies to support child care or part-time work, which are very important in their own right and must continue as part of the employment guidelines. Rather ECOFIN needs to deal with some of the really big ticket reforms in the labour market in those countries where this is a problem.

So if we see that there is a very great duality in the labour market with very high levels of protection for permanent contracts and low-level protection for temporary contracts, and that is a major distortion in the economy, ECOFIN has to step forward and say that it needs to be tackled as a priority, when it is big. The Europe 2020 strategy is part and parcel with some of the things that we have been talking about here. You then have the other work, on which the sectoral councils that need to take forward work, or innovation policies, such as the digital agenda. All those things are critical policies in their own area, but the difference is probably more in terms of the time horizon. These policies will deliver results, but they will take four, five or six years before we see the effects feeding through. It was a bit of a problem in Lisbon that you had all these microeconomic policies bundled in with the bigger macro picture. They kept getting crowded out. If you organise a discussion today about economic policy, you will be talking about fixing the banking system, the crisis resolution mechanism and how we correct or ensure a sustainable fiscal policy. You are never going to have time for a discussion on the digital agenda, or a single market for internet shopping, or that kind of stuff. We want to create space so that there is room to allow those important debates to take place, so they are not crowded out by macro issues. It is part and parcel.

Q399 The Chairman: I couldn't agree more. Do you want to say something briefly on the UK?

Mr Costello: Of course, all the proposals on economic governance apply to the UK, except where the UK opt-out precludes it. The UK has been very supportive of the whole process; it is very much in favour of transparent, evidence-based policy making, which is traditionally something that the UK has pressed for. For many years, it has also pressed Europe to proceed on more structural issues, as well as the fiscal ones. So I think that it is in the UK's general interests that the governance of EMU is strengthened and that we avoid the huge imbalances and severe crises that have emerged in a number of our economies. Probably of interest to the UK is the point that resolution of these issues involves finding satisfactory means to discuss and come to coherent policy lines, which facilitates discussion at the global level for resolving imbalances. So the greater the coherence of the policy making at the euro-area level facilitates reaching what will have to be; important elements of that will have to occur at international level.

The Chairman: Mr Costello, the Committee is very grateful to you and your colleagues for coming this morning and answering an array of questions. As I said earlier, if you have further thoughts, please communicate them—and please check the transcript. We are working together on this and will produce our report in January or February. In the mean time, we are grateful to all three of you for coming this morning.

Supplementary memorandum by the European Policy Centre (EGE 22)

1. Why did market react so late to the Euro area debt crisis? Is the UK at risk of contagion?

2. What might be the risks if the UK did not participate in any crisis resolution mechanism? Is there any expectation that that the UK should contribute to any wider stabilisation fund?

3. Would joint Eurobonds contribute to ending the euro crisis? How?

1) It is surprising that the markets did not react to the differences in economic performance within the Eurozone before the crisis hit. It would have been normal to see some spread in the interest rates (although not at current levels). I think the economic crisis and political changes (a new government in Greece) exposed the full extent of the underlying problems and it also raised the question in how far the stronger economies were willing to help the weaker ones.

In terms of contagion risk for the UK economy, this seems fairly low with regard to public deficits/debt, given that the UK performance here (and in terms of growth) is not bad when compared to other countries and the exchange rate can float to compensate for differences in competitiveness. However, the big danger for the UK I think lies in the banking sector, where, potentially, difficulties in the major financial institutions could trigger a crisis for the UK, similar to Ireland, for example if there was a default in one of the Euro countries to which UK financial institutions are particularly exposed. However, the risk for this is almost impossible to evaluate.

2) The risk for the UK is relatively small as the bail-out mechanism will work with or without the UK (which is in any case indirectly participating through the IMF). However, this means that the UK's influence on the design of the mechanism and on associated policy issues is very limited. In addition, the UK is not pulling its economic weight in helping Europe's economically weaker member states, which also implies that future problems in the UK have to be faced alone.

However, the UK needs to guard against potential problems in the financial sector in other EU countries where the UK is likely to be disproportionately affected as seen in Ireland. Here it might well be in the UK's direct interest to help support other countries' financial sectors to prevent a knock-on effect on UK financial institutions (as in the Irish case).

3) Eurobonds is a term which has been used for many different instruments. The question here is very much one of detail: how would they be designed and for what purpose. The difficulty for Eurobonds as a vehicle for common debt issuance is how to ensure that the cost for the stronger member states (e.g. Germany) does not rise disproportionately and that there is no moral hazard problem, i.e. that there is a strong incentive for reform in the highly indepted countries. I don't see how the currently discussed Eurobonds could square this circle and I think we would need to see far further economic integration to make this work. However, I think a potentially more promising direction to investigate is the use of common bonds (EU project bonds) to invest in common EU objectives (e.g. trans-European infrastructure), including a focus on generating more growth in the weaker member states.

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