HOUSE OF LORDS

Unrevised transcript of evidence taken before

The Select Committee on the European Union

EU Economic and Financial Affairs (Sub-Committee A)

Inquiry on

GENUINE ECONOMIC AND MONETARY UNION AND THE IMPLICATIONS FOR THE UK

Evidence Session No. 4 *Heard in Public* *Questions 55 - 77*

TUESDAY 18 JUNE 2013

10.15 am

Witnesses: Professor Willem Buiter and Dr Holger Schmieding

Dr Federico Steinberg

USE OF THE TRANSCRIPT

1. This is an uncorrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.
2. Any public use of, or reference to, the contents should make clear that neither Members nor witnesses have had the opportunity to correct the record. If in doubt as to the propriety of using the transcript, please contact the Clerk of the Committee.
3. Members and witnesses are asked to send corrections to the Clerk of the Committee within 7 days of receipt.

Members present

Lord Harrison (Chairman)
Lord Boswell of Aynho
Viscount Brookeborough
Earl of Caithness
Lord Carter of Coles
Lord Davies of Stamford
Lord Dear
Lord Flight
Lord Hamilton of Epsom
Lord Kerr of Kinlochard
Baroness Maddock
Lord Marlesford
Lord Vallance of Tummel

Witnesses

Professor Willem Buiter, Chief Economist, Citigroup, and **Dr Holger Schmieding**, Chief Economist, Berenberg Bank

Q55 The Chairman: Willem Buiter, Holger Schmieding, you are old friends of this Committee and we welcome you back again on this occasion to help us with Genuine Economic and Monetary Union. Since you have been here before, you know that we make a transcript of all that transpires between us and we send that to you. We ask you to correct it and to improve it because you may have further thoughts that could help the Committee to decide its view on these matters by adding to those first thoughts. You will recognise we are being webcast and the matters will be broadcast, I understand, later on. We would be most grateful if the two of you could just announce yourselves when I ask the first question, just to say who you are. It will be helpful to get that on the record.

My first question is: do you think GEMU does resolve the crisis? Are we on our way in terms of what is being presented to us? If the answer is no, not quite, what further elements might be needed that we should bring attention to in our final report? Holger Schmieding, would you care to take that one, first of all?

Dr Schmieding: Thank you very much. I am Holger Schmieding, Chief Economist at Berenberg. I think we are well on the way to resolving the euro crisis. We have to understand the nature of the crisis, which is that parts of the eurozone had lost competitiveness and had come under market pressure as a result. They are now, and have been for the past two to three years, implementing reforms that are very akin to those implemented some 30-plus years ago here in Britain by Margaret Thatcher and to those implemented 10 years ago by Gerhard Schröder in Germany. These reforms take time to work.

The problem of the euro periphery is and was that, in the wake of the global financial crisis, markets were no longer financing them through their difficult adjustment period and, as a result, the eurozone, with the IMF, had to come up with mechanisms to prop up those countries. As key elements, first of all, we needed a safety net to signal to markets that all countries that do reform themselves will be kept in the euro. The ECB finally delivered that last August. To forestall future crises we need stricter fiscal rules because within the monetary union the fiscal problems of one country can affect other countries. We have, with the fiscal compact, de facto, the fiscal rules we need. They are being phased in. The key rule is that no country can run a budget deficit adjusted for the business cycle of more than 0.5% of its GDP.

What we still need to improve upon is the policing of these rules, where I find the troika not optimal, to put it that way. Personally, I would prefer to have an independent council, like the Central Bank Council, to check whether countries are making what they have to, to check whether they are meeting the requirements of the fiscal rule and whether they are making their fiscal position sustainable for the long term. I would delegate the verdict on the state of where countries are and what they are doing away from the troika to an independent council of experts.

We also need, in my view, a much faster resolution of banking problems. That does not have to be a banking union necessarily, but we need to force every country to tackle its banking issues. Unfortunately, there seems to be a bias in many national regulators to treat their own banks leniently. As a result, it makes sense to delegate the task of finding out what is the shortfall in the banks to an independent organisation that is not national. I think the ECB, as an organisation that we have, is the right one for that.

For the task of supervising major banks and finding out what is the shortfall, the ECB is probably good. The recapitalisation does not have to come from a European banking union. For that, it would suffice to have the current institutions, which are the nation first and the European stability mechanism as a backstop if the nation is not good enough. Banking union is an interesting subject but the key is not the banking union. The key is to find the mechanism to force every country first to address its banking issues.

Q56 The Chairman: Professor Buiter, could I invite you to answer the first two questions, but also to reflect on Herr Schmieding's point about an independent committee that might oversee what is happening?

Professor Buiter: Thank you, My Lord Chairman. I am Willem Buiter, Chief Economist of Citigroup, and I am speaking in a strictly personal capacity. We are getting to the point that the resolution of the European crises—there are multiple ones—are in sight, although it will take many years still to put financial matters in order. I want to differentiate the banking crisis of the euro area and the sovereign crises in the euro area periphery from the wider supply-side and productivity issues raised by Dr Schmieding—the agenda 2020 issues of inefficiency, lack of competitiveness. I think these problems can and should, to a large extent, be decoupled. You can be poor but solvent. Countries do not have to get into the kind of banking crises and sovereign debt crises simply because their productivity growth has been miserable and the unit labour costs have got out of line with underlying productivity both from a domestic and from an international perspective. As I said, I would not recommend the course of action of being poor but solvent, but poverty and insolvency are separate problems. I will focus mainly here on the banking crisis and the sovereign crises.

Although we can see now where we will likely end up ultimately, we are nowhere near there. To deal with the sovereign aspect of the crisis—I still think there are a number of most likely insolvent sovereigns in the euro area periphery—we need two things: a framework for the orderly resolution of insolvent sovereigns and liquidity support for those sovereigns that are fiscally challenged but most likely solvent. The euro area must be able to ensure that a sovereign that is doing the right things, pursuing the right policies to restore solvency, cannot be forced into unnecessary disorderly default by a self-fulfilling funding stop, driven by fear in the markets. As regards liquidity support for most likely solvent but at risk of a sudden funding stop sovereigns, we have both belt-and-braces at the moment. We have the ESM, of which part that is for sovereign liquidity support (rather than for direct bank capital support) is far too small a facility, with probably no more than €440 billion available at this point. I would like to see that greatly extended, making liquidity support available against strict conditionality. We have, of course, the OMT, which is the sovereign lender of last resort role as interpreted, again in a conditional way, by the ECB. That is sufficient as regards sovereign liquidity, although there is too much reliance on the ECB/Eurosystem and too little on the ESM.

We do not have a sovereign resolution facility (SDRM) in the euro area and that is unfortunate. We need one. We should have had one when Greece first knocked on the door in the Spring of 2010, and the IMF has belatedly recognised that. We do not have one now. We have a few ingredients of a sovereign resolution regime but they are mainly market-based and contractual, like the collective action clauses (CACs) that have had to be incorporated in the majority of new sovereign debt issues since the beginning of 2013. This will help reduce the severity of holdout problems when sovereign debt needs restructuring. That is good and useful but it is not enough. We need a statutory dimension. I would combine the SDRM with the conditional sovereign liquidity support role of the ESM after taking the direct bank capitalisation role out of the ESM. At the moment, the ESM is a bit of an institutional dog's breakfast. It provides liquidity support for sovereigns and capital support for banks. Those two functions should not be managed by the same facility. They are quite distinct functionally and financially.

I agree with my colleague on dealing with the banking problem. We have overleveraged banks throughout the euro area, core and periphery. Many of them are effectively zombie banks, accounting for the extreme slowness of the unwinding of the crisis in the euro area. Banks will not lend to potentially viable new projects because they have a large overhang of often unrecognised, strategically hidden on-and off-balance sheet losses or assets of doubtful quality. But it needs to be tackled; the stables have to be cleaned. That will require additional capital for insolvent systemically important banks that ought to survive for wider economic reasons. Other systemically important insolvent banks should, of course, be liquidated.

The way in which bank resolution is done—the recovery, resolution and recapitalisation mechanism—does not have to be anything as grand as the full banking union that the Commission is dreaming of. I would be in favour of a European Resolution Authority and 20 years from now we may have one. But a network of national recovery, resolution and recapitalisation regimes, according to a common European template, with a supervisory board-like structure to facilitate co-operation for cross-border resolutions, would be adequate to the task of dezombifying the euro area banking sector, provided it can work, as regards the resources it draws on, as a sort of three-stage rocket. First, you bail in the unsecured creditors of the banks; then, for any legacy bad assets the domestic taxpayer; and, only in the last resort, the European taxpayers through the ESM. What is currently the direct bank recapitalisation facility of the ESM would be the third stage of this bank recapitalisation rocket.

The Chairman: We will probably come on to those aspects. Before we leave this territory, Lord Dear, please.

Q57 Lord Dear: Gentlemen, echoing the Chairman's remarks, thank you very much for coming and helping us today. Can I focus on the ECB and GEMU and look at the role of the Central Bank in GEMU and ask you, first, do you think it has been given enough attention? Is it prominent enough in that equation? Secondly, I suppose allied to that, what do you think is the proper division of labour, of involvement, between the Central Bank and governments, so far as the governance of GEMU is concerned?

Professor Buiter: First of all, I must say how poorly named GEMU is. Genuine economic and monetary union, as opposed to phoney or fake monetary union? Who dreamt this up? But never mind; we are stuck with it.

Lord Dear: It was not our Committee. It was not us!

Professor Buiter: The four pillars of GEMU, the four elements, are three sets of economic institutions and one set of political arrangements. As regards the economic pillars, there is, first, an integrated financial framework that more or less corresponds to full banking union, second, an integrated budgetary framework and third, an integrated economic policy framework to look after the long-run growth and competitiveness agenda. Then, very importantly and much underemphasised, after Mr Van Rompuy very wisely introduced it, democratic legitimacy and accountability. I have a major problem with the growing role of institutions such as the European Commission and the European Central Bank, which basically are run by unelected technocrats without political legitimacy, other than what is bestowed on them by the fact that they operate under the Treaty. There is no 'input legitimacy' through elections or through substantive accountability to elected representatives of a European 'demos'. Output legitimacy (success in the pursuit of one's mandate) is also problematic, as (a) success or effectiveness is hard to verify objectively, and (b) the subjective popular assessment of the effectiveness of the Commission and the ECB is most likely not very flattering.

But there has been, and there promises to be in the next few years, a major increase in the power of these institutions without any commensurate increase in their accountability to the electorate, either through a more effective European Parliament or through a new arrangement involving national Parliaments in a Senate-like setting. This is very worrying, especially in the case of the European Central Bank. Although for most of the world's central banks operational independence (let alone target independence) is a construct whose time came and went, this is not the case for the ECB. This crisis has effectively ended the operational independence of most leading central banks—in the US, in the UK and in Japan—but it has not ended it in the euro area. This is not because the Treaty makes a lot of play about central bank independence but simply because in the euro area we don't have a single central bank facing off against a single Treasury or Ministry of Finance—a confrontation that invariably ends with fiscal dominance. In the euro area it is 17 Finance Ministers against one central bank, so every Finance Minister is small, even the Finance Minister of Germany.

The Chairman: I wonder if I could ask Dr Schmieding to answer Lord Dear's point about the ECB. You may like to know that for our banking union report we interviewed Dr Constâncio, the Vice-President of the ECB, who was very good at coming forward to listen to our questions. What is your view of the ECB's role?

Dr Schmieding: Thank you. The role of the Central Bank should be to safeguard price stability and financial stability. Financial stability is something that central banks, post-Lehman, realised only over time and a role that the ECB has assumed somewhat reluctantly and rather late, but these are the proper roles. It also took the ECB and, say, a number of European countries and Finance Ministers some time to realise that safeguarding financial stability does entail offering a backstop, a lender of last resort to prevent self-reinforcing market panics. It has been a long learning process but we are there, in that sense, with the ECB and can only hope that the German Constitutional Court does not stick to the old view that only price stability, come what may, is what the Central Bank should be concerned with. What I do not like about the role of the ECB at the moment is, as mentioned, the troika. I do not think that Central Bank staff should be among those to pass judgment on the state of public finances in Italy, Spain, Greece and wherever. On that I would rather have an independent body so that the ECB can function on the huge tasks that it has anyway.

The Chairman: Thanks very much. I think now we must press on. We have the witnesses for only an hour.

Q58 Lord Marlesford: On what Dr Schmieding said at the beginning is the cause of the crisis, of course we can all see that lack of competitiveness has made it difficult for countries to get out of the crisis. However, to suggest that it was lack of competitiveness that caused it puzzles me a bit. It is almost as though you were saying there is a balance of payments problem. Surely the primary cause was, on the one hand, unsound lending by banks and on the other budgetary imbalances of central Governments. Take Ireland for the first and Greece for the second.

The Chairman: I am going to ask Lord Davies to put his question. You may wish to respond to Lord Marlesford's, which is something we deal with on a regular basis in terms of the origins of the euro area crisis. Lord Davies, would you come in? Please do respond, if you wish, to Lord Marlesford.

Lord Davies of Stamford: My point to Dr Schmieding was simply going to be that the idea that central banks have a responsibility for financial stability is hardly new. Bagehot described that as one of the Bank of England's classic roles back in the middle of the 19th century. It was the main reason for the establishment of the Federal Reserve in 1913.

Professor Buiter, you have moved from academe to the private sector, so perhaps you are the ideal person for me to put this question to. How do you see the markets reacting to GEMU? Do they think, on the whole, that these proposals by the Commission are adequate, inadequate or go too far? Do they think they are ill conceived, well conceived? Do they think that the Franco-German paper is more pertinent than the Commission's proposals? How do they see the merits of the two approaches?

Professor Buiter: I do not think that the market much cares about most of the proposals for GEMU, because most of it is a long-term blueprint that has no relevance to the resolution of the current crisis. In the integrated economic policy framework, the third element, for instance, is about the 2020 agenda—competitiveness, growth, happiness—and that has nothing to do with the crisis. On the fiscal capacity of the eurozone, a lost federalist sheep like me likes the proposals in GEMU, but I know this is not going to happen for the next 30 years. There will not be anything smacking of a fiscal capacity, even a minimal one that responds to asymmetric shocks with the conditional automatic transfer of payments cross-border from the centre funded either out of the centre's own tax resources or out of the centre's own debt issuance.

Lord Davies of Stamford: You say there will not be. Do you regret the fact that there will not be?

Professor Buiter: I regret it because I would like to see a stronger European Union with stronger supranational institutions both because I believe this is the only viable future for Europe, including the UK, and because it would be sufficient to resolve the resolution of this crisis. It is not necessary for the resolution of the crisis and the survival of the euro area, however. For asymmetric national shocks, what we need is proper cross-border borrowing and lending mechanisms, private and public, so we need to get the financial markets going again. At the moment, we have de facto capital controls inside the euro area, not just the explicit ones in Cyprus but implicit ones throughout the euro area. Subsidiaries of cross-border euro area banks headquartered in the periphery have been told by supervisors in core European countries that, for unconvincing prudential reasons, they cannot send funds to the parent in the south. So let us restore the proper functioning of private and public sector borrowing and lending. We do not need centralised cross-border fiscal stabilisation to get out of this crisis.

As regards the preventive arm of the pact, which is by now so complicated that I doubt whether even the authors of various bits of it could pass a test on it, we have the six-pack, the two-pack, the Treaty on Stability, Co-ordination and Governance (aka the Fiscal Compact), which all implement and augment the failed Stability and Growth Pact. The whole preventive part of this new potpourri of approaches is as yet untested. Every time in the past when the Commission tried to discourage pro-cyclical behaviour during the upswing—and that is really what these things are about—they have failed. Its recommendations and proposals have been ignored by Germany, France and the UK. The fiscal compact, like the Stability and Growth Pact, is trying to make anti-cyclical fiscal behaviour symmetrical. Counter-cyclical policy is always wildly popular in the downturn, never in the upturn. Counter-cyclical fiscal policy has never been symmetrical, except occasionally in a few countries, and has led to the steady upward drift in public debt and deficit burdens over the past two decades. How can the Commission impose fiscal discipline when the economy is booming and markets are keen to fund the sovereign?

The last time two serious countries, Germany and France, got into trouble—in 2003 under the original Stability and Growth Pact—they thumbed their noses at the Commission and got away with it because it took a qualified majority of the Council to enforce the proposals of the Commission. Now it is slightly different in the Fiscal Compact because it now takes a qualified majority of the Council to overrule the Commission. But I personally do not believe that we have anything like the institutional set-up necessary to enforce the preventive arm.

As regards a committee of experts ruling on fiscal matters, independent means unaccountable (that is, substantively unaccountable) and I am really concerned about that if the Committee of Experts were to make policy proposals or were to be able to overrule the legitimate national policy makers. I would be very careful before we create yet another collection of eggheads who will tell the citizenry what to do with their votes.

Q59 The Chairman: Herr Schmieding, would you like to take on that comment and the question about the influence of the markets?

Dr Schmieding: To take that comment first, I am a big fan of the way in which the independent central bank councils, the monetary policy councils or the ECB Council, roughly run their monetary policy. I think for an extremely difficult question such as monetary policy and passing judgment on the sustainability of public finances in countries, I would rather have a non-politicised body and that is a council like the ECB Council but not the ECB—a separate fiscal council, as to some extent this country has for itself with the Office for Budget Responsibility.

The Chairman: If it is independent, is it then unaccountable, as Professor Buiter says?

Dr Schmieding: To some extent independent is unaccountable. The ECB is, of course, in a way accountable to the European Parliament. Its members are appointed in a way that is ultimately political, but once appointed their political masters who appointed them can no longer tell them, "Oh sorry, I thought you would be doing this rather than that". That kind of independence, ultimately appointed by Parliaments ideally, for a limited number of years with a clear mandate but within that mandate being the ones to judge how to exercise it, is something that has served the world well for central banks. On the other question: I very much admit this one point: relearning the lesson that financial stability is part of a central bank mandate has been the relearning of a lesson that is not new.

Professor Buiter: I disagree with that, My Lord Chairman. First of all, as regards the need for independence, even in monetary policy, the argument for independence is not that monetary policy is incredibly technical and difficult. Basically, anybody can do it. It does not take a genius to do monetary policy: 25 basis points up, down or sideways. What's hard about that? The reason for de-politicising monetary policy is that it is a high-frequency instrument that is very easily manipulated in a political manner with both immediate consequences (the ones that are sought by political manipulation) and long-term consequences that tend to be ignored by myopic politicians elected by myopic electorates. That is different from saying it is complex or technical. Fiscal sustainability is a deep, complicated, technical problem and I certainly would like experts to evaluate it, but even if the experts' work is purely technical, advisory, or scenario-building, the experts would have to be substantively accountable.

There are two dimensions to accountability. One is to provide information so those to whom you are notionally answerable can make a judgment on how well you did. The ECB has some (minimalist) information requirements imposed on it by the Treaty: it has to publish a weekly this, a monthly this, that and the other and an annual something; and the European Parliament can call the members of the Board for hearings that the ECB perversely refers to as dialogues. Dialogues occur between equals. The ECB is the Agent or the

Trustee; it is not the Principal. The European Parliament and the euro area citizens are the Principals to whom the ECB is supposed to be accountable. Agents and Trustees give evidence or are summoned to hearings. They don't engage in dialogues with the Principals. Substantive accountability means that if those to whom you are accountable do not like what they find out about your performance, they can do something about it: they can reward or punish you. That is clearly not the case with the independent central banks. The European Parliament cannot fire the Board members or the ECB Governors; they cannot lower or raise their financial remuneration. And Governing Council members have not (so far) been sued by euro area citizens for incompetence in the performance of their tasks, for dereliction of duty, or for careless or reckless performance of their responsibilities. Substantively, therefore, the ECB is clearly unaccountable as regards monetary policy. As regards monetary policy you might be able to tolerate it but to extend this to banking supervision, which is a deeply political activity, I think would be extremely perverse.

The Chairman: I am going to ask the Earl of Caithness to ask his question but, Herr Schmieding, if you would like to reply to Lord Marlesford in the reply to the Earl of Caithness, please do so.

Q60 Earl of Caithness: I would like to move on to the banking union. First, do you agree that a successful banking union should have three distinct legs: a single supervisory mechanism, a common resolution mechanism and a common deposit insurance scheme? The only leg that has any sort of shape to it is the single supervisory mechanism. What are the risks of a fudge on the other two legs? Will it work and, if there is a fudge, or even if there is not a fudge and we get three good legs, will there be a decisive break between bank and sovereign debt?

Professor Buiter: We do not need the third leg, deposit insurance, for a successful banking union, but we need three legs because we need a common regulatory framework, not just in a monetary union but in a single market for banking services. In the wider EU, you cannot have cross-border banking, as the case of Icesave made very clear, on a Passporting basis without having a single regulatory and supervisory framework right across the Union. For meaningful cross-border banking and a single market in banking products and services, you have to do away with national supervisors and get to the EU level, not just the eurozone level.

So, yes, we will get progress towards a single regulatory framework, and a single supervisory mechanism. But, of course, the supervisor is fangless if he or she cannot shut down banks or tell them to recapitalise, so you need a recovery, resolution and recapitalisation authority or a cooperating network of national authorities. The network, the minimalist approach, can work for a long time, certainly long enough to clean up the current mess.

We have deposit insurance for two reasons in the real world: one is social policy and the other is financial stability. For social policy, I think current deposit insurance is greatly excessive. "Widows and orphans" protection should maybe go to €20,000. A €100,000 deposit protection on "wretched and poor" grounds does not make any sense. What about financial stability—preventing bank runs? That is surely desirable but the other way to deal with bank runs is to provide compensatory financing. You do not need belt and braces. Credible deposit insurance—if it applies to all deposits that can be withdrawn on demand (which it does not of course; a much larger scheme would be needed)—is a way of preventing bank runs. But we already have the ECB acting as lender of last resort, capable of making short-term funding available, through collateralised loans to banks or by outright purchases of bank securities.

It would be nice to have mutualised deposit insurance but it is not essential at all, in my view. I would, in fact, discourage deposits withdrawable on demand as instruments. I think they are death traps. We have learnt in this crisis that overnight funding is not a good idea for financial institutions. Deposits, of course, are the ultimate example not just of overnight funding but of over-the-second funding. I would put limits on the ability to withdraw deposits, other than very small amounts of transactions balances.

Dr Schmieding: On banking union, the key at the moment is to force banks to face up to losses, whichever way we do that. If a banking union proposal is a way to do that, fine. If we have another way, fine. That is for dealing with the current situation. For the longer-run improvement of the eurozone and the EU, yes, a banking union is good. It should be built on the principle of subsidiarity, ideally. That is, all those institutions that are systemic should ultimately be under a single supervisory regime, subject to a single resolution regime. Deposit insurance, I agree, is a nice complement but is not the major ingredient for me, even in the longer run.

Will there be fudges? Yes, there will likely be fudges, as always in international or even national politics. But I am fairly confident that over time—probably over the next year and a half—we will get the key elements of a banking union dealing with systemically important banks, the common supervision and a common approach to recapitalise the banks that are found wanting by the common supervisor. I would not be surprised if the ECB, because it would like to take on banks with a fairly clean slate, came up with much higher estimates of how much capital will be needed for banks than all the stress tests we have seen so far. That will probably politically—late this year or early next year—force much more thorough European thinking about resolving those banks.

So much on banking union. May I briefly come to this question on the causes of the crisis? For me, fairly easily, parts of the eurozone had phenomena just like the US and the UK—that is excessive public spending growth and credit bubbles. When these went bust in the US and the UK, we had the backstop through the central bank quantitative easing and the like. In the euro periphery we did not have a backstop for that and, as a result, had the market panics. In the process of building up credit bubbles, real estate bubbles and excessive government spending, wages in a number of countries rose too fast and, as a result, they also have a competitiveness problem.

We see now that, in their adjustment crisis, wages are falling fairly fast in those countries. In Greece, wages are probably down 12% to 15% in the private sector on where they were at the start of the crisis. There are similar developments—not quite as pronounced but similar—in Portugal, to some extent Ireland, whereas Germany has wage gain, relative to the start of the crisis, of close to 10%. There has in relative terms been roughly a 20% adjustment in the relative competitiveness between the euro periphery and Germany. That is going a long way towards making these countries sustainable again once they leave the immediate period of fiscal pain, which they likely will do soon.

Q61 Lord Kerr of Kinlochard: Following directly from what you have been saying, Dr Schmieding, and what you said in your opening remarks when you talked about an independent council of experts as the policeman of fiscal discipline, the Franco-German proposal of 30 May runs with the idea of contractual arrangements, which I do not fully understand. It says that they would be backed up by limited and conditional financial incentives, the creation of a specific fund for the euro area, more regular euro area summits and dedicated structures specific to the euro area within the European Parliament to ensure adequate democratic control. I think, by the way, that the proposal for an independent council of experts runs into some difficulties on democratic control. It seems to me that if you are requiring Governments to change their economic policies in the direction of greater austerity, you had better have some kind of democratic mechanism overlooking that decision. But I do not fully understand the contracts proposal, even as spelled out in the Franco-German paper. I would be very grateful if you could tell us what you think it is and whether you think it could work.

Dr Schmieding: First, on the independent council, what I am proposing is not a council that takes all the political decisions. The troika does not take the decisions on Greece. That is ultimately the ECOFIN and the parliaments of the countries that then authorise the ESM, for instance. But the troika report as to whether Greece has met 8% or 88% of its commitments. Whether the calculations on fiscal sustainability, ideally for all countries ranging from Greece to Germany, make sense—whether the growth assumptions in there make sense—the expert judgment should not be made by the EU Commission, which is a half-political body. It should not be done by the IMF, which has no idea of Europe and has demonstrated that repeatedly over the last few years, despite the head being European. It should not be done by the ECB, which should stay out of these things as much as humanly possible because it ought to focus on monetary and not fiscal policy. The independent expert committee does not make the political decision of whether Greece should be asked to leave the euro, which I think it never will be, but decides whether Greece has met the commitments and is on the right track, and whether Germany is on the right track as well. That is on that, the expert task.

The contracts proposal is, in my understanding, which is a mere political understanding, a sweetener for the countries in adjustment recession. "If you conclude a contract with us on the following structural reforms we will have the fiscal capacity to give you a little money as a reward for that". That is a little step towards a mini EU budget. You could say it is something like an adjustment fund at the EU, on top of the structural funds or regional funds that the European Union has had for quite a while. That is my understanding of it: a little money from core Europe in an EU fund for countries that conclude a contract on structural reforms and then adhere to these commitments.

Professor Buiter: It is fine to talk about an independent council that is merely a bunch of experts doing a forecast—or independent assessments of fiscal programmes—but that is very different, of course, from the ECB, which takes substantive policy decisions. The OBR or the Netherlands' so-called Central Planning Bureau (I know it sounds vaguely Soviet Union-esque) do that kind of thing. The CPB evaluates each party's electoral programmes, but it is generally considered to be a useful thing, so I support that.

As regards the contractual arrangement, God knows. When I hear the words "contractual arrangements", I think courts and enforceability. As I said, this is simply a supposedly conditional cookie out of a very small cookie jar for countries that are suffering the indignity of being under a set of fiscal financial austerity programmes. They are offered incentives for restructuring reforms using the convergence and competitive instrument, the so-called CCI, as a carrot; but since the EU has a minimal budget, 1% of GDP, about half of which is wasted on the Common Agricultural Policy, this is really tokenism at this point. Also, who enforces the contracts? How many bailiffs and arresting police officers does the Commission have?

Q62 Viscount Brookeborough: Would you like to tell us something about what you think of a euro area budget, whether you think it is a long way down the line, how necessary it might be, whether it would really work and how it might be funded, especially with the way they put in resources?

Professor Buiter: My view is that ultimately the EU budget will become the euro area budget because I cannot see non-eurozone members of the EU sticking around indefinitely; either you join the euro area or you are out of the EU. For the rest of the proposals—that you get another 1% of GDP to play with, possibly with independent revenue-raising capacities; dedicated fiscal instruments, whatever they are; maybe the financial transaction tax, although that is shrinking so fast it is no longer visible to the naked eye; and perhaps even independent borrowing capacities—I think all that is a distraction from what we need to do at this point, which is clean up the sovereigns, clean up the banks and set in operation structures that can force symmetry in the counter-cyclicality of fiscal policy. Those are the things that matter. I think that an independent euro area budget is a dream of Brussels. But it is not relevant to this crisis, nor is it relevant to the prevention or management of the next crisis, nor will it become relevant in the foreseeable future.

The Chairman: Dr Schmieding, will any budget become a euro area budget and is it almost irrelevant, as suggested by Professor Buiter?

Dr Schmieding: I hope that the European Union stays wider than just the euro area, as I hope that Britain will remain in the EU, and so some EU budget should remain. As to a euro area budget, that is either a red herring if it is small, or it is dangerous if it is big, because a big euro area budget would mean a lot of room for political decisions on redistribution, which I should not like to see. I much prefer what is currently happening in the euro area: if there is a need for the strong to support the weak, it is a case-by-case decision with a conditionality that is evaluated case by case, rather than having a grand budget that gives transfers from the strong to the weak on a semi or even fully automatic basis, which is just not incentive-compatible.

Q63 Lord Vallance of Tummel: Can we come on to debt mutualisation? Is it necessary and, if so, what form might it take? I wonder if you could look at it in two ways. First, look at it while relaxing the current treaty constraints and perhaps even the concerns in creditor countries about moral hazard. What would be the ideal if you had a clean sheet of paper? Secondly, given that we are where we are politically, what if anything is likely to happen or has it happened already by the back door?

The Chairman: Could I ask Lord Carter to add his question, which links very neatly to Lord Vallance's?

Lord Carter of Coles: In many ways I think you have addressed this, but it is about competitiveness and the presence of the persistent imbalances across the member states. Does it make a system of permanent financial transfers inevitable if the euro area is to survive or could we do this in some other way? Could we preserve the goals of fiscal union in some other mechanism?

Professor Buiter: Debt mutualisation, whether it is backward-looking (that is, it applies to the outstanding stock or to part of the stock, as in the Council of German Economic Experts' proposal for a Redemption Fund), or forward looking, through joint and several guaranteed issuance of new bonds to fund some share of future national budget deficits, are neither necessary nor desirable unless they are accompanied by the other half of fiscal union: the transfer of national fiscal competencies to the federal level. You cannot have front-door mutualisation by explicit joint and several guarantees without having this surrender of national fiscal competencies. Since that is not on the cards, it is not going to happen.

There is, of course, some ex-post mutualisation inevitably in this crisis already, both back door and front door. Front-door ex-post mutualisation refers to the losses that have already been incurred in net present value terms by the various official facilities—the Greek Loan Facility, the EFSF, the EFSM and now the ESM. Ultimately, all the loans provided by these entities to countries on programmes will be turned into zero-coupon perpetuities, promising to pay nothing for ever. With full face value and zero net present value official creditors retain a fig-leaf and official debtors get the substantive gains. It is happening rapidly. We see in the case of Ireland and Portugal the recent seven-year maturity extensions. There were earlier examples for Greece, Ireland and Portugal OSI through maturity extensions, coupon cuts and delays in interest payments. Take that to the limit and you have a zero-coupon perpetuity. There will be a bit more of that but not a lot more because the resources available to the ESM are unlikely to increase significantly.

Then we have the potentially much more important ex-post back-door mutualisation through the ECB, or the Eurosystem, as and when the Eurosystem finally takes losses on its sovereign exposures, and on its exposures to mostly likely insolvent banks that have offered, as collateral, securities issued or guaranteed by most likely insolvent sovereigns. The Eurosystem has already bought €210 billion of sovereign debt, or rather periphery sovereign debt, and indeed the worst afflicted peripherally sovereign debt, through the now defunct SMP, the securities markets programme. I cannot see the ECB/Eurosystem being made whole on its SMP exposure unless the ESM were to take it off its hands at the prices at which the debt was purchased. Of course, other than the SMP exposure, the Eurosystem has very little sovereign debt outright on its balance sheet. The Eurosystem balance sheet, unlike most advanced economy central banks, has less than 10% of its balance sheet in sovereign debt held outright. Of course, if and when the SMP gets activated, there will be more periphery sovereign debt held outright on the Eurosystem balance sheet. And it will again be the least solvent sovereigns who will avail themselves of that. There is material credit risk that could in fact 'go live' and present the Eurosystem with an actual realised loss.

Finally, the existing indirect exposure of the ECB/Eurosystem to sovereigns (and especially periphery sovereigns) is massive through the collateralised loans it has made to banks of doubtful solvency that offer as collateral security either issued or guaranteed by sovereigns of doubtful solvency. That is not all that different substantively from holding outright sovereign debt with significant credit risk attached to it. I think there will be significant losses before this crisis is over for the euro system but not anything like large enough to endanger price stability. We have estimated the non-inflationary loss absorption capacity (NILAC) of the Eurosystem as being close to €3 trillion, so there is still a bit to go before any capital losses on the Eurosystem would endanger price stability. Central banks can, of course, operate with a large negative conventional net worth or equity without this threatening inflation or other loss of control, as long as the negative conventional net worth is compensated for with a sufficiently large NILAC.

Dr Schmieding: Briefly, I do not agree with this assessment of the ECB. It is a normal part of monetary policy for the central bank to have sovereign paper on its balance sheet and to be exposed to bank and sovereign risk. I do not see any need for the ECB to take any losses on its sovereign holdings. The euro crisis, short of a major political accident, can be resolved and will be resolved without further sovereign haircuts. The Greek debt outcome was a major mistake because of the contagion it sparked. It was expensive. I see risks, of course. Life is full of risks, but I do not see them materialising short of a major political mistake in the euro area.

As to the questions on debt mutualisation, I am very much against it. I am a German; of course, I ought to be against it because it could be largely at Germany's expense. I much prefer the current approach of case-by-case support for those who need it on case-by-case conditionality. Debt mutualisation is one empowering law and from then on the weak can borrow with a guarantee of the strong. At least that is how debt mutualisation is being presented. That would not be incentive-compatible.

On fiscal transfers, the argument is exactly the same. A system of automatic fiscal transfers distorts incentives. It makes it more likely that some regions, such as southern Italy—or should I mention some regions of the UK?—will for a long time depend on the stronger regions, northern Italy, or Greater London in this country. If there are fiscal transfers, I would much rather have the system of conditional support on a case-by-case-basic to force the weaker regions to either get as strong as the stronger ones or, as you said, just to stay poor but live within their means, which if you are poor you can do.

The Chairman: I invite Lord Marlesford to ask his question, which will be the final one, but if there is anything further that the witnesses would like to add to advise the Committee on these issues, perhaps you would add that to your replies to Lord Marlesford.

Q64 Lord Marlesford: My question follows on rather neatly from what has just been said. I find it a little difficult to understand the difference between mutualisation of debt and ECB-held debt. I thought that debt held by ECB was mutualised debt because the ECB is a mutual organisation of the eurozone. What I am really getting at is, in the single market, the British Government have decided not to join most of these outfits, particularly the banking union and so on. Do you think this has any great impact on the single market or do you think the single market can go along quite happily with us staying out of these particular institutions?

The Chairman: And what about the effects on the UK itself, Dr Schmieding?

Dr Schmieding: Of course, the ECB is a mutual organisation. Everything that goes wrong in the ECB balance sheet is a mutual event, yes, but this is very different. Having the ECB as an organisation that can accept sovereign paper as collateral or can buy it outright under certain conditions is very different from telling a Government that you can now issue a new bond as Italy with a de facto mutual guarantee on it, which is the debt mutualisation idea.

As to the role of the UK in it, the UK is in a very precarious position. The UK once got very close to eliciting a very strong European counterreaction when it vetoed the fiscal compact as being part of normal EU treaties in December 2011. If the UK opts to be out of things but vows not to get in the way of what consenting adults in the eurozone want to do, the current arrangement, from the continental perspective, can work. But if the UK wants to use decisions about eurozone affairs to pursue its own agenda in these things and press its own demands and hence block, potentially, things that the eurozone would want to do, we would be getting into very dangerous territory.

The fact is simple. The top priority for the eurozone is to fix itself and the eurozone will not, ultimately, let anybody get in the way.

Lord Marlesford: It depends on whether you have to have treaty change to do these things.

Dr Schmieding: Yes, exactly. The clear solution to that is there will be no treaty change forced upon the UK. More precisely: the UK can opt out of everything, but it ought to ratify the changes which the eurozone would like to do for itself. Otherwise we would be going towards a division between the eurozone and the EU that could ultimately lead to the eurozone, rather than the EU, being the genuine common market, which is the dangerous potential end of it.

Q65 The Chairman: Professor Buiter, do you agree that the UK should not interfere with consenting adults in these matters?

Professor Buiter: Since it is not part of the eurozone—

The Chairman: May I just stop you there? I understand that Dr Schmieding has to go and I would just like to take the opportunity to thank you if you do have to rush off. We are most grateful to you. Thank you very much indeed.

Professor Buiter: The old saying, "If you do not play the game you do not make the rules", applies to the UK in these matters. Of course there are areas in which the single market, as it is, is at risk for those not part of the eurozone. This tends to occur through restrictions imposed on the capacity of non-eurozone members of the EU to engage in transactions and other activities—restrictions that are irrelevant from the point of view of the proper functioning of the eurozone. Instead they amount to opportunistic abuse of the eurozone institutions' roles in rule-making, resulting in discrimination against legal and natural persons operating in the EU but outside the euro area. Most are obvious violations of single market legislation or of other parts of the Treaty. Fortunately, much of this attempt to impose protectionist barriers against 'offshore' euro-denominated activity outside the euro area (i.e. in the UK) seems to have been put to bed in the EU MiFID agreement reached yesterday on the trading of derivatives on organised exchanges and similar platforms. This was one of the more outrageous attempts by eurozone-based financial centres to steal business from London by means mostly foul.

That said, the relationship of countries not in the eurozone with countries that are in the eurozone will inevitably get more difficult as the eurozone moves towards deeper integration, even though I see the integration that is both necessary and likely as quite limited for the foreseeable future. I regret to have reached the conclusion that I have trouble envisaging the UK in the EU but out of the eurozone 10 years from now. I just cannot see that.

There is one point that was asked a couple of times but I never got around to saying anything about it: the decoupling of banks and sovereigns, and whether this would happen as a result of the kind of banking union we will see. If we find ways of comprehensively resolving and recapitalising systemically important banks without relying on national sovereigns, we will achieve that decoupling. Therefore, a key step toward decoupling has nothing to do with banking union per se. It simply requires the bailing in, by writing down the unsecured creditors claims or by converting them into common stock, of unsecured creditors of the banks to the full extent necessary to achieve adequate realisation, going all the way up to unsecured bondholders and possibly, and only if necessary, as in the case of Cyprus, the non-guaranteed, non-insured depositors. The bail-in rules should be common to all euro area member states. Of course, the bail-in requirement does not bring full decoupling of bank credit risk and sovereign credit risk if the capital requirements of banks exceed the maximal amount of unsecured debt that can be bailed in. As long as there is, for legacy losses in excess of the amount that can be squeezed out of the unsecured creditors, a requirement that a contribution has to be made by the national tax payer—that is the current consensus, I think—before mutualised bail-out funds from the ESM or somewhere else are put in, we will not get complete decoupling. I think it is politically unavoidable and also fair that for legacy bad assets the national taxpayer is bailed in, after the unsecured creditors but before the mutualised contribution of the ESM.

For losses on any new assets acquired by banks after the ECB takes over as the head of the Single Supervisory Mechanism, a specific national taxpayer contribution, other than through the national taxpayer's contribution to the mutualised ESM recapitalisation resources, should not be expected. To make this symbolically clear, I think that in the euro area, we should require that all banks that are supervised by the ECB—ultimately all banks in the euro area—be incorporated immediately as Societas Europaea (under European corporate law rather than under national corporate law) to make it clear that these banks are no longer a ward of the nation state. That could be done, of course, without any treaty changes.

The Chairman: Professor Buiter, as ever, we thank you as a Committee for coming in to see us. You are always thought-provoking, sir, and we will think about the thoughts that you have provoked in us in our further deliberations on this important matter. Thank you very much personally.

Witness

Dr Federico Steinberg, Senior Analyst, Elcano Royal Institute, Madrid

Q66 The Chairman: I have great pleasure in welcoming Federico Steinberg who has been kind enough to come from Madrid to be our final witness this morning. Colleagues, Federico Steinberg has given me advice that he, too, has to flee very quickly back home again and so without further ado we will begin the questioning. You may know that we will be making a transcript of this event. We will ask you to check that and add to it. You know that it is webcast and will be available to the public. I would be very grateful if you could tell us your institute back in Madrid. I also understand you would like to make an opening statement and I would be very grateful if you could do that. Thank you very much indeed.

Dr Steinberg: Thank you very much. First, I would like to thank you for the invitation. It is a great honour and it speaks very highly of this institution that you are interested in opinions of experts outside the UK and in the eurozone. I have quite a lot of time because the flight is at 5 pm. My name is Federico Steinberg. I am senior analyst for international economics at the Royal Elcano Institute, which is an independent think-tank in international relations, very similar to Chatham House. I am also professor at the Autónoma University in international economics.

I thought it would be interesting, reading the questions you proposed, to give a two-minute introductory statement, very brief, on why we are here, and where I think we will be in the foreseeable future. As you have discussed in this Committee, I think that we need to understand the eurozone crisis was caused by a combination of events, on the one hand the global financial crisis that came and hit us from outside. Without that coming from the US, and it has to do with the way we regulated the financial system, we would probably not be talking about this today. However, there were intrinsic failures of architecture and governance within the eurozone that made the crisis much worse and that, in particular, started what we now call the eurozone debt crisis. Those are the ones that we will get into in detail on, I am sure. They are more or less trying to be addressed.

It is important to take a political economy approach to understanding the crisis. The current situation has dramatically changed the balance of power within the European Union and within the eurozone. It has given creditor countries much more power and it has made debtor countries policy-takers instead of policymakers. I admit that southern European countries have never had a lot of influence in European affairs but now they have zero influence or very little influence, and in particular this has redefined the way we do things in the European Union.

I think that the principle, first, of equality among member states and, secondly, the principle that solidarity is at the heart of the Union because of the historical reasons why we created the Union have been somewhat diluted. I would not say they have been eliminated, but at this point it is crucial to understand these dynamics. More importantly, I think that at the end of the day for all these new elements on the new governance agenda—banking union, fiscal union, economic union and political union—the key place to look at is still France.

We are not looking at France at this point but at the end of the day my reading of the crisis is that Germany would like to take advantage of this situation to force on France reforms that France would not otherwise make. The southern European countries are just places where you try this strategy to see if it works, but we will only resolve this or, to put it clearly, Germany will accept that mutualisation, some sort of model of federal budget, a good banking union—we can talk about what that means—if and only if France accepts changing some elements of its economic model. The German strategy has to do with the role of European globalisation, of course, and that is where we have to look.

In terms of where we will be going, my reading of the crisis is that this will take quite a long time. Things will get worse before they get better. I am not particularly worried about the competitiveness problem in the southern countries, maybe a little about Greece and Portugal but certainly not about Spain. I think we will do the internal devaluation that is needed. We have been doing it and we will do more. That is not a problem.

I see some problems in terms of the sustainability of debt in some southern countries and for that we need a more active ECB. I think at this point European leaders have understood that it is too risky to play with fire, to play with the exit of anyone from the eurozone, be that Greece or Cyprus. I think that the political commitment of European populations in the south towards the European project is much larger and much more intense than we thought. I am personally surprised why Cyprus did not exit. I do not understand it from an economic perspective. I have to understand it from a political perspective. There are security issues there, for sure, and those are probably more important than we normally think.

My reading is that we will stay together—"we" meaning the eurozone plus the new members of the eurozone because, as we know, some countries are deciding to join the eurozone at this point—and we will muddle through, doing the minimum necessary to maintain the boat afloat; that is, with Germany accepting these little elements as the situation gets worse. But in normal times of calm, like now, we are most likely to see a slowdown in the progress. So, paradoxically, we need things to get worse so that we can construct this Genuine Economic and Monetary Union.

The Chairman: On that point, I shall turn to Lord Hamilton, whose interest must have been whetted by some of the things you said on southern Europe.

Q67 Lord Hamilton of Epsom: You have echoed Dr Schmieding's view that this is all going swimmingly. We are seeing devaluation happening in all the countries including yours. Wages have been lowered. Indeed, your balance of payments, I gather, is starting to look up.

On the other hand, I think even you think that economic growth is not going to come back very quickly in your country. Youth unemployment is in excess of 50%. How long politically can you go on with these appallingly high levels of unemployment without eventually infecting your politics and leading possibly to extremist parties, partition, the break-up of your country? Are you quite philosophical about all that?

Dr Steinberg: I am more an economist than a political scientist but I will try to answer. I think this is the key question. If the eurozone breaks up it will be because anti-Europe parties get into power, not because of bank X or bank Y collapsing or someone needing a bailout.

In the case of Spain, a number of elements make it less likely for this to happen in the next few years, so we still have quite a lot of room for manoeuvre. The reasons are the following. First, the Spanish political system is one that facilitates the formation of stable Governments in general by our electoral law, so small parties have a hard time getting a lot of seats. Secondly, there is a very strong identification in Spain between Europe and modernity, Europe and progress, Europe and the solutions to Spanish endemic problems, and this comes from Ortega y Gasset who said, famously, that Spain is the problem and Europe is the solution. As such, you do not see any anti-European party in Spain. You do not see it even in the Izquierda Unida, which we can call extreme left, if you want something like Syriza in Greece. We do not have an extreme right party in Spain, maybe because of our historical Franco regime tradition.

Therefore, it is very difficult to find an anti-Europe party emerging. I think that despite that we are seeing lots of protests by teachers and doctors. We have seen sectoral protests but no common element that could channel these protests towards the formation of an anti-European party. In fact, one of the parties that is rising as an alternative to the two big parties is one that would like to see more reforms faster, so it is more European than anti-European.

Secondly, on youth unemployment, which is a problem and not only in Spain, we have to be careful with the numbers in one sense. There are lots of students who would normally not be part of the labour force. They would not be an active population because they are studying, but given that their families are going through a difficult situation, many are looking for a job while they are studying, so they are becoming an active population where they would normally not be so. If you correct for that—we have done some studies at our institute—that puts the number down to approximately 35%. You can discuss how many of these will finally drop out from school or from university and end up looking for a job actively, but I would say those figures are a little bit exaggerated.

Another element that is important is that Spain has the highest number of home ownership as a percentage in Europe. Some 85% of families own their house, and 59% of them have already finished paying their mortgages completely. If you add that to the issue that family networks in Spain are quite strong, many young people can go back to live with their parents. That means that if you own your house and you have a little salary, you have something that is enough to survive and do not need to join movements that are really anti-system or anti-Europe. In that sense, I am not worried at this point. Of course, if there is no growth in three years I will be worried, but I do not foresee that.

Q68 Lord Boswell of Aynho: Thank you very much for that slightly reassuring account, and I realise it is important we do not take a literal account of the figures but, going behind it, there are always variations between particular regions, for example. Yours is a country that is differentiated by region and relative prosperity and—indeed, this is an issue that, as you know, is current in the UK—has some interesting pressures towards greater regional autonomy or even separation. How bad is it in some of your regions, and is that something that can be contained within the Spanish political system?

Dr Steinberg: Yes. I do not think there will be a separation of Catalonia or other regions from Spain. Honestly, I think that the nationalist government in Catalonia embarked on a risky bet. I think that they were making an electoral calculation because they anticipated the elections. They decided to do the elections earlier because they thought that in four years the recession would be over and, therefore, they would have a chance to win again, whereas if the elections were when they were supposed to be, the recession would still be there so they might lose. To justify changing the date of the elections, they constructed this idea of being much stronger and asking for a referendum on independence and so on.

I think that the result was not very successful in the sense that they did not get an overwhelming majority. They are still in power but in a coalition. I think that there has been a general feeling in Catalonia that maybe a majority of the population would like to be outside of Spain and inside the eurozone, but with a treaty in your hand that is not really possible and they know it. I do not know and I am not a political scientist—let me just say that clearly—but at this point I do not see that as a big risk as well. I understand that it is interesting from outside to see those developments and they are difficult to understand, but at this point I do not think that will happen.

Lord Boswell of Aynho: Just factually, presumably the greatest unemployment pressures are in the south, even if those are not the areas of greatest separatism?

Dr Steinberg: Yes. For that also, there is another element I did not mention before. The black economy, the informal economy is very large in Spain. Nobody knows how large, of course, but it has been estimated at between 18% and 23% of GDP and it has clearly gone up with the crisis. The southern regions, which have official rates of unemployment of about 30%, probably have a larger share of the black market economy and therefore their real unemployment rate is a bit lower. These are regions that are used to living with relatively high levels of unemployment. Even at the peak of the boom in Spain, average unemployment was 8%, which is still very high, and this has to do with the labour laws, but in the south it was higher than that. Again, I do not see that as risky or unsustainable if we see growth at some point in the next years.

Q69 Lord Dear: Thank you for coming. Can I ask you first about GEMU and the whole situation there? Although I know you cannot speak authoritatively about Italy and France, taking Spain, Italy and France as a sort of southern European economic belt, if you like, in your view is there any common ground in those three countries, particularly on how GEMU should develop? Internally, in your own country, in Spain, do you have what we call red lines, any rigid rules or constraints around GEMU or are you more flexible on the way it might develop?

Dr Steinberg: I think that Spain, France, Italy and the southern countries would share the view that we need a more active European Central Bank at this present moment to reduce the risks of pay risk reappearing, and more active monetary policy, both in the conventional way of lowering interest rates a little bit more but also on trying to secure funding or make funding available for small and medium-sized companies in southern Europe, which are really not getting the money. Therefore there is a problem with the transmission monetary policy mechanism, and the ECB designed the OMT policy to deal with that, but again more active, and also to depreciate a little bit in Europe in this context of currency wars we are in.

But at the end of the day, in the case of Spain, I think that the current Government is committed to structural reforms, and in that sense would like to be closer to Germany in the sense that the Spanish Government want to appear in front of Germany as a country that is serious about reform, that is taking the steps required to gain competitiveness, and therefore it is possible, in exchange, to ask for some more solidarity. I would say that, as a general view, southern countries in Europe want debt mutualisation, a big budget and so on, a more active ECB, as I said. But then at least Spain—I cannot speak for Italy or France—understands that it has nothing to gain by taking a confrontational approach towards Germany, because we understand that the only way to have a confrontational approach towards Germany is to threaten exit and that is not a credible threat for Spain. It could be for other countries but not for Spain.

In the second part of the question, which I think is very relevant, what are the red lines? I think Spain has no red lines, and let me explain. Spain, as I said before, tends to see more pulling of sovereignty and more giving up sovereignty—it depends what you want to call it—as something that is positive, and I would say this is unfortunate. This in part has to do with our own history. If you look at the recent history in Spain, most of the reforms that made us a prosperous nation after the Franco dictatorship were facilitated, if not imposed, by European integration. I see no big resistance. The average Spaniard wants economic growth and prosperity but does not care that much about giving up sovereignty, and this debate about legitimacy of the troika and so on is very much constrained, I think, to the current situation.

In France I think it is very different. France has an issue with a fiscal union. France would like to see all the carrots of the fiscal union, meaning a big budget and eurozone mutualisation of debt, but none of the sticks; that is, that Brussels can tell them they do not like their budget and they have to rewrite it. I think that France has an issue with that, but I do not think Spain has an issue with that. Spain is very interested in proceeding as fast as possible with banking union. I think this is a must for Spain because, as you know, there are still doubts about the sustainability of some of the banks in Spain after the banking bailout, and because we understand that to break down the vicious circles between sovereigns and banks it is essential to complete the banking union.

Also, we think that in banking union Spain has a priority, I think, which is to ensure equal treatment. We have seen some differentiated treatment depending on the country, and I think the government argues, and I would agree with that, that this is not a rules-based system. If we are really about rules, as the Germans say they are, we should have the same rules for all.

Lord Dear: A very short question on the north-south divide. There is a view in some of the popular press here, not necessarily the more esoteric press but the more popular press, that sooner or later, probably sooner, there will be some sort of north-south divide between the economies. From what you say, if I understand you correctly, that is not going to happen in the case of Spain and you would not want to see it.

Dr Steinberg: North-south divide? You mean creditors and debtors across the eurozone?

Lord Dear: Yes.

Dr Steinberg: I think that there is a division between north and south that has become explicit, as I said, between creditors and debtors. What I am saying is that at the end of the day in Spain the Government will not lead a group of southern European countries against Germany. I do not think that is going to happen.

Q70 Lord Davies of Stamford: Professor Steinberg, there has been an amazing range of developments and measures taken over the last three years, the bailouts, the bail-ins, the governance and stability pact, the fiscal co-ordination, the two-pack, the six-pack, the ESM, the conditional facility from the ECB since last September. One can hardly remember all that has been going on, and of course you and other countries have been going through your own austerity programmes, structural reform programmes and labour market reform programmes. We have the first stage of banking union in respect of common supervision. Do you think the essential elements are now in place to resolve this crisis and to create the right framework for our prosperity and new growth in the future in the European Union, or do you think there are any important elements lacking that still have yet to be conceived or developed?

Dr Steinberg: I think we have to distinguish that some of the elements that are in place are not for this crisis, they are for the next one. So far so good, to have them. Anticipating new macroeconomic imbalances in the eurozone is very important, but we need to solve the legacy assets problem, not the next imbalances problem.

Lord Davies of Stamford: There is no inconsistency in doing both things, is there?

Dr Steinberg: Of course, but what I am saying is that many of the things we have done were useful things but we are missing some elements to solve the crisis today, which would be basically the attitude of the European Central Bank, I think. As I said before, a more active policy and a recognition—and this came in the debate before—that in order to clean the sovereigns, or some sovereigns not Spain, you would need some haircuts and maybe the ECB to absorb some losses, first to purchase more bonds and then maybe to absorb some losses, I think that is going to happen, and the sooner we realise that this has to happen the better. The same goes for Greece. I think that Greece needs a second restructuring of its debt, and I think that that is going to happen after the German elections, but the sooner we do it the better. The IMF has said recently that they made a mistake not forcing a restructuring of the debt sooner.

To sum up, I think we need more action on the monetary side to compensate the fact that we have a very contractionary fiscal policy and that we will have a contractionary fiscal policy in the years to come because we have to bring down the deficits, and that is okay. That is a fact. Maybe we should slow down that pace a little bit, but we have to continue that, and to compensate for that we need more expansionary monetary policy and maybe some help through exports outside the eurozone.

Secondly, an understanding that the crisis has to be resolved not only by forcing adjustment and internal devaluation in the southern countries, but also through growth of wages in creditor countries, because I think the eurozone runs a big risk at this point, which is going into deflation. If we go into deflation things are going to be much worse. Why do I say that? If you take into account the inflation level in the eurozone area, it is coming down, and many countries in the south that have increased taxes are showing levels of inflation that are higher than they would be if you take this increase in taxes out, and that will happen next year. Greece is already in deflation. If we see deflation, deleveraging the financial sector is going to be much more difficult, and therefore I hope that the ECB is looking at that closely. It does not look like they are doing it, but I hope they are doing it. That concerns me.

Q71 Lord Carter of Coles: Dr Steinberg, you noted the importance of a banking union to Spain. Do you think that this is going to break the link between bank and sovereign debt and make it, therefore, much easier for your country to get on to a secure financing basis?

Dr Steinberg: I think a full and proper banking union would break that. It is not only the three legs we normally talk about, it is also the ability of the ESM to lend directly to banks, not to the sovereign. So direct bank recapitalisation is also very important and I think that is under negotiation but that should also be accelerated. If we get the full package, that would be enough. I am worried that we might not get the full package on time, the full package meaning single supervisory resolution fund with the ability to close down the banks and a common deposit insurance mechanism.

Lord Carter of Coles: Which bit of the package would you least like to lose? What would be the most dangerous for Spain?

Dr Steinberg: For Spain, what is essential is to have a single supervisory mechanism, basically because that sends a message that progress is on its way, not because at this point that would change anything that has to do with Spanish banks, and then very clear rules about resolution of banks with, if possible, a fiscal backstop that is credible, and by that I mean that uses more than private money. Now on the table is the idea that just the banks will finance that, and I think that we need something stronger. Probably not the ESM—I think the ESM is better for sovereigns and to create something else for banks, but something that is big, permanent and is there.

Lord Kerr of Kinlochard: By the way, I do not entirely accept that the influence of Spain had been close to zero and is now—

Dr Steinberg: I exaggerated. I am sorry.

Q72 Lord Kerr of Kinlochard: Having watched the influence that Prime Minister González had over Prime Minister Thatcher or having watched the Edinburgh European Council when it was perhaps Prime Minister González's triumph, I think you are unnecessarily modest. What about fiscal capacity and what about fiscal discipline? Is it particularly difficult in Spain, where the crisis did not result from fiscal ill-discipline, to contemplate the sort of structures that we find in, for example, the Franco-German paper? What is the Spanish reaction to that?

Dr Steinberg: I like the point you made that the fiscal deficits and the increasing debt in Spain were not the cause of the crisis, and I think this is something that we would like to re-enforce and to explain to the creditor countries. It is the consequence of the crisis. I think that there is an understanding in general in public opinion that you cannot live with permanent fiscal deficits. What I think that people would like to see—public opinion and the Government—is a reduction in the speed of adjustment. Within that framework, I think that there is no big resistance in Spain for that. Obviously, the problem is that that has to be negotiated, and the European Commission has given Spain more time now.

In a way, I would like to see the European institutions pressuring Spain much more on the structural reforms side than on the speed of the adjustment of the public sector deficit.

What is useful for Spain, coming from Europe, is the ability to have an external force that puts pressure on some industries or some sectors that need structural reform that have powerful lobbies inside, and that has been the history of Spain. That goes more to the idea of contracts, which we will talk about in a minute, I guess. In that sense I think that the Spanish population would like to see more of their reforms. Also, in the case of the cuts in the budget deficits, there are some issues of redistribution and how you make those cuts. That is an issue in public opinion, of course.

Lord Kerr of Kinlochard: Yes. How would fiscal transfers work? What sort of mechanism? Do you see a specific euro facility, as is proposed in the Franco-German paper, or contractual relations as proposed by the Chancellor, which presumably would have to have some sort of incentive attached to them, or a stick if not a carrot? There would have to be something. How do you see that working?

Dr Steinberg: I would like to see it. I doubt that it will be in place soon. I think that if we look at the theory of optimal currency areas, we all know that we need some sort of mechanism to transfer funds from one region to another if we have an asymmetric shock, and especially given what we have learned in the last decade, it is probably likely to happen at some point again that we have an asymmetric shock.

I think it is necessary for that to be there in the medium term. In the case of Spain we would like to see it relatively fast. In the case of Germany and other creditor countries—the Netherlands, Austria, Finland—what they have in mind is that they will do it only once the southern countries have Germanised their economies; that is, have made the structural reforms that Germany did in 2003 and 2004 under Schröder that, according to the German narrative, and I do not know if that is correct, prepared Germany to compete in globalisation.

I have some sympathy for that idea. I think that in southern Europe we have not understood what globalisation is about, and this is very serious. We have to make the structural reforms, we have to make these important changes in our economic structure, but I would like to see that as a voluntary process of reform domestically.

Going more precisely to your question, I think that it might happen as a fiscal capacity going within the eurozone, not at the European Union level probably—that is another issue—but very limited in size until Germany understands that the south has made these reforms.

Viscount Brookeborough: Would you like to tell us what you think about a potential euro area budget in the future: whether it is a very long way off, whether you would expect countries like your own to support it, and what you feel about it being funded and the new own resources that might be involved?

Dr Steinberg: This is interesting because all the people who see the European Union and study it with a lot of enthusiasm always talk about the necessity for a big budget. That never happened and what allowed transfers between countries was a financial crisis. This is in a way paradoxically that the money crosses borders when we have a big risk of falling apart. The discussion of the budget in a way takes much longer and it is not a decision you should have to make when you have the financial crisis in front of you. I think that if we go to this Genuine Economic and Monetary Union we would need to increase the size of the budget to put it at least at 7% of GDP, according to some of the estimates. There are many numbers, but I had this in mind as something that could make it operational, and that is probably not going to happen in the next decade, I would say.

I say 7% as a way to be able to fund the number of policies that we need to make the European Union work properly and the eurozone particularly, asymmetric shocks, but that would require an element of conditionality that is much stronger than what we have today. I would emphasise that, and this goes back to the idea of contracts, probably you need to have clear guidelines on how you spend that money. You need contracts for countries in the south, of course, but also for countries in the north if they do not do some of the reforms that the European Commission requires.

Viscount Brookeborough: Do you think that can only happen if it is an EU budget and therefore all the nations would have to be within the eurozone?

Dr Steinberg: What I envisage is the EU budget to stay as it is at 1%, and then an incremental budget for the eurozone.

Q73 Viscount Brookeborough: Yes, but do you think the eurozone would have to include every nation within Europe in order for there to be a euro area budget? We would have to take the euro.

Dr Steinberg: Yes. I see. I think it is possible to design it as a separate thing or to have opt-outs or different negotiating ways of countries that want to stay in the European Union and do not want to be in the euro. I think that is possible to design. I would say you have a budget for the EU and then a larger budget for the eurozone, and this could be made compatible but you probably have to have important negotiations or tough negotiations about how to do it.

Q74 Lord Vallance of Tummel: Can we move on to debt mutualisation? Is some form of mutualisation necessary for Spain and, if so, what form might that take that perhaps would allay some of the natural fears of the net creditors about markets?

Dr Steinberg: I think, for obvious reasons, all debtor countries would like to see full mutualisation tomorrow. That is not going to happen, and that is probably not a good idea also because, as I said, I think that what we have learnt in this crisis is that countries reform only under the pressure of financial markets. They do not reform under the pressure of the six-pack or the two-pack or their peers at the Commission. It will be necessary to have some form of mutualisation to fully solve the crisis, and that will have to include some of the legacy assets. As was mentioned previously, that is already happening somehow in the case of Ireland with the promissory notes, that the ECB accepts to monetise partially part of the debt informally, in other cases to extensions and reductions in interest rates of ESM loans.

From the different proposals, my view is that we will end up having something similar to the redemption fund proposed by the German economic experts, just because Germany is the hegemon in Europe today. Out of the different proposals, theirs will be taken more seriously.

Q75 Lord Carter of Coles: On the issue of varying levels of competitiveness, the question is: do we need continuous transfers to deal with those imbalances or is there another way of solving that problem if we want to keep the union together?

Dr Steinberg: I think that it is possible. As I said before, I am not particularly worried about competitiveness issues to solve the crisis, in the sense that I think that countries can adjust their unit labour costs through internal devaluation. If we take the six-pack seriously and therefore we use this instrument to monitor imbalances that are building up and countries take them seriously and there are changes in policies when those are identified, that would be enough and you would not need such strong adjustments in the future.

I have to say that what we have seen in the past decade in the eurozone is an asymmetric shock of enormous proportions because nobody understood what the euro was about, particularly financial markets. I think that markets have learned from this experience, and in the future the accumulation of imbalances, if it happens, will not be that large, even without the six-pack. With the six-pack it will be even smaller. In a way, I think that markets have understood that within an imperfect monetary union—and I think the euro will be an imperfect monetary union for many years to come because we will not have a full political union, which is required to have a United States of Europe or something like that—risk premiums between different bonds have to be there and that there is credit risk and there is sovereign risk even in a monetary union. This shock was too big, I think.

Lord Carter of Coles: How far do you think wages can be pushed down? We heard earlier that they have been pushed down by perhaps 15% already in Greece. What do you think will happen in Spain?

Dr Steinberg: I think that in Spain they will go down as much as necessary to start competitiveness. Let me explain. Given that there will not be anti-Europe parties getting into power, given that sectoral protests will be sectoral not general, I think, and given that people with property, which is most of the Spanish population, have a lot to lose from a complete breakdown and financial apocalypse, then we will do whatever it takes in terms of how much wages have to go down.

The key thing would be to have a narrative within Spain, which we do not have at this point, about how we share the burden of adjustment between the different groups, and why we are doing this. If we have the narrative, given that we have the courage in the population to do it, it will be much easier. We now are doing it but we need a new narrative.

Q76 Earl of Caithness: What is your view of the UK's position? You are entitled as participating members to take the drift in the direction that you want to. What is your reaction to a country like Britain, where we are saying we do not want to participate, but all the evidence that we have from British institutions is that you have to be there in the room, at the table, influencing the negotiations?

Dr Steinberg: Let me start by saying that I think the UK has made a very valuable contribution to the European Union in general and I hope it will continue to do it. I think that the European Union without the UK would not be what I would like to see. Having said that, for a number of reasons—I will give you only one—and this was mentioned before, I think that what the European Union countries will be doing in the next few years is a level of deeper integration that is unprecedented, and it is up to the UK to decide if it wants to be part of that fully or only to a certain extent. The other countries have nothing to say about that, of course.

What is perceived in a bad way, I think, in continental Europe is an obstructionist attitude of vetoing things. I think it is possible to maintain an agreement. It is absolutely possible to maintain the internal market and complete free trade, and even the business model or economic model of the UK, but the British Government have to be careful about not appearing to obstruct something that we think in continental Europe is absolutely essential for us to survive. If we can make a deal about it, that would be good.

Earl of Caithness: If you proceed with this further it will not be Genuine Economic and Monetary Union but perhaps, we hope, better economic and monetary union - do you see your attitude towards Britain changing or the need for Britain to change its attitude?

Dr Steinberg: I think that there is going to be a point, if we in the eurozone do this thing really well, where the UK is going to have to make a hard choice between being in or out, in the full package or out of the package. That will not happen soon but at some point I think it will happen. At that point I would love to see the UK in fully.

Q77 Lord Marlesford: You have indicated already that there need to be a lot of reforms in Spain, particularly on the tax front, and to try to stimulate the economy to deal with the very high unemployment that you still have. There is one area in which I do not understand Spanish policy at all: VAT, value-added tax. In Britain, you do not have to register for VAT until you have a turnover of €90,000, which means that a painter who paints my house is a single employed person; I do not pay 20% extra if I employ a big company. Your threshold, the only country in the EU, is zero. In other words, everybody has to register for VAT. Why do you have such a totally different system and neglect the huge employment opportunities you give to small craftsmen and people by having a VAT threshold?

Dr Steinberg: I have to say I am not a fiscal expert so I do not have a thorough response to that. I guess that we have in Spain a number of elements of red tape and bureaucratic difficulties that affect small and medium-sized companies, and that would be one of those as well. This is one of the places where some level of tax harmonisation coming from the EU to us, if this is actually a big problem, would be more than welcome, but I cannot give you an answer on the specifics of why that is the case.

Lord Marlesford: Each country in the EU fixes its own threshold. The Spanish Government could say tomorrow, "We will have, say, a €50,000 threshold". Then a lot of little people who are out of work could get jobs and paint people's houses.

Dr Steinberg: Yes. This probably has to do with the law tradition in Spain that is somehow different from yours.

Lord Marlesford: Perhaps a change needs to be made.

Dr Steinberg: I am all for tax harmonisation within the European Union if we can all agree on the grounds of changing things we are doing wrong.

Lord Hamilton of Epsom: Presumably a lot of people do have the work in Spain and do paint Mark's house and they get paid in cash, and that contributes to the black market.

Dr Steinberg: Yes. It is true it is probably an element that really forms the black market economy.

The Chairman: Seňor Steinberg, muchas gracias first of all. You are the witness that we have been missing all along. What has been so refreshing in your evidence to us is not only to have a better understanding of a country like Spain, but also the wise words you had in getting us to think about the southern mentality in all this with GEMU, and of course to identify the source of potential problems or solving the matter with France. So we are extremely grateful for you coming over today and we would ask you to look at the transcript but I can say that if there is anything further you might add to what has been such an illuminating session we would be most grateful if you would do that for us. In the meantime, do keep in touch and we hope to see you before us many times in the future. Many thanks indeed.