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Otmar Issing and Jan Pieter Krahnen

Transcript of a hearing before Members of the House of Lords (UK) in Frankfurt on

Genuine Economic and Monetary Union and its Implication for the UK

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Inquiry on

Genuine Economic and Monetary Union

and its Implications for the UK

Transcript of evidence taken before the Select Committee on the European Union Economic and Financial Affairs (Sub-Committee A) of the British House of Lords

Friday, 8 November 2013

Witnesses: Professor Jan Pieter Krahnen and Professor Otmar Issing[1]

Members present: Lord Harrison (The Chairman), Viscount Brookeborough, Lord Davies of Stamford, Lord Flight, Baroness Maddock, Lord Marlesford

Abstract

On November 8, 2013, several members of the British House of Lords' Subcommittee A conducted a hearing at the ECB in Frankfurt, Germany, on "Genuine Economic and Monetary Union and its Implications for the UK". Professors Otmar Issing and Jan Pieter Krahnen were called as expert witnesses.

The testimony began with a general discussion on the elements considered necessary for a functioning internal market. Do economic union and monetary union require a fiscal union or even a political union, beyond the elements of the banking union currently being prepared? In this context, also the critique of the German current account surplus and the international expectations that Germany stimulate internal demand to support growth in crisis countries, were discussed.

With regard to the monetary union, the members of the subcommittee asked for an assessment of how European nations and the banking industry would have fared in the banking crisis that followed the Lehman collapse, had there not been a common currency. Given the important role that the ECB has played in the course of the crisis management, the members further asked for an evaluation of the OMT-program of the ECB and also if the monetary union is in need of common debt instruments, in order to provide the ECB with the possibility of buying EU liabilities, comparable to the Fed buying US Treasury bonds. Finally, the dual role of the ECB for monetary policy and banking supervision was an issue touched on by several questions.

[1] Professor Claudia Buch, President of the Halle Institute for Economic Research (IWH) was also present as a witness. This version of the transcript only contains shortened contributions of Professor Otmar Issing and Professor Jan Krahnen. The full transcript is available for download at: http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/GEMU/cEUA081113ev25.pdf.

The Chairman:

Professor Otmar Issing and Professor Jan Pieter Krahnen, many thanks indeed for coming before Sub-Committee A on this inquiry that we are pursuing on genuine economic and monetary union.

Professor Issing, you could start us off by analysing the proposed architecture of the genuine economic and monetary union, telling us those elements that you think are necessary and with which we should press ahead, and those which may be less necessary and possibly even unhelpful.

Professor Otmar Issing:

I cannot hide that I am critical of the term genuine or "echte" monetary union. The term is misleading in two ways. First, it gives the implicit message that without these four packages—economic, fiscal, banking and political union—a monetary union is not viable. When we started with the euro it was a fact that political union was not around the corner, so the question was: can this arrangement survive?

The term genuine economic and monetary union implies that it cannot survive—we need political union—and I think that this is wrong. For that to happen, the appropriate framework of surveillance and control of financial markets must be in place. For a long time to come, and I do not speculate about the very distant future, monetary union can survive without political union.

My second concern why the term is misleading is that it suggests that political union could happen, realistically, in the near future. I think that that is not the case. If you talk to high-ranking politicians, and so on, in any country, it is a vision, yes, but almost nobody believes that we will have real political union in the foreseeable future. If you accept this premise it will have dramatic consequences because any intermediate steps might land in a transfer union without corresponding political or democratic legitimacy. This implies that the principle "no taxation without representation", which for me is key in any democracy, is violated.

The Chairman:

That is really helpful. Professor Krahnen, perhaps you could add to or subtract from what we have heard.

Professor Jan Pieter Krahnen:

If we put it all together we will see that the basic issue that we have to deal with concisely and correctly is how to set up a banking union. How can we deliver some aspect of fiscal co-ordination that is the backstop for the banking union without going a step too far? If we have these layers: the banking union, the fiscal union, the political or economic union at the top, we are all agreed that there will not be this third level. We will get to the second one, to some extent, maybe to the extent needed to make the banking industry again market-oriented, where the market forces prevail and market discipline can be observed. As Otmar Issing said, control by financial markets should function again, which does not happen right now. For that, we need some sort of co-ordination that has some aspects of fiscal union, although it is not there entirely.

Lord Marlesford:

The US Treasury has said that the Germans should use their surpluses to generate growth in favour of other countries and that other countries with surpluses should do the same. This is quite a strange idea when you do not have a union. What do you feel about that?

Professor Otmar Issing:

The IMF and the Americans have made this case many times in the past, so every economist in Germany is well prepared for this question. To have a current account balance as a policy target is fundamentally wrong. There is one case in which international arguments are valid. This is the case when the exchange rate is manipulated. When the Chinese, for example, suppressed the appreciation of their currency, their surplus was artificially created. This manipulation of the exchange rate does not happen in Germany. In Germany, we do not have an output gap; we have an extremely lax expansionary monetary policy. We have a more or less balanced fiscal policy. We are close to what might be called full employment. We have a debt ratio of 80%. Why the hell should a country in such a situation stimulate demand by increasing public debt? This is against any reasonable economics.

Lord Marlesford:

Professor Krahnen, we heard during our discussions in Berlin that in the process of forming the coalition the SPD is rather anxious to get some form of government action to change private sector investment from overseas into domestic. That is not dissimilar to what the Americans are suggesting. Would you like to comment on that?

Professor Jan Pieter Krahnen:

I do not understand the economic logic of it, so it is going to be difficult for me to comment. We should not forget that Germany is part of a larger internal market in the European Union and the eurozone. For that reason, if I were to apply the same argument to the US, I would say that we should look at California, Massachusetts or even New York City, for that matter, to see whether they have imbalances in their current accounts and, based on that, come to a conclusion on whether they should invest less or more.

Lord Flight:

If we accept the logic of Professor Issing's argument, which I do, what seems to follow is that if Germany naturally has a surplus but the deficit countries are forced into surplus as a result of economic measures, the overall effect will be to put upward pressure on the euro. That is rather inconvenient for an economy like Italy which is struggling to get out of its debt trajectory. We have to look at the effect on the whole picture. Again, the logic of Professor Issing is to say, "So be it. They will have to tighten their belts even more." However, that begins to risk becoming politically unpleasant, as one saw in the effect of the Gold Standard in the 1930s.

Professor Otmar Issing:

I agree that the dimension of this problem is twofold. The first is the international one. Germany's surplus is rising against trade partners outside the monetary union. Inside the monetary union, the balance is shrinking. This process is going in the right direction; it is a balancing process. What is also wrong about what can be called the American argument is that within Europe—let us take Spain as an example—exports are now strongly increasing. What we need is not just expansion in Germany. Many studies have been published to show that the multiplier for neighbouring countries is very low. Even if Germany were to have a high deficit in its public spending, the impact on Spain and Italy would be almost invisible. It would be stronger in the Czech Republic, Poland et cetera. Finally, what is needed in countries like Spain, Portugal, Italy and so on is a change in the internal structure of production and economic activity from non-tradables to tradables. This is not a basic argument about macroeconomic demand, it is about competitiveness, unit labour costs and so on. This is now happening in Spain. Progress is slow and it should be faster, but it is happening, and that demonstrates once again that this is not just an issue of macroeconomic demand: it is mainly about the composition of activity. These countries need to change from non-tradable services and home-based industries to export-oriented business. This process is under way.

Lord Davies of Stamford:

I totally agree with Professor Issing—I think your comments are very persuasive. I have been very struck and pleasantly surprised by the extent to which wages in these countries are not sticky, whether in real terms or nominal terms, in the way that many of us had feared.

Professor Issing, when the euro project was being conceived and implemented, you had the reputation of being very sceptical, if not hostile, towards it. Can I ask you now, in the light of that experience, how you assess that particular project? What have been the failures and the successes? Had we not had the euro, and retained national currencies, is it your view that a banking crisis such as the one triggered by Lehman and so forth would have produced worse or better outcomes in the real economy? Would output and employment and so forth be higher or lower than in a situation in which we had separate national currencies? Or, to put the same question the other way round, would a foreign currency crisis, added to a banking crisis, have made the outcomes for the real economy worse?

Professor Otmar Issing:

Can you stay over the weekend? This is a long story. First, I should say that I was never hostile—that goes too far. I was sceptical. Even when I was at the European Parliament, testifying during the appointment process, I said that it was an experiment but that if I passed the process and was appointed I would try to do everything I could to make the experiment a success. Just on monetary policy issues, the euro is a success: it is a stable currency, the exchange rate is strong and it is the second most important international currency—some distance from the US dollar but undisputed in its place. However, what comes first is price stability. My critical position was unfortunately confirmed very early on when the euro started. I stress that evidence, otherwise it looks like an argument from hindsight. In the early years, I gave many speeches and when I came back and my colleagues in the ECB asked me, "Otmar, are you still against the euro?" I said that I was never against it, and was not against it now, but that I saw the weaknesses and the problems that will come. Those people who see problems and try to solve them should not be blamed as being "hostile" to the project. Just the opposite is true. This development led to a crisis which was foreseeable. It was a result of a failure of national policies relating to labour costs, divergence in competitiveness, manipulation of the stability and growth pact, and the boom in housing markets in some countries. This combination of causes led to the depths of the crisis.

My good friend Martin Feldstein, the famous Harvard economist, was always a strong opponent of the euro. He wrote an article a year ago, saying that Europeans—by that he meant the members of the monetary union—have problems now that they would not have had without it. To some extent that is true, but the question is what problems we would have had if we did not have the euro. In his latest article, he has said that leaving the euro or dissolving it now would create more problems than staying in. With or without, it is very difficult to prove.

My thinking is still deeply informed by what is known as Black Wednesday—or White Wednesday—in September 1992. I am not talking so much about the UK exit from the exchange rate mechanism but about the Italian lira. The lira was devalued against the DM in a short period of time by over 30%. For me, the key issue of European economic integration is the single market. I am convinced that the single market would not have survived another September 1992. At that time, many companies went bankrupt or asked for import restrictions or export subsidies. I think it is hard to argue that countries living so closely together and so connected in trade and finance etc. should have flexible exchange rates. Theory and empirics argue the opposite. As soon as you go in the direction of fixing exchange rates, you end up in the situation that leads more or less to monetary union. Who would believe in the irreversibility of fixed exchange rates that are fixed only on paper? On balance, the problems would have been greater. Dissolving the euro would create a political and economic mess. I would say that the experiment will continue.

Professor Jan Pieter Krahnen:

One aspect that I find most interesting is that we spent many years interpreting the convergence of interest rates in Europe. I remember being in conferences here in this building, with people from all around the world, discussing what the reason was for the convergence of interest rates across Europe. There was a belief on the part of many people that it showed that we had somehow equalised competitiveness across Europe. That is why prices fell for debt and became so similar. That was a misunderstanding and we now know much better. We have to get rid of the mistake that an implicit government guarantee produces in markets: namely, uniform prices for debt. They are only uniform because of the guarantee, not because of the risks. For me, that is the main lesson that we have to take from the first years of monetary union. We have to be very careful to get rid of implicit government guarantees for funding in markets.

Lord Davies of Stamford:

Professor Issing, can I take you forward to something which you could not have anticipated, any more than I or anybody could, at the time when monetary union was set up? That is the development of outright monetary transactions. I wonder whether you feel that that is an acceptable and sensible development or whether you think that it is dangerous and takes monetary authority into fiscal policy.

Professor Otmar Issing:

You put me in a very difficult situation because when I left this institution, I swore to myself that I would never comment on the monetary policy of the ECB. For example, yesterday some journalists asked me to comment on the decision to reduce the interest rate. I declined, of course, but I have commented on the OMT. I comment because I do not think it is monetary policy. It goes back to May 2010 and the famous weekend when it was obvious that Governments should have supported those countries under pressure with fiscal measures but were unable and/or unwilling to do so. So the ECB came in as the last resort, which demonstrated that it was a substitute for fiscal actions. I hope that the OMT will never be implemented. If it is implemented, it is so obvious to me that it is a substitute for fiscal policies because it cannot be compared with the Bank of England buying UK government bonds or the Fed buying the US Treasury's. It is a selective buying of the bonds of some countries and not of others. This is not monetary policy; this is something for which, in the end, you need a political decision, political support and, finally, democratic legitimacy. That is not happening.

Lord Davies of Stamford:

That is a very interesting and clear answer, but it opens up and begs a very important question. **The trouble is that the ECB, as we know, does not have the obvious instruments with which to conduct monetary policy that classic central banks such as the Fed and the Bank of England have. It cannot use, for example, an EU liability because there are no issued EU liabilities. Should the EU issue either longer-term bonds or shorter-term Treasury bills, which the ECB could use in normal circumstances as the instrument for open-market operations in exactly that classic way?** Would that not be a help in present circumstances, when interest rates are extremely low? It would surely be useful to have other arms or instruments available. For example, in America and the UK we are using quantitative easing, which again requires such an objective instrument. My technical question to you, Prof. Issing, is: would it not help the ECB to concentrate on its monetary function, and do that more effectively, if it had that additional instrument available, particularly at the low levels that interest rates have now reached, when classic interest rate policy is not so effective? That is a technical question, not a political question.

Professor Otmar Issing:

Just to be very short, if it is about fighting the risk of deflation—is this the issue you are talking about?

Lord Davies of Stamford:

Well, combating monetary policy. At the moment that happens to be the risk. Sometimes the risk is inflation.

Professor Otmar Issing:

No, I agree. If this threat exists; I do not think that this threat exists now, but let us call it a technical question. In case of deflationary threats, the ECB could, to make it comparable to a policy of the Bank of England or the Fed, buy proportionally bonds of all member countries, according to their GDP weight. Then it would be comparable and not discriminatory; it would be purely a monetary policy instrument. However, to create EU bonds—or whatever you call them—to help the ECB would be a poisoned instrument. We do not need it for technical reasons and it would open the door to all requests to mutualise debt.

Professor Jan Pieter Krahnen:

On this, I fully agree. The whole idea that we need a special instrument to conduct monetary policy in the way that it should be conducted bypasses the very obvious solution, which is the one that Otmar Issing just outlined.

Baroness Maddock:

I will continue on the role of the European Central Bank. The role of the troika has led to the bank taking on both the crisis management and surveillance role. Do you think that this is a task that the ECB is suited to, and is it comfortable with that?

Professor Jan Pieter Krahnen:

It is important that the ECB is involved in this process. I sense that the direction of your question is that it is suited for carrying out that role in the troika setting given the institutional limitations that we face at the moment. We do not have any other agency that could basically be mandated with the role of overseeing the fiscal discipline and structural reforms needed in other countries to become competitive again.

Professor Otmar Issing:

This has two sides. On the one hand, the ECB has a very strong position insofar as it is most suited to insist on commitments, etc. The Commission is more or less under political pressure and the IMF changes its views from time to time, so in this respect it is highly welcome that the ECB is participating. However, you need to weigh it against arguments which speak strongly against; that in the end, the ECB will be involved in national politics, etc. If you see that now the European Parliament has established, I think, a committee to do a survey on what has happened, the ECB will be drawn into politics. On balance, that is detrimental for the reputation of the ECB, but it was probably unavoidable. On the one hand I know that politicians tell you, “You are always criticising, but if we ask you to participate, then you say, ‘We are independent—it is not our business’”. So it is a very difficult situation for the ECB, this strange, unique institution that is a currency and a central bank for 17 countries. The device should be to stay out of politics as far as possible.

Lord Flight:

There has been a ducking of a fundamental issue, which is the model of, say, currency union: let internal devaluation deal with things, you cannot have any cross subsidies, and so forth. What Italy in particular has demonstrated is that the social costs are incredibly high. Can internal devaluations work adequately? Italy has not grown for 10 years and has something like 50% youth unemployment. It is fine to talk the theory of it, but the social cost to a generation is very high. Moreover, ultimately there is the risk of serious political instability, which was in essence caused in Europe in the 1930s by the gold standard. The other side of the coin of the model that we are all talking about needs to be focused on this and we need to ask whether that is sustainable.

On the issue of supervision the only issue is that if the monetary authority is also the body doing the stress testing, they happen to cock up the testing and a bank collapses or gets into trouble, is there a risk that they have damaged their reputation and damaged confidence in the market? Secondly, and more importantly, in the whole area of the single resolution mechanism, I am still slightly unclear on what is intended. Part of the desired effect is to separate bank debt problems and sovereign debt problems. However, if you say that most of the resolutions have to be done by the country in question, like Ireland and Spain you are pushing it straight back onto the state and worsening the state bank problems. I think we are saying that the ESM pot is there only to be used in a crisis, and the decision is that it has to be the Governments, and if it worsens their debt problem, hard luck, although whether people will want to buy their debt as a result is slightly another matter. The idea that it is just left to the countries in question is not a very good answer, because it risks worsening the whole country debt problem with countries that are in trouble.

Finally, the common deposit insurance scheme seems to me to be about stopping everyone rushing to take their deposits out of an Italian bank and putting them into a German bank, because they have suddenly woken up to the fact that Italian euros might be rather less reliable than German euros. **Unless there is a common deposit arrangement, you still have that vulnerability when things start to go sour, which we saw a couple of years ago and will probably see again later next year as the Italian economy really hits the rocks.**

The Chairman:

Professor Krahnen, would you like to find a couple of questions from all that that you can possibly answer?

Professor Jan Pieter Krahnen:

Yes, with pleasure. I shall start on the general point and then go on to the instruments. Do I support the general idea of the banking union? That has several parts. I fully support this concept. I think that it has several elements; you mentioned some of them. There is the single supervisor and the single resolution, deposit insurance and the single resolution fund. The whole funding part is a major issue; without it, the whole thing will not work. So in a way it is a very subtle construction, like a building, but it will be stable and solid if it has all the angles in place. Let me say a few words on these elements. On the single supervisory mechanism, it is very important to get rid of national interests. Moving it to a European place will get rid of much of the national protective energy, which is very much true of Germany and France—for the big countries—and also true of the UK, of course.

The single resolution mechanism is an important issue in itself; it has to be functional, strong enough to do the job, and have its own data access and its own staffing. Those are all issues on which it is a bit uncertain whether it will go in that direction. A very important issue that I mentioned at the beginning is the resolution fund, which needs to be set up. This is not simply an issue of national versus European; I think that we will come up with a more intelligent way in which to deal with the issue. We may start with national funds and we may have European funds in an intermediate range before it goes back to the national budget. So we have private national and European reinsurance, as you could call it; we have public national as a third layer and, as a fourth layer only, the ESM, which backs up the nation state if there is some interlinking between bank failure and state failure, so to speak. I think that these are the main issues. We did not talk about the resolution and recovery directive, the basic legal framework under which all this is functioning.

Lord Flight:

Deposit insurance you have not talked about.

Professor Jan Pieter Krahnen:

Right. For deposit insurance, it is a parallel thing, as with the resolution funding; it should follow the same idea of a layered system. We have national practice so we should use it and equalise it across Europe so that there are equal standards. Then you have the European reinsurance system. On the third layer, it falls back on the national fiscal authorities to some extent—before they get back-up, basically. Then only a European back-up would stand behind that.

The Chairman:

Professor Issing, I wonder whether you could cover the same ground, perhaps starting where Professor Krahnen talked about national supervisory bodies needing to be reformed into the ECB's role of supervising. Would that be a necessary step?

Professor Otmar Issing:

There is probably no country in which national supervision has not failed. So it is a huge challenge for the ECB to be neutral and objective, and supervision will not be easy. There will be political pressure and, despite having a large staff, it is not so big in relation to the task. It will always depend on national information. This is a critical point. I was member of the de Larosière commission, which warned strongly against mandating the ECB with banking supervision because of potential conflicts with monetary policy, and being involved in politics. When it comes to rescues and so on, you have to deal with national politicians. So it is a huge challenge. If you compare the experience of the past, the ECB has the chance to do much better. But the proof of the pudding is in the eating, so we have to wait. The ECB recognises this as a challenge to its reputation.

Lord Marlesford:

I was struck by Professor Issing saying that that there is no central bank that has not failed to supervise. The point is that when the ECB announces the result of the stress tests, there will be a risk that the markets will ask what is the total sum that will be needed and where will it come from. It has been suggested that there should be something more sophisticated than the single fund. The maximum figure for the single fund sum mentioned so far in Brussels has been €500 billion, but we have no idea what the fund will be, so how is this going to be handled, how will the ECB keep confidence and keep the show on the road?

Professor Jan Pieter Krahnen:

I think that the ECB has moved cleverly, because it has said, "Let us fix the date of the test first. Let us talk about the seriousness of our conditions first", and put them in place. It is like saying, "Check". Now the move is on the other side. The speed has a lot to do with the speed of markets. My expectation is that markets will pretty soon come up with estimates of what type of correction is needed on the capital side for the European banking system. It is the nation states who have to move now, not the European Commission. In particular, I think that the German and the French Governments have to get their act together and make a decision on how such a back-up could be funded, not leaving it entirely to the nation states to come up with a back-up which of course, in the eyes of the market, will not be credible. I am actually optimistic that this backstop will come up.

Professor Otmar Issing:

I think that it is a complex process. The starting point for genuine monetary union is that, if national authorities had not failed, nobody today would talk about the need for banking union. Open financial markets could have worked perfectly in a well supervised and regulated system, so it is about correcting failures. I would be more hesitant about bringing in the resolution fund and deposit insurance too early as European solutions. If you think for a moment that Germany would ask Italian and Spanish taxpayers to pay e.g. for terrible mistakes that the German bank, HRE, has made, all would say that you are crazy. If you put it the other way round, they say that this is a sign of solidarity. That says something about the quality of the argument. If we leave it to the European level to deal with legacy problems, the ESM will very soon be exhausted. It was created for different purposes.

Lord Davies of Stamford:

I am most grateful. I have been thinking, Professor Issing, about your proposal that the ECB could perfectly well use a weighted portfolio of member state liabilities for open-market operations, including QE if they want to do it, and that there is no need, for this purpose at least, for eurobills. I have not had a chance to put that to the ECB. I am sure that it has thought it through, but I have no idea what its response would be. However, I suspect that its response might be that it is technically not feasible because some member states have not issued a sufficient amount of debt. Some states may not have issued any short-term debt and there may be very few longer-term bonds close to maturity.

It would be a terrible conflict of interest if the central bank bought interest rate-sensitive debt. That would not be a sensible idea at all. I am sure you agree with me. There may be technical problems of that kind. Romania, I know, has a debt ratio of 30%, so you might not be able to put together a weighted portfolio with sufficient amounts to be able to conduct those open-market operations. How would you react to that possible difficulty?

Professor Otmar Issing:

In short, I think that this is a minor technical problem. If a country like Latvia has not issued any debt at all, we ignore it.

Lord Davies of Stamford:

But then immediately people like you will say that this is the ECB moving into fiscal policy and that it is making political choices and selections.

Professor Otmar Issing:

No, the country does not provide something you can buy, so you can leave it out without any major conflict with the basic idea.

Baroness Maddock:

I wanted to talk particularly about the position of the United Kingdom, because we are not going to take part in much of this. One of our main concerns has been how this affects the single market. If I quote correctly, I think Professor Issing said that the single market would not have survived without the euro. I found that very interesting. Do you think that the position that the United Kingdom is taking is realistic? How else should we try and engage with this whole agenda?

Professor Jan Pieter Krahnen:

My basic premise is that, given the current crisis, the most important issue we are facing in Europe is systemic risk in the banking industry that brings us to the brink of collapse. This applies also at state level, but it was caused by the banking crisis. My point of departure is how we get there. The big challenge for the time after the financial crisis is to avoid any reappearance of that constant systemic risk being part of our decision-making. I do not think that that can be achieved without some co-ordination among the big European countries, in particular the UK and others. In that sense, I cannot imagine that, even if one tries to move apart and distance oneself, the issue will go away. Financial markets and banking markets in particular are so highly integrated that the power of politicians to cook their own meal basically is much more limited than many people still remember from history. It was different. Now we are in a flow of financial market dependency that will make us behave better, in a co-ordinated way, to protect and preserve a minimum of manoeuvrability for our national boat. This cannot go on independently any longer.

Professor Otmar Issing:

The contribution of the UK within EU concepts is so important that we should make regulation as light as possible. Its strength is needed. It is in your interests and it is in the interests of Europe. To conclude, as you referred to my remark on the euro and the single market, I shall be a bit teasing here, if you will forgive me. The people across the Channel are very critical of what is happening in what you call Europe, and with most of the criticism I agree. However, if the situation in the UK over time became so strong and much better than on the Continent, I would expect, if it was based on something fundamental, that the pound sterling would appreciate like the Swiss franc. If it is not happening, it is not a sign of strength. But if it did happen, I think that businesses and people in the UK would think twice about having an extremely strong pound, with all the problems that you have avoided so far. There we come back to the currency and the single market.

The Chairman:

We are most grateful to you.