



# HOUSE OF LORDS

Unrevised transcript of evidence taken before

## **The Select Committee on the European Union**

Economic and Financial Affairs (Sub-Committee A)

Inquiry on

## **GENUINE ECONOMIC AND MONETARY UNION AND ITS IMPLICATIONS FOR THE UK**

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**10.50 am**

**Witness: Lorenzo Codogno**

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### Members present

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

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### Examination of Witness

**Lorenzo Codogno**, Department of the Treasury, Italian Ministry of Economy and Finance

**Q197 The Chairman:** Buonjourno, Signor Codogno. Mi chiama Lyndon Harrison. Primo, vorrei dire che siamo molto contenti di discutere con lei stamattina tutti i problema finanziari Europei. Ora parliamo in Inglese. Thank you very much for appearing before the Committee this morning. I hope you can hear us very plainly. We have a number of questions to ask you. Perhaps I should tell you that we will send you a transcript of our exchanges. We would be most grateful if you could correct that and improve on it if you have further thoughts later on when you see it. We would be so grateful to you if you had any further thoughts to help us with our study, which we hope to publish around Christmas. Do you want to say anything to start?

**Lorenzo Codogno:** First of all, thank you Lord Chairman. It is a privilege and I very much appreciate being here today to act as a witness to your inquiry. I hope that I will be able to provide you with a small contribution.

**The Chairman:** Thank you very much. Perhaps we can start with the question of which elements of genuine economic and monetary union you believe are necessary to pursue and

which are unnecessary. In fact, which elements might be harmful to the ambition to achieve a genuine economic and monetary union?

**Lorenzo Codogno:** You are certainly aware that a roadmap has been put forward by the President of the EU Council and that several documents have been published on the topic already by the Commission. It is clear that in order to achieve a successful union, we have to go the full way, meaning economic, monetary, fiscal and eventually political union. All these steps are necessary. Of course, some steps are more urgent than others. I am referring to the banking union, which is the key achievement that needs to be decided in the very near term.

**The Chairman:** Do you think that the supervisory mechanism, the resolution mechanism and the deposit guarantee scheme are all essential, or do they have to line up in a queue before they are done or achieved? Are any of them expendable?

**Lorenzo Codogno:** As you certainly know, there are three elements of banking union: the single supervisory authority, the single resolution mechanism, and the depository insurance. The latter is probably not strictly necessary, although it would be desirable. The first two are absolutely essential. A decision has already been made on supervision, and the ECB, together with the system of European central banks, will deliver on that over the next few months. There is still debate over the single resolution mechanism and negotiations are probably not proceeding with the speed that would be desirable.

**The Chairman:** On Thursday of this week we may have the financial markets in turmoil if our American colleagues do not find a resolution to their own financial problems. Do you think the new set up of genuine economic and monetary union is capable of suffering and dealing with an asymmetric shock of that kind?

**Lorenzo Codogno:** That is its purpose. Whether that will be the case is still to be seen, but the economic and monetary union is now in better shape to withstand such a shock should

it occur. The idea is to make the whole economic and monetary union more resilient to any shock in the future, including shocks like the one you mentioned.

**The Chairman:** Thank you very much indeed.

**Q198 Lord Kerr of Kinlochard:** Director-General, you have spoken so far about what is necessary for Europe. You are in a very strong position to do that because, like some of your predecessors, you play a central role in the Brussels debate. Could you enlighten us on what is necessary for Italy and how Italy sees the priorities, if you can distinguish between Italian and European interests?

**Lorenzo Codogno:** First of all, European interests are not different from Italian interests. We are very much committed as a country to achieving economic integration. Certainly you are aware that Italy over the years has always been very keen to achieve integration. I still remember my Minister, Mr Padoa-Schioppa, claiming long before the crisis that we needed to achieve a banking union and a much more integrated financial system in Europe to withstand potential shocks. Indeed, he was right. We have unfortunately learnt the hard way that we need a much more integrated financial and economic system to make it resilient to any given crisis coming from outside the region. There is a strong rationale for making the monetary union resilient to exogenous and asymmetric shocks. It is a matter of priority for European authorities to make sure that that happens. There is a long road, however, between the current situation and reaching the final objective. Europe is still a work in progress, which inevitably means that, to some extent, the monetary union is still vulnerable. Europe has made significant progress since the outset of the crisis in putting in place mechanisms and facilities that can respond quickly to any shock that might come from outside the region.

**Lord Kerr of Kinlochard:** You are quite right to disagree with me. Had we listened to Mr Padoa-Schioppa at Maastricht, the world would be a better place today. I would like to press

you a little on the Italian position. What about mutualisation of debt or Eurobonds? These do not look to me to be a high priority in German policy. Are they a high priority in Italian policy?

**Lorenzo Codogno:** You are certainly right that at the moment it seems that the issue of Eurobonds is a bit outside the radar screen of the debate in Brussels. Certainly some countries are strongly opposing any such development. The Italian position has always been in favour of some sort of mutualisation of the European debt. We also understand that to achieve mutualisation of debt Europe has to achieve a higher degree of integration, particularly fiscal integration. Of course, Europe also needs a centralised fiscal authority. The two things come together. In other words, if you have to have a single debt in Europe, you must also have a fiscal authority that is in command. That is clearly an essential requirement. Of course, to the extent that you have a common debt in Europe, you also have to give up some sovereignty to European authorities. That is the other essential ingredient. Italy understands that. Historically, the position of the Italian Government has always been in favour of some form of mutualisation of debt over time. This is not going to come over the next few months or even years, but it should be an overreaching objective for the economic and monetary union going forward.

**Lord Kerr of Kinlochard:** If there was debt mutualisation, how much conditionality would the Italian political system be prepared to accept?

**Lorenzo Codogno:** I think there is a growing understanding that we live in an increasingly integrated world. Europe is increasingly integrated as well. Not long ago, European leaders were unwilling to accept that their economies were strongly linked with each other. Now, perceptions have changed a lot. Public opinion has not yet fully changed, but it will over time. It is key for the future of Europe to make sure that voters and the general population fully understand that the situation calls for achieving a higher degree of integration, which

inevitably means that each country has to give up some power at the national level, some sovereignty. I think political leaders are increasingly aware. Public opinion is becoming increasingly aware as well, but it will take more time.

**Lord Kerr of Kinlochard:** Can I press you once more on Italy, specifically? Going back to the Italian presidency in 2000, the Italian economy has grown since then by 0.3%, the Commission tells us. That is in the 13 years that have passed since then. What is needed to shift the Italian economy into a higher gear to bring back growth? It seems to me that the domestic acceptability of Brussels conditionality is bound to be dependent on perceived results, and so far, if I were Italian, I would say that for all my ambitions and beliefs in Europe, it has not exactly delivered since 2000.

**Lorenzo Codogno:** You are probably right in the sense that the general perception is that Europe has not delivered on the ambition of bringing stability and growth for the countries participating in monetary union and the European Union. At the same time, the responsibility for that lies as much in European capitals as in Brussels. There is a growing understanding that our objectives are not disentangled from those of the whole Union and the objectives that are pursued in Brussels. Italy has done quite a lot over the years to improve its structural position. Needless to say that especially the past couple of Governments have done a lot to introduce structural measures. Let me mention that Italy has introduced a significant pension reform that brings its pension system up to state of the art internationally. Italian Governments have introduced a number of product market reforms over the years that are now gradually showing their results, and a major labour market reform last year. The Italian economic situation is in a much better position now, on a structural basis, than 10 years ago. I certainly acknowledge the fact that Italy needs to do more. Europe provides some help with that.

The pressure from European leaders and other countries goes in the right direction. The European surveillance process and the European semester basically provide support to our own reform process and will be beneficial over time.

**Q199 Lord Flight:** Particularly given your experience in being involved in EU policy co-ordination, are you optimistic that the effective co-ordination of a more integrated economic policy framework can be achieved? What needs to change to improve the prospects of achievement? In particular, no currency union that I am aware of has not had to involve transfer payments from the more successful economic areas to the less successful and competitive ones. Even within the UK itself, there are substantial transfer payments from the south-east to other parts of the country.

**Lorenzo Codogno:** You are absolutely right. The problem with economic and monetary union is that we started this process, which is very important for the future of the European people, without knowing what the final goal is of all this. There were different perceptions in different countries and among different political parties and parts of the electorate in Europe about what that final goal was. It is becoming clear that monetary union is only a transition to something else. It is not a goal in itself. As such, it requires additional steps in banking and fiscal union and so forth. There is a growing acceptance that this has to be the case going forward. Where do we stand? Europe has made tremendous efforts over the past three years to increase integration and improve governance. Europe is now in much better shape. Admittedly, European policymakers have made a number of mistakes that have resulted in some economic suffering and delays in the process. Now, European integration is proceeding, but maybe not with the speed that would be desirable, in my view. As you are certainly aware, the next two important steps in the European process are defining more clearly the issue of convergence and competitiveness instruments, which basically implies some contractual arrangements with States and delivering ex ante co-ordination of policies.

It is proceeding gradually but the process is very encouraging. However, it is absolutely urgent and essential that banking union progresses. The European financial system is still broken and markets are still dysfunctional. There is very little financing across European countries at this stage. Policymakers need to overcome this situation. The only way to overcome this is to speed up banking union.

There is a list of actions that need to be undertaken between now and the end of next year. Most of them are the responsibility of central banks. A balance sheet review will be done soon. There is an asset quality review and of course there will be a stress test. All these things together will basically set the ground for banking union going forward. These are the essential steps, and the sooner Europe takes them the better, in order to overcome remaining problems and the current still not ideal situation in financial markets in Europe.

**The Chairman:** Before I bring in Lord Vallance, could you recognise that there is still a sharp divide in Italy North and South, despite the fact that there have been big transfers within the country to try to ameliorate the economic problems of the South?

**Lorenzo Codogno:** Yes, absolutely. Unfortunately, the efforts of many Governments over the years to close the gap between the northern part of the country and the southern part have not been particularly successful, which probably also means something for Europe. Transfers are probably necessary on some occasions for shocks but they are not necessarily the recipe to close the gaps in economic development between different areas. At any rate, I do not see the whole issue of transfers as one of solidarity because this issue has been overplayed. It is more a matter of common insurance against economic shocks. It is necessary for Europe to have a common insurance to prevent asymmetric shocks from having significant effects across the whole Union. We have learnt that during the crisis. Institutions and facilities need to be set up to make sure that the current crisis does not happen again in the future. It is not a matter of solidarity but one of insurance.



**Lord Flight:** Can I just make the point that transfer payments have rarely been successful in bringing the less successful areas up. They are a political necessity to keep the people in the less successful areas happy with the institutions as they are. They have continued in America ever since the civil war, with 30% of federal spending. They have existed in the UK and Italy. The point I make is that you need them if you want to have political consensus to union.

**Lorenzo Codogno:** I would agree with that. They are necessary to maintain support for the process because otherwise European voters would basically perceive that the whole process is not in their best interests. The Commission has put forward some proposals to speed up the reform process and at the same time put in place contractual agreements that would provide some financial support for the areas and countries that are more in need and are willing to engage in a deeper and more profound reform process. All aspects have to come together. People's engagement and commitment to the whole project needs to be maintained. The risk of losing the support of the people is probably the most important and relevant risk at this stage.

**Q200 Lord Vallance of Tummel:** Director-General, the first question I was going to put to you you have answered in part, en passant. I will put it to you anyway in case there is anything that you want to add. Do you think that there is a clear understanding of what the integrated economic policy framework should encourage? You were good enough in the context of the banking union to distinguish between essential and desirable elements. You might like to do that in the context of my question.

**Lorenzo Codogno:** Thank you for your question. As I said before, it is absolutely essential and urgent at this stage of the process to achieve banking union because of the still poor and fragmented state of European financial markets. This is absolutely the key target in the near term. Over time, more co-ordination in economic policy needs to be achieved. The process is ongoing. The so-called European semester has been very successful in streamlining budget

processes in Europe, and has made all these processes aligned so that we have a single European calendar to co-ordinate economic and fiscal policy in Europe. There is a need to move beyond the current situation and achieve a higher level of co-ordination over time. This is again quite important, but I would say that banking union is the key priority right now.

**Lord Vallance of Tummel:** I have a specific question on convergence and competitiveness instruments, which are being proposed to encourage structural reforms through a system of rewards or sanctions, sticks and carrots. Do you think that that proposal is likely to be effective, and specifically how could it be enforced?

**Lorenzo Codogno:** It is still a tricky issue. Italy is in favour of further integration. However, it is still not clear how these instruments will work. I think we need a bit more clarity and transparency on how this will proceed. There is still an open debate in Brussels and the design of these instruments for convergence and competitiveness is not clear cut yet. I hope it will become clearer in the near future. On our side, Italy is keen to co-ordinate policies, provided that there is a clear framework and a clear setting as to how and when financial support would be given in exchange for giving up some sovereignty over policies.

Now you might argue that there should be no need for financial support when you do the right things. Doing the right thing should provide the benefit in itself. That is the usual argument, I would say. At the same time, going through a deep reform process inevitably implies some social cost and some near-term pain, which might be eased if you have the support of Europe. So I think—

**Lord Vallance of Tummel:** We have lost volume, I fear. We cannot hear you at the moment, Director-General. We will try to sort out the technical hitch first.

**The Chairman:** Could we just have the last paragraph of your answer to Lord Vallance? Do you want to start again?

**Lorenzo Codogno:** I will answer again. Can you hear me? There is ongoing debate in Europe right now as to what exactly these new convergence and competitiveness instruments imply. They are ways to combine contractual arrangements between countries and European institutions with some financial support. The usual objection to this is: why should you have some financial support while you are doing the right things anyway? You should not really need financial incentives in order to do the right things because reforms should provide a nice payoff over time anyway. That is absolutely correct. However, sometimes making painful reforms necessarily implies some social cost and some near-term pain that might be eased if there is some support at the European level. These tools might be useful and instrumental in supporting the reform process in Europe, so Italy's view is that it would certainly be helpful to have this facility, provided that the setting is clear and transparent. At the moment, we do not have a clear and transparent setting for this type of co-ordination of policies in Europe. The debate is still ongoing, and we look forward to clarifying the issue so we may give our support to the whole process.

**Lord Vallance of Tummel:** Do you think the Italian Government might use such instruments once they are clarified?

**Lorenzo Codogno:** There is a very strong incentive to use these instruments to ease the possible social tensions and potential social costs of painful reforms. Having said that, Italy has already gone through painful reforms. The most important one is the pension reform, which is a very touchy reform, but again Italy has already gone through it, so we do not need that facility for it because we think that Italy's pension system has already been adequately reformed. However, it might be useful in the context of additional changes in the labour market, for instance, even if not in the immediate future. The labour market in Italy may need to be reformed again in the future, once we have a better understanding of its response to the reform that has recently been introduced. At that stage, it would probably

be helpful to have some support in the form of European co-ordination and finance to ease social resistance that might develop.

**Q201 Lord Davies of Stamford:** Director-General, you mentioned the asset test and the stress test, which will be a feature of the Italian banking system over the next few months. You have very considerable experience of that system, both as a commercial banker and now as a policymaker and regulator. Are you confident that the Italian banks will come through that process satisfactorily, because if not and if further significant provisions have to be made by them, presumably Italy will face the choice between seeing its banks reduce their balance sheets, which will have a contractionary effect on demand and growth in the Italian economy. Alternatively, they will have to recapitalise. In those circumstances, will the banks be able to recapitalise themselves from the capital markets, or will the Government have to step in with public money? In that event, could there be contagion between the banking market and the government bond market, as happened in Spain?

**Lorenzo Codogno:** That is a very good and certainly very timely question. There is some concern in financial markets at this stage about the stability of Italy's system, but let me say that the Italian banking system has been resilient throughout the crisis. Initially, at the end of 2011, it suffered because of liquidity issues, and then because of undercapitalisation, but the Italian banking system has been able to get the capital from the market and by translating some hybrid instruments into proper capital so that now the so-called tier 1 capital is more than adequate in the current situation for most banks. In effect, the Italian banking system has been able to cope with a difficult situation without government support. The Government introduced facilities to provide some financial support to banks at the very beginning of the crisis and, contrary to many other countries, these facilities have been used very little. The Government only provided financial support to banks in the order of 0.2% to 0.3% of GDP, which is far below what any other country provided during the crisis.

Now, with the weakness of the economy, non-performing loans are rising. If that continues it might eventually lead to more need for capital. However, at the moment we are confident because the Bank of Italy is doing a wonderful job in pushing Italian banks to restructure themselves to be prepared for the asset quality review and to recapitalise where needed. By the time the European institutions carry out the asset quality review the Italian banks will be ready and well capitalised, so we are not too concerned. Clearly, there is one major bank that has gone through a difficult time, but the Government has already fixed the problem through intervention in the form of a bond, which might be translated into equity if the restructuring process does not eventually work.

Other bits and pieces include some small regional banks that have some problems now, but these problems are limited and the overall banking system is in a sound position. So again we are quite confident that the Italian banking system will be well prepared for this European test so that Italy can actually enter the banking union without causing problems whatsoever for the rest of Europe.

**Q202 Lord Marlesford:** Director-General, it has been suggested that while north Italy and south Italy were for some years moving closer together, they are now moving further apart economically, socially and politically. Do you agree, and if so what do you think can be done to bring them closer together?

**Lorenzo Codogno:** It is probably not fair for me to say that northern and southern Italy have been moving farther apart. I do think it is fair to say, however, that there has been no convergence over the years. My personal feeling is that rather than using transfers and pumping money into the southern part of the country, the best way would be to change the incentive structure, basically moving more and more towards a fully market-based economy. Having the proper incentive structure even in the southern part of the country might move the animal spirits so to achieve higher growth over time.

I think the Government is moving in this direction now. There has been a clear shift in policies for the southern part of the country and this is slowly but surely becoming more effective to address Italy's divide.

**The Chairman:** Before I turn to Lord Dear, can I just ask you about the single resolution mechanism, whether you have any expectation that a deal might be done at the December council, and indeed whether the timeline of 2018 is insufficient, given that you have talked about the necessity of having greater dispatch than hitherto?

**Lorenzo Codogno:** This is a very good question, because it is exactly the state of the European debate at this stage. It is clear that some Eurozone countries are not in favour of a single resolution mechanism that is pan-European and that has a centralised authority able to push national banks towards resolution. The debate is still ongoing. It is a difficult debate. I hope Eurozone Countries will be able to come up with a compromise solution that is ambitious enough to guarantee that banking union is credible and effective because, as I said at the beginning, you cannot really have a single supervisory institution in Europe without a single resolution mechanism. The two things must come together and must be efficient and effective in preventing a banking crisis in Europe. It is absolutely essential that policymakers deliver as soon as possible, and I hope it will be done by December. Markets are still fragmented. Banking union is a key ingredient in resolving the so-called negative feedback loop between banks and sovereigns, which is still a problem and has not been solved so far. By delivering the single resolution mechanism I think the Eurozone would make a big step in the right direction.

**Q203 Lord Dear:** Director-General, good morning. Early in your presentation, you helpfully talked briefly about the three-pronged model of the banking union. You said that in your opinion the single supervisory mechanism and the single resolution mechanism were essential, but you had some doubts about the common deposit insurance scheme. I

understand that, but I wonder whether I could take you a little further on that point. How realistic do you think a banking union such as that would be, were it to be put in place? Would it work?

**Lorenzo Codogno:** It must work. Otherwise Europe would not proceed with integration. The UK position has always been in favour of a single market in Europe and a level playing field for companies. This is also true for banks. It is absolutely essential. At the moment, we have a financial system in Europe that is dysfunctional, and there is a massive misallocation of resources. At the moment, a top quality credit in Italy has borrowing costs that are equal to a junk company in Germany, simply because of the current European situation. This produces a massive misallocation of resources within Europe. This issue needs to be addressed. There must be a level playing field for all banks in Europe. I think it is an essential step in order to proceed towards integration. It is the first step and the most urgent one, and I hope that Europe can deliver on it.

**Lord Dear:** Thank you for that. I wonder whether you are a little confused, as I think some of us are a little confused, about the recent comments of the German Finance Minister, Wolfgang Schäuble, who famously described the SRM—the single resolution mechanism—as being only timber-framed rather than steel-framed, which seems to have caused some doubt as to its longevity. Can you give us a view on that?

**Lorenzo Codogno:** I hope that it is steel-framed, because it will have to resist many shocks in the future. Europe needs something that is well framed, so to speak. Again, while we are on the deposit insurance, it would be desirable to have it, but strictly speaking it might not be necessary. However, a single resolution mechanism that is credible and effective is absolutely essential. Europe cannot do without it. It needs to be steel-framed. It needs to be very strong and very credible for financial markets. In order to go to the next stage of monetary union, fiscal union and integration in Europe, banking union has to be achieved,

which, again, is absolutely essential in the near term to address the issue of dysfunction and fragmentation in financial markets in Europe.

**Lord Dear:** As you said, if you are going to have a single resolution mechanism, you have to have a supervisory mechanism to go with it.

**Lorenzo Codogno:** Yes, absolutely. The supervisory mechanism does not seem to be a major issue at this stage, as it has already been decided. The European system of central banks will deliver on that. Clearly it is not an easy task—it is a massive task to harmonise all the banking systems in Europe and to have effective centralised supervision. That implies a lot of co-ordination between the European Central Bank and national central banks, but it can be done. I am sure that the central banks will do a wonderful job. It will take some time, but it will be done. That is no longer perceived as a big issue in Europe, but the single resolution mechanism remains an issue. As you mentioned, there are different views in Europe at the moment. I hope that these differences will be sorted out soon, because it is absolutely essential to solve the issue of fragmentation and dysfunctionality in financial markets in Europe soon.

**The Chairman:** To buttress this steel-framed house, do we need a taxpayer backstop?

**Lorenzo Codogno:** Yes, we do. The way it is developing in Europe is that in order to have a fully-fledged banking union we need a backstop. The debate now is whether this backstop needs to go through different national layers first and then go to Europe or whether we should have a mechanism—the ESM—that can intervene directly on individual banks. That is still to be seen; the debate is on. The so-called cascade system prevails in Europe at the moment. In other words, if you need to recapitalise your bank you first go out and ask financial markets, then as a second layer you have your equity holders and then your senior debt holders. Then eventually you go to the national backstop and, if that does not work, you go to Europe and the ESM. That might not be the best solution; it might not be fully



satisfactory. I think that we need to be bolder in that regard. We need to make sure that there is a proper backstop that is fully functioning and fully available also at the European level, in order to make sure that the negative feedback loop between banks and sovereigns is broken as soon as possible. Again, this is a key issue for Europe right now.

**Q204 Baroness Maddock:** Good morning, Director-General. The European Central Bank is going to take over as the single supervisor. You referred in your remarks to the asset quality review that is being undertaken. I wonder how credible you think this review will be. How should any problems exposed by it be financed?

**Lorenzo Codogno:** It needs to be credible for the very reason that if it is not credible there is no point doing it. I fully acknowledge that the reviews done in the past were not sufficiently ambitious or strong—those done by the European Banking Authority. However, we need to move to the next stage. One problem of the reviews done in the past was that the accounting rules and regulations in Europe were not harmonised. Therefore, you might end up with totally different outcomes. Let me give you an example. The Bank of Italy is much more strict in the accounting of non-performing loans than other supervisors, so in effect if you have a loan that has been restructured in Italy it is still considered as non-performing even a year after restructuring. A number of loans are backed by real estate assets and are still considered to be non-performing despite the fact that they have large collateral that might be used in case of default. There are different rules in Europe. They need to be harmonised in order to achieve effective supervision across European countries. I think that the ECB, together with the system of European central banks, has all the instruments and skills to do it. I am not saying that it will be an easy task, but I think that all the conditions are in place for it to be a successful exercise. It needs to be credible for the financial markets. If it is credible, effective and transparent, it might go a long way towards solving the issue of fragmentation and dysfunctionality in financial markets.

**Q205 Viscount Brookeborough:** Director-General, just before I go on to question 12, let me follow up on Lord Marlesford's question about the north-south divide, which we of course have in the United Kingdom as well. However, would you accept that yours is different, because of climate change and global warming, which are affecting the southern areas of countries in Europe? This could become a big issue socially in the future.

**Lorenzo Codogno:** I am not sure that this is really the key element of the north-south divide, although probably it is part of it. At any rate, if you look at the European Union, there are a number of areas that show differences. At this stage, regional differences are more important than national differences. This issue is relevant not only for Italy but for many other countries. Spain has the same problem, as well as Germany with respect to eastern Germany. Even in the UK there are differences between regions. It is a pan-European problem. In each country there are differences in economic performance among regions. Most of the time they are more important than national ones. These problems need to be addressed so that these areas can converge and have the standard of living of the best-performing areas.

**Viscount Brookeborough:** We understand the aspiration of the Commission for a separate euro area budget. Does Italy support this additional fiscal capacity? How might it be funded, do you think, and what might the timescale be?

**Lorenzo Codogno:** I do not think that this is absolutely urgent or a top priority, but it would be useful that over time Europe builds up some fiscal capacity at the central level. That is an important ingredient to any kind of union. If you look at the United States and how it has developed over time, it took much longer than Europe to achieve some form of integration. Having a centralised budget with some fiscal capacity at the central level is key. Again, it is probably not the most urgent element at this stage, but over time it needs to be

addressed. How will it be financed? Clearly it has to be financed by European taxpayers, so part of the national budget will have to be allotted to a European budget.

**Q206 Lord Vallance of Tummel:** Director-General, I apologise for taking you back to an earlier question—on the ECB's asset quality review. You said that you thought that it was essential that that review should be transparent. In your view, should that transparency go as far as making public the results of the asset quality review for individual banks?

**Lorenzo Codogno:** I think it would be desirable, yes. Even more important, it would be desirable to announce, well in advance of the outcome, exactly the criteria and methodology that will be used. I think that this is the level of transparency that is needed in order to make this whole exercise credible in the eyes of the financial markets.

**Lord Vallance of Tummel:** Thank you very much. That is very helpful.

**The Chairman:** If it is shown to be credible, how would you finance any problems that were exposed by that asset quality review?

**Lorenzo Codogno:** First of all, I hope that there will be no problem, at least in Italy, with the recapitalisation of banks. I hope that, if there is a problem, it will be addressed ahead of the asset quality review—ahead of schedule. It can be done through the financial markets in the meantime. If, however, there is a need for some kind of intervention, again I think that we have to build up a backstop of government money to complement equity holders and bond holders. Together with that, there must be some kind of European backstop. In order for this whole exercise to be credible, you need to have a credible backstop at European level to break the negative loop between sovereigns and banks. If we rely exclusively on national backstops, Europe will not achieve that. European backstops should be fully effective and ready to be used in case of need.

**Q207 Lord Marlesford:** Continuing to talk for a moment about government debt, first of all, as an economist, what do you believe the constraints are on the level of government

debt that a country can have in general economic terms? Secondly, going on to Italy, your government debt is the third biggest in the EU. It is nothing like as big as Greece's but it is pretty close to Portugal and is expected to go up slightly next year. What is the situation with your government debt in Italy? I would like to know your view on the macroeconomic question first, please.

**Lorenzo Codogno:** It is certainly well known that Italy has a very high public debt to GDP ratio. This year and next year it will be slightly in excess of 133% of GDP. From 2015 onwards we project a steady and significant decline. Part of the rise in the debt to GDP ratio was due to the payment of arrears by the Government. It was decided to clean up the backlog of commercial debt in arrears, which resulted in a rise in the debt to GDP ratio. Of course, the debt to GDP ratio was also pushed up by help provided by Italy to other European countries through the ESM and bilateral loans. Debt dynamics in Italy are much more favourable than in many other countries. In other words, despite the high debt to GDP ratio, Italy has already achieved a significant improvement in its fiscal position. Let me just mention that in 2012 the change in the structural deficit, that is net of the cyclical components and the one-offs, was 2.4% of GDP, and this year it is estimated not far from 1%. So, basically, in only a short period—a two-year period—Italy delivered more than 3 percentage points in fiscal consolidation. Italy is now in a much better fiscal situation than many other countries in Europe, because in effect it has already delivered a big chunk of the adjustment that is needed. With what has been done and with current projections, Italy already has a surplus of 2.5% in the primary balance. The deficit will be close to 3% this year and will steadily decline over the years. The Government aims to balance the budget in 2017.

In structural terms, it is already close to balance, and the Government expects it to stay close to balance next year. Although the debt to GDP ratio is, admittedly, very high, the

debt dynamics are favourable and Italy has already accomplished most of the fiscal consolidation needed. Barring additional economic shocks, there will be a steady decline in the debt to GDP ratio over the coming years on the back of what has already been delivered.

**The Chairman:** Signor Codogno, the good news is that we have come to our last question. It is to be asked by the Earl of Caithness. I know that he is also anxious to ask an additional question that is not particularly to do with the subject today. Please answer it as you would like.

**Q208 Earl of Caithness:** Director-General, could I change from the subject of GEMU on to the financial transaction tax? What do you think the future of the proposal of the 11 member states for the financial transaction tax is given the devastating opinion of the legal services of the Council?

**Lorenzo Codogno:** That is a very touchy issue. As you are certainly aware, the Italian Government basically went ahead with the financial transaction tax alone last year. The Government was keen not to have a tax that might affect business behaviour, particularly for retail investors, and it was designed to be small enough to prevent any transaction from moving abroad. Having said that, it would be desirable to have a single approach in Europe. I would be very much in favour of a single approach to the financial transaction tax.

On a personal basis, I would be more in favour of taxing banks directly, if you want to tax banks, rather than through transactions, but in that regard we need to make sure that we have a common and single approach in Europe so that we maintain a kind of level playing field in the financial industry in Europe. Otherwise, we end up again with fragmentation and dysfunctionality, and this is not what we want. So again, regardless of whether the financial transaction tax goes ahead or not in Europe, we absolutely need to have everyone on board

and on the same page in the way we tax and in the amount of the tax, if there is any, so that we do not cause any kind of dysfunctionality or fragmentation.

**Earl of Caithness:** Thank you for that. You have stressed throughout your evidence to us, and again in answer to that last question, the need for a single cohesive approach in Europe. As you know, the UK has opted out of, or is not going to participate in, many of the things that we have discussed this morning. How do you reconcile that? How do you get a single approach in Europe with non-participating member states, and as more and more items are decided by the eurozone countries, where does this leave Britain? What would your recommendations be to us, given this situation?

**Lorenzo Codogno:** First of all, let me say that the Italian Government has shared a number of positions with the British Government over the years, as we are very keen to have an efficient single market, which I believe is one of the key priorities for the UK as well. The Italian Government have sided with the UK Government on a number of issues, and there are a lot of areas where both countries have a common interest. In that regard, it is a pity if the UK does not really join the debate as a core country at this stage, because if the British Government is not part of the debate, clearly it may lose the possibility of being influential. Having said that and having followed the UK position in Europe, I must say that it has always been very constructive and the British Government has always tried to provide the most comprehensive contribution to the European debate. So I hope that the role of the UK will be important in the future, particularly on matters that relate to financial markets, because clearly London is the most important financial centre in Europe and we cannot do without it. London as a financial centre needs to be considered very important in any debate in Europe. It is unfortunate that the UK is not fully participating in some of these debates that are now taking place at the monetary union level. Again, it would be desirable to have a single European position on all matters, including the financial transaction tax, because we cannot

afford to have segmentation or divisions between financial markets in Europe or between London and the rest of Europe.

**Earl of Caithness:** Finally, can I ask your opinion from Italy of the question of public opinion? You said that it was important that the leaders took the public along with you, yet given the recent election results in Germany and Holland and what is happening in the UK, do you think that the leaders are getting too far ahead of public opinion, which will cause problems for Europe in the not too distant future?

**Lorenzo Codogno:** I would agree with that statement. A combination of the economic and financial crisis in Europe and some responses to this crisis have not facilitated the closing of the gap between policymakers and voters in Europe. This needs to be very high on the political agenda. It is absolutely essential that the population is on board in any move towards integration in the future. Also, there is the non-negligible possibility of a significant anti-European group in Brussels in the not-so-distant future, in the next European elections, although I have to say that anti-European groups are such sometimes for very different reasons; we are not talking about a coherent, cohesive group of people, so to speak. This needs to be addressed by European leaders, because again you cannot have integration in Europe or go farther ahead in integration without having the population on board. It is a matter of having political leaders who can credibly deliver and tell European voters a credible story on the future of Europe. We have lost a little of the optimism and commitment to a common goal that I think was present a few years ago. I think we have probably now lost that because of the crisis and because of some bickering in Brussels. We need to go back to the original idea of Europe: a Europe that should benefit people not just the leaders.

**The Chairman:** Signor Codogno, let us come to a conclusion there. As I advised you at the beginning, we will send you the transcript of all that has passed this morning. We would

be most grateful if you could check it, and indeed for any further thoughts you might have to be sent to us. Can I say to you that the wisdom and common sense that you have displayed today has enormously impressed the Committee? We are most grateful for the quality of your answers and for your providing the time that you have. It will be a very substantial contribution to the report, which, as I say, we hope to publish one side or other of Christmas. In conclusion, may I say tante grazie, mille grazie, buona fortuna all'Italia, and thank you very much indeed. Alla prossima. Molte grazie, Signor Codogno, per oggi. Arrivederla.

**Lorenzo Codogno:** Thank you very much, Lord Chairman. It has been a pleasure for me as well.