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Introduction

Relaunching Europe

Dieter Reiter
Jürgen Chrobog
Hans-Werner Sinn

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Joaquín Almunia

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Becoming Slimmer: Why Europe Needs to Cut Debt and Reduce Leverage

Daniel Gros

Panel 2

Getting Fitter

Vincenzo Galasso

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Growing Stronger: What Way Out for Europe?

Harold James

Trends

Statistics Update

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Welcome Address by

Dieter Reiter

Councillor, Head of Department of Labour and Economic Development, City of Munich

Ladies and Gentlemen,

It is a great pleasure for me to welcome you to this 12th Munich Economic Summit on behalf of Lord Mayor Christian Ude. This forum provides economic and political decision-makers with a great opportunity to exchange opinions in discussions and presentations delivered by scientists and experts in the field and serves as a platform to reflect on one's opinions and engage in discussions with an expert audience. The City of Munich is proud to host such a high-level conference year after year. I would now like to seize the opportunity and thank the organizers of this 12th Munich Economic Summit: the BMW Foundation and the CESifo Group.

At a first glance, 'Relaunching Europe' seems to be a topic of national and European significance rather than a municipal issue. But already today, more than one out of two Europeans lives in a city. In the federalist German system with its federal states and a comprehensive local self-government scheme, cities like Munich are in a relatively strong position. Taking into account the consequences of European decisions on financing, services of general interest or procurement law for cities and municipalities, it is pretty obvious that Europe becomes more and more important for municipalities as well. For that reason, I would like to review the three panel topics from a municipal angle in my short address today and provide you with the City of Munich's perspective before you'll focus on the European and national perspectives in the coming days of this Summit.

Getting slimmer

Europe needs to get slimmer! To me, that also means reflecting on the current allocation of tasks and responsibilities and organizing them in a decentralized manner wherever possible. But at the same time, I would like to warn against misunderstanding this need to get slimmer by relaunching a wave of privatization similar to that of the 1980s and 1990s.

As Head of the City of Munich's Department of Labor and Economic Development, I am, among other things, responsible for the utility company Stadtwerke München and thus for the provision of services of general interest. I don't want to go into too much detail here, but let me mention that the possible privatization of water supply is currently one our main concerns. Decisions made at the European level often have an impact on municipal fields of action. Against this background, it would be very helpful to take a closer look at the situation and the framework conditions at the local level as well as at the possible repercussions before passing Europe-wide reforms and privatization legislation.

Market liberalization and transparent procurement is one aspect but citizens' needs and high security of supply is another aspect which must not be ignored. At the European level, the cities' and municipalities' problems and interests are often not given sufficient consideration or the attention corresponding to their significance. That should also be an aspect of 'Relaunching Europe'.

The City of Munich is not opposed to opening up the markets or to free market access. However, a full and unconditional privatization alone cannot be the solution. The City of Munich with its city-owned enterprises and corporations clearly shows that it is very well possible for municipalities to face free competition while at the same time remaining in charge of providing services of general interest. These services of general interest are not entirely comparable to regular goods and services and while there are many reasons in favour of privatization, there are also many reasons against it. The final decision on how to provide services of general interest should therefore remain with the local players.

The financial crisis and the corresponding discussions on a new orientation for Europe allow for reallocating responsibilities to lower levels of administration which are closer to the citizens – permanently, if possible. Lobby groups calling for more privatization need to be opposed in my opinion, especially when it comes to services of general interest provided by the local level.

Getting fitter

I believe that increasing competitiveness is a challenge faced by the European Community as a whole just like by individual countries, regions and municipalities. In the competition between cities and regions, both companies and citizens compare the framework conditions and location factors encountered on site. They want to know if certain location factors apply and if the region can provide an attractive overall package of business factors and quality of life.

It's these framework conditions which make companies stay in a region or locate there. They therefore have a crucial influence on whether people stay or even migrate to a region. In addition to the current situation and quality of life offered by a city or region, the future potential also plays an important role. Which opportunities can a city offer today, how fast will it develop and what are its future prospects?

For the EU member states, increasing competitiveness thus does not only mean launching the necessary reforms as quickly as possible. First and foremost, it also means showing people where a city or a region will stand after the implementation of an often cumbersome reform process. The European countries are faced with the challenge of a double competition here. On the one hand, Europe as a whole has to be attractive in competition with other global economic regions, but on the other hand Europe's member states and regions are also in competition with each other. The objective of 'getting fitter' thus also requires an idea or a vision of where we want to stand at the end of the process.

The European Union has developed a comprehensive scheme of support programs to improve business and living conditions throughout Europe. Being a dynamic economic area with a growing population, Munich is very well-placed, both in Germany and in Europe. But as a consequence of this favorable situation, Munich hardly has a chance to access any of the European support programs.

I would now like to seize the opportunity and put an idea up for discussion: if Europe really wants to become fitter and more competitive, can it really afford to neglect its dynamic economic centers? For only these regions really have a chance to be successful in the global competition between the regions. So, wouldn't it make sense to think about how to promote Europe's strengths as well? Shouldn't we also promote dynamic metropolitan regions which are usually the driving force behind any economic development in order to make other regions and Europe as a whole more competitive?

Growing stronger

How can Europe grow closer together? Economic integration in Europe is progressing. This is not least a consequence of intensive and still increasing economic interrelations. Accounting for a share of more than 50 percent in export sales, European partners are already the most important customers for Munich-based companies.

In addition to that however, political support is required as well when it comes to implementing large-scale international projects. There are many examples of that in the Munich region such as Airbus and Eurocopter, EADS or the Galileo navigation system. In order to grow closer together, Europe needs to strengthen its core competencies and step up cooperation also in the fields of social market, solidarity and the diversity of living conditions.

The percentage of foreigners living in Munich is almost 25 percent. More than half of them come from other EU countries. Munich is thus among the German cities with the highest percentage of immigrants. Local politics has therefore focused on integrating these citizens into Munich's urban society. For only people who feel well-integrated and accepted can make a contribution to keeping the city attractive and promote its further development which can actually benefit from this diversity.

Munich is one of the very few German cities which has been growing from within, as a consequence of a birth surplus, for years. But the most significant

growth factor is migration, both from other German regions and from abroad. In order to integrate the newly arrived, we need a welcoming atmosphere and offer help and support.

Different reasons for migration may of course have an impact on the success of integration measures. It is for instance a win-win situation when well-educated, qualified employees who couldn't find a job in their European home countries take up work here in Munich and, at the same time, help to mitigate our shortage of skilled labor. Their integration is usually unproblematic and often accompanied by employer's schemes. But then there is also migration which is not so much driven by the perspectives and opportunities offered by the target regions but rather by a lack of prospects in the region of origin migrants are trying to escape from. Naturally, the cities and regions are responsible for making sure that these people are equally well-received and integrated into society.

But the framework is provided by the European Union. At present, cities and municipalities are often left alone in coping with the problems resulting from this so-called migration of poverty. This is where a relaunch of Europe could begin to not only shape a European community of states but also develop ways and mechanisms allowing for European citizens to feel well-integrated in the European Union.

European integration is a great political, social and economic achievement, despite repeated setbacks we experienced during the years of the European unification process and which we will certainly continue to experience in the future. I am convinced there can be no doubt that we all need and want a strong Europe. This also, maybe even particularly, applies to regions like Munich and countries like Germany which are well off economically.

We, therefore, need to discuss how Europe can become slimmer, fitter and stronger and what the co-operation between different countries and players is to look like in the future. So what should Europe's relaunch look like, if you'll permit this little play on words, to create a stronger and more competitive Europe 2.0.? I'm looking forward to the answers this conference will find to this question.

Welcome Address by

Jürgen Chrobog
Chairman of the Board of Directors, BMW Stiftung Herbert Quandt

Ladies and Gentlemen,

On behalf of the BMW Stiftung Herbert Quandt, I welcome you most warmly to the 12th Munich Economic Summit in the Bavarian state capital. This year, more than 180 participants have accepted our invitation together with the CESifo Group. This new record-high number of attendees is impressive proof of the positive development of the Summit since its inception 12 years ago as an international political and economic forum.

Just as last year, this year's participants come from more than 20 countries, most of them from the EU or its neighbours and from all walks of life: the business world, science, politics, and civil society, thus reflecting Europe's diversity. As we see, this forum brings together a diverse range of people and offers the opportunity to engage in an international and cross-sector dialogue. This is the very essence of our programs and it reflects our belief that in order to reach long-term results, complex challenges and decision-making processes that are typical of our interlinked societies require wide-ranging participation.

As we face the fifth year of the debt and financial crisis, we want to discuss possibilities for a restart for Europe by focusing on the following aspects: Getting slimmer – How can we decrease government debt in socially acceptable ways? Getting fitter – How can we boost competitiveness in large parts of the EU? Getting stronger – How and with what goal can we push ahead with reforms and the institutional deepening of the EU?

The negative assessment of Europe's economic development recently announced by the IMF in Washington demonstrates the urgent need to renovate Europe's crumbling house. The Managing Director of the IMF, Christine Lagarde, talked about a three speed global economy and ranked Europe among the tail group. She expects emerging markets such as China, India, and Brazil to exhibit strong growth. Forecasts for the United States have also improved. But a continuing recession will keep the seventeen EU countries in its grip.

Is the harsh criticism voiced by the IMF correct that Europe's slumping economy is not only an indicator of weaknesses in its periphery but also of 'a certain weakness at its core' that does too little or chips in too late to help?

Let me say first that this criticism reflects the ideological dispute between Washington and Berlin in terms of economic policy, in particular when it comes to questions of crisis management. Whereas Washington and the IMF support an easy monetary policy to stimulate the economy, Berlin favours debt reduction as a solution to restore market confidence. In fact, all-in-all Europe has not been doing all that bad thus far: despite initial organizational difficulties, the measures taken to save Cyprus have had an overall positive impact as proven by the relaxed reactions of the financial markets.

Today, the EU as a whole stands taller than at the outset of the crisis. The Managing Director of the European Stability Mechanism, Klaus Regling, who unfortunately had to cancel his participation on short notice, rightly stressed that Europe is on the right track: collaboration in the field of economic policy has improved, the banking system has been strengthened and the ESM was created.

Nevertheless, Europe still faces a multitude of problems, and pressure to solve them increasingly mounts. Just think of the high unemployment rates in Greece and Spain that are at a rate of 20 percent overall with youth employment exceeding 50 percent. Potential scenarios of highly explosive social uprisings in these countries are in fact well within the realms of possibility.

In the near future, good relations between France and Germany, who will have to revive their traditional role as the motor of the EU, will be all the more important. Among other things, they must chart a clear course that equally represents the northern and the southern EU members and which all the states can accept. Both Paris and Berlin are currently working on suitable policy proposals for saving the euro while at the same time adjusting the speed of reforms to match the specific social and economic conditions of the individual member states. However, I believe that not much is going to happen in this field before the federal elections in Germany in September. On the other hand, we have no time to lose: 2014 might be the decisive year for the fate of the eurozone.

I hope that today's and tomorrow's panel discussions will provide new insights into a possible future for Europe and may inspire you all to take an active role. On behalf of myself and our partner, Professor Sinn of the CESifo Group, I thank you very much for coming and hope that you will have two stimulating and enriching days.

Introduction

Relaunching Europe: Problems, Reform Strategies and Future Options

Hans-Werner Sinn
Professor of Economics and Public Finance, University of Munich;
President, Ifo Institute, Munich

Dear Mr. Chrobog,
Mr. Quandt, Mr. Almunia,
Ladies and Gentlemen,

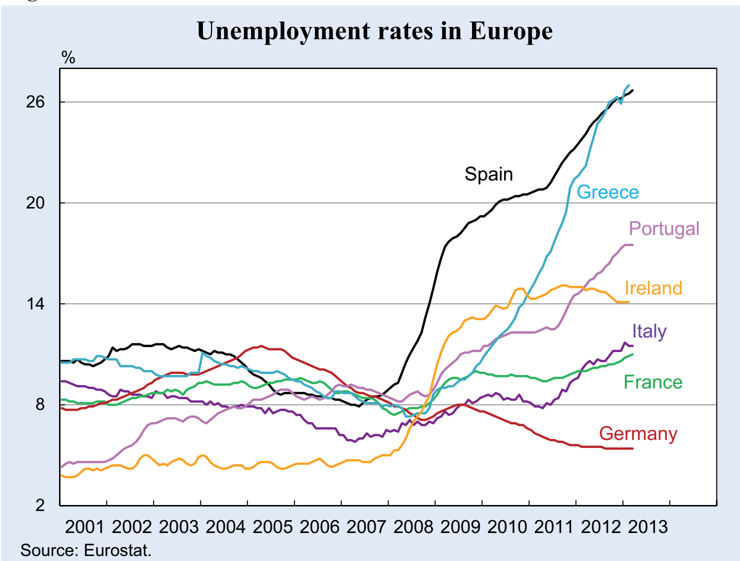
Europe's main problem at present is the question of how it can resolve the euro crisis. Never in my lifetime has there been as much strife among the peoples of Western Europe as there is today. Twenty years after the introduction of the euro as a major peace project for Europe, the common currency has obviously fallen far short of its goals. In the words of Martin Wolf: "You have to be a masochist to think that the introduction of the euro was a good idea". Now that we have the euro, however, this does not mean that we can or should abandon it. On the contrary, our challenge is to turn the euro into a success story.

You may remember the frightening words of Jean-Claude Juncker, who said in April that the year 2013 reminded him of 1913, a year when nobody anticipated what was about to happen in Europe a year later. While this statement is a bit exaggerated, it reveals the tension that grips politicians. Frits Bolkestein, one of the EU's most successful commissioners ever, advised his country, the Netherlands, to exit the euro. He argued that the euro was doomed and was not compatible with the prosperity of a common market.

I would like to look at a few key economic indicators to outline the current shortcomings of the eurozone economy before addressing the question of potential solutions. If we look at unemployment rates (see Figure 1), Germany is now doing fine after suffering its own crisis a decade ago, but the situation is very different in the other eurozone countries. In France unemployment is rising and has reached levels that exceed those seen during its last economic slump in the winter of 2005-2006. In Italy and Ireland unemployment is stabilizing at a high level, in Portugal it is slightly decreasing, and in the two problem countries of Spain and Greece overall unemployment rates are as high as 26 percent and 28 percent.

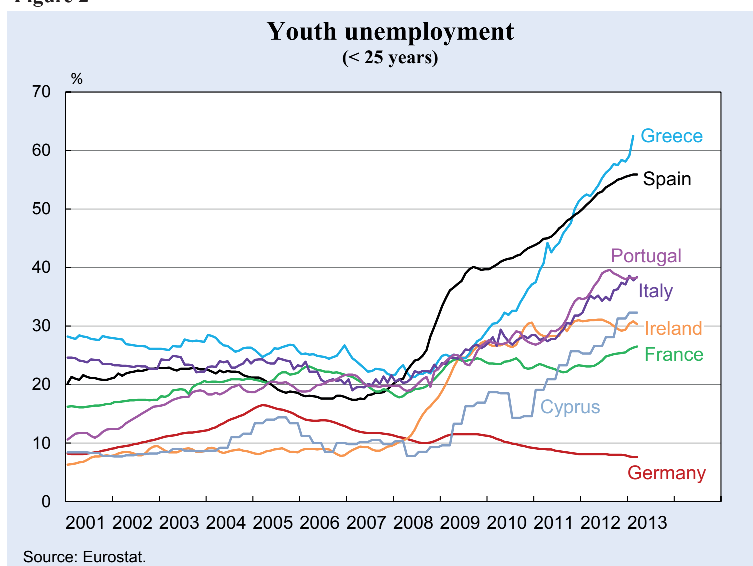
The situation is even worse when it comes to youth unemployment (see Figure 2). In Greece 62 percent, or two-thirds of the labour force aged 15-24, are unemployed. This is largely due to widespread protection of older workers' jobs, which makes it hard for younger workers to gain a foothold in the labour market, but the overall situation is nevertheless a catastrophe, as the overall rate of 28 percent starkly underlines.

Figure 1



Source: Eurostat.

Figure 2



Focus on competitiveness

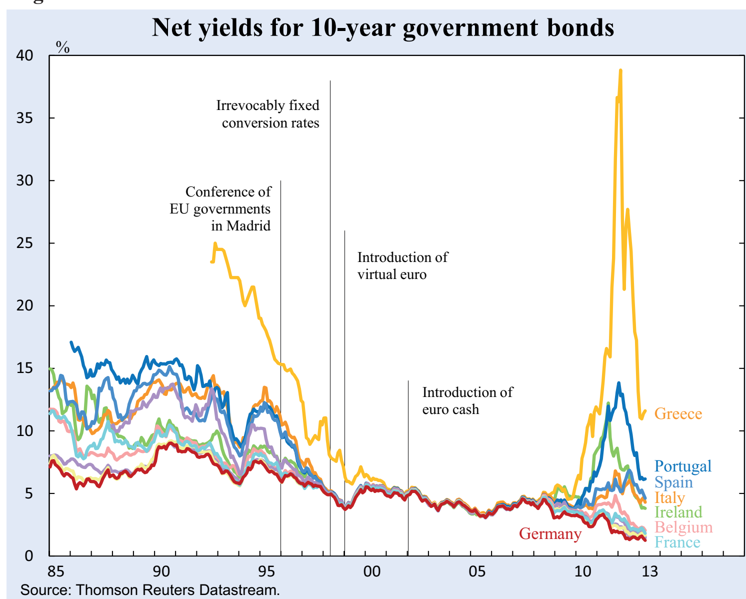
The debate over austerity is still raging and tends to revolve around the following questions: should we have more Keynesian deficit spending to stimulate growth? Do we need a banking union with a common resolution fund? Should we even create an Outright Monetary Transactions (OMT) programme for companies, as European central bankers are now discussing, involving the issue of some structured securities composed of company credits, which the ECB may possibly guarantee in the same way as it guarantees government bonds?

Unfortunately, all of these options are merely painkillers and do not represent lasting solutions. The true problem of Europe lies much deeper than the financial crisis, which is merely a surface symptom of it. The true problem is one of competitiveness, and if we wish to relaunch Europe, we must begin by addressing this issue.

When the euro was introduced interest rates converged (see Figure 3). Key points in the euro's history are shown by the vertical bars on the chart. For me the most important point is the EU's Madrid Summit of December 1995, where it was agreed that the exchange rates would be irrevocably fixed two years later in 1997 and that the euro would definitely be introduced. That was the point at which investment in any part of Europe was perceived to be safe and that capital began to flow across the borders in unprecedented volumes. The interest rates converged to the same level for a long period of time until crisis struck and the spreads emerged again, as shown on the right of the chart.

The chart raises a number of interesting questions: why did interest rates converge? Why was there such reckless lending to debtors who would obviously have problems repaying, especially given that article 125 of the Maastricht Treaty (TFEU) expressly states that no country will be bailed out if it goes bust and creditors must bear the full loss? One answer is that the unlimited firing power of the ECB made state bankruptcies very unlikely in the Eurosystem. Another is perhaps that the EU undermined Article 125 with practical policies, such as allowing lending to governments and banks with no or only minuscule equity requirements. Whatever the true reason, the introduction of the euro encouraged capital flows beyond any reasonable level and created an artificial boom in Southern Europe. This boom

Figure 3



became inflationary, deprived Southern European countries of their competitiveness and made them dependent on foreign credit which, when it dried up, unleashed the balance-of-payments crisis.

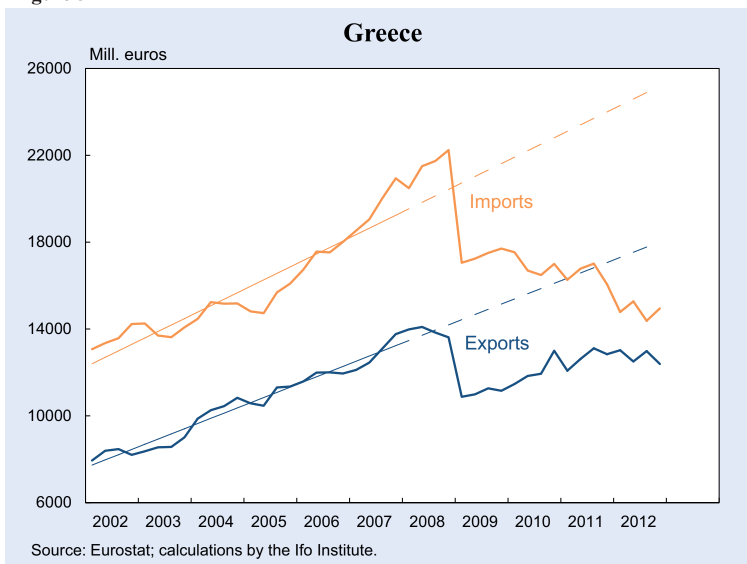
A look at price developments during the period from the Madrid Summit to the Lehman crisis (see Figure 4) shows that the crisis-afflicted GIPSIC countries revaluated by 30 percent (trade-weighted relative to the rest of the eurozone), while Germany devaluated by 22 percent. These enormous relative price changes are the key problem facing Europe today, as they have fundamentally deprived the South of its competitiveness. We now need to rewind the price clock, but that is easier said than done. All reform programmes aimed at making economies more competitive must operate *via* the price channel. Either relative prices fall because relative wage are implemented given the productivity, or productivity jumps up, given the relative wages. As the latter is a dream, relative wage cuts will be unavoidable. In my opinion, this is the only way of relaunching Europe if we do not want to allow exits from the eurozone followed by open devaluations. All of the various measures that we will discuss over the next two days are, in my view, part of this programme of realigning relative prices.

A great deal has happened in recent years and current account deficits have disappeared, so Europe could be said to be headed in the right direction. I would agree to a certain extent. The gap between imports and exports has certainly declined, but why? This decrease is not due to exports exceeding their pre-crisis levels; it is merely due to the collapse of the economy, which has meant that people can no longer afford imports. That has nothing to do with an improvement in competitiveness of the economy.

Figure 4

Source: Eurostat, Database, Economy and Finance, National accounts,GDP and main components - Price indices; Ifo Institute calculations.

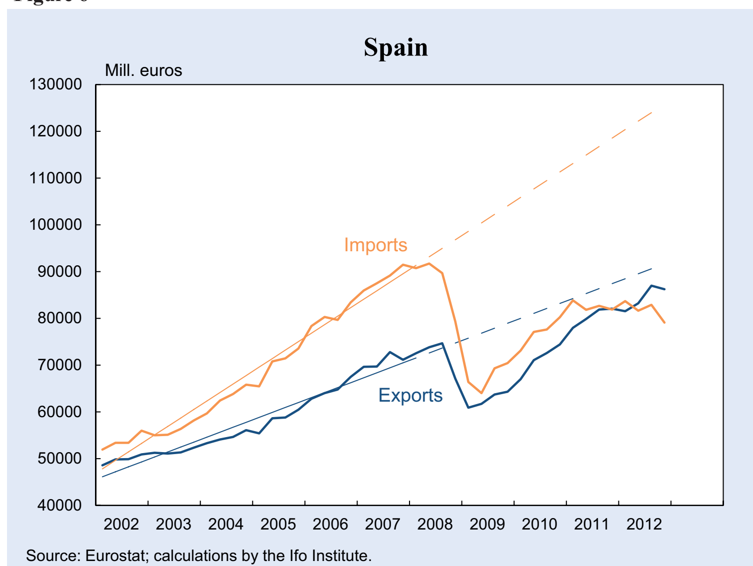
Figure 5



Source: Eurostat; calculations by the Ifo Institute.

While exports have risen a bit in Spain (see Figure 5) and Greece (see Figure 6) after the Great Recession of 2008, the collapse in imports resulting from plummeting domestic consumer purchasing power, which has been significantly weakened by mass unemployment, dominates the picture. So the improvement in the current account situation of Spain, for example, in no way indicates an improvement in its competitiveness. I do not wish to be overly negative: there are some signs of improvement in Spain, such as movement on the wage front, as well as greater flexibility, reforms and so on. Nevertheless, as is clearly visible from the graph, the improvement in its current account balances is mainly due to the effects of the

Figure 6



Source: Eurostat; calculations by the Ifo Institute.

crisis. It is misleading to use current account balances as an indicator of competitiveness.

Realign relative prices

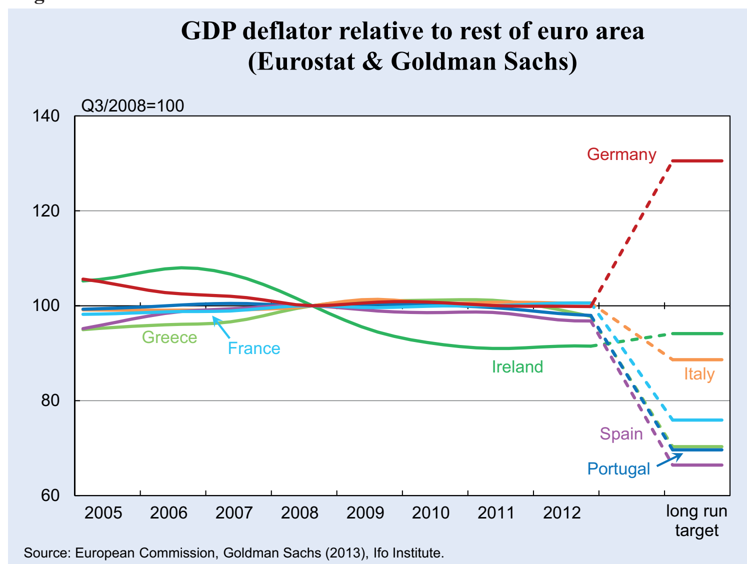
A realignment of relative prices is required to achieve debt sustainability. In the old days, before the introduction of the euro, this would have involved a realignment of exchange rates in a fixed exchange rate system, but now such a realignment can only be achieved in the eurozone through relative price changes. How much progress has been made towards price realignment to date, as the crisis nears the end of its sixth year?

Europe's progress so far can be charted by the Eurostat GDP deflator relative to the rest of the euro area, normalized such that 100 is the point of the Lehman collapse (see Figure 7).

Let's take a look at Spain, which appreciated relative to its trading partners before the Lehmann crisis and deflated thereafter. At what level do its prices need to settle to achieve debt sustainability? This question is explored in a very useful study by the economics department of Goldman Sachs, which examines the realignment of prices that is required in the eurozone in order to achieve debt sustainability, which is defined as bringing the net foreign asset position below 25 percent of GDP in the long run. According to the Goldman Sachs study, Spain's goal should be a ca. 30-percent price reduction relative to the eurozone average which translates into a decline of 33 percent relative to the rest of the eurozone as shown in the figure. While some progress has already been made towards such goal, there is still a very long way to go.

In France property prices have exploded like their Spanish counterparts, the only difference being that the real-estate bubble in France has not burst yet. French industry has lost its competitiveness; manufacturing is declining and only accounts for 9 percent of GDP. The French have compensated by creating more jobs in the government sector (which has twice as many employees as Germany's public sector) and by indulging in high government spending (56 percent of GDP, 10 percentage points higher than in Germany). These Keynesian replacement measures have helped the French to alleviate economic pain, but they have not promoted its competitiveness. According to Goldman Sachs France would have to devaluate by 20 percent relative to the eurozone average which

Figure 7



Source: European Commission, Goldman Sachs (2013), Ifo Institute.

is 24 percent relative to the respective rest of the eurozone.

Italy, on the other hand, is doing much better than many other euro states, so the price devaluation required there is small, while Germany, according to the Goldman Sachs study, still needs to become more expensive to make Greece competitive. German prices relative to the rest of the eurozone would have to go up by 20 percent and relative to the rest of the eurozone by 30 percent.

The level at which realignment can be achieved remains an open question. Can the South cut its prices while the North increases its prices slightly? Should we increase the average so that no country has to cut its prices and the core merely inflates? The realignment process will in all circumstances be painful. Germany will not be willing to accept the necessary inflation and some of the GIPSIC countries will not accept the necessary deflation.

Ireland is the only country that has managed to carry out the necessary devaluation. It devaluated by 15 percent in real terms since 2006 by implementing the harshest austerity programme of all European countries. While Ireland helped itself, the other countries were hit by the crisis simultaneously after Lehman, nearly two years later than Ireland's crisis; and rather than following Ireland's painful austerity programme, they opted for a political solution in the form of local money-printing in their national central banks to replace the missing private capital.

Three options for Europe

In my view, Europe has three options. The first option is that of a reform strategy with austerity and deflation in the South. Austerity is necessary because the money is simply no longer there and lenders are no longer willing to loan it; but austerity is also necessary to rebalance prices, which is necessarily a painful process. While moderate austerity stopping the inflation is possible, I personally do not think that a sizeable outright deflation constitutes a feasible option for all countries. An economy can be squeezed to the point that the country is pushed to the brink of civil war without bringing its prices down very much. The countries of Southern Europe have borrowed too heavily and now need to service their debts. Against this background, they cannot achieve a real devaluation through price and wage cuts, because they would drive their citizens to bankruptcy. Thus, a reform strategy based on austerity and strong deflation would prove impossible.

The second alternative is inflation in the eurozone's core countries. According to the Goldman Sachs study mentioned above, Germany would need an inflation rate of 5.5 percent for 10 years to increase its prices by 70 percent. Realistically, this is not going to happen, for various reasons.

The third option is that of individual countries temporarily exiting the euro. Exits, however, are disastrous for the capital market, as they lead to bank runs and capital flight, as seen in Cyprus. On balance, there does not seem to be any clear-cut solution available to resolve the eurozone's underlying problems. Instead, the euro countries may have to muddle through using a combination of all of the strategies put forward above, namely a little bit of inflation in the core, a little bit of austerity in the South and a little bit of exit in isolated cases.

A fourth option is to give up austerity and just continue living on credit that is publicly provided or guaranteed by other countries. This option is preferred by many, in particular the debtor countries and their private creditors, who would like to safeguard their wealth. However, it obviously finds less support in the Northern countries and would not be a solution in the long run. It lifts private credit contracts to the public level, creating tensions between countries. It imposes huge risks on the taxpayers of the creditor countries and will in all likelihood deprive them of some of their wealth. It means that the allocation of capital in the eurozone is determined by political rather than market forces. And, last but not least, it turns the recipient countries' lack of competitiveness into a chronic Dutch disease, with permanent mass unemployment and a state of enduring dependence.

Europe is unfortunately trapped in a situation with no attractive solutions, forced to choose between ugly alternatives. If we want to rule out the fourth possibility, namely an exit, a realignment of relative prices is indispensable. While some countries' prices are sufficiently close to equilibrium to achieve the necessary realignment within the eurozone by keeping their prices constant and waiting for Germany and other northern countries to inflate, others would have to really cut them and undergo a very painful

adjustment. This process may be so dangerous and harmful for the society that it might be better for them to exit the euro.

In such a case, a programme of orderly exits should be defined for them which keeps them formally in the eurozone, allows for re-entry at a later point in time, and supports the exiting economies' banking systems. I personally think that we made a mistake with Greece three years ago, for if the country had been allowed to exit at that time, its troubles would now be over. However, continuing as we have done to date is definitely not an option for the future, as the current situation is one of terror without end. How long can the Greek population withstand a youth unemployment level of two thirds? The mistake that we are making is to place a financial crisis on the same logical level as a crisis in terms of risking the stability of society.

Some conclusions

Discussions are needed of a new model for Europe that lies somewhere between the dollar and the Bretton Woods system. In my opinion, Europe cannot have a common currency without a common state. Realistically, however, I do not see a United States of Europe taking shape in my lifetime. In its absence, the eurozone needs a flexible system that gives its members the possibility to exit and re-enter the monetary union if necessary.

Our goal should be a United States of Europe, but at the same time we need to avoid the mistakes made by the Americans. One of their biggest mistakes was that of debt mutualisation when the United States was founded. Alexander Hamilton, the first US finance minister, mutualized state debt in 1791 arguing that this would act as cement for the new US state. In fact, however, the opposite proved true. In 1812-1813 there was a second round of debt mutualisation during the second war against Great Britain, but all this merely gave the US federal states the impression that they were better off borrowing if their neighbours did, as this would enable them to finance infrastructure development, the costs of which would be shared. These events led to the emergence of a major credit bubble in the United States that burst in 1837. From 1837 to 1842, nine of the US states went bankrupt and the result was a great deal of strife. According to Harold James of Princeton, history shows that fiscal unions have proved explosive in the past, rather than acting as cement to strengthen newly formed states.

Europe needs to learn from the US experience by creating a United States of Europe with a strong power centre, but avoiding mutualising local debt, as this would poison relations between European countries by lifting debtor-creditor relations, which are currently largely private, to a state level. Since we do not have a legal resolution mechanism at a state level, debt socialization would therefore lead to endless quarrels in Europe and a repetition of the mistakes made in the United States.

The first step towards a true federation is to have a common foreign policy and a common army to defend the territory. Surprisingly, no one speaks about that. All the effort is directed instead towards fiscal transfers and loss mutualisation schemes. This is putting the cart before the horse and does not strike me as the right approach. Europe, in my opinion, does not mean reinventing the wheel: it means replicating the best aspects of the model from the other side of the Atlantic.

Keynote Address by

Joaquín Almunia
Vice-President and Commissioner for Competition, European Commission

I am very happy to be with all of you and to share with you some of my ideas on the situation of Europe, the European project, European integration, European economies and how to tackle some of the big challenges that we are all facing. I will not follow all of the points that Professor Sinn has already presented in his very coherent speech, but will instead follow my own line of thoughts on the situation in Europe. Although I studied economics as a young man and have to deal with economic issues in my professional and political life, I am, as a member of the European Commission, a politician and will speak as a politician, and thus not at the same level as the economic presentation given by Professor Sinn.

I will start this speech with the reality in figures as presented yesterday when Eurostat released its figures for the first quarter of 2013. According to these figures, both the euro area and EU is undergoing a recession in terms of GDP development, after two consecutive quarters of negative growth. In terms of year-on-year change, the euro area was –1 percent at the end of the first quarter of 2013 compared to the same period last year, while the EU was –0.7 percent. So the negative growth figures are a little higher for the euro area, but overall there are no major differences in the evolution.

It is true that when we look at the composition of these aggregate figures in Europe or in the euro area, different situations emerge; but they are not as different as in some of the slides that Professor Sinn showed us. In terms of growth, the three Baltic countries constitute the group of good performers. The Southern periphery (and Ireland has escaped this periphery when it comes to GDP figures and now has positive growth), including France, is in a recession, which is stronger in Greece, weaker in France, and somewhere in between the two in the other countries. However, the core economies of the EU, starting with Germany of course, are not in good shape in terms of growth either.

In view of the strong interdependencies of our economies, these problems are not the problems of a small group of countries, regardless of the acronym used to define this group. The problems that we are facing are the problems of the entire European economies and of Europe. The best way to pick up on these shared problems, which require analysis and solutions, are the messages that we receive as Europeans, be it Europeans working at the EU or at the national level, when we establish a dialogue with any other non-European interlocutor European. For interlocutors from outside Europe do not talk about the problems of Italy, Spain, Portugal, Greece or France, they talk about the problems of the euro area and the EU as a whole.

These are not only problems in terms of growth. In this case, the way that the situation is perceived at the national level changes more than when we look at the GDP figures *Employment*, of course, is an extremely serious issue in Spain or Greece, and less serious in many other European countries like the Netherlands and Finland, where employment levels remain quite favourable, even if there are negative figures of growth.

Credit flows and the cost of funding are very serious issues and to a far greater degree in some members of the euro area than in others. We all appreciate the importance of banking and financing to the continental European economies and there are serious problems within the same economic and monetary union with the same monetary policy. The transmission of monetary policy or the different problems of the banking system that needs to allocate resources or to organize the financing of the non-financial part of the economy is not working well at all and this is a serious problem. The impact of this situation is different from country to country, but the differences are not so major in political terms.

Opinion polls show that Europeans' feelings regarding Europe are becoming increasingly negative. Despite national differences in these negative feelings, we are generally observing a serious degeneration in the trust and confidence of citizens in EU institutions, coupled with different degrees of lacking confidence *in national* institutions. In some countries opinions of EU institutions are still less negative than those of national institutions. In Germany, however, this trend does not apply. This general evolution is worrying because we are not only experiencing economic difficulties and suffering serious social tensions and problems, we are also experiencing a political crisis too. Many Europeans are pessimistic, their confidence in democratic representatives is evaporating and this is not only an economic problem, it is a political problem that we need to tackle and discuss. My point is that we cannot split economic analysis from political analysis.

For this reason, I cannot express any support whatsoever for the temporary exit solution. This is a major political issue that cannot be explained in a slide with a graphic. We are not only living with social unrest, demonstrations, tensions, fears, uncertainties, we are in the middle of a serious political malaise that is giving way to new forms of populism, which go far beyond the traditional forms that we are accustomed to suffering in our democracies. In some cases the expression of this populism is not democratic at all.

Many of the big challenges that we are facing have not been created by the crisis. The debate over how to achieve higher levels of growth, improve Europe's productivity and regain our competitiveness *vis-à-vis* developing economies was taking place before the crisis emerged. Ageing and the related risks that it poses for our social policies and systems in terms of social inequalities is not a new problem created by the euro crisis; it was there before. The fears of globalisation in parts of our societies, nationalism and protectionism have only been exacerbated, and in some cases to a great degree, by the crisis. The crisis has merely added new and very important points to our agenda.

These include the crisis of governance and the lack of adequate instruments in the Economic and Monetary Union. The euro continues to be a very good idea, both economically and politically, as a way of reinforcing our integration as Europeans. But the instruments put into the hands of those who are responsible for adopting decisions in fiscal and financial policy or in structural reforms by the EU treaties; and that should result in a coherent policy mix that helps the EMU to fulfil our expectations, were not created before the crisis. During the difficult times of the last 4–5 years we have tried to advance and it is very difficult to think of the future, or the next 10–15 years, with ideas like mutualisation, and at the same time, to have to take the relevant short-term decisions to fight against the urgent problems faced every month in the Ecofin, for example. This work is being done, but it still is an on-going process and is far from finished.

When my colleague Michel Barnier, the Commissioner in charge of financial regulation, explains what we have been doing for the last three years in the so-called Barroso Commission, he has a long list of initiatives that, in many cases, have been finally agreed by the European Parliament and the Council, and in other cases are being discussed. Almost all of the initiatives of the G20 in 2008, or of the Financial Stability Board in the months after October/November 2008, that have been put forward as necessary regulations to overcome the problems caused by the financial crisis have either already been adopted or are in the adoption process.

At my level as Commissioner for Competition and State Aid Control, we have dealt with over 60 individual restructuring plans for financial institutions since the beginning of the crisis. In some cases we have looked at resolution plans, and in some cases at the winding down of institutions, including here in Germany, or in many other cases restructuring plans. This is a very important task that is on-going in the problem countries, as well as in some other countries of the euro area. Considerable public resources and effort is going into this process of financial repair and it remains important for the near future.

We have adopted many important decisions, some of which were *not* possible before the crisis; and were only made possible due to the pressure of the crisis because as leaders, governments and institutions, the crisis made us focus more on what is urgent and important. But the question is whether these decisions are enough? What needs to be done on top of the measures that are already being implemented, or have been discussed and agreed?

I think that the steps taken already are not enough. Even looking at the long list of very important, and

in some cases, historical decisions that have been adopted over the past three to four years, it is not enough. What else needs to be done from an economic standpoint, in my view, for countries that still have deficits and high levels of public debt? Consolidation needs to be continued. We now have more efficient tools to discipline fiscal consolidation at an international level, but at the same time, because fiscal consolidation is taking place, there are problems in terms of aggregate demand that cannot be ignored. Financial repair should continue, but at the same time we know that a banking system is being repaired and financial institutions that are being restructured at an individual level cannot take the lead in granting credit. Deleveraging in the financial sector is occurring in places where financial repair is the most intense and this is creating problems for the non-financial sectors of economy. Structural reforms are being agreed, but their impact on demand, on growth, on jobs is not immediate. Structural reforms produce excellent results, but their positive impact is only felt in the mid-term.

So everything that has been done is necessary, but does not go far enough. I would like to mention two points that deserve deeper discussion. From the macroeconomic point of view, I am worried about imbalances in the current accounts within the Economic and Monetary Union. The adjustments in deficits in the current accounts at the euro area level have been very rapid. All the countries with deficits, if we aggregate the figures, will not give us a deficit for 2013 when we aggregate all the traditional deficit countries, whereas the surplus at the EMU level will increase because the surplus countries have not reduced the size of their surplus. The size of the surplus this year is, according to our estimates, exactly the same in terms of GDP as the size of the surplus in 2006. The surplus of the aggregate euro area was close to zero before and at the beginning of the crisis, and will be 2.6 percent or 2.7 percent of the total GDP of the euro area this year, or more than the total size of the Greek economy. The logic and the consequences of this fact need to be discussed.

In the past we have lived with lower imbalances both on the surplus and the deficit side, and with an aggregate current account at the euro area level that was roughly balanced; but we will no longer be living in this world in the future if things do not change. The other point from the financial side are credit flows and how we will finance our economy if credit flows are diminishing and set to remain extremely subdued, not only because of the problems of financial institutions and the lack of solvent demand, but also due to the implementation of Basel III and other elements that are creating additional pressure on banks' balance sheets. In terms of credit flows, all other things equal, I cannot expect that credit flows to increase in our euro area economies.

So there are three responses that need to be worked out. Firstly, a banking union to forge a link between the sovereign and the balance sheet of the banks, which was the principle under which the heads of states and governments committed to advance proposals and decisions towards a banking union one year ago. This remains a key element in the return to reasonable growth and employment figures. Secondly, we need to discuss internal demand, not in the simplistic terms of saying "Well, the Germans need to increase inflation to 5.5 percent", but by seeking ways of boosting internal demand or trying to create the conditions for more active internal demand, given that internal demand looks set to decrease in other parts of the euro area because we are in a process of consolidation and deleveraging.

So how can these problems be solved? With more Europe? Of course! I understand that some do not wish to advance any further towards integration, but it is the real challenge that we face. I don't see any possibility of gradually advancing proposals and gradually getting results or of improving the current situation, which is not only affecting part of Europe, but the whole of it, without more integration. We have too many things in common, too many common interests and values shared by 500 billion Europeans, to ignore that when we face this kind of extremely challenging period, the solution is to discuss reasonable instruments of economic policy and reasonable decisions. This does not mean giving up any of the rigor or quality of our policies, or the protection of a balanced economy, as all of these elements are necessary to improve productivity and lower imbalances. However, ensuring that the aggregate result of decisions at the European level is a better, more dynamic economy, higher growth figures, lower unemployment figures and the protection of our values without further social tensions and without widening the gap in trust that exists between citizens and politicians and between institutions and leaders, requires, in my view, more integration and not less; deeper integration and not exits.

Panel 1

Becoming Slimmer: Why Europe Needs to Cut Debt and Reduce Leverage

Daniel Gros
Director, Centre for European Policy Studies, Brussels

Introduction

The ongoing crisis has focused attention on macroeconomic policy. Fiscal policy is especially controversial because of the widespread perception that 'austerity' is the main culprit for the ongoing recession in Europe. However, this perception is mistaken.

I will argue that the more important problem for Europe (and in particular the euro area) is how to deal with the existing overhang of private debt. Over five years have now passed since the onset of the financial crisis, which many thought was precipitated by 'Anglo Saxon' finance. The US economy is now visibly recovering from the crisis, but the euro area remains mired in recession. What is the reason for this divergence?

All credit booms create an overhang of debt. The recovery depends on the speed at which this overhang is eliminated. Unfortunately very little has changed in Europe during this period of over five years in terms of private debt. The increase in public debt has, on average, actually been better contained in Europe, than in the United States, but private debt, especially in the banking sector, has not been dealt with sufficiently.

Moreover, the corporate sector in Europe has a much lower capacity to finance investment from internal sources of funds. This implies that a recovery of investment in Europe will be much more difficult than in the United States as long as the banking sector remains weakened by excessive levels of leverage. This problem, not excessive austerity, is the reason why the cost of the crisis could be much larger in Europe than in the United States.

Genesis of a crisis

The literature on financial crisis has demonstrated that almost all major crises are preceded by a combination of two phenomena: an increase in leverage (or credit expansion) and an unusual increase in asset prices.[1] These two alarm signals were observed not only in the United States, but in Europe as well. Yet, unfortunately, they were largely ignored on both sides of the Atlantic[2] and, contrary to a widespread perception, Europe accumulated more imbalances than the United States. Moreover, the higher reliance of the European corporate sector on external financing suggests that it will take longer for Europe to recover.

As the key problem for Europe is now its dysfunctional banking sector, it is instructive to look more closely at a macroeconomic indicator of credit expansion or leverage. Every boom is similar in that low standards of risk aversion (or a perception of a low risk, known as 'great moderation') invite financial institutions to increase credit and this happened on a large scale on both sides of the Atlantic. Excessive levels of leverage are an essential ingredient of most crises and the 'great financial crisis' constitutes no exception. Leverage is defined in financial markets as the ratio of debt to equity financing. A higher level of leverage generally indicates a lower capacity to absorb losses and hence greater fragility. In this respect there has been progress, as Europe's banks have increased their equity cushion (from extremely low levels). European

[1] See, for example, Adalid and Detken (2007) or Alessi and Detken (2009). According to Borio and Lowe (2002), a low inflation environment increases the likelihood that excess demand pressures show up in the form of credit growth and asset price bubbles, rather than in goods price inflation. If this is the case, inflation-targeting central banks with a 'myopic behavior' could contribute to financial instability (see de Grauwe 2009), and de Grauwe and Gros (2009).

[2] See de Grauwe and Gros (2009), and Carmassi Gros and Micossi (2013) on the reasons for this.

banks have thus marginally increased their ability to absorb losses.

But the new higher capital requirements have not yet been satisfied and do not take effect until 2018. Long transition periods are justified when real investment needs to be made. But this is not the case when one considers an increase in capital ratios for banks. On the contrary, the complicated and lengthy implementation timetables for Basle III, stretching in some cases over a decade, increase uncertainty and create time inconsistency (time is never ripe). This is the real problem today: the current shareholders own a valuable franchise, namely the bank at its present (low) level of capitalization, which ensures a high probability of government intervention in case the bank gets into difficulties. However, the present shareholders know that required capital levels will go up over time. Their incentive today is to restrict credit, rather than increase capital because that would dilute their own stakes. Sinn (2010) also analyses the incentives for owners of bank equity with limited liability.

But what about the likelihood of losses? This can be measured better in macroeconomic terms *via* the ratio of credit to GDP. Leverage defined this way increases when credit expands, but nominal GDP does not increase. This usually occurs when the perception of risk diminishes, making banks more inclined to extend credit to marginal borrowers. One key reason why this happened on a large scale prior to 2007 was that great moderation gave the widespread illusion that macroeconomic volatility had permanently been reduced because of central banks targeting inflation and keeping it at a low level.

A high level of leverage is an essential ingredient in any major financial crisis because it means that many agents have issued promises to pay a certain nominal amount, but do not necessarily have the 'expected' regular cash flow to honour these promises – see Minsky (2008) for the classical description of leverage schemes leading systems towards instability. Since regular cash flows will be proportional to GDP, macroeconomic leverage can be measured by relating the stock of credit to GDP. It is not possible to establish an absolute benchmark for leverage as different financial systems can support quite different ratios of credit to GDP. However, changes over time, and especially rapid increases in this ratio, constitute alarm signals that have been identified as reliable predictors of financial crises.

Credit boom and bust: a transatlantic comparison

The (by now) standard warning signals were certainly flashing in Europe before 2007/2008 as the ratio of debt to GDP increased.[3] From the start of EMU to the peak of the credit boom total debt (defined here as all claims fixed in nominal value) increased in the euro area from about 250 percent to over 330 percent of GDP, as shown in the last column of Table 1. Most of this increase came from the financial sector[4] whose leverage almost doubled from about 60 to 112 percent of GDP. Government debt actually declined slightly as a share of GDP (from 76 to 69 percent of GDP) and the increase in leverage of the other sectors (households and the non financial corporate sector) was much more moderate.

[3] We leave aside the question of why the build-up of the credit boom was ignored. Inflation targeting by central banks was probably one key reason. According to Borio and Lowe (2002) a low inflation environment increases the likelihood that excess demand pressures show up in the form of credit growth and asset price bubbles, rather than in goods price inflation. If this is the case, inflation-targeting central banks with a 'myopic behavior' could contribute to financial instability (see de Grauwe 2009) and de Grauwe and Gros (2009).

[4] Note: the financial sector in the EA is defined as MFIs, insurance corporations and pension funds and other financial intermediaries, including financial auxiliaries. MFIs debt is given by debt securities issued plus currency, but excludes deposits. Our data differ from those of the McKinsey Global Institute, which have been used in other publications. However, the McKinsey data appear to be too low to be plausible, as they give the total debt of the financial sector as only 40 percent of GDP for the United States.

Table 1

Euro area leverage: debt as percentage of GDP

	Non-financial corporations	Financial sector	General government	Households	Total economy
1999	63	64	76	45	248
2007	92	112	69	62	334
2012	99	128	102	65	394
Change 1999–2007	29	48	– 7	16	86
Change 2007–2012	7	16	33	4	59

Source: Own calculations based on ECB data.

Table 2

US leverage: debt as a percentage of GDP

	Non-financial corporations	Financial sector	General government	Households	Total economy
1999	61	73	53	66	253
2007	76	113	56	96	341
2012	80	87	92	81	340
Change 1999–2007	15	41	2	30	88
Change 2007–2012	4	– 26	36	– 15	– 1

Source: Own calculations based on data from the Federal Reserve.

Given that it is difficult to establish an absolute benchmark for leverage, a transatlantic comparison is useful here. The increase in overall leverage, measured by the debt-to-GDP ratio, in the United States (88 percentage points of GDP) was very similar to that of the euro area (86 percentage points of GDP), only its distribution over different sectors differed, as can be seen from a comparison of Tables 1 and 2.

Total economy-wide leverage was thus very similar across the Atlantic both at the start of the boom (around 250 percent of GDP in 1999) and at its peak (340 percent of GDP in 2007). 'Anglo Saxon finance' was initially the main culprit, but in reality the increase in leverage of the financial sector was somewhat smaller in the United States. One reason for this lower increase is that the much maligned securitization of sub-prime mortgages actually results in securities (so-called RMBS) that are more like equity than debt, whereas the covered bonds much preferred in Europe do not have that quality. This implies that if there is a problem with the underlying mortgages, the issuing bank is not threatened with bankruptcy (and the attendant disruption and cost).

The sectoral differences appear less important in retrospect. In the United States the contribution of households was somewhat larger than in the euro area, whereas that of the non-financial sectors was smaller. The sum of the increase in leverage resulting from these two sectors is the same across the Atlantic – they are just inversed in terms of relative importance.

The more relevant differences between the United States and the euro area can be seen in the response to the crisis, as shown in Figure 1, which uses the data from the last rows of Tables 1 and 2. The two major differences are in the household sector and the financial sector. Households in the United States have been paring down their debt by over 10 percent of GDP. This was, of course, partially possible thanks to the 'no recourse' features of mortgages in many US states, which allow households to walk away from their mortgage debt when the value of the house falls below that of the mortgage balance still due.

But the key transatlantic difference lies in the financial sector, where leverage has fallen substantially in the United States (about 25 percent of GDP), but has increased in the euro area (by about 15 percent of GDP).[5] The stark difference in the financial sector is also the reason why overall leverage (see the last columns of Tables 1 and 2) has continued to increase strongly (by almost 60 percentage points of GDP) after 2007 in the euro area, whereas it has been constant in the United States (where the increase in government debt was counterbalanced by a fall in both the financial sector and households).

This continuing increase in economy-wide leverage is the key reason why the financial crisis is bound to linger longer in Europe – even abstracting from the specific 'euro' aspect, which has dominated the discussion and absorbed the attention of policymakers in Europe so far.

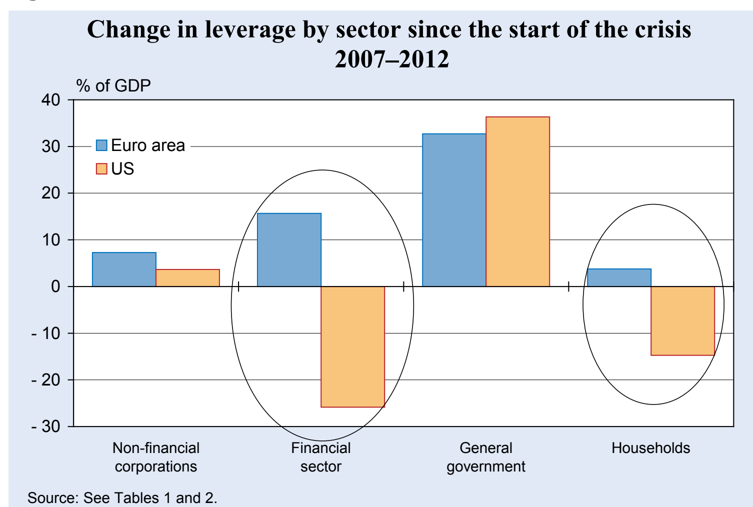
Two conclusions emerge immediately from this simple comparison:

- deleveraging the financial sector is possible as the example of the United States shows; and
- deleveraging has not even started in the euro area.

[5] The financial sector comprises in both cases of the central bank and this might affect the results as both central banks have increased their balance sheet considerably. However, as the increase in the balance sheets of both central banks has been of a comparable size, this aspect should not affect the comparison. Moreover, the ECB has lent large amounts to the banking sector (and it has been accorded de facto a preferred creditor status, thus making other debt less secure) whereas the Federal Reserve has been taking large amounts of deposits from the banking sector, which it has mostly invested in government guaranteed securities.

Panel 1

Figure 1



Why it matters: the importance of the financial sector to investment

A financial system that needs to reduce leverage has a tendency to restrict the availability of credit. How important is this to the economy? This depends, of course, on the financing needs of the various sectors in the economy. European consumers traditionally have been large savers (with the exception of Spain). They do not need credit to maintain consumption.

However, the corporate sector is in a completely different situation. It typically needs access to external financing to maintain investment. Yet in this area the starting situation in the United States is once again more favourable. One key reason for this is that the US corporate sector has traditionally had a much smaller financing gap than the European one. Tables 1 and 2 above already showed that the increase in the non-financial corporate sector was smaller in the United States than in the euro area.

Figure 2

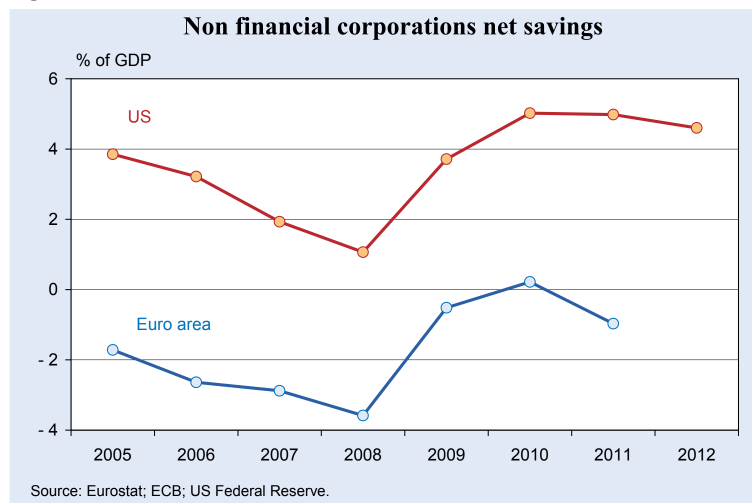


Figure 2 right shows that the US corporate sector is actually typically a net saver because its profits are usually larger than its expenditure on investment. This implies that the US corporate sector does not need to receive new credit (from banks or other sources) in order to maintain investment at least at the present level. There are naturally large differences within the US corporate sector, with some parts having a large cash flow surplus (e.g. the tech sector) and other parts (e.g. the automobile sector) suffering from a major deficit. However, the commercial paper market, which continues to function, can recycle the surplus funds of enterprises such as Microsoft to those firms needing funds.

The situation of the European corporate sector is quite different. It can finance only part of all investment from internal sources as its savings rate has remained negative for a long time. This implies that the corporate sector in the euro area needs a continuing flow of new credit just in order to maintain investment at its present level. Europe thus faces the unpleasant combination of having a stronger need for deleveraging in the financial sector and a corporate sector that is more dependent on external finance than that of the United States.

Can debt be serviced in Europe?

The euro area therefore has a double handicap (at least compared to the United States): leverage is higher and the corporate sector is more dependent on additional credit. A third drawback is that servicing debt (i.e. claims fixed in nominal terms) is more difficult in Europe for the simple reason that the difference between the growth rate of nominal GDP and the interest rate is less favourable (and has

worsened since the start of the crisis). Table 3 shows the difference between the growth rate of (nominal) GDP and the (nominal) interest rate actually paid by governments and non-financial corporations.

Panel (a) of Table 3 looks at government debt, which usually sets the benchmark for all other interest rates and for which a transatlantic comparison is possible. This table shows that, even before the crisis started, this difference was already negative for the euro area average, indicating that interest was accumulating at a faster pace than the capacity to service the debt due to growth (this implies that 'Ponzi units' in the parlance of Minsky (2009) would already have had a difficult life). After the crisis the difference worsened by about one full percentage point (to minus 2.1 percent). By contrast, for the United States the difference was slightly positive during the boom and has remained positive even after 2008, indicating that it remains much easier to service nominal debt in the United States than in the euro area.

There are, of course, vast differences across the euro area in terms of this key indicator of debt sustainability. This indicator has improved considerably in Germany (which had one of the worst growth – interest rate differentials during its slow growth period prior to 2005), but deteriorated very sharply in the euro area's periphery, as shown in the lower part of Table 3. Most member countries are either much worse (the periphery) or much better (most of the core) than the euro area average.

Table 3
Can debt be serviced with growth? The interest rate growth differential

Panel (a): Government debt

	Boom (until 2008)	Bust (since 2008)	Change
Euro area	– 1.1	– 2.1	– 1.1
US	0.4	0.2	– 0.1
Germany	– 2.7	– 1.2	1.5
Spain	2.0	– 3.3	– 5.4
Italy	– 1.4	– 3.7	– 2.3

Source: Own calculations based on Eurostat data.

Panel (b): Cost of financing for the non-financial sector

	Boom (until 2008)	Bust (since 2008)	Change
Euro area	– 0.3	– 2.7	– 2.4
Germany	– 2.1	– 2.1	0.0
Spain	3.6	– 3.9	– 7.5
Italy	– 0.7	– 3.6	– 2.8

Source: Own calculations based on ECB data for new business of medium term loans to non-financial corporations.

Looking at the cost of medium-term loans to non-financial corporations confirms this picture: for the euro area average the interest rate – growth rate differential was actually close to zero during the boom, but worsened after the crisis (by almost two points). A stark difference again emerges between Germany (no change) and countries like Italy and Spain, where the interest rate now exceeds the growth rate by almost 4 percentage points. The deterioration was particularly stark for Spain (over 7 percentage points) given that, during the boom, Spanish interest rates had been lower than the euro area average and the growth rate (of nominal GDP) had been much higher. Both elements have now turned around. It is also interesting to note that the interest rate – growth rate differential for Germany before 2008 was not that different from that of Spain today.

Conclusions

Getting the European economy to grow again requires a radical overhaul of its financial sector. The financial sector was already too highly leveraged at the start of the crisis in the euro area, but, in contrast to the United States, this has not improved since then. On the contrary, leverage has even increased strongly as debt continues to increase, both in the financial and government sectors. Given this parallel increase in debt, one should not be surprised by the 'diabolic loop', which could, at times, be observed between these two sectors. Moreover, servicing debt is becoming more difficult in the euro area as the difference between interest rates and growth rates grew even more unfavourable with the start of the crisis.

Unfortunately, however, it is proving almost impossible to cut debt in Europe. Part of the problem is that bankruptcy costs are very high in Europe. This is

an important consideration for households. In the United States a household can emerge from personal bankruptcy in a matter of weeks or months (with little social stigma attached). In Europe, by contrast, personal bankruptcy proceedings usually last several years (in Germany a household has to show 'good behaviour' for six years before being discharged of its remaining obligations).

An even more important aspect, however, is that bank debt has been considered sacrosanct to date – or at least it was until the case of Cyprus emerged in early 2013. The ongoing debate on the rules for bank resolution and the bailing in of bank creditors is thus crucial to allowing Europe to deal with its debt overhang in the financial sector.

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Panel

The panel's first speaker, **Axel Weber,** Chairman of the Board of Directors at UBS, offered an outsider's perspective on the euro crisis from Switzerland. In his opinion, the crisis has revealed major flaws in the construction of the euro, which can only be corrected with courageous political decisions and bold reforms. Weber advocated a well-thought out, sequenced approach to reform and argued that stabilizing the financial and banking sector should be a clear priority as Europe needs an orderly and appropriate flow of credit to enable its economy to expand.

With its intervention the ECB has opted for short-fixes, but general expectations of how much central banks can achieve are too high, warned Mr Weber. The powers of central banks are limited, especially when interest rates are already close to 0 percent. In other words, warned Mr Weber, central banks certainly cannot be expected to fix structural problems. They have merely created a breathing space that needs to be used wisely by policy-makers, he added, while expressing fears that this may not be the case.

So what should be done, asked Mr Weber? He identified recapitalizing banks as the key to stabilizing the financial system and restoring credit flows as a crucial precondition for sustaining economic activity. Bigger capital buffers are needed by banks (in Switzerland these buffers are 19 percent) to better withstand their adversaries in the market. While the instruments used to achieve this are widely known, recapitalisation can be harder to achieve when a sovereign is under pressure, acknowledged Mr Weber. So if more capital for banks is the answer, how can it be raised, he asked? In view of the difficulty of raising capital on today's market, most banks have opted to deleverage their balance sheets. Yet if banks deleverage and reduce risk-rated assets, they cannot at the same time grant new credit to stimulate the economy.

In his closing remarks, Mr Weber insisted that: *"A global diversification of banks has never been as useful as it is now"* in terms of offering banks protection from problems in the eurozone. *"In terms of where the eurozone needs to go, […]"* he added, *"There need to be structural forms, but […] once a country has lost market access and banks don't lend to that country any more or buy its assets, there is no alternative to austerity because, having lost market access, the only thing*

you can do is de-lever". Mr Weber ended by calling for greater fiscal harmonization across Europe, but stressed that this should be an evolutionary process which must be preceded by further integration and convergence on a European level in terms of effective retirement ages, tax rates and labour market regulations.

For **John Evans,** General Secretary of the Trade Union Advisory Committee at the OECD, the immediate issue is the short-term relaunch of growth, and not just the long-term perspective. This short-term boost could be achieved *via* major programmes to increase infrastructure investment, which would, in turn, create more jobs. The populations of crisis-stricken countries like Greece cannot accept any more austerity, cautioned Evans. Instead they need to be given renewed confidence in the future *via* investment in on-the-job training. Evans also cited a more equal distribution of income increases as the key to a broad-based recovery.

Andrius Kubilius, MP and former Prime Minister of Lithuania, on the other hand, was far more positive about austerity. In his experience austerity works and can bring real growth. Nicknamed the "Crisis Prime Minister" for his terms in office in 1999–2000 and his election in October 2008, one month after the Lehman Brothers collapse, Mr Kubilius spent 4 years managing economic crisis. In 2009 Lithuanian economy went into very deep recession during which the country's GDP fell by 15 percent while its deficit grew by 14 percent. Instead of appealing for IMF assistance in 2009, Lithuania opted for internal devaluation.

By 2012 the results were impressive with GDP growth up to – 3.5 percent, the deficit at ~ 3 percent GDP and public debt at 40 percent of GDP. In addition to instant cuts in public wages and pension benefits, internal devaluation in Lithuania reduced labour costs by 15 percent, enabling the economy to regain competitiveness. Exports started to recover by annual 30 percent growth, reaching levels that far exceeded the pre-crisis figures. These results were achieved thanks to the political will to implement effective austerity measures *via* internal devaluation, explained Mr Kubilius. Austerity was built on a national consensus between the government and its social partners like the major labour unions, business and pension associations. Indeed, in Mr Kubilius' view, crisis is the best time to reform and slim down public sector.

However, as the fourth speaker **Georg Milbrandt**, Former Minister-President of the Free State of Saxony pointed out, *"If you are going to cut off a leg you need to do it fast, not inch by inch".* Although Mr Milbrandt agreed with Hans-Werner Sinn that devaluation is required in the South, he doubted whether the flexibility or political will exists in the periphery to take the harsh, swift measures required to achieve devaluation internally. He also highlighted the problems created by the flawed design of the euro, but argued that the solution does not lie in a transfer of funds. For if wealth were to be transferred to Europe's poor, noted Mr Milbrandt, it should be sent East to Poland and the Baltics, not South to Greece. In his view the solution consists of real economic adaptation i.e. in reducing wages and savings or *via* an exit, which should not be treated as a taboo. To believe that the stabilization of the bank sector alone will resolve Europe's present crisis is an illusion in Mr Milbrandt's view. He cited deleveraging and the injection of more equity into the system as essential components of the long-term solution, along with not just more, but better regulation.

Opening the discussion up to the floor, **John Peet,** panel chairman and Europe Editor at *The Economist*, raised the issue of the US' reputation for treating its banks more aggressively than Europe, where individual states protect their banks and have not been tough enough. In response, Mr Weber noted that US banks were all recapitalized immediately with TARP etc. after the crisis, but said it was a myth that US banks are better capitalized than their European counterparts. He attributed the difference in capitalization levels to the different accounting standards adopted by banks on either side of the Atlantic. He also pointed out that many US banks are not yet fully compliant with Basel III whereas their EU counterparts are. US banks, explained Mr Weber, have not yet consolidated their off-balance sheet engagements as EU banks have, which constitutes a major difference. The real debate, in Mr Weber's view, centres on the question of whether non-national money should be used as a backstop for national banks. That pillar of banking union is a long way off, he noted.

Mr Peet subsequently touched on the issue of convergence by citing the general consensus that countries need to adjust to become more like Germany in terms of their legal retirement age, for example. If all EU countries become more like Germany, however, they will all run a large current account surplus, he

noted. To counter the potentially negative effects of such convergence, Mr Weber suggested funding for common features of the social welfare system at an EU level, with nations opting for idiosyncratic elements (such as a lower retirement age) being obliged to fund the latter themselves. In his opinion, this would make the price of being different to the EU average transparent and would open up a national debate over it. Mr Weber believes that if their citizens can see the cost of being different, some countries may reconsider this option.

A question from the floor raised the issue of whether a deeper microeconomic debate with a focus on innovation and entrepreneurship would not be more appropriate than a debate of macroeconomic instruments to manage the crisis? Mr Weber agreed with this point and described the whole debate in Europe as too inward looking, especially in terms of redistribution mechanisms for the proceeds of growth. Germany or Europe cannot afford to become less competitive, or other global emerging markets will steal Europe's market share, warned Mr Weber. Europe cannot sort out these issues internally. It should focus on being part of a global growth story, he added, and not on redistributing wealth within the continent. His views were echoed by Georg Milbrandt.

Raising another question from the floor, **Mats Hellström**, Former Ambassador of the Kingdom of Sweden, cited Mr Costas Simitis, former Prime Minister of Greece, who noted several years ago at the Summit, that the crisis was a matter of Southern European productivity, and not just Greek productivity. It is now generally recognised that all of Southern Europe has lost productivity and cannot compete with emerging economies. The key industry policy question, according to Mr Hellström, is how to revive competitive force and productivity in industry in Europe? He argued that EU funding should be devoted to innovation and services to help countries in emerging markets in Southern Europe to compete with Asia. Mr Gros, however, disagreed. *"The question of Southern Europe is not whether these countries are productive, but whether their consumption adjusts to their productivity or not".* In Mr Gros' view the central question is whether a country accepts the need to live within its means. In Germany a current account surplus has accumulated in recent years because Germans stopped consuming, not because the country was highly productive or competitive.

Mr Peet brought the panel discussion to a close by asking Mr Kubilius why Lithuania is still keen to join the 'EU disaster club'? *"Europe has always gone from crisis to crisis and has got stronger and more competitive",* responded Mr Kubilius, affirming Lithuania's continued optimism about the European project.

Panel 2

GETTING FITTER

VINCENZO GALASSO
Professor of Economics; Director, Centre for Economic and Political Research on Aging, Università della Svizzera Italiana, Lugano

Over the last decade, EU16 member countries have experienced average growth of less than 1 percent per year (Eurostat, 2003-2012 real GDP growth data). Germany and Sweden have seen average annual real growth rates of 1.2 percent and 2.2 percent respectively, but economic growth in Greece and Italy has dropped to zero or even turned negative. The US economy, on the other hand, grew by an annual rate of 1.7 percent over the same period, while Turkey has enjoyed annual growth of 5 percent. It is thus not surprising that several European countries have become less competitive. According to the IMD World Competitiveness Index, only one EU country member – Sweden – was among the top 5 most competitive countries in the world in 2012. Germany made it into the top 10 at 9th place. However, Spain, Italy, Portugal and Greece fared worse, ranking respectively 39th, 40th, 41st, and 58th out of the 59 countries investigated, while France was positioned in the middle of the ranking at 29th place.

According to another IMD survey, this lack of competitiveness is coupled with a negative attitude towards globalization. The French are reported to have the worst attitude towards globalization among the 59 countries analysed, but Greece (54th), Spain (43rd), Italy (41st), Portugal (34th), and even Germany (29th) can hardly be considered as globalization-friendly societies. Moreover, those countries that need to reform the most appear to be the least willing to do so. According to the IMD, the need for economic and social reform is least understood in France (59th out of the 59 survey countries), and remains highly controversial in Spain (53rd) and Greece (44th), albeit less so in Italy (23rd).

All EU countries are facing difficult demographic, economic and social challenges. However, the drop in competitiveness experienced by several, particularly southern European, countries calls for a quick reaction. These countries urgently need to return to economic growth. In other words, they must *get fitter*. But how can this be achieved?

A crucial step towards exploiting the potential benefits of the globalization process, instead of falling victim to it, is to liberalize the product market in order to increase efficiency. The emergence of new technologies and the acceleration of the globalisation process have created the opportunity to increase productivity and prosperity. However, only those economies with lightly regulated product markets have managed to take advantage of such innovation (Nicoletti and Scarpetta 2003). This is because regulations that restrain competition slow the diffusion of innovation, by reducing investment in new technologies and lowering the amount foreign direct investment flowing into a country.

Efficiency gains may justify labour-market reforms aimed at improving the allocation of labour and increasing participation rates (Bassanini and Duval 2006). Yet equity reasons also emerge in countries with strong employment protection legislation (EPL), which experience labour-market 'dualism' between (senior) workers on permanent contracts and other workers – typically young, females, poorly educated individuals or migrants – on temporary or other non-standard contracts. These forms of temporary employment have come to represent a persistent status, as workers find it increasingly difficult to move into permanent jobs.

Given that long-term growth rests on innovation and increases in labour productivity, countries that aim to get fitter need to monitor their education system. A cross-country comparison of the mathematics performance of fifteen year-old students based on a standardized international test – the OECD Programme for International Student Assessment (PISA) test – shows that, in 2009, Britain, Ireland,

Portugal, Spain and Italy were well below the OECD average, while the chart was topped by Korea, Finland and Switzerland. This early disadvantage in scientific education may lead to less innovation later on and could prove detrimental to a country's economic growth and wellbeing. Low labour productivity may also be driven by a poorly educated labour force. For instance, in 2010, the share of individuals aged 25–64 with upper secondary education attainments was 40.4 percent in Italy, in line with the figure in EU15 countries (42.2 percent), but well below that in several East European countries like the Czech Republic (75.2 percent), Slovakia (73.6 percent), Poland (65.8 percent) and Romania (60.5 percent), where many western-European firms delocalize their business.

A common challenge facing all EU countries is population ageing. The combination of falling fertility rates and a generalised increase in longevity has significantly raised the share of elderly individuals in the population. Between 1980 and 2007, the percentage of individuals aged 60 years or over increased from 13.4 to 19.9 percent in Italy, from 14 to 16.4 percent in France, from 15.5 to 19.8 percent in Germany, and from 10.9 to 16.7 percent in Spain. Public awareness of this demographic phenomenon has increased over time, especially since the actual process has far exceeded the forecast ageing trends. For instance, current OECD demographic forecasts for the expected shares of the elderly in the 2050 population differ substantially from the 1980 projections, with underestimates ranging from +1.3 percent in Denmark to +10.4 percent in Greece. This increased awareness of the actual magnitude of the ageing process, and of its impact on the financial sustainability of public pension systems, has played a key role in promoting pension reforms in many OECD countries over the last two decades. Yet many more countries will need to redesign their pension systems to cope with their ageing populations, and to reassure the financial markets of their solvency.

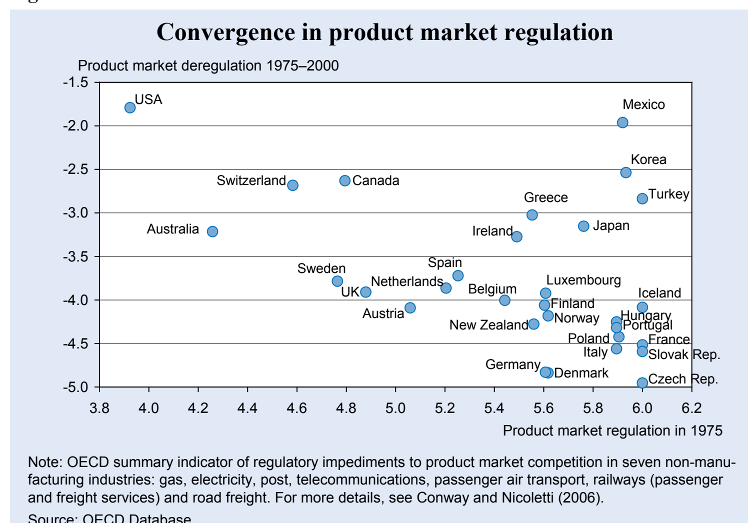
Taking stock of reforms

Over the past few decades many EU member countries have been involved in a process of structural reform. However, there have been significant cross-country differences in the depth, scope and pace of reform, which may explain, at least in part, the increasing divergence in the economic performance of the different EU member countries.

For the product market, indicators provided by the OECD that measure the level of anti-competitive regulation (see Conway and Nicoletti 2006) and the degree of public ownership in seven non-manufacturing industries (electricity and gas supply, road freight, air passenger transport, rail transport, post and telecommunications) show that the timing and intensity of the reforms have differed significantly from country to country. Product market liberalization[1] began in the United States in the mid-1970s. Among European countries, only Britain, Norway and, to a lesser extent, Finland and Austria followed this trend towards liberalisation in the mid-1980s. For most other countries product market liberalization came after the EU's internal market programme had been introduced and once they had gained access to the eurozone (see Høj *et al.* 2006; Alesina *et al.* 2010). In the end, as shown at Figure 1, some degree of cross-country convergence in product market regulations has indeed been achieved, since countries with strong product market regulation in 1975, like Italy, Portugal, France, Denmark and Germany, have recently been more active in deregulating their product market.

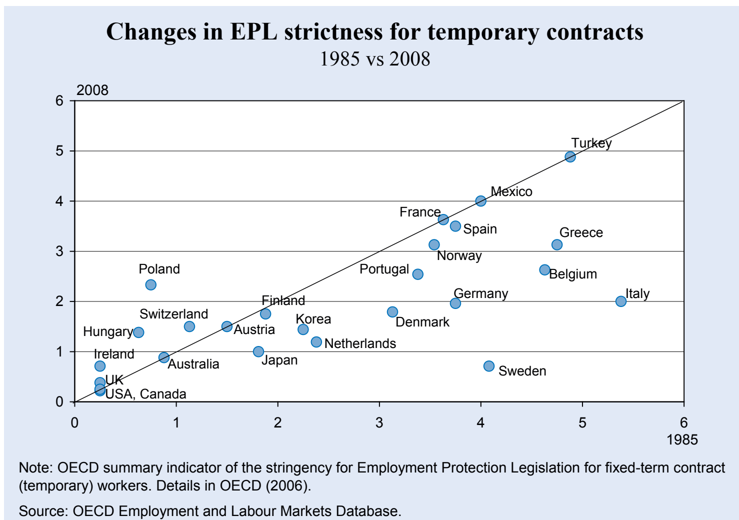
[1] Liberalizations started with road transport and spread to the air transport industry, and have also been seen in the electricity and telecommunications sectors since the mid-1990s.

Figure 1



Note: OECD summary indicator of regulatory impediments to product market competition in seven non-manufacturing industries: gas, electricity, post, telecommunications, passenger air transport, railways (passenger and freight services) and road freight. For more details, see Conway and Nicoletti (2006).
Source: OECD Database.

Figure 2



Changes in EPL strictness for temporary contracts
1985 vs 2008

Note: OECD summary indicator of the stringency for Employment Protection Legislation for fixed-term contract (temporary) workers. Details in OECD (2006).

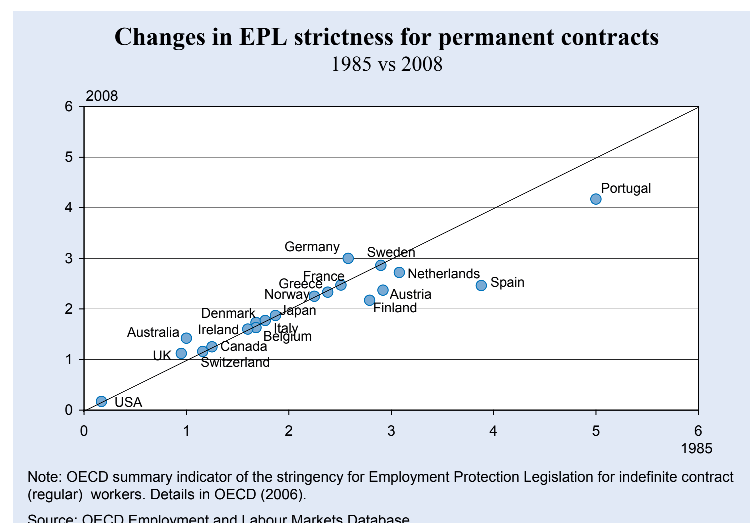
Source: OECD Employment and Labour Markets Database.

The labour market, on the other hand, has seen much less action. During the 1960s and 1970s most European countries adopted employment protection legislation (EPL), which increased labour market rigidity and hindered adjustments in job flows. Early retirement provisions were also introduced in many social security schemes, which created strong economic incentives to retire early. Since the late 1980s, however, there has been a move to make overall labour market regulation more employment friendly.[2] Labour market reforms typically featured a relaxation of EPL for temporary workers, as in Spain in 1984, in Italy in 1997 and 2003, in Sweden in 1996–1997, and in Germany in 2003. This trend is shown in Figure 2, which displays the degree of EPL for the OECD countries in 1985 and in 2008. These reform policies largely reshaped the structure of the labour market in the years that followed. In Spain, temporary contracts as a share of total employment contracts increased from 11 percent to 33 percent in about ten years; while temporary contracts represented 96 percent of the annual job-creation flow by 1997.

No labour market reform – with the exception of those in Portugal, Spain and to a lesser extent Finland – affected permanent contracts, as suggested by Figure 3. In Portugal restrictions on lay-offs were phased out between 1989 and 1991 and the use of fixed-term contracts was restrained. In Spain a new permanent employment promotion contract targeting the young (up to 30 years old) and older (above 45) unemployed individuals, as well as temporary workers, was introduced in 1997; while 'objective' reasons for layoffs were also allowed.

Perhaps the most comprehensive reforms of the last three decades were those addressing the financial sustainability of public pension systems. Among other countries, reform measures to postpone the retirement age were adopted in France (2003), Germany (1992, 1997 and 2003), Italy (1992, 1995, 2004 and 2011), and Britain (1986), either by increasing the normal and early statutory retirement age or by modifying the benefit formulae in order to reduce incentives to retire early. The striking impact of these reforms on the trend in average retirement ages in OECD countries is displayed in Figure 4, which shows how the downward trend was indeed reversed in the late 1990s. A few radical reforms modifying the architecture of the pension systems were implemented in Italy and Sweden, in the mid-1990s, and in Poland a few years later, as these countries abandoned their existing defined-benefit schemes to switch to a notional defined contribution (NDC)

Figure 3



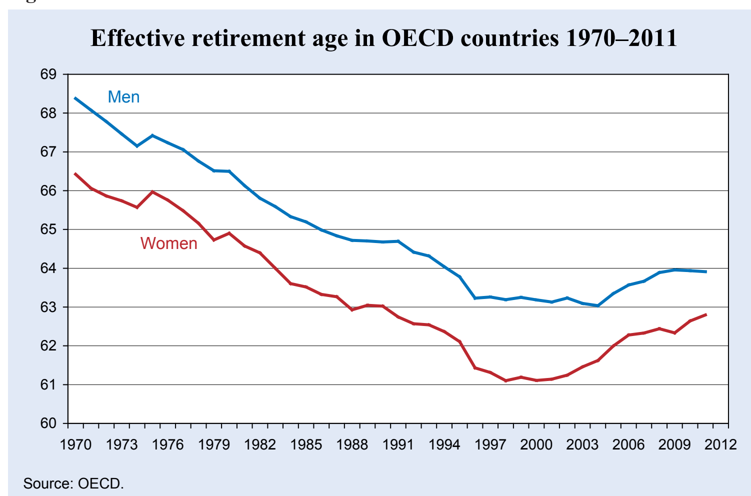
Changes in EPL strictness for permanent contracts
1985 vs 2008

Note: OECD summary indicator of the stringency for Employment Protection Legislation for indefinite contract (regular) workers. Details in OECD (2006).

Source: OECD Employment and Labour Markets Database.

[2] For a comprehensive analysis – see OECD (2006).

Figure 4

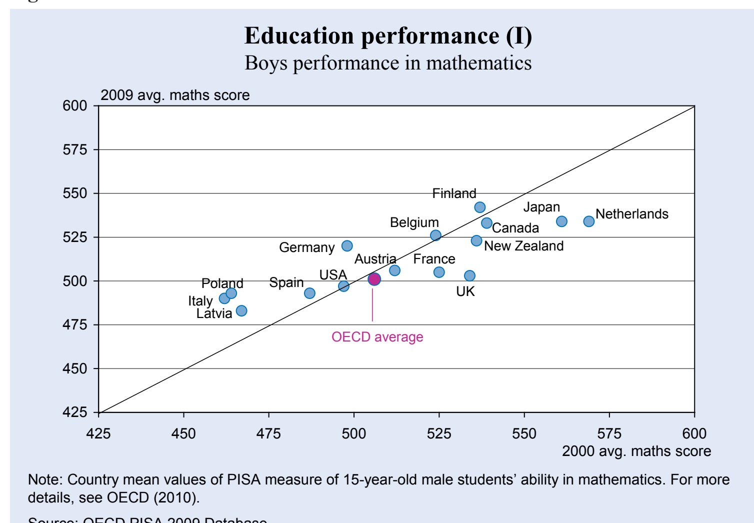


Source: OECD.

scheme, which was complemented with elements of a funded system. Additional reform measures were implemented in Italy in 2011, which included the introduction of a link between retirement age and life expectancy, following the example of the United States and of the 2004 German reform, which adopted a sustainability factor to adjust pension benefits to the old age dependency ratio.

Minor modifications in the educational systems occurred in virtually all countries. Yet, quantifying the magnitude of these reforms is often difficult, as they frequently involve qualitative and/or organizational measures, and, as such, are hard to assess. Most reform measures included one or more of the following strategies: (i) decentralization, with more decisions being taken by local schools; (ii) a greater focus on underachieving students, often with targeted programs; (iii) a better mix of school types; and (iv) the recruitment of good teachers. Results from the PISA (Programme for International Student Assessment) test in mathematics for male and female fifteen year-old students from OECD countries in 2000 and 2009 make it possible to assess which country, and thus which reform measure, improved the most. As shown by Figures 5 and 6, male and female students in Germany, Poland and Italy largely improved their math scores from 2000 to 2009, although in Poland and Italy they remained below the OECD averages. In Poland and Germany, these achievements were the result of major reforms of the education system (see Tompson 2009). In Poland, the system was largely decentralized and the local hiring of teachers was allowed. In Germany, reforms focused on improving schools for weak performers, and hence their achievement levels.

Figure 5



Note: Country mean values of PISA measure of 15-year-old male students' ability in mathematics. For more details, see OECD (2010).

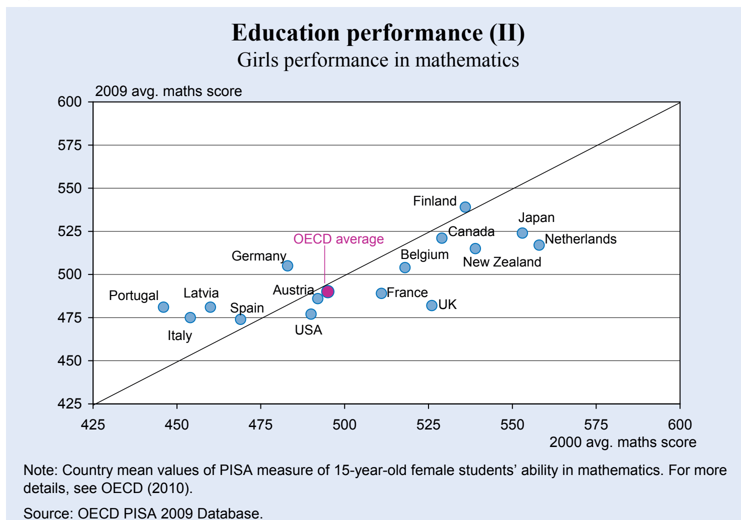
Source: OECD PISA 2009 Database.

Political challenges

Reforming tends to be unpopular. As Jean-Claude Juncker famously stated: "We all know what to do, we just don't know how to get re-elected after we've done it".[3] In fact, the mere existence of large public programs, such as education or welfare, and of labour and product market restrictions creates a political constituency of programme beneficiaries and bureaucrats, which supports the *status quo* and opposes any reform effort. This is problematic since policy-makers, who have been portrayed as opportunistic incumbent politicians seeking re-election, aim to implement economic policies that serve their electoral interests, by targeting their core constituency of voters or the undecided (swing) voters (see Persson and Tabellini 2000). The electoral costs of reforms may be particularly large for retirement and

[3] See, however, the empirical analysis by Buti *et al.* (2008).

Figure 6



Education performance (II)
Girls performance in mathematics

Note: Country mean values of PISA measure of 15-year-old female students' ability in mathematics. For more details, see OECD (2010).

Source: OECD PISA 2009 Database.

labour market policies and measures concerning the educational system, which typically affect a wide range of individuals (Galasso 2006). Institutional features, such as electoral laws (majoritarian or proportional system) or political regimes (presidential or parliamentary democracy), that modify the rules of the electoral game, and thus the policy-makers' incentives, may therefore be important for reforming.

In policy areas in which reform benefits tend to be small and widely spread, while costs are sizable and concentrated, a 'collective action' problem emerges since the potential beneficiaries constitute a large, yet less organised electorate than the losers (Olson 1965). Product market liberalizations typically exhibit these characteristics. In such cases, resistance to reforms mostly tends to come from special interest groups composed of firms operating in protected sectors that often provide information favouring their case and/or financial contributions to policy-makers (see also Grossman and Helpman 2001).

A *status quo* bias may also emerge due to uncertainty on the part of individuals about the effects of the reform on their personal situation. As most reforms have redistributive effects besides clear winners and losers, a (potentially large) group of individuals may exist who are *ex-ante* unsure about their own future prospects, and thus prefer to block a potentially beneficial reform (Fernández and Rodrik 1991).

The timing of the costs and the benefits of reform do not help to achieve political sustainability. In fact, while the costs of implementing structural reform tend to be upfront – labour market liberalizations may, for example, immediately increase unemployment risk – the benefits may take a while to materialise, as higher employment probability will increase only slowly over time (see Coe and Snower 1997). Therefore, the government's strength and time horizon may be crucial to reforms.

The road to reforms

There is no one-size-fits-all reform strategy that can be applied in all countries and sectors. However, a few lessons for reforming can be drawn from the wide variety of successful (and failed) reform experiences in many OECD countries over the past decades.

Reforming is easier during *economic and financial crises* for two reasons: firstly, crises provide information, as they may help to unveil the cost of existing inefficient policies. This information becomes publicly available and widely spread. Secondly, crises create a sense of urgency to react, which may make it possible to overcome the usual opposition to reform and to build momentum for adopting courageous (that is, electorally costly) policy measures (Haggard and Kaufman 1992; Drazen 2000). Yet, crisis may also hinder reforms, since individuals and socioeconomic groups are likely to be even less willing to losing their rents or benefits in difficult times. Furthermore, compensatory packages for the losers of the reforms are more difficult to finance during economic crises.[4]

Past experience suggests that privatizations of state-owned enterprises, particularly in the energy and telecommunication sectors, occurred during financial crises in an attempt to fill depleted public coffers; whereas liberalizations, particularly in air transport and postal services, followed economic crises in order to enhance efficiency (Høj *et al.* 2006).

Labour market reforms, which followed large increases in long-term unemployment rates, were as-

[4] Indeed, reforming under good economic conditions would be beneficial, because the costs of reforming are lower in a growing economy, and more resources are available for compensation packages. In the absence of a crisis, however, the reform process may lack the necessary political momentum.

sociated with a reduction in regulations, but for temporary contracts only, and sometimes with more generous unemployment benefits (see IMF 2004; Duval and Elmeskov 2005; Høj *et al.* 2006). Except for in Spain, this initial reform measure did not lead to further deregulation for regular contracts, and thus produced inequitable and inefficient dual labour markets. Hence, whether these reform measures, which mostly affected temporary workers, have (at least to date) improved welfare is questionable. Indeed, even in Spain, where both temporary and regular contracts were liberalized,[5] the major differences in the protection still provided by the two contracts gave rise to one of the most extreme dual labour markets. Economic crises featuring high unemployment rates may also lead to *pension* reform measures that reduce the incentives to retire early (see Høj *et al.* 2006). This is somewhat surprising, but at the same time reassuring, given the popularity that the 'lump of labour fallacy'[6] achieved in the 1980s and 1990s. Large financial crises, as in Italy in 1992 and in 2011, have also been pivotal to the implementation of the radical reforms that curbed pension spending.

Reforming under crisis is also more likely to occur in countries, such as Italy, featuring strong initial regulations – and thus more inefficient markets. However, half-hearted attempts led either to the adoption of partial reform measures, as described in the labour market, or to long transition periods, which delayed the arrival of efficiency gains from reforming, as in the Italian pension reforms of the 1990s. The current crisis should instead be used to push forward structural labour market reforms that feature compensatory measures, like the Danish 1994-1997 labour market reforms. A feasible trade-off to exploit is to reduce the employment protection of regular workers in exchange for a package of unemployment benefits and active labour market policies (Boeri *et al.* 2012). Obviously, crises ought not to be engineered just to reform. However, once they occur, the policy implication should be clear: be ready to reform.

Another driver of reform is the release of independent, credible *information* about the cost of the *status quo* and the potential benefits of reforming.[7] This proved particularly important in the product market in terms of assessing the uncertain redistributive effects of the reform measures. Successful governments need a clear communication strategy about the benefits of their proposed reforms and must be able to enlist the support of their beneficiaries, like customers or potential new entrants (Tompson 2009). In terms of *pension* reforms, reliable projections of the future cost of the ageing process, which helped to increase public awareness about the true costs of the status quo, were crucial in facilitating the adoption of significant measures in Italy (1995), France (2003) and Poland (1997–1999), for example.

As far as educational reforms are concerned, crises and the release of information may actually coincide. A sense of urgency related to the need to improve the quality of the schooling system may come from the release of credible reports on disappointing educational outcomes. 'A Nation at Risk' published by the US National Commission on Excellence in Education in 1993, and the release of the PISA results in 2000 (OECD 2001), with disappointing, yet surprising, results for Denmark and Germany, paved the way for important reforms of the education system in both of these countries. In fact, new information may come as a shock to the players that typically oppose reforms, such as students, parents, teachers, employers and trade unions, creating enough momentum to reform the system.

Anchoring to external agreements, such as entering the European Single Market or adopting the euro, has proven an extremely powerful tool for driving domestic reforms. The pro-reform push of the EU Single Market Programme forced product market deregulation, particularly in air transport, road freight, telecommunications, and, to some extent, the gas sector. Moreover, this pressure also worked indirectly: faced with widened international competition in tradable goods and services, domestic producers sought lower prices for non-manufacturing intermediate inputs. The introduction of the euro also had a significant, positive effect on the speed of the adoption of structural reforms in the product

[5] More flexibility was also introduced for permanent workers in 1994, after a deep recession characterized by a drop in total employment of 4 percent and an unemployment rate of over 20 percent.

[6] According to this 'lump of labour fallacy', the total number of job in the economy is to be considered fixed, so that inducing early retirement among the elderly workers represents a policy that would increase youth employment. This argument has been proven wrong both theoretically and empirically (see Boldrin *et al.* 1999).

[7] Providing credible information is not easy. As governments have their own ideology, public opinion may attribute the information released by the government as due more to its ideological leanings than to actual economic concerns. Paradoxically, a reform can be given greater credibility by the representatives of parties that would typically be expected to oppose the reform on ideological grounds. Thus, left-wing parties may be more credible advocates of liberalisation, which is only put forward for economic reasons (Cukierman and Tommasi 1998).

market. Such deregulation was stronger in EMU countries (like France and Italy) and certain sectors (like energy and communication), which featured higher initial levels of regulation. This seems to suggest that those countries and/or sectors that were more heavily regulated and less competitive, and which suffered the most from not being able to use competitive devaluations, were forced to liberalize to some degree.

This political strategy of blame avoidance has largely been used by European countries over the last two decades to reduce the electoral costs of reforming. Yet, heavy reliance on this mechanism may have come at the long-run cost of reducing the popularity, and perhaps the credibility, of the anchoring institutions, such as the European Commission, in cases where reforms are blamed on Brussels.

Packaging reforms properly, on the other hand, may represent a better strategy for reform-oriented governments.

In product markets, the sequencing of reform measures, for instance choosing to corporatize monopolistic firms before liberalizing, has proved efficient in breaking down the entrenched vested interests of workers and the managers or owners of monopolistic firms.[8] Trickle-down effects may also be achieved by liberalizing product markets first, in order to reduce economic rents and thus to minimise resistance to labour-market reforms, before moving to deregulating labour markets (see Blanchard and Giavazzi 2003; Fiori *et al.* 2007; IMF 2004;, Høj *et al.* 2006). Gradualism has been successful in promoting the structural reforms of public pension schemes, for instance in Italy in 1995, when a long transition period was envisaged to reduce the cost of the reform for the elderly, and thus to minimize political opposition.

Compensatory strategies should be used in the labour market to achieve a more efficient combination of policies to protect workers against the income risk of losing their job. This is possible, since different policies or institutions, such as unemployment benefits and employment protection legislation (EPL) are indeed close substitutes (Pissarides 2001; Blanchard and Tirole 2003). Reforms aimed at more flexicurity, that is, less EPL and more unemployment benefit, may exploit this substitutability (see Boeri *et al.* 2012). Analogously, a reduction in the generosity of unemployment benefits can be offset by an expansion of active labour market policies (ALMP). This compensatory scheme was at the heart of the successful 1994–1997 labour market reforms in Denmark.

Reforms of the educational system need the support of teachers, whose lack of compliance with new measures may jeopardize them entirely. Hence, policies typically opposed by teachers, such as the introduction of performance tests, should be accompanied by measures that increase teachers' involvement in the process, as was the case with the early 2000 Danish reform.

Finally, although *political institutions* seem to have played only a minor role in the adoption of reforms, some policy implication can still be drawn. A political mandate to reform has often proved crucial to the actual implementation of policy measures. Although political parties may be reluctant to discuss detailed reform measures in their electoral programmes, the media, independent organizations, and the public at large should urge the different parties to present their reform platform. Finally, political systems giving rise to stronger government are better suited to implement reforms. Hence, constitutional reforms (or electoral laws) that facilitate the emergence of strong governments should not be overlooked.

[8] In the telecommunication sector, resistance to the privatization of the Italian Telecom was limited, since Telecom had already been corporatized, its employees had private contracts, and union density was in line other private sectors (and thus lower than in the public sector). The privatization of France Telecom, on the other hand, was largely opposed by its workers, who had the status of public employees, and were able to mobilize the unions (Boeri *et al.* 2006).

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Panel

The second speaker, **Pier Carlo Padoan,** Deputy Secretary-General and Chief Economist at the OECD in Paris, continued with the theme of structural reform by looking at the costly adjustment process currently taking place within the eurozone, as well as the root problems of poor productivity performance and inadequate competitiveness that predate the recent crisis in many countries. Intra-euro area trade imbalances (or current account balances), possibly one of the clearest manifestations of the euro crisis, have narrowed, noted Mr Padoan. But what is driving this trend? One major and very traditional factor is that unit labour costs are adjusting, albeit not in all countries, and have fallen in the wake of the crisis. Is this trend permanent, due to the crisis or driven by cyclical factors? In Europe's periphery, where current account deficits have been narrowing, unemployment has been rising and is now the number 1 challenge facing policy makers. In Mr Padoan's view, *"A healthy and permanent adjustment process is one which tackles the roots of unfavourable or unsatisfactory productivity development".*

To some extent, he continued, it is productivity dynamics that ultimately generate strong performance. These dynamics are often measured using a composite unit called multi-factor productivity (or MFP) growth, he explained. This unit is composed of innovation, institutions and the way that production is organised, investment and labour force participation. However, Mr Padoan warned that MFP growth is an insufficient measure in many cases. Other factors may also indirectly have a major impact on productivity dynamic, he noted, citing the example of judiciary systems, which determine how effectively and quickly labour disputes are settled. Unfortunately, deeper reforms of this nature are not necessarily being addressed under the huge pressure of the crisis.

Taking a long-term perspective, productivity and growth look set to fall in both advanced and developing economies. Is this trend inevitable? In relation to this question Mr Padoan cited a paper by Robert Gordon, a leading authority on economic growth. The ultimate source of productivity growth may be innovation, notes Gordon, but the major innovations have already happened. Against that background, where will new sources of productivity come from, asked Mr Padoan? In view of the delays associated with the fruits of structural reform, *"Going towards intangible assets is one way of dealing with the Gordon problem",* he concluded.

Its loss of competitiveness is certainly the major problem facing France's beleaguered economy at the moment, according to Professor **Agnès Bénassy-Quéré** who is a director of the French government's Conseil d'Analyse Économique. France has lost a 2-percent market share in the global market over last decade due to an accelerated rise in prices, hampering its ability to sell goods abroad. Unit labour costs don't really account for the divergence in exports between France and Germany in recent decades, noted Ms Bénassy-Quéré, who focused instead on the services sector to explain France's loss of competitiveness. As prices for non-traded goods in France soared between 1999 and 2010, the labour costs were largely added to the price of services. As Ms Bénassy-Quéré, protection of the services markets also fell over this period. Emphasizing the importance of the price of services to external competitiveness, Ms Bénassy-Quéré called for greater deregulation of non-traded goods in France to lower their prices. Areas potentially ripe for deregulation in France include housing, transportation, retailing, the healthcare system and several protected professions such as chemists, for example. Ms Bénassy-Quéré also warned that the pace of national wage increases needs to be slowed. *"In France there is a lack of awareness of the need for reform and no perception of the benefits of reform"* she noted. In view of the lack of press interest in this issue, Ms Bénassy-Quéré emphasized the need to start with public opinion and create a desire for reform, which should be accompanied by fiscal space to compensate the 'losers' of reforms.

The third panel speaker **Roland Koch,** Chairman of the Executive Board, Bilfinger Berger SE, Mannheim and former Minister-President, State of Hessen, noted that politicians and business people often have to make pragmatic, but unwelcome decisions. In his view, voters in the eurozone are relatively satisfied with their basic situation and are not really prepared to endure the suffering that accompanies reforms in order to improve it. Mr Koch went on to express scepticism regarding the extent to which the 'losers' can be compensated under such circumstances. He outlined two basic alternatives for decision-makers: the first is to flood the market with money in the form of subsidies, which businesses happily accept; and the second is to give companies more room to manoeuver (greater flexibility in terms of labour, etc.). Politicians, he continued, are always asking how quickly businesses can deliver results if reforms are introduced, as they have their sights set on the next election. Their operational space is reduced by relative electoral prosperity, explained Mr Koch. He asked whether we can give politicians more space to act. Stakeholders on the business side have alternatives and will go elsewhere if regulation becomes too tight, he warned.

Addressing Ms Bénassy-Quéré, Mr Warner, ventured that the difference between Britain and France is that France is in a state of denial. He asked what can be done to shake France out of its complacency and whether France needs a Margaret Thatcher. In response Ms Bénassy-Quére noted that France's new government has delivered on its commitments in its first year and that its second year should be very different. She expects reforms of the pension system and of adult vocational training and predicted an uptick in the pace of reform. Ms Bénassy-Quéré also took pains to stress the existence of a political willingness to cut French government spending.

The first question from the floor was raised by **Peter Jungen**, Chairman of Peter Jungen Holding GmbH and of Project Syndicate. Almost everything has been tried in Europe to restore dynamism, but why is there not a greater emphasis on innovation? The start-up rate is 2.5 times higher in the United States than in Europe, reflecting its faster paced innovation, yet financing entrepreneurship is a real way to finance growth, he remarked, before throwing the question open to the panel. Mr Galasso agreed that innovation is very important and speculated that low venture capital investment in Europe may be due to poor incentives. He cited cultural differences as another key reason for reticent investment in start-ups. In the United States it is acceptable to fail, noted Mr Galasso, but in Italy failure is still seen as a stigma.

Weaker links between universities and business in Europe represent another reason constraint on innovation, added Mr Padoan. He called for the creation of a European research space that goes beyond national boundaries and promotes competition between R&D institutes. In France, noted Ms Bénassy-Quére, the situation in terms of as stimulating corporate growth is rather puzzling. While creating a firm is easy in France, hiring employees is difficult due to inflexible labour laws. Many French firms seem to struggle to grow from a small company to a medium-sized enterprise. Ms Bénassy-Quére specu-

lated that this may partly be due to paper work, but suggested that there was also a corporate culture problem. Small French companies would do well to emulate their German counterparts in this respect, she noted.

Moving onto the issue of demographics, **Guy de Jonquières,** Senior Fellow, European Centre for International Political Economy, London, pointed out that one way of alleviating the shrinking labour force problem would be to encourage more immigration. Could this offer an answer to our problem? Mr Galasso agreed that some countries like the United States rely on an inflow of young migrants to help solve labour market shortages, but argued that this was not a long-run solution. Once they enter a country migrants immediately converge with the fertility rate of its residents, explained Mr Galasso, which is why migration can only be seen as a short-term labour market fix. Ms Bénassy-Quére criticised companies for remaining mute on the topic of immigration and called on them to be much more vocal if they do wish to employ foreign workers.

Addressing Ms Bénassy-Quéré, Hans-Werner Sinn blamed the increase in wages in the services sector for France's lack of competitiveness. Germany's wage distribution, he noted, widened in the wake of Schröder's reforms, which created jobs at the lower end of the quality scale by abolishing second tier unemployment benefit. In the absence of such reforms, Mr Sinn postulated that higher wages for lower end jobs in France may have pushed up the price of services. Rephrasing Hans-Werner Sinn's question, Mark Warner asked whether France needs to get rid of minimum wages. Ms Bénassy-Quére responded by citing studies that show that the minimum wage has little impact on unemployment, except for the young. However, this is now a taboo topic in France after the last government's disastrous attempt to introduce a minimum wage for the young. All the government can do is to cut the social contributions required for young workers at the lower end of the wage scale, she observed.

Bringing the question session to an end, Mr Koch refuted the idea that immigration may be a way to reinvigorate Europe's economy, but supported the concept of a transatlantic trade zone as one of the best ways of boosting mid-term growth. There are a large number of long-term strategies for stimulating growth that were not discussed during the panel, as Europe's problems are currently foremost in almost everybody's mind, Mr Koch concluded.

Panel 3

Growing Stronger: What Way Out for Europe?

Harold James
Professor of History; Director, Program in Contemporary European Politics and Society and International Affairs, Princeton University

Introduction

I would like to offer two contrasting historical patterns or models, three lessons to be drawn from those very old experiences, and finally one principle – flexibility – on which a stronger Europe can and should be built. Maybe we should think of this exercise as carrying on the over-arching conference metaphor of slimming, getting fitter and building strength: what do we need to eat after the lettuce and carrots purgative regime? Should we get strong by eating Bavarian *Weißwürste*, Austrian *Knödel*, French *pâté de foie gras,* or English *roast beef*?

Some history and some models

We are today in Europe in the middle of a debt crisis and a political crisis. Debt can be a political poison, or it can become what Alexander Hamilton hopefully styled 'the strong cement of our union'. Looking to history, we see two contrasting models of how apparently excessive debt can be handled, coming from two contrasting political traditions. They are associated with two revolutions, one peaceful and wealth-enhancing (1688 in England), the other violent and destructive (1789 in France).

Not reneging on public debts is a central principle of political life that is deeply intertwined with the development of legal security, of representative government, and of modern democracy. Both the movement to hold governments accountable and the move to control budgets had their beginnings in England, before the successes of that largely peaceful 'revolution' inspired worldwide imitation. This is the roast beef solution.

In the late seventeenth century, in the wake of Britain's Glorious Revolution in 1688, when Britain revolted against the spendthrift and autocratic Stuart dynasty, the British government adopted a new approach to debt. Voting budgets in parliament – a representative institution – ensured that the people as a whole were liable for the obligations incurred by their government. They would thus have a powerful incentive to impose controls. Fundamentally the people who voted the taxes in parliament were also the holders of government debt. A constitutional approach limited the scope for the wasteful spending on luxurious court life (as well as on military adventure) that had been the hallmark of early modern autocratic monarchy. The result was a dramatic reduction in the borrowing costs of the British state. Representative government, and its logical outgrowth, the democratic principle, became part of the classic model of good debt management.[1]

It also reduced private borrowing costs, by promoting the operation of a well-functioning capital market. What distinguished the private borrowers from the state was the possibility of bankruptcy, which for the state had become an unthinkable event. A market, in which there are many separate interactions, and always a possibility of failure, thrived because of a state that was so managed that it could not go bankrupt.

At the beginning the achievement was precarious. Eighteenth century Britain seemed constantly in danger of ignoring the basis of the 1688 constitutional settlement, because of its costly addiction to Great Power politics. Particularly in the middle of the eighteenth century, British debt levels surged. At the end of the *Wealth of Nations*, Adam Smith commented on the legacy of the Seven Years War: "the progress of the enormous debts which at present oppress, and will in the long-run probably ruin, all the

[1] The classic exposition is North and Weingast (1989).

great nations of Europe, has been pretty uniform [...] When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes by an avowed one, but always be a real one, though frequently by a pretended payment" (Smith 1976, 466–467). So even the greatest economist was scared of debt and of the ruination it might cause.

The alternative model to that of British constitutionalism was that of *ancien régime* France: there regular state bankruptcies involved a reduction of interest payments and a stretching of maturities on state debt. France's debts too built up in the eighteenth century as a consequence of great power politics, the search for empires, and costly wars. After the conclusion of the American war of independence, instead of going back to the old French model – default – which had been put into effect as recently as 1770, the French elite did everything they could to avoid a default. They were afraid that their system was fragile, and so, in 1787, the government offered *foie gras*. It bailed out the private investors who had lost in an immense speculative scheme to corner shares in a reorganized East India Company (see Velde and Weir 1992). But there was a problem: the existing tax system had reached the limits of its capacity, and no more revenue could be raised without ending time-honored privileges and immunities. In the end, the only viable course was massive confiscation – the creation of *bien nationaux* as the basis for the issue of state debt. But that measure, instead of calming the financial situation, led to an escalation of expectations of what the state could and should do, and exacerbated social tensions. In short, adherence to the principle of non-default produced the French Revolution. The lesson of the French experience is that political systems will collapse if they take on too much debt and then try to pay at any cost. The situation was the reverse of Britain: there was no adequately functioning market that discriminated between risks, and as the counterpart a state whose commitments became incredible as it absorbed losses produced in the non-functioning market. The experience involved a long term cost. It made French society poorer relative to Britain in the century after the Revolution, as well as habitually inclined to look for *étatist* solutions.

A European problem

Contemporary Europe faces a new version of these eighteenth century historical dilemmas in an acute form. Do we or do we not have a debt level that is unsustainable? And if it is sustainable, how does Europe need to be organized so as to let the confidence in the secure asset of state debt translate into a more general capacity to finance private initiative, based on a secure belief that private claims are safe from unpredictable acts of state seizure?

In theory, Europe shouldn't be in a bad shape. The fiscal picture is not hopeless, even in the aftermath of the acute financial crisis of 2008–2009. For 2012, the government deficit for the eurozone was 3.6 percent, and the net government debt level (swollen in some countries such as Spain and Ireland by the cost of bank bailouts) was 71.9 percent of GDP. The debt figure is lower than that of the United States (87.9 percent), whose deficit is also much worse (8.5 percent) and Japan's statistics are much much worse (134.3 percent and 10.2 percent).[2]

There are reasons to be confident, and even proud: the history of the major successes of post-1945 Europe, of restoring democracy and peace to a war-ravaged continent. But currently Europe is in an existential crisis, more profound than any challenge of the postwar order. The problem is primarily political. Muddling through is a characteristic response of complex intertwined and interlocked political systems, but it is deeply destructive of confidence and capacity, and ultimately of legitimacy. In fact, maybe we should think of a third historical model, alongside that of Britain and France: that of the multinational Habsburg Empire. While France had increased its power by military conquest, the Austrian Habsburgs depended on the chance accumulation of territories with mutually incompatible political and legal orders through dynastic marriage *(tu felix Austria nubes)*. There is more than a little of the old Austrian principle of *Fortwursteln*, muddling through, in contemporary Europe's approach to crisis.

There are two related problems: the political/institutional disfunctionality that turns the overall debt and deficit figures into existential issues; and a long term doubt about the effectiveness and capacity of Europe to produce innovation, entrepreneurship,

[2] See IMF World Economic Outlook, April 2013.

dynamism, and growth. Even before the financial crisis, long term growth assessments were generally gloomy; they have become worse since then.

What can governments do to improve longer term capacity? It is hard to see isolated big infrastructure projects – more Stuttgart stations or Berlin-Brandenburg International Airports – as the answer, though such spending is vigorously championed by newly invigorated Keynesian enthusiasts for stimulus. Later, I shall return to the theme of measures that might make the labor market operate more efficiently, on a European rather than a national level. At the moment, fixing the institutional flaws looks like the most urgent task.

Problems and lessons

The first lesson from the historical models is that indecision, trying to take ideas and policies eclectically as a result of a bargaining process leads to poorer choices and indeed paralysis. That was the French problem on the eve of the French Revolution: denying that debts should be written off, but at the same time accepting a large expansion of potential claims.

The second lesson is that the difficulty of reaching a clear and consistent answer is heightened when class or distributional conflict becomes the major focus of concern. The Cyprus crisis has exposed a new dimension to the clashes over Europe's debt and bank crisis. The discussion of a levy on bank deposits, and whether small customers should be exempted, puts class conflict at center stage. At one of the tensest moments, as Cyprus was looking for an alternative rescue package from Russia, the German Bundesbank announced the results of a new ECB study on comparative wealth distribution in Europe. According to this study, German average wealth was below that of the southern European states, largely because fewer Germans own their own houses. The message must have been intended to influence the international discussions: why should poorer Germans make sacrifices to support Mediterranean millionaires? Or Russian oligarchs?

On the other hand, southern Europe saw itself as a victim of a mercantilist export promotion strategy of the north – especially Germany – to obtain competitive advantages through a fixed currency regime. That was a case that was already sometimes made in respect to the European Monetary System established by Helmut Schmidt and Valéry Giscard d'Estaing in 1978, but more potently in respect to the currency union. North and South see the effects of the monetary union in class terms.

In the aftermath of the financial crisis, income and wealth distribution has moved to the center of political discussion. Even the cardinals of the Catholic Church seem to have caught the new mood quite precisely, when they elected Archbishop Bergoglio as Pope Francis. The clear reference to St. Francis of Assisi recalls the Church's mission to stand up for the poor.

The third historical lesson is that solutions become even harder – and distributional conflicts more common – when there is an obsessive focus on economics and economic growth alone. There is a well-known paradox of freedom, that free institutions promote economic growth, but that if you desire freedom primarily and instrumentally because it is likely to bring growth, you are unlikely to get the good result. The story of state- and nation-building is similar: good rules make for prosperity and happiness, but explicitly looking for growth backfires.

Europeans find it hard to find a positive way of describing the exercise in which they have been engaged for the past half century. One common interpretation is that integration is simply the best or most convenient way of making people better off. Togetherness is supposed to be a foundation of prosperity. The Common Market was presented at the beginning in terms of an argument about the gains that would follow from increased trade. There then followed a debate about the benefits of capital market integration, and then of a single currency.

This case was a repetition of some powerful arguments that were made in the nineteenth century about national integration and unification. In particular the two countries whose problems drove much of the need for twentieth century European integration – Germany and Italy – were culturally and politically highly diverse. In the early nineteenth century, both countries had had a romantic and idealistic nationalism – but that gave way after the failures of the revolutions of 1848 to a new hard-headed sobriety and an obsession with economic forces.

The influential German journalist August Ludwig Rochau, the inventor of the term *Realpolitik*, gave a very nice definition of the new German mood on the eve of Bismarck's last war of unification. German unity was not a question of a desire of the heart, he said. Rather it was 'a mundane business transaction, in which no one should lose, but everyone should grab as much as they could for themselves'.

This sort of economic nationalism briefly produced in Germany and Italy coalitions of interests that supported the drive to national unification under Bismarck and Cavour. The problem arose that when growth faltered, the credibility of the national project seemed to crumble. Instead, movements emerged that championed a much more aggressive and confrontational nationalism that was based on the principle of a violent assertion of principles of cultural identity. That is the risk that we are currently facing.

Constitutionalization

Europe has not gone about constitutionalization in the way traditionally associated with state formation, and with the British example of 1688. In the often-cited case of the United States, the monetary framework, with the 1790 Coinage Act, and the fiscal framework provided by Alexander Hamilton's controversial debt mutualization, took place in 1790. That was only possible because the Congress had agreed in 1787 on a constitution: it was deeply influenced by the lesson of 1688.

Nineteenth century Germany also has the same very clear pattern. Constitutional rules first, a monetary framework later. The German Empire was created on 18 January 1871. In 1873 the coinage systems of the German states, the Thaler of the north and the Gulden of the south, were superseded by the establishment of the Mark. Only two years later was a central bank, the Reichsbank, created: not to handle fiscal issues so much as to deal with the financial instability that followed in the aftermath of the *Krach* of 1873.

The Europeans seemed to turn this on its head in the 1990s. They developed a mechanism that provided a mechanism for debt claims to expand, without a secure and precise set of rules limiting the exposure of the public sector to private obligations. In choosing a 'pure' money in the 1990s, free of any possibility of political interference and simply designed to meet the objective of price stability, Europeans were taking an obvious risk. They were obviously and deliberately flying in the face of the dominant modern tradition of thinking about money. The creation of money is usually thought to be the domain of the state: this was the widely prevalent doctrine of the nineteenth century.

The post-crisis search for fiscal rules and for a banking union, with not only a system of regulation and supervision, but also a resolution mechanism, is part of a drive to make the eurozone more like a conventional state. But both of these exercises raise profound problems.

How can Europeans be created?

What is the alternative tradition to thinking about Europe as a way of generating wealth and prosperity? A few years ago, the European Union was extolled as a postmodern creation, not like a traditional state with a firmly defined sovereignty (and a dramatic contrast with the United States) – see Cooper (2004). Sometimes analysts looked at the old, but very long-enduring, Holy Roman Empire, famously analyzed by the jurist Samuel Pufendorf as 'like a monster' because it had no clear head or sovereign. In fact, I believe, something of this flexibility needs to be revived.

What is needed is a new flexibility: not a replication of any sort of existing state. That flexibility is the core principle needed for realizing a secure and robust system of rules. The primary goal of such flexibility should be to avoid the build-up of expectations about support – or bailout – from common political institutions; and at the same time build an awareness of Europe's unique interconnectedness.

More flexibility in monetary policy

A common criticism of monetary union is that it requires a single monetary policy, that thus becomes 'one size fits all' and deprives policy-makers of a policy tool in responding to particular national or regional circumstances. This old critique was recently taken by Chancellor Merkel.[3] It reflects a genu-

[3] Financial Times, 26 April 2013, Merkel austerity comments highlight eurozone division on interest rates.

ine problem in the original conception of monetary union. When the EC Committee of Central Bank Governors began to draft the ECB statute, it took two principles as given: price stability as the primary objective of the central bank; and the indivisibility and centralization of monetary policy. This would not be 'in contradiction with the principles of federalism and subsidiarity' (James 2012). But in fact the second assumption was not really justified either historically or in terms of economic fundamentals.

Think first of the gold standard. A critical part of the gold standard was that individual national central banks set their own interest rates, with the aim of influencing the direction of capital movements. Incidentally the same differentiation of interest rates also occurred in the early history of the Federal Reserve System, with individual Reserve Banks setting their own discount rates. The eurozone is now moving to a modern equivalent, driven by a new concern with macro-prudential regulation. Bank collateral requirements are being differentiated in different areas; and the logic should be carried further in order to forestall future regional bubbles (Brunnermeier 2012). This represents a remarkable incipient innovation. In the aftermath of the crisis, some policymakers are beginning to see that a monetary union is not necessarily identical with unfettered capital mobility. Recognition of diverse credit quality is a step back into the nineteenth-century world, and at the same time forward to a more market-oriented and less distorting currency policy.

More political flexibility

In the aftermath of a big financial crisis, banking regulation is inevitably linked to implicit or explicit lender-of-last-resort functions and to resolution for failed banks. So there is also a significant fiscal cost, and that raises the same thorny political questions. In particular, what is the optimal unit for handling the resolution issue? The logic of possible bank workouts points to a desirability of larger banks and more cross-national banks as a risk-sharing mechanism. But the fiscal cost and the fact that only states can bear that cost push in the opposite direction, and have led in the past three years to a dangerous disintegration or renationalization of finance in Europe.

What is now termed a banking union – that is common European regulation with some fiscal capacity for resolution in the case of failed banks – is a very belated but necessary completion of the monetary union. Even this step is still uncertain, and excites a great deal of opposition from Germans who do not want to bailout south European banks. The critics have correctly identified the problem that some sort of permanent fiscal mechanism is required in order to pay for the bailouts and thus in fact implies a move to a real political union which regularly redistributes resources.

Problems of transfers in a large unit are at the heart of the political process of building federations or federalism. Integration had its own historical momentum, and if and when it goes into reverse, that process will also have a counter-momentum. The argument against the creation of new European structures rests on hostility to a transfer union that might lead to some redistribution of resources. Why should our money be taken away and given out to people in a very different area? What sort of claim do those very different peoples have?

The better way of discussing transfers within a large and diverse political order is to think of them as individualized or personalized. In particular, a European-wide social security system would not only offer the advantage of completing the labor mobility requirements of the single European market. It would also provide an important buffer in that booming areas would pay in more, and shrinking areas would draw out more – without these payments going through government bodies and appearing as transfers from North to South – whether in a country such as Italy or in the whole of the European area. Defusing the political problem requires less stateness and statehood, and not the erection of a European super-state.

Restraint in the creation of new state structures is required for another reason. We know that a commitment to monetary stability is only possible in the context of governments that can credibly commit to a fiscal regime in which there is no long term build-up of claims that cannot be funded through taxation – or in modern parlance, avoid fiscal dominance. That was a problem to which federal systems of the past were especially vulnerable (Sargent and Wallace 1981). Hyperinflation almost tore apart early 1920s Germany, with separatism in Bavaria, the Rhineland and Saxony. In late 1980s Yugoslavia, as the socialist regime disintegrated, the monetary authorities in Belgrade were closest to Serbian poli-

ticians such as Slobodan Milosevic and to Serbian business interests. The Croats and Slovenes wanted to get away. In the Soviet Union, inflation appeared as an instrument of the central Moscow bureaucrats, and more remote areas wanted to break away. A coherent and stable framework is needed to stop the proliferation of fiscal actions that destroy monetary stability.

Concluding remarks

The euro story is about the breakdown of governance mechanisms in the face of enormous financial claims, for which there is no obviously just mechanism of working out a burden-sharing arrangement. It echoes some of the problems of ill-defined or poorly constitutionalized federalisms of the past: the Austro-Hungarian Empire or Argentina. The European experience holds broader lessons, for other countries as well. Risk can be better managed if it is broken down into smaller packets, and not consumed as an indigestible whole.

(1) Mega-finance is a danger to fiscal stability, because first it permits the easy financing of deficits, but also the development of large disparities of wealth and income. Its breakdown then requires large government funded rescues and raises the problem of fiscal sustainability.

(2) Fiscal sustainability in the long run requires some sort of politically negotiated agreement. That needs to be rule-based, but also to permit flexibility as part of a strategy of immediate crisis response. Rules do not often constrain governments, so it is better to run stabilizers through non-government institutions such as insurance systems.

(3) Without such flexibility sovereign bankruptcy becomes a disastrous and destructive event that uncontrollably generates contagion.

Though all the underlying problems have been around for a long time, there is always a temptation to do what Europeans did until the financial crisis that is merely hope that with time the problems would vanish.

Preserving democracy in the face of antagonistic competing claims on the state involves the elaboration of mechanisms for giving citizens a share in a joint project – both materially and imaginatively. That was essentially the lessons of 1688: payments can become an act of solidarity when people believe they may benefit, and know that they won't be expropriated, because overall liabilities are legally and politically fixed. The alternative lesson is that of 1789: when claims become too complex as well as too large they trigger a distributional free for all in which solutions can no longer be negotiated, and need to be violently imposed. Europe today should be looking for its 1688, and not for a reenactment of 1789. Roast beef, not *foie gras*.

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Panel

Taking up Mr James' idea that prosperity alone is not sufficient to cement a union, the second speaker, **Wolf Klinz,** Member of the Committee on Economic and Monetary Affairs (ECON), European Parliament, Brussels, insisted that Europe is more than the euro and the eurozone, it is a vision of basic shared values. Yet a clear vision of Europe twenty years from now and the consensus to implement such a vision are both currently lacking, noted Mr Klinz. Instead there is a widespread crisis of confidence in Europe among its citizens.

Against this background, Klinz believes that this visionary element urgently needs to be added to the bail-out packages for crisis-afflicted countries as re-

cent euro rescues have violated many of the shared values expressed in the European treaties. Europe, in Klinz's opinion, needs to be relaunched with a focus not on ceding sovereignty, but on pooling it. In the relaunch of Europe the question of subsidiarity is very important in the sense that decisions should be taken at the right level. The principle of democratic accountability needs to be applied much more strictly in the future, he added. Due to time pressures and the need to react to the markets, the member states have opted for an inter-governmental approach over the last 2–5 years, rather than implying a community method; leaving the European parliament out of decisions on important projects like the ESM and the fiscal compact. Mr Klinz also highlighted flaws in the European Parliament itself, which is not based on proportional representation and needs to become more transparent. Opener communication policies are required to manage the expectations of Europe's citizens more effectively, argued Mr Klinz.

Looking ahead, Mr Klinz expressed the hope that tomorrow's Europe will be attractive to investors and innovation leaders, it should ensure that non-eurozone members like Britain are happy within Europe, that the competences between member states and regions are readjusted by pooling sovereignty and implementing a European approach to issues like energy policy, transport etc.

Mr Klinz ended his speech by raising two questions: whether the powers of the European parliament should be beefed up in the future to give it more clout, and whether a second, Senate-like chamber should be introduced, so that we can say that these representatives have been directly elected. In Mr Klinz's view the European Commission should be reduced to the status of a governing body with a president elected by the European Parliament.

Despite the progress that has been made in Europe, Mr Klinz acknowledged that it is not an optimal currency area. In his view, this is all the more reason to try to make improvements in areas where they are possible like the labour market by facilitating more migration within Europe. Welfare standards should be at least partially harmonised, he concluded, and elementary school education must be improved if Europe's re-launch is to be successful.

The next speaker, **Jay Ralph,** Member of the Board of Management of Allianz SE and Chairman of Allianz Asset Management, Munich, began by pointing out that both the United States and Switzerland didn't have federal currencies initially, and that their currencies were only introduced at a later date. Citing the Latin Monetary Union (LMU), which was founded in 1785 and disintegrated in the late nineteenth century, Mr Ralph highlighted three lessons to be learned from it. Firstly, cheating destroys unions, so you need a means of enforcement if you have a union; secondly, fixed exchange rates can attract speculation, so systems with flexible mechanisms are needed to deal with change; and thirdly, any monetary union will fail without a political and a fiscal union.

Will the crisis push the EU towards a stronger fiscal, banking and political union? In Mr Ralph's opinion, this is inevitable as the alternative is chaos. He outlined the following seven pillars for the future of Europe: tougher EU governance *via* EU institutions with greater democratic legitimacy, explicit exit rules, a fiscal rule book, the provision of economic guidance to correct imbalances, institutions with enhanced competencies, common policies to foster competitiveness and growth, and a sovereign debt mechanism. In his opinion, less banking intervention is needed and more political leadership. He wound up his speech by saying: *"We need a destination that is clear and a roadmap on how to get there"*.

Werner Hoyer, President, European Investment Bank, Luxembourg, picked up on the historical perspective of the euro crisis presented by Mr James and Mr Ralph. Mr Hoyer began by recalling that the link between political and economic union was clear to everybody when the euro was designed. There was a very controversial debate between Hans-Dietrich Genscher and Otto Graf Lambsdorff at that time. Lambsdorff supported the optimal currency area, but thought that events were happening in the wrong order, i.e. that political union should have preceded financial union. Yet Genscher sensed that there was no political will amongst Germany's neighbours (shortly after German unification) to make the *quantum* leap towards political union at that time, so he reasoned that monetary union would bring about the necessary pressure to proceed with political integration.

As the Germans were keen to see some protection against the potential risks of a monetary union, the idea of the stability and growth pact was born. As

an instrument this pact may have had too few teeth from the outset, conceded Mr Hoyer, but the principle of minimising risk was clear. Nobody would ever have imagined that the strongest partners in the EMU, France and Germany, would later be the first to break pact, he continued. They exerted their influence to escape the few teeth of the pact, but have suffered the consequences. According to Hoyer, these developments highlight the urgent need to re-establish the link between political and economic union. This process should involve rebalancing the equality of peoples within Europe to give a small country a say, but to grant citizens equality. Like Mr Klinz, Mr Hoyer emphasized the need to reweight votes into the European Parliament in order to give it greater legitimacy.

Moving on to the topic of reform, Mr Hoyer cited perseverance as a major problem in Europe and stressed the need to invest more heavily in sustainable structures. He noted that the ECB has taken courageous steps towards restoring confidence in the EU, but these measures have only bought time for politicians to sort things out and this time is running out. One of the lessons to be learnt from the crisis, he added, is that people should concentrate on their own remit and not mix functions. He expressed concern that expectations regarding the possibilities open to banks like the EIB and ECB are too high and need to be managed. Mr Hoyer ended by warning that we should not rely exclusively on banking finance, which is Europe's major weakness, but should ease access to long-term financing and credit for SMEs.

The first question from the floor was raised by **John B. Richardson,** Special Adviser on Maritime Affairs, FIPRA International, Brussels, who pointed out that there had been a great deal of talk about austerity, but little of solidarity. In his view the use of these terms is often confusing. According to Mr Richardson, Europeans want greater fiscal responsibility and discipline, not austerity, from their governments. He floated the idea that the richer citizens of Europe may prove more willing to express solidarity with their fellow European citizens suffering from austerity if they could bypass government. Mr Klinz responded that austerity often leads to misery and can produce empathy among others, but likened it to chemotherapy treatment for cancer, which may cause pain, but subsequently leads to a return to solidity. Solidarity and solidity need to go hand in hand, emphasised Mr Klinz.

The next question came from Clare Pearson, Corporate Social Responsibility Manager Asia, DLA Piper UK Ltd, Beijing, who asked what Europe is doing to integrate immigrants, to engage China and to flatten its borders in order to sell projects. How is Europe going to compete as a continent in the future? Mr Klinz did not think that Europe should try to imitate China's behaviour in conquering new global markets. It is true that China is successful, conceded Mr Klinz, but he was sceptical about China's value as a role model.

Guy de Jonquières, Senior Fellow, European Centre for International Political Economy, London, shifted the discussion towards a common social security system by asking how it would be financed and whether this would revive quarrels about a transfer union. Mr James answered that it would be very problematic to set up a common social security system and such a system would have to depend on payments into it, which would mean moving towards a US-style system as a model.

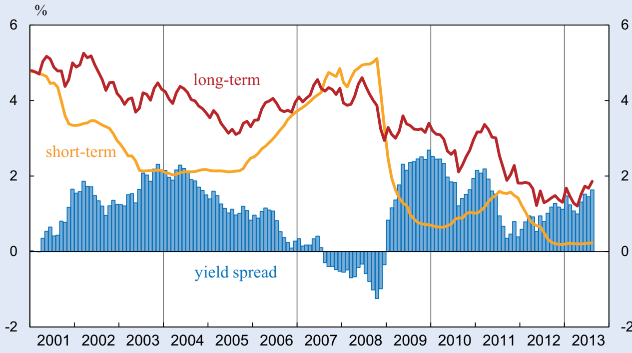
Mr Ralph noted that workers in Switzerland pay into a corporate system, but if they switch jobs, their pension moves with them. Any fiscal union involves some redistribution of wealth, noted Mr Ralph, who suggested taking VAT revenues, pooling them and redistributing term per capita and issuing Eurobonds against those funds backed by stream of revenue, with conditionality. Mr Ralph believed that these bonds would only be used to finance debt and speculated that immediate liquidity would be seen in the markets. Such VAT backed bonds would only serve to eliminate debt, he argued. However, Mr Sinn questioned the viability of financing European bonds *via* VAT, or introducing any form of redistributive mechanism, without a European state.

Andy Goldstein, Executive Director, LMU Entrepreneurship Center, Munich, raised the serious issue of high youth unemployment and asked how this could be reduced and how young business could be more effectively supported. While Mr Hoyer described youth unemployment as a ticking bomb, he admitted that there was no quick-fix solution to the problem and highlighted the need for a hugely differentiated toolbox to tackle the issue. To boost start-up businesses and venture capital projects, Mr Hoyer ad-

vocated a focus on innovation and stressed the need for Europe to be less inward-looking and to adopt a more global outlook by analysing major worldwide trends and their implications more closely. Mr Klinz suggested that start-ups should enjoy a grace period of exemption from strict labour market laws, which would enable them to hire and fire on a totally flexible basis. Mr Klinz concluded by remarking that the successful dual education system of Germany and Austria should also be applied more widely.

Financial conditions in the euro area

Nominal Interest Rates a)

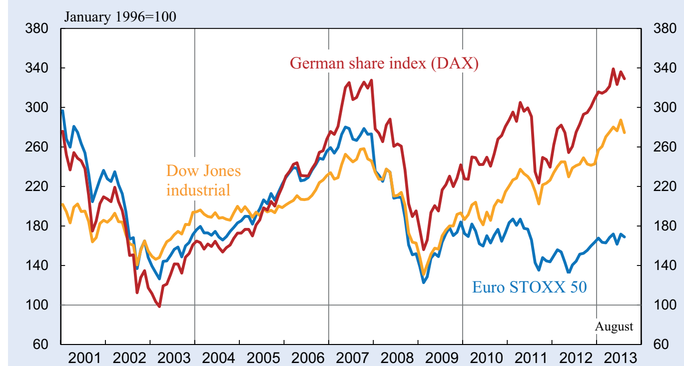


a) Weighted averages (GDP weights).

Source: European Central Bank.

In the three-month period from June 2013 to August 2013 short-term interest rates slightly increased. The three-month EURIBOR rate grew from an average 0.21% in June 2013 to 0.23% in August 2013. The ten-year bond yields increased also from 1.73% to 1.86% in the same period of time. Furthermore the yield spread grew from 1.52% in June 2013 to 1.63% in August 2013.

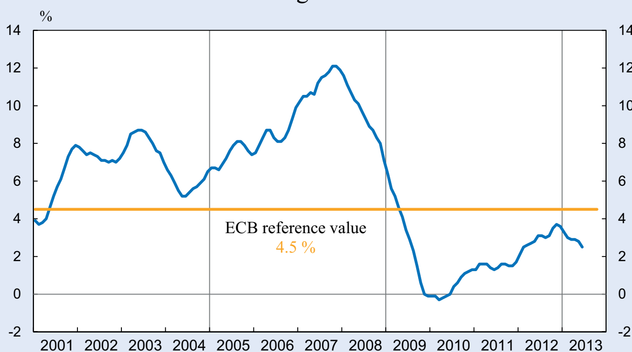
Stock Market Indices



Source: Deutsche Börse; Dow Jones; STOXX; Datastream.

The German stock index DAX decreased in August 2013, averaging 8,103 points compared to 8,276 points in July 2013. The Euro STOXX declined also from 2,768 to 2,721 in the same period of time. The Dow Jones International decreased, averaging 14,810 points in August 2013, compared to 15,500 points in July 2013.

Change in M3 a)

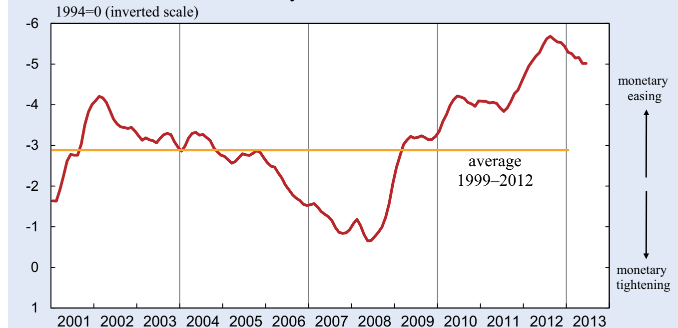


a) Annual percentage change (3-month moving average).

Source: European Central Bank.

The annual growth rate of M3 decreased to 2.2% in July 2013, compared to 2.4% in June 2013. The three-month average of the annual growth rate of M3 over the period from May 2013 to July 2013 decreased to 2.5%, from 2.8% in the period from April 2013 to June 2013.

Monetary Conditions Index

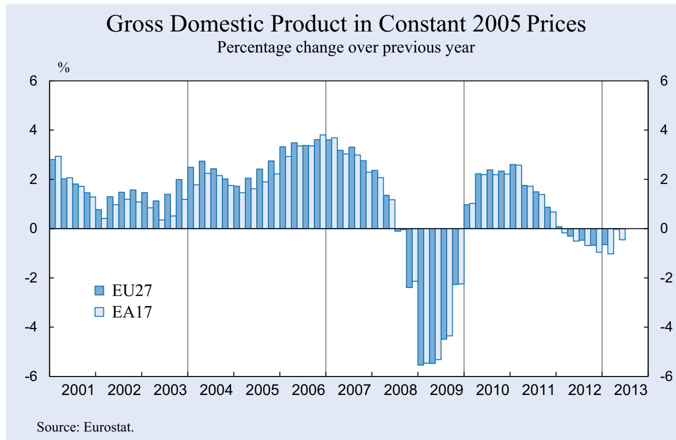


Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

Source: European Central Bank; calculations by the Ifo Institute.

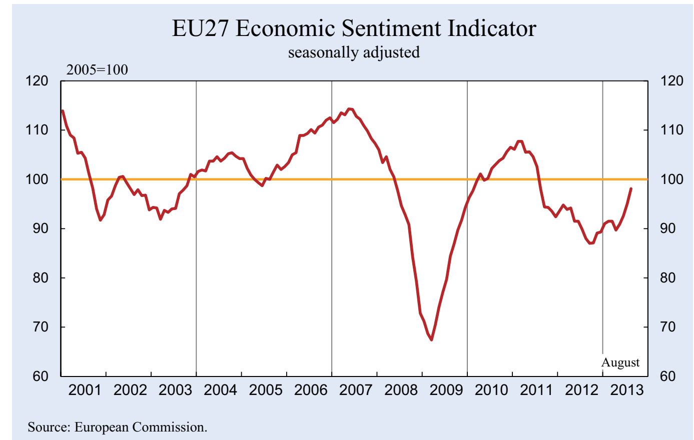
Between April 2010 and July 2011 the monetary conditions index remained rather stable. This index then continued its fast upward trend since August 2011 and reached its peak in July 2012, signalling greater monetary easing. In particular, this was the result of decreasing real short-term interest rates. In June 2013 the index continued its downward trend, initiated in August 2012.

EU SURVEY RESULTS



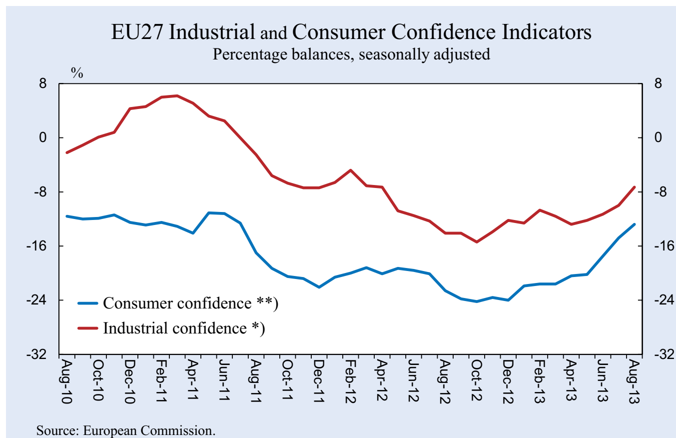
Source: Eurostat.

According to the second Eurostat estimates, GDP grew by 0.3% in the euro area (EA17) and by 0.4% in the EU27 during the second quarter of 2013, compared to the previous quarter. In the first quarter of 2013 the growth rates were -0.2% and -0.1%, respectively. Compared to the second quarter of 2012, i.e. year over year, seasonally adjusted GDP fell by 0.5% in the EA17 and remained stable in the EU27 in the second quarter of 2013.



Source: European Commission.

In August 2013 the Economic Sentiment Indicator (ESI) increased by 2.7 points in the euro area (to 95.2) and 3.1 points in the EU27 (to 98.1). In both the EU27 and the EA17 the ESI stands below its long-term average.

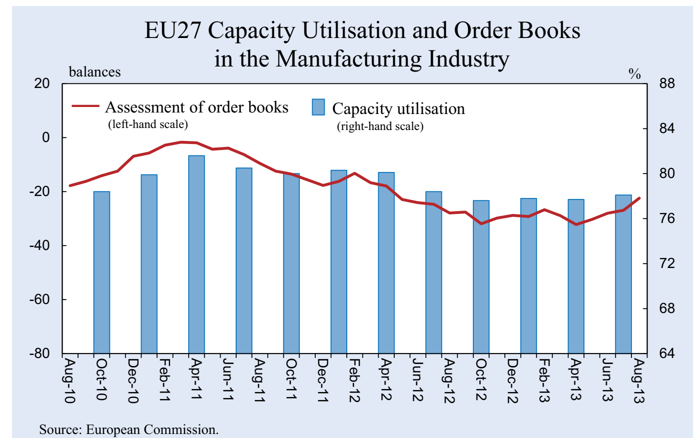


Source: European Commission.

* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).

** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

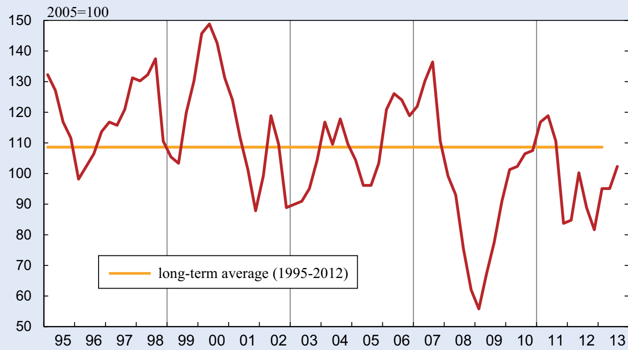
In August 2013, the *industrial confidence indicator* increased by 2.7 in both the EU27 and the euro area (EA17). The *consumer confidence indicator* also improved by 2.0 in the EU27 and by 1.8 in the EA17.



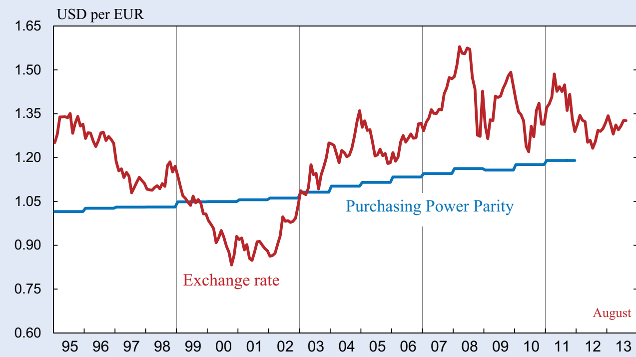
Source: European Commission.

Managers' assessment of *order books* improved from -26.9 in July 2013 to -22.4 in August 2013. In June 2013 the indicator had reached -28.0. *Capacity utilisation* increased slightly to 78.1 in the third quarter of 2013, from 77.7 in the previous quarter.

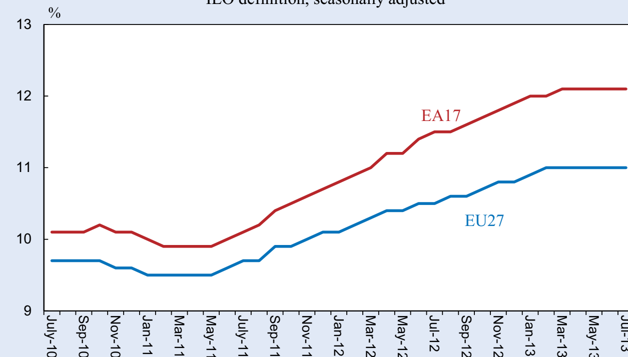
Euro area indicators



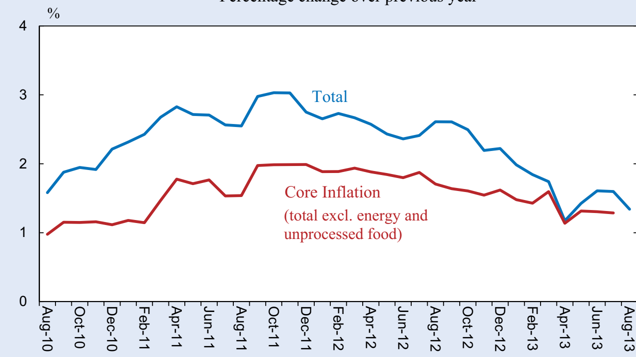
The Ifo Economic Climate Indicator for the euro area (EA17) improved, but remains below its long-term average value in the third quarter of 2013. The current economic situation in the EA17 brightened only slightly and remains at a low level overall. Expectations for the next six months, on the other hand, were significantly more positive than last quarter. An economic stabilization in the euro area seems to be emerging.



The exchange rate of the euro against the US dollar averaged approximately 1.32 $/€ between June 2013 and August 2013. (In May 2013 the rate had amounted to around 1.30 $/€.)



Euro area (EA17) unemployment (seasonally adjusted) amounted to 12.4% in July 2013, stable compared to June 2013. EU28 (including Croatia) unemployment rate was 11.0% in July 2013, also stable compared to the previous month. In both zones, rates have risen compared to July 2012, when they were 11.5% and 10.5%, respectively. In July 2013 the lowest unemployment rate was registered in Austria (4.8%), Germany (5.3%) and Luxembourg (5.7%), while the rate was highest in Greece (27.6%) and Spain (26.3%).



Euro area annual inflation (HICP) was 1.6% in July 2013, stable compared to June 2013. A year earlier the rate had amounted to 2.4%. The EU27 annual inflation rate reached 1.7% in July 2013, stable compared to June 2013. A year earlier the rate had been 2.5%. An EU-wide HICP comparison shows that in July 2013 the lowest annual rates were observed in Greece (-0.5%), Bulgaria (0.0%) and Denmark (0.4%), and the highest rates in Estonia (3.9%), Romania (3.4%) and the Netherlands (3.1%). Year-on-year EA17 core inflation (excluding energy and unprocessed foods) slightly decreased to 1.29% in July 2013, from 1.30% in June 2013.

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