CENTRE FOR EUROPEAN REFORM

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Conference report: Europe's future in an age of austerity

Europe has entered a period of prolonged fiscal austerity at a time when the private sector in highly indebted countries is still deleveraging. Economic growth across much of the region could therefore be chronically weak for a long time.

The purpose of the conference was to explore how Europe's recent growth path compares with that of other countries/regions recovering from financial crises; whether Europe's growth strategy can work; and what the political and social consequences will be if economic stagnation in parts of Europe becomes entrenched.

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Executive summary

Europe has entered a period of prolonged fiscal austerity at a time when the private sector in highly indebted countries is still deleveraging. Economic growth across much of the region could therefore be chronically weak for a long time.

The conference explored how Europe could reduce its government and private sector debt; whether Europe's growth strategy could work; whether the eurozone was bifurcating into a prosperous core and a depressed periphery; and what the political and social consequences would be if economic stagnation in parts of Europe became entrenched.

How should policy-makers promote deleveraging: through inflation, default or austerity? Several speakers argued that default had to be considered, and not just for Greece: if there were no growth and interest rates remained high, then the eurozone periphery's sovereign debt would have to be written down. Others disagreed, pointing out that the European Central Bank had failed to keep interest rates low, which would help the eurozone to pay down debt without default. They said deleveraging was least painful when inflation eats debt away, because it is higher than the interest rate on debt – and the ECB had not managed to create these conditions.

Could the current growth strategy work? On the austerity question, there was a broad consensus that public sector austerity had not encouraged the private sector to spend. But some thought it was inevitable and necessary, irrespective of its impact on short-run growth. The weaker countries' competitiveness would only be restored through real wage cuts and export-led growth. Others argued that co-ordinated austerity across Europe was increasing public debt, not cutting it. They also said that structural adjustment would not work without growth and normalised financial conditions: businesses would not invest, and unemployment would not fall.

Would Europe diverge into a permanent core and periphery? The consequences of a 'Latinised' ECB dominated the discussion. Would a central bank that was less committed to sound money promote convergent or divergent levels of income between eurozone members? The ECB served the northern, surplus countries' interests by securing trade and investment with low inflation and a stable exchange rate. But many thought it did so at the expense of southern members who desperately needed monetary stimulus to escape a vicious debt trap. Some maintained that adjustment was happening, as deficits were falling in the periphery. Others pointed out that Germany's trade surplus was just as big as it had ever been, and that the periphery's move towards surplus was caused by collapsing domestic demand and imports.

Was the EU heading towards disintegration? Some argued that populist and anti-EU parties had not done as well as they might have given the economic backdrop, and opinion polls suggested that majorities in most countries wanted the euro to survive and the EU to hold together. Some of the conference's politicians and political commentators argued that economists ignored the politics. But the economists responded that the markets were demanding transfers between countries – and so federalisation was a prerequisite for the currency's survival. Europe's recession in 2013 and a lack of appetite for integration could lead to disaster.

Session 1: Deleveraging the West: Lessons from the US, Japan and Europe

History teaches that economic recoveries after financial crises are more anaemic than those which typically follow 'ordinary' recessions. How have the US and European economies fared since the crisis of 2008? Is either doing any better than Japan in the 1990s? What do these various experiences teach us about macroeconomic policy settings in the wake of financial crises?

The chair asked what mixture of austerity, inflation and default was necessary to reduce debt levels to sustainable levels. Contrary to popular opinion, Japan's mixture – austerity and sharp interest rate rises immediately after the first recession, with robust global growth and a sharp depreciation of the yen – actually led to modest per capita growth in the 1990s and 2000s. But some of the lessons did not apply. Unlike Japan, the eurozone's troubled economies could not devalue their currencies, he argued. And some of the policies pursued by the Japanese had shown mixed results: for example, 'quantitative easing' (QE) kept zombie companies alive. Was Europe repeating the mistakes of Japanese government which tightened fiscal policy too much from 1997 and killed off the economic recovery?

The first panellist argued that the lessons of history were only partly applicable. He said that current political conditions were different than in the 19th century and the 1930s. In the 19th century there was no universal suffrage, so it was easier simply to liquidate labour and capital. This led to some creative destruction and some destructive destruction. But now, bail-outs were the norm, he argued. Private sector debt was being transferred to the public sector and total debt had risen since the start of the crisis. Most countries had hardly started to tackle debt. The US and Greece were exceptions. The US Federal Reserve had pushed interest rates below zero, and interest rates had been lower than nominal GDP growth – the key to reducing overall debt levels. Debt was written down in the US, albeit on a limited scale. Greece had been awarded a small organised default, in return for commitment to huge (and counter-productive) austerity.

Was quantitative easing helping, he asked? Central bank assets had ballooned. But there would be no possibility of exit for a long time, because the private sector was not interested in the bad assets that central banks had on their books. The only way out was to restructure the public and private debt. If there was no deleveraging to speak of, no restructuring, and no economic growth, countries would inevitably get caught in debt traps. Japan's most important lesson for Europe was the need to avoid positive real interest rates at all costs. But the public authorities in Europe had colluded in bringing about deflation; it had happened in Greece and would happen in Spain. External debt was very high as a proportion of Spanish GDP and the rate of growth in nominal GDP was well below the interest rate on the debt. He maintained that the result would be a rapid accumulation of debt.

The second panellist claimed that leading eurozone policy-makers would be spoken of by future historians in the same way as Andrew Mellon. The eurozone faced the same challenge as Japan did in the early 1990s. European economies had very large financial sectors, which were highly indebted. The EU had seemed to be in a better position than the US in 2007. But America had written down the debt, while the EU had not. America had kicked the fiscal can down the road, with success. The EU had opted for austerity right away. The UK's National Institute for Economic and Social Research (NIESR) had plugged in the IMF's latest estimates of the fiscal multipliers into its macroeconomic model (which was very similar to those used by the European Commission, central banks and national governments.) The result was that a co-ordinated fiscal consolidation in the EU of the order set to take place in 2013 would be self-defeating. The impact of the government tightening on the ratio of the debt to GDP across the EU as a whole was likely to be around five per cent of GDP.

The third panellist criticised the attempt to disguise the true levels of debt; banks had been busy 'ever-greening' loans to prevent borrowers from going bankrupt, and to portray banks' balance sheets in a healthier light. The European Financial Stability Facility was a 'greening arborium': countries in better positions lent to those in trouble, which helped out their banks. All of this was wrapped up in the language of 'moral hazard': countries should not be allowed to default because it would encourage them to do it again. The apostles of contract argued that all contracts should be "sacred", and that default was immoral. Thus Greece's default was described as an "involuntary credit event"; while Reinhart and Rogoff's This Time is Different showed that debt crises were usually overcome through default. And Keynes had pointed out that the apostles of contract were agents of revolution. There were three ways out of the crisis: the hair shirt, with debt reduced by spending less; economic growth (but fiscal policy was disabled by ideology); and debt cancellation. The panellist recommended 20 per cent hair shirt; 50 per cent growth through the expansion of government investment; and 30 per cent debt cancellation.

The fourth panellist pointed out that Keynes's central insight – that when households started to save, it deprived households of income – applied also to deleveraging. When everyone paid off debt, it deprived everyone of income. There was good forbearance and bad. It was bad when you had put off accepting losses on bad assets; it was good when you have a liquidity problem. The Bank of England and the Fed were trying to smooth the reallocation of capital. But in the long run, this could lead to capital misallocation. This was why monetary authorities were trying to force banks to recognise losses on their assets. Japan's lesson for Europe was to start this process early. Could monetary and fiscal stimulus help smooth the adjustment necessary? Up to a point, he argued, but the eurozone's underlying central problem was the periphery's loss of competitiveness. Over time Spain and Italy had to improve their competitiveness if the euro was to work. This would be very difficult.

Q&A The chair asked the panellists whether central bank activism was delaying the necessary structural adjustments. There was disagreement. One panellist argued that flat productivity and falling unemployment in the UK suggested that zombie companies were a problem. He was unsure whether these zombie companies were tying up capital in services that could have been better employed in the tradable sector, arguing that more micro data from the enterprises themselves was needed. Frontloading deleveraging was the most effective strategy. If write-downs and sharp belt-tightening in the private sector were carried out quickly, losses would be realised and the economy could start to grow again. Ireland had front-loaded deleveraging, whereas Spain had not, and this showed up in their relative economic prospects. The Swedish economy had also rebounded rapidly in the early 1990s following a successful strategy of early write-downs.

A number of participants disagreed with the panellists' emphasis on the importance of write-downs. One argued that the US federal government had offset private sector saving, while the central bank had guaranteed zero interest rates to banks by buying government debt. So the Fed had been a lender of first resort to the US government. The ECB could not do this, which meant that insolvencies in the periphery were now very likely. He said writing down government debt was difficult, as sovereign bonds acted as the benchmark for financial markets. Deciding who was solvent and who was not was also difficult. When money and bonds were the same thing, fiscal policy became monetary policy; if a central bank financed fiscal policy, exit was easily achieved by cancelling the assets that were on its books. One participant argued that the Bank of England thought QE was working, but that it worked less well than in 2009. Uncertainty that was spilling over from the eurozone was making both fiscal and monetary policy less effective. The Bank of England could have enacted 'fiscal dominance', by setting the money supply to meet the government's spending plans. But the costs of moral hazard – markets asking when that would happen again, with the elevated risk of inflationary boom and bust – were large. Things were not so dire as to make such unorthodox steps necessary.

A number of participants felt that the deep-seated characteristics of the various eurozone economies would make it hard to resolve the crisis. For Germany and other core economies, for example, it made little sense to pursue fiscal stimulus, because their economies were structured to maximise trade competitiveness, with trade unions acting as price takers. The ECB had taken this lesson and run with it in the south of the eurozone, whose economies were different, and desperately needed stimulus. Others pointed out that the Germany had executed a large competitive devaluation against the rest of the eurozone over the last decade, but that if every country followed the German route the eurozone would suffer deflation. Germany's devaluation had done nothing to raise productivity: real wages had merely risen by less than the rate of productivity growth, bringing down unit wage costs.

Session 2: The supply and demand side of Europe's growth strategy

Since the onset of the Greek sovereign debt crisis, Europe's growth strategy has rested on two pillars: fiscal consolidation and supply-side reforms. European policy-makers expect that progress on each of these fronts will restore confidence in the short term and boost productivity over the longer term. Are these hopes justified? If not, what elements are missing?

The first panellist argued that the eurozone's neglect of the demand side had had disastrous consequences for economic growth and the sustainability of countries' debts positions. Structural reforms would only work if they were accompanied by stimulus. The ECB could not stimulate demand alone; there must also be an end to excessive austerity. The current strategy had led to a depression in the periphery, which was destroying the supply-side capacity of these economies. Public and private investment was falling, and highly skilled people were leaving. The ECB's Outright Monetary Transactions scheme (OMT) would not work, just as the Long-term Refinancing Operation had not. It may offer some help for the banking system. But countries must apply for programmes, with austerity as the quid pro quo. So what had happened in Greece would happen in Spain, and it would happen again in France, he argued. Austerity must end: if there were no private sector expansion, government had to provide stimulus. The deficit in the US was far higher than in the euro area, yet borrowing costs in the US were very low. The ECB needed to be as active as the Fed if it were to bring down borrowing costs to sustainable levels. The change of heart that was needed may come with a Lehman moment, like a Greek exit from the eurozone. At this point the choice would be stark: political integration or orderly dissolution of the currency. By trying to organise everything through rules and contracts, the eurozone had avoided political integration, which was needed for the euro to survive.

The second panellist doubted that the single market, common banking supervision or the Europe 2020 programme for better economic governance would boost economic growth. Macro-economic policy co-ordination was essential. Pain for creditors and debtors needed to be symmetrical; creditors had an incentive to participate so as to minimise the debt write-downs. Structural reforms were important too: eurozone GDP could rise by five per cent if all the participating countries followed the best practice in the OECD. But these reforms needed more investment to work, and governments should raise the level of infrastructure investment, introduce UK-style funding for lending schemes and, in some cases, write down debt. Without this, structural reforms would deliver very little and the outlook would remain bleak.

The third panellist explained that the European Commission used fiscal multipliers of between 0.2 and 0.4 when making its latest economic forecast for Spain. This implied that the cuts in public spending would not make much of a difference to GDP. The IMF had acknowledged that the multiplier was around 1.5 in the currently very depressed conditions, but still used a much smaller multiplier when making its own forecasts. He argued there was absolutely no doubt that the multipliers across the south of eurozone were at least one and probably significantly higher. However, even if one assumed the multiplier were only one, Greek austerity would lead to an 8 per cent fall in GDP in 2013. Unless policy was changed, Spain would also face a deep depression. Once nominal deficit targets were missed, then austerity would be repeated, and things would get worse again. As a result, Europe actually faced a much larger fiscal cliff than the US. The EU was dominated by small economy thinking: every country believed that it could rely on export-led growth. This had led to a massive co-ordination failure. Instead of tightening fiscal policy, those countries that had scope to provide fiscal stimulus needed to do so.

The final panellist stressed that demand would only recover once debt had been purged. Europe needed to write down junior and senior bond holders. Sweden, Norway and Finland had bounced back in the 1990s because creditors had taken a hit. Governments should nationalise banks and then sell them off. More competitive markets would also help to boost growth by combating rent-seeking and reducing regulatory costs: structural reforms to labour markets had been quite extensive, but there was a need to go further on product market reforms.

Q&A The chair pointed out that the degree of fiscal consolidation planned for next year was less than this year. The crisis had forced countries to push through long-delayed structural reforms, and Spain, Portugal and Greece were moving into current account surplus. Was there not room for some tentative optimism?

There was disagreement over the transformative power of structural reforms. For some, structural reforms were the key to putting the eurozone on a sound footing. One participant said the eurozone was nobody's vision of an optimal currency area. Structural reforms were necessary to make it so. Another said rent-seeking in the hardest-hit countries – both in the public sector and by business interests – was a bigger obstacle to growth than fiscal austerity. The competitiveness problem was central and would remain so irrespective of the institutional reforms made. Spain may have moved into current account surplus but that was mostly because domestic demand was contracting, reducing imports. Spain, like Italy, would have to get more productive if it was to succeed in paying back its debt.

But others cautioned against putting too much faith in structural reforms. Credible supply side reform could certainly help boost business confidence and hence investment in the long term. Labour market reform might also give the young unemployed a sense of hope. But reforms would do nothing to boost demand in the short to medium term, and without this the eurozone faced a wave of insolvencies. For these participants, demand-side policies were indispensable. For capital to return to the periphery, debt burdens had to be made sustainable. The core in particular needed to ease back on the pace of fiscal austerity. Next year the French economy would fall off a fiscal cliff. The planned fiscal tightening of two per cent of GDP combined with a multiplier of 1.5 would translate into a three per cent decline in GDP. There was unease at the failure of the German economy to rebalance towards domestic demand, and scepticism over the likelihood of an SPD government doing anything to facilitate the process. Some thought the SPD would follow a similar course to Merkel on economic governance, even though they supported the German Council of Economic Advisors' debt redemption fund proposal for mutualisation of existing debt.

One panellist thought that the hair-shirt policy would come to an end in 2013. Fiscal austerity in the periphery had been less about putting public finances on a sustainable footing, and more about protecting the banks in the core. Although this had been a fruitless strategy, it had been possible because the periphery had acquiesced. This was likely to change in 2013. The German economy would slide into recession, and with a general election due in September or October, the German government would embark on fiscal stimulus. This would make it very difficult for the Germans to impose austerity on everyone else. Investors would start to shun eurozone government debt, forcing the ECB to intervene to cap the borrowing costs of some eurozone economies and opening the way for debt restructuring in others. Others were more sceptical of the likelihood of a change of tack on the part of Germany: the country was exceptionally democratic, and would therefore find it impossible to stop or freeze the fiscal compact as it is enshrined in law.

A number of participants thought that the only way to save the euro was to be anti-austerity and pro-reform, and so to act on both the demand and supply sides. Europe's strategy was all supply and no demand, which was exacerbating the economic and political challenges facing the region. For its part, France was failing to tackle either its supply- or the demand-side problems. There was a risk that the euro would not hold together. The economics would undermine the politics, as a huge adjustment would be needed in the future as demand continued to decline and the political space promised to be too small to deal with the economic problems. Others thought that economists were being excessively critical of the politicians. One pointed out that a lot had been done, with more macroeconomic co-ordination, more ECB action and so on. Another thought that the political integration necessary to stimulate demand was not going to happen, but that a Monti-style programme for supply side reform was workable politically and would pay dividends.

Session 3: Arc of depression versus prosperous core?

Since the financial crisis, the eurozone has consisted of a comparatively strong core and a weak periphery. Is this a temporary phenomenon from which reformed economies will emerge stronger, or is it the precursor to an entrenched, long-term divide? If the latter, what are the implications for the future of the eurozone? Could it survive without a full-blown fiscal union?

The first panellist explained that he followed the Reinhart-Rogoff interpretation of the crisis: a balance-sheet recession, with massive public and private sector debt. There must be deleveraging, and it was not possible for the public sector to offset the impact of this on economic activity by running expansionary fiscal policy. Although the European Commission now employed a fiscal multiplier of one, there was no alternative to austerity of the current magnitude. All developed countries were going through the same thing – stripping out population growth, growth in per capita had been similar in both the eurozone and the US, despite the latter's looser fiscal stance. During the boom years, banks and households had misallocated resources to the housing and construction sectors. In struggling economies, capital would have to shift from the non-tradable to tradable sectors, and this would have to happen without movements in nominal exchange rate changes. Low or negative economic growth was simply part of this adjustment process.

And the necessary adjustment was happening, he argued. The periphery of the eurozone was regaining competitiveness. German trade surpluses were coming down, albeit very slowly. Domestic demand was growing in Germany at twice the rate of the periphery. The adjustment of competitiveness positions, at about one per cent a year, was happening at about the rate the IMF recommended. To ensure that this continued, Germany needed to liberalise its services markets. The eurozone's main challenge was to stop the break-up of capital markets: capital would have to flow 'downhill' to the southern member-states again, but would have to flow to the right sectors.

The second panellist argued that the deficiencies of the eurozone were papered over with cheap credit, but then the bubble popped. The ECB now faced a choice between two models of central banking. The eurozone had first adhered to the Bundesbank principle of price stability and no bail-outs. This model used labour and product market reform to ensure similar levels of competitiveness and an optimal currency area. It looked like switching to a Latin model, where the central bank was essentially part of the government, and where growth promotion was part of its mandate. As a result, the 'core' of the eurozone was increasingly the Latin axis of Spain, Italy and France, with Germany, Finland, Austria and others becoming increasingly peripheral. There would be a three-speed Europe, as the weakest members started to set up parallel currencies, with the euro used only for certain transactions. The Latin model would damage the north, because its growth model was founded upon sound money. It would result in persistent differences in per capita GDP, because the weakest would be half in and half out of the currency, relying on devaluations, rather than structural reforms, to maintain competitiveness.

The third panellist stressed that the necessary rebalancing of competitiveness would take place of its own accord, so long as prices were allowed to do their work. In the long run, prices, the exchange rate and productivity would revert to equilibrium, and if governments were willing to wait long enough adjustment would happen naturally. There had been some progress: wage growth in the periphery had fallen back. In the meantime, he said that governments must not try to close fiscal deficits too quickly, and countries with unsustainable debts should not attempt to pay them back. The problem was not diverse economic structures, but a lack of eurozone labour mobility. If labour could move to where it could be most productively employed, many of the problems affecting the currency union would disappear.

The final panellist maintained that structural reforms, especially of the services sector, were indispensable. While there had been some convergence in GDP per capita across the EU in the run up to the crisis, this has been based on rising unit labour costs in manufacturing and services rather than a convergence of productivity rates. The service sector was crucial; in some countries, growth in service sector productivity had actually been negative. The EU's services directive had been a failure, and there was a long tail of very uncompetitive services firms across the EU. Freeing up the single market for services would allow capital to flow to more highly productive firms. This would help boost domestic demand in Germany too, by opening up that country's service sector to greater competition.

Q&A A number of delegates questioned whether declining output would bring about the necessary structural adjustments. For example, Greek GDP would have shrunk by at least 30 per cent by the end of the process, with dire consequences for debt dynamics. As capital had fled, productive investment had been postponed, and growth potential had eroded. The patient could end up being 'competitive' but would be dead on arrival. Several delegates argued that the Commission had done very little to try to change the collective action problem posed by unco-ordinated fiscal austerity, siding instead with the creditor countries. Other delegates saw little sign of Germany rebalancing. German consumption growth had been slow; domestic demand had been growing faster than the eurozone average, but only because everyone else was doing so poorly. The country's trade surplus was back to 2007 levels, and the fact that the German government had convinced the IMF not to focus on intra-eurozone imbalances in its crisis reporting revealed its mercantilist mind-set.

A number of participants stressed that emergence of a greater German economy encompassing Central and Eastern Europe meant that Germany had an inbuilt competitiveness advantage relative to other eurozone economies. For several participants, there was little chance of the German model changing; a collapse of external demand would simply be met by a redoubled effort to bear down on costs. And many doubted the ability of the periphery to compete with Germany while sharing the same currency. For one, a German exit would be preferable to a domino-style collapse, with Greece leaving and the rest of the periphery following. Another participant took a different line: German integration with the East relied upon the euro, and if the euro broke up, so would trade.

There was broad agreement that the ECB was falling under the sway of the southern Europeans but less agreement over what the implications of this would be. One delegate argued that the OMT was essentially the Latinisation of the ECB, with the bank pretending to manage liquidity while really acting as lender of last resort to governments. Others argued that this was best practice, and that such financial repression was necessary. Others pointed out that France had a central banking tradition like the Fed or the Bank of England, whose responses to the crisis had been far more successful than the ECB. There was criticism of the Bundesbank model, with one delegate arguing that the Maastricht design was an aberration that could not work. One delegate countered that domestic pressure in Germany to leave the eurozone would grow if the ECB continued to turn on the taps. A parallel 'gold mark' currency as a better store of value would emerge. Another delegate also argued that a solution lay in parallel currencies, along Latin American lines, with taxes and some day-to-day transactions paid in local currencies while saving and investing was conducted in euros.

Session 4: Employment, inequality and social cohesion

Much of Europe suffers from persistently high unemployment and/or sharply rising inequality. What implications could these two trends have for social stability and the long-term legitimacy of the market economy? What, if anything, should policy-makers do to counter them? Which EU countries have been most successful in managing these twin problems, and why?

The first panellist pointed out that unemployment (and especially youth unemployment) in Spain and France was high even in good times, and high levels of long-term unemployment had also been a problem for a prolonged period of time. There had been little change in levels of inequality across the earnings distribution in most OECD countries; the rise in inequality had mostly been down to the top 0.1 per cent of earners. Supply-side measures would not 'create jobs' but merely allowed for lower structural unemployment by reducing constraints that stopped physical and human capital from being brought together. Inequality was mostly about the dispersion of skills, and the UK and US as well as southern Europe had many poorly trained people.

He argued that the growth in real wages must not be allowed to exceed the rate of productivity growth. This did not mean getting rid of trade unions, but they had to be sensible. A deregulated services sector helped, as it allowed for more employment. But the problem was mostly at the top: globalisation had led to a group of highly mobile 'superstars'. A combination of weak competition, poor regulation and low taxes on capital had created a lot of rents to extract.

The second panellist focussed on intergenerational problems, especially the scarring effects of youth unemployment; the ageing population's needs for health and social care; and the need for later retirement ages which would mean fewer jobs for the young. Most job growth came from small and medium sized businesses, which were struggling to access finance. Given the pressures on public finances, civil society groups would have to step in to fill the gap left by the retreating state.

The third panellist argued that the Europe's strategy for dealing with the crisis had aggravated inequality by forcing tax payers to bail-out creditors. He questioned whether the Baltic states should be presented as an example of successful adjustment. Investors had bought up Central and Eastern European assets, but had then gone bust. Europe opted to force taxpayers in the debtor countries to take the hit. The results had been striking: Latvia would only recover 2007 levels of economic activity in 2017; unemployment was very high despite 15 per cent of the country's labour forced having moved abroad; and the country's public debt had quadrupled.

A similarly destructive pattern could play out in Italy. The Italian redistributive system did indeed run through families, but the state still played a critical role. Workers were paid big pensions, which were redistributed through the generations of the family. So the social system relied upon tax revenues: when they fell, redistribution would decline and inequality would rise. Thus demographics were far more important than structural reform; an ageing society, if it paid its enormous debts, would end up curtailing the chances of the young.

The final panellist praised the CER for its work on inequality. Rising inequality weighed upon consumption and economic growth. Better skills and education were needed to reduce it. Redistribution would only work if higher taxes on the rich did not lead to an exodus. There were a range of short-term and long-term policies that governments needed to consider. In the short term, there needed to be more social transfers, cuts to VAT, and a reduction in the transfers to rich people, such as tax relief on pension contributions. In the long term, there needed to be more progressive taxation on wealth, reduced taxes on labour and increased taxes on capital, as well as a common corporation tax base across Europe. He argued that governments should stimulate private investment, through the European and national investment banks, through funding for lending schemes to SMEs and through investment in infrastructure. They also needed to be aggressive on high pay, banning buybacks and acting against short-term incentives.

Q&A Not everyone agreed that rising inequality had damaging macroeconomic effects or that the EU's strategy for dealing with the eurozone crisis was exacerbating inequality. One participant argued that inequality had not risen that much, and it could in fact boost economic growth insofar as it increased the saving rate, creating available capital for investment. Another disputed that the EU was exacerbating inequality by forcing countries into unnecessarily harsh austerity. Countries whose economies had grown unsustainably before the crisis were inevitably experiencing large declines in GDP and attempting to offset the process would simply delay the inevitable.

These arguments were questioned by a number of participants. One delegate argued that there had indeed been large rises in inequality across the developed world, especially across the G8, and the rise in inequality was not just down to the ballooning remuneration of the top 0.1 per cent; the phenomenon was broader-based than that. One participant thought it was obvious that if income were passed to people with a low marginal propensity to save there would be a negative impact on growth. The effect had been masked in the run-up to the financial crisis by credit-fuelled consumption in countries that were struggling with excessive levels of debt. The developed world was feeling the consequences of a very unequal earnings distribution on output: poor consumption growth, exacerbated by more rises in inequality as governments cut spending.

For many participants, rising inequality was not just the result of the differing market value of skills, but rent extraction; that is, market failure. Unproductive wealth was not being taxed and regulation often served monopoly interests. Education mattered too, but public spending was often inefficient: governments needed to invest heavily in children's early years, because the evidence showed that early intervention was necessary to stop poor educational attainment from being passed down from mother to child. Dual labour markets of the kind present in France, Italy and Spain were also exacerbating intergenerational inequality, especially after the crash: NEET (not in employment, education or training) rates were rising, and graduate earnings premiums were coming down because young people were stuck in low skilled work or on temporary contracts.

One participant stressed that the issue was not just about rising inequality: even in countries where inequality had not grown by much the labour share of national income had fallen markedly, undermining consumption and with it investment. A drive to boost skills levels would not be enough to reverse this trend. Others agreed, heartened that Marxian arguments about reserve labour, under-consumption and falling marginal returns to capital were being revived. A truly free labour market, and complete competition led to immiseration. Unions needed to be strong. Others thought that the decline in the labour share may be due to ageing; more pension saving and investment would lead to a larger share flowing to capital, and globalisation of product markets could (in theory) boost productivity growth, earnings and with it labour's share of income.

Session 5: The political consequences of austerity in Europe

What are likely to be the political consequences if Europe's current growth strategy disappoints (or fails)? Could such failure damage the case for structural reforms, and weaken governments trying to implement them? Could it give rise to populist political forces, and/or damage relations between states? What would be the wider political consequences for the eurozone and the EU?

The first panellist argued that the French were unique in Europe, in that they were hostile to capitalism, against austerity and convinced that the state should control large swathes of the economy. Hollande had raised VAT, moved to reduce non-wage labour costs and embarked on an austerity drive, but he had also ruled out significant reform of the country's labour market or any loosening of the state's grip on the economy. France did not control the EU; the growth compact, added to the fiscal compact upon Hollande's insistence, was small and would not come into effect in any case. Extreme parties of right and left were exploiting unease over high unemployment, and talented young people were leaving the country. Would Hollande be a social liberal in the form of Blair or Schröder, or a manager of decline? He looked like being the latter.

The second panellist laid out three scenarios. The first was a collapse of the euro followed by a drifting apart of the EU. Greece could implode as GDP collapsed, provoking violence and radicalism. Any impetus for enlargement in the Balkans and the Levant would fizzle out. Russia would step in and pick up the pieces, which was already happening in Cyprus. Under the second scenario, economics would force the federalisation of the eurozone. The UK would leave the EU, becoming what Australia was to Asia. There would still be ten years of deleveraging and low growth. And the EU would continue to rely on increasingly grudging US protection. But ultimately, this would prove unsustainable as Paris would refuse to take the German medicine for long and a transfer union would be unworkable politically. This would open the way for the third scenario: a 1989-style revolt against Brussels institutions, though not a social rupture like 1789 or 1848.

The third panellist thought that the economists' views were divorced from reality. He argued that politics was about incremental steps and changes. And the eurozone had been willing to change. The glue binding countries together was strong. Spain and Italy begrudged German-led austerity and pressure to implement structural reforms, but also called for it themselves. The EU was politically important for Italy, as it held the country together. Ireland's grievances against the UK kept it pro-European. France needed the euro to avoid becoming Latin. Germany was the key. For most of the post-war period, the country could have sound money and be pro-European. Now it would have to choose, and it was choosing Europe. He said that Germany was outvoted on the ECB's Governing Council, but it was going along with Draghi's strategy. Merkel was moving cautiously, taking public opinion along with her. Creditors had to accept that they would not get their money back, but she was trying to ensure that the terms were fair, and she was reforming the rules of the bloc to make sure that it did not happen again. The question for Europe was: how to deal with Germany? He thought it was too big for the EU, but too small for the world.

The final panellist thought that irrespective of the outcome – mutualisation, muddling through, or break-up – Europe faced rapid relative decline. Politics and economics, since the crisis, had been pulling in opposite directions. The economics called for more migration, sharing of sovereignty, and the transfer of resources from old to young. But all of these things were politically very difficult. Nevertheless, the political centre was holding. There was little sign of mounting populism, Greece aside. However, the eurozone crisis was driving a wedge between the UK and the rest of the EU. The Conservatives were becoming increasingly populist about Europe, while Labour did not care enough about it to make it an issue, and would in any case struggle to defend the current, austerity-driven strategy for addressing the eurozone crisis. Those who argued that globalisation rendered regional institutions like the EU irrelevant ignored the fact that global governance was weak; countries needed to work together to counter and shape global forces.

Q&A The chair asked if muddling through would work. Many participants thought not, cautioning against taking political stability for granted. Spain would not put up with Latvian levels of pain. EU institutions had power but no authority and national governments had authority but little power. This dialectic meant that both were discredited and would sow the seeds of populism. Revolt against muddling through would happen when the French came to rebel against political union in exchange for mutualisation. One delegate argued that there was too much complacency about the implications of the crisis for separatism in a number of EU member-states. Brussels and Berlin were imposing rules on Madrid, while Madrid found it difficult to impose rules on Catalonia, which was deepening the fault lines within Spain.

One participant argued that the crisis came at a time when politicians were already considered self-serving and incompetent managers of the economy. People had little affinity with mainstream parties, and young people were completely disengaged, with trust in political parties at all-time lows. A lack of solidarity between the member-states of the EU meant that no one would invest politically in the project, for fear of losing political capital. This was eroding trust between member-states, which would be very difficult to rebuild against a backdrop of persistent economic crisis. Although there had not been many new populist parties (there was no 'Deutschmark party' in Germany, for example), mainstream political parties would become more populist. Several people thought this was already happening in the UK, citing the Conservative Party's anti-immigration stance.

One participant disagreed that the fault line was between economists and politicians – rather, it was between markets and politicians. Markets were pushing for transfers within the eurozone, but he argued politicians liked to move more slowly and opportunistically. The question was, should they come clean about what was needed to save the currency, confronting people with the depth of the crisis, or should they move slowly? If muddling through failed, the costs would be huge. Another agreed that politicians had to be open about the scale of the crisis, but must not "give birth to a mouse". The markets would drive transfers eventually, at which point politicians would have to deliver or accept that the project was doomed.

There was disagreement over what life in a third-tier of the EU would mean for Britain. Some thought that it would not be too bad, arguing that the single market, climate change, R&D, foreign policy were all areas of potential UK leadership if it could come up with policies that worked. Others disagreed. Whereas pre-ins such as Poland would be in a relatively strong position within the EU, the third tier was not a sustainable place to be. If the eurozone survived, it would supplant the single market as a eurozone core sought to further integrate financial and labour markets. The UK would end up like Norway, subject to rules and regulations but unable to influence them. Ultimately, it would be driven into an EEA-style fourth tier.

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List of participants

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